# REFORM PROPOSAL OF COMMISSIONER PETER G. PETERSON

## REFORMING ENTITLEMENTS AND TAX EXPENDITURES

## TABLE OF CONTENTS

I. Executive Summary ....39
A. Principles of Reform ....40
B. A Ten-Point Reform Plan ....41
C. Long-Term Budget Savings ....43
II. Principles of Reform ....44
III. A Ten-Point Reform Plan ....50

## I. EXECUTIVE SUMMARY



This memo summarizes policy options that the Commission should consider in designing its entitlements reform plan.

In addition to an Executive Summary, it contains two parts. The first presents a set of principles that *any* plan the Commission adopts must live up to if it is to be equitable, fiscally responsible, and politically viable. The second outlines a package of 10 entitlement reform proposals which, if enacted in its entirety, would balance the budget by the year 2000. The specific reforms in this plan include both reductions in direct benefit outlays and reductions in tax expenditures. (Both of these are considered "entitlements" in this proposal.[1]) They cover the entire range of Federal benefits, including health benefits — an area the Commission cannot shy away from if it is to be taken seriously.

The reform package presented here is not necessarily a complete plan for a budget that addresses the future needs of America. A complete plan would doubtless include some savings in discretionary spending. It might provide for increases in public investment as well as targeted expansions in means-tested entitlements. To pay for new investment spending, or to substitute for some entitlement cuts, a complete plan might also include explicit measures to raise new revenues — *i.e.*, entirely new types of taxation or *higher rates* on old taxes. This plan includes no new spending. And, while it does raise new revenues by cutting "tax expenditure" loopholes (such as the tax exclusion for many government benefits), it does not propose new types of taxation or higher tax rates.

1 When the Treasury collects less revenue than it otherwise would because the tax code accords certain types of income preferential treatment, the revenue loss is called a "tax expenditure." Tax expenditures include such well-known loopholes in the tax code as the home mortgage interest deduction and the tax exclusion for employer-paid health care. The preferential tax treatment of Social Security and Medicare benefits is also a tax expenditure. Proposals to cut tax expenditures are often characterized as tax hikes. Fiscally and economically, however, these benefit-like loopholes are the equivalent of a government check in the mail. Particularly when their effect is to subsidize consumption, most economists consider them to be benefits.

Naturally, the issue of new taxes is not the same as the issue of tax reform. New revenues aside, the Commission might recommend shifting from our current income tax system toward a system of progressive consumption taxes as a way of tilting incentives in favor of more savings. However, since this memo only covers the entitlement reform portion of the Commission's mandate, it does not address this issue.

### A. Principles of Reform

1. ***Any reform plan must balance the budget and keep it balanced.*** From Alan Greenspan to Robert Reischauer, prestigious witnesses before the Commission have testified that balancing the budget is the only sure way to boost net national savings and improve the outlook for U.S. living standards. In its Interim Report, the Commission concluded that without far-reaching reform, the rapid growth in entitlement spending will lead to ever-widening deficits beginning in the late 1990s. This plan would dramatically slow that growth — balancing the budget by the year 2000 and keeping it at or near balance thereafter (or at least an average balance over each business cycle thereafter) until around the year 2020.



2. ***Any reform plan must ask for across-the-board sacrifice.*** Across-the-board sacrifice is fair. It is fiscally necessary. And, it is a political imperative. Under this plan, no group of Federal beneficiaries need fear that their own modest sacrifice will simply allow another group to gain a bigger windfall. From Social Security and Medicare beneficiaries to Federal pensioners, veterans, and farmers, all who are able are called on to make a fair-share contribution.

3. ***Any reform plan must ask for progressive sacrifice.*** Progressivity should be a bedrock principle of our entitlement system no less than of our tax system. This plan asks for the greatest contributions from those beneficiaries who are most able to sacrifice. Its centerpiece — a comprehensive "affluence test" — would affect no household with an income beneath the U.S. median, but would ask for steeply progressive sacrifices above the median.

4. ***Any reform plan must respect the principle of generational equity.*** In the past, entitlement reform has almost always rewarded the earlier-born at the direct expense of the later-born. But the days when we could finance entitlement windfalls to ourselves by shifting the costs to a more numerous and affluent rising generation are long gone. Along with the sacrifices it asks of tomorrow's entitlement beneficiaries, this plan calls for fair-share contributions from today's well-to-do middle-aged and elderly.

5. ***Any reform plan must recognize the realities of an aging society.*** The coming aging of our population is perhaps the greatest social and economic transformation that the United States has ever faced. This plan recognizes the new realities of longer lifespans and health spans by raising retirement ages and trimming today's public pension excess.

6. ***Any reform plan must respect the principle of gradualism.*** The Commission must resist the temptation to use the principle of gradualism as cover for still more buck-passing. Yet if reforms are phased in too quickly, it could trigger an economic recession — not to mention a political firestorm. This plan would phase in most reforms over five years; in the one case (retirement age) where reform would substantially affect the long-term plans of nonaffluent beneficiaries, the phase-in period would be longer.

7. ***Any reform plan must focus on long-term structural savings.*** The greatest potential for long-term entitlement savings lies in structural reforms that adjust the generosity of retirement benefits or that slow the growth in per capita health care costs. Because this plan focuses on such structural reforms, it locks in budget savings that will compound as America ages in the next century. By the year 2000, this plan would be saving $209 billion (2.3 percent of GDP) in annual entitlement expenditures — a figure that will grow to $915 billion (4.4 percent of GDP) annually by 2020 and to $2.45 trillion (5.4 percent of GDP) by 2040.[2]

8. ***Any reform plan must always remember the bottom line.*** What matters is not the long-term "actuarial balance" of individual Federal trust funds, but the *annual consolidated Federal deficit* and its impact on national savings. Only by keeping its eye on this bottom line and balancing the budget can the Commission guarantee that vital entitlement programs like Social Security and Medicare will remain solvent in the next century. That is precisely what this plan would do.



### B. A Ten-Point Reform Plan

1. ***Enact a comprehensive "affluence test."*** *Phase-in: 1995 to 2000. Savings in 2000: $70 billion. Savings in 2020: $215 billion. Savings in 2040: $565 billion.* A central challenge for any entitlement reform plan is how to achieve large fiscal savings without hurting lower-income Americans. This plan's answer is to institute a comprehensive "affluence test" that would selectively scale back benefit payments to most households with above-median incomes. The test would include all Federal benefits: not just Social Security and Medicare, but everything from farm aid to Federal pensions. Under the affluence test, households with incomes under $40,000 would not lose a penny in benefits. Higher-income households would lose 10 percent of all benefits that cause their incomes to exceed $40,000, plus 10 percent for each additional $10,000 in income. For most types of benefits, the maximum benefit reduction rate would be set at 85 percent, applicable to household incomes over $120,000. All income brackets would be adjusted upward each year to take inflation into account.

2. ***Accelerate the rise in the Social Security retirement age.*** *Phase-in: 1995 to 2014. Savings in 2000: $16 billion. Savings in 2020: $85 billion. Savings in 2040: $205 billion.* The currently scheduled rise in the

2 All savings figures in this memo for the year 2000 are calculated against the January 1994 Congressional Budget Office baseline projection of entitlement spending. Savings figures for 2020 and 2040 are preliminary estimates based on a model linking the CBO projection with the official "intermediate" long-term cost scenario published by the Social Security and Health Care Financing Administrations.

Social Security retirement age to 67 between 2000 and 2022 is an appropriate step toward realigning our entitlement system with the needs of an aging society. But it is a step too small and too slow. This plan stipulates that the rise in the Social Security retirement age begin in 1995 and proceed by 3 months a year until a new retirement age of 70 is reached by 2014. Eligibility for early retirement would increase in tandem so that today's "reduced" benefits at 62 will eventually become available at 67.

3. ***Trim the Federal pension benefit package.*** *Phase-in: 1995 to 2000. Savings in 2000: $4 billion. Savings in 2020: $10 billion. Savings in 2040: $25 billion.* For decades, Federal employee lobbies have asked for "pay comparability" with the private sector, but they have always avoided talk of pension comparability. The reason is simple. Federal pensions are more generous than all but the most lavish private sector plans. This plan would help remedy that inconsistency by adopting a set of modest changes in Federal pension benefit formulas and cost-of-living adjustments outlined by the Congressional Budget Office. It would also subject Federal pensioners to an affluence test under which upper-income retirees would lose up to 25 percent of their total benefits. (See Reform 1.)



4. ***Limit the tax exclusion for employer-paid health care.*** *Phase-in: 1995 to 2000. Savings in 2000: $40 billion. Savings in 2020: $105 billion. Savings in 2040: $230 billion.* No responsible entitlement reform plan can afford to sidestep the task of controlling health care costs. A sensible place to begin is by capping the current open-ended tax exclusion for employer-paid health insurance. Such a cap will not only raise new Federal revenue, but, by creating incentives for employees to enroll in cost-effective plans, would also cut excess demand for health care. This plan would limit the exclusion to $410 per month for family coverage and to $170 per month for individual coverage — about the current average cost of insurance.

5. ***Raise Medicare premiums and coinsurance.*** *Phase-in: 1995 to 2000. Savings in 2000: $24 billion. Savings in 2020: $105 billion. Savings in 2040: $300 billion.* Increasing cost-consciousness among recipients of direct Federal health benefits is also crucial to controlling health care costs. To this end, this plan would raise Medicare's annual SMI deductible from $100 to $150 and increase Supplemental Medical Insurance (SMI) copayments from 20 percent to 25 percent. It would also raise the SMI premium so that it covers 30 percent of the program's costs.

6. ***Enact a Federal health benefits budget.*** *Phase-in: 1995 to 2002. Savings in 2000: $20 billion. Savings in 2020: $280 billion. Savings in 2040: $810 billion.* To ensure that it meets its savings target, this plan includes a further health care reform: As in most other industrial countries, Congress would establish an overall prospective budget for Federal health care spending that specifies annual limits (and concrete means of staying within those limits) for each benefit program. The goal of this benefits budget would be to ratchet down the rate of growth in Federal health care costs a modest one-quarter of one percentage point a year.

7. ***Expand the taxation of Federal benefits.*** *Phase-in: 1995 to 2000. Savings in 2000: $19 billion. Savings in 2020: $60 billion. Savings in 2040: $155 billion.* There is no rationale for the huge tax favors bestowed

on Federal beneficiaries. This plan would bring the tax treatment of Federal benefits more into line with that of other types of income by making 85 percent of all Social Security benefits taxable. It would also tax 25 percent of the insurance value of Medicare and extend blanket taxation to several smaller entitlement programs. An equitable and progressive tax code is a "means test" from which no citizen should be exempted.

8. ***Limit the home mortgage tax deduction.*** *Phase-in: 1995 to 2000. Savings in 2000: $6 billion. Savings in 2020: $30 billion. Savings in 2040: $105 billion.* Along with equalizing the tax treatment of Federal benefits and other income, the Commission should cut back on other costly and regressive tax entitlements. In addition to the exclusion for employer-paid health care, the home mortgage interest deduction is a prime candidate for reform. This plan would cap the deduction at $12,000 for an individual, $20,000 for a joint-filing couple, and $10,000 for separately filing couples.

9. ***Reduce farm aid.*** *Phase-in: 1995 to 2000. Savings in 2000: $5 billion. Savings in 2020: $10 billion. Savings in 2040: $20 billion.* The sums of money involved in farm aid may be small in terms of the overall budget. But the Commission can't possibly leave farm aid priorities unexamined while asking Americans to make sacrifices everywhere else. In accordance with the principle of across-the-board sacrifice, this plan would trim the cost of Federal commodity price support programs by lowering their grain "target prices" by 3 percent per year for five years.

10. ***Increase user fees.*** *Phase-in: various dates. Savings in 2000: $6 billion. Savings in 2020: $15 billion. Savings in 2040: $30 billion.* Besides farm aid, there are many other smaller entitlement programs which do not come under the major categories of retirement and health care. This plan would also trim another special type of benefit spending: the myriad miscellaneous subsidies that the Federal government now passes out to favored regions, businesses, or consumer groups by providing them services whose costs are mostly underwritten by the general taxpayer.



### C. Long-Term Budget Savings

Taken as a whole, this 10-point entitlement reform plan is consistent with the principles outlined above. Most importantly, it follows through on the first reform principle by balancing the Federal budget and then keeping it at or near balance throughout the next 25 years.

If the entire reform package were phased in beginning in 1995, by the year 2000 it would yield *annual* entitlement savings of $209 billion. Together with net interest savings, the total budget savings in 2000 would come to $246 billion. By the year 2004, the reform package would produce $344 billion in *annual* entitlement savings. Together with net interest savings, the total budget savings would come to $459 billion. As noted above, all of these savings figures were calculated against the January 1994 CBO baseline. Even against the more pessimistic August baseline, the reform package would put the budget at or near balance by the year 2000.

Farther into the future, the savings generated by this plan would be even more dramatic. The reason is that it focuses on structural reforms that will lock in compounding entitlement savings as America ages. By 2020, the plan would be saving $915 billion (4.4 percent of GDP) in annual entitlement expenditures; by 2040, it would be saving $2.45 trillion (5.4 percent of GDP) in annual entitlement expenditures. In the year 2000, reductions in direct benefit spending constitutes 70 percent of the total savings (the rest comes from reductions in tax expenditures). By the years 2020 and 2040, the direct benefit spending share rises to roughly 80 percent. The following table summarizes total savings.

**TOTAL ENTITLEMENT SAVINGS**

| | 2000 | 2020 | 2040 |
|---|---|---|---|
| Billions of Dollars | $209 | $915 | $2,445 |
| Billions of 1994 Dollars | $162 | $420 | $670 |
| Percent of GDP | 2.3% | 4.4% | 5.4% |



There are only two alternatives to enacting a package of structural entitlement reforms that saves sums of at least this magnitude: economy-shattering deficits or prohibitive tax hikes. To pay for the currently projected growth in direct benefit spending with new taxes would require a Clinton-scale tax hike roughly every four years over the next half-century. By 2020, Congress would have to raise 5.4 percent of GDP in new revenues; by 2040, it would have to raise a further 3.8 percent of GDP. That's an increase of 9.2 percent of GDP in the Federal tax burden — more than the entire individual income tax burden in 1994 (8.3 percent of GDP).

It follows from these numbers that the impressive savings of the reforms proposed here are by no means budgetary overkill. Even with these reforms in place, direct benefit spending would continue to grow faster than GDP — and faster than total savings. This is especially true after 2020. Thus, the magnitude of savings achieved by these proposals must be regarded as a minimal goal for the Commission.

## II. PRINCIPLES OF REFORM

Whatever its details turn out to be, *any* plan of entitlement reform the Commission adopts must live up to certain underlying principles if it is to be equitable, fiscally responsible, and politically viable. This section of the memo discusses those principles. The next section outlines a 10-point plan that balances the budget by the year 2000.

1. ***Any reform plan must balance the budget and keep it balanced.*** The Commission's Interim Report leaves no doubt about why controlling the growth in Federal entitlements is essential. Unless we control entitlement expenditures, they will continue to swell the deficit and crowd investible savings out of private capital markets — slowing the growth in productivity and U.S. living standards. Unless we

control entitlement expenditures, they will continue to crowd discretionary spending out of the Federal budget — depriving us of the means to make vital public investments in infrastructure, R&D, and the health and skills of our workforce. Unless we control entitlement expenditures, we will face a no-win choice between widening deficits and unsustainable payroll tax hikes. The Commission's agenda is now to solve the problem it has described — not to make a token "down payment" on reform, then pass the buck to future Congresses. We can no longer afford more denial, delay, and diversion.

It's hard to see what "solving the problem" might mean if not balancing the budget, within some reasonable timeframe (say, by the year 2000), and keeping it balanced thereafter (or at least an average balance over each business cycle thereafter). Most economists agree that if America is to once again enjoy sustained living standard growth, it must double or triple its rates of net savings and investment. Given the current anemic rate of private savings in the United States (and the uncertain outcome of policies aimed at raising it), balancing the budget is the only sure way to raise net national savings to rates approaching those of other major industrial countries.



Any plan the Commission adopts must thus meet a balanced-budget litmus test. Moreover, any plan should spell out exactly how that goal is to be achieved. The entitlement cuts that the Commission proposes must be specific. (Overall "caps" are only useful if backed up by programmatic reforms that tell us how they will be met.) If the Commission cannot agree on sufficient entitlement cuts to balance the budget, then it must specify exactly where the remaining savings will come from. Whose taxes will be raised — and by how much? What other programs will be cut?

2. ***Any reform plan must ask for across-the-board sacrifice.*** Across-the-board sacrifice is fair. It is fiscally necessary. And it is a political imperative. Only by asking all groups of beneficiaries to make a meaningful contribution can the Commission get the numbers to add up. Only by guaranteeing that the sacrifice it calls for is broadly shared can it hope to diffuse the opposition of the benefit lobbies. In short, if the Commission is to be successful, no set of programs or special interests can be singled out. But by the same token, none can be spared.

   The Commission (for example) needs to be able to say to the public and the lobbies: Yes, well-to-do seniors get their Social Security and Medicare taxed. But well-to-do, working-age families get their mortgage and health insurance favors cut back. Yes, private sector retirees face higher Social Security retirement ages. But civil service and military retirees get a "diet COLA" instead of 100 percent of CPI indexing, and high-income veterans give up a portion of their benefits. Yes, farmers will have their subsidies trimmed. But everyone from corporate jet owners to pleasure boaters pays higher user fees for Federal services that are now largely "free." The simple truth is that Americans need to know that "we're all in it together" or they won't sign onto the Commission's program — whatever its specifics turn out to be.

In calling for across-the-board sacrifice, the Commission most definitely should include consumption-oriented tax expenditures for things like housing and health care. These back-door benefits are the fiscal equivalent of a government check in the mail. They now cost the Federal budget at least $200 billion annually in foregone revenues. They are regressive. And in many cases they encourage a serious misallocation of economic resources. On these grounds alone, tax expenditures should be on the table. But there is another reason as well. The elderly are disproportionate recipients of direct Federal benefits, whereas several of our largest tax entitlements primarily benefit nonretired Americans. If the Commission excludes tax benefits from its purview, it would be difficult to argue it has asked for a fair-share sacrifice from all age groups.

Federal pensions are another area where the Commission must be especially careful to avoid charges that it has favored one interest group at the expense of others. If the Commission, at least 20 of whose members will one day be eligible for lavish congressional pensions, is perceived as reluctant to ask for sacrifice close to home, it will lose the moral authority to ask the rest of America to sacrifice.



3. ***Any reform plan must ask for progressive sacrifice.*** Our entitlement system — no less than our tax system — should embody the principle of progressivity. Yet when we look at today's entitlement system what we see is a far cry from FDR's original vision of a "floor of protection" against destitution. It dispenses most benefits without regard to need. (Three-quarters flow through programs that are not means tested.) Although it helps the poor, it does so mostly by dint of the vast sums spent; along the way, it is as likely to shower windfalls on the affluent as on the needy. In fact, in 1991 $270 billion in Federal entitlement outlays went to households with above-median incomes; including tax expenditures, the figure was about $370 billion.

It is imperative that the Commission ask for the greatest sacrifice where Federal largess is least deserved — and where the sacrifice will be least burdensome. The cuts in tax expenditures outlined in this memo — from the caps on the home mortgage interest deduction and the employer health care exclusion to the increases in taxability of Social Security and Medicare — are all progressive. So too is the plan's centerpiece: the comprehensive "affluence test."

Ideally, a balanced reform plan would redirect a portion of its entitlement savings toward strengthening our means-tested safety net. Reinforcing the "floor of protection" function of entitlements — while curbing welfare for the well-off — is sound social policy. It would also put the Commission on the moral high ground vis-a-vis the senior lobby. Consider: A targeted redistribution of just one-fifth of all unearned Social Security benefits going to households with above-median incomes would bring elderly poverty down to zero. If "counterbalancing" entitlement expansions are on the table as part of the Commission's overall reform package, two in particular merit careful consideration: higher SSI benefit levels for the poor elderly and disabled; and minimal health insurance subsidies for low-income working Americans who now lack coverage.

4. ***Any reform plan must respect the principle of generational equity.*** Our current entitlement system is based on a huge generational injustice. On average, today's retired Americans will receive windfalls that far exceed the value of their prior contributions. On average, Baby Boomers will be lucky to break even — and even that will only be possible by condemning still younger generations to unthinkable tax hikes. By 2040, according to the official projections, the cost of Social Security and Medicare alone will consume 36 percent of each worker's taxable payroll.

   Given this cascading pattern of generational inequity, it seems obvious that those Americans who are older (and able) must play a substantial role in resolving our entitlements crisis. Yet to date, the burden of entitlements reform has always fallen on younger generations. Consider, for instance, the 1983 Social Security Act — often cited as an example of farsighted policymaking. Over three-quarters of the benefit cuts and tax hikes that it provides for will be borne by workers retiring after the year 2000.

   Little seems to have changed since 1983. As evidence, take a look at the generational impact of the Rostenkowski bill. Leaving aside the provision to cover newly hired State and local employees (where the generational impact is unclear), an incredible 98.6 percent of its tax and benefit changes (the benefit formula reduction, the acceleration in the scheduled rise in the retirement age, and the payroll tax hikes) would fall exclusively on those who will retire in the next century;[3] of this, nearly two-thirds (the payroll tax hikes) would fall entirely on taxable labor income that is earned after the year 2020. Just 0.5 percent of the burden will be borne exclusively by current retirees (the one time diet COLA); 0.9 percent will be shared by current and future retirees (the lower benefit taxation thresholds).

   Any approach to entitlement reform that so favors the old over the young is unconscionable. This is especially true since, on average, today's older Americans are so much better off financially than the young either are now or (if we leave current Federal policies on autopilot) can reasonably hope to be. The days when we could finance entitlement windfalls to ourselves by shifting the costs to a more numerous and affluent rising generation are long gone.

5. ***Any reform plan must recognize the realities of an aging society.*** When America's "age wave" finally hits in earnest around the year 2010, practically every public cost associated with retirement will start shooting upward, much faster than such costs are rising today. Long before the retirement of the Baby Boom, Americans must begin to revise outdated expectations about retirement that have become unaffordable in an era of rising lifespans and health spans and slow labor force growth. Instead of trying to retire ever earlier, with ever less financial preparation, we must develop a more responsible (and possibly more rewarding) ideal: the later retirement, the fuller savings account, the better use of maturity and experience in the workplace.



3 The percentage shares tabulated in this paragraph are measured in terms of the change in Social Security's 75-year actuarial balance expressed as a share of taxable payroll; they do not refer to nominal dollars.

Unfortunately, today's entitlement policies send the wrong signals. Early Social Security retirement ages encourage seniors to spend the last third of their adult lives in unproductive leisure. Retirement ages must be raised. Instead of proving themselves to be "model employers" by heaping outsized pensions on their employees, government agencies should demonstrate their civic leadership by trimming back today's public pension excess. At the same time, we ought to get rid of policies such as the Social Security "earnings test" that deter older Americans from working. Such reforms — and the behavioral changes they foster — will serve us well in a future of unremitting demographic pressure. The Commission's job is not just to cut entitlements, but to restructure them so they better meet the needs of the next century's economy and society.

6. ***Any reform plan must respect the principle of gradualism.*** How one defines "gradualism," of course, is largely a matter of judgement. On the one hand, if the Commission phases in reforms too quickly, it could cause wrenching adjustments in individual incomes and expectations — and trigger an economic recession. It could also precipitate a political firestorm. In this regard, the fate of the 1981 (Schweiker) Social Security reform plan is instructive. In principle, there was nothing especially outrageous about its provisions, including the much-criticized 25 percent cut in early retirement benefits. The problem was that, in what has been called "a masterpiece of bad timing," the cuts were to become fully effective immediately. After the Schweiker plan was announced, Washington was inundated by irate letters and phone calls. It did not receive a single affirmative vote on the Senate floor.



On the other hand, the Commission must resist the temptation to use the principle of gradualism as cover for still more buck-passing. Consider this cautionary example. Back in 1983, the Greenspan Commission recommended and Congress passed a two-year hike in the Social Security full-benefit retirement age. The reform, however, has yet to save the budget a dime. The reason is that the phase-in is not scheduled to begin until the year 2000 — and will not be completed until 2022. No one needs half a lifetime to prepare for such a modest delay in retirement; as Congressman Jake Pickle observed at the time, the only justification for choosing the distant date was that few Americans who were then old enough to vote would be affected.

So what is the right balance? A five-year phase-in would be adequate for most reforms the Commission is likely to consider — particularly those (such as an affluence test) that would only affect well-to-do beneficiaries. In those cases (such as age of retirement) where reform would substantially affect the long-term plans of nonaffluent beneficiaries, the phase-in period might be somewhat longer.

7. ***Any reform plan must focus on long-term structural savings.*** There are two driving forces behind the projected explosion in entitlement costs early in the next century. The first and more fundamental force is the aging of America. By 2040, the rapid growth in the number of elderly beneficiaries relative to the size of the U.S. workforce is projected to push the cost of Social Security cash benefits to 17.4 percent of taxable payroll — an increase of 50 percent from today's cost rate. More elderly (as well as the rising average age of the elderly) will also mean an increase of at least 50 percent in the cost of Medicare and Medicaid relative to the size of the economy — even if per capita health care costs grow

no faster than GDP. The second force behind the coming entitlement explosion is the headlong growth in real (age-adjusted) per capita health benefit spending. This growth is largely due to the ongoing introduction of expensive new medical technologies and treatments. It is also greatly exacerbated by a cost-blind financing and delivery system that places an extraordinary emphasis on high technology and heroic intervention — and refuses to acknowledge meaningful cost-benefit trade-offs.

While it is essential that the Commission ask for across-the-board sacrifice from all groups of Federal beneficiaries, it is also obvious that the greatest potential for long-term savings lies in structural reforms that adjust the generosity of retirement benefits or that slow the growth in per capita health care costs. Consider: The total number of retired Federal beneficiaries is expected to at least double over the next 50 years while the number of frail elderly over age 85 (who consume twice as much health care as the young elderly) is expected to triple or quadruple. Any permanent percentage savings in retirement and health care benefits the Commission locks in will therefore grow substantially over time.

8. ***Any reform plan must always remember the bottom line.*** During the Commission's public hearings, any number of witnesses emphasized that Social Security is currently in "surplus" and is therefore "paying its own way." These same witnesses also stressed that the Commission's goal should be to restore Social Security to "long-term actuarial balance." Any program, however, contributes to the deficit insofar as spending more on it raises the deficit and spending less on it lowers the deficit. As for the goal of "actuarial balance," it is largely irrelevant to the Commission's task.



Using actuarial balance as a measure of solvency, the Commission could declare Social Security "financially sound" over the next 75 years by averaging its near-term surpluses with its long-term Trust Fund deficits. But the savings from the program's current cash surpluses (which each year are spent by Treasury) cannot be captured in order to cover its future deficits — which are now projected to reach $78 billion in 2015, $254 billion in 2020, and $504 billion in 2025. These staggering sums represent the amounts of annual savings we would have to find elsewhere in the budget just to keep the Federal deficit from growing.

As Federal Reserve Chairman Alan Greenspan testified before the Commission, it is the *annual consolidated Federal deficit* (not the long-term actuarial balance of any particular benefit program) that determines what Treasury must borrow — and hence the impact of our Federal balance sheet on national savings. In a word, the Commission must regard the annual consolidated deficit as the bottom line.

The Commission has also heard from the benefit lobbies that only those programs that are now growing as a share of the economy pose a problem. But this too is fiscal nonsense. The real problem is total expenditures — and (once again) the impact on our Federal balance sheet and on national savings. So long as some categories of benefit spending (chiefly health care) remain so resistant to cost control, it behooves us even more to economize wherever possible. The benefit lobbies love to segregate different entitlement programs into separate compartments. But borrowing for one purpose will bankrupt us just as surely as borrowing for another.

## III. A TEN-POINT REFORM PLAN

The specific proposals that follow include reforms in four major areas: tax code changes to equalize the treatment of Federal benefits and other types of income; a strategy for containing health care costs; a revision of retirement programs to take into account the rising life expectancies of Americans; and, most important, an affluence test to scale back benefits going to higher-income households. Although these proposals are intended to be complementary, each can be considered separately. All savings estimates are calculated relative to the January 1994 CBO baseline.

1. ***Enact a comprehensive "affluence test."*** *Phase-in: 1995 to 2000. Savings in 2000: $70 billion. Savings in 2020: $215 billion. Savings in 2040: $565 billion.* A central challenge for any entitlement reform plan is how to achieve large fiscal savings without hurting lower-income Americans. This plan's answer is to institute a comprehensive "affluence test" that would selectively scale back benefit payments to most U.S. households with above-median incomes.



How would it work? Although such a test amounts to a cut in benefits, it would be administered through the tax code. Each year, all taxpayers with incomes above the U.S. household median would be required to report all their estimated combined Federal benefits for the coming year. The relevant Federal agencies will then withhold some fraction of those benefits, based on each beneficiary's total household income. Reductions in benefits would of course be adjusted in the event people faced changed economic circumstances during the year or in subsequent years.

Households with incomes under $40,000 (nearly $10,000 above the median U.S. household income in 1994) would not lose a penny in benefits. Higher-income households would lose 10 percent of all benefits that cause their incomes to exceed $40,000, plus 10 percent for each additional $10,000 in income. (In this respect, the proposal is similar to The Concord Coalition's affluence test.) Thus, a household with $45,000 in total income and $10,000 in Federal benefits would lose 5 percent of its benefits — only $500. A household with $55,000 in income would lose 15 percent of its benefits: $1,500. And a household with $95,000 in income would lose 55 percent of its benefits: $5,500. For most types of benefits, the maximum benefit reduction rate would be set at 85 percent, applicable to incomes over $120,000.[4] Needless to say, all income brackets would be adjusted upward each year to take inflation into account.

The affluence test has clear advantages over other approaches to achieving across-the-board entitlement reductions. We might, for instance, scale back subsidies for the relatively well-off by rewriting

4 The 15 percent share of benefits not subject to withholding ensures that even today's most affluent beneficiaries enjoy a 3.5 percent tax-free return on their personal Social Security FICA contributions. This preserves the universal character of a program that in some sense has come to represent a defining link between citizen and state. For Federal pensions, the maximum withholding rate is set at 25 percent. This different treatment recognizes that pensions are in part deferred compensation to which beneficiaries have at least some quasi-contractual claim.

the benefit formulas and eligibility criteria of Social Security and every other entitlement program. But that would require amending every Federal benefit statute — a process that would have to snake its way through dozens of congressional committees and would be endangered at every turn by lobbies bent on ensuring that their constituency is not the only one singled out for sacrifice. Or we could use benefit-related cuts in COLAs in order to reduce welfare for the well-off. But such an approach cannot distinguish between the retired civil servant with two pensions and a minimum Social Security benefit and a retired widow living alone who subsists entirely on a bigger-than-average Social Security check.

The affluence test overcomes these obstacles. It would include all Federal benefits: not just Social Security and Medicare, but everything from farm aid to Federal pensions. The test would thus ensure that everyone who is able makes a fair contribution. No single group, most obviously the elderly, need fear bearing an unfair burden. The affluence test, moreover, always takes into account a household's total current income, not just the size of its Federal benefit checks. It therefore cannot inadvertently hurt households below the national median. As for higher-earning households, the progressive sacrifices it calls for are always based on beneficiaries' true financial circumstances.



Over the last year, the affluence test idea has been met with varying reactions — most favorable, some critical. One criticism is that the test would violate the "earned right" principle of programs like Social Security. But this makes little sense. How does an affluence test differ, in principle, from progressive benefit taxation — a reform that many of these same critics strongly favor? And still more to the point, how does an affluence test differ, in principle, from a progressive benefit formula — a feature of Social Security that these same critics declare to be one of the program's great virtues? After all, both the affluence test and a progressive benefit formula are explicit departures from individual equity in order to ensure what Social Security's early administrators liked to call "social adequacy." The major difference between them is simply this: An affluence test would allow us to target benefit dollars much more efficiently toward those who need them most.

It has also been said that an affluence test would constitute a "tax" on savings, and would thus discourage thrift. But the economic logic of this claim is not very persuasive. The net savings impact, plus or minus, of such a "tax" is theoretically ambiguous — and in any event would be small. More importantly, this line of criticism seems out of touch with the larger issue — which is how to increase net national savings. Any decline in private savings due to an affluence test would be dwarfed by the decline in benefit outlays — which in turn would translate dollar for dollar into smaller deficits and higher national savings.

A final criticism is that an affluence test would undermine "public support" for Social Security and other universal social insurance programs. The critics are dead wrong. When pollsters this summer asked Americans "whether you favor or oppose" an affluence test (after explaining how this test "would gradually reduce benefits to well-off households and eliminate nearly all benefits going to very high income households"), fully 62 percent favored the idea.

Those who want to preserve the status quo will apparently use any argument to justify their case. The Commission cannot allow them to succeed. The affluence test is a reform of primary importance. It will help reinfuse a sense of public purpose into a system of social welfare that now sorely lacks it. And it will generate vast budget savings — 0.8 percent of GDP by the year 2000, a sum that will grow to 1.0 percent of GDP annually by 2020 and 1.3 percent of GDP annually by 2040.

2. ***Accelerate the rise in the Social Security retirement age.*** *Phase-in: 1995 to 2014. Savings in 2000: $16 billion. Savings in 2020: $85 billion. Savings in 2040: $205 billion.*[5] Along with scaling back benefits to upper-income households, we should be preparing our entitlement system for the inevitable aging of our population. The place to start is by raising the Social Security retirement age. Although the Greenspan Commission took a useful step in this direction, it was a step too small and too slow. By 2022, when the new retirement age of 67 scheduled in current law will be fully phased in, life expectancy at 65 will not be 2, but at least 6 years longer than when Social Security was founded. Accordingly, this proposal takes a further step toward realigning our entitlement system with the needs of an aging society. It stipulates that the rise in the Social Security retirement age begin in 1995 and proceed by three months a year until a new retirement age of 70 is reached by 2014. Eligibility for early retirement would be adjusted in tandem so that today's "reduced" benefits at 62 will eventually become available at 67.



3. ***Trim the Federal pension benefit package.*** *Phase-in: 1995 to 2000. Savings in 2000: $4 billion. Savings in 2020: $10 billion. Savings in 2040: $25 billion.*[6] For decades, Federal employee lobbies have asked for "pay comparability" with the private sector, but they have always avoided talking about pension comparability. The reason is simple: From their early retirement ages and 100 percent-of-CPI cost-of-living allowances to their lofty benefit levels (the average monthly Federal pension payment is twice the equivalent average for private sector pensions), Federal pensions are more generous than all but the most lavish Fortune 500 plans.

At the high end of the Federal salary scale, it is no secret that many American taxpayers are passionately unhappy about how much the direct pay of public servants (and particularly Members of Congress) is costing them. Imagine how upset taxpayers would be if they also learned that today's typical U.S. House Member can expect to receive between $1.5 and $2.0 million in lifetime retirement benefits — none of it "funded" and most of it paid out in addition to other pensions also received by these same individuals.

5 Savings estimates for this reform have not been completed. These figures refer to a more modest proposal that would increase the Social Security retirement age to 67 (by 2006) rather than to 70 (by 2014). Over the next decade, the savings from these two reforms would be identical. Over the longer run, however, raising the Social Security retirement age to 70 will yield considerably greater budget savings. This additional savings is not reflected in the savings estimates for the years 2020 and 2040.

6 Estimated savings for the Federal pension reform package do not include substantial additional savings in pension costs under the comprehensive affluence test. (See Reform 1.)

The plan outlined here would help remedy this injustice. To begin with, its affluence test (see Reform 1) would reduce the size of pension payments by up to 25 percent for the most affluent Federal beneficiaries. Since so many Federal pension households are located in high-income brackets, the aggregate savings from this reduction would be considerable.

Further, the plan adopts four specific and entirely reasonable reforms outlined by the Congressional Budget Office. First, for nondisabled retirees under age 62, it would cut COLAs to two-thirds of the CPI. (These retirees, however, would receive a one-time "COLA catchup" at age 62.) Second, after age 62, the annual COLA would be limited to the CPI minus 1 percentage point for military retirees and to the CPI minus 0.5 percentage points for civilian retirees. Third, the base pay used for calculating pension benefits would be changed to the highest four years of salary (rather than the highest three) for CSRS and to the highest 12 months (rather than the salary at the date of retirement) for the military retirement system. Finally, the Federal matching contribution rate to the new FERS thrift plan would be reduced, above 1 percent of pay, to 50 cents (rather than 1 dollar) for each dollar that employees contribute.



The strength of the civil service and military lobbies is one reason why (despite initial consideration of more far-reaching reforms) the changes in Federal pensions enacted in OBRA 93 were either minor and temporary (such as a three-month COLA delay over three years for civil service retirees) or merely shifted liabilities into the future (such as the repeal of the lump-sum payout option). As reasonable as they are, the reforms outlined here will surely trigger a storm of protest from the civil service and military lobbies — but maybe not nearly so great a protest as will arise from the public at large if the Commission ducks making cuts in these programs. The principles of across-the-board sacrifice and comparability of total compensation — not to mention simple political pragmatism — demand that Federal pensioners make a fair-share contribution to reform.

4. ***Limit the tax exclusion for employer-paid health care.*** *Phase-in: 1995 to 2000. Savings in 2000: $40 billion. Savings in 2020: $105 billion. Savings in 2040: $230 billion.* No responsible entitlement reform plan can afford to sidestep the task of controlling health care costs. A sensible place to begin is by capping the current open-ended tax exclusion for employer-paid health insurance. This costly and regressive subsidy, which in 1994 will cost the Treasury $76 billion in lost tax revenues, benefits relatively well-paid Americans while offering nothing to those who are poor, unemployed, or uninsured. And because it is most generous to employees who sign up with the most expensive and permissive insurance plans, it induces overinsurance and thus creates excess demand for health care.

This proposal would limit the exclusion to $410 per month for family coverage and to $170 per month for individual coverage — about the current average cost of insurance. Above these levels, anything employers spend on health care would be taxable income to employees. After 1995, the limits on tax deductibility would be indexed to the CPI (rather than to the average future cost of insurance). As a result, both the budget savings and the employee incentives to reduce overinsurance would increase to the extent the growth in health care spending fails to decelerate. (To create

additional cost-saving incentives, fee-for-service plans would, as a condition of tax-deductibility, be further required to feature significant copayments and deductibles.)

5. ***Raise Medicare premiums and coinsurance.*** *Phase-in: 1995 to 2000. Savings in 2000: $24 billion. Savings in 2020: $105 billion. Savings in 2040: $300 billion.* The limits on the tax exclusion for employer-paid health insurance described in Reform 4 constitute a crucial first step toward controlling health care costs. They would not only raise new Federal revenue, but, by creating incentives for employees to enroll in cost-effective plans, would also cut excess demand for health care. At the same time, it is crucial to strengthen the incentives recipients of direct Federal health benefits have to be cost-
conscious.

To this end, this proposal raises Medicare's annual SMI deductible from $100 to $150 and increases current SMI copayments from 20 percent to 25 percent (while requiring 20 percent copayments for the use of clinical laboratory services, home health services, and skilled-nursing facilities, none of which now requires copayments). It would also raise the current SMI premium that Medicare beneficiaries pay so that it covers 30 percent of the program's costs, up from just 25 percent under current law.



These measures would still leave most Medicare recipients benefiting from a huge subsidy from the general taxpayer. But by making the real costs of their medical care even somewhat more visible to them, we would increase cost-consciousness among the elderly — besides creating a political incentive for seniors to take a genuine interest in demanding that Congress get serious about cost control.

6. ***Enact a Federal health benefits budget.*** *Phase-in: 1995 to 2002. Savings in 2000: $20 billion. Savings in 2020: $280 billion. Savings in 2040: $810 billion.* For all the disagreement among the witnesses who testified at Commission hearings, there was at least one point on which consensus emerged: Health care costs must be controlled. In addition to the steps already outlined, a complete program of cost control would overhaul a malpractice system that imposes unreasonably high insurance costs on doctors, encourages "defensive medicine," and inflates the cost of customary practice. We also need improved research into the effectiveness of medical treatments in order to develop uniform and more cost-effective guidelines for doctors (and the courts). And we need standardized forms (and possibly financial incentives) to encourage the use of living wills — and thus cut down on costly and unwanted heroic intervention in the last days of life.

Such changes in incentives would surely save money. But no one, frankly, can claim to know how much they would save — or how quickly. To ensure that we meet a savings target within a reasonable timeframe, the reform strategy outlined here therefore includes a further measure: As in most other industrial countries, Congress would establish an overall prospective budget for Federal health care

spending with annual limits on each benefit program. Setting a budget and living within it, of course, are not the same thing. To be effective, a benefits budget would have to be enforced through specific programmatic measures. For Medicaid, the limits could be administered by instituting a system of capitated lump-sum grants to the States. For Medicare, they could be administered by giving a fixed-dollar voucher to each beneficiary with which to purchase a certified health plan.

Since 1980, Federal health care spending has grown at the staggering average annual rate of 11 percent. The goal of the proposed health benefits budget would be to ratchet down that growth rate beneath current projections by a modest one-quarter of one percentage point a year between 1995 and 2002. Further into the future, the proposed budget assumes that Federal health care spending would again grow as rapidly as is currently projected — albeit from a somewhat lower starting point in 2002. It is a fantasy to ignore the fundamental social, demographic, and technological forces at work and to suppose that health care costs can somehow be suddenly and painlessly stopped on a dime. A stricter benefits budget might achieve greater savings. But even reaching the modest goal specified here would be difficult.



7. ***Expand the taxation of Federal benefits.*** *Phase-in: 1995 to 2000. Savings in 2000: $19 billion. Savings in 2020: $60 billion. Savings in 2040: $155 billion.* According to the House Ways and Means Committee, a typical retired couple with a $12,000 Social Security benefit and $30,000 in total income paid only $855 in Federal income and payroll taxes in 1993 — while a working-age couple with one child and the same total income paid $7,100. A significant share of this discrepancy is due to our lenient tax treatment of Social Security income. There is no rationale for the huge tax favors bestowed on Federal beneficiaries. Throughout the rest of the industrial world, public benefits are generally just as taxable as other income. America should follow suit.

Until 1994, only 50 percent of Social Security cash benefits were taxable, and even then only for households with incomes above certain thresholds ($25,000 for a single beneficiary and $32,000 for a couple). Beginning this year, OBRA 93 imposes a new rule: For beneficiaries with incomes over even higher thresholds ($34,000 and $44,000, respectively), 85 percent of Social Security benefits will be taxable. This proposal would take the new 85 percent taxability rule and apply it to all Social Security recipients. In other words, it would eliminate all income thresholds. (The 15 percent tax exemption is justified as an estimate of the dollar value of previously taxed personal FICA contributions.)

As for Medicare, which is now entirely tax free, this proposal would make 25 percent of its insurance value taxable to beneficiaries. (In principle, there is no reason why a larger share of Medicare benefits should not be taxed; the 25 percent share was chosen in order to maintain comparable treatment with private employer-paid health insurance, about one-quarter of whose value would become taxable under Reform 4.) In addition, this proposal would also extend blanket taxability to several smaller entitlement programs — notably workers' compensation — that until now have remained at least partially tax exempt.

Since these changes would affect only households that make enough money to pay income taxes, they would naturally affect no beneficiaries in the lowest income brackets. At higher incomes, beneficiaries would be required to pay some tax. Small or large, the tax on their benefits would be at the same rate as all Americans in the same tax bracket pay on their incomes. An equitable and progressive tax code is a "means test" from which no citizen should be exempted.

8. ***Limit the home mortgage tax deduction.*** *Phase-in: 1995 to 2000. Savings in 2000: $6 billion. Savings in 2020: $30 billion. Savings in 2040: $105 billion.* Along with equalizing the tax treatment of Federal benefits and other income, the Commission should cut back on other costly and regressive tax entitlements. In addition to the exclusion for employer-paid health care, the home mortgage interest deduction — a $46 billion subsidy that effectively steers scarce U.S. capital away from space-age robotics and toward space-age Jacuzzis — is a prime candidate for reform. Currently, a taxpayer can deduct interest on a home mortgage up to $1,000,000. This proposal would cap the deduction directly at $12,000 for an individual, $20,000 for a joint-filing couple, and $10,000 for separately filing couples. Initially, this reform would only affect a small and relatively wealthy minority of homeowners. (Assuming an 8 percent interest rate, the only affected couples, for instance, would be those with total home mortgages in excess of $250,000.) But because the limits would not be indexed for inflation, the savings would grow steadily over time.



9. ***Reduce farm aid.*** *Phase-in: 1995 to 2000. Savings in 2000: $5 billion. Savings in 2020: $10 billion. Savings in 2040: $20 billion.* Entitlements of course come in all shapes and sizes. Farm aid is one that does not fit under the major headings of retirement and health care, but which deserves the Commission's attention. At the turn of the century, a third of all adult Americans worked on farms; most of these lived in poverty and none received Federal aid. Today, less than 2 percent of Americans work on farms; of these, very few live in poverty and each receives on average over $10,000 in Federal money — much of which simply serves to prop up noncompetitive enterprises and to inflate consumer prices.

   This farm aid proposal focuses on curbing the cost of Federal commodity price support programs by lowering their grain "target prices" by 3 percent per year for five years. (Naturally, the same savings could also be found by targeting other agricultural benefit programs for cuts, including everything from crop insurance to our subsidies to wool and mohair producers and honey bee keepers.) The sums of money involved in farm aid may be relatively small in terms of the overall Federal budget. But we can't possibly allow our farm aid priorities to go unexamined while Americans are being asked to make sacrifices everywhere else.

10. ***Increase user fees.*** *Phase-in: various dates. Savings in 2000: $6 billion. Savings in 2020: $15 billion. Savings in 2040: $30 billion.* The plan outlined here would also trim another special type of entitlement: the myriad miscellaneous subsidies that the Federal government now passes out to favored regions, businesses, or consumer groups by providing them services whose costs are mostly underwritten by the

general taxpayer. This provision is really 17 different initiatives that would require agribusinesses (for instance) to pay a realistic scarcity price for their water, corporate patentees to pay for the cost of processing their applications, and yacht owners to pay for the cost of Coast Guard rescue. Most Americans would reject the notion of charging individuals special fees in return for public services that help most people in equal measure. But when the favors are large and the beneficiaries are few, most Americans will agree some payment is reasonable and fair.

## PROPOSED AMENDMENTS TO THE CHAIRMEN'S MARK BY COMMISSIONER PETER G. PETERSON

Again, I want to applaud the Commission Chairmen for proposing a plan that confronts our long-term entitlement crisis in such an aggressive and forthright manner. Whatever other criticisms you might have of the Chairmen's mark, you cannot fault it for shrinking from the awesome task the President set for this Commission nearly a year ago. Boldness of action and clarity of purpose are surely in short supply among our Nation's leadership. Both are amply evident in the plan the Chairmen have laid before us.

Any plan, however, can be improved. In the spirit of constructive criticism, I'd like to suggest a few amendments which would give us a plan that solves the long-term fiscal problem at least as effectively as the Chairmen's mark, but that also goes into effect sooner, takes a more strategic approach to health care, conforms better to the principle of burden-sharing, and avoids imposing needless (and unintended) hardship on those Americans whom Federal entitlements have always been expressly designed to assist.



I will begin by describing several difficulties in the design of the Chairmen's mark; I then offer four "amendments" or "substitutions" to the mark that address those difficulties.

## I. FOUR DIFFICULTIES WITH THE CHAIRMEN'S MARK

### 1. The implementation of the mark is too delayed and too slow.

According to the mark, very little happens before the year 2000. Then, while some of the reforms are phased in over the next five years (so the earliest fully effective reform date is 2005), others aren't fully phased in until much later. For example, the revision in the CPI won't fully alter the benefit levels of all retirees until sometime in the 2020s. The hike in the retirement age (for Social Security) affects no one currently over the *age of 50* and fully affects only those currently under the *age of 28*. Many of the Federal pension reforms are to be phased in very slowly, so that they don't fully affect pension benefit formulas until sometime in the *2030s*. The benefit formula change for Social Security has a *50-year* phase-in *after* the year 2000.

Obviously, a degree of gradualism is necessary, both to give individuals a chance to adjust their life plans and to avoid pushing fiscal policy in a sharply contractionary direction. But there are also real problems with delaying too long.

To begin with, it raises questions about our seriousness of purpose — and may deepen public cynicism about government. If the problem is so desperate as to require such far-reaching changes, why are so many of us protected from any sacrifice for so long? Is the idea simply to "solve" the problem on

paper so that we can, in effect, put off talking about it for another five years? It makes one think of St. Augustine's plea to God: "Please give me chastity and continence — but not just yet."

The mark's timetable also seems to run against the growing public demand (as evidenced by opinion surveys, to say nothing of overwhelming legislative support for a "balanced budget amendment") that the budget be balanced as soon as possible. The House leadership is now targeting the year 2002. Problem: the Chairmen's mark — like an out-of-step dancer — will hardly begin to take effect by the year 2002. Ironically, the mark's long time-delay fuse might come to the rescue of fiscal doves by justifying a delayed zero-hour for most of the budget. Worse, if it is interpreted to mean entitlements should be off the table over the short term, it could aid and abet those who want to gut the poverty and research and infrastructure and public-health outposts of the Federal budget while leaving untouched the mighty metropolis of middle- and upper-income subsidies.

Finally, the mark's extremely slow phase-in helps to perpetuate a cascading pattern of generational inequity. Indeed, the mark spares virtually all Americans anywhere near retirement age from bearing much of the sacrifice — regardless of individual financial circumstances. As a consequence, it pushes the sacrifice onto younger generations — again, regardless of individual financial circumstances. A recurrent theme in the Commission's deliberations has been the need to act now in order to avoid burdening the young. Broad grandfathering of current beneficiaries is inconsistent with this goal.



**2. The mark does not adequately protect low- to median-income beneficiaries.**

This problem arises most clearly in the mark's proposed Social Security benefit formula reforms. Social Security's current benefit formula offers each beneficiary a benefit that bears a fixed relationship to his or her relative wage history at the time of retirement (or disability). Thus, a worker who has earned 50 or 100 percent of median earnings throughout life gets a benefit (or his or her survivors get a benefit) that replaces a fixed share of those earnings. The mark proposes to cut average benefits (with its CPI indexation of bend points) by gradually changing this relationship. Over time, as real wages rise, *everyone* will get pushed up into a higher bend-point benefit bracket and thus *everyone's* "replacement rate" (monthly benefit as a percent of prior monthly earnings) will eventually decline.

The effect of this provision on median wage earners will be exacerbated by the mark's second benefit formula reform, which gradually reduces the third benefit bracket from 15 percent to 10 percent of AIME ("average indexed monthly earnings"). This change is intended to be a benefit reduction for the affluent alone. But in combination with the first provision, it will lower a bracket in which the vast majority of workers will eventually find themselves.

There are two other problems with these Social Security benefit-formula reforms as well.

First, each of these two reforms is designed to generate savings that will grow along with the rate of real wage growth; contrariwise, if there is no real wage growth, there will be no savings. This makes the reforms fiscally unstable. It is precisely in the event that real wages *don't* grow that we will need the *most* entitlement savings (relative to current law) to avoid crushing our children under debt and taxes.

More important, though the reduction in Social Security's third benefit bracket is intended to penalize the affluent alone, we should bear in mind that progressive benefit formulas are a very blunt instrument for accomplishing this end. The reason is that post-retirement family income bears only a loose correlation to pre-retirement worker income. Think of the retired widow who depends upon the survivor benefit of her high-earning husband as her sole source of income. She would be *penalized the most* under the mark's proposal. Now think of a retired couple with two Social Security benefits based on low-wage histories, supplemented by pensions, investments, and family gifts. They would be *penalized the least.*



The main difficulty of these reforms, however, is simply that they put so many median and below-median earners at a material disadvantage relative to current law. By itself, perhaps, this might be an acceptable burden. But let's keep in mind that it comes on top of several other provisions in the Chairmen's mark that will hit *all income brackets:*

— There is the higher "normal" retirement age, which reduces the initial benefits for all retired workers (relative to current law) no matter when they retire. Remember that even if you retire at age 70 or later, you will, after the reform, receive a smaller "delayed retirement credit."

— There is the adjusted CPI, which will cut real benefit levels (relative to current law) for all beneficiaries — especially the long-term disabled and the very old.

— There are the heavy new cost-sharing requirements in Medicare. These amount to at least $1,000 in new annual payments for every elderly beneficiary living alone and with an annual cash income over about $15,000.

— And, of course, there is the cap on all "other entitlements" — which will make it difficult if not impossible for any other program (such as SSI) to provide enhanced means-tested assistance to fill in the gaps.

Thus, even if the proposed Social Security benefit formula changes were unobjectionable as stand-alone reforms, they would still be hard to justify when all benefit reductions for low- to median-income persons in the Chairmen's mark are considered together. I single them out because they are large and because they pretend to be a kind of affluence test (which they are clearly not). Another proposed reform that could be criticized on the same grounds is the new Medicare Part A premium. It too is large, and it too pretends to be applicable only to those who can afford it.

### 3. The mark overlooks some major entitlement programs.

Not a single reform in the mark addresses the explosive growth in Medicaid — which is currently our third-largest entitlement program, and which, together with Social Security and Medicare, is projected to account for all entitlements growth relative to the economy over the next 35 years. Similarly conspicuous for its absence is any cap on the home mortgage interest deduction. Along with the open-ended exclusion for employer-paid health insurance (which the mark does cap), it is our largest consumption-oriented tax entitlement. But not only is the home mortgage deduction costly and regressive. By steering scarce capital away from space-age robotics in our factories and toward space-age Jacuzzis in our suburbs, this $46-billion-a-year subsidy exacerbates the shortage of productive investment in the United States — the problem at the heart of the Commission's mandate.

It is difficult to see how the Commission can sell the American people a reform plan that calls for deep cuts in a program as popular as Medicare if it entirely spares a Medicaid program that is growing just as fast (or faster). Similarly, it is difficult to see how it can justify a package that hits old-age benefit programs hard (as it must), but that leaves untouched a regressive tax entitlement whose greatest benefits accrue to higher-income working-age families. The principle of across-the-board sacrifice is not only fair and fiscally necessary. It is a political imperative.



### 4. The mark's health-benefit reforms fall short of a coherent long-term strategy for controlling Federal health care costs.

The mark's cap on the tax exclusion for employer-paid health insurance is an important reform that would introduce important new cost-saving incentives into our current cost-blind system of direct health care benefits and indirect health care subsidies. But there are difficulties with several of its other provisions. Let me first touch on these, then outline a more strategic approach to controlling the growth in Federal health care costs.

First, as I've already noted, there is the question of whether many households of modest means will be able to afford the new cost-sharing requirements in the mark: an entirely new Medicare Part A premium; a large hike in the current Medicare Part B premium; and large increases in Medicare Part B deductibles and copayments. Together, these amount to at least $1,000 in new annual payments for every single elderly beneficiary with an annual cash income over about $15,000.

Second (and once again), whatever happened to Medicaid? Even if the Commission wanted to leave welfare mothers and children entirely out of the savings equation, we should remind ourselves that one-third of Medicaid goes to the elderly. In other words, we're talking about a transfer from young to old that's similar to Social Security and Medicare — and we're talking about a cost item (long-term care) that is certain to grow rapidly as our population ages. There are reforms that could save money in

Medicaid without dumping beneficiaries off the rolls or compromising their quality of care. By excluding it, the Chairmen's mark must hit Medicare all the harder in order to reach our savings goal.

Third, history demonstrates that squeezing provider payments (though it seems like a painless cut) is not a reliable source of savings. To the extent it has worked in the past, it has worked largely by cost shifting to private payers — which has created enormous equity and efficiency problems in our health care marketplace. And even if we were willing to tolerate these, most experts believe it's no longer a practicable option. We've reached the point where further substantial squeezing may simply persuade a growing share of providers to stop treating Medicare beneficiaries at all.

It's time to try a new approach to reform. We must enact measures that: (1) compel legislators to debate openly how much we are prepared to spend publicly on health care; and (2) that sensibly realign patient and provider incentives. The best way to achieve the first aim is to institute an overall global budget for Federal health benefit spending with annual limits on Medicare and Medicaid. The best way to achieve the second aim is to enforce that budget by converting these programs to voucher systems. Today the Federal government's spending commitment under Medicare and Medicaid is open-ended — that is, it is limited by whatever care patients and providers decide to purchase in an increasingly sophisticated and expense and regulated market for medical services. With vouchers, that spending commitment would be fixed in advance (much as it is for an individual in an HMO today). Such a system would create enormous incentives for beneficiaries to shop for and providers to deliver quality care at the lowest possible price.



## II. FOUR PROPOSED AMENDMENTS TO THE CHAIRMEN'S MARK

I propose that the following amendments be made to the mark. Following the Chairmen's practice, the savings from these amendments are measured as a percent of the Commission's "entitlements goal." Together, they achieve somewhat greater long-term savings than the current provisions of the mark.

### 1. Speed up the overall implementation of the mark.

This amendment would:

— Substitute the year 1997 for the year 2000 wherever the latter is used as the starting date for a reform's phase-in (except in the case of higher retirement ages).

— Substitute the period 1997 to 2000 for the period 2000 to 2004 wherever the latter is used as a phase-in period.

— Speed the rate at which the Social Security Normal Retirement Age (along with Medicare eligibility) is raised: from two months per year to three months per year. Under the mark, the Normal

Retirement Age would start rising by two months per year in the year 2000 (for anyone then hitting age 62) and would reach age 70 in the year 2029. Under this amendment, the Normal Retirement Age would reach age 70 in the year 2019. This change to the mark would have the greatest impact on people born in the late 1950s. It would have no effect (relative to their treatment under the Chairmen's mark) on anyone born before 1939 — or after 1967.

— Require that all benefit-level changes proposed in the mark for Federal pensions be totally phased in for new pensioners by the year 2020.

Nothing in this amendment introduces any reform at a pace that exceeds the ability of the American people to adapt. The changes, however, would spare the Commission from the charge that its proposals are merely "hypothetical" (all talk, no walk), that it is falling behind the deadlines proposed by other congressional and constitutional efforts to balance the budget, and that its leisurely timing comes at the expense of younger generations. Of course, these changes would also generate significant permanent savings by closing the deficit faster and thus sparing taxpayers the annual interest costs on the extra debt that would otherwise be accumulated.



*Net Impact on Savings: At least +5.2 percent.* This is the sum of: speeding up the rise in the Social Security Normal Retirement Age (+2.4 percent) and the rise in the age of Medicare eligibility (+2.3 percent); and changing the phase-in for the itemized deduction rate cap (+0.2 percent) and for the taxation of employer-paid health benefits (+0.3 percent). Note that some savings from this amendment have not been calculated.

**2. Replace both of the Social Security bend-point changes with an extension of the mark's means test to Social Security.**

The mark currently includes a means test or affluence test (modeled after the "affluence test" designed by the Concord Coalition) that applies to all entitlement programs except Federal pensions and Social Security. This amendment would:

— Eliminate both of the mark's Social Security bend-point changes.

— Extend the mark's means test to Social Security.

Recall how the affluence test works. No beneficiary with a household income beneath $40,000 in 1995 (significantly higher than the 1995 median household) would be affected. For beneficiaries with total household incomes of between $40,000 and $50,000, 10 percent of their benefits would be withheld; for beneficiaries with total household incomes of between $50,000 and $60,000, 20 percent would be withheld; and so on. The maximum withholding rate (85 percent) would apply to beneficiaries with household incomes of over $120,000. All withholding brackets would be indexed to inflation.

Thus, the affluence test would not cut the benefits of any household at or near the U.S. median. Even if real incomes rise substantially in the future (pushing the median income above $40,000 at 1995 prices), most lower-income households would continue to be entirely protected far into the future. The mark's bend-point changes offer no such protection; in fact, the first of its two changes is designed to lower all benefits (relative to current law) over time. Over and above the affluence test's treatment of lower-income workers as a group, moreover, there is its *much superior targeting of lower-income beneficiaries as individuals.* Changes in the Social Security benefit formula just look at benefit income; the affluence test always looks at total household income, and thus cannot inadvertently hurt lower-income households.

A final reason for this substitution is that it would universalize an income-tested standard the Chairmen's mark *already intends to use for all other entitlements, including Medicare.* Viewed from this perspective, the exemption for Social Security seems hard to justify.

*Net Impact on Savings: -1.0 percent.* This is the sum of: eliminating the two bend-point changes (-9.7 percent); and extending the affluence test to Social Security (+8.7 percent).



**3. Cap the home mortgage deduction for personal income taxes.**

This amendment would:

— Introduce a $300,000 cap on the mortgage amount on which interest deductions may be taken on personal income taxes. The cap will be indexed to inflation.

This amendment would help spread the plan's overall sacrifice over all age groups while steering more of America's scarce supply of savings toward productive investment.

*Net Impact on Savings: +1.0 percent.*

**4. Eliminate the Part A Medicare premium, extend current-law taxation of Social Security benefits to Medicare, and refashion Medicare and Medicaid as portable voucher plans.**

This amendment would:

— Eliminate the mark's proposed new "Part A" Medicare premium.

— Extend the current partial taxation of Social Security benefits (including the $32,000 and $25,000 thresholds for 50 percent benefit taxation and the $44,000 and $34,000 thresholds for 85 percent benefit taxation) to Medicare benefits. The taxable value of the benefit would be equal to the average per capita insurance value (net of any premiums) for all beneficiaries.

— Eliminate the mark's provisions for higher deductibles, higher copayments, and reduced provider payments.

— Restructure Medicare as a portable voucher that beneficiaries would use to procure insurance with any accredited carrier (HMO, managed care, or fee-for-service). Accredited fee-for-service plans would be required to maintain an annual deductible of at least $300 (indexed to premiums) and copayment rates of at least 20 percent; Medigap fill-ins would be prohibited for first-dollar payments. By assumption, the voucher would be priced so that the savings from this provision and the next provision would together equal the current mark's savings from cuts in provider payments and higher Medicare Part B copayments and deductibles.

— Switch Medicaid to a voucher system similar to the Medicare system proposed above (though without the coinsurance requirements), or (at State option) allow States to receive their Medicaid funding in the form of a capitated lump-sum grant, adjusted annually to reflect State population and per capita program cost growth. By assumption, the Medicaid voucher would be priced so that the savings from this provision and the previous provision would together equal the current mark's savings from cuts in provider payments and higher Medicare Part B copayments and deductibles.



The elimination of the new "Part A" Medicare premium would spare lower-income beneficiaries a burdensome increase in out-of-pocket health care expenses. The extension of benefit taxation to Medicare would more than recoup the resulting savings loss — but would do so progressively. It is difficult to imagine a compelling objection to this substitution. To begin with, it is consistent with the extension of limited taxation to employer-paid health plans, which the mark proposes. It is also consistent with our treatment of Social Security. We currently tax Social Security, in part to recoup windfalls beyond personal contributions to the system. Yet such windfalls are even greater for HI and SMI than they are for Social Security. More generally, it is worth noting that virtually every other industrial country taxes benefit income just like ordinary income. The reason? A progressive tax code is a means test from which no citizen deserves to be exempted.

As for the restructuring of Medicare and Medicaid as voucher systems, it has huge advantages over the conventional strategy of slapping yet another round of price controls on providers. Such a reform would replace today's open-ended spending commitments with the discipline of prospective budgeting. And it would create incentives for patients and providers to scrutinize costs and benefits in purchasing and delivering care. Given the means test and other proposed reforms that would cut back sharply on the net Medicare benefit available to affluent households, there is another practical reason for a voucher plan: By "liquifying" the benefit, it would give affluent beneficiaries a better reason not simply to opt out of Medicare altogether.

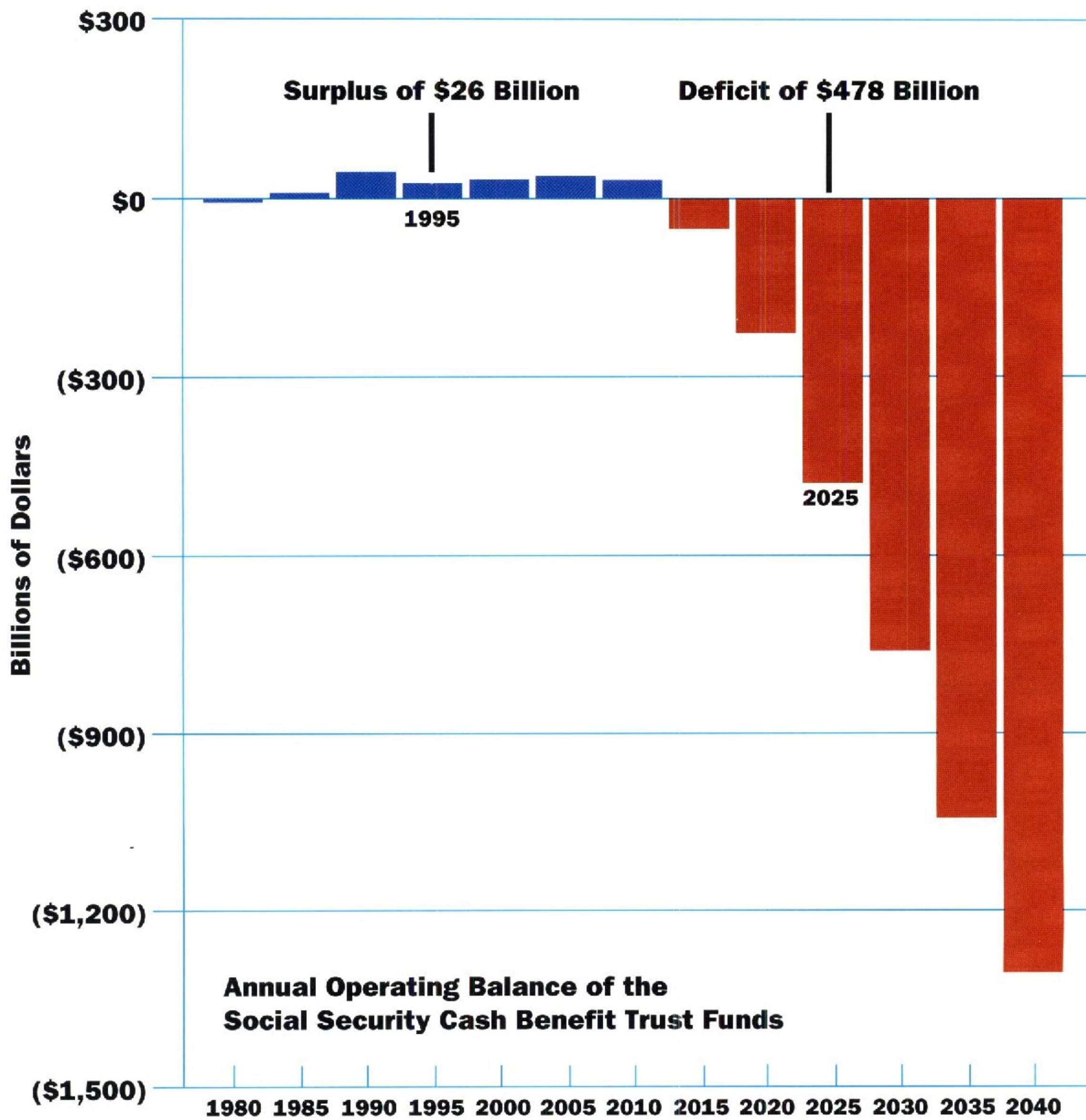
*Net Impact on Savings: +0.9 percent.* This is the sum of: eliminating the Part A premium (-6.6 *percent.*); and extending the taxation of Social Security to Medicare (+7.5 *percent.*). All other provisions net by assumption to 0.0 *percent.*

**Net savings from all the above amendments**

The total savings in these four amendments sum to 6.1 percent. Thus, if amended as proposed, the Chairmen's mark would produce total savings equal to 105.7 percent of the Commission's entitlements goal — up from 98.6 percent in the mark as now drafted. This extra savings can be viewed in two ways. On the one hand, it would bring us closer to absolute long-term budget balance — which ought to be the Commission's goal. On the other hand, some of it may be needed as a cushion against interactive effects that the Commission staff have failed to take into account in scoring the Chairmen's mark (and other illustrative reform packages). For instance, if we both means test Medicare and raise the eligibility age for Medicare benefits, the combined savings of these two reforms will be less than the sum of the savings of each considered separately.

Unsustainable Promises

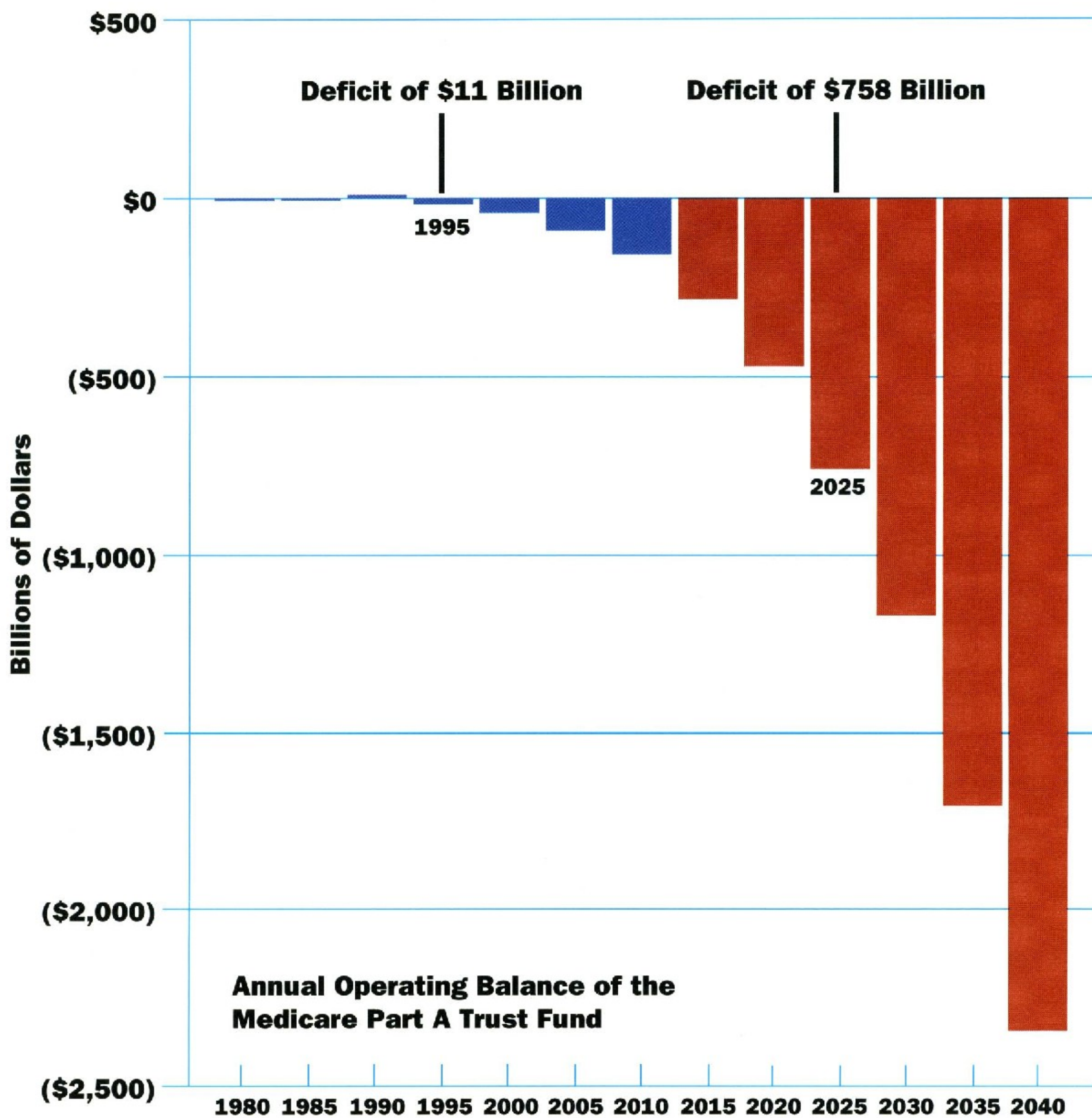
**THE LONG-TERM BUDGET DEFICIT: SOCIAL SECURITY IS A BIG PART OF THE PROBLEM**




Note: Official intermediate projection. Source: Social Security Administration.

Unsustainable Promises

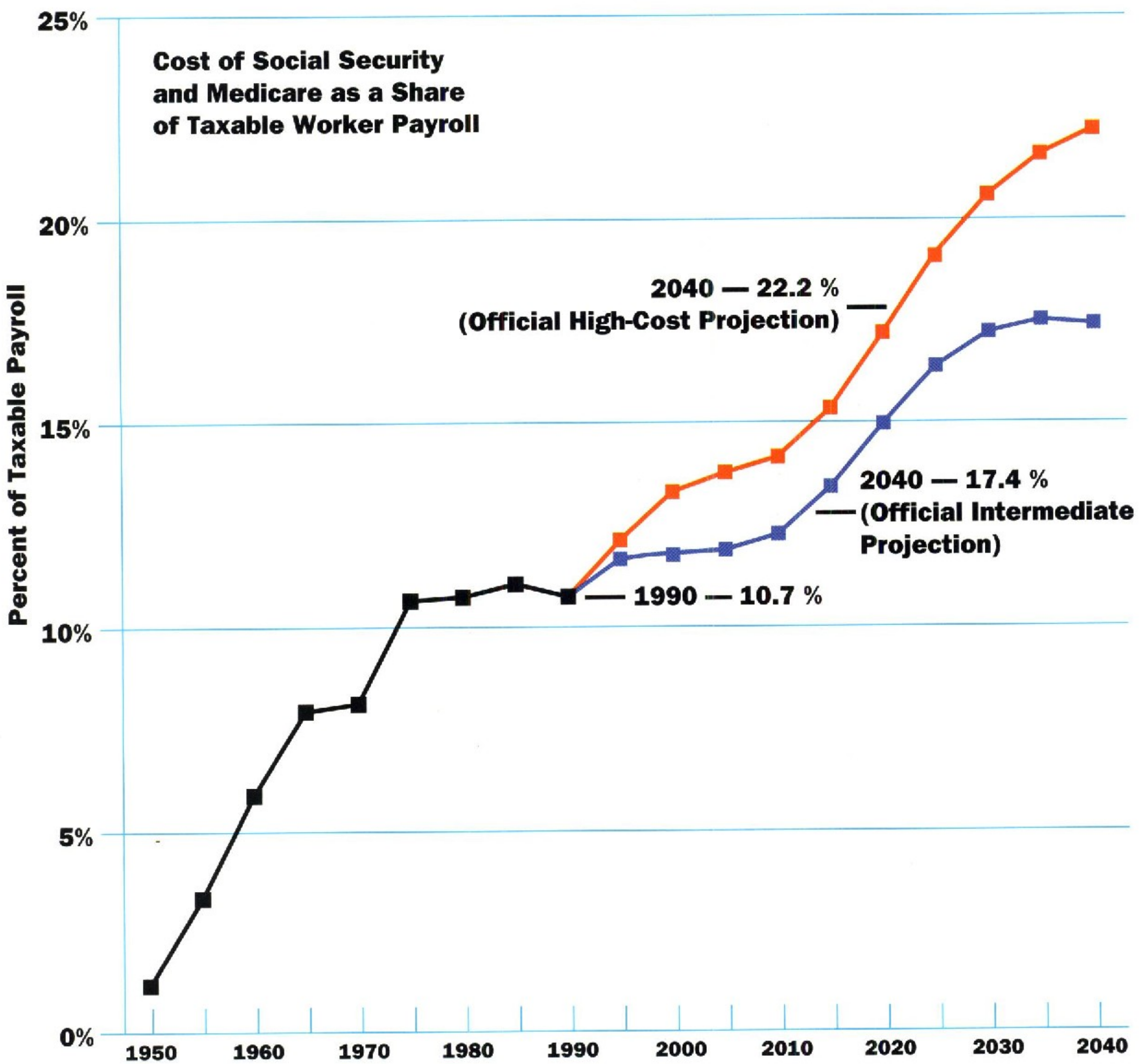
**OF COURSE, MEDICARE COSTS ARE ALSO UNSUSTAINABLE**




Note: Official intermediate projection. Source: Social Security Administration.

Unsustainable Promises

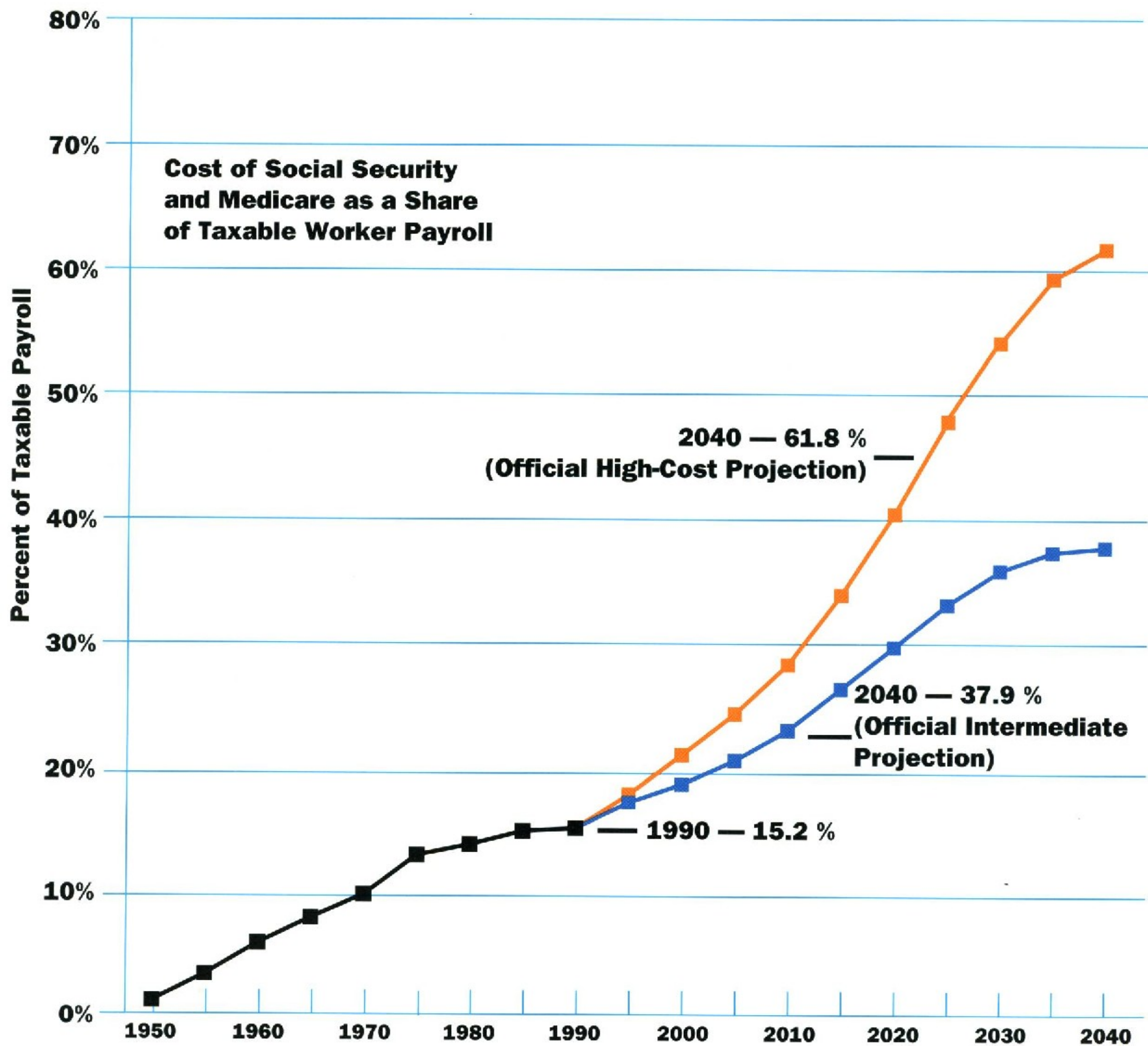
**THE COST OF SOCIAL SECURITY IS PROJECTED TO RISE BY AT LEAST 60% AS A SHARE OF WORKER PAY**




Note: Costs include employer contributions. Source: Social Security Administration.

**Unsustainable Promises**

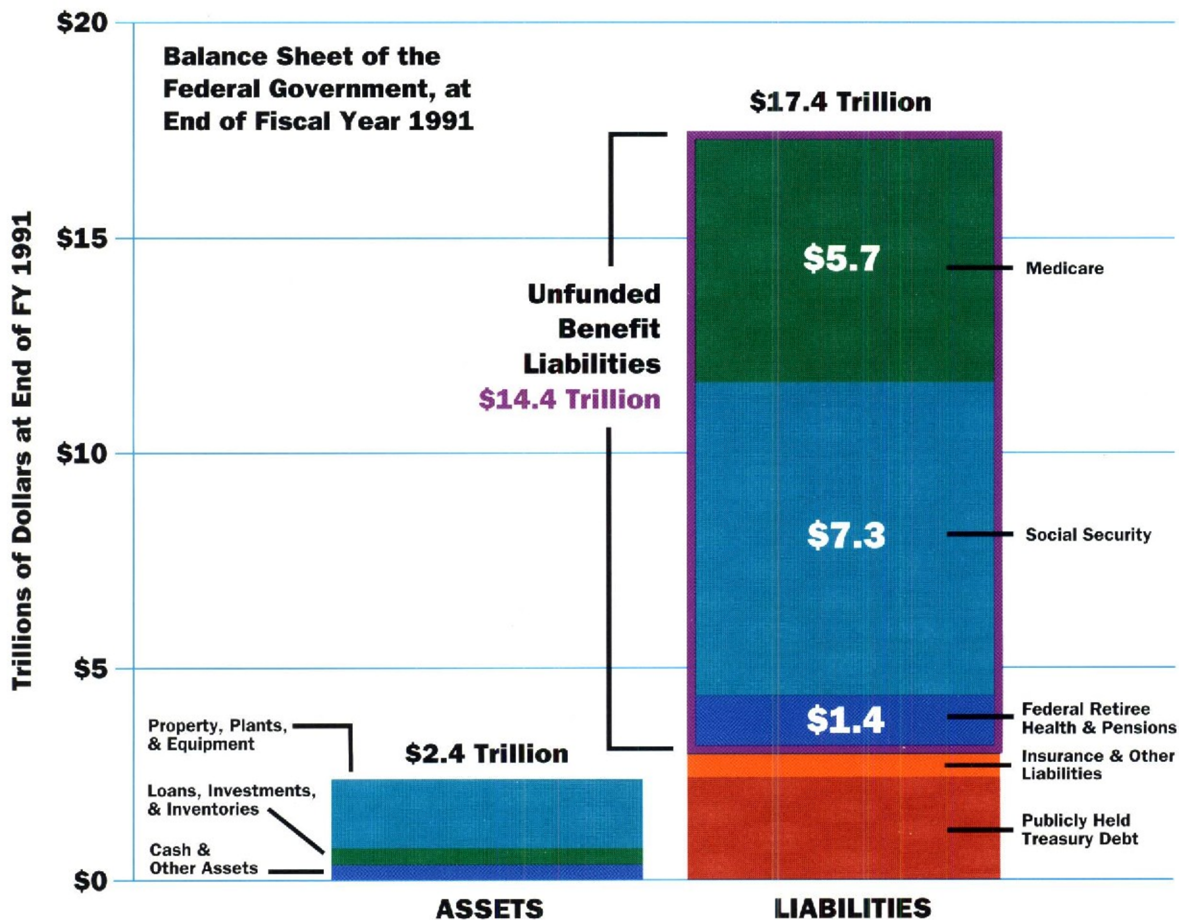
## AND THE COST OF BOTH SOCIAL SECURITY AND MEDICARE WILL RISE 150% TO 300% AS A SHARE OF WORKER PAY




Note: Costs include employer contributions; Medicare includes Part A and Part B. Source: Social Security Administration and Healthcare Financing Administration.

**Unsustainable Promises**

**OVER $14 TRILLION IN UNFUNDED LIABILITIES: THE PROMISES TO TODAY'S ADULTS IN EXCESS OF CURRENT TRUST FUND "ASSETS" PLUS THE FUTURE TAXES TODAY'S ADULTS ARE SCHEDULED TO PAY**




Source: Office of Management and Budget and A. Haeworth Robertson, *Social Security: What Every Taxpayer Should Know* (1992).