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12 Policy Toward the Aged

1. *David A. Wise and Richard G. Woodbury*
2. *Rudolph Penner*

1. *David A. Wise and Richard G. Woodbury*

American Economic Policy in the 1980s: Policies Affecting the Aged

The increasing proportion of older people in the United States and increasing life expectancy have given particular importance to the public policies that affect older Americans. Indeed, policies affecting the aged have been a major component of federal legislation throughout the 1980s. This paper considers aging legislation in the 1980s from an economic perspective, evaluating the motivations for legislative developments and the economic implications of the legislation enacted. A central goal is to relate the economic perspective on aging issues to the objectives and motivations expressed by policymakers in considering and enacting new legislation.

The discussion is organized around three major issues: (1) retirement and retirement income programs, including Social Security and private pension plans; (2) individual saving for retirement and the tax-incentive programs that encourage savings, such as Individual Retirement Accounts, Keogh plans, and 401(k) plans; and (3) the increasing cost of health care and the public programs

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that reimburse health care expenses (particularly Medicare). Some significant federal policy changes were enacted in each of these areas in the 1980s, including Social Security reform (1983), new private pension plan regulations (various years), prohibition of mandatory retirement (1986), IRA restrictions (1981, 1986), Medicare reimbursement procedures (1983, 1989), and catastrophic medical insurance (1988, 1989).

The discussion of each issue begins with a description of the economic context in which the policy decisions are made. The changing age demographics of the U.S. population are particularly important since, even without the enactment of new legislation, they have an enormous effect on the cost and the effects of government programs. Other economic trends are important to the discussion of specific aging issues—such as younger retirement, low rates of personal saving, and high inflation for health care services.

Having developed an economic context for each issue, the legislation impinging on the issue and the motivation for the legislation is then reviewed. Finally, the motivation for the legislation (as expressed by policymakers) is contrasted with the economic description of the problem. For example, given the existing trend toward younger retirement in the United States, does Social Security legislation in the 1980s aggravate or moderate this trend? An attempt is made to judge the key factors that molded the final legislation and to contrast those factors with those reflected in economic analysis.

Several themes, none of which are new in this discussion, are important across legislation in all the areas. First, the budget deficit was an overriding concern throughout much of the 1980s, and this concern placed an important constraint not only on the legislation that was passed but also on the legislation that was considered. Second, who benefits and who loses is typically a more critical determinant of policy choice than the economist's "efficiency." Third, fairness and protection of rights have taken precedence over incentive effects of policies or the economic efficiency of the policies.

12.1 Retirement and Retirement Income

12.1.1 The Economic Issue

The American population is aging rapidly, and individuals are living longer, yet older Americans are leaving the labor force at younger and younger ages. Earlier departure from the labor force may have been made possible by and may be attributed to the introduction of Social Security and firm pension plans. These programs can lead to younger retirement for two reasons. First, these programs provide a means of support during retirement so that people can afford to retire. Of course, the major reason for retirement programs is to do just this. Second and more worrisome, the benefit structure of these programs includes financial incentives that encourage retirement and penalize work. Neither Social Security nor firm pension plans have been neutral with respect to the age at which individuals decide to retire. Rather, their provisions encourage early retirement and penalize continuing participation in the labor force.

According to a recent study, the labor force participation rates of men over sixty were essentially constant between 1870 and 1930 and then declined continuously thereafter (see Ransom and Sutch 1988). The data on labor force participation, based on the decennial censuses, are reproduced in figure 12.1. These census data also have been used to construct labor force participation rates by age group for men and women at ten year intervals, beginning in 1940 (see Sandefur and Tuma 1987). The rates for men fell in each age group. For example, 61.4 percent of men aged fifty-five and over were in the labor force in 1940; by 1970, the proportion had fallen to 52.7 percent; and, by 1990, only 39.4 percent of men in this age group were in the labor force. The participation rates of women aged fifty-five and over increased until 1970. Since 1970, however, even the participation rates for older women have fallen.

The decrease in labor force participation rates after 1930 roughly corresponds to the implementation of the Social Security program and federal tax incentives for private pension plans. Social Security was introduced under the Social Security Act of 1935. Company pensions were spurred by the Revenue Act of 1942, which granted tax incentives to firms to establish pension plans. The correlation between the introduction of these retirement policies and the change in labor force participation at older ages suggests that the policies may have induced younger retirement. Many researchers have pointed to the Social Security system's high benefit levels and work disincentives as a major contributor to the continuing trend toward early retirement, and a great deal of research has focused on the effect of Social Security on labor force participation. More recent research has identified similar but more pronounced work disincentives in most private pension plans. The discussion below explains the incentive effects inherent in the provisions of public and private plans, independent of the retirement wealth that they represent.

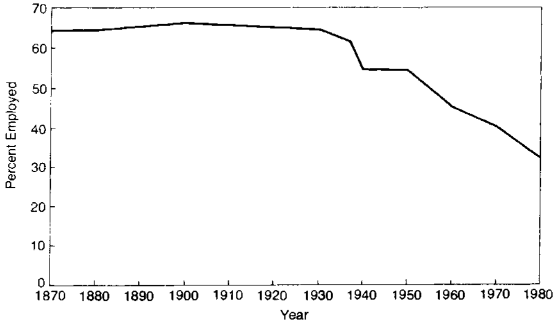

Fig. 12.1 Labor force participation of men over 60, 1870 to 1980

Social Security—Incentives

Social Security benefits are based on past individual earnings, although the benefit levels are a much larger proportion of the past earnings of low-wage workers than of high-wage workers.[1] The easiest way to understand the incentive effects of the benefit structure is to consider the compensation value of the Social Security program at different ages. The compensation value of the program is the incremental change in the present value of all future Social Security benefits that results from continued work—referred to as Social Security accrual. Work and retirement incentives are caused by the changes in Social Security accrual occurring at particular ages.

To exemplify these incentives, nominal wages by age and nominal Social Security accrual by age are shown in figure 12.2 for two representative workers, one a low-wage and the other a high-wage employee. Thus, the figure represents two forms of compensation: fig.12.2*a* nominal earnings by age and fig. 12.2*b* the increase in the entitlement to future Social Security benefits by age. Figure 12.2*c* shows Social Security accrual as a percentage of earnings. As shown, Social Security accrual is a small proportion of wage earnings for the high-wage worker but can be a significant proportion for the low-wage worker.

For the low-wage worker, Social Security accrual is about 6 percent of wage earnings at age fifty and increases to almost 10 percent at age sixty-two. However, if the low-wage worker continues to work from age sixty-two to age sixty-five, Social Security accrual becomes *negative*—negative 10 percent of the wage at age sixty-four, for example. The *loss* in the present value of future Social Security benefits is about 39 percent of wage earnings if the person continues to work after age sixty-five. This large reduction in the compensation value of the Social Security program at older ages encourages retirement at older ages. A similar (although less pronounced) pattern is apparent for the high-wage worker.

Firm Pensions—Incentives

Roughly three-quarters of all persons participating in private pension plans are enrolled in defined benefit plans where benefits are determined according

[1] The initial benefit is based on nominal earnings indexed at age-sixty dollars using the Consumer Price Index (CPI). After retirement (receipt of benefits), the benefits are indexed to the CPI. The normal Social Security retirement age is sixty-five. But benefits can be taken as young as sixty-two, with the benefit amount actuarially reduced to reflect the increase in the expected number of retirement years over which benefits will be received. That is, if the benefit entitlement is not changed because of a change in earnings, the expected present value of future benefits is the same irrespective of the age, between sixty-two and sixty-five, at which the benefits are first received. After age sixty-five, however, the increase in the benefits is much less than actuarial. It is now 3 percent per year but was only 1 percent per year until 1981. Although the change from 1 percent to 3 percent was the result of a 1977 law, it applied to those who would be sixty-five in 1981 and later years.

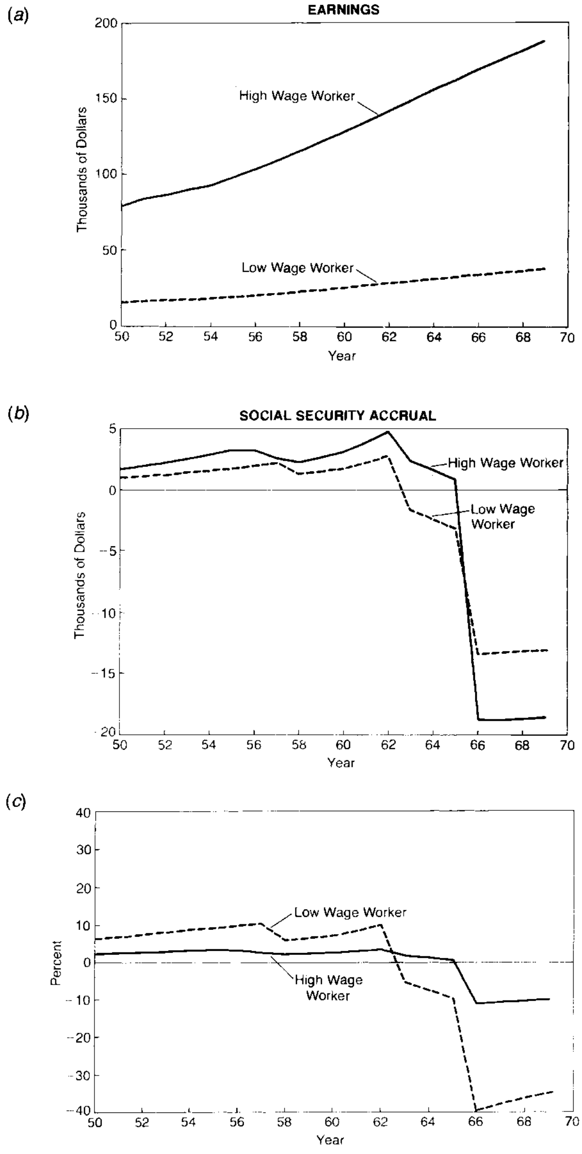

Fig. 12.2 (*a*) **Employment earnings, representative low- and high-wage workers;** (*b*) **Social Security accrual, representative of low- and high-wage workers;** (*c*) **Real Social Security accrual as a percentage of real earnings, low- and high-wage workers**

to a specified formula. The remainder are enrolled in plans where benefits are directly related to contributions made on behalf of the employee and to the performance of the plan's investment portfolio. Because most workers are covered by defined benefit plans, and because they are likely to have the greatest effects on labor market behavior, the discussion here emphasizes the incentive effects of this type of plan.

The incentive effects of defined benefit pension plans can be expressed in the same way as the incentive effects of Social Security—through the accrual of future pension benefits. The compensation value of a firm pension plan is the incremental change (or accrual) in the present value of all future pension benefits that results from continued work. Kotlikoff and Wise (1985, 1987) evaluated the retirement incentives inherent in a large number of firm plans. Figure 12.3 (taken from Kotlikoff and Wise [1987]) shows the average accrual rates (weighted by plan membership) for U.S. defined benefit plans with selected early and normal retirement ages. Pension accrual is represented as a percentage of wage compensation.[2]

Work and retirement incentives result from changes in the compensation value of the plans at particular ages. For example, consider the plans with early and normal retirement at age fifty-five, a plan stipulation that is common in the transportation industry. For these plans, the average decline in the rate of pension accrual at age fifty-five is equivalent to about 30 percent of wage earnings. The average decline in pension accrual at age sixty-five is equivalent to another 20 percent of wage earnings. This sharp decline in the compensation value of these plans creates a substantial retirement incentive.

A similar decrease in compensation value at older ages occurs in plans with different early and normal retirement ages. The more common plans with early retirement at age fifty-five and normal retirement at age sixty-five, for example, exhibit an increase in pension wealth accrual to age fifty-five, with a decline thereafter. Again, continued work past age sixty-five is associated with a substantial decrease in pension accrual—equivalent, on average, to approximately 20 percent of wage earnings. Thus, on the basis of industry-wide earnings profiles, continued employment with the plan sponsor after the age of early retirement and, in particular, after the age of normal retirement typically involves a substantial reduction in total annual compensation because of declines in pension wealth accrual.

Retirement Policies—Effects

Whether incentive effects like those described above have an effect on retirement decisions may be illustrated by considering the relation between pension

[2] The data come from a random sample of approximately 2,500 plans from the Bureau of Labor Statistics Level of Benefits Survey. Similar calculations have been made by Lazear (1983) on the basis of the Bankers Trust Survey of large pension plans. For each plan, accrual rates are calculated assuming average wage-tenure profiles in the industry and occupation to which the plan pertains, based on current population survey data (see Kotlikoff and Wise 1985).

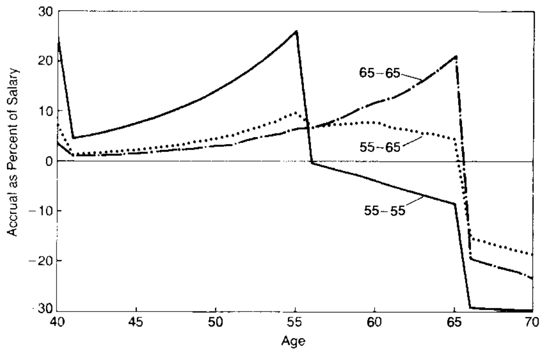

Fig. 12.3 Weighted average pension accrual as a percentage of wage earnings for percentage of earnings plans with ten-year cliff vesting, for selected early and normal retirement ages

plan provisions, Social Security provisions, and retirement in a firm. Kotlikoff and Wise (1989) have done that for a large Fortune 500 firm, showing a very strong relation between the economic incentives in the retirement policies and departure rates from the firm.

The proportion of the firm's employees who leave at each age beginning with age fifty is shown in table 12.1. The yearly departure rate (shown in the middle column) is the proportion of those employed at the beginning of the year that retires—more strictly speaking, leaves the firm—during the forthcoming year. About 3 percent of employees between ages fifty and fifty-four leave each year. The departure rate jumps to about 11 percent at age fifty-five. There is another jump at age sixty and again at ages sixty-two and sixty-five. The last column of the table ("cumulative departures") shows the proportion of employees working at fifty who *remain* at later subsequent ages. For example, only 21 percent remain until age sixty-two, only 5 percent until sixty-five.

The jumps in departure rates (at ages fifty-five, sixty, sixty-two, and sixty-five) coincide with the economic incentives in the firm's pension plan and in the Social Security program. Figure 12.4 shows wage earnings by age, pension accrual by age, and Social Security by age for a representative employee at the coınpany. The compensation value of the plans changes discontinuously at certaın specific ages. The discontinuities in compensation correspond directly wıth the jumps in departure rates from the firm.

The discontinuities are as follows. (1) By working until age fifty-five, the worker becomes eligible for early retirement benefits. Thus, there is a very large pension accrual at age fifty-five (shown as a large spike in the graph). This leads to a large increase in retirement at age fifty-five.[3] (2) Employees

[3] To understand the potential importance of the early retirement benefits, suppose that, if it were not for this inducement, the departure rates would remain at 3 percent until age sixty instead of the 11 or 12 percent rates that are observed. Departure at 3 percent per year means that 14

Table 12.1 **Yearly and Cumulative Departure Rates by age, for Employees with 11 or More Years of Service 1980**

Age	Yearly Departure	Cumulative Departure
50	3	97
51	3	94
52	5	89
53	4	85
54	3	83
55	11	74
56	12	66
57	9	60
58	10	54
59	11	48
60	17	40
61	17	33
62	36	21
63	37	13
64	29	10
65	53	5

with thirty or more years of service can receive "full" unreduced retirement benefits at age sixty. The same "full" benefit formula is used for retirement in every year after age sixty. For these employees, there is a sharp decrease in the compensation value of the pension plan between ages sixty and sixty-one, equivalent to a wage cut of about 14 percent. Again, there is an increase in departure rates at age sixty, corresponding to this decrease in pension accrual. (3) Although there is no discontinuity in the compensation value of retirement programs at age sixty-two, workers first become eligible for Social Security benefits at age sixty-two, and this eligibility appears to induce a jump in retirement rates. (4) Social Security accruals increase up to age sixty-five (the normal retirement age) but fall sharply thereafter. After age sixty-five, Social Security accrual becomes negative, equivalent to about −$8,500 at age sixty-six.

In summary, possibly the most important economic trend among older Americans has been the dramatic reduction in their labor force participation. The trend toward earlier retirement is especially striking when viewed in the light of increasing life expectancy and the increasing proportion of the population that is old. The prospect is for a declining proportion of working people supporting an increasing proportion of retirees. In addition to this economic squeeze, economic analysis reveals that public and private pension provisions have themselves contributed to the decline in labor force participation. It seems apparent that the retirement income provided by Social Security and private

percent of those who were employed at fifty-five would have left before age sixty; at 11 percent per year, 44 percent would leave between fifty-five and fifty-nine.

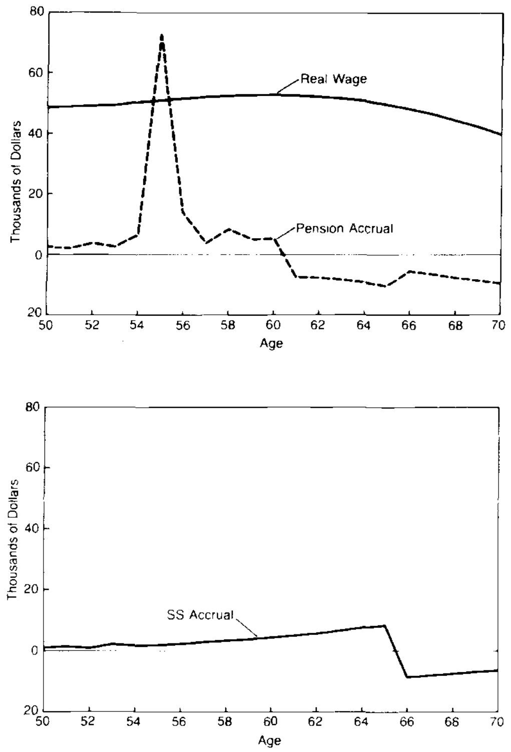

Fig. 12.4 Wage earnings, pension accrual, and Social Security accrual, representative person in Firm 1

pensions has allowed older workers to leave the labor force at younger and younger ages and still support themselves after retirement. Indeed, a principal intent of pensions is to allow just this. But Social Security and private pension provisions do not just provide for post-retirement income in a neutral fashion; they provide strong incentives to remain in the labor force until some age and then typically provide strong incentive to leave at some later age, often as young as fifty-five. Put another way, they penalize work by older employees.

Reversing the trend toward early retirement represents an important alternative for addressing the demographic transition. Additional labor supply of the elderly would relieve Social Security's finances as well as offset a potential shortage in the supply of labor relative to that of other productive factors. In addition, it is argued that, for many elderly people, prolonging their labor force participation would mean more fulfilling lives.

12.1.2 The Legislation

The most important retirement policy legislation in the 1980s pertains to Social Security reform and to the regulation of private pension plans. Although the discussion of the economic context emphasizes declining labor force participation and Social Security and private pension plan incentives to leave the labor force, the legislation in this area was motivated in large part by other concerns. In particular, the early retirement incentives inherent in Social Security and firm pension plan provisions were not the driving force for legislative change, although the legislation that resulted may be expected to have implications for retirement. Rather, the legislation was motivated first by the financial position of the Social Security system and second by a concern for protecting private pension benefits of workers covered by firm pension plans.

Social Security Legislation

Legislation enacted in 1983 made several major changes in the Social Security program. The fundamental motivation for the Social Security Act Amendments of 1983 was the pending bankruptcy of the Old Age and Survivor's Insurance (OASI) trust fund that supports the Social Security program.[4] Most of the debate on the legislation dealt with the mix of taxes versus benefit reductions and with how the burden of restoring the system to financial health should be distributed, rather than the work and retirement incentives of the Social Security program or the economic efficiency of the program. The legislation did, however, have potentially important implications for the labor force participation of older workers.

Congress had attempted to address the financial shortage in the Social Security program in 1977 by raising payroll tax rates. By 1980, however, because of lower than expected economic growth, it became apparent that the OASI trust fund would still face bankruptcy without additional reforms. Congressional consideration of Social Security reform began in 1981, although the final reform package was not enacted until the spring of 1983.

The positive spirit for reform that opened the 1981 legislative session ended abruptly with the introduction of a reform proposal from the administration. The two most controversial provisions of the administration proposal were to reduce the benefits of those retiring early from 80 percent of the normal (age sixty-five) benefit to 55 percent of the normal (age sixty-five) benefit and to impose a three-month delay in the annual cost-of-living adjustment. Congressional Democrats quickly framed the proposal as an effort by the administration to cut the Social Security program rather than to restore its financial health. Members of both parties expressed their opposition to at least parts of the administration proposal, and congressional Democrats vowed to prevent its enactment. Although the administration quickly stepped back from the details of the proposal, the momentum for Social Security reform within Congress was severely deterred.

This set the stage for the appointment of a fifteen-member bipartisan commission (known as the Greenspan Commission) to study the problem and to

[4] The potential insolvency of the Social Security system is discussed in the paper by Jim Poterba in this volume.

submit a report by the end of 1982. The Social Security reform legislation enacted early in 1983 closely followed the recommendations of the Greenspan Commission. The key to the commission's success was in finding a compromise that could be accepted by the administration and by congressional leaders from both parties *before* being presented to the more politically charged legislative forum.

Many of the provisions of the legislation were closely related to the financial solvency of the system: either raising revenues or decreasing benefits. For example, the legislation delayed the cost-of-living adjustment in Social Security benefits by six months. The dates for previously scheduled payroll tax increases were advanced, gradually raising the rates (including both the employer and the employee contributions) from 13.4 percent to 15.02 percent. And up to 50 percent of Social Security benefits became taxable for higher-income individuals and couples.[5]

A number of other provisions potentially influence labor force participation among older workers. First, the rate of adjustment in Social Security benefits for delaying retirement after the normal retirement age will increase gradually from 3 percent per year of delayed retirement to 8 percent per year. On the basis of the economic incentives inherent in this change, one would expect more people to choose retirement at older ages. Once the new law is fully phased in (in 2008), the benefit that a person loses from postponing retirement for one year will be roughly offset by larger benefits over the years that they will be received. Thus, there should be no incentive to take the benefits at age sixty-five to avoid a loss in the present value of the benefits that will be received ultimately, as there is under the current 3 percent adjustment.

In describing the purpose of this provision, the House Ways and Means Committee explicitly stated its intent to encourage older workers to defer retirement. According to their report on the bill, "Your Committee continues to believe that it is desirable to provide incentives for individuals to remain in employment beyond normal retirement age. . . . This [legislation] will dramatically increase the amount by which the combined effects of (1) the reduction factors before age 65, (2) use of earnings after age 61 in the benefit computation and (3) the delayed retirement credit can result in higher benefits for workers who delay retirement."

A second part of the legislation that is likely to affect labor force participation is the change in the normal retirement age and in the amount of retirement benefits provided to those retiring before the normal retirement age. The age of eligibility for normal retirement benefits is to increase gradually from age sixty-five to age sixty-seven over the period from 2003 to 2027. Retirees will continue to be eligible for reduced Social Security benefits at age sixty-two,

[5] The tax was imposed on individuals whose income (including half their Social Security benefits) exceeds $25,000 and married couples whose income (including half their Social Security benefits) exceeds $32,000.

but their early retirement benefits will be 70 percent of the normal benefit, rather than 80 percent as under previous law. Overall, the amount of the benefit for retiring at any age before age sixty-seven will be lower than the amount of the benefit that would have been received prior to the legislation.

The increase in the normal retirement age and the reduction in the amount of benefits received at each age before the normal retirement age will also tend to prolong labor force participation, especially among workers not covered by a firm pension plan. The strongest evidence for this expectation is the concentration of retirement at the current Social Security normal retirement age among persons who have not retired before then. In part, this concentration is probably due to a psychological incentive to retire at the "normal" retirement age that has nothing to do with economic incentives. But it must also be due to the economic incentives associated with the current benefit computation formulas.

A third provision of the legislation that is likely to affect labor force participation relates to the "earnings test." Prior to the 1983 legislation, Social Security beneficiaries under age seventy lost $1.00 in benefits for every $2.00 in earned income above the earnings limit (then $6,600). Beginning in 1990, these Social Security recipients lost $1.00 in benefits for every $3.00 in earned income above the limit (currently about $10,560). The apparent reason for this change was to reduce the perceived penalty[6] for work after retirement and thus to encourage labor force participation. Reducing the penalty for earned income also had the political advantage of giving something back to higher-income Social Security beneficiaries, who would now be subject to a tax on part of their Social Security income.

While the need to restore the Social Security system to financial solvency served as the primary catalyst for Social Security reform, economic analysis of the retirement incentives inherent in Social Security provisions seems to have had a significant impact on the composition of that reform. Some of the most important changes in the Social Security program were not cost saving but were implemented for other economic reasons. Social Security benefits for those with earned income above the specified earnings limit were increased, not decreased, as were the benefits for individuals choosing to delay retirement after the normal retirement age.

Economic analysis of Social Security has emphasized the work and retirement incentives associated with these provisions and thus may have been critical in informing Social Security reform in these areas. Economic analysis has tended to show, for example, that the earnings test discourages work among Social Security benefit recipients. The 1983 reform of the earnings test reduces

[6] Although the tax on earnings above the limit tends to discourage work, the earnings are incorporated in the calculation of subsequent benefits. The increase in later benefits may approximately offset the large earnings tax, but the adjustment in later benefits is probably not understood or appreciated by the typical beneficiary or is too far removed from the present to matter. There has been a large concentration of earnings just at the limit, suggesting that, were it not for the tax, many persons would work more.

the magnitude of this work disincentive. Similarly, economic analysis tends to show that the small (3 percent per year) increase in Social Security benefits for delaying retirement beyond the normal retirement age encourages retirement at the normal retirement age of sixty-five. Again, the change in the benefit computation formula enacted in 1983 reduces the magnitude of this retirement incentive. A financial crisis provided the initiative for reform, but more comprehensive reform, not just financial restoration, was an important part of the legislative outcome.

Further revisions of the earnings test continue to be considered in Congress, with the primary motivation of reducing the work disincentive among Social Security recipients. According to Senator Bentsen, who introduced one bill easing the earnings test in 1989, "We can't afford to keep healthy and vigorous older Americans out of the work force. It's like keeping your best hitters on the bench." Legislation raising the earnings limit came very close to enactment in 1989. The House of Representatives approved a plan to raise the earnings limit to $9,720 in 1990 and to about $10,440 in 1991. The Senate Finance Committee approved a different plan, raising the earnings limit to about $11,700 in 1990 and about $14,500 in 1991. The Senate version would also have decreased the reduction in Social Security benefits to $1.00 for every $4.00 in earned income above the limit for the first $5,000 of earned income above the limit. The House earnings test provisions became part of the fiscal 1990 budget reconciliation bill. At the end of the 1989 session, almost all provisions of the budget reconciliation that did not reduce the deficit were categorically dropped.[7] Proposals to ease the earnings test are again being evaluated at the current time.

Regulation of Firm Pension Plans

The economic description of firm plans given above emphasizes their early retirement incentives. Most recent pension legislation, however, is directed toward plan "fairness" and toward the protection of "promised" benefits.

ERISA. To put the 1980s legislation in context, it is necessary to review the 1974 Employee Retirement Income Security Act (ERISA), which protects the pension benefits of most employees covered by private pension plans and continues to be the primary tool for government regulation of firm pension plans today. The ERISA legislation established minimum funding standards for pension plans and created the Pension Benefit Guarantee Corporation (PBGC), a federal agency responsible for insuring pension plans. Employers with defined benefit pension plans were required to pay a premium of $1.00 per worker to the PBGC for pension insurance. Both the creation of the PBGC and the pen-

[7] Many bills were introduced in Congress that related to the earnings test. A bill to repeal the earnings test had two sponsors and 130 cosponsors. The bill that eventually passed the House was introduced by the chairman of the House Ways and Mean Subcommittee on Social Security. On the Senate side, there were several strong advocates for easing the earnings test. Legislation was introduced by the Finance Committee chairman and the Social Security Subcommittee chairman.

sion funding requirements were designed to assure that workers expecting pensions would not lose these expected benefits if the company experienced financial difficulties.

Congress was also concerned that companies were able to back out of their pension obligation when workers terminated their employment (either voluntarily or involuntarily) just before their retirement. An important characteristic of most defined benefit pension plans is the concentration in the accrual of pension benefit entitlements late in the working life, often referred to as "backloading." Since most of the value of pension plans accrues to workers approaching retirement age, companies can at least theoretically terminate workers just before taking on these large pension liabilities. Because pension backloading imposes the risk that workers will lose most of their pension benefits, limiting the backloading of pension benefit accrual was an important objective of ERISA as well as of subsequent legislation. Senator Bentsen expressed this concern in introducing ERISA to Congress: "There are instances where workers have not received pension benefits that they have earned through years of long hard labor. Their dreams of financial security after retirement have been shattered."

To limit the extent of pension backloading, ERISA stipulates that defined benefit pension accrual must satisfy *one of three* provisions. The first is a 3 percent rule requiring that a worker's accrued benefit must exceed his years of service times 3 percent of the normal retirement benefit he would have if he had begun service at the earliest possible age of participation and had remained with the firm until normal retirement. The second is a 133 percent rule requiring that future projected annual pension accrual not exceed 133 percent of current annual pension accrual. The third provision stipulates that the terminating worker's benefit not be less than his projected normal retirement benefit times the ratio of actual completed service to the service the worker would have if he had remained with the firm through early retirement.

While these provisions were designed to limit pension backloading, they were largely unsuccessful in this intent. First, each of these anti-backloading rules specifies that the projection of future normal retirement benefits and future pension accrual be determined by assuming that a worker's future wage equals his current wage. Accounting for wage inflation, however, future wages are likely to be much greater than current wages, and thus the real value of current accrual may be quite low. Even with a very modest rate of wage inflation, a pension plan that is significantly backloaded will meet at least one of the three anti-backloading provisions.

Second, pension plans are often backloaded through the early retirement provisions. The accrual rules specified by ERISA pertain to normal retirement benefits rather than early retirement benefits. Early retirement benefits that are larger than the actuarially fair adjustment of normal retirement benefits are apparently not restricted by the three anti-backloading rules in ERISA. Thus, for example, a firm would be free to structure its plan to have small normal retirement benefits (which satisfy one of the three ERISA rules) but substantial early retirement benefits. In this case, the large early retirement benefits might be structured with the accrual concentrated in the years just before the early retirement age rather than just before the normal retirement age. Again, a pension plan that is significantly backloaded at the early retirement age will meet at least one of ERISA's anti-backloading provisions, all of which apply to the benefit amounts at the normal retirement ago.

As the illustrations presented above demonstrate, the legislation appears to have been largely unsuccessful in limiting pension backloading. Thus, the economic implications of pension backloading are applicable to almost all defined benefit pension plans today. Backloaded pension plans encourage workers to continue working until they receive the backloaded benefits, and then to retire, once those benefits have been received and the rate of pension accrual declines. Thus, backloading decreases job mobility prior to the early or normal retirement ages and then increases retirement after the early or normal retirement ages.

The incentive effects of backloaded pension plans were not emphasized in the 1974 ERISA legislation. Congress was concerned about the risk associated with backloaded plans rather than the job mobility and retirement incentives associated with those plans. This may have been partly because the behavioral incentives of pension plans were not widely recognized at that time; only later did economic research direct attention to the potential importance of these incentives for job mobility and retirement.[8]

Legislation enacted in the 1980s. The emphasis of pension plan legislation in the 1980s was to promote "fairness" in the treatment of different workers, to protect the pension benefits of plan participants, and to prevent "abuses" of the tax advantages associated with pension plans. As in the 1974 consideration of ERISA, there was little emphasis in the 1980s on the work and retirement incentives inherent in the plans. In fact, very little of the pension legislation enacted in the 1980s is likely to have a significant effect on retirement behavior.

One exception may be a 1986 provision requiring that employers continue to provide service credit for their employees after the normal retirement age. Prior to 1986, companies could stop counting years of service, once their employees reached the normal retirement age. Since the new law enables employees to continue to accrue service credits, employees have more incentive to continue working until older ages. Despite the potential effect of this legislation on labor force participation, retirement incentives were not the primary motivation for this legislation. Instead, Congress was concerned about fair-

[8] Even today, most companies with pension plans do not fully understand the work and retirement incentives associated with their plans. Companies tend to design their plans primarily to meet income replacement objectives rather than to influence retirement behavior (see Woodbury 1990).

ness—allowing older workers to accrue service credits in the same way that younger workers accrue service credits. In addition, driven by the political influence of organized labor, the legislation was intended to increase the retirement benefit levels of workers choosing to continue working at older ages.

Many other pieces of legislation were enacted in the 1980s to promote fairness in pension coverage. In 1984, Congress enacted the Retirement Equity Act, designed to provide greater pension coverage for women. The legislation was promoted largely by vice presidential candidate Geraldine Ferraro. In a hearing on the bill, Ferraro stated, "My proposed private pension reforms would require private pension systems to recognize the contribution women make to our economy and to take into account women's unique work patterns—patterns which revolve around childbearing and other family responsibilities." Prior to the legislation, many workers (particularly women) who left their jobs temporarily lost their credited years of service toward vesting and were required to accumulate a full ten years of service after returning to their jobs. The 1984 legislation lowered the age of pension plan participation from age twenty-five to age twenty-one, permitted employees to leave a job (for up to five years) without losing the credited years of service, and required that maternity or paternity leave not be counted as a break in service. The legislation also required companies to provide survivorship benefits to the spouses of employees who died prior to retirement eligibility.[9]

In 1986, congressional concern about the loss in pension benefits for mobile workers inspired a change in pension vesting rules. The 1986 legislation required that employees become fully vested in a company's pension plan after five years of employment (rather than ten years) or that vesting be phased in (20 percent per year) during the third through the seventh years of employment. The intent of the legislation was to increase pension coverage for workers leaving jobs before meeting the prior vesting rules. Because of backloading, however, the effect of the legislation on pension loss due to job mobility will be slight.

Also in 1986, Congress enacted several measures intended to reduce employer discrimination among different groups of employees. First, Congress imposed new regulations on the Social Security offset provisions used in many pension plans. Under the new law, benefit formulas that accounted for Social Security could not reduce an employee's pension by more than 50 percent. Second, Congress developed very detailed regulations that were designed to prevent discrimination in the provision of employee benefits. In general, the new rules ("Section 89") prohibited the provision of special employee benefits for highly compensated employees, unless those benefits were also provided to lower-compensated employees. Because companies expressed enormous

[9] Prior to the legislation, companies were not obligated to provide survivorship benefits to the spouses of workers who died before becoming eligible for retirement. The 1984 legislation required companies to provide survivorship benefits to the spouses of all vested workers, regardless of their age at death.

dissatisfaction with the complexity of the "Section 89" rules, the rules were initially postponed and eventually were repealed in 1989.[10]

Also to protect pension benefits, Congress enacted several laws regulating the funding of pension plans and assuring the financial solvency of the PBGC. The financial condition of the PBGC was a concern throughout the 1980s, particularly after the bankruptcy of several large corporations.[11] The PBGC insurance premium was increased from $1.00 per worker to $2.60 per worker in 1977, to $8.50 per worker in 1986, and to $16.00 per worker in 1987. In 1987, a supplemental premium was also imposed on companies with underfunded plans. The supplemental premium was $6.00 per participant for every $1,000 of underfunding per participant (up to a maximum of $34.00). New pension funding requirements were enacted in 1987, setting specific pensions contribution rules for companies with underfunded pension plans. The intent of this legislation was to build up underfunded pension plans to full funding expeditiously, thereby reducing the potential risk of the PBGC.[12]

Finally, pension legislation in the 1980s was used to limit several perceived abuses in the tax advantages of pension programs. For example, legislation enacted in 1987 prohibited tax-deductible contributions to pension funds with assets exceeding 150 percent of current obligations. The intent of this provision was to prevent companies from using their pension funds to avoid tax liabilities rather than to provide for the retirement income of their retirees. Legislation enacted in 1986 imposed a 10 percent tax on pension payments in excess of $112,000 per year. Again, the intent of the legislation was to prevent the use of tax preferences for what were believed to be excessive pension benefits.

None of the pension legislation enacted in the 1980s was motivated by the declining labor force participation rates, and very few of the pension regulations enacted are likely to have any significant effect on labor force participation. In developing pension legislation in the 1980s, Congress attempted to promote fairness in pension coverage, to protect pension benefits for workers participating in pension plans, and to eliminate abuses in the tax advantages of pension programs.

Unresolved pension issues. Congress considered several other pension issues in the 1980s that were not fully resolved and that remain on the congressional

[10] Although the concept behind Section 89 was simple, the rules themselves were quite complex. Companies have complained about their complexity since they were enacted in 1986. The original effective date for compliance with Section 89 was 1 January 1989. The effective date was immediately postponed to 1 October and then to 1 December. Section 89 was repealed in 1989.

[11] The largest bankruptcies included Wheeling-Pittsburgh Steel Corp. ($500 million in pension obligations) in 1985, Allis Chalmers Corp. ($170 million in obligations) also in 1985, and LTV Corp. ($2.2 billion in obligations) in 1986.

[12] Other retirement benefits were also addressed by legislation in the 1980s. A 1988 law protects the health and life insurance benefits of retired workers when their employer files for bankruptcy. Only a bankruptcy court could approve reductions in benefits and, even then, only after negotiating in good faith with an employee representative. This legislation was motivated by the loss of retirement benefits to steelworkers at LTV when the company filed for bankruptcy in 1986.

agenda. Even in these unresolved issues, there is very little concern about labor force participation or retirement incentives. One unresolved issue relates to pension portability. The motivation for legislation in this area is described in a report from the House Education and Labor Committee in 1988:

> Under current law, pension plan asset accumulations are increasingly being distributed at job termination and "cashed out" in the form of lump sum distributions of employees' entire pension plans interests. This is especially so in the case of defined contribution plans, although even defined benefit plans are increasingly taking on the form of cash accumulation accounts to be distributed upon termination of employment. . . . Studies demonstrate that the vast majority of pension plan lump sum distributions are used for current consumption and that few employees reinvest such amounts for retirement in individual retirement accounts or annuities.

The pension portability legislation proposed in 1988 would have allowed workers (or their employers) to transfer assets from an employer's pension plan to a tax-exempt retirement account (an IRA, for example) without paying any early withdrawal fees or taxes on those assets. Under current law, only the worker can make this transfer, and only the contributions made by the employer (not the employee contributions) could be transferred. Pension portability legislation was reported from the House Education and Labor Committee in 1987 and 1988 but was not enacted.

A second issue that received considerable attention in Congress in the 1980s relates to pension plan terminations and reversions. Congressional concern about the issue arose for several reasons. First, with the enormous rise in the stock market in the early 1980s, the value of many pension fund portfolios became very large relative to the discounted future value of the funds' future liabilities to retired employees. Many pension funds were significantly overfunded. Second, companies with overfunded plans were finding legal ways to remove excess assets from the pension funds to be used for nonpension purposes. Many in Congress were particularly concerned about the use of pension fund assets in corporate takeovers. In an increasing number of cases, the bidding company used the assets in the pension fund of the target company to help finance the acquisition. Third, many companies were terminating their pension plans to gain access to the overfunded assets and were not replacing the terminated plans with new pension plans.[13]

The frequency of plan terminations and "reversions" of the overfunded assets increased dramatically through the 1980s.[14] The use of pension fund

[13] Under current law, companies can withdraw pension assets only by terminating the pension plan. After a plan termination, both active and retired employees are entitled to the retirement income that they have already accrued under the plan, but there is no further accrual after the termination. While most companies also replace their terminated pension plan with a new pension plan, about 27 percent of companies who terminated plans in 1987 offered no new plan, and about one-third of companies who terminated plans in 1988 offered no new plan.

[14] Between 1980 and 1986, over 1,300 overfunded plans were terminated. These plans had provided pension benefits for over 1.6 million participants. Together, the terminated plans had

assets for nonpension purposes sparked a major political controversy over who owns (and who should own) these assets: the employers or the employee. Groups representing workers and retirees argued that the funds were the for the explicit purpose of providing retirement income for workers and that the workers should have at least part of the surplus assets. Groups representing businesses argued that the funds belonged to the employer and that it would be inappropriate for Congress to dictate how those funds are dispensed. While the assets legally seem to belong to the employer, the sentiment in Congress about who *should* own the assets has been mixed.

Congress came close to resolving the issue in 1987, with a compromise proposal to split surplus pension assets between workers, retirees, and the employer. This proposed legislation was never enacted. Instead, Congress enacted a series of bills that have been considered temporary while the issue is studied more carefully. In 1986, Congress enacted a 10 percent excise tax on surplus assets removed from pension funds. Legislation enacted in 1987 prevented companies from making tax-exempt contributions to a pension fund if the fund were already valued at over 150 percent of current obligations. In 1988, the excise tax on surplus assets removed from pension funds was raised to 15 percent.

Again, the concern in Congress was the provision and protection of employee benefits, not with the economic incentives associated with those benefits.

Mandatory Retirement

One area of legislation that impinged directly on retirement behavior was the increase in the mandatory retirement age from sixty-five to seventy enacted in 1978 and the complete prohibition of mandatory retirement enacted in 1986. Although both pieces of legislation were intended to limit or prevent forced retirements, they were not motivated by a general concern with reduced labor force participation among older workers. Rather, they were intended to prevent the inequitable treatment of older workers. President Reagan supported the legislation because he thought that older workers should not be forced to stop working when they reached a specified age. In enacting the legislation, however, Congress addressed age discrimination more broadly, modifying the Age Discrimination Act to prevent any employer discrimination on the basis of age. Representative Claude Pepper (the oldest member of Congress) was a particularly strong advocate of the legislation. According to Pepper, "This legislation is an important step in guaranteeing the elderly of this nation a fundamental civil right—the right to work as long as they are willing and able."

The legislation was strongly supported by senior citizen interest groups and opposed by business groups, who argued that it would disrupt labor turnover

pension fund assets of over $35 billion, of which about $20 billion was used for pension benefits and over $15 billion was taken by the companies for other purposes.

cycles, slow down the advancement of qualified workers, and result in fewer jobs for younger people. While the elimination of mandatory retirement enabled some workers to continue working past age seventy, the number of workers affected by this legislation is fairly small. Even when mandatory retirement was legal, few workers remained employed through age seventy, and only some of those working to age seventy were employed by firms with mandatory retirement policies.[15]

In summary, retirement policy legislation concentrated almost entirely on the protection of benefits and issues that were considered matters of fairness. Incentives for early retirement received almost no attention. Thus, for example, mandatory retirement was eliminated, but little attention was given to pension plan provisions that encourage early retirement. Only in the revisions of Social Security did labor force participation incentives receive serious consideration, and this was only incidental to the principle motivation to return the Social Security trust fund to solvency. The loss in pension benefits from job mobility would appear to be an important economic issue and one that might be expected to be the subject of congressional attention. The early retirement incentives of defined benefit pension plans might also have been the subject of legislative debate, although, in both cases, the appropriate legislative response is problematic, and possibly no strict regulation is best.

12.1.3 The Result

The reduction in the labor force participation of older workers and the trend toward earlier retirement has continued unabated for several decades, although it may have slowed in the late 1980s. The planned increase in the Social Security delayed retirement adjustment, the increase in the normal retirement age, and the reduction in the postretirement earnings tax rate might be expected to reduce the incentive to leave the labor force among workers who have not retired before age sixty-two. While new Social Security policies may induce some workers to continue working longer, the strong incentives that firm pensions provide for early retirement remain as they were. Indeed, firm pension plans typically provide incentive to retire much earlier than the normal retirement age for Social Security benefits (age sixty-five) and often earlier than Social Security's early retirement (age sixty-two). Although some companies are beginning to reevaluate the early retirement incentives associated with their policies, legislation in the 1980s has not affected the basic economic incentives of most pension plans.

[15] In 1986, prior to the legislation, about 15.1 percent of people aged sixty-nine were in the labor force, and 10.6 percent of people aged seventy-one were in the labor force. (Thus, roughly 4.5 percent of seventy-one-year-olds had retired between ages sixty-nine and seventy-one—including both voluntary and mandatory retirements.) In 1989, with almost no employees subject to mandatory retirement, about 15.4 percent of people aged sixty-nine were in the labor force, and 12.0 percent of people aged seventy-one were in the labor force. (Thus, roughly 3.4 percent of seventy-one-year-olds had retired between ages sixty-nine and seventy-one—all voluntarily.)

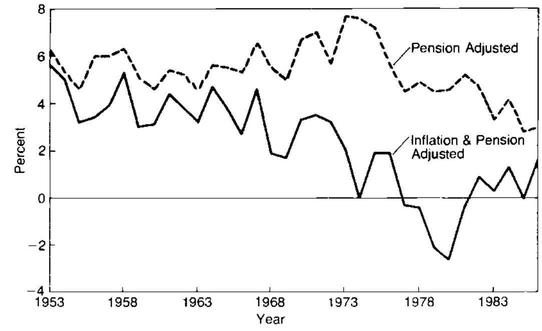

Fig. 12.5 Personal saving as a percentage of disposable private income, 1953–87

12.2 Personal Saving for Retirement

12.2.1 The Economic Issue

Personal saving in the United States has declined substantially as a fraction of personal income since the early 1950s, and a large proportion of families reach retirement age with little or no personal saving. Personal saving declined from between 3 and 6 percent of disposable private income in the 1950s to around 1 percent in the early 1980s, figures based on computations made by Summers and Carroll (1987) and reproduced in figure 12.5. These numbers are adjusted for inflation and exclude saving by employers through defined benefit pension plans.[16] Without the inflation adjustment, the downward trend begins only after 1973.

Aggregate saving rates of course reflect the wealth accumulation of all households, some of whom save very large amounts. Micro data show that a large fraction of families have almost no personal saving. On the basis of the recent Survey of Income and Program Participation (SIPP), Venti and Wise (1991) have computed the composition of total wealth for all households, for homeowners, and for renters in 1984. The results are summarized in figure 12.6. The amounts reflect median wealth by asset category. It is clear from figure 12.6*a* that most families approach retirement age with very little personal saving other than housing equity. Among households with heads aged sixty to sixty-five, the median amount of liquid wealth is only $6,600; the median value of housing equity is $43,000.[17] The majority of families rely heavily

[16] The national income accounts include firm contributions to defined benefit pension plans under "personal saving." Inflation-adjusted saving is measured saving minus the inflation rate (the GNP deflator) times net interest-bearing assets.

[17] Liquid wealth is broadly defined to include interest-earning assets held in banks and other institutions, mortgages held, money owed from sale of businesses, U.S. savings bonds, and checking accounts, equity in stocks, and mutual fund shares, less unsecured debt. Other wealth includes net equity in vehicles, business equity, and real estate equity (other than owned home).

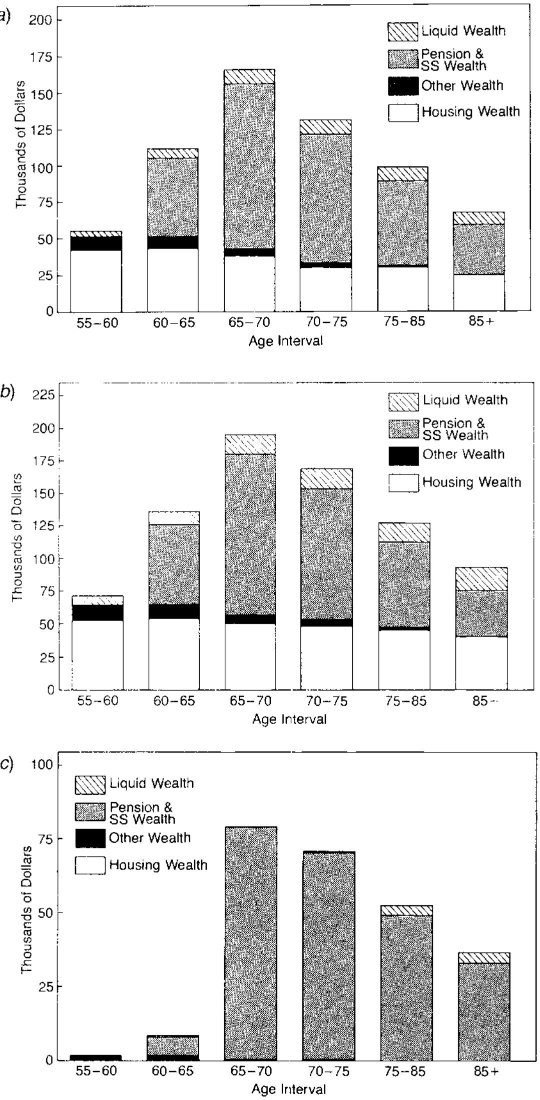

Fig. 12.6 (*a*) Median wealth by age and asset category, all households; (*b*) Median wealth by age and asset category, homeowners; (*c*) Median wealth by age and asset category, renters

on Social Security benefits for support after retirement and to a much more limited extent on the saving that is done for them by employers through defined benefit pension plans.

The Survey of Income and Program Participation data allow estimation of the value of Social Security and pension plan benefits only after the payments are received.[18] Thus, wealth in the form of Social Security and pensions is recorded only for persons who have begun to receive the payments.[19] Most persons have retired by sixty-five and thereafter are receiving the benefits to which they are entitled. About 59 percent of households with reference persons between sixty-five and seventy receive pension benefits; 89 percent receive Social Security benefits. The median of Social Security and pension wealth *combined* is $113,400 (the median of Social Security wealth is $83,700 and the median of pension wealth $11,200); the median of housing wealth is $38,000, and the median of liquid financial assets is only $10,000.[20]

In summary, the U.S. personal saving rate is currently the lowest of any industrialized country and has declined substantially since the 1950s. A large proportion of households have almost no personal saving, even as they approach retirement.

12.2.2 The Legislation

A series of legislative initiatives beginning in 1962 established and revised tax-advantaged saving programs. Initially, the legislative proposals were motivated by concerns for income security after retirement and for fairness in access to tax-advantaged saving programs. Later, legislation was motivated by the low observed national saving rates and by the tax cost of the programs at a time of large budget deficits. (These motivations of course have opposite implications for whether these tax advantages should be limited or extended.)

IRAs

Individual Retirement Accounts (IRAs) were first established in 1974 as part of the ERISA legislation. At that time, IRAs were limited to employees without firm pension plans and were intended to encourage these workers to save for retirement. IRAs were explicitly designed as a vehicle for retirement savings rather than savings more generally. The tax on the contribution and the interest were deferred until money was withdrawn from the account. According to a report from the House Ways and Means Committee, "Since the objective of the new provision is to encourage adequate provision for retire-

[18] The SIPP data do not contain Social Security earnings histories (which determine Social Security benefits), nor do they contain detailed pension plan provisions.

[19] Social Security benefits are indexed to inflation; private pension benefits typically are not. The present values of pension and Social Security are the discounted and survival weighted streams of income from each source received by the reference person and the spouse if present. Discounting is at 6 percent, and survival probabilities are calculated from mortality tables by sex. Payments from Social Security, military pensions, federal employee pensions, and the railroad retirement pension are assumed to be indexed at an annual rate of 4 percent. All other sources of pension income are not indexed in the wealth calculations.

[20] The decline in Social Security and pension wealth with age is largely an artifact of declining life expectancy. The lower housing equity of older households is a cohort effect and does not reflect a reduction of housing equity as individual households age; in fact, housing equity increases on average as the elderly age; there is little change in housing equity even among families that move from one home to another.

ment needs, withdrawal of the retirement savings prior to age 591/2 will result in a penalty tax equal to 10 percent of the amount of the premature distribution."

The primary motivations for the legislation creating IRAs were to encourage income security after retirement and to impose greater equity in federal retirement policy. It was thought that workers without firm pension plans should have some of the tax advantages to prepare for retirement that workers received at companies with pension plans. This concern for fairness was expressed in the House Ways and Means Committee report recommending the passage of ERISA: "The committee believes that there is need on equity grounds to grant individuals who are not covered by any kind of qualified pension plan some of the tax advantages associated with such plans by providing them with a limited tax deduction for their retirement savings." Keogh plans had been established much earlier (1962) and were motivated by similar concerns about equity in retirement policy for the self-employed.

The Economic Recovery Act of 1981 extended the availability of IRAs to all employees.[21] Following the 1981 legislation, any employee with earnings above $2,000 could contribute $2,000 to an IRA each year. An employed person with a nonworking spouse could contribute $2,250, while a married couple who were both working could contribute $2,000 each. The 1981 IRA legislation was motivated in large part by the need to increase national saving as well as the desire to enhance the economic well-being of future retirees. The report of the Senate Finance Committee recommending passage of the bill states,

> The committee is concerned that the resources available to individuals who retire are often not adequate to avoid a substantial decrease from preretirement living standards. The committee believes that retirement savings by individuals can make an important contribution toward maintaining preretirement living standards and that the present level of individual savings is too often inadequate for this purpose. The committee understand that personal savings of individuals have recently declined in relation to personal disposable income (i.e., personal income after personal tax payments).

Over the next few years, IRAs became an immensely popular form of saving. Annual contributions grew from about $5 billion in 1981 to about $35 billion in 1984, accounting for about 20 percent of total personal saving.

Initial plans for tax reform contemplated substantial increases in the IRA limit. The 1984 Treasury Plan (see U.S. Department of the Treasury 1984), for example, called for an increase in the IRA limit for an employed person from $2,000 to $2,500 and an increase in the limit for a nonworking spouse from $250 to $2,500. Thus, the contribution limit for a husband and a nonworking spouse would have increased from $2,250 to $5,000. A Modified Treasury Plan would have increased the limit for an employed person from $2,000 to $2,500,

[21] Indeed, even a self-employed person could have an IRA, but the contribution would be counted against the Keogh limit.

but the limit for a nonworking spouse would have increased to only $500. The so-called President's Plan would have left the limit for an employed person at $2,000 but would have raised the spousal limit to $2,000 (see U.S. President 1985). As tax reform legislation progressed through Congress, however, these proposals to expand IRAs were overshadowed by an alternative motivation—controlling the budget deficit.

Most of the subsequent congressional debate on IRAs seemed to be conditioned in large part by the tax cost of IRAs and the large budget deficit, which had become a widespread concern. In addition, two claims about IRAs themselves received considerable attention. The first was that IRAs were a benefit to the rich—that IRA savings were held primarily by wealthy people. The second was that IRAs produced no new saving. It was argued that funds were simply transferred from non-tax-advantaged savings accounts to IRA accounts or that IRA savings would have taken place anyway, even without the tax incentive. When this debate began, there was essentially no direct evidence on the saving effect of IRAs, yet Congress was exposed to pronouncements on both sides of the issue. The claims were based largely on personal anecdote and on the observation that aggregate personal saving had not increased. As shown above, the decline in personal savings (as measured by the national income accounts) that began in the early 1970s continued through the late 1980s.

Despite the lack of direct evidence, speculation on the savings effect of IRAs had a substantial effect on the legislation that was enacted. The first proposal put forth by the Senate Finance Committee was to eliminate entirely the IRA tax deduction. This proposal met with considerable public resistance. In the end, a compromise was reached that limited the IRA tax advantage for higher-income families who were covered by a firm pension plan. For persons with employer-provided pension plans, full tax-deductible IRA contributions were allowed only for individuals with income below $25,000 and couples with income below $40,000. Partial tax-deductible contributions would be allowed for individuals with incomes up to $35,000 and couples with incomes up to $50,000. No deduction was allowed for individuals with incomes above $35,000 and families with incomes above $50,000. However, the return on contributions continued to accrue tax free. The contribution limits were not changed. In recommending legislation limiting tax-deductible IRA contributions, the Senate Finance Committee made the following justification in its report to the full Senate:

> Since 1981, the expanded availability of IRAs has had no discernible impact on the level of aggregate personal savings. In addition . . . the committee believes that the wide availability of the option to make elective deferrals under cash or deferred arrangements [usually known as 401(k)s] and tax-sheltered annuities reduces the prior concern that individuals in employer-maintained plans should be able to save additional amounts for retirement on a discretionary basis.
>
> Further, data have consistently shown that IRA utilization is quite low

> among lower-income taxpayers who may be the least likely to accumulate significant retirement saving in the absence of a specific tax provision. . . . The committee believes that those taxpayers for whom IRA utilization is the largest would generally have saved without regard to the tax incentives.

More substantial evidence on the savings effects of IRAs and the wealth of those benefiting form IRA contributions was introduced during the debate and has been further developed since the 1986 legislation. New analysis of IRA saving suggested that the net saving effect was substantial. In addition, it became clear that, although wealthier families were more likely to contribute to an IRA, the large majority of contributors were not wealthy.[22] Although this new evidence did not prevent the enactment of legislation limiting tax-deductible IRA contributions, it may have forestalled the much more extreme legislation first proposed by the Senate Finance Committee (to eliminate new IRA contributions altogether).

Possibly fewer than 40 percent of prior contributors were affected by the 1986 legislation, and, even for these families, only the up-front tax deduction was eliminated. Nevertheless, IRA contributions fell by over 50 percent between 1986 and 1987, the first year under the 1986 rules. Whereas over 15 percent of tax filers made contributions in 1986, only 7 percent contributed in 1987. The reporting of the tax reform act and the less intense promotion by financial institutions apparently left the widespread impression that the IRA had been eliminated. Indeed, a 1988 survey showed that about half of all persons who were in fact still eligible to contribute to an IRA thought that they were not (*IRA Reporter,* vol. 6, no. 9 [30 September 1988]).

Potential revisions of the IRA legislation have continued to be discussed to the present time. An overriding consideration has continued to be the effect of any proposal on the budget deficit. But the extent to which IRAs increase the saving rate and the extent to which they present an advantage to a broad spectrum of the population have been painted in different colors depending on the political circumstances. Whereas in 1986 the IRA was portrayed by some as a gift to the rich, in 1989 the IRA was put forth as a saving program that would increase saving and benefit individual savers over a broad spectrum of the population.

What had changed? In 1989, the administration was pressing for a capital gains tax reduction, arguing that at lower capital gains tax rate would increase national saving. The proposal to reduce capital gains taxes was being promoted at a time when the 1990 congressional budget resolution required a net *increase* in tax revenues by at least $5 billion. Senator Bentsen (the Democratic chairman of the Senate Finance Committee), in part at least to defeat the capital gains proposal, put forth an IRA proposal, appealing to the argument that the capital gains tax was a gift to the rich since only the wealthy owned stocks

[22] For example, initial drafts of papers by Venti and Wise (1986, 1987) Wise (1987), and Summers and Carroll (1987) appeared during the spring of 1986.

and bonds. He argued that an expanded IRA would encourage more saving by the broad middle class rather than the rich. Indeed, the discussion revolved much more around who would gain from the savings incentive proposals rather than around what the effect of either would be on the economy overall. Who got the "tax break" was more important than aggregate saving and the potential benefit to the economy as a whole.

Under Bentsen's IRA proposal, those with incomes high enough to preclude a tax deduction for IRA contributions under current law would be allowed to deduct 50 percent of their IRA contributions up to the current limits ($2,000 for individuals, etc.). Both the capital gains proposal and the IRA proposal were politically popular, but it was unlikely that Congress could find enough additional revenues from other tax policy changes to pay for both the IRA expansion and the capital gains tax reduction—thus the opening to pit the IRA proposal against the capital gains tax reduction. Both could appeal to the need to increase the low rates of national saving, but the capital gains reduction could be classed as helping the rich, while now the IRA proposal could be characterized as helping everyone.

As the issue developed, Senator Roth introduced an alternative IRA proposal that became coupled with the proposal to reduce capital gains tax rates. Under Roth's proposal, the tax incentives associated with IRAs would be substantially altered, leading to increases in short-term tax revenue—and thus enabling the hoped-for cut in the capital gains tax—but decreases in longer-term tax revenue. Roth's plan would completely eliminate the tax deduction for IRA contributions (raising short-term tax revenue) but would allow both the principal and the interest earnings to be withdrawn tax free in retirement (causing long-term revenue losses). In addition, the plan could be used to save for the purchase of a first home and for college expenses. A key motivation for this structure was to avoid the up-front tax cost of the program. Under this arrangement, the tax cost would come later, when no tax would be levied on the IRA funds withdrawn. The inability of Congress to reach a compromise on the interrelated issues of capital gains tax rates and IRAs prevented legislation on either issue in 1989. In 1990 Bentsen reintroduced his IRA proposal, and the administration proposed a "back-ended" savings plan, similar to Roth's proposal in 1989. Although neither plan was enacted, legislation modifying IRAs continues to be evaluated.

In summary, the initial (1974) IRA legislation was intended to impose greater equity in federal retirement policy and to encourage retirement income security for people without firm pensions. The 1981 legislation that expanded the availability of IRA tax incentives was directly responsive to the low and declining national saving rate. The debate leading to the 1986 limitations on IRA contributions and the more recent discussion of other IRA revisions have been dominated by the tax cost of IRAs, the question of whether the benefits of IRAs devolve to the rich or to the poor, and the extent to which IRAs generate new saving. In general, the distribution of the tax benefits by income seemed to carry more weight than the potential effect on the economy at large through the saving effect.

401(k)s

These plans were formally established by the Revenue Act of 1978 but were not used much until the 1981 clarifying rules. The plans, also known as cash and deferred arrangements (CODAs), permit employees to contribute before-tax dollars to qualified retirement plans. Prior to the Tax Reform Act of 1986, the annual 401(k) contribution limit was $30,000. The 1986 legislation reduced the maximum employee contribution to $7,000 and also introduced nondiscrimination provisions to prevent plans from providing benefits exclusively to high-income employees. Employer contributions (subject to nondiscrimination rules) could still be as high as $30,000. Participants in 401(k) plans defer constructive realization of their contributions, thereby postponing their income tax liability. They also benefit from tax-free accumulation of the 401(k) investment, just as with IRAs, and may also obtain additional benefits if the employer matches part of their 401(k) contribution.[23]

As with Keogh plans (in 1962) and IRAs (in 1974), the 1978 legislation creating 401(k) plans was motivated by a concern for equity in federal retirement policy. Prior to 1978, companies with cash or deferred profit-sharing plans were not assured tax-advantaged treatment for these plans if employees had the option of taking their compensation as cash or as deferred benefits. According to the Senate Finance Committee report dealing with 401(k) plans, "The committee believes that the uncertainty caused by the present state of the law has created the need for a permanent solution which permits employers to establish new cash or deferred arrangements."

As with IRAs, the budget deficit dominated the discussion by 1986. Surprisingly, the net saving effect of 401(k) plans received little attention, even though the 401(k) plans can be thought of much like IRAs and their effect on savings is likely to be substantial. The lack of attention to the savings effect of 401(k) plans may be explained by the relatively low utilization of 401(k)s at that time. Utilization has increased enormously since then.

While the 1986 Tax Reform Act led to at least a temporary fall in IRA contributions, this has been partly offset by the rapid growth of 401(k) plan contributions. In 1983, total employment at firms with 401(k) plans totaled 7.1 million; by 1988, the number eligible to participate had increased to 27.5 million. The number of employees choosing to participate in these plans also has increased sharply, from 4.5 million in 1983, to 10.3 million in 1985, to 15.7 million in 1988. Most large firms now have 401(k) plans. A 1987 survey by Hewitt Associates, for example, found plans at 91 percent of the firms in the

[23] In the Massachusetts Mutual (1988) survey, 57 percent of the firms offering 401(k) plans matched some fraction of an employee's contribution. A 1988 GAO study (U.S. General Accounting Office 1988) found that 51 percent of firms made some matching contribution.

Fortune 200. More recent adoption of 401(k) plans has been fastest at small firms: the Massachusetts Mutual (1988) survey shows an increase in the number of small firms offering these plans from 8 percent in 1984 to 36 percent in 1988.

For those eligible to participate in 401(k) plans, participation rates are much higher than the rates in other saving plans, including IRAs. Tabulations from the March 1988 Current Population Survey (CPS) suggest a utilization rate of nearly 57 percent, up from 38 percent in 1983. In contrast, about 15 percent of tax filers contributed to an IRA account; possibly 25 percent of tax filers have IRA accounts. The average annual contribution to 401(k) plans in 1988 was about $2,000.

In summary, like Keogh plans and IRAs, 401(k) plans were introduced primarily to provide greater equity in federal retirement policy and to encourage retirement saving. The $30,000 limit allowed a great deal of tax-advantaged saving, and the possibility of employer matching made the plan more advantageous than IRAs. But, unlike IRAs, individuals could contribute only after a plan had been established by their employer. Thus, the participation rate was at first low but has been expanding rapidly. Again, like IRAs, the program was cut back just as 401(k)s were gaining in popularity. But, unlike IRAs, the 401(k) limit is still high enough that only a small proportion of participants contribute at the current $7,000 employee limit.

12.2.3 The Result

Despite the increasing availability of tax-advantaged savings programs in the early and mid-1980s, this period had among the lowest rate of personal saving in U.S. history. This observation led many policymakers to conclude that tax-advantaged savings programs do little to increase savings behavior and thus had little positive social value. An increasing number of economic studies suggest just the opposite—retirement savings programs (such as IRAs and 401[k]s) have induced a great deal of savings that would not have occurred otherwise (see e.g., Venti and Wise 1986, 1987, 1990, 1991; and Feenburg and Skinner 1989). Indeed, savings rates would have been even lower in the 1980s without these programs.

Even ignoring the savings effect of IRAs and 401(k)s, the short-term tax cost of these programs at a time of large budget deficits led Congress to limit these programs rather than extend them. The decisions to cut back 401(k) contribution limits and IRA participation were motivated largely by the budget deficit. It seems, therefore, that the concerns about the budget deficit in the short run have taken precedence over long-run concerns for national saving. Indeed the long-run tax cost associated with either of the tax-advantaged saving programs is very small compared with the short-run tax costs that are motivating policy decisions.

12.3 Health Care

12.3.1 The Economic Issue

Health care costs have risen almost continuously as a proportion of GNP since the early 1960s, as shown in figure 12.7. Total national health care expenditures claimed a full 11.1 percent of GNP in 1987. Public expenditures on health care are rising, employer expenditures on health care are rising, and out-of-pocket consumer expenditures on health care are rising.

The increases in national health care expenditures have resulted from a number of factors, including the aging of the population (and the higher health care utilization rates of older people), an increasing number of health care procedures performed per patient, an increasing sophistication of health services for most illnesses, and high rates of inflation associated with health care services. Figure 12.8 shows the increase in medical care prices as compared with the increase in the general price level, as measured by the consumer price index.

The basic economic issue is how to provide health insurance while containing the expenditures induced by the insurance—the moral hazard problem. Because health care needs vary enormously across the population, and because these health care needs are typically unexpected, there is a natural role for health insurance. However, health insurance tends to increase the total use and cost of health care services. The greater use of health care is drive by both consumers of health care (who want to get healthy at the expense of insurers) and providers of health care (whose income depends on the provision of health care services).

The moral hazard problem arises because the cost of health care to the individual is lower than the total cost of the care. When people decide how much to spend on health care, they base their decisions on their own personal costs rather than the costs to society. Once the cost is covered by insurance—either

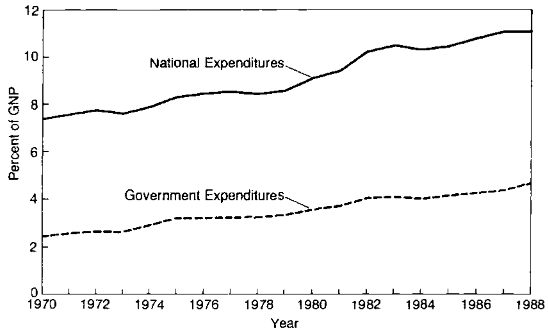

Fig. 12.7 National health care expenditures and government health care expenditures, as a percentage of GNP

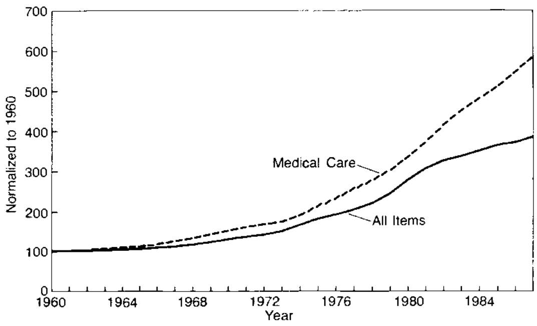

Fig. 12.8 Consumer price index, medical care and all items, normalized to 1960

through the government or through private insurance programs—the remaining personal costs of health care are small, so there is little incentive for patients to limit the use of health care. The moral hazard incentive is even more acute with health care than with other forms of insurance because the providers of health care (not just the patients) have an enormous influence on the amount and the composition of health care demanded. Like patients, health care providers have little incentive to economize on health care costs when they are fully reimbursed by health insurance.

Both economic research and legislative activity have been directed to containing the moral hazard effects of health insurance. On the demand side, one way to moderate the use of health care services is through deductibles and copayments. Since the recipients of health care services then pay at least part of the cost of their care, there is a greater incentive for them to limit these expenditures, by limiting either the extent of care of its cost. On the supply side, the use of health care services may be moderated through fixed reimbursement policies. If insurance companies (or the government) pay health care providers a fixed fee per patient (or per illness), then the providers will have a greater incentive to reduce the cost of care for their patients so that they can retain a larger share of that fee. Both the supply-side and the demand-side approaches are reflected in health care legislation in the 1980s.

12.3.2 The Legislation

The major themes of health care policy in the 1980s have been access, "catastrophic" insurance, and cost control. Two major health care policies were enacted by Congress. The first, in 1983, fundamentally changed the way the federal government reimburses hospitals for Medicare-covered services. The second, in 1988, expanded Medicare coverage for "catastrophic" medical care expenses. Owing to public dissatisfaction with the financing of catastrophic insurance, the new catastrophic coverage was almost totally repealed in 1989. These major legislative developments are discussed below.

Many other changes in health care policy were considered by Congress in the 1980s, including national health insurance, public long-term care insurance, and mandatory employer-provided health insurance. Owing to the enormous cost of health care services, the significant strain on the federal government budget throughout the 1980s, and opposition outside the government (from insurance companies, physicians, businesses, and others), none of these additional proposals has come close to gaining congressional approval.

Medicare Reimbursement

Controlling government expenditures on health care has been the single most important objective of health care legislation in the 1980s. Cost-control measures have been motivated by the large federal budget deficit, the escalating public expenditures on health care services (through both the Medicare and the Medicaid programs), and the rapid acceleration of health care costs generally. Cost-saving legislation was enacted almost every year throughout the 1980s, generally limiting the amount of reimbursement provided by the Medicare and Medicaid programs for hospital and physician services.

The most significant legislation took place in 1983, when the Medicare reimbursement procedure for hospital services underwent fundamental reform. Like Social Security reform (also in 1983), the reform of the Medicare program was inspired by a pending financial crisis. Medicare costs were rising rapidly, and the Hospital Insurance Trust Fund was projected to go bankrupt around 1987.

While the final composition of Medicare reform was developed and enacted in 1983, the background for the legislation took place a year earlier, when Congress placed new limitations on the amount of hospital reimbursement under Medicare. Under the 1982 legislation, hospital reimbursement would be limited to 110 percent of the average per-case cost among similar hospitals. During a phase-in period, the limit would be placed at 120 percent in 1983, 115 percent in 1984, and 110 percent thereafter. The 1982 legislation also limited the annual increase in reimbursements to the increase in an index of hospital wages and prices plus 1 percent.

As expected, the health care industry was not at all satisfied with the new limitations, arguing that the reimbursement limits did not adequately account for the legitimate differences among hospitals. Because of their dissatisfaction with the 1982 legislation, hospital officials were pleased to help develop and support the policy eventually implemented in 1983. In fact, anticipating that the 1982 limits would not be acceptable as a permanent hospital reimbursement policy, Congress had instructed the Department of Health and Human Services (HHS) to develop an alternative proposal for a "prospective" payment system for hospital reimbursement. The Medicare reform enacted by Congress in 1983 followed the framework of the proposal submitted by HHS.

Prior to the 1983 reform, Medicare reimbursements for health care services were cost based. Within certain guidelines, hospitals were reimbursed according to the costs incurred in providing health care services. Some believed that the cost-based Medicare reimbursement system was at least partially responsible for rising health care costs because there was little economic incentive for health care providers to control costs. The 1983 reform directly addressed this concern. The new reimbursement system provided a fixed fee for inpatient hospital services, regardless of the costs actually incurred in treatment. The amount of the fixed fee depended on the illness or the condition of the patient. Illnesses were categorized (and payments specified) for about 500 "diagnosis-related groups," or DRGs. The fixed DRG fees were intended to cover all hospital expenses in treating the illness or condition.

The intended effect of the Medicare reform was to create incentives for hospitals to decrease their health care costs. Under the old system, hospitals were reimbursed more when they incurred higher costs—creating an incentive for more extensive (and possibly excessive) treatments. Under the new reimbursement system, hospital payments were unrelated to costs. Any cost-saving measures would directly benefit the hospital because there would be no reduction in the predetermined reimbursement from Medicare.

Similar reimbursement limits have been placed on physicians at various times throughout the 1980s. Most recently (1989), Congress developed a reimbursement procedure based on a predetermined value of physicians' services. Prior to the 1989 legislation, Medicare reimbursed physicians for Medicare-covered services on the basis of the physicians' standard rates. Under the new system, physicians will be reimbursed according to a "resource-based relative value scale" (RBRVS). The RBRVS will specify a reimbursement rate for each type of service provided and will be based on the time, training, skill, and overhead costs associated with providing each service.

Both the 1983 reform of hospital reimbursement and the 1989 reform of physician reimbursement account for at least some of the behavioral incentives emphasized in economic research on health care issues. Prior to these reforms, attempts to control health care costs focused on the recipient of care rather than on the provider. Medicare policies contained (and still contain) deductibles and copayments that make the recipients of care at least partially responsible for the expenses incurred by their health care decisions. Even in the means-tested Medicaid program, Congress enacted legislation in 1982 that allows states to collect small deductibles ($1.00 or $2.00) from Medicaid patients so that the health care decisions of Medicaid patients are more cost conscious.

Both the 1983 and the 1989 reforms focused on the providers of care. The 1983 Medicare reform was intended to create cost-saving incentives for health care providers similar to the cost-saving incentives of patients when they face deductibles and copayments. Since profits under the DRG system are inversely related to costs, health care providers presumably would have a strong incentive to reduce costs. The 1989 Medicare reform was intended to control physician costs by imposing more control on their reimbursement rates. Both demand- and supply-side policies are likely to affect health care costs, although supply-side policies may be particularly effective because of the large role of health care providers in determining the choice of care for their patients.[24]

Catastrophic Health Insurance

The second major development in health care policy in the 1980s was the enactment of the Medicare Catastrophic Coverage Act in 1988 and its subsequent repeal in 1989. Congressional consideration of "catastrophic" health insurance was initiated by President Carter in the late 1970s and later by President Reagan in both his 1986 and his 1987 State of the Union addresses. Responding to Reagan's 1986 request, Secretary of Health and Human Services Otis Bowen released a report in November 1986 outlining a catastrophic health insurance plan. Secretary Bowen's initial proposal provided the basic framework for the legislation that was eventually enacted in 1988.

Bowen had recommended that a $2,000 annual limit be established on all out-of-pocket expenditures for Medicare-covered health care services and that this coverage be financed through a modest increase in the Medicare Part B insurance premium. The legislation actually enacted placed an annual limit of about $564 (1989) on out-of-pocket expenditures for hospital care and an annual limit of about $1,370 (1989) on out-of-pocket expenditures for all Medicare Part B services (including physician and other outpatient health care services). The limit would be increased each year so that 7 percent of Medicare beneficiaries would be expected to reach the limit. The final legislation also expanded the number and duration of health care services covered by Medicare, including an increase in skilled nursing home care from 100 to 150 days, elimination of the 210-day limit on coverage for hospice care, the addition of coverage for thirty days of home health care, the addition of coverage for eighty hours of respite care, and the provision of 80 percent insurance for prescription drug costs above a $600 deductible. After the phase-in period, the new benefit would be financed primarily by an increase in the monthly Part B premium from $24.80 to $35.00 and a supplemental premium imposed on all Medicare-covered individuals with an income tax liability above $150. Once phased in, the supplemental premium would be $42.00 for each $150 of annual income tax liability, up to a maximum premium of $1,050. About 60 percent of Medicare beneficiaries would pay no supplemental premium.

When the legislation was enacted in 1988, there was very little opposition to the concept of catastrophic health insurance (except among those who thought that catastrophic insurance was better left to private medical insurance policies), although opinions varied on the most desirable content of the legislation. The main lobbyists expressing an interest in catastrophic health insurance

[24] However, demand-side policies may also be quite effective. For example, some anecdotal evidence suggests that one of the reasons that internists are paid less than surgeons is that a much larger proportion of the fees of internists is paid by the patient for office services for which the patient is likely to face a copayment or even the entire cost.

were the American Association of Retired Persons (AARP), which supported the legislation; the National Commission to Preserve Social Security and Medicare, which objected to the premium increases and the lack of coverage for long-term care services; and the Pharmaceutical Manufacturers Association (PMA), which opposed insurance for prescription drugs, worrying that insurance coverage would lead to price controls at a later date. When enacted in 1988, the Catastrophic Coverage Act was viewed by many as an excellent (landmark) change in public health policy.

Opinions changed dramatically in 1989, when the effect of the program's financing became more apparent. First, Medicare recipients who were subject to the income-based supplemental premium argued that an income-based premium was unfair. For the highest-income recipients, the supplemental premium added $1,050 to their annual health insurance costs. Second, Medicare recipients began paying higher premiums before becoming eligible for any additional health care benefits. This was also considered unfair. Third, about 3.3 million Medicare beneficiaries already received catastrophic insurance from employer-provided post retirement medical benefits. Under the catastrophic care legislation, these people faced higher Medicare premiums (especially those subject to the supplemental premiums) with no additional health care benefits. Responding to the public dissatisfaction, Congress repealed the catastrophic care laws in 1989.

National Health Insurance and Long-Term Care

Some members of Congress have expressed a strong interest in expanding health insurance coverage to include both more people and more health care services. In particular, there have been numerous legislative proposals for national health insurance and for public long-term care insurance. Because of the enormous cost of these proposals, no comprehensive health and long-term care policy reform was enacted in the 1980s.

Despite the cost, the financing of long-term health care is still widely considered to be one of the most important issues on the legislative agenda for the 1990s. Nursing home care and other forms of long-term care are paid for almost entirely by the recipient, until the recipient becomes eligible for means-tested Medicaid assistance. As a result, many older people are impoverished by long-term disabilities, and the financing of long-term care has developed as a major public concern. Several bills have been introduced in Congress that would provide at least some public insurance for long-term care services. Owing to the enormous cost of long-term care services, however, Congress has only initiated studies of long-term care needs and the financing of long-term care; it has not enacted any major long-term care legislation.

Limited long-term care legislation has been enacted in several areas, however. Congress enacted legislation in 1982 to provide Medicare coverage for hospice care (home health care and related services) to terminally ill patients. The 1982 legislation provided up the $4,200 in hospice care benefits; 1983 legislation raised the maximum benefit to $6,500; 1984 legislation raised the daily hospice care rate from $46.25 to $53.17; and the 1988 catastrophic care legislation eliminated the 210-day limit on coverage. The catastrophic care legislation also expanded Medicare coverage to include up to thirty days of home health care and up to eight hours of respite care (professional health and custodial care services to relieve informal caregivers). While the provisions of the catastrophic care legislation were repealed in 1989, those relating to long-term care are being evaluated again in 1990.

One component of the catastrophic care legislation relates to the Medicaid rules limiting "spousal impoverishment." Under previous Medicaid rules in most states, most of the income and assets of the married couple was used to determine Medicaid eligibility. As a result, both the institutionalized and the at-home spouse were often impoverished, before the institutionalized spouse became eligible for Medicaid assistance. Under the 1988 legislation, when one spouse enters a nursing home, the assets of the couple were to be divided between them (with no less than $12,000 and no more than $60,000 attributed to the at-home spouse). Only the assets of the institutionalized spouse are considered in determining Medicaid eligibility. In addition, the at-home spouse is entitled to a "maintenance needs allowance" from the income of both spouses. Once phased in in 1992, the maintenance needs allowance will be 150 percent of the federal poverty threshold for a two-person household up to $1,500 per month.

While long-term care seems to be a higher priority in Congress, various forms of national health insurance have also been discussed periodically. President Carter had been determined to enact a form of national health insurance during his presidency in the late 1970s. With the budgetary pressures of the 1980s, expectations about publicly provided national health insurance were replaced with the less ambitious catastrophic insurance proposals. An alternative approach to national health insurance received more attention later in the 1980s. This alternative would require all employers to provide health insurance for their employees.[25] Senator Kennedy was a leading proponent of mandated health benefits. The Senate Committee on Labor and Human Resources (which Kennedy chairs) reported a bill in 1988, but no legislation was enacted. Opponents of the bill, such as Senator Hatch, argued that the mandated benefits would reduce jobs and raise health care costs. The disagreement, where conflicting "economic" analyses provided the political ammunition, was in how much it would cost businesses and how many jobs would be lost.

[25] Related legislation affecting employer-provided health insurance was enacted in 1982. Under this legislation, employers were required to provide the same health benefits for workers aged sixty-five to sixty-nine as were provided to younger employees. Medicare would pay only for the difference between these benefits and full Medicare benefits.

12.3.3 The Result

The objectives of health care legislation in the 1980s were to extend health insurance coverage and to control health care costs. Nonetheless, the 1980s have seen very little change in coverage and continued growth in national health care expenditures.

The Medicare reform enacted in 1983 was intended to create economic incentives for hospitals to reduce costs. While the composition of health care costs was affected by this legislation, total health care costs have continued to rise rapidly. The DRG system apparently led to a reduction in the average length of stay of hospital patients. Hospitals reduced costs by reducing the length of stay, and this apparently led to a reduction in fees paid to physicians through hospitals. The reduction in direct hospital reimbursement, however, was largely offset by an increase in outpatient physician fees paid through outpatient hospitals and offices. Total government expenditures on health care continue to increase, along with total national health care expenditures.

Efforts to extend health insurance coverage have also been largely ineffective. Proposals for national health insurance, public long-term care insurance, and employer-mandated health insurance were considered, but not enacted, in the 1980s. Catastrophic health insurance was enacted and then repealed. The distributional consequences of these proposals appear to have been the most significant factors preventing legislation in this area. Catastrophic care failed because higher-income elderly would pay more; employer-mandated insurance failed because employers would pay more; national health insurance and long-term care insurance failed because certain taxpayers would need to pay more to support the extended coverage. In fact, since even the "uninsured" have access to charity care, proposals to "expand" health care coverage seem to have more to do with distribution (who pays for the care) than coverage (who gets the care).

12.4 Conclusions and Discussion

Aging issues have been an important component of federal legislation throughout the 1980s. The legislation enacted was influenced by and will have consequences for economic behavior, income distribution, and "fairness." While economic analysis is most useful in understanding the behavioral implications of government policies, distribution and fairness were more often the dominant factors influencing aging legislation in the 1980s.

In some cases, such as Medicare reform, economic analysis has been central to the legislative debate on the issue. The intent of the prospective payment system of Medicare reimbursement was to create economic incentives for hospitals to reduce the cost of health care. Most health economics research had focused on the economic incentives among insured users of health care and reimbursed providers of health care. The results of this research were applied extensively in developing the 1983 Medicare reform legislation.

In other cases, economic analysis contributed extensively to the legislative debate but was not the central motivation for the legislation enacted. For example, Social Security reform was motivated by a projected financial shortage in the Social Security trust fund, and the legislation enacted was designed primarily to prevent this projected shortage. While not the central motivation for the reform, economic analysis was introduced and evaluated throughout the policy-making process, and the reforms enacted have important behavioral implications that were identified and evaluated through economic research. Some of the reforms enacted in 1983 decrease the work disincentives associated with prior Social Security policies and might be expected to defer retirement among workers not yet retired by age sixty-two.

In still other cases, such as IRA legislation, economic analysis was sought and considered, but its influence may have been diminished by conflicting views among economists. In 1981, when IRA eligibility was extended, most policymakers seemed to believe that IRAs would be an effective vehicle for promoting retirement saving. When IRA eligibility was limited in 1986, many believed that IRAs were not an effective means of increasing personal saving. The debate leading up to the 1986 legislation and the more recent debate on expanding IRAs have had vociferous advocates of both economic conclusions about the effects of IRAs on savings.

Finally, in some areas, such as private pension plan legislation, the issues addressed in Congress were outside the purview of central economic research. Changes in vesting rules, funding requirements, Social Security integration rules, pension insurance programs, survivorship benefits, nondiscrimination rules, and plan termination regulations were motivated by concerns about fairness or equity in the treatment of different employees and protection of pension benefits. Even the elimination of mandatory retirement was motivated by concerns about equity rather than the declining labor force participation of older workers. The work and retirement incentives associated with pension plans were rarely considered in the legislative debate, and they were scarcely affected by any of the 1980s pension legislation.

In almost all instances, members of Congress and their staff are exposed to a large amount of economic research before making any policy decisions. However, because almost no economic analysis is definitive, at least initially, the staff member must use individual judgment and intuition to evaluate this research. The more the conclusions of economic analysis differ, the greater the difficulty in making this evaluation, and the greater the role of intuition.

Economic research considers both efficiency and distributional issues. But, ultimately, concerns about distribution and fairness are typically more significant in influencing the legislative outcomes than even the most conclusive of analyses of the potential efficiency effects of alternative policies. Nonetheless, economists' warnings about the inefficiencies of potential policies and regulations may have warded off proposals that might otherwise have been enacted. And, in other cases—like the DRG legislation—efficiency arguments played a key role.

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2. *Rudolph Penner*

Federal government payments to the elderly population make all other civilian budget issues pale in relative importance. Spending on people over sixty-five now absorbs almost half of noninterest civilian spending, and the Congressional Budget Office (CBO) estimates that payments to the elderly will absorb some seventy cents of each additional dollar of noninterest civilian spending over the next five years.

Figures 12.9 and 12.10 show how important the two main elderly programs, Social Security and Medicare, are in the budget. Over the long run, the relative importance of defense has declined relative to GNP, and interest has increased, as has Social Security and Medicare. Since the late 1970s, everything else has declined, which, I believe, indicates a significant ideological shift away from the view that prevailed in earlier decades. Figure 12.10 compares Social Security and Medicare and all other types of civilian, noninterest spending and shows how rapidly Social Security and Medicare have grown, almost catching up to all other civilian noninterest spending in terms of importance.

While Social Security and Medicare are overwhelming in their importance, the elderly receive a disproportionate share of other benefits as well. Medicaid is very rapidly becoming an elderly program because of soaring nursing home costs. There are special housing subsidies for the elderly, SSI exists mainly for the poor elderly, the elderly get a disproportionate share of food stamps, and numerous nutrition programs are aimed at the elderly. In addition, civil service pensions and military pensions provide significant support to the elderly.

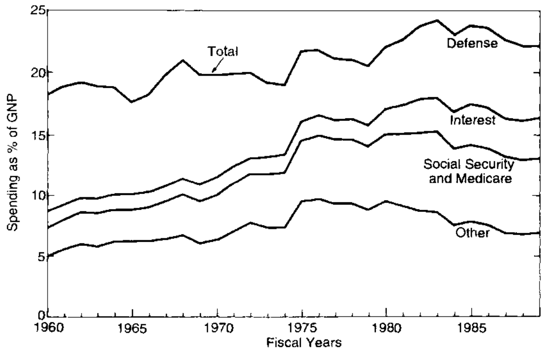

Fig. 12.9 Federal spending, by type of program, fiscal years 1960–89

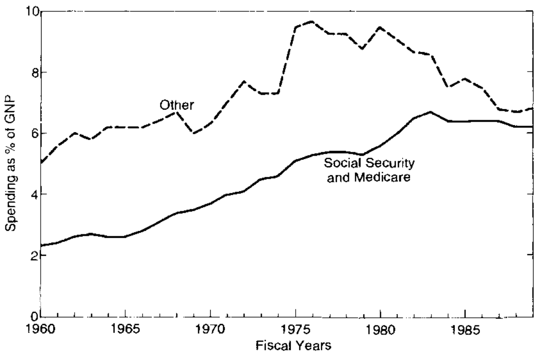

Fig. 12.10 Federal civilian noninterest spending, fiscal years 1960–89

Currently, Social Security is the most costly program focused on the elderly, although current projections suggest that without radical reform, Medicare will exceed it in size in the early twenty-first century. The OASDI program constitutes about 21 percent of total spending and about 34 percent of noninterest civilian spending.

The ordinary citizen obviously must take a very long view of the Social Security system. It affects us through our working life because of a large payroll tax burden, and it affects our expected well-being while retired. Because it is to some degree a substitute for intergenerational transfers, it probably also has significant effects on private transfers from parents to children and from children to parents. Given that you have to take a long view, I am a little tempted to begin my story in the 1880s, rather than the 1980s. We did have a fairly substantial social security program in the nineteenth century, called Civil War pensions. By some magic, almost everybody qualified. The demise of eligible veterans was one of many factors responsible for the establishment of Social Security. I have a feeling, however, that a three-hour history would not be much appreciated here.

However, the policies of the 1980s were very much a reaction to the policy changes of the late 1960s and early 1970s, and I think that it is necessary to look at those in some detail. The peak year of Vietnam defense spending was 1968, and defense spending continued to fall relative to GNP until the mid-1970s. About 70 percent of the fall in defense from the peak to the trough was absorbed by increases in the Medicare and Social Security programs. The problem was that we made permanent long-run promises to the elderly financed by a peace dividend that was, of course, temporary.

Changes in the Social Security replacement rate for the single retiree illustrate the growing generosity of the program. The average replacement rate is here defined as the benefit that a single person would get relative to his or her last year of income if the person earned the average wage for his or her whole working life. The replacement rate had eroded a bit in the early 1960s and was about 31.4 percent in 1965, but it was quickly raised to 42.3 percent by 1975. That is a before-tax replacement rate, and the after-tax rate would be considerably higher. Also, someone retiring with a dependent spouse gets an extra 50 percent.

But more important than the benefit increases during this period was the adoption of indexing in 1972. It represented a profound change in the philosophy of the system because indexing changed the definition of the entitlement. The nation said, not only that retirees are entitled to a certain nominal benefit, but also that they are going to be protected against inflation as well. Furthermore, the initial attempt to index was designed to go beyond CPI indexing and to provide a small real increase to each successive cohort of new retirees. In other words, the Congress tried to put the system on automatic pilot. Given the rates of inflation and real growth expected at the time, it was thought that the replacement rate would erode despite the small real increases expected with the new indexing system, so that Congress would have had the opportunity from time to time to be generous and give people a more substantial real increase.

The arithmetic of the indexing formula was faulty. When a surprising acceleration in inflation occurred, the formula was such (and I certainly will not try to explain it here) that the real increase in benefits increased as the inflation rate increased. The replacement rate began to soar, eventually going over 50 percent.

Ironically, indexing was first passed as a money-saving measure. I remember believing that it would, in fact, control costs. In the late 1960s, the Congress had to adjust benefits upward periodically because of the Vietnam-related acceleration of inflation. Every time they opened up the issue, which they often did just before an election, there was enormous political pressure to provide increases in excess of inflation. Indexing was seen as a discipline. It was supposed to constrain real benefit increases, and the Congress hoped that it would allow them to ignore Social Security for long periods of time.

With the benefit of hindsight, it now appears that the 1960s was a very unusual decade. There was unusually rapid economic growth, and in the early 1960s the elderly were among the poorest segment of the population. A serious social problem existed, and the nation thought that it had sufficient resources to solve it because it was forecast that rapid growth would last forever. It was not surprising, in retrospect, to see intense political pressure to spend some of the anticipated growth dividend on the elderly.

In the 1950s and the early 1960s, the needs were just as great, but the Congress did allow replacement rates to erode for long periods. I am very doubtful now that, in an unindexed system, the Congress would have compensated for the whole increase in the CPI in the late 1970s, when resources were more limited and real wages were eroding. Moreover, the CPI was upward biased during the period because of the flawed treatment of housing costs.

One of the themes in this conference asks how important economic analysis is to policy decisions. With regard to Social Security, Martha Derthick has written brilliantly on how that program evolved, and her main theme is that a coterie of experts surrounds the system and has significant power over policy changes. The system is so intricate that very few people understand it, but there is a small group of people, such as Robert Ball and Robert Myers and various other former actuaries and commissioners, who understand it well and who are advocates for the system. They have enormous influence with the Ways and Means Committee and the Senate Finance Committee because, in the 1970s, they were about the only people who understood the details of the system. So it was up to the technicians to develop an indexing system that replaced the flawed inflation indexing system that had been adopted in 1972, and I think that their choice was considered to be a technical matter, not a philosophical matter.

Their choice, nevertheless, changed the philosophy of the entitlement once again because they invented a system that attempted evermore to keep the replacement rate constant for newly retired persons at each segment of the income distribution. In other words, during people's working life, they would accumulate an entitlement that allowed them to share in the rewards of economic growth. Oddly enough, the philosophy was schizoid in that, as soon as you retired, you were just guaranteed a constant real payment, and you did not share in real growth unless Congress explicitly acted to increase real benefits.

I was working at the Office of Management and Budget (OMB) at the time that indexing reform was being considered, and I truly felt that nobody knew what was going on. I could not believe the proposed legislation when I read it. It indexed the benefit formula to wages, not to prices. I tried to create a fuss and ran head-on into the intricacies of the system. It was extraordinarily difficult to explain what was going on to any policymakers. I vividly remember our effort to prepare the presentation of different indexing options to the cabinet and to President Ford, and we corralled some very bright defense analysts, thinking that they would be a good example of the intelligent laymen that we were trying to convince and that we could explain the issues to them. We tried, and they did not know what we were talking about. We reformulated the presentation and tried it out on them again, and they seemed to understand it. But the next morning we asked them to explain it back, and none of them would have received 30 out of 100 on a test on it. I was not personally involved in the presentation to President Ford (I was at too low a level at the time), but somehow my name got associated with the presentation, and, when I saw him several months after the end of his presidency, he said, "Don't try to explain double indexing to me again!"

It was very hard to make people understand the importance of the issue. The histories of policy developments (whether they be in Social Security or tax policy or whatever) are always written as though that is the only thing on the president's mind during a particular period. If you read Derthick's book about this indexing incident, it seems as though President Ford was considering little else for several weeks. In fact, he was very busy at the time preparing for an economic summit meeting in Puerto Rico, which he considered to be very important. I remember being frustrated because I saw the summit as a ceremonial occasion whereas the Social Security issue was worth hundreds of billions of dollars in present value terms.

As an aside, you might not think that the choice of wage over price indexing cost much because of the slow subsequent growth in real wages, but the Social Security Administration (SSA) uses its own index. For reasons that I do not understand, real wages have grown much faster using the index the SSA uses for the purposes of adjustment than you would believe looking at the Bureau of Labor Statistics (BLS) index for the average hourly wage.

President Ford eventually recommended wage indexing to the Congress, but it was not enacted before he left the presidency. President Carter could not possibly recommend something less generous than President Ford, although there was some debate over the issue within his administration.

Although the 1977 indexing reform was too generous in my view, the reform also took back a lot of the unintended increase in the replacement rate that had occurred under double indexing and that caused the famous problem of the notch baby. The new reforms were designed to put the Social Security system on automatic pilot, but all sorts of things went wrong. I have already mentioned some of them, including the upward bias in the CPI. But then the nation faced back-to-back recessions in 1980 and 1982, and the system was on the verge of technical bankruptcy.

The administration and the Congress set out to reform it once again, and the reformers faced a difficult task, given the difficult politics surrounding the system. The indexing prevented them from using inflation to erode benefits, and even real growth did not help because of the wage indexing of the benefit formula. So some of the entitlement had to be withdrawn, or else the taxes used to finance the system had to be increased significantly. Politicians dreaded that task, and, to shield themselves from blame, they appointed a commission led very skillfully by Alan Greenspan. I think that, if you talk to him, he will be very modest and say that he had a lot of good luck and that there were many times in the proceedings when it looked like the commission would fall apart. But, with the help of a subgroup of commission members from the Congress, they came forth with a major set of recommendations designed to finance the system for fifty years into the future.

That commission has often been used as a model for how we might solve the fiscal crisis, and, indeed, that thinking brought forth the unfortunate National Economic Commission in the late 1980s. I think that one thing that people do not realize about the Social Security crisis of 1983, however, is that it was tiny quantitatively. If you spend a penny more than you earn every year, you will go bankrupt eventually, and that was the type of situation that the Social Security trust fund faced at the time. All the commission recommendations, and some things that the Congress added later, amounted only to about 2 percent of payroll, or to about 1–1.5 percent of GNP. With the fiscal deficit problem, the gap, when the National Economic Commission was meeting, amounted to about 3 percent of GNP, and now it is about 5 or 6 percent of GNP. Consequently, it is a much more serious problem quantitatively. The Greenspan Commission had a much easier task. But still, I give them great credit for coming up with a reform. Most of the reforms were directed at increasing the revenue of the system: payroll taxes were raised, civil servants and others were brought into the system for the first time, the benefits of the more affluent were taxed for the first time, and a cost-of-living (COLA) benefit increase was delayed.

Some see the creation of the commission as a symptom of the lack of courage of politicians, but that ignores the fact that, when the commission's recommendations came to the Congress, the Congress went far beyond the commission in one very important respect. They put the system on an actuarially sound basis for seventy-five years by extending the normal retirement age. That is to say, the age at which full benefits are paid will eventually reach sixty-seven. Under this new approach, people are still allowed to retire as early as age sixty-two, but they suffer an actuarially appropriate reduction in their benefits relative to the full benefits at the new retirement age. This is a very clever way of achieving exactly what I was trying to achieve in the Ford administration by using CPI indexing rather than wage indexing. It implies a lower replacement rate at any specific age of retirement. However, when I talk to laymen, not many people know that falling replacement rates are going to occur in the early twenty-first century, and, whether the reform will survive when people figure it out, I do not know. The replacement rate for a single person retiring at age sixty-five is now a little over 42 percent, while, under this scheme and the assumptions of the actuary, it would decline to 36 percent at age sixty-five by 2030. During the debate on the retirement age, Senator Dole suggested, perhaps with tongue in cheek, that we should index the normal retirement age to life expectancy at age sixty-five. That might not be a bad idea.

The reforms of 1983 focused on Social Security and largely ignored Medicare. This came from focusing on the viability of the trust fund, and the Medicare trust fund at that moment was not in terrible shape, although it was clear that it would go broke eventually. But we could have saved quite a bit of money in the future by increasing the eligibility age for Medicare to the new normal retirement age for Social Security. There was some debate about that, but I gather that people thought that that just might be too tough to swallow at the same time as Social Security was being made less generous. So the eligibility age for Medicare remains at age sixty-five.

There is a continuing controversy over the so-called retirement test: the level of earnings at which you start to lose benefits. That has been made more lenient through time. There was also an important 1983 reform that increased the reward if you work past the normal retirement age. That increase in the reward will phase in very slowly and is not complete until 2007. The reform makes the retirement test less relevant. The reward for waiting for benefits is almost actuarially fair. If the retirement test was eliminated after 2007, some who choose to work longer might nevertheless wait for higher benefits when they do choose to retire.

Perhaps the most important policy event of the 1980s—and I am a little surprised that neither Charles Schultze nor David Stockman discussed this earlier with regard to budget policy—was a law that failed to pass in 1985. At that time, under the very courageous leadership of Senators Bob Dole and Peter Domenici, the Republicans in the Senate fashioned a major federal deficit reduction package, which included as one of its components a COLA reduction for Social Security. A dramatic fight occurred in the Senate—the Republican leadership managed to get a 49-49 tie vote by carrying Pete Wilson in on a stretcher to vote for the package, and Vice President Bush broke the tie, voting for the package. President Reagan, having first backed the package, then turned against it as Republicans in the House fled from the proposal in the face of complaints from the elderly. Speaker Tip O'Neill was also violently against it.

To me, that was a very important event. The proposed cut in Social Security was small, but in the subsequent campaign in 1986, wherever you went, you saw Democratic candidates running ads that the Republicans were against Social Security, and many Republicans, rightly or wrongly, blame that episode for the loss of the Senate in that year. If the package had passed, pensioners would have hardly noticed the cut in benefits, but, ever since that time, Social Security has been far off the bargaining table. The cliché is that it is the third rail of politics: "Touch it and you die." Even options as reasonable as taxing benefits as though they were private pensions are effectively off the table.

Turning to Medicare briefly, the new payment system for hospitals (the DRGs, or diagnosis-related groups) enacted in 1983 is very important. Oversimplifying somewhat, the reform took compensation for hospitals off a cost-plus basis and made it a fee for service. This changed incentives for the better and is saving a lot of money. There were many attempts in the 1980s to reduce payments to physicians by freezing their fees and doing other things, but they outgamed the system every time. Every time their fees were limited, they prescribed more procedures, so their income did not suffer. We now have yet another attempt at reform that promulgates a detailed fee structure with some similarities to the DRG approach used for hospitals. Figures 12.9 and 12.10 showed the growth of Social Security and Medicare slowing somewhat recently, and I believe that that is partly related to some of the curbs on Medicare payments. But, even if these reforms work in the long run, they obviously do not imply a fundamental change in the system. Once you stop cutting payments to providers, the system will just resume growing again at its former rate. And you cannot keep cutting providers year after year.

In conclusion, I think that the elderly have gotten off very easily during the budget wars of the 1980s, given that they get almost half the civilian noninterest budget. The record shows how extraordinarily difficult it is to deal with this powerful constituency. But there is only a very small chance of cutting the rate of growth of civilian noninterest spending in the long run if the nation does not renegotiate its social contract with the elderly. The problem gets very much more serious after 2005, when the baby boomers of the 1940s and 1950s begin to retire. We are sure to return to the issue again and again.

Summary of Discussion

David Stockman explained the events surrounding the unsuccessful 1981 proposals for Social Security reform. He said that a package had been proposed in May 1981 that fleshed out $44 billion in unidentified savings in the original 1981 budget. The plan was directed at structural reform of Social Security—it reduced the benefits received by early retirees and also removed a variety of "social policy add-ons" that had been instituted over time but did not qualify, in Stockman's view, as earned retirement benefits.

The plan was announced on 10 May. By 12 May it was being denounced by the Department of Health and Human Services as a White House plan, and by 15 May it was being advertised by the White House as the Social Security Administration's plan. On 20 May the Senate voted 93-0 against the plan, and that was the end of it.

Martin Feldstein believed that it was the focus on early retirees that had killed the plan. Rather than reducing benefits by 2 or 3 percent for the entire population of retirees, the plan said that sixty-two- to sixty-five-year-olds who were about to retire would face a 20 percent cut in benefits.

William Niskanen argued that the May 1981 Social Security proposal was the major domestic policy mistake of the Reagan administration. He believed that the central lesson of the proposal's failure was that short-term budget concerns often thwart more important structural reforms.

To illustrate this point, Niskanen recalled the genesis of the 1981 proposal. Robert Myers would not entertain any changes in the basic structure of Social Security, but he had recommended a variety of changes in peripheral features of the program. In particular, he had proposed a reduction in the benefits for early retirees from 80 percent of full retirement benefits to either 75 or 70 percent. When an administration task force was considering this issue in the spring of 1981, Stockman had proposed a more drastic cut to only 55 percent of full retirement benefits, effective at the beginning of 1982. The task force had then divided into two groups, with one more concerned about early budget savings and the other more interested in long-term reform. Niskanen had been a member of the latter group, which revived the recommendations of the Hsiao report, recommendations that Penner had tried to implement during the Ford administration and that economist Henry Aaron had pushed during the Carter administration. The crucial recommendation was to index the "bend points" in the benefit formula to prices rather than wages; over time, this would transform Social Security from a system that maintains relative incomes into one that maintains real incomes. The replacement rate (the ratio of benefits to preretirement earnings) would drop gradually, without reducing the real benefits of anyone who is currently retired or near retirement. This approach reduces spending by trillions of dollars in present discounted value, but it produces almost no savings in the first year or even over a five-year budget horizon. Niskanen believed that the task force did not give this proposal sufficient consideration because of this lack of short-run savings, but he stressed that the recommendation remains the most politically realistic proposal for substantive reform.

Stockman agreed with Niskanen's description of this debate, although he added that the administration's proposal had included some bend point reform. Stockman also argued that the Hsiao report made Social Security reform sound easier than it actually was. If the bend points were in fact indexed to prices, there would be no real return on workers' contributions to the program. Stockman asserted, therefore, that something must be added to the indexing formula to proxy for the average real asset return over time. He agreed that the current approach of indexing benefits to wages or productivity is clearly excessive.

Rudolph Penner noted that, even under the Hsiao report's recommendations, Congress could increase benefits at any time in order to provide a real return on workers' contributions. Penner had supported the Hsiao report, however, because he believed that such increases would be less generous than increases generated automatically from the growth in real wages.

Feldstein added that indexing the bend points to prices would cause the entire system to shrink over time in real terms, encouraging people to put more money into private savings and pensions.

Feldstein then shifted the discussion to the Social Security reforms of 1983. Those reforms entail future increases in the regular retirement age and thus represent a significant implicit reduction in benefits. The combination of delayed retirement and the expected increase in life expectancy will mean a decline in the replacement rate for sixty-five-year-olds from 42 percent today to 36 percent in 2012. Further, essentially all those benefits in 2012 will be taxed because the 1983 reforms also called for taxing all benefits above a quite high, but unindexed, threshold.

Stockman contrasted the political design of the successful 1983 reforms with that of the failed 1981 reforms. The 1983 plan was officially sponsored by a bipartisan commission led by Alan Greenspan, but it really had been negotiated by Speaker of the House Tip O'Neill, Senator Daniel Patrick Moynihan, Senator Bob Dole, Representative Dan Rostenkowski, and President Reagan. It was arranged that President Reagan and Tip O'Neill would make simultaneous announcements endorsing the package, thereby eliminating any possible stigma or blame. This approach had worked perfectly, and it presented a brilliant act of leadership in the face of a very large national problem.

Stockman noted, however, that the reforms included only one short-term benefit change—a six-month delay in the annual cost-of-living adjustment. In the year that this delay occurred, the inflation rate had fallen to only 3.8 percent, so the delay represented a 1.9 percent real reduction in benefits for the 36 million people then receiving Social Security. Although their benefits remained permanently lower as a result, the delay had no impact on the benefits to be received by future retirees. If this delay had been implemented in 1980, on the other hand, when the inflation rate was 12.6 percent, there would have been a 6.3 percent real, permanent reduction in benefits. Stockman added that the decision to delay the cost-of-living adjustment had been made by the commission but had not been publicly announced until later; the precise mechanism for the delay was determined by Congress.

James Tobin wondered whether reductions in Social Security benefits would lead to equal reductions in payroll taxes or to reductions in the budget deficit instead. He believed that these two ways of thinking about the relation of Social Security to the rest of the federal budget corresponded to two different views that one might have of the role of the Social Security program. One view is that Social Security is a very large transfer program, involving both a large part of federal taxes and a large part of federal spending. From this perspective, for example, Moynihan is correct that the United States is using payroll taxes as a way of financing general government needs. The other view is that Social Security is a retirement program, admittedly an "imperfect and awkward" one, in which one pays taxes in order to accumulate an entitlement to future benefits. If one thinks that workers are paying more into this plan than the benefits are worth to them, then one would reduce both benefits and taxes, and there would be no effect on the deficit.

Feldstein responded that the big difference between a private pension plan and Social Security is that, until recently, the Social Security program was accumulating no assets. Thus, Social Security was reducing national saving by substituting for the asset accumulation that otherwise would have occurred through private pensions or personal saving. The 1983 reforms were a partial response to this problem because they initiated the accumulation of surpluses in the Social Security trust fund. But he believed that the policy had been proposed in order to smooth the projected tax rate, not as a deliberate effort to raise national saving. Feldstein added that the system is still pay as you go over the next seventy-five years but involves a massive buildup of assets over current workers' lifetimes.

Penner said that he regarded Social Security as a transfer program, not a retirement program, because the redistribution goals of the system imply that the amount of taxes paid by an individual has little relation to the amount of benefits received. For someone retiring today, the ratio of the present value of benefits to taxes is quite high, computed at a 2 percent real discount rate, but for most single people starting to work today, and for more affluent married couples, the present value of benefits is projected to be quite a bit less than the present value of taxes. Thus, Penner saw great merit in Moynihan's proposal to cut the payroll tax and return to a more explicit pay-as-you-go system, but only if other taxes were increased so that the deficit would not rise. But he recognized that such tax increases were a "political dream" in the current environment.

Stockman added that the Social Security system involves enormous transfers between income classes as well as between generations. First, the benefit and contribution rules shift income from those who have higher lifetime earnings to those who have lower lifetime earnings. Second, and more important, the rules index everybody's early earnings to the cumulative productivity growth in the economy over the following forty years. So the system is designed to capture the economic growth over time for every cohort of retirees and to slightly shift income from the better off to the worse off. This is a public fiscal program, not a retirement program.

Michael Mussa said that the total benefits being provided to retirees by current taxpayers had increased substantially over time as a share of GNP. He thought that the critical question is, What is the expected present discounted value of the benefits that current retirees will receive from both Social Security and Medicare, as compared to the present discounted value of their contributions to those programs? Although Penner discussed the Social Security replacement rate for those currently retired, he did not compare the benefits from these programs to the benefits that those same contributions would have purchased in a private pension or health insurance plan.

Penner thought that most people retiring in the early twenty-first century will earn roughly a market rate of return on their and their employers' contributions to Social Security. In contrast, the real return for all people retiring before the late 1980s is highly positive. Penner then returned to the replacement rate concept to capture the income redistribution element of Social Security. A retiree with average lifetime earnings faces a 42 percent replacement rate today, while someone who earned the Social Security maximum throughout his or her life faces roughly a 25 percent replacement rate, and someone who always earned the minimum wage faces a 57 percent rate.

Feldstein returned to the rationale for the 1983 Social Security agreement. He asked to what extent the agreement had been viewed as a way of reducing the budget deficit by increasing revenue through the Social Security system rather than through an explicit increase in general taxes. Also, to what extent had it been seen as a way of balancing benefits and taxes over the seventy-five years of the actuaries' projections? And to what extent had it been viewed as a way to avoid big future tax increases because of a concern that future generations of workers would not agree to those tax increases?

Stockman said that the Greenspan Commission had been driven by two numbers. One was the short-run solvency target, which had been $167 billion from 1983 to 1990. The 1983 reforms dealt with this problem by accelerating taxes that were scheduled to take effect later anyway. Thus, the planned 1986 tax increase was moved to 1985, the 1990 increase to 1989, and there was a six-month delay in the cost-of-living adjustment. The other important number was the seventy-five-year projection of the trust fund balance, which estimated that benefits would exceed taxes by 1.9 percent of payroll. Stockman said that people had not viewed the 1983 reforms as changing the Social Security system from a pay-as-you-go basis to a fully funded plan with an accumulation of capital.

Charles Schultze pointed out, however, that Poterba's paper quotes Tip O'Neill as saying that the reforms *had* fundamentally changed the way that the system works. Schultze also explained two aspects of the Social Security benefit rules that had greatly distorted the system by 1983. First, the old measure of the CPI had overstated inflation by roughly 10 percent between 1971 and 1981. This overstatement led to permanently higher benefits for everyone who was retired at the time, although, as those people pass away, this issue will disappear. Second, and more systematically, the indexing formula for benefits guarantees the elderly an absolute standard of living after they retire. Thus, the elderly are unaffected by supply shocks that hurt the rest of the population. By 1982, this indexing formula may have benefits by roughly 4 percent above the level based on more reasonable indexing.

Geoffrey Carliner commented that the discussion had proceeded as if the elderly were a special interest group, like farmers or the oil and gas industry, who had been able to win a generous support program from the government. But, during this period of Social Security expansion, there had been huge decreases in poverty among the aged and widespread public support for the program. Carliner suggested that Social Security should be viewed not as a success story for a special interest group but rather as a program that is understood and liked by most people.

Penner agreed that there is enormously strong and widespread support for Social Security. The public choice theory of special interest groups is based on the idea of concentrated benefits and diffused costs, where some small group receives a benefit whose cost is diffused throughout society and is so small that no one objects. The elderly do not fit this definition of a special interest because they are a large group and the cost of Social Security is very apparent in everyone's paycheck. Further, when one talks about reducing Social Security benefits, most of the complaints come not from the elderly but from their children, who are concerned that, if the government pays less, they will have to pay more. And, when one suggests increasing the eligibility age for Medicaid along with the normal retirement age under Social Security, the complaints come from corporate benefit officers, who realize that they would have to pay more in medical benefits.

Penner argued, however, that some of the support for these programs is based on a misperception. A recent *Los Angeles Times* poll showed that a vast majority of the public thinks of the elderly as one of the country's neediest groups. But, when one looks at the income of the elderly and adjusts for household size, it is clear that their income has grown faster than everyone else's and has reached a higher average level. What this average obscures is that the young elderly are generally better off, and one can still find horror stories among the very old. So, when people think of the elderly, they tend to think of the very poor, although they are no more representative of the elderly than are the retired people playing golf in Palm Beach.

Stockman said that, before any taxes or transfers are counted, 53 percent of the elderly have incomes below the poverty level. But, including taxes, cash transfers like Social Security, and in-kind transfers, only 4 percent of the elderly live below the poverty line. So the combined effect of all government policies toward the aged is to take a population that is 50 percent poor and make it 4 percent poor. This role for the government is now built into the fabric of U.S. society, so the aged are not a special interest group, and these policies will never be fundamentally changed.

Feldstein responded that people's private income during retirement is not independent of the fact that they can count on Social Security. *Stockman* emphasized that one cannot go back to 1935 and restart the world by telling everybody to do more private saving.

David Wise asked about the political power of the elderly. Did the expansion of Social Security in the 1970s arise from that political power, or did it result from the peace dividend as the Vietnam War was ending? It was Wise's impression that the Social Security expansion was essentially unrelated to the increasing portion of the population that was old or to the lobbying of the American Association of Retired Persons (AARP).

Penner admitted that payroll taxes had been increased to match the increase in benefits at the same time that the end of the Vietnam surtax was reducing income taxes. He was uncertain whether that huge increase in benefits and payroll taxes would have been possible without the peace dividend and accompanying income tax cut.

More generally, he believed that the elderly are extremely powerful politically but that it would be impossible for them to capture such a large share of GNP without the strong support of most of the rest of the population. Polls suggest that even the youngest workers strongly support Social Security, even though some of them do not believe that the program will exist when they retire.

Feldstein added that, when he had gone to Washington as chairman of the Council of Economic Advisers, he had thought that he had arrived in Washington at *the* moment when Social Security benefits were likely to be cut. But, even when the Greenspan Commission was searching for ways to return the system to solvency, there were no votes for significant reductions in benefits.

Wise said that it was natural that taking benefits away would be very hard, but he was still curious about the politics surrounding the increases in benefits in the 1970s.

Stockman said that the political power of the elderly and of the AARP had developed in the 1980s out of a fear of Social Security benefit reductions. He did not think that the elderly had played a large role in the earlier expansion of Social Security; rather, he believed that the expansion of the program (and its design more generally) had been the work of an unusually small priesthood of technicians. Prior to 1970, the Social Security actuaries had not included inflation in their work because people did not believe that inflation was a permanent part of the system. When inflation was first included in the seventy-five-year projections in the 1970s, the priesthood had made a number of decisions about bend points, indexing, and so on. One decision was to tie future benefits to the total growth of the economy, in the form of wage indexing of the bend points. When this rule became part of the expectations of the elderly population (with one correction of the technical error that caused double indexing in 1977), the elderly lobby was able to prevent the rule from being changed. But the elderly did not push the expansion through; the priesthood did.

Charls Walker turned to the role of commissions in resolving difficult public policy problems. He believed that the success of the Greenspan Commission showed that well-constructed commissions are sometimes able to deal with issues that weak congressional leadership cannot. He argued that the inability of the National Economic Commission to resolve the budget deficit problem was due not to an inherent failing of commissions but instead to particular circumstances at the time. When the tax issue arose during the presidential campaign, George Bush should have said that Congress had chosen a distinguished group of Americans to devise a solution and that he would listen to what they proposed before making up his mind. But when Bush said to "read his lips," he had committed himself to a course of action that precluded acceptance of the commission's ideas.

Feldstein returned to a central theme of the conference, namely, the role of economic analysis in the making of economic policy. He argued that economic analysis had played almost no role in the macroeconomic aspects of Social Security reform—determining the appropriate buildup of the trust fund—except in the almost trivial sense of having enough money in the fund to pay the future bills. But on the microeconomic aspects of reform—the retirement test on earnings and the delay in the retirement age—the economic analysis about the extent to which Social Security distorts retirement decisions had apparently gotten through to policymakers, and the reforms embodied the kinds of changes for which economists had been pressing.

Penner believed that the 1983 reforms that increased the reward for working beyond the normal retirement age had been motivated by a strong sense of fairness as well as by the economic analysis of possible distortions to people's retirement decisions. Penner found it hard to believe that the retirement test actually is very important to work effort because there is a strong trend toward early retirement anyway. He suspected, however, that many of the elderly who work do not report that fact to the government.

Feldstein said that, when all the approved changes are fully phased in, they will eliminate any differential in the present value of benefits based on whether one retires early, at the regular age, or late. *Wise* added that, given the elimination of this differential, the major effect of the reforms on labor force participation would come from changing the early retirement age, not from changing the normal retirement age.

Paul Joskow raised the issue of Medicare. The introduction of diagnostic related groups (DRGs) in 1983 seemed to be a good example of the use of economic analysis in policy-making. The idea had come from people who studied regulation, and it had been designed to promote fundamental changes in the health care system. The effects had not been as large as people would like, and they may not be as long lasting, but, as a consequence of the government buying medical care in a different and more sensible way, even private insurers have changed their approach to reimbursing health care providers. Joskow asked Penner whether policymakers at the time had perceived the introduction of DRGs as a significant event in terms of health care provisions and financing or whether it had been viewed as just a way of balancing the books?

Penner responded that this had been a clear case of a policy analyst's dream coming true. Even the strongest advocates of this reform, however, were very concerned that the system might find some way around the new rules, and that has yet to be proved one way or the other. But he had found the first reports of the effectiveness of the reform very encouraging because it appeared that a lot of money had been saved without significantly lowering the quality of patient care.