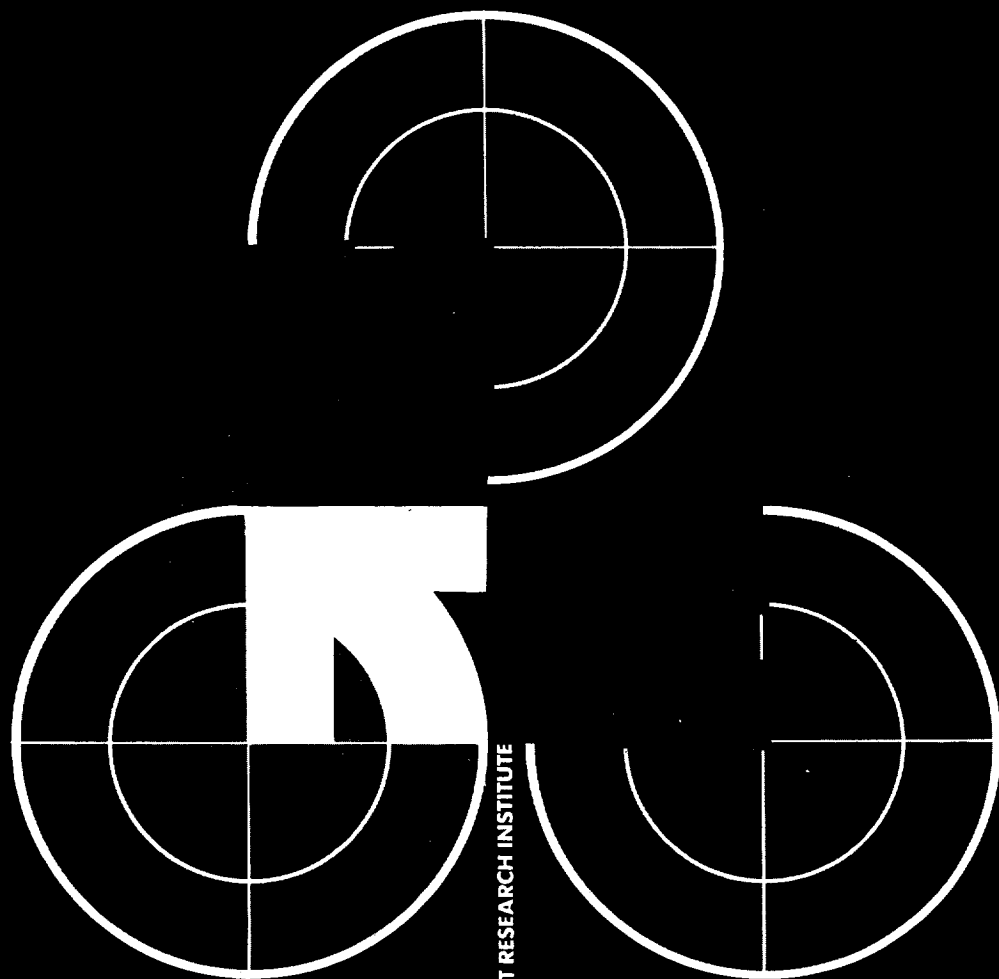


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Business, Work, and Benefits: Adjusting to Change



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Foreword

Demographic shifts, global competition, and changing tax laws are among the many challenges that have confronted American employers and employees during the 1980s and are certain to continue through the end of the 20th century and into the 21st. The need to adjust to the unfamiliar is giving rise to new ways of thinking about the nature of work, family and individual responsibilities, and the employee-employer relationship that will inevitably be reflected in policy decisions relating to the design, administration, and funding of employee benefits.

Some of the consequences of recent demographic and economic shifts for public and private retirement, health, and economic security programs were explored in the Employee Benefit Research Institute's 1986 policy forum, "America in Transition: Benefits for the Future." The continuing ramifications of these changes were further analyzed, with an emphasis on the demanding nature of today's business environment, in EBRI's May 1988 forum, "Whither Benefits?: Adjusting Today's Benefits Packages for Changes in the Tax Law, Economic Competitiveness, and Demographic Labor Force Shifts."

This policy forum brought together corporate executives, government officials, and representatives from labor, academia, elderly, and research organizations to discuss changing patterns of work, business, and benefits as the United States moves from manufacturing to the information and service industries and strives to compete in a global economy. The participants address issues ranging from the increasing medical costs that will be incurred by an aging population to the education and training needs of large numbers of young people who are unprepared for today's technologically sophisticated work place. The discussion should give policymakers, benefits experts, and the public a realistic understanding of what our options are and how they can be maximized within the context of federal budget restraint and corporate restructuring.

Business, Work, and Benefits: Adjusting to Change integrates the papers and proceedings of the policy forum and additional supplemental material into a single work. It is organized into three parts, dealing with the world of work and business, public policy directions, and the response of employers and unions to social, economic, demographic, and public policy changes.

On behalf of EBRI and its Education and Research Fund, I wish to thank the policy forum speakers and participants for their substantial contributions to this book. Special thanks are due to Laura Bos, Nancy Newman, and Shannon Braymen for planning the policy forum, to Deborah Holmes for compiling, editing, and producing this book, and to Christine Dolan for preparing the index.

The views expressed in this book are solely those of the authors and the forum participants. They should not be attributed to the officers, trustees, members, or associates of EBRI, its staff, or its Education and Research Fund.

Dallas L. Salisbury
President
Employee Benefit Research Institute

January 1989

About the Authors

KENNETH J. BROWN

Mr. Brown is retired president of the Graphic Communications International Union. He began his union career in 1954 when he was elected president of the Toronto Lithographers Union Local 12, with which he began his apprenticeship in 1942. Brown served as vice president and member of the executive board of the AFL-CIO. He is a member of the board of directors of the Union Labor Life Insurance Company and is involved in various capacities with many other organizations. Brown is a former member of the board of directors of the International Foundation and currently a member of its Industry and Government Affairs Committee.

PAT CHOATE

Mr. Choate is vice president of Policy Analysis for TRW, Inc., a high-technology, multinational corporation. A specialist in public policy and economics, he is the author of many books, monographs, and articles on trade, economic development, management, and public administration, including *The High-Flex Society*. Choate has been a Fellow at the Battelle Memorial Institute's public policy arm, the Academy for Contemporary Problems. His experience in government includes a number of positions with the United States Department of Commerce and the state governments of Tennessee and Oklahoma.

PAUL R. CULLINAN

Dr. Cullinan is a principal analyst for Social Security cost estimates and policy analysis in the budget analysis division of the Congressional Budget Office (CBO). Before joining this division in 1985, he worked in CBO's human resources division, where he was responsible for testimony and other materials on Social Security policy as well as on other income distribution issues. Prior to his employment at CBO, Dr. Cullinan was a policy analyst in the Social Security Administration, specializing in disability and family benefit issues, and served on the economics faculty of Union College in Schenectady, N.Y. He holds a doctorate in economics from the Maxwell School of Citizenship and Public Affairs, Syracuse University.

ROBERT B. FRIEDLAND

Dr. Friedland is a research associate at the Employee Benefit Research Institute (EBRI). Before joining EBRI, he was senior economist for Maryland's medical care programs, Department of Health and Mental Hygiene; assistant professor of economics in the School of Business and Economics at Towson State University; and a fellow at the National Institute on Aging. Friedland is directing EBRI's policy study on financing long-term care.

JEFFREY J. HALLETT

Mr. Hallett is president and founder of TRAC, Inc., a research and consulting firm specializing in information systems design, issue analysis, and organizational response to change. Hallett is the author of *Worklife Visions*, a book that examines the shift from an industrial to an information economy and the fundamental changes it will cause in the work place. Prior to launching TRAC in 1983, Hallett co-founded The Naisbitt Group, for which he served five years as president. He also spent five years as a consultant and productivity expert in Washington, heading programs at two agencies and the U.S Chamber of Commerce.

DORCAS R. HARDY

Ms. Hardy was sworn in as the 10th Commissioner of Social Security on June 26, 1986. Hardy also serves as chairman of President Reagan's Task Force on Legal Equity for Women. Before becoming the Commissioner of Social Security, Hardy had been assistant secretary for human development services of the U.S. Department of Health and Human Services since 1981. Prior to federal service, Hardy was associate director of the University of Southern California's School of Medicine Center for Health Services Research, where she established a multi-disciplinary health and social policy research organization.

CONSTANCE HORNER

Ms. Horner is the Director of the United States Office of Personnel Management and President Reagan's chief advisor on federal civil service personnel matters.

Prior to this appointment, Ms. Horner served as associate director for economics and government in the Office of Management and Budget. She previously served as director of VISTA—the federal domestic antipoverity volunteer program—and acting associate director of

ACTION, VISTA's parent agency. In 1981, she also served as deputy assistant director of ACTION for policy and planning. Presently, she serves as a commissioner on the President's Commission on White House Fellowships and on the President's Commission on Executive Exchange.

WILLIAM B. JOHNSTON

Mr. Johnston is vice president for special projects at the Hudson Institute. He is project director of Hudson's Workforce 2000 study, a long-range look at trends affecting work and workers in the late 20th century being conducted for the U.S. Department of Labor. Before joining the Hudson Institute, Johnston was director of public policy research for the Conference Board. Prior to that, he served as assistant secretary for policy and international affairs of the U.S. Department of Transportation and associate director of the White House policy staff.

THOMAS W. MERRICK

Dr. Merrick has been president of the Population Reference Bureau (PRB) since 1984. Prior to coming to PRB, he served as director of the Center for Population Research and as chairman and associate professor in the Department of Demography at Georgetown University. He has also served with the Ford Foundation in Brazil and the Agency for International Development in Washington as well as the Population Studies Center at the University of Pennsylvania. Dr. Merrick is the author of several books and articles on population trends and their relation to economic and social change in developed and developing countries. He has worked as an expert consultant on international demographic trends for several foundations.

ARNOLD H. PACKER

Dr. Packer is a senior research fellow at the Hudson Institute, where he is deputy project director for the Work Force 2000 study. After nine years as a professional engineer in New York and California, Dr. Packer went to the Research Triangle Institute in North Carolina. In 1969, he came to Washington as an economist for the Office of Management and Budget with responsibilities for short- and long-term forecasting of the U.S. economy. He became the first chief economist for the newly formed Committee on the Budget in the U.S. Senate, after which he returned to the executive branch to become assistant

secretary for policy, evaluation, and research at the U.S. Department of Labor. Dr. Packer has written widely about economics, employment, and training policies.

RONALD C. PILENZO

Mr. Pilenzo, SPHR, president of the American Society for Personnel Administration (ASPA), has more than 20 years experience in all facets of human resource management. As president and chief operating officer of ASPA, Pilenzo represents nearly 40,000 human resource management professionals in every state of the union and in 42 other countries. Before being named president of ASPA, Pilenzo was director, compensation and management development, for International Multifoods Corporation. He has held various executive and management positions for a number of firms, including Evans Product Company of Portland, Oregon; Allied Supermarkets; and the Ford Motor Company.

JOHN L. PALMER

Dr. Palmer is a senior fellow at the Urban Institute, where he is currently co-director of the Institute's Changing Domestic Priorities project, which is examining national economic and social conditions and policies. Dr. Palmer is an economist with broad interests in economic, budget, and social issues and policies. He has had extensive experience in policy research and analysis, in university level teaching, and in federal government policy positions. His publications include numerous books and professional articles on such topics as the federal budget, macroeconomics, population aging, income distribution, and numerous aspects of domestic policy.

JAMES S. RAY

Mr. Ray is a name partner with the Washington, D.C. law firm of Connerton, Ray & Simon. His law practice is devoted to the representation of employee benefit plans (primarily multiemployer pension and welfare plans), workers, labor organizations, and related organizations with respect to employee benefits matters before the courts, Congress, and administrative agencies. Mr. Ray is a former chairman of the Joint Committee on Employee Benefits of the American Bar Association (ABA), and a former co-chairman of the Committee on Employee Benefits of the ABA's Labor & Employment Law

Section. Currently, he is a co-chairman (Union) of the Committee on Federal Legislative Developments of the ABA's Labor & Employment Law Section.

Mr. Ray has written and lectured extensively on employee benefits law issues and developments, particularly those relating to litigation and multiemployer plans. He serves as legislative counsel to the National Coordinating Committee for Multiemployer Plans (NCCMP), the recognized representative of the multiemployer plan community with respect to government regulation. He has also served for several years as editor of the *NCCMP UPDATE*, the NCCMP'S official periodic publication.

Mr. Ray is a member of the advisory board of the Bureau of National Affairs' *Pension Reporter*.

STANFORD G. ROSS

Mr. Ross is a senior partner in the law firm of Arnold & Porter in Washington, D.C., specializing in federal tax law and administrative law. He has dealt extensively with income security and tax policy issues while serving in the U.S. Treasury Department, on the White House domestic policy staff, and as Commissioner of Social Security. Ross is a member of the Council of the International Fiscal Association and is on the Advisory Committee for the federal income tax laws of the American Law Institute. He has taught tax law at the New York University, Harvard, and Georgetown law schools. He has served as chairman of the American Bar Association Tax Section Committees on Foreign Activities of U.S. Taxpayers and Social Security and Payroll Tax Problems.

P. ROYAL SHIPP

Dr. Shipp is a senior specialist in social legislation for the Congressional Research Service of the Library of Congress. During his 10 years with the service, Dr. Shipp has managed major research projects for congressional committees and produced studies on a variety of health and pension issues. In 1983 Dr. Shipp also served as executive director of the Congressional Panel on Social Security Organization. Prior to joining the service, Dr. Shipp served as administrator for the Food and Nutrition Service of the Department of Agriculture, as a budget examiner for the Office of Management and Budget, and as an economist for the Board of Governors of the Federal Reserve System.

PAUL N. VAN DE WATER

Dr. Van de Water is chief, projections unit, of the Congressional Budget Office (CBO). His responsibilities include directing the preparation of CBO's multiyear budget projections, providing support to the House and Senate Budget Committees in preparing the annual Congressional budget resolution, and writing CBO budget projections reports and analyses of the federal budget. Before joining CBO, Dr. Van de Water was director, Office of Policy Analysis, of the Social Security Administration, where he established and directed a long-run policy planning office for the Social Security Administration.

THOMAS E. WOOD

Mr. Wood is a retired partner of Hewitt Associates, where he was a consultant and executive in the employee benefits field for more than 30 years. He is known for his work in the development of flexible compensation and for other innovative approaches to employee benefits issues. Mr. Wood was given the Outstanding Achievement Award by *Pension World Magazine* in 1987 for his overall career achievements. He currently serves as vice chairman of the Corporate Board of the International Foundation of Employee Benefit Plans, serves on five other boards of directors, teaches at the Kellogg School of Management, Northwestern University, and continues his active roles of writer and speaker.

PART ONE

THE CHANGING WORLD OF WORK AND BUSINESS

The U.S. working environment is undergoing a transformation that will affect nearly everyone in the labor force and many retired persons as well. The age composition of the labor force and family structure, for example, are changing; the information age has arrived; and our definitions of work are all different. American industry is undergoing a transformation, and the U.S. global position has changed. Part One of *Business, Work, and Benefits: Adjusting to Change* examines adjustments in business and organization outlook, employer-employee relationships, and U.S. economic competitiveness that are occurring as we approach the 21st century.

In chapter I Thomas W. Merrick discusses the importance of demographic studies, which have long been used in marketing, in making informed decisions about benefit policies for both the present and the future.

He depicts the composition of the present labor force as an age pyramid that gives the numerical size and the place in the labor force of the generations from the pre-World War I era to the teenagers born after 1970. In describing the structure of this pyramid, he pays particular attention to the baby boom, a surge in births that has had, and will continue to have, a vast effect on the American economy. Now that the baby boomers are in the labor force, two-earner families, low birth rates, and demographic diversity are active factors in the changing world of employee benefits.

In the present, says Merrick, the baby boomers raise questions about health care, the use of sick and annual leave, and maternity and child care benefits that did not exist 15 years ago. In the near future, he says, the problem of their retirement looms as an unmet responsibility. Today, many workers help to support relatively fewer retirees. Whatever the state of the future economy, when the baby boom generation retires, there will be fewer workers to support many more retirees.

Merrick believes that demographic analyses also provide important information about the quality of the work force. There is a higher percentage of college and high school graduates in the labor market today than there was 20 years ago. However, with a decline in the

numbers of native born workers, the increasing cost of a college education, and the heavy influx of uneducated immigrants, employers in the future may have to underwrite expensive training programs to preserve their work force.

The use of demographic studies to clarify these and other changes can help benefits planners make informed policy decisions, Merrick contends. This information can enable them to construct more flexible and feasible plans than would be possible with simplified projections based largely on guesswork.

In chapter II Jeffrey J. Hallet suggests that as we move into a new age, we need to reevaluate our notion of work to conform to today's and tomorrow's realities. Our economic well-being as a nation no longer depends on how efficiently we can mass produce goods, he says, but rather on how well we can incorporate higher levels of information and knowledge in products and processes and on the quality of our products. This working environment requires individuals who are educated, motivated, and rewarded much differently than their industrial predecessors.

As individuals, we need to reach the conclusion that we work only for ourselves, according to Hallett. Our personal, professional, and material rewards will come from our ability to learn and excel at the work we do. Self-reliance is becoming the key to economic security.

The basic contract between employer and employee needs to be rethought, Hallett says. Traditional arrangements are giving way to a concept of work that is defined more in terms of task and performance. A less adversarial relationship between employers and workers is needed to enhance productivity. Americans will learn the value of cooperation and attention to quality as they go to work for Japanese companies operating in the United States.

Hallett believes that the increasingly widespread dissemination of knowledge and information made possible by computer and telecommunications technology is challenging many long established traditions. In the past power belonged to those who had access to and control over information and knowledge—large institutions and a small number of elite individuals. Now an increasing number of individuals and small groups are finding that they are able to operate effectively without the support or assistance of the larger organizations. As credentials, age, race, geographic location lose importance in the new economic environment, competence, creativity, and performance are becoming essential.

Restoring U.S. economic competitiveness will require new policies and practices by both the public and private sectors, says Pat Choate

in chapter III. He believes that there are many intermediate possibilities beyond the either/or policy alternatives that assume a conflict where none actually exists.

These false alternatives take the form of industrial production versus industrial employment, high-tech versus basic industries, manufacturing versus service industries, big versus small business, absolute versus global market performance measures, free trade versus fair trade, and microeconomic versus macroeconomic policies. In each of these areas Choate sees two components of a larger whole rather than mutually exclusive alternatives.

To increase U.S. competitiveness, Choate sees a need to reduce the federal deficit, harmonize fiscal and monetary policies, monitor and manage the exchange rate, and create an economic environment in which workers can secure training, find jobs, be productive, and move more easily between jobs and occupations.

Choate believes that our objective in the international area should be to create stable and pragmatic relations with foreign economies that are very different from our own, and to recognize that the nation's economic interests are as critical to its well-being as its defense and foreign policy interests.

In chapter IV participants reflect on a number of questions related to the nature of the changes that are now occurring. Are these changes revolutionary or incremental? Are we headed for a "forcing event" that will cause a seismic break with the past? Are our responses too backward looking to meet the challenge?

The participants relate these questions to issues that concern working and retired persons. They cite plant closing legislation as one response to the problem of job loss and mandated training vouchers as another. They discuss the importance of pension portability in a time of economic uncertainty and mobility and raise the question of whether we need a minimum universal pension system to supplement Social Security. A recurring theme is the need to upgrade our educational system.

I. American Demographics: Key Trends for Benefits Decision Makers

PAPER BY THOMAS W. MERRICK

Why Demographics Are Important

During the past two decades there has been growing recognition that understanding demographic trends is critical for business decision making. The "discovery" of demographics by executives and managers represents a convergence of several important developments in business and population research. Recent demographic trends have reshaped markets for goods, services, and labor. Changing domestic and international economic and financial conditions have also increased the value of demographic information, while contemporary technology makes it easier and cheaper to access demographic data (Merrick and Tordella, 1988).

The great economic expansion experienced in the United States following World War II occurred during a period of rapid growth in the population and labor force. Keeping up with the increasing demand for housing, appliances and consumer durables, and mass-market goods and services was a major challenge. A booming economy in a booming population brought general prosperity, and growth at times seemed automatic. By the 1970s all this was changing. Overall population growth slowed, and the economy became more sluggish. However, labor force growth accelerated as young people born during the baby boom reached labor force entry ages. With increased inflationary pressures and rising unemployment, families struggled to maintain the living standards to which they had grown accustomed. Women accounted for a large share of labor force growth, and the two-earner household was one way in which households coped with economic pressures.

While recognizing that both economic and demographic forces are involved in these changes, the focus here is on a set of interconnected demographic changes that have important implications for business decisions in product and labor markets. Employee benefits cut across these two markets. From an employer perspective, such phenomena as the increase in working mothers; declines in the size of the younger working-age population; and workers' changing language, educational, and technical skills have major implications for the cost of

producing goods and services. Business firms and corporations that provide health, pension, and other benefits need to keep track of changes in the characteristics of their workers *and* their workers' dependents. Demographic factors also impinge on the regulatory environment in which businesses operate (for instance, increases in the number of working mothers have led to calls for mandatory child-care benefits and scrutiny of work-place hazards that could jeopardize the health of expectant mothers).

From an employee perspective, benefits fit into a continuum that includes the full range of goods and services on which income is expended. For many households, expenditures in such "welfare" categories as medical services, child care, and pharmaceuticals account for a significant share of outlays. Most employees recognize that employer-provided coverage of these benefits is indirect income, particularly when they are evaluating job offers, making decisions about the type of coverage to choose when copayment is involved, or in union contract negotiations. Such consumer "choices" about benefits may be exercised in ways that differ from the consumption of other goods and services, but the influence of changing demographic patterns on demand is similar for benefits and other goods and services. With the growing availability of cafeteria benefit plans, continuity between benefits and other goods and services is even stronger. Whether they recognize it or not, employers are marketing a range of services through their benefits programs. Many employers are seeking to control benefits costs by increasing employee copayments. They need demographic information to market these concepts effectively and to estimate the current and future costs of financing benefit services.

Decision makers concerned with the effects of demographic changes on benefits need to think about these links in both labor market and product market terms, since both are involved. Five important demographic changes are those involving age composition, household and family structure and associated gender roles, geographic redistribution, labor force composition, and shifting international demographic patterns. Changing domestic and international economic conditions, such as increased competition from abroad in manufacturing, have intensified the importance of demographic shifts. These factors will be discussed in more detail.

Changing Age Composition

The baby boom taught business to appreciate the impact of demographics. Demographers discuss the "changing age composition,"

but that usually mundane expression here describes a revolutionary surge in births between 1946 and 1964 that led to a 75-million-person "bulge" in the U.S. age distribution pattern. This monumental demographic occurrence had a tidal wave effect on school systems, job and consumer markets, and a host of other important social and economic institutions. Baby boomers made two-earner families, low birth rates, latchkey children, and demographic diversity the new norm in the American way of life.

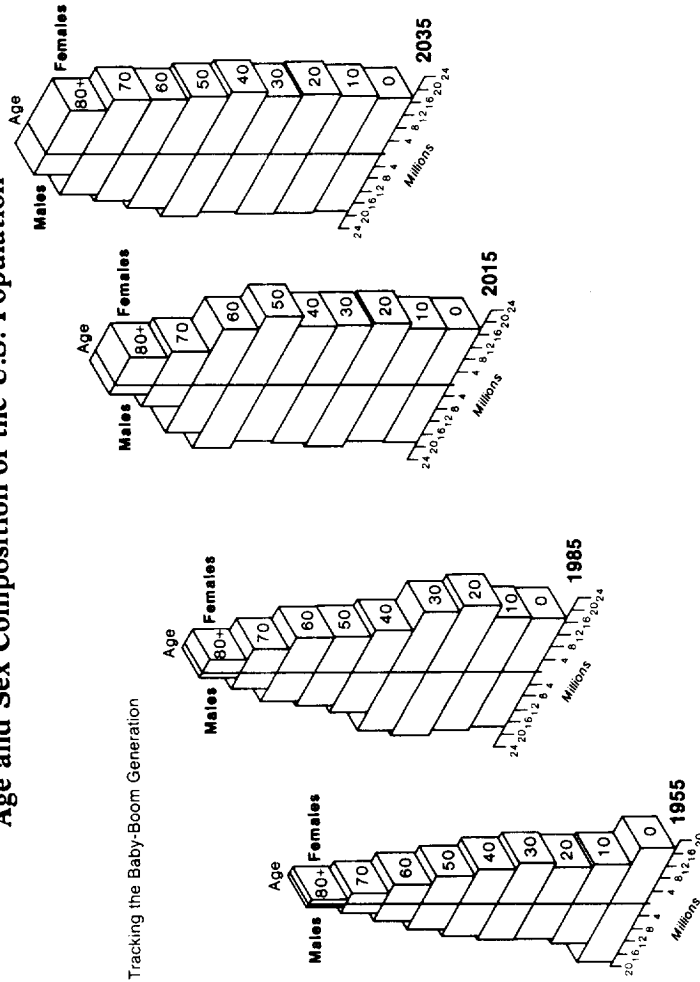
The baby boom was followed by a precipitous decline in births after the mid-1960s. That decline, together with increasing immigration flows from abroad, has major implications for the U.S. labor supply and social services to the end of this century. An increasing number of people at the top end of the age ladder increases the political and economic influence of older people, a situation referred to as the graying of America. This is already underway, as more people live longer as a result of advances in medical knowledge and care and better living conditions. The aging of the American population will take on enormous significance when the baby boom generation reaches retirement age during the second and third decades of the next century.

The age composition of a population reflects past demographic events involving birth, death, and migration patterns. Age pyramids, which break a population down by age and gender, illustrate these links (chart I.1.) An age pyramid of the 1985 U.S. population reveals the relative size and place in the life cycle of several key age groups: the baby boom generation in their twenties and thirties in the mid-1980s; the generation after them, the baby bust generation born between 1965 and 1975, passing through their teens in the 1980s; Depression decade and war baby groups born between 1930 and 1945, moving through their forties and fifties; and the cohorts born in the decades before and after World War I, who are now over age 60. Earlier generations have already moved well into the elderly population category. And while baby boom couples have fewer children than previous generations, the number of births has nonetheless risen since the early 1970s because there are so many baby boom couples to begin with.

Baby Boomers Enter Their Peak Earning Years—In 1986 the first baby boomers reached age 40, and all of them will have passed that milestone by the end of the century. This means that large numbers of people are now entering their peak earning years. It is also significant that as the baby boom generation ages, it will account for an increasing proportion of all households. And the baby boom gener-

Chart I.1 Age and Sex Composition of the U.S. Population

Tracking the Baby-Boom Generation



Source: U.S. Department of Commerce, Bureau of the Census, Population Reference Bureau, Inc.

ation is so large that variations within the group are big enough to create distinct impacts.

Many changes have occurred during the quarter century since 1960, when the baby boom generation stretched from infancy to high school. During the late 1950s and early 1960s the baby boomers had an enormous impact on school systems and created a "youth culture" with the concomitant rapid growth of child- and teen-oriented goods and services. Most of their middle-class mothers did not work outside the home. Today's baby boom generation mothers are much more likely to combine careers with child-rearing and seek child care and homemaking services in the marketplace (O'Connell and Bloom, 1987). Baby boomers who have remained childless are thinking about how to invest their resources in ways that will ensure them the support in old age that children might have provided.

Two-earner baby boom couples must also cope with the responsibility of caring for their own aging parents. Dependent caregiving, whether it be for elderly parents, children, or a disabled person, can make great demands on both the time and financial resources of any household. Employers are affected, either through lower productivity or through proposals for changes in benefits. New ways of thinking about the meaning of traditional benefits are being proposed, such as allowing employees to use sick leave when their parents or children are ill. Flexible benefit programs that allow employees to set aside outlays for dependent care on a pretax basis are another alternative (Day, 1985).

When the Baby Boomers Retire—As early as the year 2011, the older members of the baby boom generation will turn 65. The rest of the group will pass that age during the subsequent two decades. There is quite a contrast between this group and the smaller Depression-decade age groups who are passing that age threshold in the 1980s and 1990s. There will be much less concern about crises in the Social Security trust fund in the next few years. The large baby boom cohorts will be contributing at peak, middle-age earning levels as the smaller Depression cohorts will become eligible for Social Security benefits. Wise baby boomers and members of preceding age groups with increased prospects of longevity will be (in fact, already are) thinking about private investments as alternatives to a Social Security system whose intake will depend on much smaller cohorts than those who are creating current surpluses.

Health benefits are an area that deserves specific watching. Baby boom cohorts are leaving the stages of the life cycle during which

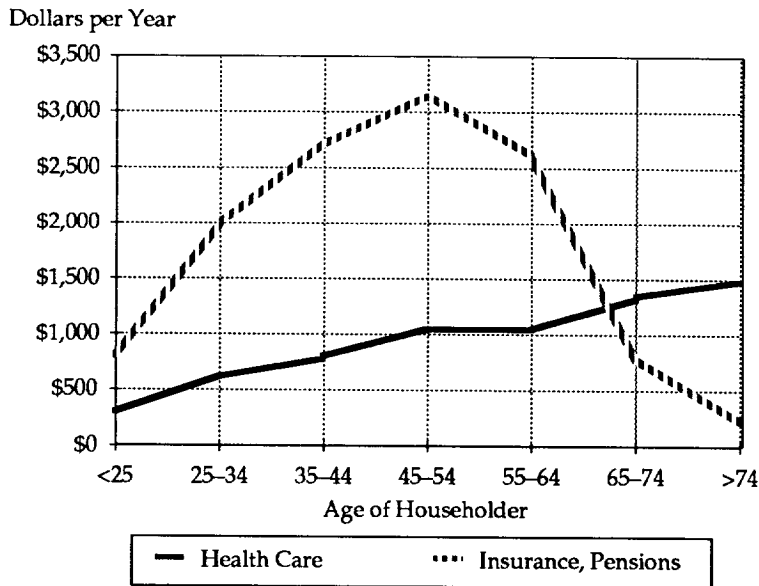
their main health demands related to sports injuries and childbirth. Even with improvements associated with healthier diet and lifestyle, late middle age brings increased health risk, including heart disease and cancer, and the associated health care demands.

By the year 2035, baby boomers will be counted among the elderly, with the youngest members of the cohort just having turned 70 and the oldest survivors being in their late 80s. These "older elderly" currently cause the greatest strain on our health system, and it is difficult to imagine how society will cope with the demands of the large baby boom generation without major changes in health care and service methods. A particular concern is the issue of long-term care. Improvements in medical technology are lengthening life expectancy but also increasing the number of years during which individuals are likely to require long-term care for disabilities associated with aging. Assuming that most baby boomers will survive into their 70s, 80s, and even 90s, the number of person-years of such services required will increase dramatically with the aging of the baby boom (Soldo and Manton, 1985).

The Implications of Age—From an employee perspective, the age of an individual, which determines where a person fits into the social and economic life cycle, strongly affects how individual and household resources are allocated. Data from the 1984 Consumer Expenditure Survey of the Bureau of Labor Statistics reveal that patterns of average annual spending in major expenditure categories differ according to the age of the head of household. For instance, expenditures on insurance and pensions rise to a peak during ages 45–54 and decline thereafter (chart I.2). Expenditures on health care rise with age and increasing medical problems, peaking at age 75 and older. The pattern of spending on education has two peaks, one below the age of 25 and another during ages 45–54, when students as well as parents are paying for higher education.

The combination of age-sensitive expenditure patterns and significant differences in the relative size of age groups in the U.S. population is the central reason for the increased importance of demographic information in product and labor markets. But age is not the whole demographic story. Age-group averages mask differences associated with other characteristics; for example, spending on education is obviously affected by the number of children, if any, in the household. The householder's income and gender as well as households' and families' structure and size are other salient factors to be considered.

Chart I.2
Expenditures by Age of Head of Household:
Health, Pensions, and Insurance



Source: 1984 Consumer Expenditures Survey, Bureau of Labor Statistics.

Households and Families, Gender Roles

For a great many products and services, the basic marketing unit is the household, and, by implication, the family. While it is common to think of "household" and "family" as coterminous, statistically they are different. *Families* consist of groups of individuals related by blood, marriage, or adoption, while a *household* can include unrelated individuals, multiple families, or an individual living alone. Another statistical and census category is *group quarters*, such as military barracks, college dormitories, and prisons.

The needs and desires of individual consumers are affected by the way they live, whom they live with, and what resources their households can generate. As the formation and maintenance over time of

households and families, their size, and what the various members see as their roles have changed so much since 1960, and even since 1975, consumption patterns have also changed. These changes are a key reason to look at the demographics when considering how demand for a product or service might change.

Average household size in the United States has undergone a precipitous decline, from 3.37 persons in 1950 to 2.69 in 1985. The stereotypical "traditional" family, consisting of a working male breadwinner whose spouse cared for children at home, accounted for less than one-third of American households even in 1960. If this figure seems low, remember that families with children under 18 represent only part of the family life cycle, and the statistics relate to all families and households including those of single people, older couples whose children who have left home, and so on. What is significant is that by 1985 "traditional" families had dropped from one-third to one-ninth of all families. Working couples with and without children (for instance, "double income, no kids" families), adults both young and older living alone, and single-parent as well as other types of households have increased in relative importance in American household structure.

Most people reside in what are known as "family" households. There were nearly 87 million households in the United States in 1985, of which close to 63 million (72 percent) were "family" households, in contrast to individuals living alone and other types of households. One would think that population growth, family growth, and household growth would move in tandem, but in fact they have not. The number of households grew very rapidly in the 1970s—by more than 25 percent—but the population grew by only a little more than 10 percent. Much of the growth of households can be attributed to two groups at opposite ends of the age scale. Baby boomers reached the age to form their own households during the 1970s, and, like everything else, they did this differently from previous age groups. They moved out of their parents' households at an earlier age than usual, but they did not get married; they started households rather than families. They lived alone, or with roommates, or with lovers. Those who did marry, delayed it until they were older, and those who had children also waited until they were older, on average, than earlier generations. At the other end of the age scale, older people increasingly have the desire and resources to live independently rather than with their children, resulting in many more one- and two-person households. The middle-aged continue to have high levels of divorce, creating many more single person and single-parent households. These

and other factors worked together to increase households more rapidly than families and at the same time decrease average household size.

Those who live alone, with roommates, or with lovers fall into the household classification termed "nonfamily" by the Census Bureau. Most market analysts make no distinction between a conventional "family" and a family that is not statistically defined as such. They think of the nonfamily household as a variant family structure. Statistics relating to households and families do make fairly clear distinctions between the two types of households, however. As a result of these trends, nonfamily households grew by 78 percent during the 1970s, compared to less than 16 percent growth of family households.

Household growth, particularly nonfamily households, slowed during the first half of the 1980s, in part because economic conditions made it more difficult for those attempting to enter the labor force to live independently. Households continue to grow more rapidly than population, but the differential rate is much less in the 1980s than it was during the 1970s. From 1980 to 1985, households increased by 7.4 percent, compared to a 5.2 percent increase in population.

Even family households are a fairly mixed group. The formal Census definition of a family is somewhat different from what comes to the minds of most market analysts: it includes not only couples with and without children, but also single-parent households with children as well as other groups such as sisters or any other combination of relatives. Eighty percent of U.S. families are headed by married couples; 16 percent have single females as heads of household, and 4 percent are single male headed (table I.1). Family households in 1985 were equally divided between those children under 18 years of age and those without children. Among families with single persons as heads of household, those headed by women were much more likely to include children than those headed by men.

Changes in Household Structure—Since 1960, a year with more than 4 million baby boom births, household structure has changed substantially. As table I.1 shows, family households were 85 percent of all households in 1960; this declined 13 percentage points, so that only 72 percent of households were family households by 1985. In 1960, married couples dominated family households, accounting for 88 percent of families, but the increase in single people as heads of families drove that down to 80 percent by 1985. Fifty-seven percent of family households in 1960 had children under 18, compared with 50 percent in 1985.

There were qualitative as well as quantitative changes between

TABLE I.1
Changes in Household and Family Structure,
1960-1985

Type	1960		1985		Change	
	Number	Percent	Number	Percent	Number	Percent
Total	53,087	100	86,788	100	33,701	100
Nonfamily	7,939	15	24,082	28	16,143	48
Family	45,148	85	62,706	72	17,558	52
Family, with Children	25,690	48	31,112	36	5,422	16
Married Couples						
Wife working	6,522	12	14,755	17	8,233	24
Wife at home	16,796	32	9,455	11	-7,521	-22
Family, Single Head						
Female	1,891	3	6,006	7	4,115	12
Male	301	1	896	1	595	2
Family, No Children	19,458	37	31,594	36	12,136	36
Married Couples						
Wife working	5,648	11	12,602	14	6,954	21
Wife at home	10,511	20	13,538	16	3,027	9
Family, Single Head						
Female	2,305	4	4,123	5	1,818	5
Male	994	2	1,331	1	337	1

Source: U.S. Department of Commerce, Bureau of the Census (Washington, DC: U.S. Government Printing Office, 1986).

1960 and 1985. Changes in women's roles within the family from 1960 to 1980 are an important dimension of change in family structure. Only 28 percent of wives living with children worked outside the home in 1960, compared with 61 percent 25 years later. Single female-headed families with children were only 4 percent of all families in 1960, doubling to 10 percent in 1985. In that year, a higher proportion of working wives was found among married-couple families living with children under 18 (61 percent) than among those without children (48 percent). This contrast probably occurred because individuals who live with young children are also in their prime working years, and married couples without children include "empty nesters," older people whose grown children have left their parents' homes.

Although these shifts in percentages indicate important shifts in household structure, changes in the absolute number of households is crucial to assessing the effects of changes in household composition in such areas as employee benefits. While the number of families with nonworking mothers and children declined from nearly 17 million in 1960 to 7.5 million in 1985, there were still about 24 million families consisting of married couples and their children during the period from 1960 to 1985. However, the number of such families in which the mother worked outside the home doubled: from 6.5 million to 14.7 million. At the same time, married-couple families without children increased from 16 to 26 million. So there are also large new segments of working mothers and childless couples with their own special needs.

Table I.1 also shows this increase in married-couple-only households, as well as female-headed families. Nonfamily households tripled in number, from 8 to 24 million, accounting for almost one-half of the 34 million increase in U.S. households over this 25-year period.

The Effect of Population Trends on Employee Benefits—What do these population trends mean for employee benefits? Different types of households have quite distinct patterns of demand for benefits. Health care providers have learned that two-earner married couple families want a different kind of “family” service than households with children. Providers are becoming much more sophisticated in pricing health care and health insurance based on risk associated with age and household structure. Child care and flex-time are important to two-earner families with children. Some workers may be attracted by the availability of child care at the work place, and it may be necessary to offer this to attract them as the dearth of younger workers creates labor scarcity in some markets. Working couples without children will be more interested in allocating benefit dollars to retirement or other options such as care for elderly dependents. The growth of single-parent households reflects rising divorce rates. Divorce as well as remarriage trends raise additional benefits issues because they shift spouses and children into or out of benefits dependency status, depending on eligibility regulations.

Changing Population Geography

Demographics also include a geographic component: while national trends provide a basic picture of demographic changes such as those just discussed, decision makers concerned with the availability and costs of benefits will in fact be dealing with a range of local

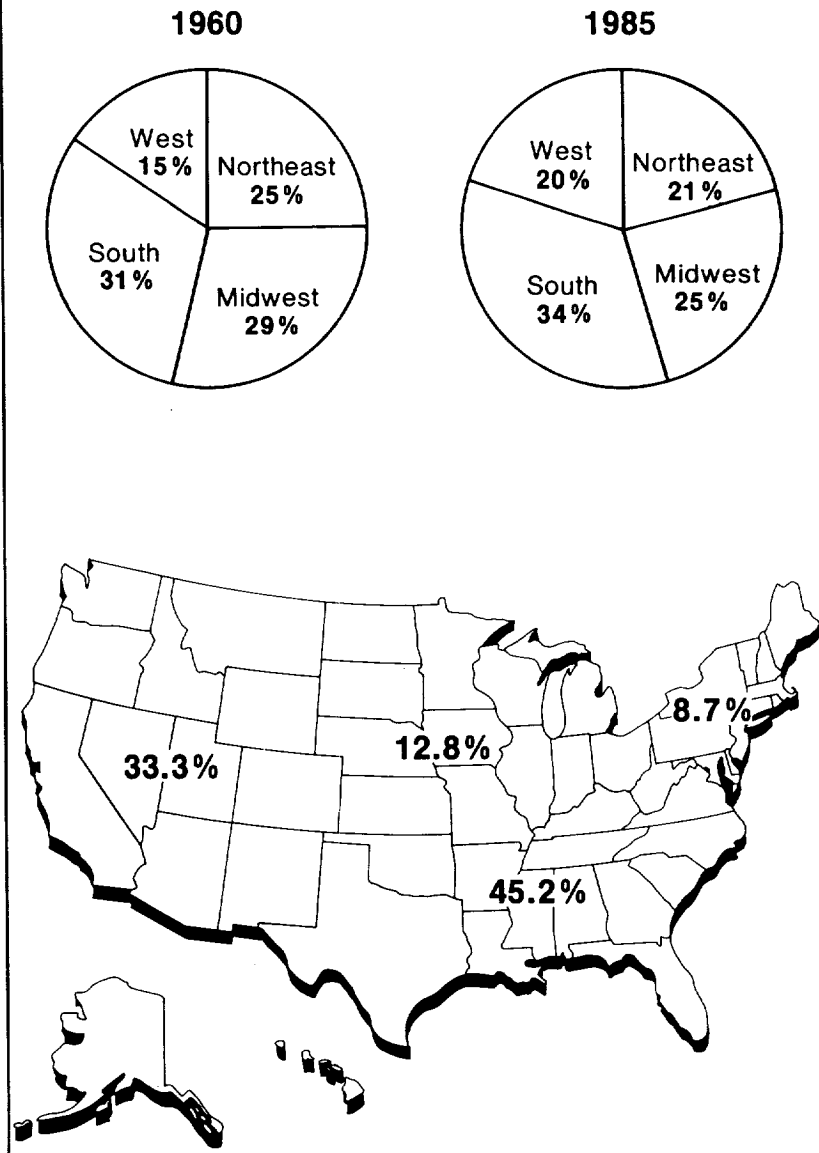
conditions which may vary in important respects from national patterns. The internal demographic structure of an organization's work force and workers' dependents is much more likely to mirror that of the local population than to reflect national averages. Some areas are experiencing rapid growth either through internal or international migration; others may be experiencing population decline. Age and structure and household composition are very sensitive to these movements, so that benefit issues that are related to them need a focus on local area demographics.

The U.S. population grew by nearly 60 million people between 1960 and 1985, but only two regions, the South and West, accounted for an impressive 78 percent of that increase (chart I.3). The Northeast, with 21 percent, and the Midwest, with 25 percent, of the country's total population captured only 22 percent of the national growth during that period. The South, the nation's most populous region, with just over one-third of the U.S. population, accounted for 45 percent of overall growth. The West, with 20 percent of the total, accounted for one-third of the increase, making it the most rapidly growing region in percentage terms. At this rate, the Western population will be greater than that in the Northeast by 1990.

The differences in regional growth trends have several causes, including employment opportunities, labor cost differentials, weather, and appeal to certain lifestyles. Census Bureau projections point to continuing regional diversity in growth trends during the remainder of this century. In fact, declines in the shares of population in the Northeast and Midwest are expected to continue through the year 2000. Even with the slower national population growth projected during the 1990s (7.1 percent), the South and West are expected to grow substantially: the South by 11 percent and the West by 14 percent. Though a region's population may be dropping, some areas within it may be exceptional. While the Northeastern population increased on the whole by only a fraction of a percentage point during the 1970s, New Hampshire's population grew by 28 percent, largely a result of the revival and northward expansion of the Boston metropolitan area. California ranked 12th among the 13 high-growth Western states in percentage increase during the 1970s, but its large population base was enough to give it the biggest increase in absolute numbers in the entire country.

Internal and international migration are key factors in regional growth differentials. International immigration to the United States concentrates in a few states, including California in the West, Florida, and Texas in the South, and the New York and Chicago metropolitan

Chart I.3
Regional Shares of Population Growth, 1960–1985



areas in the North. Movement of people within the United States also favors the South and West. The total net growth from national and international migration was 3.4 million in the South and 2.2 million in the West during 1980–1985.

Migration and Business—These migration streams raise some important questions for business. Every new migrant group forms a new labor and product market segment with different needs, skills, and preferences. Such demands will affect both the marketplace for consumer products and the business-to-business market as new immigrants pursue entrepreneurial opportunities. For both international and domestic migrant streams, market analysts must decide to what extent new residents will retain their original tastes and preferences or whether they will plunge into the “melting pot” of their new location and consume the same regional or national goods and services as their neighbors. Employers need to think about skill availability and the implications of migrants’ household structure patterns when planning benefits.

Metropolitan area growth trends also bear watching, since they can run counter to overall regional trends. Metropolitan areas include the 300 or so cities with the largest populations in the United States and their adjacent counties, designated as part of a metropolitan statistical area (MSA) by the Census Bureau, under guidelines established by the U.S. Office of Management and Budget. Metropolitan populations account for the majority of total U.S. population, ranging from 69 percent in the South to 88 percent in the Northeast in 1985. Most metro growth is concentrated in the more rapidly growing South and West, led by areas such as Phoenix, Arizona, Austin, Texas, and Las Vegas, Nevada in the Southwest and West Palm Beach, Daytona Beach, and Fort Myers in Florida. Metro areas in the Northeast and Midwest have, for the most part, experienced low population growth or even declines. There are some exceptions: areas with scenic attractions such as Atlantic City-Cape May, New Jersey; state capitals such as Lincoln, Nebraska; areas on the fringes of large metro areas such as Manchester-Nashua, New Hampshire (near Boston). All of these metro areas have grown more rapidly than the national average since 1980.

During the 1970s nonmetropolitan areas actually grew faster than metro areas, leading many to examine the causes and implications of a so-called “nonmetropolitan turnaround.” Factors such as a preference for open spaces, changing lifestyles, improvements in transportation and communication which allowed greater commuting distances and decentralization of manufacturing facilities, shifts of

manufacturing plants out of central cities, and increased energy extraction activities in response to the oil crisis are said to have contributed to nonmetro growth during the 1970s. By the early 1980s this "reversal" was itself reversed as metropolitan populations again grew faster than nonmetro areas. However, as John Herbers (Herbers, 1986) and others point out, much of the nonmetropolitan growth of the 1970s occurred just outside major metropolitan areas. Part of the resurgent metropolitan-area growth since 1980 has resulted simply from changing definitions. The government reclassified as "metro" areas of the more dynamic *non*metro counties on the outer fringes of major metro areas. For example, Frederick County, Maryland and Stafford County, Virginia "joined" the Washington, D.C. MSA in 1983. Herbers claims that many of these new low density, spread-out settlements on a metropolitan periphery are far less "metropolitan" in character than the typical urban and suburban rings around major central cities. These new areas have the characteristics of what people sought in moving to nonmetropolitan areas during the 1970s, which means that analysts will have to pay even closer attention to specific characteristics when using metro data to determine local conditions.

The Changing Work Force

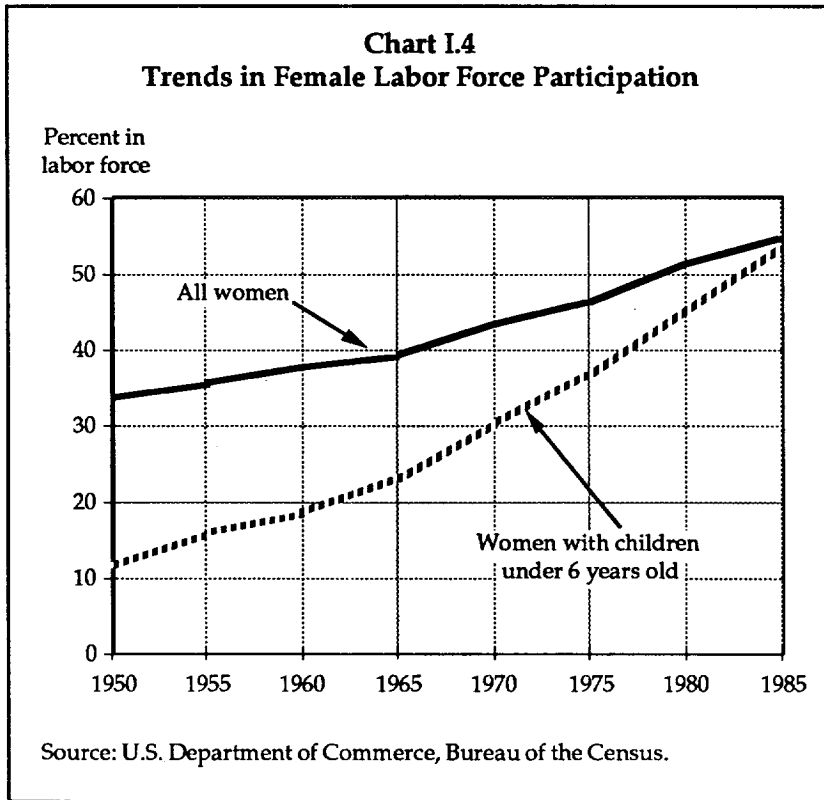
The demographics of the local and national labor force are also the key to effective benefits management. The implications of labor force changes are multifaceted, beginning with the fact that employment trends affect demand for benefits as well as other goods and services as jobs create the income needed to purchase them. Is there an adequate supply of workers whose skills match employers' demands? How does participation in the work force affect time allocation, individuals' roles in the family, and the kind of products and services needed?

Labor cost effectiveness is highly dependent on the availability of workers with appropriate experience and skills. Retailing needs a relatively unskilled, inexpensive labor force, while some manufacturing industries need highly skilled workers to produce quality goods and meet the challenges posed by innovative technology, international competition, and high-tech products.

The changes in the U.S. labor market over the last quarter century have been nothing short of revolutionary. In 1985, the U.S. civilian labor force numbered 115.5 million workers, 107 million of whom were employed. This was 46 million (or 66 percent) more people in the labor force than in 1960! Women accounted for 61 percent of the

total increase, and the percentage of men in the labor force thus dropped from 67 percent to 56 percent as a result. The proportion of wives working outside the home jumped from 30.5 percent in 1960 to 54.5 percent in 1985 (chart I.4). The advent of two-earner families has important business implications for the United States, both because of the impact on family income and because of the accompanying changing consumption patterns.

As increased female participation in the labor force coincided with the entry of the baby boom generation into the work place during the years 1960–1985, the U.S. work force grew more rapidly during that period than it did in earlier decades. Slower growth is likely to prevail during coming decades when the smaller baby bust cohorts



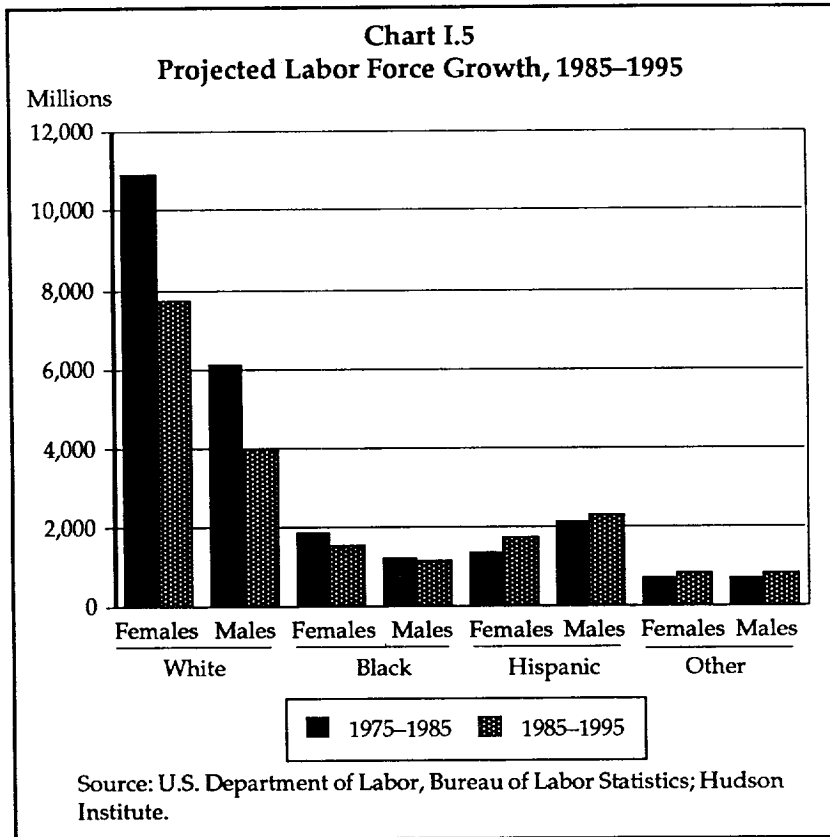
will be starting to work. There are also fewer older workers in the labor force, as many now have more secure retirement income prospects and may have been offered attractive "early out" incentives to make way for younger workers or new managements.

The people who joined the labor force between 1960 and 1985 are better educated than any previous generation in American history. In 1987, 85 percent of the labor force aged 25 to 64 had completed high school and 25 percent had 4 or more years of college. Twenty years earlier, in 1967, only 50 percent had finished high school and just 13 percent had 4 or more years of college. More good news for the U.S. economy is that these cohorts are, or soon will be, moving into mid-life, the higher earning phase of their life cycles.

Projected Growth in the Labor Force—Looking ahead, the U.S. Bureau of Labor Statistics projects only a 12 percent increase in the labor force from 1985 to 1995, compared with 23 percent rate of growth between 1975 and 1985. Women again account for 60 percent of the projected increase; white males, who contributed 29 percent of the 1975–1985 increase, are expected to account for 15.5 percent of 1985–1995 work force growth (chart I.5). The "wild card" in labor force projections is immigration from other countries. It is likely that Hispanic and Asian migrants will contribute significantly to labor force growth in coming decades.

The projections of labor force participation also show that the new entrants during 1985–1995 will not be as well educated as those who entered the labor market between 1960 and 1985. There is growing concern about the availability of workers needed to deal with very sophisticated technology and to work in information-oriented industries. Many hope that these goods and services will give the United States a competitive edge in the world economy. According to the U.S. Department of Labor, most future labor force growth will come from groups in the population that traditionally have been underutilized and have had trouble finding rewarding jobs. Women from low socioeconomic levels, members of minority groups, and immigrants will account for over 80 percent of the net additions to the labor force between 1985 and 2000 (Hudson Institute, 1988).

With slower overall growth in the labor force and much of that growth concentrated in members of minority groups, many rapidly growing suburban areas are experiencing labor shortages among retail and other relatively unskilled occupations. These jobs were customarily filled by teenagers or wives working part time. With fewer teenagers in the baby bust cohorts, few women willing to work only



part time, and few members of minority groups living in the suburbs, many companies and stores are having to rethink their staffing and benefits strategies.

There are many areas in which labor force demographics affect benefits decisions. As an organization's labor force and its dependents age, health care costs may rise. The need for on-the-job training, retraining, and adult education will increase as more immigrants and educationally deprived members of minority groups join the work force and as industrial restructuring forces occupational shifts on middle-aged workers because of changing technology and international trade patterns. The effects of women's broader participation in the labor force are just beginning to appear with respect to both

the supply and character of workers in traditional and nontraditional industries and the demand for innovative goods and services.

International Population Trends

International population trends have also contributed to the increased significance of demographics. Over the last few decades, population growth trends in the more developed and less developed countries have diverged. Rapid population growth in less developed countries has increased consumption needs and made labor cheaper, giving these countries an increasingly competitive edge in mass-market consumer goods. Population growth rates have slowed and sometimes stopped altogether in the more developed industrialized economies of Western Europe, North America, and Japan. Since fewer workers lead to higher labor costs, many more developed countries have shifted their industrial mix toward specialty goods and services. These typically require specific skills and training for production and identification of specific consumer groups for marketing.

Developing countries have also increased in importance as markets for U.S. exports. New trade patterns are being established. Newly industrialized countries (NICs) such as Taiwan, South Korea, Singapore, Brazil, and Mexico are becoming increasingly competitive with the United States in the manufacture of textiles, shoes, steel, automobiles, and auto parts as well as consumer electronics. They are also an important market for U.S. goods and services, particularly agricultural products, telecommunications, and information and financial services. The share of U.S. exports going to these five countries increased from 12 to 15 percent between 1975 and 1985 and would have increased even more had it not been for recent debt-related recessions in Brazil and Mexico, which forced them to curtail imports. The NICs, with their rapidly urbanizing populations, were good markets for U.S. agricultural exports as long as their economies remained dynamic. The decline in U.S. agricultural exports to Latin America during the early 1980s resulted more from the region's declining purchasing power than from increases in its agricultural production capacity.

While the struggle to increase living standards in less developed countries requires them to become more competitive with the United States, an increasingly prosperous Third World will also be a better market for U.S. goods and services, provided U.S. exporters take advantage of this new market potential (Sewell, Tucker, et al., 1988). Some export-conscious managers have been paying increased atten-

tion to international demographics. Ironically, officials at the U.S. Census Bureau's International Demographics Researcher Center were somewhat chagrined to learn that Japanese businessmen were more interested than American firms in their international market-oriented demographic data products.

Responding to Changing Demographics

Managers who recognize the importance of demographic changes for their personnel policies and labor costs are looking for ways to incorporate demographic information into their decision making. Actuaries have traditionally worked with personnel departments in designing benefit plans, but boardrooms are looking increasingly to their strategic planners for guidance on the longer term cost implications of an aging employee and dependent population and of the increased participation of working mothers in the labor force, which has led to proposed legislation on parental leave and day-care facilities.

One way in which demographic information is being used effectively is through what is coming to be labeled "work force demographics" or "organizational demographics." Demographic information and analytical tools are being used to track the changing size and composition of the workers in an organization and their dependents in ways that parallel the analyses of populations that are defined by place of residence and/or other characteristics. Such analyses can help decision makers to anticipate the effects of future demographic shifts on labor costs. Many examples can be cited.

Companies that have relied on lower wage entry-level workers are going to face a shrinking labor supply as smaller baby bust cohorts reach working ages. Many of these industries have comparatively narrow promotion ladders and have relied on high labor turnover to maintain their own broad-based working age population pyramids. In the future they will have to retain more workers or find alternative sources. To be successful, their strategies will have to take account of the demographics of the local labor supply and the "fit" between their particular skill needs and the costs in terms of both the wages and benefits of attracting alternative sources.

Inattention to organizational demographics may result in expensive miscalculations about the true costs of negotiated wage and benefit agreements. While demographic projections still fall far short of being an exact science, many shifts in the age and household composition of a work force can be anticipated using demographic mod-

eling techniques. Projections can help to map a range of scenarios that may occur if current trends are continued and a given set of benefit and wage offers are made.

Admittedly, demographic information is only one part of the benefits equation; social, economic, and political trends will obviously affect the way in which a given set of demographic patterns plays itself out in terms of labor costs. But the incorporation of changing demographics in these calculations has become an essential part of the planning process in business as well as in public administration.

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II. Work and Business in a New Economy

PAPER BY JEFFREY J. HALLETT

Introduction

In response to the extraordinary change now underway throughout the economy and work place, and the books and articles that have attempted to define it, we have put forth a number of "answers" to guide organizational and national policies and programs. Among the new initiatives are those calling for excellence, quality, competitiveness, innovation, entrepreneurship, and automation.

At another level, there has been a rash of friendly, unfriendly, hostile, and other forms of corporate restructuring as industries and organizations strive to meet the challenges of this new era.

For most people, however, the real meaning of the abstraction of a "new economy" and the various programs that have been initiated in response to it is in its direct effect on their work life. At the most basic level, individuals must find, hold, and protect their jobs. They need to meet deadlines, learn new technologies, and adapt to a continuing shift in corporate ownership. They must hire, train, and manage employees. They must plan their personal and family budgets.

It is also at the level of individual work that we will or will not succeed in building a strong and prosperous economy. It is here that we earn the money necessary to support ourselves and our families. It is through our activities at work that we attain the personal, organizational, and national growth and achievements that we strive for.

For millions of Americans, the emergence of the new economy has meant dislocation, unemployment, and reduced earnings. For nearly everyone it means new and growing uncertainty and insecurity regarding their work life. And this is a fact of life that is as relevant in the newest of our high-tech industries as it is in the oldest of our manufacturing industries. And it is as true for the white-collar employee as for those with collars of another color. We may wish that things were different in our organization, profession, or industry—but they are not.

Successful response to the changes underway will come from the aggregate decisions on a day-to-day basis of all of our major institutions and of each individual.

The policies we enact as a nation that affect taxes, trade, education, training, worker compensation, and benefits have a deep and continuing impact on work life. The practices we choose to guide employment, management, organization, motivation, and reward contribute directly to our ability to meet the challenges of change. Educators and the educational system itself must also assume responsibility for the effectiveness with which we are preparing our children and ourselves for a productive work life.

It would be helpful if someone could describe with certainty the specific steps and actions we should take at all levels of society to move us into the new age with as little pain and as much success as possible. Life is obviously more complicated than that. The answer, however, may be simpler. Perhaps what we need to do is simply reframe our idea of "work" to match the realities of today and the future, then use that new idea to guide our individual and group decisions on a daily basis. Indeed, the key seems to rest in a series of personal choices regarding how, when—and for what purpose—we work.

To begin the process of rethinking the realities of work, we must be clear about the reality of work life in America today. For many, this is the most difficult part of the task, because what is real about today is already so different from what was hoped, expected, or planned for.

Economic Realities

America has long since lost the position of economic, political, and technological predominance that it held for so much of the 20th century. We are approaching the next century as but one of many important actors on the international scene and have, in fact, been soundly thrashed by competitors from Japan and elsewhere in our own markets as well as abroad. Even with the current boost to exports from new lows in the value of the dollar, the quality of a sobering list of American products has not been adequate to prevent us from losing market share to our foreign rivals at a persistent rate.

This is not to say we are not or cannot continue to be a major factor in the global economy or that we cannot compete. Nor is it meant to suggest that our corporations have not been handicapped by governmental policies here and abroad.

What is important for every organization and employee to understand is that we do not approach the next 20 years from the top.

Indeed, we face a long, hard battle from companies and countries that have proven to be very formidable competitors.

The U.S. Standard of Living

The standard of living in America for most people has remained flat for over a decade. The net impact of the energy crisis, stagflation, new international competitiveness and a basic restructuring of our industries during the past 15 years has created a situation for the majority of Americans in which little real economic progress was made. The strength and reliability of the "American dream" has been badly eroded. Layoffs, cutbacks, and constant realignment of products, companies, and industries have caused millions of families to face sudden and painful disruptions in their lives. For them and their children, the reality of what is and expectations of what should be have clashed.

This means we must reshape our expectations—and the dream—to new realities. For the most part, this means less security (not *no* security, less security), fewer material gains, and the knowledge that we must work hard simply to maintain our employability.

The Importance of Information

Information and knowledge are the vital raw materials of the products and services we produce. Our economic experience and greatness were built on the exploitation and maximization of material and energy through the techniques of economies of scale and mass production. Today it is the ability to incorporate higher levels of information and knowledge in both products and processes that makes them competitive in the marketplace. In short, it no longer matters how many products one can produce; it matters how good the products are and how closely they meet the customer's needs.

This is important because it shifts the determinants of competitive advantage away from those circumstances that bring a producer close to supplies of energy, transportation, or large pools of labor. All the infrastructures (financial, transportation, educational, social, and political) that were created to sustain the industrial economy are inappropriate for the new economic realities. Information and knowledge are transmitted at the speed of light and are not geographically restricted. Information and knowledge that become creativity, inno-

vation, and application are contributed by individuals and groups who must be educated, motivated, and rewarded much differently than their industrial predecessors. The way we organize, train, reward, recruit, and manage must be determined by this new set of conditions.

The future is here! In 20 years it will be the year 2008. And while 2008 may seem a long time in the domain of science fiction writers, it is in fact the horizon around which we frame our basic decisions. We do things today in terms of what we expect will result in the future—not the past—and when thinking of work life, the 21st century is the reality we are building toward. The vast majority of the work force in 2008 is alive today and in our school systems. The leaders of 2008 are now about 30 years old and already at work. Today's college freshman will be at the core of the work force, making the decisions that shape the nation and the economy during the first decade of the next century.

The Need for Educational Reform

Our educational system has fallen way behind and simply has not adapted to the new opportunities and challenges that current and future realities present. There can be little doubt that we have already lost, and will continue to lose, ground in the new global environment unless we reshape our entire learning system.

As a nation we have been shortchanging the educational system (benign neglect) and are paying the cost many times over. Employers are forced to spend billions on training and education. Cities, counties, and states pay billions more in remedial services and programs as hundreds of thousands of our children leave school functionally illiterate.

All the rhetoric in the world and the best of technological breakthroughs will not help a society that fails to create a system that maximizes the potential contribution of each of its individual citizens. America was built on its willingness and ability to invest in what was the best and most innovative schooling system of its time. It has not, however, continued that commitment. Moreover, changing the system requires that we be as clear as possible about what kind of world and society we are preparing our children for, and that we rededicate ourselves to the commitment to ensure excellence in this area above all else.

A New Definition of Work

With these basic facts as a steppingstone, we turn to an examination of the meaning of work itself.

By definition, "work" is labor—an expenditure of physical energy. By experience, work was something we did to earn money to support ourselves. We hired out our bodies to work in mines, fields, factories, warehouses, shipyards, docks, and assembly lines. Work was not an integral part of our lives but rather something done to enable us to raise families and seek material improvement.

Today, of course, a small and decreasing number of us work in the true physical sense. Machines do physical work. People contribute mental work or very technical, highly skilled physical work on an individual basis such as that done by surgeons, electricians, plumbers, and dentists.

Work has also been defined as a place; we speak of being "at work." When you attend machines, farm, extract minerals from a mine, or unload ships, you do so at the site where the activity occurs. To hold a job and work meant being at a specific place for specific time periods on specific days; it was required. Thus, we lived our lives working at something for someone else in some other place.

Every detail of work life and management today is formed around basic ideas of work that are vestiges of work as it was in the past. As two simple—but basic—examples, consider job descriptions and work schedules.

Job Descriptions—Like other parts to a machine, job descriptions were developed to state precisely what had to be done. In any organization, all "jobs" were defined so that they related perfectly to the total assembly process. The work to be done each day was easily measured and unchanging because the expectation was that the job itself would not change. The job, not the person performing it, was important. From this simple fact has come an entire history of personnel administration, labor relations, and protracted negotiations and settlements focused on "job security."

Work Schedules—We still face hours of dangerous, boring, polluting commutes because we act as if we are required to be at "work" at a specific time so that when the whistle blows, the machinery can start and the "workers" will all be there to attend it. While there have been some moves toward flextime, and a few people work at home, the entire notion of management, control, and responsibility from

the past still requires this continuing mass movement from "home" to "work."

When 80 percent of today's employees work with their minds, why do we continue the insanity of "commuting?" We think, have ideas, plan, and create whenever we put our minds to it, and for the most part our minds do not really care where we are. However, sitting in traffic may turn them off for the rest of the day. Computers and telecommunications now enable us to talk, write, work on drawings and layouts, or compute from any place where there is a telephone and/or a computer terminal. The personal and economic inefficiency of "commuting" will end through an increased focus on results and less worry about how, when, and where the results are produced (even if they come from leased, temporary, or contract workers).

Work Life Transformations

Our ideas of work life today and in the future will be reshaped by the impact of a broad set of technological, social, and economic changes. As these changes converge to influence working conditions, several basic concepts emerge, including the following.

Self-Reliance—Demonstrated and discussed from a variety of perspectives over the past decade, one of the strongest changes underway is the move toward increasing individual and small group independence and self-reliance. This basic notion of "freedom" from the tyranny of religious and monarchical domination that precipitated the founding of America is reasserting itself to meet modern conditions. It is not so much an action of escape, however, as it is an aggressive move toward a new framework for living.

A strong movement toward self-reliance and away from a mass-consumer, mass-production society began during the 1960s. It was back to the past with a vengeance as people moved to farms, wilderness areas, and communes. Pursued to its fullest by only a few and for a short period, the movement generated a lasting boom in "do-it-yourself" activities from gardening to home repair, an interest in natural foods, and the beginnings of a genuine concern for the environment.

Politically, this shift manifested itself in the growing insistence throughout the country that more of our affairs be settled locally. Cities, states, and regions began a process of asserting their independence and uniqueness that has continued, sweeping into office presidential candidates who promise to get the federal government off our backs.

For the past decade, the demand for independence has resulted in the formation of thousands of new businesses, as growing numbers of individuals have chosen independence. Today, more than 700,000 new businesses are created each year in this country. "Entrepreneurship" has replaced "management by objectives" as the watchword to success.

And, finally, the new thrust of American management is one of innovation and flexibility that extends beyond the individual and small group participation found in quality circles. Tom Peters* has made it clear that excitement comes from those suddenly charged with an independent task of meeting a new challenge in the marketplace. Peter Drucker** is calling for a totally new emphasis in management that promotes innovation and entrepreneurship.

Every year, more and more Americans work independently, relying more on themselves and less on institutions for their economic well-being. This has made life difficult for organized labor—not because of what the unions have or have not done but simply because people have less need for that kind of mass identification. It has also made life difficult for corporate America, which is finding employees less loyal and more anxious to leap at new opportunities or form competitive companies across the street.

A New Social Contract between Employee and Employer

"Never, never say to an employee that the job is steady, guaranteed, long term, permanent, or safe."

At the core, self-reliance becomes a powerful statement regarding our expectations about work and society. It connotes a complete reversal of the fundamental notion that we "work" for someone else. Instead, it says we only work for ourselves—that we take responsibility for our own performance and progress, that we take responsibility for our own futures, that we have the knowledge and capabilities necessary to be successful contributors to the economy.

While this sounds good, nothing could be more stressful. In the "good old days," everything was much simpler. Workers simply had to do what the employer told them to do, and if they did it honestly and reliably, promotion and a career were fairly well assured. If a

* Editor's note: See Tom Peters, *Thriving on Chaos* (New York: Alfred K. Knopf, 1986).

** Editor's note: See Peter F. Drucker, *Innovation and Entrepreneurship: Practice and Principles* (New York: Harper & Row, 1986).

product failed, it was the fault of the system, not of any individual; if the product soared, it was also because of a system that had been effectively managed and controlled by management experts. If work conditions were miserable, unsafe, or poorly compensated, the unions could negotiate the needed changes.

In the past, the contract between employee and employer was simple: "A fair day's work for a fair day's pay." Now it all has to be rewritten because the exchange between individuals and organizations has changed. Individual employees have become increasingly important, as quality, excellence, innovation, flexibility, ingenuity, and change have come to define our operating reality. Workers are not simply performing predesigned tasks that could be done by any healthy body. Quality performance and true excellence occur only when each individual in the process is dedicated to it and is working, by choice, toward these goals. When the competitive reality is a demand for quality, one individual or group not so motivated or concerned can destroy the efforts of everyone else and every other element of the process. This was not the case when the challenge was quantity and the method was mass production.

Think what this does to the requirements for just-in-time manufacturing processes. Great efficiencies and responsiveness have been demonstrated when a production process is designed to maintain a constant flow of materials, information, and parts from the suppliers all the way through to individual products. These systems, however, require that everyone in the process put forth his or her best effort. A poor performance somewhere in the chain brings everything to a crashing halt.

Different Attitudes and Different Policies—As individuals we must reach the very simple conclusion that we only work for ourselves. Our personal, professional, and material rewards will come from our ability to learn and excel at what we are doing. To count on any particular employer to ensure that we will have a meaningful, higher paying job next year or the year after is a big risk—ask the 500,000 white collar workers recently laid off from the Fortune 1000 companies or the millions of blue collar workers who have seen their employers close plants, decline, and disappear.

As managers and employers, we need to design and implement procedures that help identify, employ, motivate, and reward individuals in ways that honor and support this self-reliance. This means, clearly, a power loss for those at the top, where power means the right and the responsibility to design, manage, and control the day-to-day activities of others. Innovation and flexibility come from ex-

perimentation, awareness, and individual enthusiasm, not from a set of repetitive, prescribed tasks.

More than 25 percent of the current work force consists of people who are not full-time employees, i.e., who are independent contractors, temporaries, leased, or part-time workers.

"Employment at will" is a phrase that denotes the idea that employers may hire and fire at their discretion (with the exception of discrimination). Increasingly, that concept is being challenged legally. In 1980, a new legal interpretation essentially declared that any statement in an employee handbook or even verbal statements by corporate officers, constitute a contract. This means that statements that indicate a corporate commitment to retaining employees in difficult times must be maintained regardless of the circumstances. When it is not maintained, an increasing number of fired or laid-off employees are going to court.

In an attempt to protect themselves, employers have explored and used "noncompete" contracts and clauses. Appropriately called "headfastening," this concept is a simple one concerning "who owns your brain." It represents an adversarial idea of work, as employers seek employment contracts with restrictive covenants that are directed at preventing individuals from (1) joining a competitor, (2) setting up a competitive operation, (3) using confidential information, and (4) recruiting employees if they leave. Such efforts will continue only so long as we maintain the confusion regarding the social contract in general, because the battle on the other side is just as destructive.

While individuals resist signing contracts transferring their freedom of movement and innovation to an employer, they also wish to believe they have a "right" to a job once they have been hired. In courts across the country, there seems to be a trend toward supporting the individual employee and denying the right of employers to fire or lay off an employee they have "promised" not to lay off. "Employment at will" is emerging as a major issue; in 1984 a Pennsylvania court went so far as to determine that an *employee manual* is part of the parties' employment contract. In 1985, California court declared a *letter* sent to a salesman to be an employment contract. Such letters offering employment are being presented in court as implicit contracts to hire and failure to do so is being tried as mail fraud.

The bottom line is that we need to rethink the basic contract between employer and employee. Legal approaches that attempt to bind organizations to employees and vice-versa—regardless of changes in circumstances—will generate added pressure for alternatives. At the

moment, one of the solutions is “leased” employees of one form or another. This idea is different from leasing arrangements of the past. It suggests that employers will enter into contracts with employees for very specific tasks for specified periods of time and for a pre-agreed rate of compensation. Work life in this case is defined by task and performance rather than by traditional arrangements. Indeed, it appears that this adds an element of independence and flexibility to both parties that may be more appropriate to the times than previous ideas of work.

Democratization of Information and Knowledge: Another Revolution

For the remainder of the 20th century, few issues will be of more importance to the business community than the applications and implications of technology in the work place.

—Norman Pearlstine, editor of *Business Week*

Among the many changes precipitated by computer and telecommunications technology, none is more dramatic than the shift of power that results from giving more people access to information. A revolution is underway as power changes hands, affecting every aspect of our lives.

This occurs because power in society has always rested in the hands of those individuals and institutions that have had access to and control over information and knowledge. We have lived through six or seven generations where power was accumulated in large institutions—large governments, businesses, universities, hospitals, unions, and associations. Success and power came to those institutions because only they had access to the information and knowledge necessary to compete effectively in their particular areas of service.

Individuals and small groups simply could not obtain the information and knowledge necessary to operate effectively without the support or assistance of the larger organizations. This is no longer the case. The combination of personal computers, telecommunications, and the emergence of 4000-plus on-line data bases now allows *anyone* to obtain the information and data he or she needs about anything—and to obtain it immediately.

Access to information and knowledge is no longer restricted to large organizations, adults, or the educated elite. Information is becoming a commodity. Access is being democratized. As this occurs, former arrangements regarding power, authority, and the potential for future

success are coming apart. Suddenly, key determinants of success in work change and challenge long-established traditions and assumptions about it. Computers and data bases are neutral when it comes to anything other than competence, creativity, and performance. Credentials do not matter, age does not matter, geographic location does not matter, nor does race, sex, religion, or ethnic background.

Japan as Teacher

“The Japanese philosophy is to make people an important item, as opposed to the typical U.S. philosophy that workers are just an extension of the machines.”

—William Childs, NUMMI’s general manager
of human resources

There has been a powerful reversal in the past half-century as America has changed from a nation that led the rest of the world and taught others the secrets of modern industrial and economic success to a nation that now learns from others, albeit reluctantly. Clearly, most of these lessons are coming from the very nation we assisted in recovering after World War II.

And where we have most to learn from our neighbors is in the work place. Increasingly, this will be a first-hand experience rather than experience gained through reading or an occasional visit to Japan. More and more Americans will be working for Japanese and other foreign firms right here at home.

The Japanese Presence in Industry—Japan is shifting its strategy from being an exporter of goods to the United States to being an investor here. Cautious investments are giving way to major new plant installations and buy-outs. Owing in part to the growing value of the yen, which makes Japanese imports more expensive and investments in the United States less expensive for Japan, Japanese firms have begun to invest more aggressively.

There is already a major Japanese presence in steel and automobiles, as nearly all our major manufacturers are in partnership with a Japanese firm. Similar developments are occurring in computer and telecommunication products. Japan controls 8 percent of the \$2 trillion U.S. banking market (\$170 billion of U.S. assets) and operates 90 banks in the United States, compared to 50 a decade ago.

There are now more than 500 Japanese companies that have manufacturing facilities in the United States. The total investment is estimated at \$20 billion and has tripled every year since 1980. Cur-

rently, planned investments by Japanese firms are expected to generate 840,000 jobs directly and many more indirectly. This investment is vitally important to local economies and employees and, as a result, it will give the Japanese increasing influence over governors and other public figures. This will have interesting implications as authority is decentralized from Washington, D.C., to the states.

The growing number of people in this country who work with and for Japanese companies will experience directly a new and different idea of work and of the social contract between employee and employer. Articles will continue to be written showing that American facilities can achieve levels of productivity and quality of output matching those achieved by the parent company in Japan.

These articles will describe a typical manufacturing work site, such as a Honda factory in the United States. At this site a young group, including many women, starts to work at \$10.50 an hour. All workers wear white coveralls and are known to each other as "associates." They work in a place where there are no enclosed offices, no reserved parking spaces, and no executive dining rooms.

This example exemplifies the Japanese approach to production, which emphasizes flexible teams, just-in-time deliveries, and attention to quality and which demands extremely high employee loyalty—a sharp departure from the traditional adversarial relationship in most U.S. factories. Honda president Irimajiri has no office. He sits in the same room with a hundred other white-collar workers.

This emphasis on cooperative labor relations partly explains the improved productivity. The approach is designed to increase flexibility and give workers more control over their assignments. In a traditional American facility, there are more than 100 job classifications. In practice, this means that some people are working hard to finish their jobs while others have nothing to do. Under the Japanese team system, everyone does several jobs, so the work is spread more evenly. The result is a company that is light on its feet and can shift production and retool quickly.

Trust, Integrity, and Openness

A clear and common purpose is what keeps an organization unified and productive during times of rapid and complex change. The need for innovation and intense competition requires that the organization be able to respond quickly and efficiently to new circumstances unhindered by administrative, cultural, organizational, or bureaucratic barriers. "That is not my job" will kill unity like poison on a flower.

What is needed is an integration of skills, energies, and individual contributions, a wholeness to the organization that allows it to absorb shocks and exploit opportunity. What prevents this from happening are the residuals of the industrial, competitive, win/lose, adversarial idea about work life.

We have worked under conditions in which there was constant competition and struggle—whether stated or not—between (a) labor and management, (b) hourly and salaried workers, (c) thinkers and doers, and (e) headquarters and field.

Performance should be a measure of competence, contribution, and reward—not power—whether the power be associated with unionization, credentials, or longevity. Performance is something that can be clearly and openly sought, measured, and communicated. Either there are results or there are not. Organizations that are driven by the facts, by reality rather than by power, politics, and tradition, will move toward high levels of performance.

The critical issue may be the derivation of goals, rewards, and decisions based on facts. While we may all think this is how we measure our own and others' performance, it is rarely the case. One of the major aspects of the whole quality circle movement in Japan rests on the constant evaluation and reporting of performance, down to the smallest detail. The charts that dominate the discussion of work groups are all concerned with no-nonsense feedback information on performance.

With a commitment to, and an acceptance of, the importance of facts comes the motivating power of integrity—the commitment to performing and acting with the clear and open intent of giving the highest possible service. Currently we are driven not by honesty, integrity, and trust, but by legalisms, regulations, and precedents. Time and again we see organizations marketing their excellence, quality, and deep concern for the customer while dishonest or destructive behaviors are occurring inside. In the new age everyone knows what is happening. They learn where integrity is and where it is not.

The new management challenge is simple. We simply need to manage *attention, trust, meaning, self*.

We need to return to the real meaning of growth. As applied to businesses and organizations over the past 200 years, growth has meant bigger. It has assumed that the only way to generate rising standards of living was through the production of more, rather than better, things. Lives were measured accordingly. Quality of life was a matter of how many possessions one had.

Growth that translates into bigger at all costs is a cancer. The kind of growth that is valuable to people is that which means the increasing capacity to reach higher levels of human performance both as individuals and as a society. If there is no growth of this type, there is death, whether it is slow or fast is of no matter. The differences between an organization that is growing (productive) and one that is dying (nonproductive) is easily observed.

Growing

Strong goals/visions
New activities
Individual involvement
Innovative
Excited
Committed
Loose structure
Present oriented
Risk prone
Immediate feedback
Open

Dying

Weak goals/visions
Repetitive activity
No involvement
Normative
Unexcited
Uncommitted
Tight structure
Past oriented
Risk averse
No feedback
Closed

III. Whither American Competitiveness?

PAPER BY PAT CHOATE

Introduction

Over the past two decades, U.S. industry has lost position in the world marketplace. These losses have occurred across the economic spectrum in all sectors—basic, high-tech, service, and agriculture. Moreover, this decline has occurred in industries where U.S. firms were long considered invulnerable: advanced computers, semiconductors, aircraft, machine tools, telecommunications, pharmaceuticals, scientific instruments, industrial chemicals, engines, turbines, plastics, automobiles, synthetics, insurance, engineering services, and banking, among many others.

These losses are an insidious form of economic decay. Much like dry rot, they are only partially visible—masked by inflation, unproductive mergers, profitless growth, clever financial manipulations, and unsustainable prosperity produced by the extraordinary economic stimulation created by federal budget deficits and growth in the money supply.

And like dry rot, this economic decay—evident in the diminishing share of world markets, lagging reinvestment, and waning technological supremacy—is spreading and undermining the foundations of one U.S. industry after another.

Vital Distinctions

Reversing the economic rout of U.S. industry will require new policies and practices by both the public and private sectors. Policymakers are hampered in their ability to take these steps, however, because the choices are being reduced to either-or alternatives that ignore many intermediate possibilities.

Seven of the most destructive of these false conflicts are industrial production versus industrial employment, high-tech versus basic industries, manufacturing versus service industries, big versus small business, absolute versus global market performance measures, free trade versus fair trade, and macroeconomic versus microeconomic policies. As long as the debate on competitiveness is couched in these

terms, slogans will supplant thought and cant will substitute for action.

Industrial Production versus Industrial Employment—Although the manufacturing share of all employment dropped from 24 percent in 1970 to less than 18 percent in 1986, industrial production rose by more than 65 percent. What happened in agricultural production earlier in this century is occurring in industrial production today—that is, technology makes possible greater production even as it reduces the number of workers that are required.

High-Tech versus Basic Industries—If the United States is to retain its manufacturing base and the foundation it provides for the balance of the economy, American manufacturing must introduce more technology and at a faster pace. Through automation and other technologies, it is possible for U.S. companies to achieve the quality improvements, savings in wasted materials, uniformity of production, and flexibility required in today's competitive environment.

Indeed, if there is any conflict between basic and high-tech industries, it is that manufacturers are not installing new technologies quickly enough.

Manufacturing versus Service Industries—Contrary to this false alternative, the manufacturing and service sectors are closely linked and mutually supportive. The wealth created by manufacturing provides most of the foundation for the service-production sectors of the economy such as finance, real estate, insurance, transportation, and communications. If the wealth and income provided by industrial production decline, so too will the related service sectors.

What happened in agriculture also illustrates the relationship between the manufacturing and service sectors. Less than 4 percent of Nebraska's workers, for example, are actually engaged in farming. However, more than one-third are employed in ancillary businesses related to and created by farm production.

Even as manufacturing employment falls, therefore, it is vital to increase manufacturing production because the value-added that manufacturing creates is needed to undergird job creation in the service sector.

Big Business versus Small Business—Large and small businesses have different, but crucial, roles to play in America's economic future.

The nation's 500 largest corporations, for example, produce almost one-third of the Gross National Product, finance nearly 90 percent of private research and development, and employ more than one-third of American workers, including almost 80 percent of all engineers and scientists who work in the private sector. In a growing list of

industries that require enormous amounts of capital and people, only the big U.S. companies can marshal the resources required to compete with foreign firms that are often far larger and subsidized, or even owned, by foreign governments.

Although small businesses control only one-third of the nation's economic assets, they now create more than 70 percent of all new jobs. Being innovative and able to find market niches and move quickly, small business is a major source of flexibility in the American economy.

The activities of big and small business are complexly entwined in a synergistic relationship: big business is the principal customer of small business and small companies are major suppliers of components and services for big business. The nation, therefore, requires strong big and small businesses.

Absolute versus Global Market Performance Measures—As the United States has become more deeply enmeshed in the global economy, the crucial measure of performance for economic sectors is less that of absolute change, such as improvements in annual sales or profits, and more that of relative position in global markets. Since 1973, for example, the absolute value of U.S. exports of proprietary rights and other business services has tripled to more than \$16 billion, while the U.S. share of world trade in these services has fallen from 15 to 7 percent. This slippage portends stiff competition in the years ahead, both here and abroad.

The point is that policymakers must now think in terms of both absolute changes in their performance and their relative position in international markets.

Free Trade versus Fair Trade—Despite the urgent need to modernize U.S. trade policies, the nation lacks the flexibility to take bold steps. The debate is gridlocked by the unrelenting conflict between proponents of the two main philosophies of international trade: free trade versus fair trade. The free traders, who advocate the unrestrained movement of goods and services across national borders, argue that American markets should be open. The fair traders, contending that free trade is impossible as long as other nations erect barriers to U.S. exports, assert that access to American markets should be restricted until U.S. firms are granted equal access to foreign markets. Of course, both are correct: fair trade requires equal access and equal access leads to free trade.

What the debate obscures, however, is that the overwhelming majority of global commerce and investment is between non-free trade economies. U.S. workers and firms face competition from five types

of economic systems, four of which are not free trade economies: centrally planned (such as the Soviet Union); mixed (France); developing (Brazil); plan-driven (Japan); and rule-driven (Canada and Australia).

The global trading system, as embodied in the General Agreement on Tariffs and Trade (GATT), is still modeled on the Anglo-American rule-driven economy. Yet the other four systems now account for more than 75 percent of all world trade; a growing array of nontariff barriers distort global trade flows; more than 70 percent of U.S. goods and services face stiff foreign competition; and the principal international treaty on trade—the GATT—now covers less than 7 percent of world imports, exports, and capital flows.

Because U.S. officials have failed to recognize these shifts and have been so devoted to free trade as a national strategy, U.S. trade policies remain trapped in a time warp of the 1940s, when the free trade nations—the United States, Great Britain, Australia, Canada, and New Zealand—dominated the global economy; tariffs were the principal barrier to trade; and U.S. supremacy was uncontested in virtually all industries.

Consequently, American trade policies have fallen out of step with those of other countries, causing serious and widespread harm. Industries facing predatory foreign competitors have been unable to get relief. Long-term consumer interests have been sacrificed. Reciprocal market access has been discredited as a negotiating strategy. And tough negotiating tactics have been mistaken for “bashing” other nations.

Macroeconomic versus Microeconomic Policies—Many policymakers and economists still equate economic policy solely with macroeconomic policy—the broad manipulation of fiscal, monetary, trade, and exchange rate policies. Others concentrate almost exclusively on microeconomic interventions such as those in infrastructure and education. Both macroeconomic and microeconomic policies are enormously influential.

At least one-half of what ails U.S. economic performance, for example, could be corrected if the federal deficit were reduced, exchange rates were better aligned with those of other nations, and fiscal and monetary policies were better harmonized. Improved macroeconomic policies are a necessary condition for enhancing the nation's economic performance and competitiveness; however, they are an insufficient condition. A cheaper dollar, for instance, has failed to reduce the trade deficit.

In addition to better macroeconomic policies, special attention is

also required to the dozens of powerful microeconomic interventions that influence the functioning parts of the economy and the vitality of specific industries. These microeconomic interventions include policies and programs in areas such as education and training, natural resources, strategic materials, government credit, research and development, infrastructure, regulation, and public health, among many others.

If the United States is to be a vigorous competitor, it must seek greater industrial production even if that means less industrial employment. It must strengthen large and small businesses in both basic and high-tech industries and in both the manufacturing and service industries. It must improve the absolute and relative position of U.S. industries here and abroad and negotiate free trade agreements with nations that practice free trade, managed trade agreements with nations that practice managed trade, and subtle variations for economic systems that fall between these two extremes. And it must improve and better integrate macro and micro policies.

The challenge is to take these steps in a manner that will improve the nation's capacity to adjust quickly and competently to change.

A Two-Part Linked Agenda

To create a more competitive America, two interdependent agendas of action are required, one internal and the other external.

An Internal Agenda—The internal agenda would focus on producing goods and services that are competitive in terms of price, quality, service, innovation, and marketing. This agenda would require changes in both macroeconomic and microeconomic policies.

Among the more important of the macroeconomic measures is the need to reduce the federal budget deficit, for the nation to pay for its publicly financed consumption and investment now rather than later. Equally important, fiscal and monetary policies need to be better harmonized and the exchange rate of the dollar closely monitored and managed.

At the same time, a number of microeconomic policy changes are required. Among policies that merit special attention are those that:

- reduce the pressures on business for quick results and short-term earnings;
- increase the ability of displaced workers to secure job information, counseling, testing, training, and placement;

- provide personal, portable pensions that are tied to the worker rather than the job; and
- improve the motivation of American workers by facilitating the creation of share compensation systems that better link work and rewards.

Attention to these and other elements of a domestic competitiveness agenda can do much to create an economic environment in which firms can innovate, invest, and market goods and services that are fully competitive and in which workers can secure training, find jobs, be productive, and shift between jobs and occupations with ease and confidence.

An External Agenda—At the same time, the United States requires an external competitiveness agenda. Such an agenda must be guided by the recognition that the nation's economic interests are as critical to its well-being as its defense and foreign policy interests.

The objective of such an agenda would be to create stable and pragmatic relations with foreign economic systems that are very different from our own and to do so not by punishing other nations for their success or reversing their economic progress but by increasing America's capacity to compete and creating a more flexible, less ideological, trade strategy.

Ideally, trade talks would proceed bilaterally (with one other nation); plurilaterally (with several nations); and multilaterally (with many nations). While the goal of such talks would always remain the same—to expand trade—the focus of negotiating tactics would vary from one economic system to the next. The primary focus of tailored-trade negotiations with free-trade economies, for instance, would be to open markets.

Negotiations with economies such as Japan's would be results oriented. They would concentrate on outcomes, timetables, and responsibilities.

Agreements with mixed economies would focus on a combination of market-opening and results-oriented outcomes. Agreements with the command economies would attempt to establish managed trade arrangements. Agreements with developing nations would involve a combination of market-opening processes, results-oriented arrangements, and managed trade.

Bilateral agreements need to be supplemented by plurilateral negotiations on cross-cutting issues, i.e., problems that are part of the current global economy, regardless of economic system. Counterfeiting, for instance, concerns several advanced industrial nations, in-

cluding Britain, Sweden, and Japan, each of which operates with a different system.

Conclusion

In sum, the United States still possesses the world's most stable political system, the world's largest capital base, the world's best technology, and the world's most productive workers. It has ready access to the world's largest market, its own. The nation has a tradition of entrepreneurship and competitiveness.

Because the nation has neglected the need to compete in recent years, these formidable assets have been deployed inadequately. As a consequence, the United States is now paying the price in terms of slower growth, lost markets, and real threats to our longer-term prosperity.

Yet the inertia of the past need not continue. We have the resources and the know-how needed to regain the momentum we once possessed. If business, workers, unions, education, and government can focus once again on the need to compete and eliminate the barriers that impede their competence and flexibility, the United States can show the world a new burst of productivity and competitiveness unsurpassed by either our own past performance or that of other nations.

IV. Part One Discussion

Trends or Revolution?

JEFFREY HALLETT: I have made a terrible discovery—terrible for me anyway, not for you, but for me it is terrible, because I have spent the last 10 years or so making a living doing trend analyses and consulting on social trends, technological trends, economic trends, demographic trends. And I have made a discovery that there is no such thing as a trend anymore.

I think it is a big mistake to look out there and say, “What are the trends?” What is happening is much more dramatic than that. A trend requires something—a marketplace, or technology, or demographic group—to stay still for a period of time. It has to stay still, so if you are clever you can watch the small changes that are occurring and respond to them and perhaps keep ahead of the competition.

When everything is changing at once, and it is, there are no more trends. In fact, I think what we have to grapple with is a fundamental revolution.

I have been accused of saying that because I am some kind of frustrated 1960s hippie who has always wanted to get in front of a group like this and say “revolution.” That is only partly true. The rest of it has to do with the definition of what is happening and what it really means to be in an information age: to have 200 channels of television, cellular telephones, extraordinary developments in computing, with 3,000 data bases accessible to anyone with a personal computer and modem.

What it means is a revolution because it is a universal truth that power in society has always resided in the hands of those individuals and institutions that have had access to, and control over, information and knowledge.

A long time ago that was the church, an organization that had all man’s knowledge and kept it hidden away in abbeys and cathedrals, books, and scrolls. The clergy had power. Then the printing press came along and redistributed all of that information. And the church lost that power.

What we are accustomed to, what we have studied, and what has created the institutions and the economy that we understand is the fact that ultimate power resided in the hands of large government, large business, large universities, large hospitals, large trade unions,

and large associations. Indeed, they were the only institutions that had the means to gain access to, and then control, the information and knowledge necessary to be productive in their chosen areas of activity.

The Meaning of the Information Explosion

What the information explosion fundamentally means is that access to and control over information and knowledge is being extended down to the level of small groups and individuals. As individuals and small groups get access to information and knowledge, they insist on the right to make decisions about anything that affects their lives.

As soon as they do that they do not need or want other institutions standing between them and a decision. I think that explains more than anything else why it is we see this great disaggregation of markets, why people demand cafeteria benefits, and why they want greater participation in the work force.

I think the only market niche anymore that means anything is the market niche of an individual, because we are making individual decisions about the price and value of the goods that we buy, the ideas that we buy, and the issues that we will be concerned about.

Where does that all leave us? This is going to be all conclusions. One, we can no longer expect to utilize linear hierarchical institutions driven by that fundamental pyramid or organizational chart that defines how to organize and manage, hire, recruit, and allocate pay and benefits in a mass production economy. It is not that kind of world anymore; we know that by reading the management literature. We know we have to be flexible, close to the customer, and innovative. We have to flatten our organizations. And that reflects a reality that is dynamic, nonlinear, and fluid.

As for benefits, pay, and compensation in particular, we cannot use the fundamental model that allocates pay and benefits throughout this hierarchical system, and provides better benefits and pay as employees move up. That frame of reference just is not going to work.

The Global Economy—We know that we are in a global economy. In practice, the largest organizations today throughout the world look at a work force that is global. An American company does not merely need to look at what is occurring in the United States to determine where to find the work force that it needs, nor does Japan or Germany or any other country. We have to become accustomed to looking at the changes within what is a global work force.

Career Paths—As a result of these changes, other models need to be eliminated, primarily because there is no such thing as a predictable 20-year career path anymore. We need to give a great deal of thought to its disappearance because, again, our organizational patterns, benefit patterns, and educational systems, are still based on an assumption that a predictable 20-25 year career path exists. It does not.

If you want to describe a predictable career path you would need to define what an industry will look like in the year 2003, then define a particular organization in that industry in the year 2003 and describe a predictable career path from here to there. And if anybody can do that for any industry, or any organization with an accuracy rate higher than 15 percent, I would like to see it.

Education and Training—According to those who have studied the situation, when information is doubling every two and a half years and change occurs at the current rate, to stay productive as individuals and as a society we need to upgrade our education approximately every 6 to 10 years. Lifelong learning, training, and retraining need to be seen as something vital to our personal education and to the health, productivity, and competitiveness of our organizations.

In addition, because this is an information-knowledge driven economy and world, we must start treating whole people, not people who are being hired as workers in a mass production system where they are disposable parts. We must recognize that our ideas about benefits, worker compensation, and retirement are still based on the assumption that people get physically injured or physically tired.

We are now hiring people to work with their minds, not their bodies. We need to consider such things as what to do about stress. We now need to deal with family care and to think of it—whether in terms of legislation or voluntary action—as important to employees' mental and emotional well-being, which is critical to our competitiveness and to the organization.

Competition versus Cooperation—Another change that must occur is a shift in attitude from one of intense competition to one of intense cooperation in the workplace. We need to find ways to reach higher levels of excellence and higher levels of quality not by competing against some other organization for a share of the pie but by continually changing the nature and the size of the pie as we go along.

You cannot do things like flexible manufacturing, or just-in-time inventory control except from a framework of cooperation. They cannot be done if people are competing against each other, whether the

competition takes the form of management against labor, or company against company, or government against business.

Work Contracts—The biggest mistake people can make is to think they work for somebody else. We are going to be moving in the direction of individual and small group contracts that are negotiated between the employer and the employee. The work period, the time frame used to consider how, when, and where people work and how, when, and where they are paid are going to be negotiated over two-, three-, four-, and five-year periods. The rise in the number of temporary workers is indicative of this phenomenon.

The real dilemma in terms of work contracts is that management will have to sit down with employees and determine what a given work assignment is worth. They will have to negotiate individual contracts that say, "I will, as an employer, ensure that you are compensated X, if you can accomplish this work," and not care whether it takes the person 10 minutes a day or 18 hours a day.

I think that this approach to work will lead to a concept of fully portable benefits packages that individuals will carry with them and to which individual employers will contribute or not in terms of individually negotiated contracts.

A new debate is emerging that will redefine the fundamental social contract between employers and employees. We need to redefine what is a benefit and what is a necessity. By that I mean issues such as education and what an organization can do to ensure that it is able to attract, retain, and ensure the competitive excellence of its own particular work force.

Beyond that, I think we need to go through a real shift, if we are an information-based economy. If we are going to compete in the ways that we say we are, we need to change our minds concerning the value of human resources, not just as organizations, but as a society. And the issue, I think, is not one of what benefits cost. It is time that we start looking at benefits as an investment.

The Questions Our Society Faces

MR. CHOATE: I think that the questions we face as we look at 1989 and 1990 are going to center around several key issues. One, is it likely that the Congress and the next president will finally grapple with the federal budget deficit? And if they do, can it be done other than during the first six or nine months? And if they do put us on a downward slide, what will be the implications of that added to the

demand? Is it a possibility that we can push ourselves into a recession?

If the Congress and the next president do not deal with the deficit, will the central banks of other governments be willing to continue to finance it? How many dollar denominated bonds do they really want? The private investors clearly ceased wanting them in the spring of 1987.

The second question: how long can we continue with the short-term syndrome in the American business economy, in which major capital investment, investments in technology, and work force performance are geared to quarterly earnings, particularly when our principal competitors are thinking and acting from a long-term perspective?

Because of inadequate investments, inadequate productivity, and inadequate competitiveness, our industries are being rolled up in one market after another, even with the surge of exports that is now occurring in the basic high-tech, agriculture, and business areas.

The third problem is how to deal with the realities of trade policies that were put in place in the 1940s and 1950s and are now obsolete. These policies are artifacts of a time when the United States dominated the world economy. We do not dominate the world economy today.

It was a great dream that we could encourage other nations to adopt an Anglo-American free and fair trade model. It is clear that the economic models in operation in the world—the Soviet model, the Marxist model, the Japanese-like models that are developing—serve very well the interests of the countries that have adopted them. Is it likely that these countries will change the economic systems that serve their interests to ones that serve ours?

Seventy-five percent of these countries operate with different models than ours. The principal trade agreement in the General Agreement on Tariffs and Trade (GATT) covers less than 7 percent of global commerce, even after 40 years of negotiations. What does that mean for an economy such as ours, in which 25 percent of the Gross National Product comes from trade? We are badly out of step with the rest of the world.

What all of this suggests is that we are going to experience extensive changes through the next administration and later. It is clear to me that what we are going to see is a continuation of what is already obvious. The federal government seems unable, for a variety of reasons, to accept a number of the responsibilities that many would wish it to assume. In a very real sense what we are seeing is a replay of

what happened 20 years ago, when it became obvious that the war in Vietnam would not permit a full funding of many of the Great Society programs. There was a regulatory boom during which, when it was not possible to finance directly what needed to be done, the government regulated others to do it.

That is precisely what happened in the late 1960s and into the 1970s. The federal government mandated business and the states, and the states mandated local and county governments to undertake certain activities. It is an indirect way of passing taxation. It is a clever way.

Another area concerns pension portability, the idea of tying benefits such as pensions to workers rather than to the job and perhaps developing a minimal universal pension system.

In addition, there is a need to develop some form of a mandated training benefit. Since 1979—and particularly between 1979 and 1985—perhaps as many as a million persons a year lost their jobs because the jobs disappeared.

The question is how to deal with circumstances in which a large and significant portion of the population lose their employment because their jobs disappear? It is traumatic. Most of the workers involved do not have the ways and means to begin to deal with these work force adjustments.

I think it is likely that we will have some form of mandated voucher, or voucher-based, system that would tie into plant closings.

As I take a look at our future, I think we are going to have real, wrenching political change. Part of that shift, in sum, is going to come as we shift from consumption to savings and investment, which we are going to be forced to do. Part of it will derive from our adjustment to the decline of the American century and the necessity for us to treat our trading partners increasingly as equals. And part of it is going to come from the fact that we can no longer use the old ways of addressing these problems—with the federal government adding a program and taking it out of general revenue. That era is now coming to a close.

Increasingly, we are going to see the responsibilities shifted to employers and supportive units of government.

MR. SEIDMAN: I am going to ask Pat Choate a question. You posed two alternatives: budgetary expenditure or mandating various types of requirements, including benefit requirements, on employers. And we all know the problems—the 37 million people who are uncovered

for health care and the one-half of the population who are not covered by pensions.

We are aware of the difficulties involved in moving in either direction, and I wonder why we have to think of these approaches in terms of alternatives. Is it possible that one of the problems with mandating benefits is that there is no cost sharing. The cost is borne entirely by the employer, and that creates both an economic and a political problem.

On the other hand, the question of the budget deficit and the limited possibility of increased budget expenditures cannot be avoided. It seems that we should consider a combination of mandated benefits and limited financial liability for the kinds of catastrophic costs that are borne by the employer. This could involve either reinsurance or some kind of subsidy above certain levels. The problem may become more manageable if we combine the two approaches rather than consider them as alternatives.

MR. CHOATE: Concerning health benefits, I agree with Mr. Seidman. In the areas of training or retirement programs, I suggest that the responsibility is going to be too great for the individual worker to assume. But by sharing, individual workers can not only deal with these problems but they can also solve some other national issues, such as increasing national savings.

I have advocated that we create an individual training account, in which the government would grant a tax exemption similar to that granted for the individual retirement account (IRA) and a matching contribution would be made by employers and employees. When workers are displaced, they could draw a voucher and use the money for training, retraining, or adjustment. When they retire and leave the work force, they could draw back their contribution and the compounded interest, and the employers could also draw back their unused contribution and the accumulated interest.

Concerning pensions, I think it important that we set up a minimal universal system to which both employees and employers contribute and which would be portable.

I think it also important that the funds collected be held in the private sector—by banks, insurance companies, etc.—and not put into government trust funds. This is a real way to increase national savings, which is critical in this country because we now have a 2 percent savings rate. We must learn how to increase that savings rate, and perhaps this would be a way.

Reducing Inequities

MR. MIKKELSEN: A question for Pat Choate. It seems to me that America has been reasonably free from open social class strife. As you contemplate the distribution of income and wealth today, what do you foresee for the future?

MR. CHOATE: As I look toward the 21st century, I see some conflicts based on the population's age characteristics and the different interests of those who will be paying for Social Security and those who will benefit from it. But I think the size of our middle-class is probably sufficient to overcome this difficulty. The real issue is how to prevent the conflict that will occur if we do not involve the underclass in society by providing training and reforming the educational system. How can we get enough growth in the economy so that we can involve them?

MR. HALLETT: I think the question of involvement is a good one, and it has not been adequately discussed. I think it is something that we would rather not deal with. For instance, I think that we mask the real numbers that show that the average family in this country has not made much progress in the last 10 years, to say nothing about the underclass or whatever you want to call the group at the lower end of the economic spectrum.

And I think that the issue of access to information and knowledge could exacerbate the problem. It is not as if there were many people who do not know that Lee Iacocca is making \$17 million a year. From what I hear, that kind of thing is beginning not to feel quite right. And I think there can be some real difficulties, if we do not face this issue.

On the other hand, I believe that if we are to compete in the real world, we are going to experience a flattening of our organizations with regard to perks, pay, benefits, and everything else. Our organizations will have to pay attention to how their policies and practices affect the loyalty and enthusiasm of the work force. And we are going to make changes simply because that is the only way we can compete, not because of some social do-gooder image. We may move fast enough to ameliorate some of the real inequities that exist.

MR. MERRICK: I would add as a word of caution that I see more of a two-tier society in which there will be a flattening in one tier, but the other tier—comprised of minority groups in whom society has not made a social or educational investment, and immigrants who have not yet been integrated into society—may not participate.

MR. HALLETT: I agree, and I would like to address Pat Choate on this point. There is concern about entry-level workers and the shortage of workers age 18 to 24. It seems to me that this shortage automatically creates an opportunity, again for reasons of economic competitiveness, to start upgrading the treatment of those people who traditionally enter at the bottom rungs.

In some areas where unemployment rates are very low, fast food chains and similar organizations are going out of their way now to change the way they treat entry-level workers. They are not only increasing the minimum wage but are also starting to treat these workers like real employees instead of people who are funneled in and out every six months.

Do you think that is going to happen?

MR. CHOATE: So much depends on what happens in the macro-economy. It is my contention that the economic boom that we are now experiencing is unsustainable. We are living about 2 to 3 percent beyond our means. We need to rebalance our economy, and we are going to run into a long period of stagnation unless we can develop creative solutions.

The traditional problem we have is that large numbers of our young people—more than one million every year—are leaving school functionally illiterate. We have great difficulty with our educational system, and a large segment of the population must be retrained.

The U.S. Department of Labor has a state-of-the-art program, the Jobs Training Partnership, that is good. The question is how to take 10,000 vocational, technical, and community colleges and bring them up to speed, modernize them, and make them attractive to employers.

Again, my concern is what will happen if and when the country enters a recession lasting two or three years—or longer—particularly if we do not have the capacity to make another massive change.

Changing Our Attitudes

MR. JACKSON: I have two points. One is the tendency I have observed to analyze how our population is going to change in terms of people who are old and young, male and female, white, Hispanic, Asian, and black. It is traditional to do this. But in a way it reminds me of the apartheid approach. There is an implication in looking at such statistics that black workers, Asian workers, female workers, and old workers are different and have different needs.

Obviously we are not all identical, but there is a common humanity

running through the population and I think we would be better served by looking at unemployed workers rather than teenaged workers who are unemployed. We should be looking at specific problems, without any racial overtones.

The other point is that I had an impression from some of the contributors to this forum that there is great dissatisfaction with our society today. And I was thinking of the time when I took my first full-time job, about 50 years ago. In my lifetime, I do not think things have ever been better. They are obviously not as good in every area as anyone would want them to be, but they are not as bad as they were in the "good ole days."

And as to this being a time of sharp change, there has never been a period when there was not sharp change. There was sharp change in the 1940s, in the 1960s, and in the 1970s. There are sharp changes occurring today. They may be happening at a faster rate, but it seems to me that all this proves is that we live in an uncertain world. We seek certainty, and we are never going to find it.

And one of the problems when we look around at all the things that are not right today is that we cannot fix them from the top down. I doubt very much whether it is a real solution to say, "Look, we have some teenagers here who are illiterates. The government ought to do something about that." My belief is that people who are illiterate should be approached in a way that suggests to them that they, as individuals, have a lot to gain by not being illiterate. They are missing out on a kaleidoscopic picture of life that they will never enjoy if they do not learn to read. And it is up to them to do something about it.

MR. CHOATE: I would respond as follows: when one looks at such programs as Jobs for Delaware Graduates or 70001*, what one comes away with is the awareness that if disadvantaged young people are given support and opportunity, there will be a high rate of success and they will go forward. They will learn, and they will engage themselves in productive society.

But what is discouraging to me is the recognition that this outcome requires a special effort, and although many companies are doing a great deal today, the amount of money they are spending is insufficient. In the final analysis, an increasing number of school systems have become mediocre and they are getting worse. And, more importantly, many of these school systems—which are in our major

* Editor's note: 70001 is a national nonprofit employment and training institute for disadvantaged youth.

urban areas and are dealing with large numbers of disadvantaged children—are being operated more as political patronage systems than as educational institutions.

The question is, how do we intervene in this situation? Do we let it continue or does the federal government, which is providing support for these schools, have a certain responsibility to intervene?

As to the larger question of the economy doing well, it is doing well. There is an illusion of good times. My concern is that a major part of these good times is largely supported by debt. We are financing our good times through heavy borrowing. And the dramatic thing about that borrowing, at least from the federal side, is that it is increasingly coming from the central banks of other governments. There is, after all, a limit, and we are, in some respects, not different from Mexico and Brazil and other countries that have borrowed up to the limit. When you cannot borrow any more, what do you do? My argument is that we have to step back and take control of our destiny. We simply cannot gain that control on borrowed money.

Social Security as a Minimum Universal Pension

MR. WALKER: Going back to the benefits issue, I am somewhat perplexed: some say we need a minimum universal pension system. If I am not mistaken, we already have one and it is called Social Security. It has almost universal coverage, full portability, mandatory preservation, and it is targeted to provide greater levels of benefits to lower- and middle-income workers. It has shared burden allocation between the individual and the employer. It is not perfect, but it is a solid foundation.

Clearly, it is important that Social Security be supplemented by private pensions and personal savings. I agree that we need to do more in the areas of investments and savings. And I think we need to do more to expand the private pension system. But I question whether we need to have a mandatory, minimum universal pension system in the private sector when we already have one through a public program.

Such a system seems somewhat inconsistent with the idea of flexibility. The idea is to provide a certain degree of flexibility—both for the employer and for the individual—to determine what they want, based on their individual needs.

It also seems to me that while income security is and will continue to be an important issue as our society ages, the real challenge in the

benefits area for both employers and the country—from a social, economic, and political perspective—is health.

Health issues are much more multifaceted and have more important socioeconomic implications than pension issues. And we are not nearly as far advanced in that area as we are in pensions.

And, last, a question for Pat Choate. What do you mean by “portability?” What is the objective and how would you achieve it?

Pensions for a Changing Work Force

MR. CHOATE: It seems to me that, as we look at the future and the demographics relating the post-World War II baby boom, the three-legged stool approach makes real sense: substantial private savings, a substantial well-financed private pension system, and a substantial well-financed Social Security system. To the extent that we have that balance, I think we can maintain a situation in which no single component overstrains the capacity of the others.

As we move into the future, I think that we must ask whether—if we continue on our present path—the Social Security system will be able to meet all the demands put on it. Equally important, I think we must ask if our economy will be as vigorous in the 21st century as it is today. Is there going to be inequity because the shift of wealth from one generation to the other that is already occurring will continue on a more massive scale? Will a second set of inequities be created because about one-half of the working population is covered by Social Security and those workers and their employers are subsidizing the workers and employers who are not paying into the system? Is that equitable?

Concerning the issue of flexibility, we find increasingly that we have an aging work force and that when people move into their thirties and form families, buy homes, or take on obligations they become far less flexible. In a period of great change, there is real concern about leaving jobs. One of the strengths of our society and our economy has been labor force mobility—the willingness of our workers to adapt and change.

A National Bureau of Economic Research study indicates that, under normal circumstances, workers over the age of 30 who participate in a defined benefits plan lose about 25 percent of their pension accumulation if they change jobs once and about 50 percent if they change twice. That is a substantial obstacle to making changes.

The concept of portability is based on the development of a portability fund to which both workers and employers would contribute.

Employees would have the mechanisms to move their equity into the fund as they move from job to job, the idea being to build up retirement benefits in a private pension throughout their career.

MR. LEONARD: The discussions of Tom Merrick, Jeffrey Hallett, and Pat Choate confirm a feeling that I had about a year ago when I was thinking the unthinkable and picked a date—year 2000—as the time that Social Security would stop for all new entrants. The tax rate would go down once there is enough money to pay off participants in the system. The government would mandate a minimum, or supplemental pension, and it would require workers to work until they reached a given retirement age. This arrangement would have a positive impact on post-retirement health expenses, because the longer a person works the less time he or she has to collect retirement and health benefits.

Immigrants and the Work Force

QUESTION FROM THE AUDIENCE: Following the discussion of demographics and the number of immigrants, Pat Choate said that we are living beyond our means and we need more savings and less consumption. However, traditionally, when immigrants become integrated into the work force, they become avid consumers, wanting the things they see that everyone else has and that they have never had. I do not see how these two tendencies can possibly be meshed. If there is a large number of immigrants, and if we develop structures to train people who we have never trained before because they were not needed in the work force, are we not going to create an engine for consumption?

MR. CHOATE: The answer to your question is in two parts. The first concerns the number of immigrants we can expect to come to the United States, and the second concerns their characteristics. The recent immigration bill should slow down some of the illegal immigration.

On the flip side, the country takes in large numbers—I think about one-half million—legal immigrants every year. There is a good argument to be made for expanding the number of legal immigrants and encouraging those with wealth, productive ability, and knowledge.

In our universities today, about one-half of the students in graduate-level engineering and other scientific disciplines are from other countries. We require these students to return to their countries for a

period of time before they are permitted to work here, despite the fact that we do not have Americans to fill the available jobs.

Perhaps it would be a clever policy for us to train the brain power for the rest of the world—because we do have the very best university system in the world—and require that the students who come here to be educated make a commitment to work in the United States. If they do not agree, they would not be allowed to come here.

I think that we have real potential to strengthen our economy and our productivity through our immigration policy.

MR. MERRICK: Our current immigration policy is still based on the principle of family reunification, which has very little to do with the economic interests and needs of the United States. There is some indication that there may be change, but right now we do not have a policy. And we could learn, for example, from countries such as Canada that have thought through this issue and have instituted what I would say are more rational immigration policies.

Another point is that our recent immigration experience is really just the tip of an iceberg, in terms of world demographics. U.S. population growth is slowing down, but an enormous population increase is occurring now in the developing countries, and it will continue for at least a decade, probably two decades.

To put this in perspective, the size of the work force of industrialized countries today is about 700 million. The developing countries will add that number to their work forces in the next two decades. Some of those people are poor, but not all of them are. Many of them belong to the labor forces of newly industrializing countries that will be competing with us in manufacturing, services, and the information industries.

There is no way that we can avoid being challenged and affected by this process in terms of dealing with our own internal issues. I think that Jeffrey Hallet's point about the need for an international perspective includes immigration.

MR. LEONARD: Immigration is selective. Immigrants are typically young adults who are better educated than most of the people in the countries they leave. They are in the part of the life cycle during which they are interested in accumulating wealth. I think the challenge to immigration in the United States is to channel these interests.

There is every reason to believe that immigrants could contribute to the savings in the United States. They could also be saving in Mexico; in fact, most Hispanic immigrants are now channeling their surplus money back to Mexico and Central America as remittances.

In addition, immigrants do represent labor and potentially trainable workers for the economy's labor-intensive industries and services. For example, health care. One of the issues involved in providing for our aging population is finding people to staff nursing homes and provide low-cost health services.

Social Security as a Safety Net

MR. WOOD: David Walker's thesis is that the universal portable system we have is sufficiently adequate that we need not make any other portion of our private retirement system portable. This begs the question of the size of Social Security. If one accepts the thesis that we have a universal portable system, then the question is, is 70 percent replacement of income enough for lower-paid workers and 41 percent income replacement enough for workers with average earnings? If Social Security is assumed to be the universal system, then the question becomes, how much is enough?

I would rather accept the proposition that Social Security is the safety net, the basic, underlying security system, not the whole system itself. And if you accept that, then you need to look at the other components of our retirement system to see if they need adjustment.

MR. SALISBURY: I think you are right. I too believe in the three-legged stool. I think most of us probably do. I think that Social Security, indeed, is a foundation. But it must be supplemented by other forms of savings, whether they be private pensions or personal savings. And I think we could and should do more to encourage both of these.

At the same time I would say that Social Security does represent a safety net and a foundation, and it is our minimal universal pension system. It basically covers everyone, it is fully portable, and preservation is mandatory. And I think that we cannot lose sight of the fact that we have to a certain degree achieved enhanced portability with our existing voluntary pension system.

Employers can have a defined contribution plan right now, and people can negotiate for defined contribution plans if they want to. They can have a combination of the two arrangements. People can roll over monies into individual retirement accounts, and they can roll over monies into other defined contribution plans. It is not as if we do not have anything.

Clearly, there are some other things we ought to look at, I do not disagree with that. But we are not starting from scratch.

Visions of the Future

MR. ROSS: I think there is a bit of schizophrenia in this discussion. Jeffrey Hallett's vision of the future is one that is discontinuous with the past, that happens rapidly, and he calls it revolutionary.

Pat Choate looks at many of the same things, but offers a kind of incrementalist or gradualist approach to these things. His ideas and Jeffrey Hallett's pass as trains in the night.

Tom Merrick has pictured quite a different world in the next 50 years than the one we have experienced in the last 50 years.

I would guess that reality will be closer to Jeffrey Hallett's picture than to Pat Choate's depiction. I think that what is missing in Pat Choate's analysis is the effect of all these things that are building up: the borrowing; the living as if there were no tomorrow, at the national as well as the individual level; and the breakdown of institutions. I think that sometime, possibly in the next 10 years, a watershed break will occur, similar to the break that occurred in the 1930s, which resulted in what one political scientist called the birth of a "second republic." Assuming something like that is going to occur, the solutions will require many new concepts. Major changes will be needed to put things back together and to get another 50-year run like we have had since the 1930s. And these changes will not be incremental as Pat Choate has suggested. They are more apt to be revolutionary, in Jeffrey Hallett's terms.

As we examine these problems, I think there is a certain schizophrenia developing over whether we are going to take an incremental approach to problems that are rapidly becoming cataclysmic.

MR. HALLETT: I think that you will find that Pat Choate and I probably agree on almost everything. The reason I am insistent about the revolutionary nature of what is occurring is that, although we know what is happening, I think we still tend to fall back on notions such as the "three-legged stool."

We use comfortable terms and phrases and are not getting about the business of causing the "revolution" to happen. This concerns simple things such as the discussion of retirement and the numbers we associate with people who reach age 55 or 60. The image we have of what people do when they are 55, 60, and 65 conveys the idea that they go out to pasture, are physically tired, do not work, do not start new businesses, and are not productive. And that is wrong. As we move into the future, fewer older people will be going out to pasture.

We still talk as if a cohort of new entrants into the work force will

have to support these old people, as if they are not doing anything and have no productive capacity. And that is wrong.

I just do not hear enough discussion about the vitality of today's elderly population and what that means in terms of retirement, retirement benefits, Social Security, and how much of an income floor is needed. Perhaps older people can keep contributing, as many of them do, for another 20 years.

It is more difficult at the policy level, inside of organizations, to make changes. I am nervous about continuing incrementalism, because I think we have to be bolder than that.

I think, however, we will not have the sort of the cataclysm that we might otherwise experience because, for the first time in a period of great change, we are aware of what is happening. This ought to make us more astute about how we respond. We should not be surprised.

MR. CHOATE: Our history of public policy during this century shows that we chart a course and stay with that course for many years. And we attempt to make some incremental shifts. That is what we have done. Then there is a seismic break, which occurs around some forcing demand. During this century it has happened three times: it happened in 1913 with Woodrow Wilson and the New Freedoms; in 1933 with the New Deal, the agenda of which was completed during the administrations of Presidents Kennedy and Johnson; and in 1981 with the Reagan revolution.

What I am suggesting is that we are approaching a point where we will have another one of these seismic breaks. I do not know if it will be a depression or a collapse of the financial markets. And what I am arguing is that we have the opportunity to build an agenda based on ideas that make sense and are sane and thought through, so that when that moment comes we will have an intellectual storehouse of capital in place to guide us. Because when the moment comes, none of the ideas has as much chance of being implemented.

Medical Inflation

MR. WEISMANN: We have talked very briefly about mandating benefits. But the fundamental issue here is not how benefits are going to be provided; it is that medical inflation is running rampant in the country today.

The statistics concerning the percentage of GNP that is spent on medical care are well known. And these costs are rising much more rapidly than costs in any other area of the economy.

I wonder if Pat Choate or someone else could comment on what the future holds in terms of medical benefits and how they will be provided.

MR. HALLETT: As far as I can tell, the costs of medical benefits are almost directly and fully related to the costs per day of a hospital stay.

The fact of the matter is that we have eliminated the causes of cheap death. I hate to say it that way, but as we advance in medical technology we are finding more expensive, exotic ways to keep people alive longer than we were able to do in the past.

The thing that bothers me most is that we look at only one side of the equation: the cost. There is not enough discussion on the other side, which concerns the benefits. There are some extraordinary benefits related to the degree that we can make investments to keep people well.

But as long as we look only at costs, I think we will never get it right. We need to step back and ask if we are prepared to make investments in wellness programs. Is that a good idea? Is that a medical expense? Should that be part of the insurance? Should that be part of the benefits? Is that a cost, or is it an investment? What do we get in return?

Haves and Have-Nots

MS. THIERMAN: I have two comments concerning some points made by Jeffrey Hallett. The first one concerns the Information Age and the fact that power is in the information one has, and such information will be spreading beyond large entities such as government and corporations. I was wondering if you have given some thought to the problem of the haves and the have-nots. Some individuals have access to a computer and the ability to get to information through it. And others have neither.

My second comment is related to the discussion of longevity. There seem to be two opposing trends: people are living longer but early retirement is also increasing. And I wonder if you could comment on that, especially since many people do not move into second careers after they retire early but instead pursue avocations, hobbies, or travel. They are living longer but do not necessarily take second jobs after they retire from their initial one.

MR. HALLETT: Concerning the haves and the have-nots. I do not think there is a one-to-one relationship between access to information

and knowledge and access to a computer. We are drowning in information and knowledge, and it has a major effect on everyone.

We are still at the very beginning of the development of computer technology. It has been explosive so far. I would imagine that in another five or six years the cost of putting a meaningful computer in front of every person is going to be so low that it will be outrageous if we do not do that.

This leads to the educational issue, because the only reason there are have-nots is that we adults—as parents and in government, business, and our communities—have failed miserably in what I think is our single greatest responsibility to the younger generations: to provide them the best opportunities we can imagine to learn and to become productive citizens. And we are so far away from that it is unreal.

One of the things that the computer allows us to do right now—and it has been amply demonstrated—is to place in the hands of the “have-nots” an unbelievably powerful tool that is also very tolerant. It will work for them 24 hours a day. It does not care whether the kids are green, yellow, black, orange, tall, short, or fat. However, we are not doing that. We could do it, and it is not all that difficult, but we still do not have the vision to get excited about what is possible.

We could end up very easily, 15 years from now, with huge groups of haves and have-nots, and if we do, it is our fault because this problem is resolvable.

In terms of the retirement issue, again, it is just a model, it is not an absolute. Everything that I have observed indicates that it is no longer proper to associate retirement with what it used to be, particularly in terms of work and productive capacity and what have been our models of career, employment, benefits, and productivity. Retired people have a capability, willingness, and desire to work.

Rationing Health Care

MR. MIKKELSEN: A question for Jeffrey Hallett concerning the provision of health care benefits for an increasingly aging society. My question draws partly on the writings of Daniel Callahan of the Hastings Institution. Do you believe that we, as a society, are going to have to grapple in the near-term with the issue of health care rationing for the so-called “old old” and perhaps even the “younger old?”

MR. HALLETT: Health care rationing because of what?

MR. MIKKELSEN: I am asking whether it is a resource allocation decision and how it relates to the notion of a normal life span. Substantial resources are being expended to keep people alive, come what may, without regard to the quality of life.

MR. HALLETT: I could only say that I agree that that is a major issue. I do not have the foggiest notion, seriously. I do not know how we are going to deal with that. I think it is a real problem.

PART TWO

PUBLIC POLICY DIRECTIONS

Part Two of this book discusses various public policy responses to the demographic shifts and changes in the nature of work and business that were the subject of Part One.

In chapter V, John L. Palmer says, "A coherent longer-range vision of how our society wants to finance retirement and health care for the aged is needed, so that any potential changes in public policies can be assessed on the basis of their consistency with such a vision and appropriate adjustments in the behavior of individuals and private institutions can be fostered." Palmer points out that, although the proportion of the elderly within the total population is projected to continue to rise moderately over the next two decades, the share of the very old (those aged 85 or older) is advancing much more rapidly. During the period from approximately 2010 to 2030, the elderly population will increase much faster. He sees a growing mismatch between the problems the elderly face in terms of their retirement and health care and the current policies that address these concerns. Unless the current public commitment to financial support is cut back, the working population appears to be facing major tax increases to pay for this support before long, he concludes.

One of the problems of the current system, Palmer says, is that although the elderly as a group are better off financially than they were 15 years ago, there is a wide disparity between the top 5 percent who have over one-half of the assets of the total group and the 41 percent of elderly women who live below the poverty line. To improve income security among the elderly, Palmer recommends that private pensions and annuities be expanded, reverse-annuity mortgages facilitated, and Supplemental Security Income benefits liberalized. He also thinks that health care benefits need to be expanded, in most cases through governmental assistance, because private sector financing is likely to be inadequate.

To accomplish these objectives, Palmer says that both increased participation by beneficiaries and an income-related strategy of savings in public programs will be necessary. Privatization of these programs seems unlikely, he adds, because of the impossibility of attaining an actuarially fair market and the basic instability caused by inflation and interest rates.

In chapter VI, Paul N. Van de Water and Paul R. Cullinan review government budget trends during the past 25 years and make projections through the year 2000 to establish a context for the discussion of employee benefits.

They point out that between 1965 and 1985 entitlement programs directed primarily at the elderly (Social Security, Medicare and Medicaid, and other retirement and disability programs) grew from 3 percent to 8.2 percent of Gross National Product as it was decided to pay for an increasing share of the elderly's needs through public programs. Nevertheless, despite the growth in public and private spending for health care and retirement income security, gaps remain. The authors believe that efforts to expand either the role of government or the contributions of employers to fill these gaps should be informed by a solid understanding of the relationship between governmental and private-sector activities and of the real resource costs of the proposed alternatives. In an era of government deficits and little growth in real wages, none of the alternatives for filling the gaps in the nation's safety net is an easy choice, they say.

In chapter VII, Stanford G. Ross reviews the history and framework of U.S. federal tax policy. He begins with the history of income and Social Security taxes from World War II. During the war, the individual income tax became a mass tax, based on the withholding of wages at the source, and corporate income tax became a major source of revenue. At the same time, the Social Security system, financed by payroll taxes, began to expand rapidly. Although there have been many changes in tax practices since then, the basic structure of our present tax system emerged during this period, according to Ross.

Tax rates were reduced immediately after World War II, but rose again with the advent of the cold war. During the 1960s, policymaking was largely the work of the executive branch, and tax policy was characterized by an emphasis on equity and incentives. The following decade saw Congress take the initiative for tax reform and, with the Budget Act of 1974, begin to consider tax policy and tax expenditure policy together.

The bracket creep that had occurred because of high inflation rates during the 1970s was addressed in the Economic Recovery Tax Act of 1981, which, Ross says, marked the beginning of revenue-driven tax reform.

Ross completes his discussion with the application of tax policy to employee benefits. "Absent a basic change in national politics, it does seem clear that the current model for tax policy will continue to

precipitate a great many tax changes and that the employee benefits area will be one of the areas most affected by these changes."

In chapter VIII, P. Royal Shipp examines the effect of the baby boom's retirement on the nation's retirement income and health care programs. His discussion, based on a study conducted by the Congressional Research Service and the Congressional Budget Office, indicates that the Social Security system seems to be working well and that financing pressures on the nation's retirement system will be adequately addressed; however, paying for the baby boom generation's health care in old age raises a different and more troublesome set of issues.

Two characteristics of medical care distinguish it from issues of retirement income, according to Shipp. First, the dollar cost of the obligation is open-ended. In contrast to income from other retirement claims, which varies more predictably with economic growth, no such relationship limits growth in medical care expenditures. The problems associated with this open-ended claim are exacerbated by the second feature: our national ideal of equitable access to medical care, regardless of income.

Shipp foresees a continuing problem arising from the incompatibility of policies directed at providing greater access to medical care (by closing gaps in current insurance coverage) with efforts to reduce the rate of increase in medical care expenditures (particularly for publicly financed care) while maintaining the quality of care. The approaches he discusses to the issue of financing suggest that over the long run, some or all of the elderly will have to devote an increasing share of their cash income from Social Security, pensions, or other retirement savings to medical insurance premiums.

In chapter IX, Dorcas Hardy discusses the present status and the future of the Social Security program. Currently, Social Security payments represent about 40 percent of the retirement income for most retirees, although they represent as much as 75 percent for lower income workers. While 40 percent of all retirees receive private pensions, the number is not expected to reach more than 60 percent by the year 2000. Furthermore, at present private pensions represent an average of less than 20 percent of total retirement income. Frequent government intervention in the regulation of employee benefit plans and individual retirement accounts has slowed the expansion of private pension coverage, she argues.

According to Hardy, the current expectation is that the Old Age, Survivors, and Disability Insurance (OASDI) funds are in close ac-

tuarial balance for the long-range period (1988-2062), with increases in the reserves expected to grow for about the next three decades. However, she warns, these trust fund reserves must be allowed to build. They could easily be affected by future congressional actions that would divert the funds to other uses or fall victim to the overall federal budget deficit. Another source of potential threats to OASDI trust funds are proposals to use the reserves to increase benefits, cut payroll taxes, or expand Medicare.

Early retirements, encouraged by the \$8,400 limit on earnings, and disability insurance, which in itself is being used for early permanent retirement, are two current problems cited by Hardy that need to be solved now rather than postponed until the future.

Hardy maintains that we have an obligation to examine the issues facing the children who will be tomorrow's taxpayers. If the payroll tax continues to rise as rapidly as it has in the recent past, a time may come when support for the program will become as much a question of *ability* to pay as *willingness* to pay. To emphasize this point, she notes that in 1988 a person with maximum Social Security covered wages paid \$3,379, more than twice as much as the maximum rate paid just eight years earlier.

Hardy sees the expansion of private pensions as appropriate to the era of self-reliance and individual responsibility that we are entering, and she believes that we can best meet the challenges of the future by making sound public policy decisions today.

In chapter X, participants in Part Two comment on workers' attitudes toward increased Social Security payroll taxes, their understanding of the nature of the tax, and the importance of Social Security as a family benefit. They question whether the trend toward early retirement is reversible in view of what seems to be a strong desire on the part of many people to leave the work force as soon as they can. Restructuring the work environment is suggested as a possible way to retain older people on the job.

V. Financing Health Care and Retirement for the Aged

PAPER BY JOHN L. PALMER

Introduction

Current demographic trends are producing a growing proportion of elderly households whose need to finance health care and retirement poses a major societal challenge. The purpose of this chapter is to document the ongoing changes that give rise to this challenge, to consider the particular issues they raise for public policies, and to discuss some concrete alternatives for dealing with them.

From the Social Security Act in 1935 through the mid-1970s, retirement and health care financing for the aged expanded rapidly, reflecting general agreement on the need for greater public spending for the aged and a tolerance for higher taxes on the working population. Since the mid-1970s, however, the foundations of this political consensus have been shaken by a number of developments, particularly the prolonged slowdown in economic growth, escalating health care costs, concern about the overall fiscal health of the federal government, and a growing public awareness of the greatly improved economic circumstances of the aged. Hence, proposals to further expand programs benefiting the elderly have stalled, and numerous steps have been implemented to restrain the growth in public expenditures that previous measures had built in.

Present circumstances, however, are not sustainable. There is a growing mismatch between the actual problems the elderly face in financing their retirement and health care and the current policies addressing these concerns. As a result, public pressure has been building once again to expand the federal role in a number of areas of concern to the elderly at the same time that there are strong fiscal pressures for further—and more drastic—federal budget cutbacks. Quite independent of the continuing search for means of reducing the federal deficit is the long-term prospect of a mushrooming financial

I want to thank Susan Hendrickson for research assistance, Stephanie Gould for editorial assistance, and Henry Aaron, Emily Andrews, Hugh Hecllo, Bruce Jacobs, Jack Meyer, and Timothy Smeeding for comments on an earlier draft.

burden on the working population simply to maintain spending under current policies for a rapidly growing aged population.

The overall conclusion of this discussion is that current federal policies in support of the elderly must be significantly modified to encompass both carefully targeted expansions of financial support for some purposes and contractions for others—although in neither case as extreme as many people are advocating. Future policies will also have to focus more sharply on encouraging the further development of private as well as public sources of financing. The task of forging a political consensus around these policies will prove formidable and lies outside the scope of this discussion. But, as discussed later, this task will be substantially eased if policies toward the elderly are formulated in the context of two large, societywide concerns: promotion of long-term economic growth and control of spiraling overall health care costs. In the absence of progress on these two fronts, it is hard to imagine any satisfactory resolution of the thorny issues examined here.

The body of this chapter has four major sections followed by conclusions. Because the aged population's current and prospective claim on overall economic resources is at the heart of much of the present concern, the first section explores the fiscal implications of current policies. The second section discusses the desirability of, and scope for, modifications in these policies in light of the changing needs of the aged. The third and fourth sections assess some of the concrete measures these policy modifications might entail—first, ones that would improve the economic security of the aged and then ones that would result in fiscal savings relative to current policies.

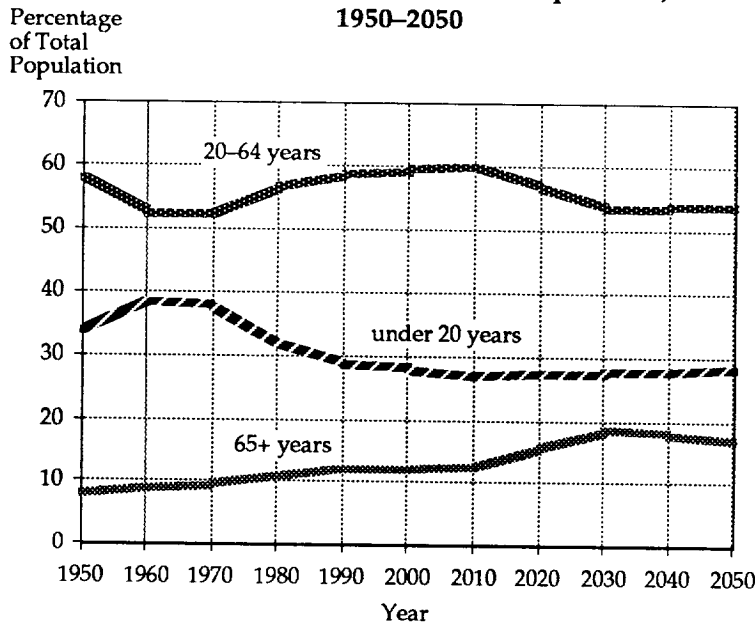
Changing Numbers

The fiscal pressures that attend the aging of the U.S. population will be determined primarily by changing demography and public policies and by the future course of the economy and health care costs.

The contribution of demographic change per se is attributable not simply to the growing numbers of Americans aged 65 and over, but also to major shifts in the age distribution of the population—among the young, working-age, and aged, and within the aged population itself (charts V.1 and V.2).¹ Over the next two decades the share of the

¹For general purposes, changes in the size of the group between the ages of 20 and 64 serve as a reasonable proxy for changes in the size of the labor force. Of course, labor force participation trends within this group are subject to change as well. In partic-

Chart V.1
Age Composition of the Total Population,
1950–2050

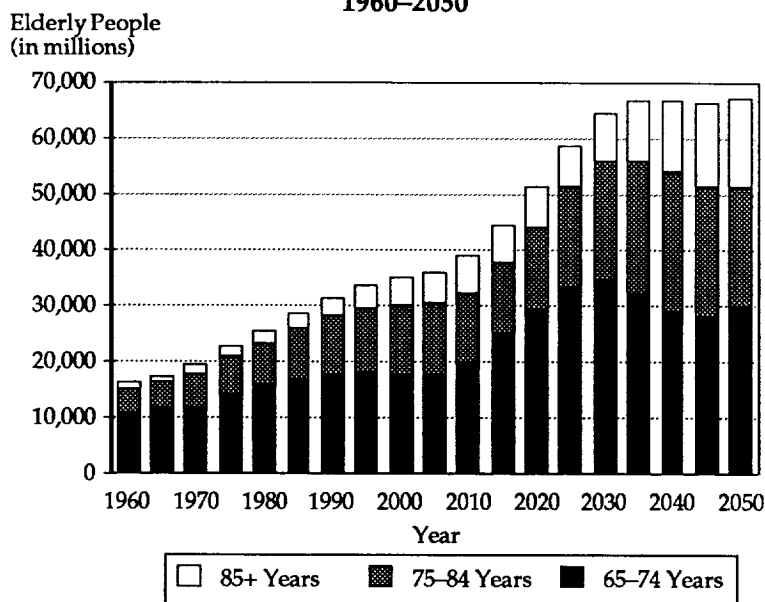


Source: U.S. Department of Health and Human Services, Social Security Administration, *1987 Annual Report of the Board of Trustees of the Federal Old Age, Survivors Insurance, and Disability Insurance (OASDI) Trust Funds*.
 Note: Projections are based on the Social Security Administration Actuaries' intermediate demographic assumptions.

aged within the total population is projected to continue to rise moderately, with the share of the very old (those 85 or older) advancing much more rapidly. In contrast, the share of the population under age 20 is expected to decline moderately. The net result of these two trends will be a small rise in the share of the working-age population. During the subsequent 20 years (roughly 2010 to 2030), the expected

ular, the labor force participation rate of men aged 55 to 70 has been declining for the past several decades and is expected to continue to do so for several more, although at a more moderate pace. However, this decline is likely to be more than offset by continuing—also moderating—increases in the labor force participation of women under age 65.

Chart V.2
Number and Age Composition of the Elderly Population,
1960–2050



Source: U.S. Department of Commerce, Bureau of the Census, *Current Population Reports*, Series P-25, nos. 311, 519, 917, 929, and 952.

Note: Projections are based on the Census Bureau's intermediate demographic assumptions.

combination of continued low fertility rates, declining mortality rates, and the retirement of the baby boom generation will produce a much more dramatic shift. While the proportion of the population under age 20 will decline marginally, the aged population will grow much faster as the baby boom generation reaches retirement age, expanding considerably the potentially dependent population in comparison with the working population. Finally, unless the long-term downward trend in fertility rates substantially reverses early in the next century, this big change in the population's age structure will be more or less consolidated.²

²The baby boom aside, the total fertility rate (the average number of births over a woman's lifetime) has been declining in the United States (and all Western indus-

Concern about the longer-term fiscal pressures resulting from the aging of the population stems primarily from the consequences of these demographic changes for spending under public programs for the elderly. From being largely the concern of families and charities, the support of the aged has increasingly become a public or collective concern, underwritten by programs such as Social Security, Medicare, Medicaid, and public assistance (and tax subsidies to promote private savings and pensions). Until recently, legislation has successively expanded the coverage and benefits under this set of programs. As a result, the bulk of all transfers of resources between the working and the aged populations now occurs through the public sector—in particular, through the federal government. (Federal expenditures for the aged amount to about 7 percent of the Gross National Product [GNP], whereas state and local expenditures are less than 1 percent.) Moreover, almost all the programs are entitlements for which all aged members of households with low incomes and assets, or aged ex-workers (and their dependents), are eligible. And program benefit levels are now automatically adjusted upward to reflect not only the rising costs of health care and other consumer goods but also (in the case of Social Security) the higher lifetime earnings of each new group of retirees.

These developments, in concert with the changing demographic picture, have resulted in a massive transfer of resources from the working population to the elderly and have been responsible for much of the growth in federal expenditures relative to GNP over the past several decades. Moreover, these developments ensure that, despite recent measures to slow their rate of growth, aggregate public expenditures for the elderly under current policies will once again grow faster than the economy as the next century approaches.

Awareness that simply maintaining the present degree of support would require greater taxation of the working population in the future has prompted many people to argue for further major cutbacks in the current federal commitment to the elderly. It has also stimulated concern about heightened competition for potentially dwindling public resources between the elderly and other dependent groups, namely,

trialized societies) since the Industrial Revolution. Recently this rate has stabilized at about 1.8, although there is some evidence of a slight upward creep. The replacement rate—the rate of total fertility that will yield an indigenous population of more or less constant size in the long run—is 2.1. The “best guess” demographic assumptions underlying charts V.1 and V.2 assume that fertility rates will creep up toward this level but not exceed it. If this is the case, then only a major shift in expected trends in mortality or net immigration rates could alter the basic picture shown in chart V.1 for the first half of the next century.

children and the nonelderly poor. At the same time, it appears likely that many of the elderly will need more public resources to cope with the problems associated with their greater longevity. All this potentially adds up to quite a strain on the public purse.

Just how much of a strain is difficult to quantify because it will depend not only on future adjustments in public policies but also on the uncertain course of the economy and health care costs. One rough measure of the magnitude of the problem can be derived from projections of future expenditures for Social Security and Medicare under the policies now in effect, because these two programs currently account for more than four-fifths of all federal spending for the elderly (as well as 48 percent of all domestic program spending and 29 percent of all federal outlays).³ Some current policy fiscal projections (and historical data) are shown in table V.1, using both the "intermediate" and "pessimistic" assumptions usually employed for the two programs. Obviously, they are not hard forecasts, because the assumptions on which they are based will undoubtedly change; but they at least provide some basis for thinking about the future.

Pension and Health Care Financing—Under the intermediate assumptions, the combined outlays for pension and health care financing creep up only marginally as a percentage of GNP over the next 20 years but then rise substantially (about 4 percentage points) as

³Other major federal programs that serve the elderly are veterans' health care and pensions, housing assistance, Medicaid, Supplemental Security Income, and federal workers' retirement pensions. However, no one of them accounts for more than 5 percent of total federal spending for the elderly and most account for far less. Furthermore, their overall share of total benefits for the elderly is expected to decline over time, even though Medicaid outlays will increase substantially with growing long-term care needs.

TABLE V.1
Current Policy Projections of Social Security and Medicare
Expenditures as a Percentage of GNP,
1990-2050

	Social Security	Medicare*	Total
Historical Data			
1965	2.4%	(b)	2.4%
1970	2.9	0.7%	3.6
1975	4.0	0.9	4.9
1980	4.3	1.2	5.5
1985	4.7	1.7	6.4

TABLE V.1 *Continued*

	Social Security	Medicare ^a	Total
Projections			
Intermediate assumptions			
1990	4.7	2.1	6.8
1995	4.7	2.3	7.0
2000	4.4	2.5	6.9
2005	4.2	2.8	7.0
2010	4.4	3.0	7.4
2015	4.9	3.2	8.1
2020	5.6	3.7	9.3
2025	6.2	4.2	10.4
2030	6.5	4.5	11.0
2035	6.5	4.8	11.3
2040	6.4	4.8	11.2
2045	6.3	4.8	11.1
2050	6.2	4.8	11.0
Pessimistic assumptions			
1990	5.2	2.3	7.5
1995	5.2	2.8	8.0
2000	4.9	3.3	8.2
2005	4.8	3.8	8.6
2010	5.0	4.5	9.5
2015	5.6	5.3	10.9
2020	6.5	6.3	12.8
2025	7.3	7.6	14.9
2030	8.0	8.5	16.5
2035	8.3	9.0	17.3
2040	8.5	9.1	17.6
2045	8.7	9.1	17.8
2050	9.0	9.0	18.0

SOURCES: For 1965–1985, Executive Office of the President, Office of Management and Budget, *Historical Tables: Budget of the United States Government* (Washington, DC: U.S. Government Printing Office); for 1990–2050, U.S. Department of Health and Human Services, Social Security Administration, Office of the Actuary, *Annual Report of the Board of Trustees: Old-Age, Survivors, and Disability Insurance Program* (Washington, DC: U.S. Social Security Administration).

a. This includes both the Hospital Insurance (HI) and Supplemental Medical Insurance (SMI) components of Medicare. Long-time projections are provided by the Medicare actuaries only for HI. SMI outlays are assumed to rise from 63 percent of HI outlays in 1990 to 66 percent in 1992 (as in the Congressional Budget Office's five-year projections) and then to remain a constant 66 percent of the HI outlays.

b. Medicare was not implemented until the late 1960s.

the baby boom generation retires, before becoming relatively stable once again. But although Social Security outlays fluctuate—going down and then rising—over the next 40 years, Medicare outlays climb steadily throughout the period, greatly increasing in relative importance. (The initial decline in Social Security is attributable to the 1983 amendments to the Social Security legislation, which provided for, among other things, a significant reduction in benefits relative to most retirees' prior earnings, which is scheduled to be phased in gradually early in the next century. Eventually though, the dampening influence of these amendments is far overshadowed by the retirement of the baby boom generation.) The continuously faster-than-GNP growth of Medicare outlays is attributable to two factors. The first is demography, including not only the general increase in the share of the elderly population but also the increase within that population of the very old, who have relatively higher medical expenses. The second is increases in general health care cost per capita, which for years have greatly exceeded the rate of general inflation and are assumed to continue to do so, but by a much narrower margin.

Although the intermediate assumptions supposedly reflect the current "best guess," they are more likely than not to prove optimistic, particularly with regard to real rates of growth in the economy and of health care costs.⁴ Different assumptions about these two and other relevant variables can dramatically alter the outlay projections. As shown in table V.I, the pessimistic assumptions yield a far different fiscal outlook: combined Social Security and Medicare outlays climb rapidly over the entire projection period, increasing by 10 percentage points of GNP by the end of the retirement of the baby boom generation. This pessimistic projection series merits attention not because it portrays a likely outcome, but because it illustrates the sensitivity of estimates of the future fiscal burden to variations in the

⁴Even the pessimistic projections assume that the performance of both variables over the long run will be considerably better than it has been during the past 15 years. For example, labor productivity has increased at an average annual rate of about 1 percent since 1973, but the assumed long-run increase in the pessimistic projection series is 1.5 percent and in the intermediate series 1.7 percent. (These rates bracket the average for the past three decades.) Trends in real health care costs and the prospects for their slowing as much as is assumed in the intermediate series are discussed near the end of this chapter. The key demographic differences underlying the two projection series are concerned with fertility and death rates. The intermediate series uses basically the same assumptions reflected in charts V.1 and V.2, which assume a modest rise in fertility rates and a slowdown in the rate of decline of mortality rates relative to the recent past. The pessimistic series assumes a somewhat faster rate of population aging resulting from both a continuing rapid decline in mortality rates and a modest decline in fertility rates.

assumed trajectories of key variables. However, given the rosiness of the intermediate assumptions, the outlay trends they yield under current policies are clearly on the optimistic side.⁵

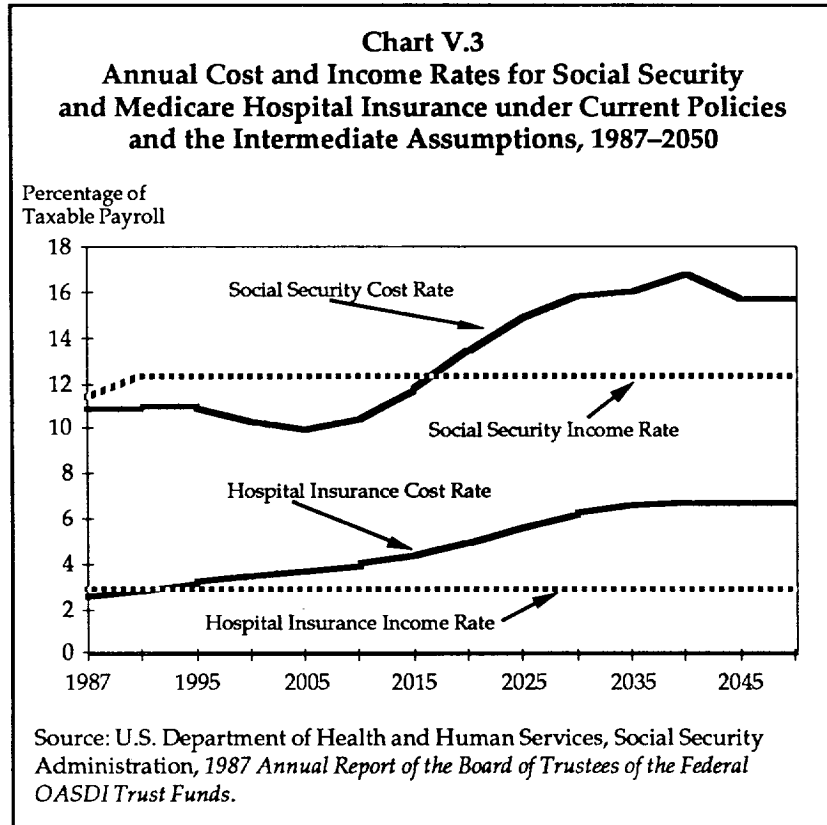
Although rapid growth in the elderly population is a major contributor to the rising costs of current policies as projected in table V.I, there is another dimension of the changing composition of the population that should serve to moderate the fiscal severity of the picture portrayed there. As shown in chart V.I, youth's share of the total population is expected to fall by an amount equal to about one-half of the increase in the aged's share by the end of the retirement of the baby boom generation. However, per capita public expenditures of the preworking age population are only one-fourth to one-third those for the aged; and because these expenditures are much more a state and local responsibility, this relative shrinkage in the youth population will have only a minor effect on projected federal spending under current policies. Nevertheless, the total tax burden on the working age population (and the strain on their private resources) should be relieved somewhat by this development.

Higher Taxes—Even granting this mitigating development, however, unless the current public commitment to financial support for the aged is scaled back, the working population appears to be facing major tax increases to pay for this support before long. In a display of unusual foresight, Congress attempted to provide at least partially for this contingency in the 1983 amendments to the Social Security Act. In addition to measures designed to avert the pending bankruptcy of the program's trust funds and to reduce long-term benefit commitments, the amendments included provisions for increasing Social Security's future revenues sufficiently to put the program on a sound financial basis well into next century. Most important, the earmarked payroll tax paid equally by employers and employees on Social Security-covered earnings was scheduled to increase by one percentage point between 1988 and 1990 (from a combined level of 11.4 to 12.4). And, in a significant departure from past practice, one-half of Social Security benefits for persons with adjusted gross incomes in excess of \$25,000 (\$32,000 for couples) were subjected to income taxation, with the proceeds also destined for the Social Se-

⁵The Social Security Administration actuaries also publish projections for an "optimistic" set of economic and demographic assumptions (not shown in table V.I), which show a modest decline in combined Social Security-Medicare outlays as a percentage of GNP over the next 20 years, followed by an increase to a peak after the retirement of the baby boom that is about two percentage points higher than today's level. These projections are not included because the assumptions appear unduly optimistic.

curity trust fund. These steps were designed to produce large annual surpluses that would accumulate as sizable reserves in the Social Security trust fund over the next two or three decades (possibly exceeding \$2 trillion) and could then be drawn down to pay for the retirement of the baby boom (chart V.3)

The intention is admirable, but the execution has been problematic so far and threatens to worsen. Although projected outlays and income for Social Security are in actuarial balance over the next 50 or so years under the intermediate assumptions, this does not necessarily mean that the total economic resources available to the population during the retirement of the baby boom generation will be any larger than they would have been in the absence of this build-up of reserves. If the reserves in the Social Security trust funds are



to be of any real benefit in easing the financial burden of the retirement of the baby boom, they must be used to enhance economic growth in the interim. This will be the case only if the Social Security surpluses, which are a form of public savings, result in higher overall national savings and investment than would otherwise occur. But they cannot have this effect if they are used simply to offset deficits in other federal accounts. Unfortunately, this is what is already occurring.⁶ In this era of Gramm-Rudman budgetary politics, no political leader is advocating balancing the federal budget exclusive of Social Security. The annual Social Security surpluses—which are expected to total \$70 billion (more than 1 percent of GNP) by 1992 and still growing—are being used to avoid the need for even larger politically painful deficit reductions.

If general deficit reduction does not continue to supply sufficient temptation, yet another threat to the Social Security surpluses is looming a little further down the road. Unlike the action on Social Security, no provision has yet been made even on paper for the financing of Medicare's projected faster-than-GNP growth over the next 20 years, let alone the retirement of the baby boom. Medicare has two components. The larger one, Hospital Insurance (HI), accounts for about 60 percent of total program outlays and is financed by a 2.9 percent (combined employer-employee) payroll tax on Social Security-covered earnings. In the early 1990s, HI will begin to run annual deficits that, even under the intermediate assumptions, will deplete its trust fund around the turn of the century and will exceed 1.6 percent of GNP (3 percent of payroll) once the baby boom generation is retired (chart V.3). Medicare's other component, Supplemental Medical Insurance (SMI), which covers physician and outpatient services, is financed one-quarter from enrollee premiums and three-quarters from general revenues. Consequently, under this arrangement, as SMI outlays continue to rise relative to GNP, so too will the tap on general revenues required to finance the program. Under these conditions, it will be politically tempting to reallocate the Social Security surpluses in order to postpone Medicare's day of reckoning or to finance new health care benefits for the elderly.

⁶This subject is too complex for discussion here. It is also true that under the pessimistic assumptions the Social Security program itself is substantially underfinanced over the projection period. However, given the uncertainties involved in such long-term projections, it seems reasonable to rely for now on the intermediate assumptions for planning purposes. But the shortfall under the pessimistic assumptions is indicative of a possible need for further steps within the next two decades to ensure Social Security's fiscal health during the retirement of the baby boom generation.

In sum, the interaction of an aging population, public policies, and rising health care costs has resulted in a substantial increase in the share of total economic resources being devoted to the support of the aged population over the past several decades, and this share undoubtedly will continue to increase over the foreseeable future. By how much is difficult to predict, because the amount will depend on the uncertain course of the economy and health care costs, among other things, as well as on future adjustments in public policies in support of the elderly. However, it appears likely that the revenues necessary to finance projected expenditures *under current policies* would have to increase modestly over the next two decades and by at least 5 percent of GNP by the end of the retirement of the baby boom—with the bulk of the increase earmarked for health care. How burdensome such an increase would be on future working generations is discussed further in the concluding section.

The next section deals with the needs of the elderly. The same factors that have altered the fiscal outlook are also contributing to major changes in circumstances among the elderly, and it is important to understand the nature of these changes in considering possible shifts in public policies that are responsive to the evolving needs of the elderly and to overall fiscal concerns.

Changing Needs

Over the past several decades the sizable expansion of federal programs, as well as general economic growth, has led to one of the greatest success stories of public policy—an overall major improvement in both the absolute and relative economic status of the aged. This improvement is clearly reflected in aggregate income statistics. Between the late 1960s and the mid-1980s, the median per capita income of the elderly population rose by 50 percent, from three-quarters to over nine-tenths of that of the nonelderly population. The poverty rate among the elderly also declined, from well above the rate for the nonelderly (28.5 percent versus 13.3 percent in 1966) to somewhat below (12.4 percent versus 13.7 percent in 1986).

This general story of substantial improvement in the economic status of the elderly appears to hold true even when simple income measures are adjusted for numerous other differences in the circumstances of the elderly and nonelderly. For example, the elderly receive greater amounts of in-kind assistance (such as Medicare), pay proportionately less in taxes, have lower consumption needs (because of

lower caloric intake requirements and fewer work-related expenses), and have greater net worth (as a result of a lifetime of savings). Conversely, the elderly have greater health care needs and are less able to take advantage of the economies of scale available to the nonelderly, who typically live in larger households. Several studies, using various methodologies, have tried to adjust for these kinds of differences.⁷ The general conclusion they reach is that the economic status of the elderly *as a group* is more or less on a par with that of the nonelderly and such that they can maintain in retirement the standard of living achieved in their middle-age working years.

Even these adjusted measures of the elderly's economic status fail to capture the full extent of the improvement in this group's well-being. The gains have been realized despite a major reduction in the labor force participation of the elderly. (Participation of elderly men has been declining for several decades, dropping from 46 percent in 1950 to 16 percent in 1986, with a corresponding decline in the share that earnings represent in the total income of elderly households from more than one-third in 1950 to about one-seventh today.) Rising pension and asset income and rapidly expanding Social Security benefits have made retirement a more economically viable alternative to continued employment among this group and many have responded by taking a large portion of their rising standard of living in the form of leisure. (The same phenomenon is also prevalent among men ages 55 to 64, who have increasingly opted for early retirement.) Further testimony to the elderly's improved well-being is their increasing ability to live independently—a preference which they and their children have consistently and strongly registered in surveys over this period. The big gains in such independent living came in the 1950s, but they have continued since then. Between 1960 and 1984 the percentage of all persons age 65 and over who were household heads or spouses of heads increased from 80 to 91 percent, and the share of single, elderly persons with no live-in relatives rose from 40 to 70 percent.⁸

⁷See, for example, Timothy Smeeding, "Full Income Estimates of the Relative Well-Being of the Elderly and Nonelderly," in Daniel Slottje and David Bloom, eds., *Research in Economic Inequality*, vol. 1 (Greenwich, CT: JAI Press, forthcoming).

⁸See Bruce Jacobs, "The Elderly: How Do They Fare?" in Douglas Besharoz and Leslie Lenkowsky, eds. *Understanding Poverty and Dependence* (New York: Free Press, forthcoming). Some of these increases in independent living may not be voluntary and could reflect diminished well-being. But as the previous sentence in the text indicated, they generally appear to be consistent with the preferences of the elderly.

The Composition of the Elderly Population

Although it is commonplace to present data on the elderly as a group, averages by no means tell the whole story. Rather, they mask an extremely (and increasingly) heterogeneous population which spans more than 30 years of age and has highly disparate economic, demographic, and health conditions. For example, elderly persons who live alone, are very old, or are minorities are the most likely to be poor. Poverty rates ranged in 1984 from as low as 5 percent for younger, married elderly persons to as high as 41 percent for older single women (table V.2).⁹ Because of the combination of their high poverty rates and large share of the total elderly population (due to their greater longevity), single women account for nearly two-thirds of all aged poor persons.

In general, the economic status among the elderly is more unequal than among the nonelderly.¹⁰ Despite their lower overall poverty rate, a much higher proportion of the elderly than the nonelderly have below-average incomes. For example, in 1984 nearly one-third of the elderly, in contrast to less than one-fifth of the nonelderly, had incomes between only one and two times the poverty level. At the other end of the distribution, net wealth is extremely concentrated among elderly households; the top 5 percent account for well over one-half of the total. The only important form of wealth that is widespread among lower- and middle-income aged households is home equity.

The elderly also manifest quite different exposure to economic insecurity over their remaining lifetimes. Despite the past rapid expansion of Medicare and Social Security, many elderly persons are still very vulnerable to certain financial exigencies—most notably, medical expenses or the death of a spouse and concomitant loss of income—that can overstrain their resources and, for many, result in a precipitous decline in their standard of living. Medicare pays less than one-half of the health care costs of the elderly and covers neither long-term care nor many acute-care needs (such as prescription drugs until catastrophic bill passed. And the availability of private insurance covering either long-term care or extraordinarily high acute-care costs is extremely limited. The portion of the annual income of the noninstitutionalized elderly that is currently devoted to health

⁹The source of the data for table V.2 does not permit a full cross-classification by age, race, sex, and marital status. Other sources indicate that the poverty rate for very old black women is in excess of 65 percent.

¹⁰See Joseph F. Quinn, "The Economic Status of the Elderly: Beware the Mean," *Review of Income and Wealth* (March 1987): 63–82.

TABLE V.2
Poverty among Demographic Subgroups of the Elderly in 1984

Demographic Subgroup	All Elderly				White				Black				
	Number (in thousands)	Percentage below 125% of Poverty Line		Percentage of Total Elderly Poor Persons*	Number (in thousands)	Percentage below Poverty Line		Number (in thousands)	Percentage below Poverty Line		Number (in thousands)	Percentage below Poverty Line	
		Line	Line			Line	Line		Line	Line		Line	Line
All Elderly													
65-74	12,027	17	26	47.7	NA	NA	NA	NA	NA	NA	NA	NA	NA
75-84	6,878	24	38	37.8	NA	NA	NA	NA	NA	NA	NA	NA	NA
85+	1,886	34	51	13.9	NA	NA	NA	NA	NA	NA	NA	NA	NA
Total	20,791	21	32	100.0	18,590	18	29	1,888	48	61			
Married Couples													
65-74	5,757	5	9	11.8	NA	NA	NA	NA	NA	NA	NA	NA	NA
75-84	2,177	9	15	8.0	NA	NA	NA	NA	NA	NA	NA	NA	NA
85+	355	11	20	1.6	NA	NA	NA	NA	NA	NA	NA	NA	NA
Total	8,289	7	11	22.6	7,665	6	10	508	20	28			
Nonmarried Persons													
Men													
65-74	1,530	21	34	6.6	NA	NA	NA	NA	NA	NA	NA	NA	NA
75-84	909	27	40	5.0	NA	NA	NA	NA	NA	NA	NA	NA	NA
85+	315	33	49	2.1	NA	NA	NA	NA	NA	NA	NA	NA	NA
Total	2,754	24	38	13.7	2,303	20	30	388	48	60			

TABLE V.2 Continued

Demographic Subgroup	All Elderly			White			Black		
	Number (in thousands)	Percentage below Poverty Line	Percentage of Total Elderly Poor Persons*	Number (in thousands)	Percentage below Poverty Line	Percentage below 125% of Poverty Line	Number (in thousands)	Percentage below Poverty Line	Percentage below 125% of Poverty Line
Women									
65-74	4,740	30	43	29.1	NA	NA	NA	NA	NA
75-84	3,791	32	50	24.8	NA	NA	NA	NA	NA
85+	1,215	41	60	10.2	NA	NA	NA	NA	NA
Total	9,746	32	48	64.1	8,621	28	45	992	62
									77

Source: U.S. Department of Health and Human Services, Social Security Administration, *Income of the Population 55 and Over, 1984*, pubn. no. 13-11871 (Washington, D.C.: Government Printing Office, 1985).

NA: Not available.

Note: Numbers include noninstitutional population only. Entries may not add to total because of rounding.

*Based on person weights. Data in all other rows are based on household weights.

care averages about 14 percent and is rising.¹¹ However, these expenses range from well above an average of 20 percent of income for the low-income elderly to below 5 percent for those with per capita income above \$20,000. And within all income groups, these health expenses are heavily concentrated among the elderly who, in any given year, require extensive hospitalization. Moreover, nursing home costs (\$20,000 to \$30,000 a year) are a further burden to many of the elderly. Only about 5 percent of the elderly are now in nursing homes, but the lifetime risk of such institutionalization exceeds 40 percent, with its likelihood increasing markedly with age.

The elderly who face the greatest economic insecurity are the one-half to two-thirds who are in the broadly defined lower-middle income class.¹² Medicaid covers most health care costs, including nursing homes, for the poorest elderly; and the more affluent generally have sufficient income and assets or supplementary medical coverage to cover most contingencies. But people in between these groups are largely dependent on Medicare and have had to "spend down" their income and assets to poverty or below-poverty levels before becoming eligible for Medicaid.* They are also the most likely to be dependent on modest earnings or pension income, in addition to Social Security, to maintain their former standard of living, and these sources of income often cease with the disability or death of a spouse.

What of the Future?—How are the circumstances of the elderly likely to evolve in the absence of any major policy changes? Any answer to this question must, of course, be speculative, because it depends on many factors that cannot be predicted with any certainty. Nevertheless, a few observations seem warranted.

There is little doubt that the economic status of successive new groups of elderly persons will continue to improve on average. Far less clear is what the rate of that improvement is likely to be and, in particular, whether the economic status of the elderly will continue to rise faster than that of the nonelderly. Past improvements in the overall relative economic status of this group have largely been the

¹¹This share is about the same as that prevailing before the implementation of Medicare; it had dropped considerably in Medicare's early years, but continuously escalating health care costs and recent increases in Medicare cost sharing resulted in its increase.

¹²See Timothy Smeeding, "Nonmoney Income and the Elderly: The Case of the Tweener," *Journal of Policy Analysis and Management* 4 (1986): 707-724.

*Editor's note: The Medicare Catastrophic Coverage Act of 1988 increases the amount of income and assets that can be retained by the spouse of a married person who enters a nursing home. Single elderly persons still must spend down. The law makes additional improvements in catastrophic health care coverage and prescription drugs.

result of public pensions and health care financing programs, whose coverage has been greatly expanded and whose average benefits have increased far more rapidly than earnings. Both these trends have largely ceased. Indeed, the fact that Social Security benefits for new retirees are scheduled to grow more slowly than earnings in the next century and that the elderly will live longer will tend to reduce the relative economic status of elderly individuals as a group. But private incomes of the newly elderly are likely to rise faster than workers' earnings over the next several decades as a result of the greatly expanded coverage of the labor force by employer-based pensions from the 1940s through the 1970s and improvements in pension vesting and portability and in tax incentives for individual retirement savings since the mid-1970s. In addition, the generation that will reach retirement age over the next two decades will probably be favored by relatively high net worth.¹³

Aside from the matter of averages, there is a strong possibility of increased disparities in the future economic status of the elderly. Unfortunately, the public sources of income that will be growing less rapidly are far more important to the lower- and moderate-income elderly (particularly the very old) than the private sources that are likely to be growing more rapidly (table V.3). Social Security and other public cash assistance account for 55 to 85 percent of the total income of elderly persons in the bottom three quintiles of the income distribution, whereas the top income quintile of these persons receive more than 80 percent of their income from assets, private pensions, and earnings. (The importance of Social Security to the lower-middle-income elderly is underscored by the fact that nearly one-half of the elderly would be poor without Social Security benefits.) As a result of these factors and the greater longevity of the elderly, it appears likely that there will be more pulling apart of the "haves" and the "have nots" among the elderly in the future—with the economic status of those at lower income levels declining in the future relative to the status of nonelderly people, and the status of the well-to-do continuing to gain.¹⁴

¹³This age group has had the good fortune to be in their prime working years during the high earnings growth of the 1960s, to find the value of their homes soaring during the housing inflation of the 1970s, and to be in the maximum liquid asset position to capitalize on the high real interest rates and stock boom of the 1980s. See Marilyn Moon and Timothy Smeeding, "Can the Elderly Really Afford Long Term Care?" in Sean Sullivan and Marian Ein Lewin, eds., *The Care of Tomorrow's Elderly* (Washington, D.C.: American Enterprise Institute, forthcoming).

¹⁴This situation will be further reinforced by the gross disparities in wealth among the elderly, particularly as a result of the schism between tomorrow's elderly, who

TABLE V.3
Percentage Distribution of Income by Source for the
Elderly, by Income Quintiles, 1984

Elderly Couples ^a						
Income Source	All Income Groups	Income Quintiles by Dollar Range				
		Less than \$10,100	\$10,100– \$14,449	\$14,450– \$20,099	\$20,100– \$30,099	\$30,100+
Social Security	37.6	82.2	69.2	55.5	37.4	17.8
Pension Income	16.2	4.7	12.4	17.2	20.4	16.6
Income from Assets	27.6	6.1	10.4	17.9	26.7	38.4
Earnings	16.9	2.2	6.0	7.9	14.7	25.7
Means-tested Cash						
Transfers	0.3	3.3	0.6	0.1	0.0	0.0
Other Income	1.3	1.5	1.4	1.4	0.8	1.5
Total	100.0	100.0	100.0	100.0	100.0	100.0

Elderly Individuals ^a						
Income Source	All Income Groups	Income Quintiles by Dollar Range				
		Less Than \$4,200	\$4,200– \$5,799	\$5,800– \$8,049	\$8,050– \$13,699	\$13,700+
Social Security	44.5	75.0	81.6	74.2	52.9	21.7
Pension Income	12.5	1.0	2.1	7.8	15.3	16.1
Income from Assets	30.6	3.5	4.7	10.0	21.6	48.5
Earnings	8.1	0.6	1.3	2.5	7.1	12.3
Means-tested Cash						
Transfers	2.3	17.8	7.2	3.1	0.2	0.0
Other Income	2.1	2.1	3.1	2.4	2.9	1.4
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Congressional Budget Office calculations based on the March 1985 *Current Population Survey*. Entries may not add to totals because of rounding.

^aElderly couples include those in which the older spouse is age 65 or older and the younger spouse is age 62 or older. Elderly individuals include all unmarried people age 65 or older. The institutionalized population is not included.

Although the overall financial resources of the elderly will increase over time, so too, it appears, will the financial burdens associated with health care, especially long-term care. Projections of the future health status of the elderly are especially problematic in view of the considerable uncertainty surrounding advances in medical technology and their consequences for morbidity (illness), disability, and

will have benefited (either directly or indirectly through inheritance) from the great escalation in housing prices, and those who will not have benefited.

mortality rates. However, in the past, general medical advances against the predominant causes of ill health among the elderly have been offset by our increasing ability to keep alive many of the least healthy members of the population. Hence the general health status of the senior citizens of any given age remains roughly unchanged—and there is no reason to expect a major future shift in this pattern.¹⁵ Thus, as the elderly become increasingly numerous and long lived, the economic insecurity engendered by extensive long-term care needs will become far more widespread. As evidence of this, simple extrapolations based on current population projections and age-specific institutionalization rates indicate an approximate doubling of the nursing home population over the next 30 years and quadrupling over the next 50 years.

This overview of the changing circumstances of the elderly suggests two general conclusions. First, despite the dramatic overall improvement in their economic status, the elderly still have several important current (and prospective) needs for economic security. Second, because of this improvement, some of the elderly have a greatly enhanced (and growing) capability for directly shouldering more of the burden for their own economic security. In short, there is a growing mismatch between the needs of the elderly and the policies now in place. The need for a more discriminating set of public policies seems obvious.

The major needs of the elderly now are much more particular than general. If the United States is to address these needs in a fiscally responsible way, as well as address the growing fiscal gap under current policies, policymakers must develop a set of policies that (1) will increase the direct responsibility of the well-off aged persons for their own economic security without unduly undermining the important gains thus far achieved by the elderly as a group and (2) will make more efficient use of both public and private resources. The two sections that follow first explore the primary options for filling gaps in current policies with regard to income security and health care financing and then survey the prospects for achieving savings in public programs in ways that are consistent with these objectives.

¹⁵See James Poterba and Lawrence Summers, "Public Policy Implications of Declining Old Age Mortality," in Gary Burtless, ed., *Work, Health and Income Among the Elderly* (Washington, D.C.: Brookings Institution, 1987): 19–58.

Improving the Economic Security of the Aged

As is evident from the previous discussion, a major economic security need of the elderly is protection against catastrophic expenses for acute and, especially, long-term care. In addition, poverty continues to be a reality for a significant minority of the elderly, and a much larger group still has inadequate private resources after retirement with which to supplement Social Security and meet the more routine expenses of daily living. Although these concerns confront all demographic subgroups of the aged to some degree, very old people and divorced or widowed single women are especially vulnerable.

The most promising approaches for addressing the income security needs identified earlier are expanding private pensions and individual retirement annuities, facilitating reverse-annuity mortgages, implementing some form of so-called earnings sharing under Social Security, and liberalizing the Supplemental Security Income (SSI) program.

Expanding Pensions and Individual Retirement Annuities—As noted, the importance of employment-based pension income for the elderly is expected to continue to grow over the next several decades. The gains will be particularly widespread and dramatic for women, because of their greatly increased labor force participation since World War II.¹⁶ However, less than 60 percent of the labor force currently has pension coverage, and this percentage is not expected to change significantly under current policies.¹⁷ This means that pension reciprocity rates will cease to rise once all those workers who entered the labor force during the period of greatly expanding coverage have retired. Thus, a sizable portion of the lower-middle-income elderly

¹⁶Whereas the proportions of the aged who received pensions in the early 1980s ranged from less than one-tenth for unmarried women to about one-third for married couples, these proportions are projected under current policies to exceed one-third for unmarried women and to approach two-thirds for married couples who will retire in the next 5 to 15 years and, for retired baby boomers, to exceed one-half for unmarried women and approach three-quarters for married couples. See Emily Andrews, "Changing Pension Policy and the Aging of America," *Contemporary Policy Issues* 2 (1987): 84–97.

¹⁷After growing rapidly for decades, pension coverage of the work force leveled off in the late 1970s at about 60 percent. Since then, it has declined moderately because of slow economic growth and the continued shift in employment away from jobs that typically provide pension coverage to those for whom coverage is less likely. Although substantial continued deterioration of pension coverage is not expected, neither are sizable increases. See Emily Andrews, "Changing Pension Policy and the Aging of America," *Contemporary Policy Issues* 2 (1987): 84–97.

population will still be left with little or no pension income to supplement Social Security benefits at a time when the share of past earnings replaced by these benefits will be declining for those who retire before age 67. Because most of these elderly people will be the same ones who will have found it difficult to accumulate other forms of liquid wealth during their working years, it would be desirable to increase the availability of pension and annuity income in their retirement.

The most obvious way to address this concern is to mandate some basic coverage for all employers above some minimal size for their employees who meet certain conditions with respect to age, hours worked, and, possibly, job tenure (as was recommended in the 1981 report of the President's Commission on Pension Policy). However, such a step raises a number of concerns, particularly regarding the potential economic costs to the newly covered workers and their employers. In view of the potential negative impact on profitability and employment in small firms (for whom pension coverage is currently much lower and the per capita costs of administering a plan much higher than for larger firms), more study and refinement of mandated pension systems are clearly called for before legislation is considered.

In the interim, the federal government could consider taking several more modest steps that could expand somewhat the expected pension and annuity income of lower-middle-income retirees who would otherwise have little or none. Three of these steps appear particularly meritorious, because they would be minimally disruptive of the current private pension system and entail relatively small private and public costs. First, the provision of a tax credit to smaller employers to offset their higher administrative costs should encourage many more to offer pension plans.¹⁸ Second, much more stringent penalties or restrictions could be imposed on workers for using tax-sheltered retirement savings in individual retirement accounts (IRAs) and employer-based pensions to finance either early retirement or current consumption in their preretirement years, which is now common practice among workers with such sources of wealth. And, third, tax incentives could be increased for IRA contributions by lower-middle-

¹⁸In the most recent survey year (1983), more than two-thirds of uncovered workers between age 25 and 64 who worked at least half-time were in firms of fewer than 100 employees. Also, 35 percent had earnings of less than \$10,000, and 88 percent had earnings of less than \$25,000. See Emily Andrews, *The Changing Profile of Pensions in America* (Washington, D.C.: Employee Benefit Research Institute, 1985), table IV.2.

income workers and their spouses, whose current use of this form of retirement savings is quite low.¹⁹

*Facilitating Reverse-Annuity Mortgages*²⁰—About 40 percent, or an estimated \$700 billion, of the total net worth of the elderly population is currently held in the form of home equity. Nearly three-quarters of elderly households are homeowners, and more than four-fifths of these homes are unencumbered by a mortgage. Although high levels of home equity are concentrated among higher-income households, home equity is not uncommon among lower- and middle-income households.²¹ Heretofore, elderly homeowners have not generally been able to convert their home equity into available income without selling their houses and moving to rental property or new homes that cost considerably less than their equity in their previous home. Recently, however, variants of innovative financial instruments—popularly called “reverse-annuity mortgages”—have emerged for translating equity into income. Their potential benefits are particularly attractive for very old persons, whose shorter expected lifespan would enable them to obtain higher monthly payments for any given amount of equity.²²

Unfortunately, for a number of complex reasons, markets for reverse mortgages have been slow to develop: banking laws and regulations effectively prohibit them in some states; there are inadequate protections for both lenders and borrowers if the homeowners’ actual lifespan greatly exceeds their expected lifespan; insurance is generally unavailable to spread the risk of default (in contrast to the case with conventional mortgage insurance); homeowners face the pos-

¹⁹As a result of the 1986 tax reform, the tax savings from the \$2,000 deductible IRA contribution to low- and moderate-income workers will range from zero to a maximum of only \$300 (because they will be in either the zero or the 15 percent marginal tax bracket). There are numerous ways in which the incentives restricted to these workers to contribute to IRAs could be increased through the use of higher deductions or refundable tax credits.

²⁰The discussion in this subsection is largely based on Bruce Jacobs, “The National Potential of Home Equity Conversion,” *Gerontologist* 5 (1986): 496–504; and Bruce Jacobs, “The Elderly: How Do They Fare?” in Douglas Besharoz and Leslie Lenkowsky, eds., *Understanding Poverty and Dependence* (New York, NY: Free Press, forthcoming).

²¹For example, more than one-quarter of those with incomes below 140 percent of the poverty level have home equity of \$50,000 or more. See Bruce Jacobs, “The National Potential of the Home Equity Conversion,” *Gerontologist* 5 (1986), table 1.

²²The home equity loans that have become so popular recently are not useful for the purposes discussed here because they are amortized over relatively short periods and require monthly payments not easily affordable on a limited budget. Reverse-annuity mortgages, in contrast, require no monthly payments and are amortized over a longer period.

sibility that the liquidation of home equity will affect their program eligibility and benefit levels under public assistance programs; and potential borrowers are generally reluctant to take on new debt and often lack the sophistication to assess the advantages and disadvantages of doing so. Some of these problems are now being addressed, but more aggressive action by the federal government, as well as by state and local governments, will be necessary to overcome the barriers.

Implementing Earnings Sharing under Social Security—The Social Security program itself offers obvious opportunities for greater targeting of cash assistance on particularly needy elderly persons. As noted earlier, the dramatic improvement in the economic status of the elderly population in recent decades has been primarily a result of the rapid expansion of Social Security as a source of retirement income. But further general increases in Social Security would be extremely expensive and, in any event, would only hit the desired target on the periphery. In contrast, several proposals have surfaced in recent years for some form of sharing of earnings records between spouses for purposes of determining individual benefits. These proposals could hit the target more directly, for a politically feasible price. The proposals vary considerably in the complexity of their design and consequences, depending on the relative weight given to different possible objectives. But, for the purposes here it is necessary only to note that, among other things, they can be structured to provide significantly higher benefits than under current law to the remaining spouse of a married couple (typically the wife) with the lower (or no) history of Social Security covered earnings in the event of divorce or death of the spouse.

Several prototypical incremental earnings-sharing plans, which do not compromise any current or future Social Security beneficiaries, have been analyzed by the Congressional Budget Office.²³ They would increase average benefits to widows and divorcees about 10 percent, with an eventual (during the retirement of the baby boom) annual cost of about 4 percent of currently projected Social Security outlays. (Four percent of Social Security outlays in 1988 would be \$8 billion.) Moreover, this increase in benefits would be distributed in a highly progressive manner, ranging in excess of 20 percent for low-benefit recipients to under 2 percent for high-benefit recipients. The cost of full implementation of any of these incremental plans would be less

²³See U.S. Congress, Congressional Budget Office, *Earnings Sharing Options for the Social Security System* (Washington, D.C.: U.S. Government Printing Office, 1986).

than 2 percent of total Social Security outlays. A phase-in for new beneficiaries only, or immediate implementation of only some of the several potential changes involved, could reduce the costs even more. Also, more full-blown earnings-sharing plans have been designed which could be implemented at little or no long-run cost, because they would naturally result in reduction of benefits (relative to current law) for certain classes of recipients (particularly divorced men).²⁴

*Liberalizing SSI Benefits*²⁵— None of the previous three categories of possible measures to improve the income security of the elderly are directly targeted on poverty per se. And, although all would eventually contribute to further reductions in poverty, their effects would take several decades to be fully felt. Fortunately, there is also a direct and relatively inexpensive way to achieve a substantial and immediate effect on poverty rates among the elderly—liberalizing SSI benefits.

The federal means-tested SSI program currently provides an inflation-indexed income guarantee at 77 percent of the poverty level for aged individuals and 91 percent for elderly couples. Many states supplement these benefits, but few do so to the poverty level, and the real value of these supplements has eroded by more than one-half since the program was instituted in the mid-1970s. Raising the federal income guarantee to the poverty level for individuals and couples would reduce poverty among the elderly by one-third, at an annual cost of about \$5 billion. Moreover, this reduction would be concentrated among elderly persons with the highest rates of poverty. (For example, the poverty rate among the oldest single women would decline by one-half or more.)

There are two reasons why raising the SSI income guarantee to the poverty level would not entirely eliminate poverty among the elderly. Many of the elderly who qualify for SSI benefits on the basis of their incomes are excluded from eligibility by the program's limitation on liquid assets (scheduled to be \$2,000 for an individual and \$3,000 for a couple in 1989). In addition, more than one-third of the people who are eligible do not participate because of their unwillingness "to be on welfare," the small size of the benefit they would receive, or lack of knowledge about the program. Liberalization of

²⁴However, because it might be desirable to phase in the increases in benefits inherent in such plans more quickly than the reductions (to protect current beneficiaries and persons near retirement from cuts in their benefits), the annual costs could be significant for a substantial transition period.

²⁵This discussion of SSI, including the cost and poverty impact estimates, is based on Sheila Zedlewski and Jack Meyer, *Toward Ending Poverty among the Elderly and Disabled: Policy and Financing Options* (Washington, D.C.: The Urban Institute, 1987).

the assets test, greater efforts at program outreach, and an income guarantee higher than the poverty level—all would improve the anti-poverty effectiveness of the program for a cost of a few billion dollars beyond that of simply raising the guarantee to the poverty level.

Health Care Financing—Greater assistance in financing catastrophic health care expenses is probably the most pressing economic security need for the elderly. But, although a consensus on the public role in catastrophic acute care has emerged, public debate about how to proceed on financing of long-term care has barely begun.

The Medicare Catastrophic Coverage Act of 1988 limits beneficiary cost sharing for Medicare-covered expenses to somewhat less than \$2,000 in 1988 (an amount that would automatically increase in line with an appropriate cost index in future years), and adds a separate upper limit to expenses for prescription drugs—along with several other minor changes. The new benefits would be entirely self-financed by SMI enrollees through a mix of a small increase in the current flat-rate SMI premium and the institution of a new income-related supplemental premium collected through the tax system. These modifications to the Medicare program may substantially ease the financial burdens of acute-care costs for many elderly Americans, although they do little to help those lower-income aged whose expenses are under the caps but still high relative to their incomes.

Long-Term Care—As a nation, we currently spend about 1 percent of GNP (\$45 to \$50 billion) on a long-term care for the functionally limited aged population through a highly fragmented payment and delivery system. Approximately one-half of this spending is public and one-half private, with Medicaid accounting for about three-quarters of the public share and direct out-of-pocket spending (as opposed to insurance) accounting for virtually all the private share. The great bulk of both public and private spending for long-term care is for the 1.3 million elderly persons in nursing homes. The remainder is spent on a wide range of personal and medical services in support of the much larger (5 million) noninstitutionalized disabled elderly population. This formal (paid-for) noninstitutional care, however, meets only a small part of the needs of the disabled elderly people living in the community. More than four-fifths of such assistance is provided by family members (primarily spouses and daughters), who average 26 hours a week in care giving.²⁶

²⁶Although many disabled elderly persons in the community are only moderately impaired, about one-third are limited in three or more of the activities of daily living that are commonly used to define the degree of functional limitation (for example, getting in and out of bed, eating, dressing, getting around indoors, going to the toilet,

As the proportion of the very old markedly increases in the population, so inevitably will the share of GNP devoted to long-term care. Advances in medical technology and a more efficient delivery system that encourages noninstitutional care to the extent practicable could somewhat slow this increase. But, in addition to the increase in the sheer number of disabled elderly, there will be upward pressure from health care cost inflation and a declining pool of informal care givers (because of lower birthrates, higher divorce rates, and increased labor force participation of the primary care givers, middle-aged women). Thus, the major public policy issue is not *whether* we are going to devote a substantially larger share of our GNP to long-term care but, rather, *how* we are going to do it—through what mix of public and private means.

Two extremes for this public-private mix are conceivable. One would entail a fully comprehensive long-term benefit with minimal cost sharing under Medicare. Under this approach, Medicaid's role would be limited to picking up any remaining out-of-pocket costs for the poorest elderly persons. This would mean, in effect, public social insurance financing for most long-term care. The additional public costs for such a scheme cannot be precisely estimated, but they would probably be upwards of 2 percent of GNP or more within several decades (depending on the degrees of accompanying utilization and payment controls and of substitution of formal for informal care). Alternatively, Medicare coverage could be limited to acute care with Medicaid serving as a last resort, as it does now, and private sector mechanisms could be relied on to meet the needs of the nonpoor elderly insofar as possible. Each of these extremes is a potentially feasible outcome for long-term care policies in this country. But given the current public fiscal outlook and the continuing American preference for private sector approaches where feasible, on the one hand, and the growing public concern about the inadequacies of current financing mechanisms for long-term care, on the other hand, some less-extreme approach involving the expansion of the roles of both the public and private sectors seems both likely and desirable.

Just what is the potential for the expansion of more attractive private sector financing mechanisms for long-term care? Until recently there had been essentially no systematic analysis of this sub-

bathing). In fact, there are two elderly persons in the community for every one nursing home resident with the same level of disability. Most husbands, wives, and children provide home care for their disabled spouses and parents for as long as is possible for them. See Korbin Liu; Kenneth Manton; and Barbara Marzetta Liu, "Home Care Expenses for the Disabled Elderly," *Health Care Financing Review* 2 (1985): 51–58.

ject. However, in the past year or two, several studies have been completed (with numerous others in progress) that may shed some light on the matter.²⁷ One major study analyzed the likely overall consequences 30 years from now of a wide range of private sector financing mechanisms under what the authors characterize as fairly optimistic assumptions both about the possibility for their development and about improvements in the economic status of the aged in the interim. The mechanisms considered were private insurance, continuing care retirement communities, reverse-annuity mortgages, tax incentives for IRA types of accounts for long-term care, and the extension of the health maintenance organization (HMO) concept to include long-term care services. The conclusion reached was that

... with the exception of home equity conversions, only a minority of the elderly could afford private sector financing mechanisms. Moreover [as a whole] private sector approaches are very unlikely to finance more than a modest proportion of nursing home and home care expenditures and will have only a small impact on ... the number of people who [would otherwise have to] impoverish themselves down to Medicaid financial eligibility limits.²⁸

Other studies are somewhat more optimistic about the potential of private sector financing mechanisms.²⁹ However, even they indicate that, although these mechanisms could eventually play a major role, a sizable expansion of public program expenditures also will still be necessary if tomorrow's elderly are to be protected against widespread hardship from catastrophic long-term care expenses. In

²⁷See for example, ICF Inc., *Private Financing of Long-Term Care: Current Methods and Resources* (Washington, D.C.: ICF Inc., 1985); Mark R. Meiners, and Jay N. Greenberg, *Improving the Role of Private Markets in Financing Long-Term Care Services* (New York: New York University, 1987); Marilyn Moon and Timothy Smeeding, "Can the Elderly Really Afford Long-term Care?" in Sean Sullivan and Marian Ein Lewin, eds., *The Care of Tomorrow's Elderly* (Washington, DC: American Enterprise Institute, forthcoming) and Alice M. Rivlin, and Joshua M. Weiner, *Caring for the Disabled Elderly: Who Will Pay?* (Washington, D.C.: Brookings Institution, 1988).

²⁸See Alice M. Rivlin and Joshua M. Weiner, *Caring for the Disabled Elderly: Who Will Pay?* (Washington, DC: The Brookings Institution, 1988). According to the authors, there are basically two reasons why private sector financing mechanisms do not have a bigger effect. First, they are too expensive for most of the aged to afford. Second, they offer limited financial protection. (For example, most private insurance plans have prior hospitalization requirements and exclusions for prior conditions.) The essential problem is that improving insurance protection raises the costs and reduces still further the number of people who can afford it.

²⁹See especially Mark R. Meiners and Jay N. Greenberg, *Improving the Role of Private Markets in Financing Long-Term Care Services* (New York: New York University, 1987), and ICF, *Private Financing of Long-Term Care: Current Methods and Resources* (Washington, D.C.: ICF, 1985).

any event, the challenge to public policymakers will be to design this public program expansion prudently, while also fostering the development of the most promising complementary private sector mechanisms. (The two such mechanisms that appear to have the potential for the widest effects are reverse-annuity mortgages and long-term care insurance.)

Such a moderate expansion of direct public financing could be sensibly built into Medicaid and Medicare along either of two separate lines.³⁰ The first approach would be limited to Medicaid. Its eligibility for long-term care could be extended so that the *descent into abject poverty*, which now must precede any coverage, would be cushioned with graduated subsidies and more asset protection.³¹ Medicaid coverage is currently governed by a complex set of determinations involving SSI eligibility, stringent income and asset limitations, and spend-down provisions that vary considerably from state to state and even exclude the majority of elderly persons with incomes below poverty level. The measures to expand SSI discussed earlier would improve Medicaid coverage of the elderly poor. Complete, uniform, national coverage of the elderly poor would cost a few billion dollars more; costs would rise rapidly if coverage were extended further up the income and assets ladder.

The other approach to a moderate expansion of direct public financing for long-term care would involve reforming Medicare to provide a measure of protection against catastrophic expenses for all the elderly. This could be done either as an alternative to a major, or a complement to a minor, liberalization of Medicaid. In either event, it would involve adding to Medicare a long-term care benefit for elderly persons with rather serious functional impairment; the benefit would include a waiting period for eligibility, a substantial deductible, and possibly other cost sharing.³²

Such a Medicare approach would have three main advantages. First, far fewer middle-income elderly households would have to spend

³⁰See Jack Meyer, "Reforming Medicare and Medicaid," in *The Care of Tomorrow's Elderly* (Washington, D.C.: American Enterprise Institute, forthcoming).

³¹As part of the Medicare Catastrophic Coverage Act of 1988 Congress liberalized somewhat the Medicaid asset limitations and spend-down provisions that apply to the spouse of someone who is in a nursing home.

³²For example, premiums could be charged starting at age 65 but eligibility could begin at age 70, could be restricted to those needing assistance in three or more activities of daily living, and could exclude coverage for the first 6 months of nursing home care.

down into poverty or near poverty to obtain coverage for long-term care. Second, this level of public protection against expenses for catastrophic long-term care could reduce many of the barriers to private sector financing mechanisms and generally encourage rather than substitute for their development.³³ Finally, the added public costs could be kept to under 0.5 percent of GNP.³⁴

Achieving Savings in Public Programs

The steps considered in the foregoing section would target additional public and private resources on the priority needs for income security of today's and tomorrow's elderly. But financing any such expansions in public programs without adding to the deficit will require additional revenues or reductions in other budgetary commitments. So, too, will bridging the projected long-term fiscal gap under current federal policies that assist the elderly. In addition, because of their large share of the budget, cutbacks in the Medicare and Social Security programs are often advocated as one means of achieving overall deficit reduction in the near term. It was pointed out earlier that the improving economic status of the elderly provides scope for some of them to shoulder more of the burden for financing their retirement and health care without undermining the improvements in economic security already achieved. This section considers various approaches that at least partially address the fiscal needs just mentioned through changes in the Medicare and Social Security programs.

General Considerations—There are numerous ways of effectively increasing the burden on the elderly for the financing of their retirement and health care while still preserving the essential functioning of the current social insurance system (i.e., Social Security and Medicare). It is important to note at the outset, however, that the desirability of preserving that system has been increasingly called into

³³According to Meyer in *The Care of Tomorrow's Elderly*, if Medicare offered this kind of "backend" catastrophic protection, private insurers and prepaid plans would be more willing to enter the long-term care financing market by providing coverage at the front-end and in the middle in new insurance and delivery packages because their exposure could be limited. Similarly, there is a greater chance that the restrictions built into current private insurance would be relaxed.

³⁴According to one expert, "a moderately comprehensive" plan would cost between \$12 and \$15 billion annually in 1990, and "a more ambitious" plan from \$20 to \$30 billion (excluding the costs of any liberalization of Medicaid). See Karen Davis, *Medicare Financing and Beneficiary Income* (Baltimore MD: Johns Hopkins University, forthcoming).

question in recent years. Numerous proposals (politically unthinkable a decade ago) have cropped up for replacing the current system with private provision ("privatization") for retirement and health care for the vast majority of the elderly, accompanied by expanded provision of means-tested benefits (as in Medicaid and SSI) to cushion the consequences for the less fortunate. At the very least, the proponents of privatization argue, the current working generation ought to be given the choice of opting out of the social insurance system. Such partial or total privatization, it is alleged, not only is more in keeping with the American ideology of individualism and free markets, but also would reduce taxes on the working population and solve the fiscal problem posed by the rapid aging of the population.

The issues raised by various proposals for privatization and means testing are too complex to discuss fully here.³⁵ But it is worth noting the major opposing arguments, because they are sufficiently compelling to justify the focus here on less extreme adjustments to current policies. Briefly, these arguments are as follows.

First, it is true that switching from our present social insurance system for the elderly to a system much more oriented to the private sector could eventually permit a sizable reduction or elimination of the current sources of taxation supporting Medicare and Social Security. But because of the present reliance on pay-as-you-go financing, unless social insurance benefits were abruptly terminated (which would be neither politically feasible nor socially fair), the current and near-future generations of working taxpayers would have to finance two systems: the current public one for the elderly and near-elderly populations and another one financed through added private savings for themselves.³⁶ This would approximately double the expenditures for these purposes for these households.

A second argument against privatization is that private insurance markets are generally unable to provide actuarially fair policies. The primary reason for this is that the risk of adverse selection—the ability of low-risk persons to opt out of insurance—means that actuarially fair insurance markets simply do not exist, except where participation is compulsory (as for Social Security and Medicare). Furthermore, the private market—unlike the public one—cannot guarantee a steady

³⁵For more background on this discussion, see Michael J. Boskin, *Too Many Promises: The Uncertain Future of Social Security* (Homewood, Ill.: Dow Jones-Irwin, 1986).

³⁶A modest reduction in scheduled payroll taxes and future benefit commitments to Social Security could be achieved without reducing the expected benefits of current retirees and near retirees by simply foregoing the projected surpluses over the next several decades. However, doing so would add to the overall federal deficit.

flow of real income during retirement (for any given amount of savings over the working years) because of the uncertainties posed by fluctuations in inflation and interest rates.

Beyond these two arguments is the overriding fact that, in contrast to many public programs, Social Security and Medicare have been extremely successful in accomplishing their objectives and have earned unusually strong and widespread support among Americans of all ages. They were created and have thrived because the alternatives were unacceptable to the overwhelming majority of the public. These programs are particularly popular among the broad middle class, many of whom would otherwise experience substantial hardship in their middle years from supporting their parents and to whom the prospect of having to rely on their own children or "demeaning" means-tested public programs in their own old age is fearsome indeed. Surveys as recent as the mid-1980s have shown that, despite some lack of confidence in the future ability of the system to provide for their retirement, two-thirds of young adults thought that Social Security taxes were fair and that their level was about right or too low.³⁷ In short, some modifications in our social insurance system for the elderly appear to be needed to respond to changing circumstances, but privatization as a solution looks like another case of the proverbial baby and bath water.

What, then, are the most promising ways to alter social insurance programs to increase the burden on the elderly for the financing of their retirement and health care while still preserving the essential functioning of the current social insurance system? Several are detailed here, but they all share certain general characteristics. The wide array of options boils down to two fundamental approaches: the burden can be increased in a way that either is or is not related to income. Refinements come into play over the implementation of these approaches. The increased burden can be achieved directly, through explicit reductions in benefits, or indirectly, through measures such as taxation of benefits or increased premiums in the case of Medicare. Also, timing is important: changes could affect today's elderly or only those who will become elderly after some future date.

The advantages of income-related approaches are obvious in light of our earlier evidence about the heterogeneity of the economic status

³⁷See Hugh Hecl, "Generational Policies" in John L. Palmer, Timothy Smeeding, Barbara B. Torrey, and Martin Rein eds., *The Vulnerable* (Washington, D.C.: The Urban Institute Press, 1988).

of the elderly population. In particular, income-related approaches can minimize the adverse consequences for the lower- to middle-income aged, who currently are highly dependent on Social Security and Medicare to maintain their former standard of living and avoid poverty. But income-related approaches are not without their disadvantages. One problem is the potential for administrative complexity. The implementation of non-income-related approaches requires no new information about recipients, whereas income-related approaches require information about the income not only of recipients but also of their households. Neither type of income information is currently collected by Medicare or Social Security, and instituting any mechanism to do so would be a complex and costly undertaking for the government and an undesirable imposition on recipients and their families. For these reasons, use of the tax system to accomplish the income-relating process is vastly preferable, even though some precision in targeting might be lost by less-than-ideal definitions of income or family unit.

A second disadvantage of income-related approaches is their potential for undermining political support for the programs. This erosion of support could be widespread—because of a generally perceived violation of the “earned right” concept underpinning social insurance—or it could be concentrated among higher-income recipients, who might increasingly perceive social insurance as a bad deal for them, because their added burden would be much larger. (Non-income-related approaches obviously also have this potential, but to a lesser degree.) Although this concern is legitimate, there are several mitigating factors. The first is that the sine qua non of our social insurance system—universal eligibility for all workers (and their dependents, where relevant) with covered earnings—would be retained. The “earned right” would still be there; only the net benefit ultimately derived would be affected. Second, to the extent that taxation of benefits is the chosen instrument, benefits would simply be treated on a comparable basis with other sources of income, such as private pensions, that are currently included in the tax base, in accordance with our collective notion of what constitutes ability to pay. Finally, when all is said and done, our current system of social insurance constitutes a “good deal” even for prospective higher income recipients. By virtue of being in on the early stages of a pay-as-you-go system, retirees at all income levels are currently receiving benefits of value far beyond what they contributed. And although the windfall component of benefits for new retirees is now declining rapidly with

the maturation of the social insurance system and changing demography, it has a long way to go before calculations of self-interest should become problematic.³⁸

So far only the abstract merits of broad approaches to changes in our social insurance system that would increase the burden of elderly persons for the financing of their retirement and health care have been considered. The next sections consider some of the concrete measures that might be taken to reduce benefits for, or raise revenues from, Social Security and Medicare recipients.

Social Security—Three general classes of options for Social Security are most often suggested. These are listed in table V.4, along with estimates of the fiscal effects of variants of each.

First, the annual Social Security cost-of-living adjustments (COLA) to benefits could be restricted. Eliminating the COLA for one year would amount to an immediate and identical percentage cut (equal to the prevailing rate of inflation) in real benefits for all current recipients. Limiting it to, say, two percentage points less than the rate of inflation for five years would amount to a 10 percent cut in real benefit levels by the end of that period for all recipients. (Recipients also participating in SSI would receive offsetting increases in

³⁸Assessing just how good a deal Social Security is for current and prospective elderly persons is an extremely complex matter. The assessment is highly dependent on the specific circumstances of individuals (for example, their age at retirement, their position in the income distribution, their life expectancy, whether or not they receive dependents' benefits), the assumptions made about the future course of the economy (especially real interest rates), whether only payroll taxes paid by workers or those paid by both workers and their employers are considered, and the value placed on such things as Social Security's ability to guarantee a steady flow of real income during retirement (which, as noted earlier in the text, cannot be done by private annuities). The numerous studies that have been done vary considerably in the way they deal with these matters and, therefore, in the conclusions they reach. See, for example, Geoffrey Kollman, *Social Security: The Relationship of Taxes and Benefits for Future Retirees*, Report no. 87-103 EPW (Washington, D.C.: Congressional Research Service, March 9, 1987); Michael J. Boskin; Lawrence J. Kotlikoff; Douglas J. Puffert; and John B. Shoven, *Social Security: A Financial Appraisal Across and Within Generations*, Working Paper no. 1891 (Cambridge, MA: National Bureau of Economic Research, Inc., 1986); Robert J. Myers and Bruce D. Schobel, "A Money's Worth Analysis of Social Security Retirement Benefits," *Transactions*, vol. 35 (1983); Anthony J. Pellechio and Gordon P. Goodfellow, *Individual Gains and Losses Before and After the 1983 Social Security Amendments* (San Francisco: Cato Institute, 1983). They agree (1) that all current retirees, especially those with high earnings histories, receive benefits from Social Security far in excess of any contributions made over their working lifetimes and (2) that this excess value will be declining over time for successive future groups of retirees, with the net redistributive effects of Social Security among these groups becoming more progressive. However, it is impossible to arrive at any definitive answer to the question of just how good (or bad) a deal Social Security will prove to be for today's youth or young workers, based on these analyses.

TABLE V.4
Options for Reducing or Taxing Social Security Benefits

Option	Program Savings or Revenue Increase When Fully Implemented
<i>In billions of 1990 dollars</i>	
Restrictions on the Cost-of-Living Adjustment (COLA)	
Eliminate the COLA for one year ^a	9
Limit the COLA to the CPI minus two percentage points for five years ^b	13
Taxation of Benefits	
Lower or eliminate current thresholds for taxation of 50 percent of benefits ^c	3-7
Tax 85 percent of benefits with lower or no thresholds ^c	9-17
<i>As a percentage of GNP in the long run</i>	
Phased-in Benefit Reductions	
Raise age of eligibility for full benefits above 67 ^d	0.4 (for each year raised)
Reduce benefits proportionately across the board ^d	0.6 (for each 10 percent reduction)
Reduce benefits progressively across the board ^d	0.6 (for each 10 percent total reduction)
Addendum:	
<i>Estimates for 1990 of:</i>	
<i>In billions of 1990 dollars</i>	
GNP	5,380
Outlays for Social Security under current policies	355

Source: Author's estimates based on Congressional Budget Office and Social Security Trustees report data.

^aThe expected savings of eliminating the COLA for 1990.

^bThe expected annual savings in 1993 of limiting the COLA to the Consumer Price Index minus two percentage points beginning in 1988 and going through 1992.

^cThe lower revenue estimate assumes that the current adjusted gross income thresholds of \$25,000/\$32,000 are lowered to \$12,000/\$18,000. The upper estimate assumes that the thresholds are entirely eliminated.

^dThese are the approximate annual average savings during the retirement of the baby boom generation based on the intermediate assumptions. If the aged were to work more in response to the changes, the savings would be greater.

SSI benefits.) If the formula for calculating benefits for new retirees were similarly adjusted downward, in order to eliminate the disparities that would then otherwise exist between their treatment when they began to receive benefits and the treatment of the already retired, these COLA restrictions would reduce the cost of Social Security over the long run by roughly the same percentage as in the short run.

Second, more of Social Security benefits could be subject to income taxation. The current adjusted gross income (AGI) thresholds could be lowered or eliminated and more than 50 percent of benefits included in income (on the rationale that the windfall currently far exceeds that proportion of benefits). The revenue yield of any such measure would increase over time with the income of the elderly. However, lower-income elderly persons would still have no income tax liability because of the zero bracket amount and personal exemptions (which are indexed for inflation under the Tax Reform Act of 1986), and only the highest income elderly would face a marginal tax rate on Social Security benefits above 15 percent.

Third, benefits could be constrained to grow less rapidly than earnings more or less across the board for future retirees. The previous two steps discussed would have sizable immediate, as well as long-term, fiscal consequences. In contrast, numerous other measures have been proposed which would not have any immediate fiscal impact, because they would only affect new retirees at some future time. Depending on how these reductions are structured, they could place more of this future burden on workers who retire early rather than later and on workers with higher rather than lower earnings. They also would ensure future retirees real benefit levels at least as high as those of their predecessors.³⁹

Medicare—Because of the complexity of the Medicare program, with its two separate components, multiple sources of revenues, and several types of cost sharing, an enormous variety of measures could be employed to increase the financial burden on beneficiaries of Medicare-covered services. All such measures that do not affect reimbursement rates to providers (discussed later), however, will fall into

³⁹The Social Security benefit formula is now structured so that the typical worker in each successive new group of retirees receives a benefit that is a constant proportion of his or her covered earnings. Because real wages tend to rise over time, this means that the average benefit level of successive groups of new retirees also rises over time in line with the average increase in earnings. Thus, the reductions in Social Security benefits affecting future retirees as discussed in this option need not result in those new retirees' receiving lower real benefits than previous groups of retirees. Rather, the real benefit levels of successive groups of new retirees would simply grow more slowly than under current law or be held constant.

one of five basic categories. Table V.5 shows the fiscal impact of some illustrative approaches for each category based on the structure of the program in 1987 (that is, before any modifications as a result of the Medicare Catastrophic Coverage Act).

First, cost sharing that is tied to utilization (deductibles and co-payments) could be increased. The greatest strength of such an approach is that it might discourage unnecessary care, and the greatest weakness is that it would increase the costs for precisely those beneficiaries who are the heaviest users (generally for necessary care) and therefore already have the greatest financial liability. With the new catastrophic benefit for acute care, this liability will be capped, but the burden of the increase in cost sharing will still fall on the heaviest users across all income groups (except for those covered by Medicaid).

Second, the current flat premium paid by all SMI enrollees could be raised to cover more than 25 percent of total costs, or a similar premium could be instituted for HI. The added dollar costs would be identical for all Medicare enrollees. Such a step would be entirely consistent with the historical method of financing SMI, because enrollees paid premiums equal to 50 percent of costs when the program was first instituted.⁴⁰ However, it would be a major departure for the HI program, which heretofore has been financed exclusively through a payroll tax.

Third, the insurance value of a portion of Medicare benefits could be subject to income taxation, with consequences similar to those discussed earlier in connection with fuller taxation of Social Security benefits. Such a step would also raise the issue of parallel treatment of employer-based health insurance, for which employer contributions are currently nontaxable. Taxation of some portion of this employee benefit is often advocated as a means of broadening the income and payroll tax base and raising revenues.

Fourth, as an alternative to taxation of benefits, an income-related premium could be instituted through the tax system. Doing so for HI

⁴⁰In the early years of the program, the Medicare law provided for automatic annual increases in the SMI premium in line with the general rate of inflation. Because medical cost inflation was consistently much higher than general inflation, the portion of total SMI expenditures covered by premiums gradually declined (and that covered by general revenues gradually increased) over time. Several years ago Congress amended the law, effective through 1988, to fix the premium at the level deemed necessary to cover 25 percent of expected total SMI expenditures. Unless that provision is extended, the calculation of automatic SMI premium increases will revert to the former basis in 1989. All fiscal projections based on current policies in this chapter assume that the premium will be set at levels in the future necessary to continue to cover 25 percent of projected total SMI expenditures.

TABLE V.5
Options for Increasing the Financial Burden on Medicare Enrollees

Option	Program Savings or Revenue Increase in 1990 (billions of dollars)
Increased Cost Sharing	
Increase HI copayments ^a	\$3
Increase SMI copayments ^b	3
Raise SMI deductible ^c	2
Increased Non-income Related Premiums	
Raise the SMI premium above 25 percent of costs	3 (for each 5 percent increase)
Institute an HI premium	7 (for each 10 percent of program costs covered)
Taxation of a Portion of Benefits ^d	4-7
Institution of an Income-related Premium through the Tax System ^e	4-10
Increase in Age of Eligibility to 67 ^f	7
Addendum:	
<i>Estimates for 1990 of:</i>	
HI outlays	<i>In billions of 1990 dollars</i> 68.7
SMI outlays	44.8
GNP	5,380

Source: Author's estimates based on Congressional Budget Office data.

^aInvolves eliminating the current structure of copayments in favor of copayments of 10 percent of the deductible for the second through the thirtieth annual hospital days.

^bInvolves raising the SMI coinsurance from 20 to 25 percent.

^cInvolves raising the SMI deductible from \$75 to \$200 in 1988 and indexing thereafter to the Consumer Price Index.

^dInvolves taxing the portions of SMI (75 percent) and HI (50 percent) not financed by employees or enrollees. The lower estimate assumes the same adjusted gross income thresholds currently applying to Social Security benefits, whereas the upper estimate assumes no thresholds.

^eInvolves adding a constant percentage tax on the taxable income of enrollees, with the total liability for each person capped at 75 percent of the insurance value of SMI and 50 percent of the insurance value of HI. The amount of revenue raised will depend on whether the tax is applied to both SMI or HI or to only one and what rate (ranging from 1 to 5 percent) is imposed on the aged persons (currently about 40 percent of the total) who have taxable incomes.

^fThis is the amount that could be saved in 1990 if the age of eligibility were immediately raised to 67. However, if it were phased in along with the change in Social Security as discussed in the text, there would be no savings from this measure during this century. The savings would gradually increase early in the next century, reaching a maximum in 2020, after which they would amount to 6 or 7 percent of currently projected annual program costs.

would represent a major departure for the program, just as would a flat-rate premium. In contrast, the political precedent for an income-related premium for SMI already has been established in the provisions of the Medicare Catastrophic Coverage Act of 1988. However, the passage of this bill greatly limits the potential for further raising beneficiary costs through an income-related premium for general cost-saving purposes.

Fifth, the age of eligibility for Medicare could be raised above 65 early in the next century, as will be the case for eligibility for full Social Security benefits under the 1983 amendments. However, the distributional effects of this measure for Medicare would be very different from those caused by the change in Social Security. The Social Security change will essentially amount to a partial benefit reduction relative to the previous law for all workers who retire before age 70, with the degree of reduction depending on the precise age at retirement.⁴¹ In the case of Medicare, no benefits would be provided to 65 or 66 year olds, who would then have to rely fully on private individual and employer-based insurance; the status of people once they turn 67 would be the same as now.

All the preceding measures would directly increase the costs to Medicare enrollees for health care services currently covered by the program. But the potential fiscal impacts of all these measures are small compared with Medicare's long-term fiscal problems under current policies. For this reason, changes in Medicare's reimbursement policies also are often advocated. Although these would most directly affect health care providers, they could also have important consequences for Medicare enrollees and raise important broader issues about health care in this country.

Recently enacted reform of the Medicare system for hospital payment reflected the widespread belief that the previous system of cost-based reimbursement encouraged increasingly expensive and inefficient modes of care. With the implementation of a prospective payment system based on diagnosis-related groupings beginning in 1984, Medicare substantially changed the cost incentives facing hospitals, shifting the determinants of future rates of growth in hospital payments per admission from a professional medical judgment to a budgetary one. On budgetary grounds, the first years of the program

⁴¹The degree of reduction will vary inversely with the age at retirement and amount to a maximum of about 12 percent for workers who retire at age 62, the earliest age of eligibility for old-age benefits under Social Security. Thus this measure would contribute to overall deficit reduction and strengthen the financing of both Medicare and Social Security.

appear to have been successful. Medicare admissions, length of stay, and increases in rates of expenditure for hospital care have all declined significantly relative to past trends. But there is ample reason to doubt that budgetary savings on the order of those experienced thus far—and carried forward by the current projections—can be sustained, let alone increased.⁴² Concerns about such phenomena as premature discharges of patients, “dumping” of other uninsured patients, and cost shifting on the part of hospitals are already prevalent. Over time these concerns are likely to intensify and new ones to emerge about the consequences of the new hospital reimbursement policy for the coverage of newly developing services and technologies.⁴³ Similarly, there is undoubtedly some scope for new savings through the adoption of more stringent reimbursement procedures for physician services. However, these savings, too, must be quite limited, if they are not to reduce the kind and quality of care available to at least a substantial portion of the aged.

These complex issues cannot be discussed in any detail here.⁴⁴ But the heart of the matter is that rapidly rising health care costs are endemic to the entire health care system and not just to public programs, and that attempts to deal with them that are largely constrained to public program payment systems will ultimately undermine these programs’ objectives, as well as have other undesirable consequences.⁴⁵ As one noted analyst has observed:

⁴²The assumption of a continuing, similarly stringent hospital reimbursement policy has led to a major decline in previously projected long-term HI expenditures, which is already reflected in chart V.3 and table V.1. For example, in 1983 and 1984, Medicare actuaries were projecting that HI expenditures would eventually rise to well in excess of 9 percent of taxable payroll during the retirement of the baby boom, as opposed to only 6+ percent for taxable payroll costs shown in the more recent projections in chart V.3.

⁴³Age- and sex-adjusted per capita health care costs have risen much more rapidly than the general price level for the past several decades, primarily because of increases in the services provided (for example, greater number of, and more sophisticated, diagnostic tests) per day of hospital stay or per physician visit. Average annual increases in measures of “services intensity” exceeded 3 percent over this period. In the past, Medicare essentially paid prevailing rates for whatever services were provided. The allowable increase (that is, what Medicare will pay for) in service intensity is a policy variable under the new hospital reimbursement system for HI and is assumed to grow at an average annual rate of only 0.25 percent in the future.

⁴⁴For background and further discussion, see John Holahan and John L. Palmer, “Medicare’s Fiscal Problems: An Imperative for Reform,” *Journal of Health Policy, Politics, and Law* 1 (Spring 1988): 53–81.

⁴⁵Despite some slowdown in the growth of real expenditures for Medicare and Medicaid in the 1980s in response to more restrictive provider reimbursement and other program cutbacks, cost inflation in overall health care has not slowed in real terms from its high level of the 1970s. Restraint of Medicare provider reimbursement to below-market levels is a primary source of the problems alluded to here.

All developed nations face a profound dilemma—to bear the rapidly increasing costs of providing ever more sophisticated care to aging populations or, alternatively, to ration care, and in doing so deny some potential benefits to some patients. Some savings, possibly large in absolute amount, can be achieved by eliminating services such as unnecessary hospitalization or idle equipment that provide no medical benefits at all and by improving the efficiencies with which beneficial services are provided. But these savings can be achieved only once. After they have been reaped, the source of the rising trend in medical outlays—the technological transformation of medical care—will reassert itself. At that point the dilemma—pay the bill or ration services—will have to be faced.⁴⁶

So far the United States is unique among Western industrialized democracies in its overwhelming reliance on the marketplace to accomplish whatever rationing is done, and the aged have been shielded from the consequences of this choice. If this country continues to rely primarily on the marketplace, the government will have to continue to pay the bill for the elderly or tolerate even greater variation in access, by income, to mainstream health care among the aged than now exists. Of course, continuing to pay this bill on current terms threatens to skew the overall distribution of health care resources even more toward sick and dying old people in the future than is now the case. If Americans want to have their health care cake (i.e., achieve reasonably equal access to mainstream health care across all age and income groups) and still be able to afford their dinner (i.e., slow the rise in the share of GNP devoted to health care), this country must adopt far more drastic changes in its health care system than policymakers have heretofore been willing to consider.⁴⁷ Even so, Americans will have to expect some continued increases in the share of the nation's GNP devoted to health care as a result of the aging of the population and advancing technology.

Conclusions

This chapter has dealt with two issues: (1) the growing mismatch between the problems the elderly face in financing their retirement

⁴⁶Henry Aaron, "When Is a Burden Not a Burden? The Elderly in America," *Brookings Review* 3 (Summer 1986).

⁴⁷The share of our GNP devoted to health care is currently over 11 percent and still rising rapidly (having doubled since the early 1960s). This percentage is higher than that of other Western industrialized countries, virtually all of which have comprehensive national health insurance systems with comprehensive cost controls and substantial nonmarket rationing.

and health care and the current policies that relate to these concerns, and (2) the growing gap between projected public expenditures for the aged and the share of GNP currently devoted to supporting such expenditures. Substantial adjustments in current policies are both desirable and inevitable. Just how substantial is impossible to specify with any precision, because the answer depends in part on the uncertain size of the fiscal gap and future economic gains of the elderly. However, even under the relatively optimistic intermediate assumptions about economic growth and health care costs (among other things), expenditures for current commitments for Medicare are projected to rise by well over 1 percent of GNP during the next 20 years, and for Medicare and Social Security combined by another 4 percent during the retirement of the baby boom.

Thus, one clear lesson to be drawn is that the aging of the population should further compel policymakers to deal with two issues that presumably would be high on their agenda in any event—the promotion of long-term economic growth and the control of cost inflation in health care. Treatment of these issues is beyond the scope of this paper, but it is worth underscoring two points made earlier: (1) If the Social Security surpluses are to make a meaningful contribution to easing the fiscal burden attendant to the aging of the population, they must not be used to offset deficits in other areas of the federal budget.⁴⁸ (2) Because escalating real health care costs are not limited to Medicare or the aged, any approach to restraining these costs that will be both effective and capable of sustaining public support in the long run will have to go far beyond changes in Medicare reimbursement to more fundamental changes in the way the nation organizes and finances the provision of health care in general.

Although it is impossible to specify the extent to which the current policies for financing the elderly's retirement and health care will eventually need to be adjusted, the preceding pages have provided

⁴⁸This would be of less concern if other measures were taken to increase the national savings rate commensurately. As Henry Aaron has pointed out, larger groups of elderly persons need not impose a large fiscal burden on the rest of the population if these larger groups save enough more than the previously smaller groups during their working years. See "When Is a Burden Not a Burden? The Elderly in America," *Brookings Review* 3 (Summer 1986). However, the political prospects look dim for generating large, net, public savings through any means but the Social Security surpluses in the foreseeable future, and our private savings rate has remained remarkably stable over time despite large shifts in the age distribution of the population and major changes in public policies that might have been expected to affect it.

pointers for the directions that adjustment should take.⁴⁹ The chapter contains a menu of possible expansions in public policies that, both directly and indirectly (through the leveraging of private resources), would respond to the current and prospective needs of the elderly for greater economic security. These are by no means the only possibilities, but they do satisfy the criteria of being politically both feasible and fruitful. Although many of the measures would require little or no new commitment of additional public funds, implementing all of them would entail annual public costs on the order of 0.5 percent of GNP over the next decade or two and 1 percent GNP during the retirement years of the baby boom generation, if the public financing of long-term care were only moderately expanded.⁵⁰

It is not the intent here to weigh the relative merits of such new public expenditures for the elderly vis à vis other competing claims on the public purse, but it is important to reiterate that any such expenditures should be carefully aimed at the changing needs of an increasingly heterogenous elderly population. Furthermore, it can be argued that policymakers should vigorously pursue the measures that require no significant new resources. Also, among the measures that do require much more government money, policymakers should give priority to the ones providing the greatest assistance to the low-income elderly.

The chapter has also considered various approaches to modifying Medicare and Social Security in line with the growing capability among some of the elderly to shoulder more of the burden for the financing of their retirement and health care. In the immediate future these measures could be used to finance any expansion in assistance to the aged or to contribute to general deficit reduction. Eventually they could at least partially alleviate the increased pressures on the public purse that will attend the retirement of the baby boom.

Here there are clear grounds for establishing priorities among the measures discussed. Income-related approaches that operate through the tax system are strongly preferable. They would concentrate the added burden on those among the elderly who are in the best position

⁴⁹ Many other adjustments to public policies and private practices beyond those focused upon in this chapter also may be desirable (for example, increasing immigration quotas and reducing incentives for early retirement in order to expand the future size of the labor force relative to the retired population). For a general discussion of these matters, see John L. Palmer and Stephanie G. Gould, "The Economic Consequences of an Aging Society," *Daedalus* 1 (Winter 1986).

⁵⁰ These added costs would probably run 2 to 3 percent of GNP under a very generous approach to public financing of long-term care.

to bear it. Of course, as noted earlier, there are limits to how far income-related approaches can be pushed before they become widely viewed as inequitable to higher-income elderly people. Thus, depending on how much of the growing fiscal burden is ultimately borne by the elderly rather than by the working population (through higher taxes), some across-the-board measures might eventually be considered desirable. However, across-the-board measures will be less problematic if they apply only to future groups of the aged, because even the lower-income members of these groups would have the advantage of greater overall financial resources and a longer lead time during which to adjust.

The desirability of such a lead time for adjustment is only one of several reasons why the nation needs to focus now on the kind of policy adjustments discussed in this chapter. Pressures for general deficit reduction and selective expansion of benefits will continue to motivate more immediate changes in social insurance and other programs serving the aged, and actions to greatly improve Medicare's fiscal outlook will be required in the next decade. Furthermore, whereas Social Security, *per se*, may be on sound financial footing for the next few decades, its rapidly accumulating reserves are already generating strongly conflicting views on their desirable disposition. A coherent longer-range vision of how our society wants to finance retirement and health care for the aged is needed, so that any potential changes in public policies can be assessed on the basis of their consistency with such a vision and appropriate adjustments in the behavior of individuals and private institutions can be fostered. Otherwise the country may have to make more wrenching and less palatable changes in public policies and private circumstances in the future.

Many analysts tend to pose the issue as one of inevitable conflict between the elderly and nonelderly populations. Although the focus of this chapter is on the consequences of policy changes for the elderly, changes in taxes on the working age population also will have to be part of the equation. But it is important to keep two points in mind concerning the trade-off between relatively lower benefits for the elderly and higher tax burdens on the nonelderly.

First, today's working age population will be tomorrow's elderly population. Thus, in the longer run, the issue is not "us" versus "them" but the role all Americans would like to see public policies play in promoting economic security over their lifetimes. Less consumption when people are working will increase the economic resources available later and vice versa. The overall structure of taxes and public

benefits will be an important determinant of the prevailing lifetime pattern of resource usage.

Second, in the future, Americans in all age groups will almost certainly have a much higher level of material well-being than Americans in similar age groups have today. In the four decades following World War II, per capita real GNP increased at an average annual rate of nearly 2 percent, leading to more than a doubling of the overall standard of living. Even if this rate of growth were to slow to, say, 1.5 percent annually (about that assumed in the intermediate projections in table V.1), per capita real GNP would double once again by the time the baby boom generation is fully retired. Under these circumstances, closing a fiscal gap of 5 percent of GNP or even more certainly need not entail an onerous burden from today's perspective—so long as this burden is distributed reasonably equitably both between *and within* the elderly and nonelderly populations. Developing consensus on just what constitutes equitable distribution will be an arduous task for political leadership. But if the task is pursued in the context of policies to enhance long-term economic growth and constrain cost inflation in health care, it need not prove herculean.

VI. Government Budget Trends

PAPER BY PAUL N. VAN DE WATER
AND PAUL R. CULLINAN

Introduction

In the 20 years from 1962 to 1981, the federal budget deficit averaged 1.7 percent of the nation's Gross National Product (GNP). Since then, however, the deficit has averaged almost 5 percent of GNP. These large deficits have muted most recent demands for increased government spending. Not only have they caused the growth in social and other domestic spending programs to be curtailed but they have even halted the defense buildup. The Balanced Budget and Emergency Deficit Control Act of 1985 (commonly known as Gramm-Rudman-Hollings) formalized this constraint by requiring that the budget deficit be eliminated by 1993. According to the most recent baseline projections of the Congressional Budget Office (CBO), some combination of annual spending reductions and revenue increases totalling almost \$140 billion—about 2.1 percent of GNP—would be required to meet this target.

Over the same period, state and local government budgets also increased substantially, as did private spending for employment-related benefits. Despite this growth in public and private spending, gaps in protection against ill health and retirement income loss remain. In evaluating public and private mechanisms to fill these gaps, it is essential to look beyond the effect on government budgets and consider the real demands on society's resources and the economic implications of the financing mechanisms chosen.

This paper provides a brief overview of government budget trends during the past 25 years and makes projections through the year 2000. The federal budget projections for fiscal years 1989 through 1993 derive from the CBO baseline, which assumes a continuation of current tax and spending policies. These projections are extrapolated for 1994 to 2000 under three alternative sets of policy assumptions. We also examine the fiscal outlook for state and local governments. Finally, we consider the implications of these budgetary trends for employee benefits.

In setting the context for a discussion of employee benefits, it is important to look at the whole federal budget rather than only at the portion devoted to social programs or to programs for the aged. Particularly with the restrictions imposed by the Balanced Budget Act of 1985, social spending competes with national defense and other nondefense programs for scarce federal resources. Moreover, there is no clear distinction between social spending and other forms of spending, or between programs for the aged and for the nonaged. For example, should farm price support payments be classified as income support or as aid to agriculture? Are Social Security dependents' benefits to be viewed as payments to the aged or to the nonaged? To the extent that this discussion focuses on particular programs, it emphasizes Social Security, Medicare and Medicaid, and other federal retirement and disability programs, which together represent the overwhelming bulk of programs affected by the aging of the population.

Overview of the Federal Budget

Projections inevitably lack the richness of history. Federal spending and revenues during the past 25 years have been pushed up or down by events such as the Great Society, the Vietnam War, OPEC oil shocks, periodic recessions, and biennial revisions of tax law. But it is hard to look ahead and see other than smooth trends, even though we can be quite sure that the future will be at least as variable as the past.

Recent Budgetary Trends, 1962–1988—The role of the federal government in the economy has grown over the past 25 years (table VI.1). After a period of 13 years from 1962–1974, during which federal spending rarely reached 20 percent of GNP, outlays averaged 21.3 percent of GNP during the 1975–1979 period and 23.3 percent of GNP during the 1980s. Total federal revenues show less distinct trends, fluctuating between 17.4 percent and 20.1 percent over the entire period. During these periods, total federal deficits averaged 1.0, 3.0, and 4.4 percent, respectively.

Substantial shifts in spending components have also occurred during the period. When measured as a share of GNP, spending for discretionary appropriated accounts—both defense and nondefense—declined by about one-fourth over the 1962–1987 period. (Despite the increase in defense spending during the 1980s, discretionary spending has fallen as a result of even larger decreases in nondefense programs.) On the other hand, entitlements and other mandatory spending have

TABLE VI.1
Federal Outlays, Revenues, and Deficits as a Percentage of GNP,
Selected Years, 1965–1988

Category	1965	1970	1975	1980	1985	1988 ^a
Outlays						
National Defense	7.5	8.2	5.7	5.0	6.4	6.1
Nondefense Discretionary	4.8	4.6	5.6	5.9	4.5	3.8
Entitlements						
Social Security	2.5	3.0	4.1	4.4	4.7	4.6
Medicare and Medicaid	^b	1.0	1.3	1.8	2.4	2.5
Other Retirement and						
Disability	0.5	0.7	1.1	1.2	1.1	1.1
Other	2.1	2.0	3.7	3.0	2.9	2.5
Subtotal	5.1	6.7	10.2	10.4	11.1	10.7
Net Interest	1.3	1.5	1.5	2.0	3.3	3.2
Offsetting Receipts	-1.2	-1.2	-1.2	-1.1	-1.3	-1.2
Total	17.6	19.8	21.8	22.1	24.0	22.6
Revenues	17.4	19.5	18.3	19.4	18.6	19.2
Deficit	0.2	0.3	3.5	2.8	5.4	3.4

Source: U.S. Congress, Congressional Budget Office.

^aEstimate.

^bLess than 0.05 percent.

nearly doubled their share of GNP over the past 25 years, more than offsetting the fall in discretionary spending. In addition, the rapid rise in the federal debt during the past decade and the relatively high interest rates during the same period have caused net interest on the public debt to be the fastest growing spending category in the federal budget.

Federal social welfare expenditures, as defined and compiled by the Social Security Administration (SSA), rose from 5.6 percent of GNP in 1965 to 11.3 percent in 1980 and 11.4 percent in 1985. This pattern closely tracks CBO's category of entitlements and other mandatory spending, which represented 5.1 percent of GNP in 1965, 10.4 percent in 1980, and 10.7 percent in 1985. As a result, the discussion here will concentrate on the CBO projection of entitlement spending. (The SSA social welfare series includes certain education, veterans' medical care, and Public Health Service spending, which is included in nondefense discretionary spending. These items exceed in total

those entitlement programs that are not in the social welfare category—for example, farm price supports, general revenue sharing (prior to 1987), and the deposit insurance activities of the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation.

Between 1965 and 1985, entitlement programs directed primarily to the aged (Social Security, Medicare and Medicaid, and other retirement and disability programs) grew from 3.0 percent to 8.2 percent of GNP. The number of Americans aged 65 and over grew from 18.5 million to 28.5 million over this period, increasing from 9.5 percent to 11.9 percent of the total population. But more important than this demographic shift, decisions were made to pay for an increasing share of the needs of the aged through public programs. Medicare began operation in 1966, and Medicaid was greatly expanded. Social Security replacement ratios were increased substantially during the early 1970s. In more recent years, modest steps have been taken to stem the growth of both Social Security and Medicare.

Baseline Budget Projections, 1988–1993—Budget projections depend both on the assumed tax and spending policies and on assumptions about economic performance. CBO's five-year baseline budget projections assume that revenues, offsetting receipts, and entitlement spending are projected according to the laws now on the statute books. Defense and nondefense discretionary appropriations are assumed to be held constant in real terms. The baseline projections are not forecasts of future budgets, which will doubtless include numerous policy changes, but are a benchmark against which to judge the budgetary consequences of proposed legislation. The baseline projections discussed here are based on a CBO economic forecast that features real growth averaging 2.2 percent per year in 1988 and 1989. Interest rates are expected to start rising in 1988. Beyond 1989, CBO's economic assumptions are not a forecast of future conditions but are projections based on historical trends. These longer-term economic assumptions are characterized by annual real growth of about 2.7 percent, inflation stabilizing in the 4 percent to 5 percent range, and slowly declining unemployment and interest rates.

The baseline projection shows overall federal spending rising at a rate somewhat slower than nominal GNP over the next 5 years, resulting a gradual shrinking of the federal outlays as a share of GNP. This occurs principally because spending in defense and nondefense discretionary programs slows—a reflection of the assumption that appropriations grow only at the rate of inflation. While there are

small fluctuations in the other spending categories, the 1988 and 1993 spending estimates for these categories as a percentage of GNP are virtually unchanged. On the other hand, revenues under current law, as a share of GNP, are anticipated to increase modestly from current levels and stabilize around 19.4 percent by 1993. As a result of these spending and tax projections, CBO's baseline deficit rises slightly from 1987 to 1989 and declines slowly thereafter, reaching 2.1 percent of GNP by 1993.

Social Security was removed from the budget totals by the Balanced Budget Act of 1985. If one distinguishes between the off-budget and on-budget components of total federal activities, two clear patterns emerge. First, Social Security is projected to have large and rapidly growing surpluses over the 1989–1993 period. Second, during the same period the non-Social Security portion of the budget shows deficits of about \$230 billion per year.

Extensions of the CBO Projections, 1994–2000—Since the decade of the 1990s will be characterized by a set of relatively favorable demographic factors, a straightforward extension of the five-year projections would suggest a lessening of the fiscal pressures on the federal government. In fact, some have argued that the federal deficit will disappear around the turn of the century as a result of the legislated financing structure for Social Security currently in place. In this section, we discuss three alternative budgetary scenarios for the 1990s and their implications for the federal deficit. Under only one of these alternatives, as shown in table VI.2, does the deficit disappear.

Under each alternative, outlays for entitlement programs are assumed to continue growing at the same rate as their averages for fiscal years 1992 and 1993, and federal revenues are assumed to be fixed at their GNP share for 1993. The three alternatives differ only with respect to the assumptions about defense and nondefense discretionary appropriations. For alternative 1, funding for discretionary programs reflects adjustments for inflation but provides for no real growth. (That is, it continues CBO's baseline projections methodology.) Discretionary spending in alternative 2 is increased so as to maintain defense and nondefense programs at their 1993 shares of GNP over the 1994–2000 period. Finally, alternative 3 holds discretionary programs, not at their 1993 shares of GNP but rather at their 1989 shares, using the budget authority figures specified in last year's budget summit agreement. In this scenario, defense outlays continue to decline as a share of GNP for several years because appropriations for fiscal years 1986 through 1988 (and, by assumption,

TABLE VI.2
Projections of Outlays to the Year 2000, Extending CBO Baseline under Alternative Assumptions, by Fiscal Year and as a Percentage of GNP

Category	Alternative I			Alternative II			Alternative III		
	1989	1993	2000	1989	1993	2000	1989	1993	2000
Outlays									
National defense	5.9%	5.3%	4.4%	5.9%	5.3%	5.3%	5.9%	5.5%	5.5%
Nondefense discretionary	3.9	3.4	2.7	3.9	3.4	3.4	3.9	3.9	3.9
Entitlements									
Social Security	4.7	4.6	4.4	4.7	4.6	4.4	4.7	4.6	4.4
Medicare and Medicaid	2.6	3.1	4.1	2.6	3.1	4.1	2.6	3.1	4.1
Other retirement and disability	1.1	1.1	1.0	1.1	1.1	1.0	1.1	1.1	1.0
Other	2.4	1.9	1.5	2.4	1.9	1.5	2.4	1.9	1.5
Subtotal	10.7	10.7	11.1	10.7	10.7	11.1	10.7	10.7	11.1
Net Interest	3.3	3.2	2.2	3.3	3.2	2.5	3.3	3.3	3.0
Offsetting Receipts	-1.2	-1.1	-1.1	-1.2	-1.1	-1.1	-1.2	-1.1	-1.1
Total	22.7	21.5	19.2	22.7	21.5	21.3	22.6	22.3	22.3
Revenues	19.1	19.4	19.4	19.1	19.4	19.4	19.1	19.4	19.4
Deficit	-3.5	-2.1	0.2	-3.5	-2.1	-1.9	-3.5	-2.8	-2.9

Source: U.S. Congress, Congressional Budget Office.

Note: See text for details on projections methodology.

1989) grew less than inflation. As a result of these differences in appropriations, debt service costs are also different in the three alternatives.

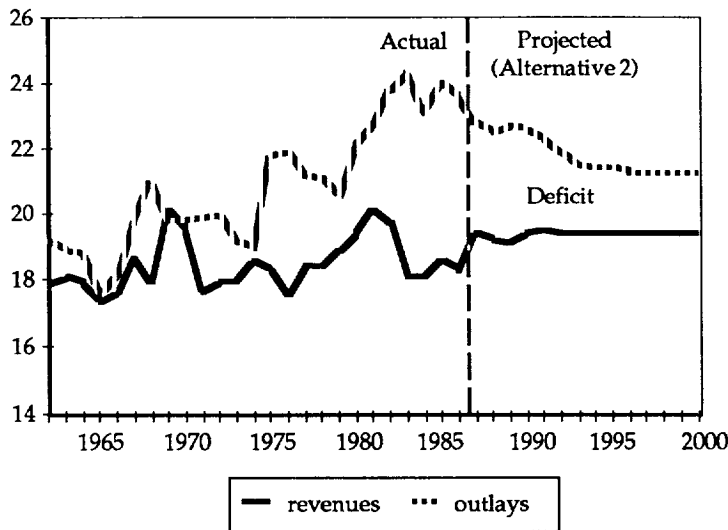
Deficits under the three scenarios for the year 2000 range from a small surplus under alternative 1 to 2.9 percent of GNP under alternative 3. The extension of the CBO baseline using the 1993 shares of GNP for discretionary programs falls near the middle of the range at 1.9 percent of GNP—a level slightly below the baseline projection for 1993. With discretionary spending held constant in relation to GNP, entitlement growth is more than offset by the declining share of GNP devoted to debt service. Thus, even with rather stringent budget policy with regard to discretionary programs over the next five years, combined with sustained moderate growth and declining unemployment, federal deficits would remain at relatively high levels through the 1990s, absent legislated increases in taxes or reductions in entitlement spending.

Uncertainties in the Projections—Revenue and outlay projections under alternative 2 are displayed in chart VI.1. Trends in the major components of spending are shown in chart VI.2. As indicated earlier, the projections are deceptively smooth because of the inability to foresee the myriad of special factors that will impinge on the budget. But these are not the only uncertainties in the projections.

First, as the presence of three alternatives shows, the assumptions made about discretionary appropriations are crucial. While alternative 2 is marked by higher discretionary spending than alternative 1, it still represents a rather stringent policy. As chart VI.2 shows, defense spending is assumed to stabilize at 5.3 percent of GNP—a level that was widely considered to be inadequate in the late 1970s and early 1980s. Nondefense discretionary programs have borne the brunt of budgetary restraint during the 1980s, declining from almost 6 percent of GNP at the start of the decade to 3.8 percent at present. These programs cover a wide variety of federal activities, including science and space, transportation, education, and the legislative, judicial, and tax-collecting functions. With numerous pent-up spending demands, it may be difficult to hold this category to 3.4 percent of GNP, as alternative 2 assumes.

Second, the budget projections are critically dependent on the economic assumptions, and the uncertainty surrounding the economy increases as the time horizon lengthens. In its most recent annual report, CBO has attempted to quantify this uncertainty. CBO finds that there are about two chances in three that the level of real GNP in 1993 will turn out to be within 7 percent of its projected value, or

Chart VI.1
Revenues and Outlays as Percentages of GNP, 1962–2000



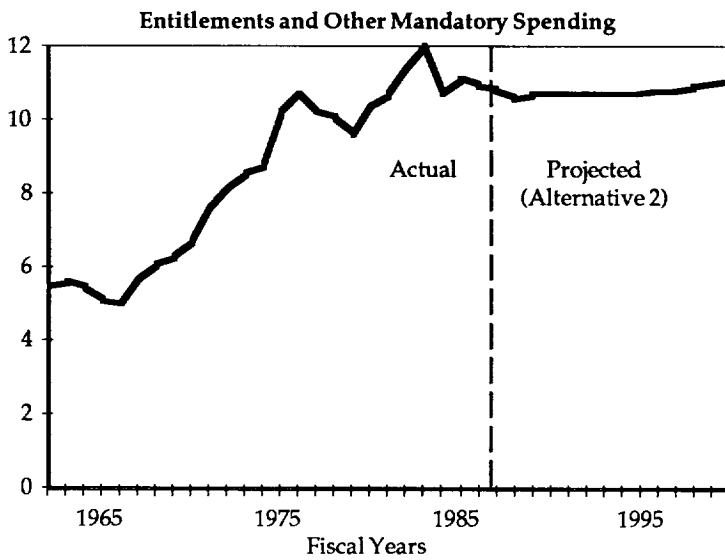
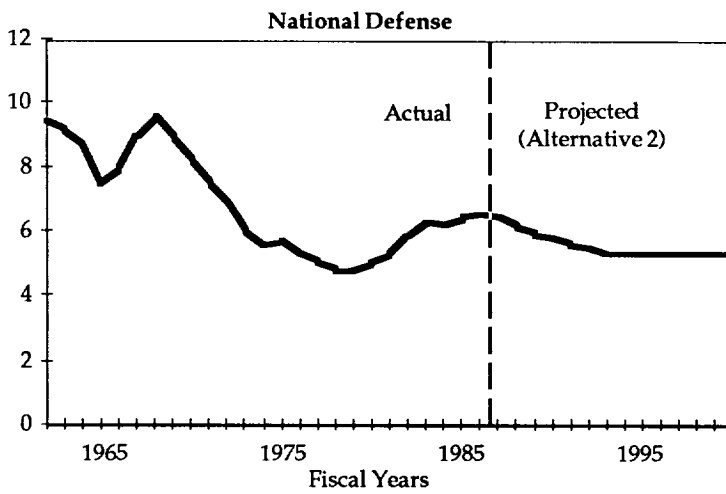
Source: U.S. Congress, Congressional Budget Office.

that the average real growth rate will be between 1.6 percent and 3.6 percent. As a result, there is a two-in-three chance that the baseline deficit will fall between 4.4 percent of GNP and zero.

Third, our budget projections do not incorporate the deficit targets in the Balanced Budget Act of 1985. Even if significant deficit reduction had been enacted for fiscal year 1989, meeting these targets would have been difficult. Instead, however, the administration and the Congress intended only to implement the few remaining elements of the November 1987 budget summit agreement. (These are enumerated in CBO's February 1988 annual report.) If the economy performs similarly to CBO's current forecast, or if substantial new spending needs—for example, to assist troubled financial institutions—arise, it may prove virtually impossible to meet the 1990 deficit target of \$100 billion.

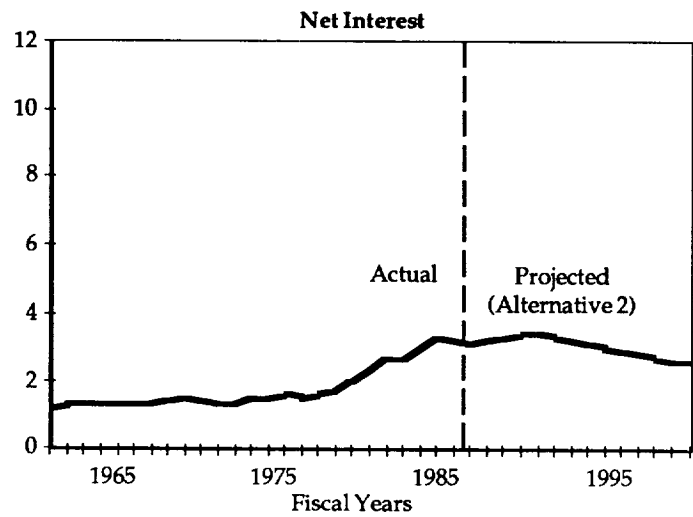
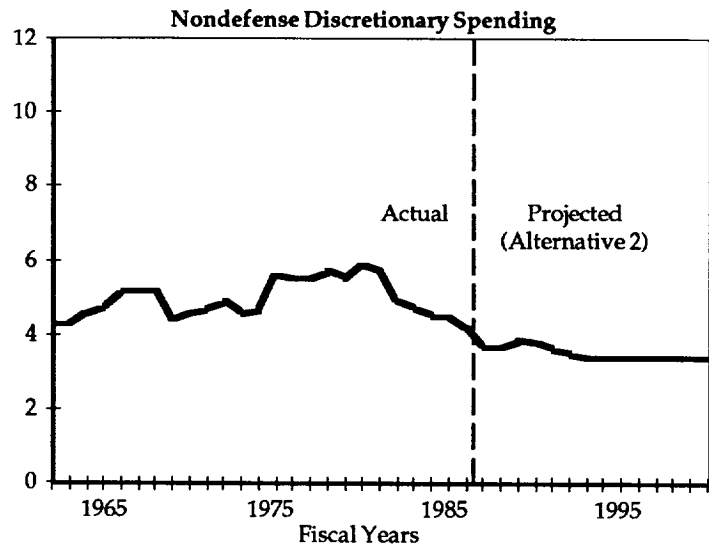
Finally, the budget figures depend on the growth in medical care costs and utilization. In CBO's five-year baseline projections, in-

Chart VI.2
Outlays by Category as Percentages of GNP, 1962-2000



continued

Chart VI.2 continued
Outlays by Category as Percentages of GNP, 1962-2000



Source: U.S. Congress, Congressional Budget Office.

creases in Medicare and Medicaid spending per enrollee more than offset the slowing of the growth in the elderly population. Federal outlays for Medicare and Medicaid benefits are projected to rise from 2.5 percent of GNP in 1988 to 3.1 percent of GNP in 1993. These benefits are projected to grow by 10 to 11 percent in 1993 as compared to nominal GNP growth of nearly 7 percent. Extrapolation of these trends to the year 2000 would cause the health programs to account for nearly 18 percent of the budget and about 4.1 percent of GNP.

In addition to the overall aging of the population, the very old—persons age 85 and older—are becoming more prevalent. Over the 1985–2000 period, the very old population is projected to grow by more than two-thirds, while the elderly population as a whole is anticipated to rise by less than a quarter. Under these projections, the over-85 group would grow from 9 percent of all persons aged 65 and over to about 12 percent by the turn of the century. The very old are 80 percent more likely to use Medicare-covered hospital services than are their younger counterparts, and they are 18 times as likely to reside in a nursing or personal care home. This suggests that the slowed growth of the elderly population will not lessen the demands on our health care delivery systems.

State and Local Government Budgets

The fiscal burdens of the aging population also affect state and local governments. Besides having to pay a share of the Medicaid costs of the elderly, the state and local government work force is also maturing. Although most state and local pension funds are reasonably well funded, some are not, including several of the largest plans. For these plans, past funding practices will impose additional burdens on taxpayers in the future.

Moreover, children constitute the largest dependent group, and their costs are borne primarily by families and local governments. For example, in 1985 spending on education totalled \$247 billion, with state and local governments bearing almost two-thirds of these costs and private spending accounting for another one-quarter. With the new education reform movement and associated increases in teachers' salaries, many localities are facing demands for more spending. The distribution of these costs varies considerably, however; certain jurisdictions face substantial increases in the student population, while others will experience little or no growth, or even declines.

The activities of the federal government also cause reverberations in the budgets of states and localities. For example, the creation of

the Supplemental Security Income program, while relieving states of some income maintenance costs, increased the number of people eligible for Medicaid. Similarly, cutbacks in federal discretionary spending during the 1980s have fallen heavily on grant-in-aid programs, such as urban mass transit, employment and training, subsidized housing, and general revenue sharing. The federal government can also impose additional costs on state and local governments—for example, to meet water quality standards—without providing commensurate financial resources. For all these reasons, it is important to look at total government fiscal activities, not only those of the federal government.

Table VI.3 shows the trends in governmental finance since 1950 for all levels of government. In order to make the federal and the state/local data comparable, the figures are shown on a national income and product accounts (NIPA) basis by calendar year. As a result, the federal budget figures differ somewhat from those shown earlier in tables VI.1 and VI.2. Because federal grants-in-aid to state and local governments are reflected in federal expenditures and state and local receipts, total government receipts and expenditures have been adjusted to eliminate this duplication.

Spending by state and local governments grew rapidly as a share of GNP during the 1950s, 1960s, and early 1970s. But in the late 1970s and early 1980s, declining school-age populations and taxpayer revolts caused state and local spending to grow less rapidly than GNP. Revenue growth also fell off, but not by as much, so that the state and local sector has shown substantial surpluses during the 1980s. Most of these surpluses, however, are associated with public employee pension funds. State and local operating budgets—that is, excluding social insurance programs—have been in approximate balance for the last several years.

Government activities as a share of GNP increased by almost two-thirds over the 1950-1985 period, with virtually all of the growth occurring before 1975. Spending growth over the entire period is comparable for federal and for state and local governments, but in recent years federal spending has grown somewhat as a share of GNP, while state and local spending has diminished. Federal government revenues have risen less rapidly than federal spending, while the opposite is true for state and local governments.

The projections of federal government spending for 1990 and 2000 shown in table VI.3 are consistent with alternative 2, described earlier. The state and local government projections derive from the January 1988 long-term trend forecast prepared by Data Resources, Inc.

(DRI). In the DRI projections, state and local expenditures and revenues both rise slightly in relation to GNP, and the state/local surplus remains a bit over 1 percent of GNP. By the year 2000, in these projections, the federal deficit declines to the point where it is little greater than the state and local surplus, so that the total government sector is roughly in balance.

Whether state and local governments will expand their social programs or institute new ones cannot be foreseen, and action is likely to differ substantially among the states. For example, Massachusetts has recently enacted a universal health insurance program for state residents. But this move is not necessarily a precursor of similar initiatives in other states. State finances vary considerably. New England is currently experiencing an economic boom, while the oil-producing states of the South and Southwest face significant fiscal stress. Moreover, Hawaii has had an extensive health insurance program since 1974, but it has taken 14 years for the next state to enter the arena.

Implications for Employee Benefits

The federal government's budgetary straits have encouraged proposals that would require private employers to provide additional benefits for workers and their families. Indeed, the Congress is currently considering proposals for providing additional incentives for child care benefits, as well as proposals for mandatory employer-provided health insurance and parental leave. In the United States, the responsibility for the provision and financing of social benefits has been shared by governments, employers, labor unions, and non-profit organizations. This shared responsibility has been encouraged by the tax-favored status of employee benefits.

For this and other reasons, employer outlays for employee benefits (including employer contributions for social insurance) grew from 5.4 percent of total compensation in 1951 to 17.0 percent in 1985. By 1987, this figure had declined slightly to 16.4 percent of compensation. Thus, at the same time as the total tax burden has risen substantially, the portion of compensation paid in cash has declined at an average annual rate of 0.3 percent. Individuals may therefore see little difference between an employer-provided benefit or a government provided one, both of which reduce their disposable cash income.

From a public policy point of view, choosing between employment-based benefits and direct public provision involves weighing several

factors. First, the approaches may differ in their real cost to the economy, as measured by the amount of goods and services they absorb. Second, the choice of a financing mechanism may alter total production and its composition through its effect on relative prices. Third, all these factors will affect the distribution of income.

The financing of health care services may serve as an illustration. Proposals for expanded health insurance coverage are intended to increase the health care resources available to those not now covered. If a plan for mandated employer-paid benefits leads to the same amount of health care spending as a direct public program, the real resource costs of the two approaches are the same. While the former approach does not show up in the federal budget, the government is making essentially the same claims on the economy's output. On the other hand, a purely employment-related plan is likely to leave gaps in coverage. To deal with these, the Massachusetts plan, for example, includes state subsidies for the unemployed and the self-employed to buy health insurance for themselves.

An employment-based minimum health insurance benefit scheme and a federally financed one could also have similar effects on prices and production, depending on the tax source used. One could imagine a levy on employers for covered workers that was identical to the per-worker cost of a minimum insurance package paid by employers through premiums. These two alternatives would have virtually the same effect. On the other hand, financing the same benefit through a broad-based tax is likely to have a less adverse effect on the employment of unskilled workers in relatively low-paying jobs and result in a more progressive incidence of the burden.

In an era when government finances are in deficit and real wages show little growth, none of the alternatives for filling the gaps in the nation's safety net is an easy choice. Efforts to expand either the role of government or the contributions of employers are both likely to generate heated debate. This debate should be informed by a solid understanding of the relationships between governmental and private-sector activities and of the real resource costs of the proposed alternatives.

VII. Federal Tax Policy

PAPER BY STANFORD G. ROSS

Introduction

It is daunting to try to predict the future course of federal tax policy. At a basic level, one is hard put to state what tax policy is at present. We are now in an era in which tax policy has become highly volatile, with many abrupt and unexpected twists and turns. Then there is the problem of projecting the future circumstances external to the tax system that will influence what happens with tax policy. Nevertheless, the inquiry, if inherently uncertain, is necessary, since we can be sure that tax policy will be important in the future. Moreover, I do believe that if one takes a careful look at what has transpired with respect to tax policy in the past, one can speculate reasonably about the future. It may not be possible to predict the exact date or precise form of particular changes, but if one takes a sufficiently long view, say 10 to 20 years into the early 21st century, it would be remarkable if certain eventualities did not occur. At any rate, I will sketch some tax policy tendencies that have emerged in the past, turn them into a model of how the tax policy system presently is working, and apply that working model to the future, particularly as it affects employee benefits.¹

The Importance of the Past

The modern federal income tax grew out of progressive political reforms around the turn of the century, and the penchant for a progressive income tax system, with the economic and social values it reflects, has strong roots in American society.² Moreover, the changes in the tax system between the early 20th century and World War II are also instructive. There have been periods before in which income tax rates were raised and lowered, generally in response to wars and

¹On a subject like tax policy, there are many commentators with various views. While presenting my own views, I have in the footnotes to this paper pointed out a number of other views that should be of interest.

²For a history of the income tax, see J.F. Witte, *The Politics and Development of the Federal Income Tax* (Madison, WI: University of Wisconsin Press, 1985).

their aftermath, and when either tax avoidance or tax incentives were the major concern, generally in response to national political changes. The payroll tax was added in the mid-1930s with passage of the Social Security Act. Particular tax provisions, such as those affecting employee benefits, date back to the period before World War II. Many of the current tendencies of the tax system can be traced back to these formative decades.³ Nonetheless, for present purposes, we can usefully focus our attention on what happened during World War II and subsequently.

World War II as a Watershed

The current shape of the federal tax system essentially stems from World War II, when the individual income tax was made a mass tax, with collection by withholding on wages at the source, and the corporate income tax was made into a major revenue raising source. Furthermore, the Social Security system, financed by the payroll tax, began its rapid expansion at this juncture. Also, while the federal government generally has imposed some excise taxes, consumption taxes have remained a relatively less significant revenue source at the federal level than at the state and local level. Thus, a snapshot of the federal tax system today (1989 estimates) shows the following sources of tax collections (in billions):⁴

Individual income taxes	\$412.4
Corporation income taxes	117.7
Social insurance taxes and contributions	354.6
Excise taxes	35.2
Estate and gift taxes	7.8
Customs duties	17.2
Miscellaneous receipts	<u>19.8</u>
Total	\$964.7

³See G.M. Brannon, "Tax Loopholes as Original Sin: Some Lessons from Tax History," *Villanova Law Review*, vol. 31 (1986): 1763.

⁴Numbers are estimates for fiscal year 1989 from the Reagan administration's fiscal year 1989 budget.

Post-World War II Developments

In the first period after World War II, the tax law changes centered on reducing the very high tax rates required to finance the war to something considered more normal for a peacetime era. Whether with the advent of the Cold War, and its requirements for heavy defense expenditures, there has really been a peacetime era and whether the tax rates have ever been truly normal is debatable, but at least the statutory rates were reduced and the impetus was to develop a tax system not reflective of a national emergency. A number of base-narrowing incentive provisions were put in during the 1950s and rationalized as an alternative strategy to rate reduction. The Eisenhower administration made its mark by the fairly technical exercise of recodifying the tax laws into the Internal Revenue Code of 1954.

Reforms Initiated under Kennedy—A first era of tax reform began under President Kennedy. Kennedy's 1961 tax proposals were proclaimed to be a first step toward total reform and produced the 1962 Revenue Act, with numerous structural changes. A second set of more far-reaching reform proposals in 1963 turned into the 1964 Revenue Act, with numerous additional structural changes. Furthermore, detailed tax reform studies were released in early 1969 that turned into the 1969 Tax Reform Act and influenced tax reform acts for another decade.

Tax policy between 1961 to 1968 reflected in important ways the views of the late Professor Stanley S. Surrey, the Assistant Secretary of the Treasury for Tax Policy. The Treasury Department proposals from this era displayed several major characteristics. First, there was an emphasis on horizontal equity and an attempt in most situations to treat income and persons in similar situations the same. At the same time, there was an appreciation of the need for incentives, and the Kennedy administration initiated the investment tax credit, albeit in a different form than finally enacted. Further, there was a willingness to manipulate revenues up and down, depending on economic circumstances and a generally pragmatic, rather than ideological, approach to particular tax reform subjects.

The 1962 Revenue Act was a balanced package intended essentially to be revenue neutral. The 1964 Revenue Act was intended to be a tax cut and was cited by the Reagan administration in 1981 as evidence that supply side economics worked. Under President Johnson, revenues had to be raised because of the Vietnam War buildup, and here the climate for tax reform changed. Despite the urging of the

Treasury Department that a tax increase could be facilitated by adding tax reform measures, Johnson insisted that taxes be increased before he would initiate tax reform. Johnson was concerned that Congressional churning on tax reform proposals would delay enactment of the tax increase needed to curb inflation. Given the favorable popular response to the tax reform studies released in January 1969 by then Secretary of the Treasury Barr, it appears likely in hindsight that Johnson miscalculated, perhaps because of his personal indifference to tax reform, but this is a subject on which there will be continued debate.

An Era of Congressional Initiatives—The period 1969 through 1980 can be viewed as a second era of tax reform in which the initiatives generally came from the Congress rather than from the executive branch. This happened at first because, with Republican presidents (Nixon and Ford) and a Democratically controlled Congress, tax reform legislation became an important element of political strategy for the Democrats. The Tax Reform Act of 1976 represented a high watermark for congressionally initiated tax reforms. Indeed, it was the high watermark for tax reform prior to the enactment of the Tax Reform Act of 1986.

This era reflected in important ways the views of the late Dr. Laurence N. Woodworth who, as chief of staff of the Joint Committee on Internal Revenue Taxation, played a leading role in all the tax changes during this period. In basic ways, Woodworth picked up the tax reform baton from Surrey. Although Woodworth and Surrey were not like-minded on all issues, they both had a healthy appreciation of the need to balance pragmatically equity and incentive approaches. Both were prepared to raise or lower revenues, depending on fiscal circumstances. They both had a broad and deep knowledge of the tax law and genuine concern for technical clarity and the overall coherence of tax policy. Yet neither was ideological about tax policy issues, and both were often criticized for being at times too prone to blend tax policy and political considerations. Together they were also involved in conceptualizing the tax expenditure budget and having the Budget Act of 1974 enacted so that consideration of tax and expenditure policy might be unified in Congress. While the results here have fallen far short of the promise, no one can doubt the correctness of the directions being pursued.

Transition in Tax Reform—The period under President Carter (1977–1980) reflects a curious transition in tax reform approaches. The Treasury team, first under Woodworth and then under his deputy, Donald

Lubick, tried to harken back to the Surrey era. Substantial tax reform studies were undertaken and proposals made, including some that were a legacy from the first tax reform era, such as capital gains reforms, heavier taxation of multinational corporations, and more tightly restricting the employee benefits area. However, in this area as in others, the Carter administration lacked the political astuteness to develop and carry out viable strategies for enactment of its initiatives. The 1978 Revenue Act represented a victory for incentives over equity, enacting provisions substantially opposed to the directions articulated by the Treasury. Capital gains taxes were reduced and other incentives were put in. Ironically, despite the control by the Democrats of the executive branch, the Carter period overall was essentially continuous with the Congressionally initiated reform period that preceded it, except that the changes were basically oriented toward providing incentives rather than seeking equity.

The Reagan Era

By 1981, tax policy was clearly in a muddle. Bracket creep during the 1970s meant that many taxpayers were being taxed at much higher rates relative to real economic income than had originally been intended, with the federal government's revenues being increased by the hyperinflation of the 1970s rather than by principled tax policy decisions. Regardless of who was president in 1981, there would likely have been a tax cut. The Carter administration was prepared to move in this direction had it won a second term, although probably with considerable caution. However, the Reagan administration decided to make tax policy its principal domestic initiative and to move with a force fueled by deep ideological commitment to lowering taxes as far as politics would permit.

The legacy of the Reagan administration in the domestic area will be primarily noted for its tax policy, which when compared to the past was far more revolutionary than incremental in its approach.⁵ Its effects on domestic expenditure policy and social programs has been less dramatic. After having fumbled politically on its early initiatives to deal with Social Security programs, the administration became among the staunchest supporters of that entitlement. A good deal of the cutting in the discretionary domestic areas probably would

⁵For an analysis of tax policy in the Reagan era, see J.J. Minarik, "How Tax Reform Came About," *Tax Notes* 2 (December 28, 1987): 1359.

have been done under any administration, although perhaps to a lesser degree and with more concern for reconstructing programs to meet their goals. The Carter administration moved in this direction, having both restructured disability benefits and proposed milder versions of the Social Security cuts which the Reagan administration enacted in 1981. But the Reagan era saw the creation of a far more difficult climate for proposals requiring additional expenditures, whatever their merits.

The Economic Recovery Tax Act of 1981 (ERTA) represented a triumph of the income tax incentive approach to tax reform. In addition to broad structural changes such as indexing of tax brackets and the lowering of rates, the Reagan administration sponsored numerous special incentives. Greater depreciation, larger investment tax credits, more capital gains preferences, and many special provisions were all strongly pursued. What is remarkable also about the 1981 Tax Act is how irresponsible the legislative process became.

Historically, there have been chaotic tax legislative periods; political acts are often not orderly. But never before had responsible officials acted with such disregard for the general public interest. At the highest levels of the government there was a general recognition that the tax cut was too large and would commit the country to deficits of unprecedented size. It was specifically understood by some that a revenue shortfall was being created that would leave about a 5 percent wedge between expenditures and revenues for the foreseeable future.⁶ To gamble that this wedge would force the Congress to cut expenditures was an unprecedented act and far from customary in a political system based on checks and balances. It is remarkable that there was so little protest to the 1981 Act at the time. The Democrats in Congress generally tried to outbid the Republicans with constituency groups and thereby raised the ante as they went along. While some of the participants learned a lesson which came back in 1986 to benefit the country, the blame that must go to all key participants in the 1981 political process is large. Perhaps it can best be explained in terms of an underlying change in national politics, symbolized by the 1980 election of President Reagan, in which Republicans moved away from traditional conservative concerns with budget balancing and Democrats moved away from traditional liberal concerns with progressivity and equity.

⁶See D.A. Stockman, *The Triumph of Politics: Why the Reagan Revolution Failed* (New York, NY: Harper & Row, 1986).

Because of the Reagan administration's commitment to tax cutting as its major domestic initiative, the impetus for additional revenues had to come from the Congress. With the Reagan administration unwilling to raise rates, structural change to raise revenues became the central focus. Here, with the Senate in the control of the Republicans, Senator Dole was the most active figure. He was responsible for initiating the Tax Equity and Fiscal Responsibility Act (TEFRA) in 1982, which led to the Deficit Reduction Act (DEFRA) in 1984, and began the era of revenue-driven tax reform. Because of this background, the tax reform era that began in 1982 is distinctly different from that of the 1960s and early 1970s. While revenues have always been an important tax policy consideration, principles of equity and efficiency were far more important in the earlier eras. It is important to remember the changed basis for tax reform in the 1980s when speculating about tax policy in the future.⁷

Another important development in the early 1980s was the tax reform approach initiated by the Democrats in the Bradley-Gephardt fair tax plan. When this approach quickly became emulated on the Republican side by the Kemp-Kasten plan and other similar approaches, the left and the right began to converge on the concept that a broader based, lower rate tax might be beneficial. The seeds were thus laid for the change of direction that produced the Treasury tax reform studies in 1985 and led to the landmark Tax Reform Act of 1986 (TRA '86).⁸

The Tax Reform Act of 1986

TRA '86 was the most unprecedented tax development in the taxation period commencing with the Revenue Act of 1942. Although the changes were intended to be revenue neutral because rates were lowered, never before had so much revenue been raised by structural changes that adversely affected numerous powerful interest groups.⁹ It could only have happened because of the excesses of the 1981 Act,

⁷For descriptions of these changes in the process by two key participants, see R.J. Leonard, "Perspectives on the Tax Legislative Process," *Tax Notes 2* (February 29, 1988): 969, and "The Process Behind Successful Tax Reform," *Villanova Law Review*, vol. 31 (1986): 1803 (comment based on remarks by David Brockway).

⁸See J.A. Pechman, "Tax Reform: Theory and Practice," *Economic Perspectives*, vol. 1 (1987): 1.

⁹See J.H. Birnbaum and A.S. Murray, *Showdown at Gucci Gulch* (New York, NY: Random House, 1987).

and the successes, albeit limited, of TEFRA and DEFRA in pioneering these revenue-driven reform approaches.

TRA '86 emphasized equity and efficiency over incentives and fairness, with perhaps the pendulum swinging too far too quickly. Not only were investment tax credits eliminated, depreciation lowered, and taxes increased on many sectors but minimum taxes and other revenue-driven changes produced a complex mass of rules that will take years to sort out. Some of the 1986 Act may well be unadministrable and not complied with by taxpayers. Massive technical correction acts will be required. Nonetheless, the sea change did take place, and it will influence all tax policy in the future.

Which leads to the question of what happens after 1986. My own feeling is that because of these alternating tendencies to pursue equity or incentives and to find efficiency and fairness in one direction or another, there likely will be continued change. All tax policy in the present era may be short-lived and transitory. But before sketching the changes I anticipate, I want to focus more closely on the tendencies that I find in this modern history of tax policy and to suggest a working model of the tax system which should help us to speculate about the future.¹⁰

Tendencies of Tax Policy

Tendencies are currents of thought and conduct that characterize the debate and activities surrounding the formulation of tax policy. While tendencies do not necessarily dictate any particular tax policy, they suggest the basic framework from which tax policy emerges.

Equity—The strongest tendency of income tax policy is to seek equity. Equity is often in the eye of the beholder, and reasonable people will often differ about what advances equal treatment. Analysis can draw distinctions between horizontal and vertical equity and produce a myriad of complexities. But at bottom considerations of equity possess a legitimacy that makes it a powerful force. This tendency is rooted in the fact that the income tax has become a mass tax. Tax populism is important at a political level.¹¹ When ordinary people see large corporations and wealthy individuals with tax ad-

¹⁰For factual and analytical information, see J.A. Pechman, *Federal Tax Policy* (Washington, DC: The Brookings Institution, 1987).

¹¹For a view that the 1986 developments reflect populist developments, see R.G. Darman, *Looking Inward, Looking Outward: Beyond Tax Populism* (Washington, DC: U.S. Department of the Treasury, 1986).

vantages, whether apparent or real, there inevitably is a reaction, which means that the pendulum will swing.

Incentives—On the other hand, there is another tendency, which is to recognize that the tax system can provide incentives to promote desired activities. Research and development, for example, generally are recognized as economically desirable. The international competitiveness of business is accepted as critical to American jobs and economic growth as well as to business profits. Capital formation is generally understood to be a necessity. Encouragement of private savings is recognized to have social and economic values. While the tax expenditure budget may help us to analyze the relative benefits of direct expenditures and tax expenditures, the fact is that the tax system does work well at times to provide effective incentives and may usefully be employed as a tool of social and economic policy.

Efficiency—A third tendency is to want economic efficiency.¹² Here there are several competing concepts. One holds that treating all sources of income the same will promote a better allocation of resources and efficiency. Another and opposite concept is that by encouraging certain needed activities we may be more efficient. Another concept would find greater efficiency in a consumption-based tax than in an income-based tax. Politicians often move from one concept of efficiency to another, depending on circumstances, often simply paying lip service to the deeper concerns reflected in these economically oriented concepts.

Fairness—Another tendency is the quest for fairness. Although closely related to equity, this concept refers to basic concerns for tax justice. Almost all tax proposals are grounded in the rhetoric of fairness, whether they are based on the criteria of equity, incentives, or neutrality. Thus, while the quest for fairness often seems problematic to experts, who tend to approach issues based on the more analytic criteria of equity and economic efficiency, judgments based on fairness often seem far less elusive to the general public or politicians.

Fiscal Circumstances—A final tendency relates to the way in which fiscal policy circumstances external to the tax system often dictate tax policy. Concerns about inflation can lead to tax increases. Concerns about recession or jobs can lead to tax reductions. In the present era, persistent, deep budget deficits have made revenue concerns paramount. The important point is that these external considerations

¹²For an analysis of this concept, see A.S. Blinder, *Hard Heads, Soft Hearts: Tough-Minded Economics for a Just Society* (Reading, MA: Addison-Wesley, 1987).

can overpower normal considerations of tax policy because they tend to rise to a higher level of political concern.

Many of these tendencies create tensions in tax policy, because they seem to be moving in opposite directions. Thus, equity is generally opposed to incentive approaches, revenue-raising is generally inconsistent with making tax expenditures, and tax cuts often stand in contrast to pursuing responsible fiscal policies.

In sum, an overarching tendency is that tax policy attempts to do many things at once and generally winds up with compromises reflecting second best choices. There is generally no way to take one tendency or another and pursue it to its logical conclusion. Our tax system combines many tendencies at once and the pendulum generally swings back and forth as one or the other temporarily gains priority.¹³

These swings are exacerbated in part because our goals are vague and in truth the search for equity, incentives, efficiency, or fairness is often frustrating. Furthermore, the country often has broader goals such as jobs, economic growth, or international competitiveness that tend to overwhelm any considered tax policy analysis and lead to changes because the tax laws are one thing that can in practice be changed. If, in former eras, politicians liked to throw money at problems, more recently they like to throw tax laws at problems. The fact that the money may have been wasted or the tax laws ineffective is only determined after the fact and may simply provide additional grist for the political mill.

Thus, the basic reason the pendulum swings back and forth relates to politics and the short-term nature of the focus of our political system. Congressmen are elected every two years. Chairmen of major committees such as House Ways and Means and Senate Finance generally want to respond to the pressures of their committee members to produce something notable in each Congress. Presidents want to leave their mark on the system. Secretaries of the Treasury and assistant secretaries for tax policy who seek to make a difference come and go. Everyone who comes into power feels he or she should improve things. Thus, if the tax system has swung a little too much toward equity, the reaction is generally to push incentives, and vice

¹³For an analysis of the complexities involved in particular tax policy issues, see D.F. Bradford, *Untangling the Income Tax* (Cambridge, MA: Harvard University Press, 1986).

versa. Change is seen as politically preferable to maintenance of the status quo.¹⁴

The Reagan administration exemplifies the hazards of allowing the pendulum to swing too far. Thus, the president proposed restoring incentives for capital gains in January of 1988, about a year after he had convinced Congress to treat them as ordinary income. Vice President Bush has also taken a stance for restoration of capital gains preferences. But it would be incorrect to identify any of these tax policy tendencies too strongly with Democrats or Republicans. The tendencies displayed tend to be less partisan than circumstantial to the political moment. Numerous examples can be found of Democrats seeking incentive provisions and Republicans seeking equity and vice versa. The political currents that direct tax reform generally are not based on party.

As I will discuss below, I think a centrist approach that tries pragmatically to take account of a variety of considerations without allowing the swings in policy to be too great would be beneficial. One of the most deleterious characteristics is the rapid and volatile change that has been occasioned by pushing tax policy too far in one direction or the other. There have been too many promises, too little delivery, and a general loss of confidence in the credibility of tax policy.

The Model

We have a second best income tax system that has equity and incentives as alternate poles and in which considerations of efficiency, fairness, and revenues are manipulated depending on starting points and political factors. Stability in the tax system can only result when the principal political participants in the Congress and the executive branch show restraint and do not push so much in one direction as to trigger a reaction. For example, had the Economic Recovery Tax Act of 1981 not gone so far, TRA '86 might not have gone so far. Stability, if it is achievable to any extent, will be found somewhere in between these two approaches.

Tax policy must always address new issues. The hyperinflations of the 1970s and fluctuating foreign exchange rates, for example, precipitated significant changes in tax law in recent years based on concerns with the time value of money and the role of money as a

¹⁴For a similar view, see B.I. Bittker, "Tax Reform—Yesterday, Today and Tomorrow," *Washington and Lee Law Review*, vol. 44 (1987): 11.

commodity in international transactions. Currently, for example, the increasing globalization of business and internationalization of finance and the continuing wave of corporate mergers and acquisitions are all developments that tax policy must confront. If tax policy were more coherent overall, its response to new issues might be more measured and constructive. But in an era in which tax policy is chaotic, the response is often skewed and the tax law may not move in productive directions. Thus, the ability of the U.S. tax system to adjust appropriately to a changing world may well depend on the restoration of balance to tax policy generally.

One of the major new developments in tax policy is the increasingly chaotic nature of the tax legislative process. This was exemplified during the consideration of the Revenue Act of 1987 by the failure to have hearings, to issue reports, or to show proposed legislative drafts to affected constituents. Staff operations in general have become less professional and more political in orientation than in the past, and tax policy considerations have become subordinated to politics to a greater degree than in the past.

One reason for this increasing chaos is that private interests are bringing unprecedented pressure to bear on the political system. With political action committees (PACs), honorariums, and lobbyists applying constant pressure, tax legislation in basic ways has become a 12-months-a-year sport for those who participate actively in the process. It may be that the only way the political system can operate at times is to shut off interaction with private interests and to do its will.

On the other hand, the political system also has developed an antidemocratic tendency to be disdainful of private interests. Many members of Congress and relatively inexperienced congressional staff have learned that they can get away, at least temporarily, with high-handed procedures that would not have been thought of 5 or 10, much less 20, years ago. The Congress at times has ceased to operate reasonably by any historic standards. There have been many times during the deliberations over the 1982, 1984, 1986 and 1987 tax acts when the Congress simply ignored traditional processes of dialogue with the affected public. These shortsighted legislative developments ultimately lead to detrimental developments in the operation of the federal tax system in the longer term.

It is obvious that greater integrity needs to be brought back into the federal tax policy process. We now have massive areas of the income tax law that are probably unadministrable. A recent survey showed that some 40 percent of the answers by the Internal Revenue

Service (IRS) to taxpayer questions were incorrect. There will likely be some intentional, and much more unintended, noncompliance by taxpayers. It is ironic that at a time when we are concerned with an underground economy and the tax gap, when some 1988 presidential candidates have said that a contribution to balancing the budget might be made by greater collection efforts, our legislative processes are continually churning out tax laws that can only bring disrepute and disrespect for the tax system. The taxpayer bill of rights legislation developed by the Senate to enlarge the procedural protections afforded taxpayers in disputes with government is another reaction to this increasingly chaotic system, an attempt to provide solace for increasingly perceived taxpayer grievances. Nonetheless, the point here is that the model we have to use to speculate about the future of tax policy must take cognizance of these extraordinary changes that have occurred during the past several years.

Future Changes

The coming battles will largely be about revenues—the need to increase them and where they will come from. In the longer term, I believe that tax policy will return to concerns over incentives that increase capital formation, savings, and competitiveness. One thing is certain: basic issues of tax policy are never resolved for all time and must be reconsidered as circumstances change.

The Reagan administration proposed only minimal changes in its 1989 budget and made clear it wanted no significant tax bill in 1988. Congress was satisfied in 1988 with enactment of technical corrections to the 1986 and 1987 provisions. Thus, the focus essentially is on 1989, when there will be a new president, and beyond.

There are several possibilities here. One is that the proliferation of tax legislation up to 1986, and especially during the 1981 to 1984 period, was largely the result of misguided tax policies and that with the enlightened approach reflected in TRA '86 there will now be greater stability. This is not to say that there will not be frequent tax bills to correct or improve the 1986 provisions, but only that the massive shifts in policy that have characterized the recent past will not recur. Another possibility is that the 1986 Act largely reflected just a more grandiose reshuffling of the cards in the tax deck and that future Congresses will feel free to declare a new game and reshuffle the cards once again on a relatively broad scale. There are obviously possibilities in between these two extremes of relative stability and relatively extensive change, and my own guess is that a

period of continuous, moderate change, measured by recent standards, will occur with respect to the federal income tax system.¹⁵

I think the starting point for change is that key aspects of TRA '86 are inherently flawed and unstable.¹⁶ For example, I do not think that treating capital gains as ordinary income will long suffice, particularly if there is a resurgence of inflation. The absence of investment tax credits and relatively sparse depreciation allowances will not for long be viewed as compatible with the desire for capital formation and international competitiveness. The relative bracket flattening is not likely to be sustained because of concerns for equity and fairness. Policymakers will want to change much of what was done in 1986 in one way or the other, sooner or later. My own best guess as to a scenario is that the changes will start with modifications in the treatment of capital gains.¹⁷

The question of the revenue effects on capital gains are controversial. Some believe that reducing capital gains taxes will increase revenues. Others believe that keeping the capital gains tax high and taxing capital gains at death will increase revenues.¹⁸ Most countries either do not tax capital gains or tax them at a preferred rate. Here, the American tax policy position is at present quite exceptional, although it is possible that other countries will shift their approaches based on U.S. developments.

My own feeling is that the present treatment of capital gains is not politically sustainable over a long period however strong the arguments are from the standpoint of equity and efficiency for treating all income the same. There would be a greater chance of stability if some sort of indexing, based on the length of holding period or an inflation adjustment, had been added in 1986 so that capital gains were taxed more equitably.¹⁹ This kind of reasoned approach might

¹⁵For the views of a number of knowledgeable economists on the state of the tax system following the 1986 Act, see *The Journal of Economic Perspectives* 1 (Summer 1987).

¹⁶See C.E. McLure, Jr. "Where Tax Reform Went Astray," *Villanova Tax Review*, vol. 31 (1986): 1619.

¹⁷The critical nature of the treatment of capital gains can be seen in the following recent articles: R.A. Gephardt and M.R. Wessel, "Tax Reform and Capital Gains: The War Against Uniform Taxes Is Far From Over," *Journal of Legislation*, vol. 14, (1987): 1; J.A. Gravelle and L.B. Lindsey, "Capital Gains," *Tax Notes* (January 25, 1988): 397.

¹⁸The Congressional Research Service has recently issued a report, *Capital Gains Taxation: An Analysis of the Recent Debate* (March 21, 1988); also see Congressional Budget Office, *How Capital Gains Tax Rates Affect Revenues: The Historical Evidence* (Washington, D.C.: U.S. Government Printing Office, 1988).

¹⁹See E.M. Sunley, "A Summing Up of the 1986 Act; What Happened to Comprehensive Income Taxation," *Tax Notes* (January 5, 1987): 63.

well be a compromise to having them treated once more in a preferential manner, but the opportunity for a more rational system may have been lost by the harshness of the 1986 revenue-driven approach.

The pressure to provide a lower rate for capital gains likely will combine with a pressure for greater progressivity and higher rates for upper income individuals. As soon as 1989, particularly if there is a heavily Democratic Congress, the top individual rate could be raised to 35 or 40 percent, perhaps even 50 percent, with brackets at say 10, 15, 20, 25, 30, 35, 40 and possibly 45 or 50 percent. Capital gains might then be pegged at the 20 or 25 percent bracket. The minimum tax will likely be rationalized in a way to remove redundancies, and other excesses of TRA '86 will be removed. But in conjunction with these ameliorative changes, there will be an attempt generally to achieve greater progressivity in the incidence of the tax structure.

Income tax reforms may be intended to raise revenues as in 1982 or 1984, or to be revenue neutral as in 1986. If they are intended to be revenue neutral, they will not address the problem of the deficit. My guess is that future changes are likely to raise some revenues but not enough to balance the budget, so that there will be a continuing need for greater revenues.

It is interesting to note that the Russians, who in trying to promote economic growth are reinventing the capitalist's wheel, have recently discovered that a progressive income tax is necessary to provide an equitable scheme for creating individual incentives.²⁰ It seems to me that, with the progressive nature of the income tax so much a part of the historic American political consciousness, concerns for greater progressivity will return in this country. The progressive nature of the income tax was important in its enactment and important during its development during the 1930s. While too much progressivity may be unfair, there also is a sense in which a flat tax is not fair either. It is remarkable that in 1986 liberals were so willing to accept the flat tax features of the Reagan proposals. On the other hand, it is also clear that, given the opportunity, they would restore some greater degree of progressivity. They will particularly do so when items that favor the higher income groups—such as capital gains—reenter the system and they no longer have the broader tax base that provided the rationale for the reduction in progressivity.

The direction of corporate tax changes is less clear. A 34 percent corporate rate is not that low if the broad base is preserved so that

²⁰*New York Times*, 9 March, 1988, p. 1.

the statutory rate and the effective rate are similar. Perhaps what will happen here is that there will be some move toward integration with the individual tax and some greater allowances of investment tax credits and depreciation. Since these changes would be costly, the corporate rate might rise to 40 percent, particularly if the top individual rate rises to 40 or 50 percent. The present situation in which the top individual rate is 28 percent compared to the 34 percent corporate rate creates too much pressure for taxpayers to innovate with organizational forms. The country will soon have had enough of master limited partnerships and other paper manipulations that attempt to game the tax system. Ideally, the tax system should not unnecessarily distort normal structures for conducting business, although it often does and will undoubtedly continue to do so to some extent.

The burden of employment taxes has grown rapidly in recent years and will undoubtedly continue to grow. Although such taxes are not high relative to those imposed in other advanced countries, they equal or exceed the personal income taxes paid by many workers, and this relationship may be significant politically. It may be increasingly perceived by the public that employment taxes are a regressive feature of the tax system, falling disproportionately on lower and middle income workers. Taxpayers may come to believe that overall fairness requires progressivity in the income tax to balance the regressivity of the employment taxes. If so, the political system is not likely to be far behind in enacting changes.

Under the social insurance system, employment taxes bear almost the entire weight of the entitlement programs, which are likely to continue growing. Yet these taxes raise the cost of labor, possibly costing jobs and making American produced goods less competitive. Sooner or later these deleterious tendencies will cause difficulties based on tax populism and political pragmatism. Accordingly, we ought not to lose sight of the long-term pressure for tax policy change in reaction to the increasing importance of employment taxes in the tax system overall.

The final aspect of looking at the future is to note that the tax acts of both 1981 and 1986 were traditional tax reforms in that they involved manipulation of the income tax system. A larger issue, which was not addressed in 1986, is what is likely to happen with the issue of consumption taxes. There was a trend among academics, particularly economists, during the 1970s and early 1980s to consider a consumption tax system as preferable to an income tax system. It was thought to encourage investment, to be more neutral in its effects

on taxpayers, and generally to be more efficient and equitable. This academic thinking did not, however, infiltrate the political world to any significant extent.²¹

In the political world, there has developed an undercurrent that a value added tax of the type used in Europe might well be a good way of providing another revenue source and taking the pressure off of income taxes and perhaps employment taxes. However, when this possibility first began to be broached by persons like Chairman Ullman of the Ways and Means Committee and Chairman Long of the Finance Committee, it proved to be highly unpopular and was attacked by a variety of constituencies. Liberals and labor groups argued that a consumption tax was regressive and would be unfair as well as inefficient. A number of businesses feared that it would unduly burden them in relation to other businesses. There was no significant base of support other than the perception of a few knowledgeable politicians that it would be a feasible way to raise a great deal of revenue relatively painlessly.

It now seems clear to many in Congress that a sophisticated value added tax might well be a useful addition to a second best tax system. Thus, Senator Ernest Hollings has recently called for enactment of a 5 percent value added tax that would exclude food, housing, and health care. It would raise \$66 billion annually, one-half to be used to reduce the deficit and one-half to finance new domestic programs. The regressive features could be mitigated to some extent by credits for lower income earners or exemptions for certain essentials such as food or medicine. The tax would still cover a broad range of transactions and could raise a good deal of revenue. Also, unlike income taxes, a value added tax tends to spread some of the tax burden on those members of society who are not current income earners but nevertheless have significant wealth.

Japan is an example of a country whose political leadership has come to the view that a value added tax is a needed component of a modern tax system. Japan, like the United States, relies mainly on an income tax system and does not have European-style consumption taxes. The Japanese government proposed to introduce a value added tax and, although it failed the first time around, it is likely to be enacted before too long. The Japanese believe that as their population ages and the elderly are not subject to income taxes, a broad-based

²¹For an analysis of the problems of adapting an income tax system to achieve consumption tax goals, see H.J. Aaron, H. Galper and J.A. Pechman eds., *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax* (Washington, DC: The Brookings Institution, 1988).

consumption tax such as a value added tax that keeps the elderly as taxpayers adds an important element of equity and efficiency to the tax system.

A controversial aspect of the value added tax debate is its relationship to international competitiveness. Many politicians believe that because a value added tax is rebated on exports and imposed on imports it helps the balance of trade. Forms of the value added tax designed strictly to increase international competitiveness have been considered in Congress. Economists generally find the impact of the value added tax more problematic and virtually none believe it would significantly affect the balance of trade. In truth, considerably more work on the value added tax will be required to determine its effects.²²

I believe the United States eventually will adopt a value added tax. Under the model I have sketched, we have, and probably will continue to have, a second best income tax system that combines a number of disparate elements on a pragmatic, political basis. It would, for example, be far more feasible politically to raise needed revenues through a relatively small value added tax, denominated as a deficit closing tax, than to raise income tax rates or to have massive structural changes in the income tax. Once Japan adopts a value added tax, American exceptionalism in this matter is likely to be short-lived.²³

Also, as the costs of Social Security and Medicare rise, a value added tax could take pressure off the need to increase employment taxes. A part of the value added tax, perhaps the part that falls on the consumption of the elderly, might be earmarked for the Social Security trust funds, the same way that the income tax on Social Security benefits presently is earmarked. This recycling feature, which has not yet been considered, seems to me to have some promise in making a value added tax more palatable politically. It resembles in some respects the new financing mechanism under the 1988 Medicare Catastrophic Coverage Act in which the costs are imposed on the elderly in a progressive way. The value added tax would be imposed on the elderly according to the amount of their consumption, arguably an equitable way to proceed if the revenues from the tax are used to help finance entitlement programs.

It does seem clear that rather than cutting entitlements for the elderly, the political system is likely to increase taxes to finance them.

²²A current symposium on consumption taxes can be found in *Tax Notes* (March 7, March 14, March 21, March 28, April 11, and April 18, 1988).

²³See discussion of worldwide tax policy trends in Herbert Stein, ed., *Tax Policy in the Twenty-First Century* (New York, NY: John Wiley & Sons, Inc., 1988).

For example, there is active consideration in Congress of raising or eliminating the ceiling on the wages subject to employment taxes, particularly to provide revenues to finance benefit expansions. Greater taxation of Social Security benefits seems highly likely in all events. There is active consideration of proposals to subject a greater portion of Social Security payments and perhaps the insurance value of Medicare coverage to income taxation. The overall equity and efficiency of such changes deserve far more consideration than has been given thus far, and both the employment tax and benefit sides of the social insurance system need to be taken into account at the same time.

Application to the Employee Benefits Area

Under the model of our tax system that I have suggested there will be continued change triggered by political considerations. The tax system will at various times emphasize equity and at other times incentive concerns. As much as it would be desirable to have stability in the tax treatment of employee benefits, this is likely to be an area that will continue to be subject to frequent change.

In the *Special Analysis to the Federal Budget of 1989* on tax expenditures, employee benefits provisions are the single largest item, amounting to some \$113 billion. Employer pension plans alone account for some \$44 billion, and employer contributions for medical insurance premiums and medical care account for some \$28 billion. Employee benefits have been classified as tax expenditures for a considerable time and are likely to continue to be viewed in that way, despite the fact that this portrayal tends to exaggerate in some respects their costs and preferential aspects.²⁴ Thus, whenever tax reform is considered, employee benefits will likely be on the agenda for change. For example, the February 18, 1988, issue of *Time* magazine, in offering a plan to reduce the deficit, proposed removing or capping the tax exclusion for employer-paid health and life insurance benefits and halving the contribution limits on defined benefit plans, to raise revenues of about \$12 billion annually. The Congressional Budget Office study of deficit reduction options pointed in similar directions.

During the recent revenue-driven tax reform era, there has been constant micromanipulation of the rules affecting employee benefits.

²⁴For an analysis of the tax expenditure concept in the retirement income area, see S.M. Korczyk, *Retirement Security and Tax Policy* (Washington, DC: Employee Benefit Research Institute, 1984).

Reforms based on overall concepts that would rationalize the area have not been considered. It would be easier for the private sector to manage change if there were some basic understanding of how to treat employee benefits for federal tax purposes.

It is likely that in periods in which equity concerns are emphasized, the changes will be limiting or constricting. When incentives are emphasized, limits may be expanded and restrictions curtailed. It would be desirable if the pendulum would not swing too much one way or the other and the whole area became rationalized, but at the present it would be unrealistic to expect such developments.

In terms of directing change along a more constructive path in the future, it would be desirable if the tax expenditure approach to tax reform of employee benefits were further developed and could enter a new stage of sophistication. There is a need to balance the consideration of the revenue costs of items with the benefits achieved by the expenditures. Too often, inquiry ends with the identification of an item as a tax expenditure. Yet this is where the discourse should begin. If the activity sought to be induced does in fact take place, and the tax system is an efficient way to secure such activity, the tax expenditure may on balance be desirable. At present, careful analysis of employee benefit tax expenditures seldom takes place.

A beginning for a more sophisticated approach would be to increase recognition that employee benefits as a category is too broad, and that such benefits ought to be scrutinized individually in terms of the social values reflected in their design. In this way, the relative importance of the social benefits can be weighed against the costs, and social priorities can be taken into account in tax expenditure analyses of benefit issues. To be concrete, employee benefits can be broken down into at least four categories, even though some might argue about which category or categories a particular benefit belongs to. These categories represent benefits that are (1) essentially a substitute for current compensation such as subsidized food, housing, or other consumption items; (2) retirement benefits such as some defined benefit pension plans; (3) capital accumulation plans such as some profit-sharing and thrift plans; and (4) health care related benefits such as employer-provided medical insurance.

From the standpoint of social values, there is little justification for preferred treatment of the first category of benefits, which are essentially a substitute for compensation, and issues related to measurement and the timing of such income should not obscure the case for imposing current taxation. Many recent changes in the United States have moved in this direction, even if fitfully. The revenues here may

not be huge, but if tax expenditure analysis is to progress as a guide to change, it needs to be taken into account whatever the revenues it produces in a particular situation.

With respect to the other three categories of benefits, the analysis is more complicated because of the presence of significant social values. In particular, there are issues of efficiency and effectiveness in providing social protection that need to be more directly addressed than they have been in the past.

Benefits that encourage accumulation of assets solely for retirement annuities, such as some employer-provided pensions that do not allow for diversion of the assets for other purposes, can be viewed as a relatively efficient and effective way to achieve a desirable social goal, assuming a sufficiently high priority is assigned to retirement income security. The cost of these benefits can be compared to those provided under the Social Security system, but the analysis here is complex and involves issues of judgment. My belief is that in our society these two systems are largely complementary and not competitive because they further different values and reflect different strengths and weaknesses. I believe, pragmatically, that it is better if both systems are strong.

Admittedly, mine is not the universal view. There are some who would constrict private employee retirement benefits and increase public programs such as Social Security.²⁵ There are others who would like to restrict Social Security but who would do this simply to save revenues and would not seek to strengthen employer-sponsored pensions. Thus, various approaches are being pursued when proposals are made for change in public or private sector programs affecting workers' retirement income security.²⁶

Plans that are essentially mechanisms for capital accumulation can be viewed as having a lower social priority than those that are designed solely to provide retirement annuities. Such plans may be designed largely to be tax preferred savings mechanisms, or they may in practice operate that way because the beneficiary is given relatively ready access to the funds by borrowing or otherwise being able to use the benefit before retirement or at retirement as a lump sum distribution. In addition to some profit-sharing and thrift plans, some defined benefit and defined contribution retirement plans can essen-

²⁵See M.C. Bernstein and J.B. Bernstein, *Social Security: The System That Works* (New York, NY: Basic Books, 1988).

²⁶See S.G. Ross, "Public and Private Aspects of Social Policy: What are the Appropriate Roles for Public and Private Sector Programs?", *The National Social Conscience Conference Proceedings* (Waltham, MA: Brandeis University, 1986).

tially be viewed in this category. Such plans lack the justification of furthering a relatively high-priority social goal such as providing retirement income security throughout the retirement years, and they can be justified only if they are seen as increasing savings and if increased savings is in itself seen as a relatively high priority social goal.

In the case of small businesses that may have no other benefit plans, and perhaps in some other situations, capital accumulation plans may be seen as having a significant social role. Also, Congress has taken some steps in recent years to restrict these plans in ways that make them serve broader purposes and may well do more in this vein in the future. In the long run, capital accumulation plans may be required to become essentially plans to provide retirement annuities on a nondiscriminatory basis. Thus, future tax reforms may justify these plans as a useful tax expenditure because of the social values they are required to achieve.

Health care related benefits are perhaps the most complicated category to analyze. They can be viewed as contributing to a desired social goal or as a substitute for cash expenditures that a worker or retiree would otherwise have to make from wages or pensions. Increasingly, however, adequate health care is seen as a right that everyone should enjoy, and the social priority assigned to this category of benefits is increasingly high.

There is considerable political pressure currently to expand public health care systems. Catastrophic health care coverage was added to the Medicare program in 1988. Whether the revenue estimates are reasonable is unclear. This could be another social program that will greatly expand in the years ahead and have costs far beyond those projected by its sponsors. Yet, despite many unanswered questions, the Reagan administration and Congress took action to agree on this measure.

The larger expansionist item on the agenda, however, is long-term care for the elderly. Representative Claude Pepper (D-FL) had a bill to expand Medicare to provide home health care and personal care benefits, with financing to be provided by lifting the ceiling on the part of wages subject to the employment taxes earmarked for the Medicare program. Even some of the most liberal members of Congress acknowledged that the coverage aspects raised considerable questions and that the revenue numbers were extraordinarily large. However, the bill did get strong support, including endorsement from Senator Edward Kennedy (D-MA) and Governor Michael Dukakis; and, while it failed to be enacted in 1988, the events surrounding the

Pepper bill are an indication that long-term care has moved forward rapidly as a concept whose time for enactment is near.

The practical difficulties of implementing long-term care proposals have not as yet been adequately addressed. Many of the long-term care expenses, such as for housing, food, cleaning, and other daily needs, have generally been provided by the private sector and left to individual choice. It is true that the elderly in nursing homes or other facilities cannot separate the costs of these daily maintenance requirements from medical care. But when long-term care in the home is covered, making distinctions in types of expenses may be more compelling. Some analysts believe that limits could be put on benefits that would make the financing of the programs feasible and that it could be handled with a modest increase in employment taxes or general revenues. Although the problems to be resolved are formidable, my own belief is that a feasible program will be developed at some point soon on a bipartisan basis, expensive as it may be, and it will become a part of the Social Security system.

A related benefit issue is mandated benefits, particularly with respect to health care and related forms of worker and retired worker assistance. There is a great deal of interest in this area in Congress. Some have suggested this approach to deal with at least a part of the long-term care issues. Again, Democrats and Republicans who are anxious for expansion of social programs may pursue these directions. On the other hand, they are on the horns of a dilemma since mandated benefits may not be an equitable or efficient way to provide benefits. Mandated benefits are likely to raise labor costs, thereby reducing competitiveness and causing job loss.²⁷ Also, for that part of the population that will be left uncovered even under mandating, the government has to provide benefits on an equivalent basis and incur direct costs.

It seems clear in the health care area that, if costs could be controlled, it would be far better to have some universal minimal health care program, whether provided for at a state, local, or federal level. Nonetheless, mandated private benefits are a development that may take on speed because of the difficulty of enacting programs with direct costs to be financed by the tax system. Very likely, if mandating does occur, tax incentives will be provided so that the government indirectly shares the cost of the benefits with employers. This could result in a large tax expenditure that requires cutting back on some

²⁷See *Government Mandating of Employee Benefits* (Washington, DC: Employee Benefit Research Institute, 1987).

other tax expenditure in the employee benefits area, such as employer deductions for pension contributions, or taxing portions of health insurance premiums as income to employees. Although not necessarily logical, the use of a tax expenditure approach often suggests a lower social priority than a direct expenditure approach, as with proposals for long-term care expansions under Medicare, so that more tradeoffs may be required.

In the longer term, assuming mandating is pursued as an approach to the expansion of benefits, the question may be raised whether tax expenditures are required or justified. The argument will develop that if benefits are required, tax incentives are not needed. Tax expenditures may be seen as only required in a voluntary system in order to provide employers with incentives to take certain actions. In short, a compulsory approach may be seen as requiring government subsidization through the tax system at the time of enactment and yet ultimately lead to a removal of the tax expenditure because of perceived inconsistency in the mandating and tax expenditure concepts and the practical pressures to raise revenues.

It also should be recognized that the country may continue to pursue a number of public sector and private sector approaches simultaneously. Mandating of some aspects of health care may occur at the same time that Medicare under Social Security is expanded to take care of other aspects. It is to be hoped that careful study will enable these various developments to be coordinated and to be as efficient and equitable as possible. But if the past is any indication, initiatives are more likely to occur as separate thrusts at problems and to be seen as related only after enactment. A comprehensive plan for addressing the retirement income security and health care needs of the nation remains to be developed.

In sum, there will undoubtedly be a great deal of change in the future in the taxation of employee benefits. In truth, employee benefits is too broad a category to be useful in analyzing the tax policy issues that are likely to emerge. Greater specificity of the costs and social and economic effects of particular categories of benefits is surely desirable. There should also be more careful delineation of the social goals being sought and their relative weight as a justification for any tax expenditures involved in the benefit. My guess is that tightly directed retirement income security benefits and carefully constructed health care related benefits may serve as adequate justifications for some employee benefit tax expenditures, but others will not survive over the long term.

Conclusion

This paper has highlighted a great many complicated subjects germane to federal tax policy. Public and private social programs present a seamless web with threads that all lead to the federal tax system. It would be desirable if there developed a balanced, centrist approach to tax policy that provided greater coherence and stability and a respite from the rapid and abrupt change of recent years. A more cautious approach might also help to improve the tax legislation process and the interaction of private interests and the government. Whether the underlying political base for such an improvement in federal tax policy can develop is unclear. The Republican party would have to return to a more traditional conservatism concerned with fiscal prudence and skeptical of tax system solutions to social and economic problems. The Democrats would have to build on their traditional liberal concerns with equity and social programs to develop a new, more centrist approach to social and economic issues.

Absent a basic change in national politics, it does seem clear that the current model for tax policy will continue to precipitate a great many tax changes and that the employee benefits area will be one of the areas most affected by these changes. It also seems clear that the employee benefits community could benefit by developing some consensus on the proper shape and role of private employee benefits and taking actions that advance public understanding so that reasonable limits could be put on changes. This might prevent drastic pendulum swings against employee benefits and curb the appetite for excesses during incentive periods when more employee benefits may be sought. This may be too optimistic an agenda, since the employee benefits community is not monolithic. But objectively staking out a playing field for the years ahead might well have a moderating and pragmatic influence on future tax policy.

VIII. Paying for the Baby Boom's Retirement Income and Health Care

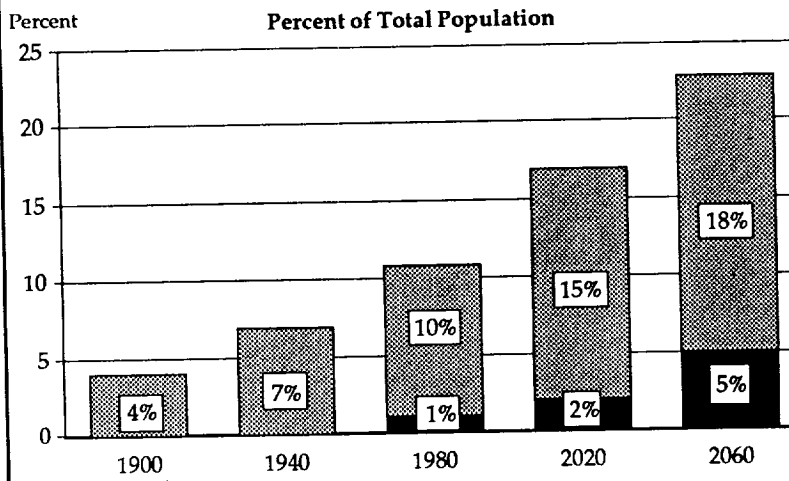
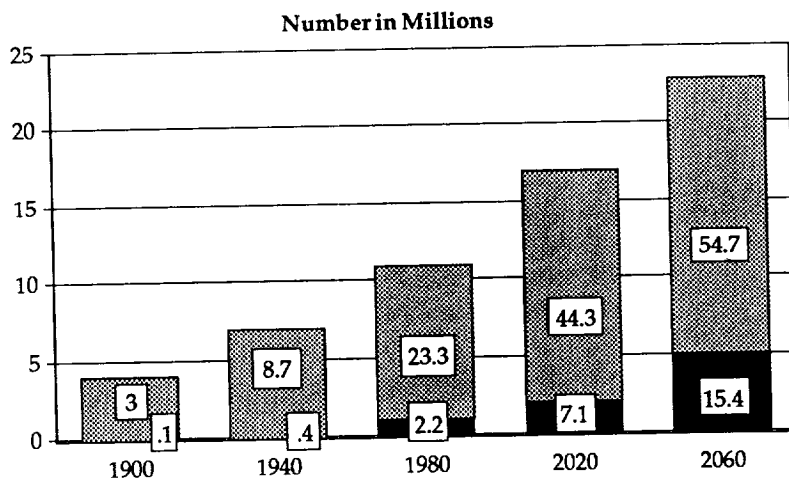
PAPER BY P. ROYAL SHIPP

Introduction

The aging baby boom generation will yield an unprecedented number of elderly and retired people in the next century and will put pressure on the adequacy and affordability of the nation's retirement income and health care programs. Americans who will grow old between now and the middle of the next century already have been born, and few things about the future are as certain as the coming large increase in the elderly population—particularly when the baby boom (the generation born in the two decades between the mid-1940s and the mid-1960s) reaches old age. According to the Census Bureau's intermediate projections, the number of people age 65 and over will double from 25.5 million in 1980 to 51.4 million in 2020, about a decade after the first members of the baby boom have reached age 65. By the time the last of the baby boom reaches old age, the number will have soared to 70.1 million. This increase in the number of elderly and retired people in the next century will put pressure on the adequacy and affordability of the nation's retirement income policies and programs in the next century (chart VIII.1).

The number of elderly reaching age 85 is growing at an even faster rate, and by itself constitutes a serious challenge to the long-run stability and viability of the nation's medical care system. People in this age group disproportionately suffer from chronic illnesses requiring long-term nursing home or other care, often do not have a spouse to help care for them, are disproportionately women who were not in the labor force in earlier years, and often are poor. Medicare, the health insurance program for the population over age 65, pays little for long-term nursing home or other care for chronic illness. Private health insurance instruments within the financial reach of most elderly persons have not been forthcoming to date. Medicaid, a federal/state program designed to finance medical care for the poor, now buys about one-half of aggregate nursing-home care, but this

Chart VIII.1
The Increasing Elderly Population
(U.S. Bureau of the Census Projections)



■ 65+ ■ 85+

program has until recently required individuals to “spend down”^{*} their assets to qualify.

This paper briefly sets forth the reasoning and conclusions that were developed in a year-long study conducted by analysts from the Congressional Research Service and the Congressional Budget Office and published by the Ways and Means Committee. A major conclusion on the issue of retirement income was: do not panic because of the baby boom. The Social Security program seems to be working as Congress intended. At present, its cost as a percentage of the Gross National Product (GNP) is actually declining and will continue to do so until the year 2005. Financing pressures on the nation’s retirement income system may emerge, but if changes are needed in the program to address these pressures (or to respond to other issues that occur), there is plenty of time to do so. After all, the oldest age cohort of the baby boom era does not reach old age for nearly a quarter of a century, and then it stretches out for an additional 20 years.

Furthermore, private sector and government institutions respond flexibly to changing economic and social conditions. For example, the relatively well-educated baby boom generation may continue working in an increasingly service-oriented economy—particularly if economic growth during their younger working years does not provide them with what they consider to be adequate levels of retirement income. And “panic-driven” cuts in Social Security benefits for today’s retirees, whether by restricting cost-of-living adjustments or in other ways, would do nothing to ameliorate any economic difficulties posed by increases in retirement income costs when the baby boom does retire. A brief summary of these arguments about retirement income are included later in this discussion.

The larger part of the discussion, however, will focus on paying for the baby boom generation’s health care in old age, which raises substantially different issues. Although the Social Security and Medicare programs are sometimes analyzed as a single unit, there is no inherent or overriding reason for doing so. Even though both programs are part of the Social Security Act and both rely at least partially on the payroll tax for paying benefits, program costs are driven by different phenomena. Medicare and Medicaid expenditures respond to conditions in the health care industry and the costs of these national

^{*}Editor’s note: Under the Medicare Catastrophic Coverage Act of 1988, the income of a spouse of an institutionalized, Medicaid eligible individual is protected up to a specified amount.

governmental health financing programs for the elderly, the disabled, and some of the poor reflect trends in overall health industry costs.

The United States spends a larger share of its GNP on health care than any other nation. This percentage has more than doubled in the past 25 years, increasing from 5.3 percent in 1960 to an expected 11.2 percent in 1987. If health care price increases continue to exceed price increases in the remainder of the economy, the United States will be allocating 15 percent of its GNP to health care by the year 2000—long before the baby boom retires. The point of this discussion is not to say whether this or any other amount is too large, not large enough, or just right. This analysis is concerned with the important issues that the aging of the population and the retirement of the baby boom generation raise for the medical care system. To summarize:

- (1) The elderly are much greater users of health care than the young; this means that an aging population will put additional upward pressures on health care costs.
- (2) The United States, unlike other industrialized countries, does not have a universal public health care system. The part of medical care costs that go through governmental budgets (federal and state) are the parts most directly affected by population aging.
- (3) Medicare's Hospital Insurance (HI) trust fund will become insolvent in 2005, according to projections by the Board of Trustees in 1987.
- (4) Every year between now and the time of the baby boom generation's retirement, Congress will have to consider questions of the cost of the health care system and access to it.

The threat of trust fund insolvency always focuses political attention and generates political action. However, focus on Medicare's HI trust fund, even more than Social Security trust funds, disguises underlying problems with a facade of governmental accounting practices. The critical issue is continuing increases in the cost of health care, not the solvency of a payroll tax financed HI trust fund.

Under conditions of moderate economic growth, it is possible to make the argument that the Social Security program is on "automatic pilot" and will be for many years, requiring only infrequent attention from Congress. In contrast, conditions in the medical care sector will keep health care issues on the congressional agenda indefinitely. In addition to the question of cost increases and the share of national production, several so-called gaps in health care coverage will receive legislative attention—particularly long-term care, health insurance for the working uninsured, and inadequate insurance coverage for the poor. These issues will be discussed in greater detail later.

The Baby Boom's Retirement Income

This section discusses some ideas about earning and paying for the baby boom generation's retirement benefits. It considers, first, how claims for future retirement income are built up during a work career. Second, the section discusses ways to measure the effect of the baby boomers' retirement on the overall economy. A third section raises the possibility that earnings could account for a larger share of the elderly's future income than they do today. And, finally, the section notes that the nation's institutions and policies will adjust incrementally (almost automatically in some cases) to accommodate the baby boomers' retirement.

Building Claims for Retirement Income—While workers are in the labor force, their savings and work efforts contribute to the growth of the economy. At the same time, workers build up claims for retirement income from Social Security and pensions that can be “cashed in” after they retire and used to purchase goods and services. In addition, individuals save for retirement through investments, including homeownership, that are separate from their employment-related pensions and Social Security. In aggregate, retirement income from these other savings, while less than Social Security, exceeds benefits from pensions and other employer-sponsored plans.

Most projections of future retirement income claims from Social Security and pensions assume continuous economic growth. If this assumption holds, future retirees will have a higher standard of living than the elderly of today. Thus, the rate of productivity growth during a cohort's working lifetime determines its prosperity in retirement, relative to previous generations, and this growth also builds the base for future economic activity.

The economic pressure of providing for the baby boom's retirement would be eased by building up the nation's productive capacity over the next quarter century. Then real GNP (per worker) would be high enough to offset the expected decline in the work force relative to the retired population, providing adequate real income for both groups. To achieve this buildup, national policy should tilt toward, or at least not hinder, a high investment economy in the period from now to 2010. This would require increases in saving and productivity growth because both are below historical rates at a time when, to prepare for retirement of the baby boom, above average rates appear warranted. Among policies to raise saving, increased saving by the federal government (in the form of reductions in the budget deficit) is the most likely to have a major impact. Policies to raise private saving

may also be helpful, although they have not been notably successful in the past.

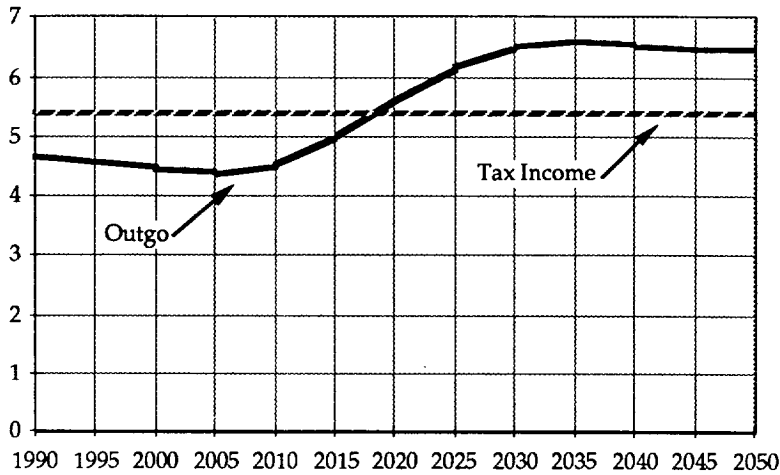
The Cost of Retirement—As the number of elderly people grows rapidly, particularly during the years of the baby boom's retirement, the cost of paying their retirement benefits will grow also. Over the years, analysts have developed measures designed to assess the impact of these cost increases on the rest of the economy.

Some measures of the economic effects of Social Security and pension programs, often called "dependency ratios," compare the number of elderly to the working age population and suggest that economic pressure will mount as the elderly become an increasingly large segment of the population. Dependency ratio measures, though useful for some purposes, can be misleading. They suggest that the elderly are "dependent" on the working-age population when, in fact, both workers and retirees have claims against the productive capacity of the economy. In addition, dependency ratios ignore important variables such as economic growth and productivity improvements, and by themselves do not reflect the ability of society to care for its dependent populations. Comparisons of total benefit payments to the GNP shift analytical attention to an assessment of the size of Social Security benefits compared to the overall economy. This ratio measures more accurately the economic pressure of paying for the baby boom's retirement income.

In 1983, Social Security payments reached nearly 5 percent of GNP—the highest level to date. By 1987, this percentage had declined to 4.73 percent, and the Social Security Board of Trustees' 1988 intermediate projection shows continued decline over the next two decades, to 4.39 percent in 2005. This decline is due to the large number of baby boom workers in the labor market and the relatively low number of new retirees—those born during the depression years of the 1930s. As the population ages and the baby boom begins to retire, however, the cost of providing their Social Security benefits will grow by 51 percent over a 30-year period, reaching 6.61 percent of GNP in 2035 (chart VIII.2). (Under the Trustees' most optimistic assumptions the percentage in 2035 would be 5.50, and under the most pessimistic assumptions it would be 8.11.)

In assessing the economic pressure from the baby boom's retirement, emphasis on Social Security's cost as a percentage of GNP seems appropriate. However, it does not tell the whole story because many complex and difficult political and economic issues are raised in financing these benefit costs. In fact, much current attention is focused on the implications of a Social Security trust fund that is

Chart VIII.2
Social Security Trust Fund Income and Outgo
as a Percentage of GNP, 1990-2050



Source: U.S. Department of Health and Human Services, Social Security Administration, *1988 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Trust Funds*.

projected to become very large under current financing. During the next 25 years, current law overfinances Social Security and underfinances Medicare. Accordingly, financing techniques of these federal programs will generate policy and legislative concerns even before the baby boom retires.

Major Social Security amendments enacted in 1977 and 1983 shored up Social Security's short-run and long-run financing. These amendments included reductions in benefits and increases in Social Security's payroll tax to take effect in 1988 and 1990. The combined payroll tax (on both employees and employers) climbed to 12.12 percent in 1988 (from 11.4 percent in 1987) and will increase further to 12.4 percent in 1990. These payroll tax increases take effect at the very time that Social Security benefit payments (compared with either GNP or total taxable payroll) begin a two decade decline. During the next 20 years, revenues from Social Security's payroll taxes will exceed benefit payments by large amounts, thus building up Social

Security's trust fund balances to unprecedented levels (a high point of about \$2½ trillion around the year 2020). This trust fund build-up would occur before the baby boom generation's retirement. Its potential effect on the economy is being brought under close analytical scrutiny, so far with varying conclusions. The financing plan adopted in 1983 would generate payroll tax revenues that would either help finance other government operations or reduce the national debt held by the public while the trust fund is building up. Then, during subsequent years of trust fund decline, other sources of government revenues (including federal borrowing) would be required to help finance Social Security as the debt held by the trust funds is redeemed to pay current benefits.

To some extent, federal borrowing may be tolerable in the baby boom retirement period but only if budgetary surpluses (measured over all federal activities) have been experienced previously. This strategy also implies export surpluses before, and import surpluses during, the baby boom's retirement. One alternative to the current-law financing plan would be to peg the payroll tax more closely to the annual outlays of Social Security, which would mean that the payroll tax rate would actually decline during the next 20 years, and then increase steadily for the following 30 years. Another alternative would be the explicit infusion of general revenues into the system, particularly during the peak years of the baby boom's retirement.

The prospect of an unprecedented build-up in Social Security trust funds is joined by equally unprecedented changes in the economy. Social Security reached maturity in a U.S. economy that was not very dependent on foreign trade, an economy that was dominant in most commercial activities, and whose currency was the world's standard. American saving financed American economic growth. All that has changed. Policy analysts are just beginning to explore the implications of worldwide capital markets, of service industry economies, of our nation's new position as premier debtor. Surely all aspects of government finance—including how we pay for retirees—will be influenced by such emerging studies.

These same factors affect retirement claims that workers accumulate in the private sector through employer-sponsored plans or through their own savings, including homeownership. As with Social Security, the accumulation of private retirement wealth depends on underlying trends in employment and productivity during the period of accumulation. So too, the final value of retirement wealth depends on the capacity and willingness of society in the future to honor the contracts and debt instruments in which that wealth is embodied.

Trust fund issues are important, but this paper emphasizes program cost rather than financing. Although this discussion does not analyze alternative methods for financing future Social Security claims, the following four points should be considered as other analyses are conducted on alternative financing techniques.

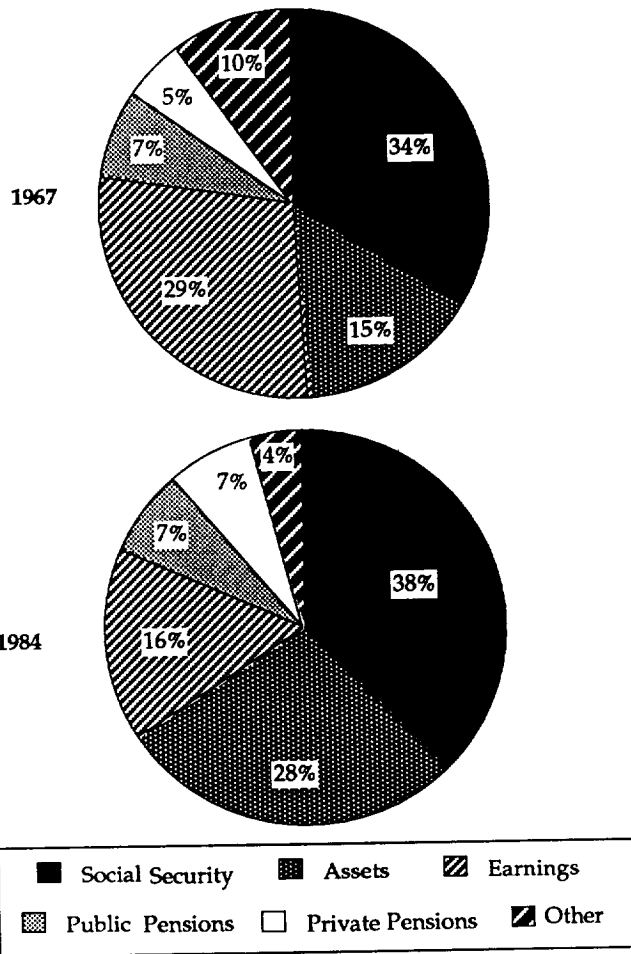
- (1) The proposed trust fund build-up is not inevitable, and Congress has the flexibility to modify it.
- (2) The cost of paying future benefits will have to be met from taxes and production of goods and services in the year the benefits are paid, regardless of the size of any trust fund.
- (3) A financing technique should be chosen to promote optimal levels of economic growth, but any technique must recognize the political importance of maintaining the people's trust in the system's future.
- (4) Different financing techniques will have different effects on income distribution.

Earnings as a Source of Income for the Elderly—Retirement ages have declined steadily since World War II. Based mainly on extrapolations from past experience, official projections assume that early retirement will continue into the future. However, workers have control over their retirement age and in the future could choose to work longer.

Past decisions to retire have been strongly influenced by levels of retirement income. For example, from 1967 to 1984, average income to the elderly (in real terms, including earnings) grew by 38 percent (chart VIII.3). These increases corresponded to the trend to early retirement during the same time. Recent retirees worked during years of rapid economic growth. Not only did their retirement income claims from Social Security and pensions grow, they were able to accumulate financial assets. Furthermore, these financial assets generated large amounts of income when interest rates were high during the late 1970s and early 1980s.

If economic growth is high, retirement income claims will be large and current early retirement trends may continue. On the other hand, if economic growth rates are lower, retirement income claims will either be relatively lower or more difficult to honor fully. The elderly may have to choose whether to work longer or to retire with a lower standard of living than they would have achieved under more favorable economic conditions. Earnings could become a greater source of income received by the elderly—as they were only two decades ago.

Chart VIII.3
Income Shares of Aged Households^a
 (All units, including married couples
 and nonmarried individuals)



Source: U.S. Department of Health and Human Services, *Income of the Population 55 and Over (1978-1984)* and *Demographic and Economic Characteristics of the Aged: 1988 Social Security Survey*.
^aIn 1984 dollars.

Adjusting Incrementally—Market conditions, democratic political institutions, and governmental policies all adjust incrementally to changing demographic, economic, and other conditions. And there is substantial time for such adjustments; the oldest members of the baby boom generation do not reach age 65 for nearly one-quarter of a century. Furthermore, this generation does not reach old age all at once, but gradually over two decades.

Given these time horizons, future Congresses will consider proposals to reduce or increase the level of Social Security benefits as they see the necessity for doing so. Until the mid-1970s, Congress consistently increased benefits for future Social Security recipients, but since the mid-1970s it has generally constrained their growth. Most recently, the 1983 Social Security amendments constrained benefit growth, both in the short and the long run. Furthermore, the level of benefit obligations earned by the baby boomers will vary directly with rates of overall economic growth. And if a worker shortage develops because of the “birth dearth” that followed the baby boom, rising wage rates could induce older workers to stay in the labor force longer.

In the final analysis, a worker’s retirement claims are only as good as the nation’s economic well-being, its traditions of obligation and trust, and the absence of conflicting priorities of overwhelming urgency. If the United States and its economic partners can successfully manage the global economy, incremental policy changes emerging from future political debates should be sufficient to accommodate retirement income needs of the baby boom generation within the framework of current policies and programs.

Paying for the Baby Boom Generation’s Health Care

Paying for the baby boom generation’s health care in old age, however, raises a different, and more troublesome, set of issues that are discussed in the sections that follow. These sections point to conditions in the U.S. health care system that will keep these issues on the national agenda through the remainder of the century and into the next—well before the baby boomers reach old age. Some of these issues are concerned with providing health care to the elderly and some are not, but any changes in the health care system in response to these issues will have important consequences for the provision of health care to an aging population. And, for a variety of reasons, the health care issues affecting the elderly will not wait until the baby

boom generation reaches old age before crowding onto the congressional agenda.

Two characteristics of medical care distinguish it from issues of retirement income. In the first place, the dollar cost of the obligation is open-ended. In contrast to income from other retirement claims, which varies more predictably with economic growth, no such relationship limits growth in medical care expenditures. The second distinguishing feature exacerbates the problem of this open-ended claim. The nation, at least tentatively, subscribes to the ideal of equitable access to medical care, regardless of income. Whereas substantial inequality in overall income status of the elderly (and other population groups) is expected, accepted, and provided for in cash retirement income programs (the means-tested Supplemental Security Income program, for example), greater equity has thus far been demanded for medical care.

Recent changes in medical care financing threaten this egalitarian view. Past methods of financial reimbursement to medical care providers enabled them to charge self-paying and privately insured patients more, so that roughly equitable medical care could be provided to patients without the means to pay. Some analysts note that recent moves to control medical care costs (by governments and businesses), if pushed to the extreme, could lead to the practice of "two-tier medicine," with population groups that rely on publicly financed health insurance (the elderly and the poor) having access only to lower-quality medical care.

Attempts to control rapid increases in the costs of health care have dominated government and private sector policy debates for two decades. Until 1970, post-World War II health care policy was successfully designed to expand the health sector's resources and access to them. Since the early 1970s, however, emphasis has shifted to reducing the rate of cost increases. Despite bipartisan efforts to slow the growth in health care costs, they have exceeded the growth in the rest of the economy during this entire period. Continuation of this trend will channel an ever-increasing portion of goods and services to the medical care industry—an outcome that might affect the overall economy by making it more difficult to generate adequate capital for future economic growth.

Furthermore, continued deficits in the federal budget at a time when medical cost increases exceed GNP growth limit the system for supporting an aging population because the bulk of these expenditures flow through the federal budget. Only the medical care costs of the elderly and poor, about one-quarter of U.S. medical costs, flow

through federal budget accounts. In contrast, most other industrialized countries have national health insurance plans covering their entire populations. Federal expenditures in this country account for about one-half of the elderly's medical care expenditures and about one-half the cost of coverage for the poor. Other population groups generally receive medical insurance as part of their overall compensation from employers, if they are employed and if their employer offers a medical insurance plan. A sizable minority are only able to buy individual health insurance policies, which are usually much more expensive. And 37 million people have no health insurance at all.

Federal expenditures for Medicare and Medicaid (the cooperative federal/state program for the covered poor) will total \$116.7 billion in fiscal year 1989, nearly 2½ times the level at the beginning of this decade. These expenditures are estimated to be about one-fifth of the nation's total medical care bill in 1989, about 10.7 percent of federal budget expenditures, and about 2.3 percent of GNP.

Growth in health care costs will be exacerbated in the future by the increasing number of elderly persons when the baby boom generation reaches old age. Any program reforms and expansions considered by the Congress must take these future demographic changes into account.

Growth in Medical Care Costs—During the past 25 years, the share of the nation's total production of goods and services accounted for by the medical care sector has more than doubled—from 5.3 percent in 1960 to an estimated 11.2 percent in 1987—a level substantially exceeding that of other industrialized countries.¹ This share has risen rapidly because growth in medical care costs has greatly exceeded growth in the economy.

Medical care expenditures as a percent of GNP leveled off at between 10.5 and 10.7 percent during 1983–1985, leading to some optimism that government and private sector cost management measures had been successful in stopping inexorable increases. However, expenditures rose again in 1986 to 10.9 percent of GNP. If percentage increases that prevailed from 1974 to 1984 are projected into the future, this figure will exceed 15 percent by the year 2000.²

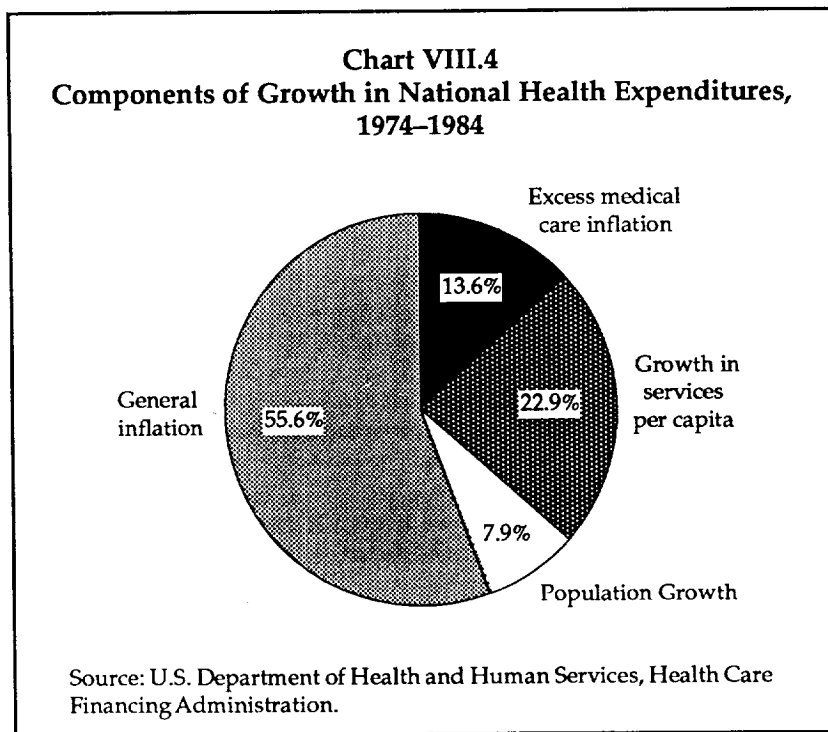
¹See U.S. Department of Health and Human Services, Health Care Financing Administration, Office of the Actuary, Division of National Cost Estimates (June 1987).

²See U.S. Department of Health and Human Services, Health Care Financing Administration, Office of the Actuary, "National Health Expenditures, 1986–2000," *Health Care Financing Review* 4 (Summer 1987): pp. 1–36.

Four factors account for growth in medical care expenditures. Chart VIII.4 indicates their relative size during a recent decade. (Relative weights of these factors have been estimated for the future by actuaries of the Health Care Financing Administration and have been used to estimate future increases in health care expenditures.)³

Between 1974 and 1984, 55.6 percent of the rise in medical care costs was caused simply by general inflation in all goods and services. A relatively small cause of expenditure increases in medical care (but one that will grow over time as the population ages) was population growth, which accounted for 7.9 percent. Thus, nearly two-thirds of the cost increases were caused by general economic and demographic conditions, not by any features of the health care system.

An additional 13.6 percent occurred because prices in the medical care sector rose faster than general inflation. Although public policies



³Ibid.

designed to limit medical care price increases have been implemented, they have had limited success. Even though success has been marginal to date, efforts will continue.

The fourth component of expenditure growth, accounting for 22.9 percent of growth, measures the intensity of services provided. This component reflects the open-ended nature of the medical obligation/entitlement. Efforts to exercise policy control over the intensity of services raises important ethical and political issues with far-reaching implications for the medical care system. However, without such control, further increases in the share of GNP going for medical care can be expected.

Intensity of services in health care becomes an issue because specific illnesses can be treated in a variety of ways, some requiring costly surgery or advanced technological techniques and others not requiring them. For example, diagnostic imaging using X-rays is much less costly than magnetic resonance imaging.* As technological innovations in medical care continue, the issue becomes more acute. Changes in the intensity of medical treatment, particularly using advanced technology, together with population aging, will largely determine the future growth of medical care as a proportion of GNP. Changes resulting from technological advances are impossible to project, but as they occur health policymakers can weigh their effectiveness in treatment outcomes against their effect on medical care costs.

In summary, people desire the best medical care possible when it is needed and they prefer the decision regarding the appropriate treatment to be made without having to take financial considerations into account. These views, while understandable for emergency or life-threatening conditions, constitute a formula for continued growth in medical care costs. Deliberate (though difficult) policy decisions to control intensity of services can be made by private and governmental medical care policymakers. If cost management efforts are unsuccessful, however, economic pressure could lead to a financial rationing of care in a medical care system in which individual doctors have relatively less control over appropriate medical treatment.

The Elderly: Growing Numbers and Intense Users of Medical Care— The elderly require more medical care than younger age groups. Thus, continued improvements in longevity rates could independently in-

* Editor's note: This is an imaging technique based on the physical response of atomic nuclei to the imposition of a forceful external magnetic field and therefore not requiring the ionizing radiation associated with x-ray technologies.

crease medical care spending. Demographers project that the population age 85 and older will grow from 2.2 million in 1980 to 7.1 million by the year 2020—a tripling over this 40-year period (chart VIII.1). People age 85 and older require significantly more nursing home care and other treatment because of the much greater incidence of chronic ailments that prevent them from taking care of themselves and often from being cared for at home. Thus, longevity improvements will exert pressure on the medical care system long before the baby boom generation reaches age 65. When the baby boomers become very old (starting in 2030), the pressures will worsen. The Census Bureau projects 16 million in the 85 and older cohort in 2060.

A complex relationship exists between increases in the number of elderly and increases in medical care expenditures. People over age 65 used three-and-one-half times more medical care than the under age 65 population (\$4,200 per year compared to \$1,200), but these averages hide important distinctions. The elderly population (age 65 and over) varies greatly in its use of medical care, with the average for the age 65 to 74 group only slightly greater than younger age groups. Those age 75 and over (and particularly those age 85 and over) use much more medical care. One way to view the issue is to calculate the cost of medical care during the last year of life, regardless of age. In 1978 average medical care expenditures for Medicare patients during their last year of life were \$4,527—in contrast to \$729 for enrollees who did not die.

Demographers agree that future elderly persons will live longer. However, they disagree over how much longer and over reasons for longevity increases. If increases in lifespan are accompanied by corresponding improvements in the health status of the elderly, more people living to late ages would not by itself result in major resource shifts to the medical care system. (In this case, the amount spent during the last year of life, whether death occurs at age 65 or age 80, would largely determine expenditure levels.) On the other hand, if increases in lifespan occur because intensive use of medical care technology extends the period preceding death, when the elderly suffer from chronic (and expensive) illnesses, the open-ended nature of medical care obligations will lead to substantial growth in expenditures for an aging population. Health economist Robert G. Evans has formulated the issue as follows:

... it is not the increasing numbers per se of the elderly which are creating strains on the health care system, and by extension increasing claims by that system on the resources of the rest of society. Rather it

is the way in which the health care system reacts to the elderly, the expanding service mix on the intensive and extensive margins, which is creating economic strains as well as serious questions about the effectiveness and the appropriateness of that response.⁴

Pressures for Program Reform and Expansion—To review briefly, economic, ethical, demographic, and scientific factors combine to produce upward pressures on health care costs. Containing and managing these pressures will probably require extraordinary political skill. Furthermore, “gaps” in the U.S. health care system will, if filled, add to upward pressures on costs and program financing. These are discussed below. Ultimately, the amount of resources going to the health care system, whether 11 percent or 15 percent, or more, cannot be determined by analysts but could be by consumers, suppliers, and political leaders.

Pressures exist for substantial change in the medical care system (usually called reform), independent of the aging baby boom generation. In particular, most of today’s elderly have no insurance to pay for long-term care, 37 million nonelderly have no health insurance at all, and Medicare’s two trust funds face financing problems. As Congress grapples with these current issues, the specter of long-run population aging and actuarial projections of attendant program costs serve to limit legislative solutions. To summarize, pressures for program reform are driven by short-run problems, and potential solutions should be reviewed in the light of longer-run concerns. Short-run legislative action will be directed at:

- Gaps in health insurance coverage
- Medicare’s financing problems
- Retiree health benefits

Gaps in Coverage—Claims for most retirement income are built up over a working career to be drawn upon in old age. In contrast, access to the medical care system is often thought of as a right available to all people. Exercise of this access is facilitated by insurance, and those seeking to fill gaps in medical care coverage usually refer to a lack of, or inadequate, health insurance. Other industrial countries generally provide publicly financed or mandated health care for their entire population, but in the United States health insurance for most

⁴See Robert G. Evans, “Illusions of Necessity: Evading Responsibility for Choice in Health Care,” *Journal of Health Politics, Policy and Law* 3 (Fall 1985): 446–7.

working people and their dependents is provided as a tax-subsidized component of employment compensation. Of the estimated \$497 billion spent for medical care in the United States in 1987, roughly one-fourth flowed through federal or state government budgets that paid the medical care bills for the elderly, the disabled, and the eligible poor under the Medicare and Medicaid programs. The remainder of the nation's medical care bill was paid by private (mostly employer-sponsored) insurance or unreimbursed out-of-pocket expenditures. So-called gaps in health insurance coverage affect both the elderly and the nonelderly populations.

When Medicare was enacted in 1965, its benefit structure was patterned after common acute care private insurance plans of the time—principally Blue Cross and Blue Shield plans. Medicare's benefits have changed little since then. In the meantime, private health insurance plans have changed. In contrast to Medicare, for example, many private plans now provide some dental and outpatient drug coverage. Furthermore, Medicare's reimbursement methodologies (including enrollee-required deductibles, copayments, and premiums) may not provide appropriate utilization incentives. However, the Medicare Catastrophic Coverage Act of 1988 places a ceiling on Medicare enrollees' out-of-pocket expenditures and adds outpatient drugs to Medicare covered services.

Congress also is concerned about a much larger and costlier gap in program coverage for the elderly. Surveys show that most respondents think Medicare pays for long-term care—that is, medical and custodial care provided for those with chronic conditions such as paralysis from strokes or severe arthritis. However, Medicare's current benefit structure does not provide such services, the demand for which will almost certainly increase steeply in the decades ahead as the number of the very old grows. In 1985, approximately 1.4 million elderly persons, or 5 percent of the total elderly population, resided in nursing homes. Projections based on the 1977 National Nursing Home Survey and the 1982 Long-Term Care Survey estimate that the nursing home population will more than double, to 4.4 million by 2040.⁵ The expected doubling in the number of 75- to 84-year-olds between now and the year 2050, and the projected sixfold increase

⁵For further discussion of financing long-term care services in the future, see Carol O'Shaughnessy, Richard Price, and Jeanne Griffith, *Financing and Delivery of Long-Term Care Services for the Elderly*, Congressional Research Service Report #87-143 EPW (Washington, DC, U.S. Library of Congress, 1987).

in the number of people over age 85, portend a potentially enormous increase in the demand for long-term care.

In a special report to President Reagan on the question of catastrophic illness expenses, Secretary Otis Bowen of the Department of Health and Human Services explained the report's recommendations regarding long-term care. In doing so, he captured the dilemma facing the Congress and the nation on this issue.

Unfortunately, no immediate resolution of this problem is possible without the infusion of large sums of federal monies. Given current budget constraints, this is not a feasible solution. Longer term private sector partial solutions are feasible. However, decisive action is needed now if we are to have these mechanisms in place in time to address the enormous public policy crisis that the baby boom generation will present when they become the elder-boom in the ensuing decades.⁶

Limited coverage is offered by the few long-term care insurance policies available from private companies. While growing in number, private insurance policies for long-term care are not widely available nor affordable by large numbers of the elderly. Of the existing long-term care policies, most provide indemnity benefits, generally for nursing home care, that pay a fixed amount for each day of covered service. Home care benefits, especially those related to custodial care, are less common. Plans that provide any coverage for home care may require a prior stay in a skilled nursing facility. This limits benefit payments for home care and helps to keep the premiums for these policies affordable. However, this benefit structure does not assist persons who have not been institutionalized and for whom home care services might delay the need for admission to a nursing home.

Proposals to expand insurance or other financing for long-term care raise serious budgetary and financing problems. At present, some \$25 billion is paid for long-term care—about one-half by the Medicaid program for the elderly poor (including those who have become poor by spending their assets to qualify for nursing home care under Medicaid) and one-half from out-of-pocket sources. In addition, an indeterminable demand for such care is now met in home settings by relatives. Concern about potential expansions in demand for care in institutional settings has deterred attempts to add an open-ended, long-term care benefit to Medicare.

⁶See U.S. Department of Health and Human Services, *Catastrophic Illness Expenses* (Washington, DC, U.S. Government Printing Office, 1986) p. ii.

Medicare's Financing Problems—The specter of a financial crisis in Medicare has hovered over the program for the past decade. While the analytical focus should remain finally on the cost of programs rather than on their financing mechanisms, threatened trust fund depletion requires congressional action.

Five years ago Medicare's board of trustees projected depletion in the HI program by 1988. In subsequent annual reevaluations, the board of trustees has pushed the year of trust fund exhaustion further—to 2005 in its 1988 report. The trustees, however, also estimate that program expenditures will exceed current payroll tax revenues starting in 1998, with the gap widening for Medicare's entire 25-year and 75-year estimating periods. The reprieve from 1988 to 2005 for fund exhaustion occurred in part because the Reagan administration and Congress have held expenditures under Medicare's new prospective payment system for reimbursing hospitals below initial estimates.

The potential financial imbalance in the HI program's trust fund lurks in the background of debates about medical care policy. Five years ago, when trust fund depletion seemed imminent, a Social Security Advisory Council proposed a series of benefit reductions and trust fund revenue increases to restore the program to actuarial balance over the next 25 years. The HI financial outlook has improved since that time even though the bulk of the advisory council's proposals were not enacted. While the short-run financial picture is brighter, program actuaries still project an actuarial imbalance over the next 25 years. Indeed, the HI trust fund would go to zero in 2005 (based on the board of trustees' intermediate assumptions) according to the latest estimates. However, starting in 1998 benefits paid out of the HI trust fund will begin to exceed payroll tax revenues into it. When this happens, the net effect of the HI program will be to add to the budget deficit, which may spur renewed cost containment proposals.

Trust fund depletion would occur earlier if economic conditions should be less optimistic than the actuaries' intermediate assumptions. Furthermore, the 25-year estimation period stops short of the year in which the oldest cohort of the baby boom reaches age 65. One way or another, this basic financial imbalance will have to be resolved if medical care costs continue to outpace growth in the overall economy.

Medicare also pays for physician services, both in and out of hospitals, through the Supplementary Medical Insurance (SMI) program. Financing for this program, part B of Medicare, does not come from

the payroll tax, which is used for hospital insurance. Rather, costs are shared between enrollee premiums and general fund revenues. In 1965, when the program was enacted, legislators required enrollees to pay about one-half of program costs, with the other one-half coming from general revenues. However, the years since the passage of Medicare have seen inflation in medical care costs far outstrip price increases in the overall economy, causing SMI premiums to rise much faster than Social Security cash benefits, which were linked to general price inflation. To solve this problem, Congress in 1972 limited the extent to which SMI premiums could increase. Over time, the enrollees' share shrank to under 25 percent, with general revenues picking up over 75 percent. (Current law has established the enrollee premium and general revenue shares at 25 and 75 percent, respectively.)

General funds sufficient to make benefit payments under SMI are automatically appropriated, and thus, under current law, SMI's trust fund would never become depleted. Nonetheless, analysts identify a financial imbalance in SMI because as long as medical care costs increase faster than general fund revenues, SMI will require an increasingly larger share of the federal budget and overall national resources.

Over the years, public and private groups have proposed major changes in Medicare, including combining the HI and the SMI trust funds and revamping the benefit structure of Medicare to include provision for long-term care. Such proposals have not yet reached the active legislative stage.

*Retiree Health Benefits*⁷—Many medium-sized and large employers pay for health insurance after their employees retire. Employees usually qualify for these benefits after working 10 or more years and achieving a certain age. When a worker retires before age 65, the employer's health plan may be his or her only source of health insurance until he or she becomes eligible for Medicare and an important source of additional coverage thereafter. In 1983, an estimated 6.9 million retirees and their dependents were covered by employer-sponsored health plans.

Congress is becoming increasingly concerned about the future of employer-financed retiree health benefits. As more and more companies seek to reduce or terminate their plans, the danger grows that retirees will lose an important source of privately sponsored health insurance.

⁷This discussion draws heavily on Beth C. Fuch, "Health Benefits for Retirees: An Uncertain Future," *CRS Issue Brief*, IB880011 (updated regularly).

A number of factors are converging to make retiree health insurance more expensive for employers, including health care inflation, continued early retirement, increasing longevity, and changes in Medicare payment policy. Over time, companies have accumulated large unfunded liabilities for the coverage of current and future retirees. All but a small percentage of firms that offer retiree health benefits pay for the benefits as they are incurred. The total unfunded liability of employers for future retiree health benefits has been estimated to be in excess of \$100 billion. The liability question may become explosive if the Financial Accounting Standards Board (FASB) promulgates rules requiring companies to recognize the aggregate costs of their retiree health plans on financial statements. Companies with substantial commitments to pay for their retirees' health care and little in the way of funds to pay for them may be viewed as poor investment risks on Wall Street.

Some companies have already sought to reduce their retiree health commitment by modifying or eliminating their plans. Others have tried to eliminate their liability through Chapter 11 reorganization under the U.S. Bankruptcy Code. The latter approach was taken by the LTV Corporation. After filing for reorganization in 1986, LTV terminated health and life insurance benefits for more than 78,000 retirees. The company restored the benefits after substantial public pressure, and Congress stepped in with a stopgap measure to protect the LTV retirees.*

The LTV case sent a warning that retiree health benefits are uncertain for current, let alone, future retirees. In the 99th Congress, legislation was enacted to temporarily ensure that retirees of certain companies that had filed for bankruptcy continued to receive health benefits. Legislation to permanently safeguard retiree health benefits in cases where companies file for reorganization under the U.S. Bankruptcy Code was enacted in the 100th Congress. Bills have also been introduced to encourage employers to prefund and vest retiree health benefits. Finally, the Reagan administration has submitted a proposal to Congress that would permit employers to use part of their surplus pension assets to fund health benefits for current retirees.

Approaches to Reform—The 101th Congress will face concerns over program and policy changes in medical care. Many of the concerns will rank high on the legislative agenda in the future, as they have in the past. Policy concerns will be directed at:

- providing greater access to medical care by closing gaps in current insurance coverage (for both the elderly and the younger populations), and

- controlling the rate of increase of medical care expenditures (particularly for publicly financed care) while maintaining the quality of care.

Unfortunately, these two objectives are incompatible. Increased access would cause additional pressure on costs, while cost containment programs carry the danger of denying appropriate medical care to those who need it.

Over the past decade, policymakers and analysts have debated competitive as opposed to regulatory means of reforming medical care. This debate, which will continue, reveals basic disagreements about the nature of medical care and the role of government in our society. A competitive market would allocate the share of national resources to be devoted to medical care by letting individuals buy what they can afford from the private services provided. However, some could afford very little care. Furthermore, the necessary conditions for efficient competitive markets are arguably less available in the area of medical care than they are for other goods and services. For example, patients have little ability to evaluate their own need for medical care and are usually not in a position to bargain over prices.

Competitive market solutions rely on two principles:

- Providing incentives for efficiency by consumers at the time of the decision to purchase health insurance or to pay deductibles and copayments at the time of treatment since the desirability of health care is not questioned.
- Putting medical care providers at risk for treatments and outcomes of medical treatment—for example, through promoting the use of various types of medical care organizational arrangements (health maintenance organizations and others) in which the providers take financial risk.

During the past decade, private businesses have become much more conscious of the cost of their employer-sponsored health insurance obligations and have moved aggressively to promote competitive market solutions. The Reagan administration advocated such policies for the Medicare program and encouraged states to do likewise with Medicaid. In addition, greater cost sharing by Medicare enrollees was proposed in annual budget submissions from the administration, but Congress rejected these as excessively injurious to the elderly and the poor.

The Reagan administration attempted to instill competitive market principles in the Medicare program through support for voucher proposals and through proposed expansion of Medicare's use of alternative delivery systems (HMOs, PPOs, etc). For example, in its

submission to Congress for fiscal year 1988, the administration's budget included proposals for:

... urgently needed Medicare reforms that will restrain the rapid growth in federal health spending and, in turn, will help improve the nation's competitive position. The principle of capitation—paying a fixed, pre-determined price for health services—would be expanded in Medicare and Medicaid, replacing the inflationary incentives inherent in cost reimbursement. By creating incentives for the efficient delivery of quality care, capitation and other reforms can bring to federal programs the same efficiencies realized by employers and private insurers.

These efforts did not receive a sympathetic hearing by Congress.

In 1983, Congress enacted major changes in the way Medicare pays hospitals under the HI program. Program changes required payment of a fee fixed in advance (varying according to 475 "diagnosis-related groups") for treating Medicare patients, rather than paying after the fact for whatever allowable costs the hospitals incurred. This and similar proposals for changing physician reimbursement provide incentives to hospitals and to physicians to offer less costly treatments.

Efforts for controlling rates of growth of medical care costs will undoubtedly continue in future years—both from government and private sector sources. At the same time, concerns will continue to mount regarding the need to provide sufficient access to medical care for all. To the extent such efforts are successful, one result will be to add pressures on medical care costs. The 100th Congress began addressing some of the access issues with its passage of the 1988 Medicare Catastrophic Coverage Act, which protects beneficiaries against major hospital and physician charges. Congress also considered legislation to put a ceiling on the amount Medicare enrollees would have to pay for inpatient hospital care. Pending legislation would establish long-term medical care under Medicare and mandate employer-sponsored health insurance for all employees (37 million individuals do not have insurance because they are in families with heads who are either unemployed or work for employers who do not provide health insurance).

These proposals are controversial, and the debate over how to provide greater access to medical care for uncovered services and populations undoubtedly will continue into the future.

With continuing pressures on the overall economy and on government budgets and with a perceived need for additional medical care coverage, various possible ways to finance greater medical care access are being considered. Briefly, two possible ways of viewing the fi-

nancing questions seem directly relevant to concern about an aging population and the baby boom's retirement. First, radical change could base eligibility for Medicare on health status rather than on age. Most people aged 65 to 75 remain in good health, as opposed to those a few years older. Secondly, care for the elderly poor could be financed by requiring larger payments by the more affluent elderly for their Medicare protection.⁸ Over the longer run, either approach implies that some or all of the elderly will have to devote an increasing share of their cash income from Social Security, pensions, or other retirement savings to pay for medical insurance premiums. Of course, this would not be a completely new development. Currently, some 70 percent of the elderly supplement their Medicare coverage with private Medigap policies, paying the premiums from their after-tax cash income. Some Medigap coverage, however, is provided as non-taxable employer-paid health insurance for former employees (generally called "retiree health benefits").

Policies that further shifted medical premiums to those elderly who are comparatively young or wealthy would have several consequences. For many, less cash income would be available for nonmedical expenditures. Arguably, such a shift might also increase the demand for post retirement health insurance benefits, which in turn could lead to lower pension benefits (or possibly lower current cash compensation to those still in the work force). In contrast to cash benefits, retiree health benefits are not taxed, and accordingly, tax revenues would be lower.

If the elderly, on the other hand, are not required, by these or other means, to explicitly pay for more of their medical insurance from their own income, then the budgetary costs of Medicare will be greater. To keep overall federal spending on the elderly within certain bounds, those larger Medicare costs could cause future Congresses to curtail growth in Social Security benefits. Such action would decrease the cash income that the elderly would have available for nonmedical expenses; however, the distributional effects could be different.

As long as any explicit cost-shifting to the elderly basically takes the form of higher premiums for Medicare or Medicare substitutes, the elderly's overall use of medical care is unlikely to change. As discussed earlier, the tradeoff between risk-sharing and utilization

⁸This approach was introduced in the 1988 Medicare Catastrophic Coverage Act, under which out-of-pocket expenditures are financed by the covered elderly population. The higher-income elderly pay more for their Medicare protection, which introduces an element of income-testing into the program.

incentives exists in both government or privately financed health insurance. Even now, Medicare and Medigap insurance reinforce one another. Medicare helped create the conditions for the Medigap insurance market to exist; paradoxically, the prevalence of Medigap coverage likely increased overall utilization and, therefore, Medicare costs. As long as the government is involved to any significant degree in the financing of the elderly's medical costs, long-term pressure for increased government involvement in the pricing and use of health care by the elderly is unlikely to diminish.

Conclusion

In conclusion, demographic trends that measure the aging of the population and the retirement of the baby boom generation are now widely recognized, and the heightened public awareness has caused some concern about future old-age financial security, including financial access to medical care. Consequently, considerable public attention has focused on policies that affect contemporary workers' future retirement and old age. However, refining the society's system of retirement income and medical care claims so that all citizens can expect to accumulate an adequate combination of assets and rights for their retirement years will not in itself assure that those expectations can be honored when they come due. The potency of the claims depends upon the vitality of the economy within which they are presented as well as on the public policies that create them. These assets must retain their value and these rights must maintain their support. Both depend on the health of a future economy of which little is certain, although a suspicion persists that some of what we are now doing is endangering it.

IX. Social Security in the 21st Century

REMARKS OF DORCAS R. HARDY

Introduction

As we contemplate the beginning of the next century, we need to think more systematically and more critically about the future of our national retirement income system. Social Security should be included in this process of review and reexamination because it is the nation's largest source of retirement income and the largest domestic commitment of the federal government.

The first "baby boomers" have passed age 40, and we should be increasingly concerned about our own retirement as we move into the next century. The dependency ratio of retired to employed persons will not change dramatically between now and the year 2000, but soon after it will begin a very steep increase unless there is a shift toward much older retirement ages. The more farsighted baby boomers should be thinking about employee pensions and private investments as alternatives to Social Security, since there will be fewer workers contributing to the program than there are at present.

There will be about 10 million more retirees at the beginning of the century, just 12 years from now. Those retirees will be expected to live more than 20 years after they stop working—that is four to six years more than today's average.

Since the Social Security system was adopted in 1935, we have changed from a nation of farmers to a nation of factory workers, and now to a nation of office workers. We have moved from an industrial economy to what some call a service or information economy.

These changes and others will challenge many of our basic assumptions about traditional work patterns, and they will require all of us to make adjustments in our thinking about work life, retirement, and, ultimately, about Social Security.

We undoubtedly know more about the probable shape and content of the future than any previous generation. The question before us is, "Will we have the foresight and the courage to apply this growing body of knowledge, now that we are so smart, to the future of our Social Security program, as well as to our nation's retirement income system?"

Social Security's Role

I do not have an answer to that question, but I would like to share some information and views on three important aspects of the Social Security system: (1) the status of the program, particularly its financial status, through the end of this century; (2) the current and future responsibility that all of us share to inform and educate the public about what Social Security is and is not; and (3) the need to reflect and plan for changes in the program's provisions, to get ready for the future.

First, we should look at the program's financial status—where are we today and where are we going to be 12 years from now. Social Security is part of that proverbial three-legged stool that is the national retirement income system—Social Security, employer pensions, and personal savings and assets. Many would agree that this retirement income system is more of a *de facto* arrangement than a coordinated national policy.

I do not mind a lopsided stool, in which two legs are long and one shorter, if Social Security is the shortest leg. But we know that many workers continue to rely very heavily on Social Security, which represents about 40 percent of retirement income for most retirees and up to 75 percent for lower-income workers with little or no other pension coverage.

Although more and more retirees are receiving a private pension benefit—about 40 percent of total retirees—this number is, unfortunately, not expected to be more than 60 percent by the time we get to the year 2000. Moreover, it is easy to overlook the fact that private pension benefits in many cases still do not represent a significant portion of total income for most retirees, since on average it is less than 20 percent.

A hard look at our retirement income system leads one to the conclusion that we have a very wobbly three-legged stool to rest on in our retirement. Being wobbly is not, in itself, necessarily a problem; it is the size of the respective legs that concerns me.

Public Perception

The absence of a more coordinated pension policy at the national level is further exacerbated by several recent events that have severely undermined the public's confidence in their future retirement security. The severe financial crisis of Social Security in the early part of this decade left a very deep impression on younger workers and tax-

payers. A recent survey conducted by the Home Testing Institute found that almost 70 percent of 18 to 45 year-olds said they were “not too confident” or “not at all confident” in the future of Social Security.

Frequent government intervention in the regulation of employee benefit plans has left the pension private industry, in many cases, feeling battered and bruised and has no doubt slowed the extension of private pension coverage to more workers. Even with regard to private savings initiatives, Congress has sent mixed signals to the public by changing the tax treatment of individual retirement accounts, for example, for most middle-income Americans.

One of my responsibilities has been to educate the public about the future financial stability of the Social Security program and to assure current and new beneficiaries that their benefits will be paid on time and in the right amounts.

Growing Trust Fund Reserves

The 1988 trustees’ report affirms that the Old Age, Survivors, and Disability Insurance (OASDI) funds will remain in actuarial balance over the next 75 years, with increases in the reserves continuing to grow for about the next three decades. After that point, the retirement of the baby boom starts to have a negative impact on the trust funds, which begin a gradual decline until they are exhausted about 60 years from now, or sooner. Nevertheless, we will be in good financial shape to permit timely payment of the right amount of benefits for many years to come, *if* our actuarial projections are correct and *if* the trust fund reserves are allowed to build.

The assumptions used in the trustees’ report include the following, over a 75-year period: a fertility rate of 1.9 children per female, a 4 percent average increase in the Consumer Price Index, 6 percent unemployment, and 600,000 net migration. Some say those assumptions are too optimistic, some say they are too pessimistic, but that is what we have at the moment. We need to make sure that, to the best of our ability, we continue to update those and adjust our assumptions in the future based on the correctness and adequacy of our actuaries’ projections.

A significant innovation has been adopted by the board this year to better reflect the importance of interest income to the trust funds as reserves accumulate in the future. The trustees have adopted an approach for the present and future reports which takes more explicit account of interest income. For example, according to current pro-

jections, interest income will rise from about 5 percent of our total income in 1990 to almost 24 percent in the year 2020. For those who remember the financial crunches of previous years, this is quite a change, and it needs to be reflected in our long-range financial projections.

The growing Social Security reserves and interest income have certainly not gone unnoticed by the press or, more significantly, by members of Congress. The debate has already begun and can only be expected to intensify as to whether we should leave in place the payroll taxes and benefit levels recommended by the president's bipartisan Social Security Reform Commission and legislated by Congress in 1983.

This is very recent history, but I think it is worthwhile to refresh our memory about what Congress did to stabilize Social Security financing for the future, and why. The 1983 legislation formalized the concept of moving from a pay-as-you-go method of financing to one of partial funding to pay for the baby boom's retirement. Today about 12 to 13 percent of our Social Security tax revenue goes into the reserves.

The elderly population in the United States will more than double between now and 2020. Unfortunately, after the turn of the century, the growth in the work force will not keep pace with the aging of the population, unless, of course, we all work much longer. In fact, by the year 2025, we project that Social Security will be paying out more than \$3.5 trillion in benefits a year—or almost \$10 billion a day. Today we spend \$600 million a day. That means that now is the time for us to make a concerted effort to increase savings for retirement. This strategy clearly implies that we will have to defer some consumption over the next few decades, which could be used for other public or private purposes.

This belt-tightening exercise is necessary. We have an obligation to ensure payment of Social Security benefits not only to today's elderly but also to today's workers, who will be tomorrow's retirees. If we do not plan now, the baby boomers' children and even their grandchildren will have to pay extraordinarily high payroll taxes—unless we decide, as a society, to have a totally different system.

If we succeed in explaining to the public the reasons behind the trust fund build-up, it will go a long way toward restoring public confidence in the program and perhaps easing the burden of paying much higher payroll taxes in the future.

There are potential pitfalls associated with the continued build-up of the trust funds. The trust fund build-up could, and most likely will,

delude our lawmakers into thinking that we have more funds available for non-Social Security (non-OASDI) programs in the federal budget. Currently, and for the next several years, the Social Security trust funds are counted toward meeting the deficit reduction targets of Gramm-Rudman-Hollings, so that increases in the trust fund reserves can substitute for deficit reduction elsewhere in the budget.

To the extent that the trust fund reserves substitute for other deficit reduction, savings are not increased and the Social Security payroll taxes are simply being invested and borrowed against to fund other government spending. That means we must bring the budget deficit under control, and there may be very unpalatable choices that we will have to make in order to pay for and ensure future benefit expenditures.

Although this may sound rather like using magic mirrors to handle federal budget problems, we need to explain the situation clearly to counteract another potential threat to the trust funds. This threat appears in the guise of proposals to use the reserves for such purposes as raising Social Security benefits, cutting payroll taxes, and fixing the so-called "notch" issue in Social Security programs. Even more risky is using the reserves to expand Medicare by creating some form of long-term care insurance at the federal level.

There is at least one thought that encourages me to believe that our legislators will act responsibly as the annual trust fund balances begin to grow even larger. By the mid 1990s, the baby boom generation—the people depending on the reserves to pay their benefits—will make up the largest and most influential voting bloc of the electorate.

The Need for Public Information

We need a great deal more public information and understanding about what Social Security does and how it works. Our recently launched Ad Council campaign is a good start in that direction. I have also tried to get people to focus on what will be there for them in the future. We will soon begin issuing improved personal earnings and benefit statements that will include a year-by-year breakdown of earnings, with corresponding FICA tax payments; a wider range of benefit estimates, including disability and survivors estimates and more realistic retirement estimates that use lag earnings and projected future earnings; and insured status requirements for all three types of benefits and the requestor's current number of credits.

The Decision to Retire

Among the issues needing urgent attention is the influence of Social Security provisions on the decision of when to retire. The average age of new retirees has been steadily declining. For example, according to the Bureau of Labor Statistics, only 16 percent of men age 65 and over were in the work force in 1985. There are a number of reasons for this sharp decline, but Social Security has been a contributing factor, because there are some specific disincentives built into the program.

The worst offender is the so-called "retirement test." People age 65 through 69 who work and earn more than \$8,400 in 1988 have their Social Security benefits reduced by one dollar for every two dollars they earn over that limit.

Senior citizens should be allowed to continue to participate in the work place, remain productive members of society, and not be forced into the so-called "gray underground economy" working for under-the-table money. I have joined U.S. Department of Health and Human Services Secretary Otis Bowen in calling for the elimination of this antiquated provision.

We all agree that we need a more flexible labor force in the future, entailing more frequent job changes as well as temporary and part-time work. Older workers represent a valuable pool of experience, and it no longer makes sense to retain a provision which discourages them from taking part in this more flexible work force.

I would like to challenge personnel directors and benefit specialists to reexamine their employment practices and, particularly, their pension plans, to assess *why* workers are leaving the labor force at increasingly earlier ages. In spite of recent legislative changes that require that private pensions allow workers to continue to accrue retirement credits if they work past the normal retirement age, the trend continues to be in the opposite direction, toward early retirement.

This trend seems to be further exacerbated by the same lack of knowledge among employees about their future private pension benefits as we have already encountered with Social Security. For example, a recent survey by the General Accounting Office found that over 70 percent of workers in defined benefit plans were incorrect about when or under what conditions they would be eligible for early or normal retirement benefits. This level of misunderstanding will become increasingly critical if private pension plans continue to encourage early retirement at a time when Social Security raises its

normal retirement age in stages from 65 to 67 at the beginning of the next century.

Disability Insurance

Another issue that we need to examine more closely is disability insurance. Our actuaries project that one in three males will qualify for disability insurance benefits before reaching the normal retirement age at the beginning of the next century; the projection for women workers is one in four. It is, therefore, not surprising that the 1988 trustees' report notes 1998 as the date of exhaustion for the Disability Insurance trust fund. That is a surprising number of people. In spite of the strict definition of disability used by Social Security for determining eligibility, the program is being used by a significant number of workers (and employers) as an early retirement program. This is confirmed by our relative lack of success in getting disabled people rehabilitated and reemployed. The Disability Advisory Council reports that less than 1 percent of disability beneficiaries leave the Social Security rolls each year to resume work. This number undoubtedly masks an enormous and tragic loss to society of the skills and experience of tens of thousands of disabled persons.

Funding Considerations

We must consider issues pertaining to the long-range future of the system. We have a responsibility to today's taxpayers as well as an obligation to examine the issues that will face Social Security's youngest citizens—those who are now in nursery school or kindergarten.

In 1980, the Social Security tax rate was 6.13 percent of the first \$25,900 in earnings, and the maximum tax paid by wage earners in 1980 was \$1,587. Today, workers pay 7.51 percent of the first \$45,000 in earnings. That means that a person with maximum Social Security covered wages will pay \$3,379 in 1988, more than twice as much as the maximum rate paid just eight years ago. In fact, a worker who contributes the maximum into the program in 1988 will pay as much in Social Security taxes *this year* as the worker who paid the maximum Social Security tax during the first 33 years of the program!

That is why we must be sensitive to the concerns of young people. Up until now the public has generally been tolerant of the payroll tax, in part because of the clearly visible evidence of the program's advantages to members of virtually every family. One out of six of us receives a Social Security check every month. Partially because

Social Security's success, however, the poverty rate for the elderly is lower than that of the workers who are, at least in part, supporting them. Moreover, the average wealth of retired families is, not surprisingly, substantially higher than that of the average working-age family. These are all averages, but there still comes a point when support of the program becomes as much a question of *ability* to pay as of *willingness* to pay.

As today's children become adults, the problems associated with support for Social Security will be compounded by demographic factors. Demographics will affect not only the financing of the program—in terms of there being fewer workers to support an increasingly large number of retirees—but will also affect the political consensus on which the program rests.

We need to avoid intergenerational conflict, and must examine and reexamine whether the "right level" of resources is being transferred from the working to the nonworking population. The right level, of course, is simply the level that has the greatest political acceptability.

The Importance of Private Sector Programs

Private pensions need to be encouraged and expanded. Social Security cannot and should not be expected to constitute the primary source of retirement income for most Americans. There are practical limits to what one program can be expected to do in terms of individual needs.

One of the many strengths of the American system has been its combination of public and private efforts. Regarding retirement income, I think we have put too much emphasis on the public efforts, and it is time to recognize and articulate efforts in the private sector that enable *individuals* to plan for their own retirement.

I would like to work with you, as representatives of private-sector approaches, to encourage a discussion of the future relationships of public and private pension arrangements and to broaden the public debate on the future of our national retirement income system.

A Shift toward Self-Reliance

I would like to leave you with a view that is important to our deliberations on the future of public and private retirement: We are emerging from an era characterized by the creation of increasingly generous and extensive publicly provided entitlement programs for retirement and other benefits and moving into an era characterized

by more self-reliance and individual responsibility. Several factors seem to be contributing to this subtle shift in our national mentality:

- Continuing public deficits have severely constrained social experimentation and benefit improvements at the federal level.
- Severe shake-ups in the financial markets, numerous corporate takeovers, and increased foreign competition and ownership of companies have made employees less confident about relying on employers to provide for their old age.
- We have also learned certain lessons from our foreign competitors—particularly in Western Europe—where the highly complex and generous systems of social benefits have undoubtedly retarded economic recovery, particularly job creation for younger unemployed workers. A more flexible economy has distinct advantages when facing the future.

We have, relatively speaking, a reasonable amount of time before the bulk of the baby boomers begin retiring. We have a great deal to do, but I view this as an opportunity and as a challenge. Let us not allow this rather unique public policy opportunity slip away by simply continuing to muddle through until the next century. Let us use this opportunity to make some decisions for our future, as well as that of our children.

X. Part Two Discussion

Insurance Risks

MR. JACKSON: I have two comments on John Palmer's paper. He states that . . . "the risk of adverse selection—the ability of low-risk persons to opt out of insurance—means that actuarially fair insurance markets simply do not exist, except where participation is compulsory." I do not see any fairness at all in forcing individuals into an insurance system if they perceive the cost of insurance to be far greater than the value they assign it. Compulsion does not give you actuarial fairness; all it gives you is a greater spread of risk.

I think the private insurance sector, in which participation is voluntary and participants are charged the average cost that they incur, is a much fairer system.

Next, Mr. Palmer made an observation about rationing medical care. He indicated that medical expenditures may eventually account for 30 percent of the Gross National Product (GNP) and that one of the ways of limiting medical care cost increases was by limiting technology.

I think this is most unlikely. In fact, I think it will never happen, because I think the desire to go on living is far more basic than the desire to keep the medical expenditures under 30 percent of the GNP.

MR. GARBER: I have to say that the intent of limiting technology is to make sure that the technology being brought in is useful and cost effective. This does not have anything to do with the issue of prolonging life. A lot of new technology is being introduced that, according to what doctors say, cannot pay for itself. This is just nonsense. In the end there has to be a way to control—if not the technology itself—at least how many of the different kinds of machines there are and in what places.

Medical technology is a cost item that can be dealt with more thoroughly without getting to the issue of length of life.

Increasing National Savings

MR. HOBBIIE: We have heard much about overconsumption and the need to increase our savings quickly. Royal Shipp, did the CRS study

for the Ways and Means Committee look into ways of increasing our national savings rate, and if so, what are they?

MR. SHIPP: We looked at those, and our conclusion was that it is important that it be done. And the most likely prospect for doing so is to reduce the federal budget deficit. Private sector efforts might help, but they probably could not be expected to help much to stimulate private savings.

Taxes and Early Retirement

MR. SEIDMAN: I will comment on what may appear to be three different points. But what they have in common, at least from my point of view, is that the conventional wisdom on the subject—some of which is public knowledge and some of which is more or less confined to experts—is not necessarily true.

And the three examples I have are employment taxes, the value added tax, and the question of postponing retirement.

I have to be very sensitive to the concerns of workers about the taxes that they pay.

I have been expecting, and I have been hearing from my trade union colleagues for a long time—every time that the payroll taxes increase—that there will be a tremendous hue and cry. Thus far I have not heard it. That does not mean that there is not some point at which the straw will break the camel's back; there undoubtedly is. But to assume that people are unwilling to pay payroll taxes, I think is wrong. It is wrong to assume this in circumstances where people understand that they are paying for a program that means a great deal to them. Social Security is in this category. I would guess that, if we move in that direction, health programs would also be in it.

The second point I want to raise is on the value added tax. People keep saying that there can be a value added tax that is progressive, and I am sure that Stan Ross could tell us how to construct one that is.

I was in Sweden around 1962, at the time when the value added tax was being adopted. I said to my trade union colleagues, "How can you support a value added tax? A value added tax is regressive; it is going to affect the low-income people." And they replied, "Oh, we have that all worked out. We are going to use it for the social programs and so the net effect will be progressive."

I have no doubt that that is probably what happened in Sweden, but I certainly would not expect it to happen in the United States.

The third point, which has been made a number of times during this forum, is that somehow or other we are going to convince people that their desire for early retirement, which they are expressing clearly, is something we can reverse. The idea I have heard expressed is that people really want to continue working and that they are being prevented from doing so.

I would like to think that that is right, but I do not see any evidence of it. We have recently done a survey of union retirees, and much to our surprise, overwhelmingly they are not working, and they are not interested in working. Most of them are not even interested in part-time work, volunteer, or anything of that kind.

I guess they feel that they have worked hard all their lives and that now that they are in the older age brackets they are entitled not to work any longer. And I think it is going to be very difficult to change these basic desires.

MR. PILENZO: Are you talking about the 30-year career employee?

MR. SEIDMAN: Yes, that is right, I am talking about 30-year-career employees who have worked hard all of their lives.

MR. PILENZO: I am not sure it is that limited though, because among the people I have talked to at this forum there was a consensus that everyone wants to retire by the time they turn 50. And these are people who have not yet even approached 30 years in the work force. Some of them have changed jobs with great rapidity.

I do not believe work mobility will be restricted by a desire for economic security programs. I believe that we need to give people the flexibility to move in and out of companies and careers without penalty. The polls show a strong interest in doing just that.

MR. SEIDMAN: I am all in favor of doing that.

MR. PILENZO: I hope I have reinforced your point.

MR. BROWN: I would like to reinforce Bert Seidman's comments. In the graphics industry in which I worked all of my life, which is a relatively high paid industry, we have had private pension funds in place for a number of years and what we call "an early retirement plan." Little did we dream when we started these plans how successful they would be. Our idea was that, because of the technology coming into the industry, we needed a young work force that was adaptable to change. The employers did not want to pay for retraining an older work force to meet the production demands in the industry. It was a great theory; it was sound.

The trouble is the membership ran way ahead of us with respect to the rate at which they wanted to retire and the age at which they wanted to retire. I think the last numbers I saw indicated that the average age at which our people were retiring (this is a population of about 50,000 in one plant) was 60 years and 9 months. This is a comparatively high-income industry and the work is certainly not repetitive; it includes a certain amount of artistic content. It is not hard labor in any sense of the term.

Thus, the desire to retire, when it is accompanied by the financial ability to do so, leads to early retirement. The only pressure we hear about is "Why don't you cut it down to 55, and we will get out of here sooner?"

As people have said to me when they have offered me a job, "Why don't you come to work for us?"

I say, "Look, I have a job, what do I want another job for?"

That is inconsistent with the decision I made. You may define the word "job" a little differently once you retire—people have different views of what constitutes being productive and keeping busy. But they are clearly moving out as quickly as they can, and this is also true among middle-level executives in corporations.

The DuPont Company offers a classic example. They offered early out, and I think two-thirds more people than they anticipated accepted it. In fact, all of the wrong people took it.

MR. LEE: I am from DuPont, may I comment? Yes, more people chose to retire than we anticipated, but it was only about one-third more. In any universally offered program you will lose some people that you did not wish to lose, and we did. We expected that.

I would also like to make another comment that reinforces yours. The average retirement age in our company is less than 60 now, slightly over 59 years. That includes executives and all wage and salaried workers.

MR. WOOD: My recollection is that the notion of early retirement was first fostered in 1963–1964, primarily through the United Auto Workers (UAW) contract. The issue that was on the table at the time was one of inverted seniority for layoff purposes, which General Motors and Chrysler were not going to accept under any circumstances. The result was an agreement to move toward the early retirement liberalization, and that ultimately led to the concept of 30 years and out.

The average worker has been told repeatedly that he or she ought to be bored with working after 30 years and want to retire. And, with

the availability of pensions and Social Security at age 62, workers were willing to do so. It has now become standard practice to retire early.

A recent survey showed that the age for early retirement has bottomed out at about age 61. In fact, the retirement age may be on the verge of moving back up a bit.

I think we forced this early retirement notion on our work force. I agree with you, it will take a very long time to turn it around. But if we force it in one direction, through economic actions, we may also be able to force it in the other direction, by removing some of the liberalization we have put in our plans that encourages early retirement. But I do not think we can expect to reverse the trend as long as we continue to provide subsidies.

MR. CRABTREE: I agree with what Bert Seidman said about people's attitude toward early retirement. But it seems to me we are discussing this subject in a framework that looks only backwards at what retirement means.

And as Pat Choate said, maybe we need to change some things. I believe that we could remove some of the liberalization. But is it not possible that there is an opportunity here for us to restructure work for older people? These people represent an asset that corporations can retain by providing a more flexible work style that would use workers differently and give them a different look, so that after the 30 years they are not in the same working environment.

I think there are a significant number of people asking for such a restructuring, and we have not yet been inventive enough to figure out how to make it work. I think we can turn the retirement trend around in the desired direction, but we need some innovation to do it.

Social Security as a Tax and as a Benefit

MR. BRIGHTMAN: In answer to the question of tolerance for increased Social Security taxes, I think many workers understand something that many politicians do not: Social Security is a very progressive tax, not a regressive tax, in terms of its benefits.

MR. SEIDMAN: You and I know that the system, on balance, is progressive, but I do not believe that people think in those terms. I think all they consider is that a certain amount is being taken out of their checks each week, and they find that bearable because they think

that the future benefits are worthwhile. That must be how people think, because otherwise there would be a much greater protest against the payroll tax than has occurred.

MR. BRIGHTMAN: But if the U.S. median income is less than the maximum amount that is taxed by Social Security, then the people below the median income are happy. They are receiving more from Social Security proportionately than those who are earning more than the median income. I am suggesting that they know that, and they are happy.

MR. SALISBURY: A second aspect of the Social Security question was discussed in some of the papers and was also mentioned by Commissioner Hardy. It is that many of us have family members who receive Social Security benefits, and by doing some basic math we are able to see that—regardless of how we feel about what we may receive—the family unit, on a year-to-year basis, is still breaking even.

In my own family, there are 17 people paying into the system, and their combined contribution, including their employers' share, is still less than the five recipients are taking out. And some of the five are couples, so the benefits are combined. I can still look at it economically and not lose sleep over paying Social Security taxes.

I am sure there may be a point at which that dynamic will change. But as Dorcas Hardy said, today most of us are related to people who are receiving benefits from the system. I would much rather have that transfer take place through the Social Security program than force my mother and father to call me and my brothers and sisters once a month and say, "Why hasn't your transfer arrived?" My parents fall into the category of retired people whose only source of income, with the exception of a monthly \$110 pension from an employer, is what they receive from Social Security. I think that dynamic is a very real one.

MS. LADENHEIM: I think we could also look at the trends in employee negotiations and employees' willingness to pay privately for some health and retirement benefits. My understanding is that more and more people are negotiating for these benefits rather than for wage increases. And although these benefits are not taxed as the same amount of wages would be, this trend still reflects a willingness on the part of workers to pay for improved health and retirement benefits.

Retirement Plans of Younger Workers

MS. YOUNG: Our discussion of what will happen when the “baby boom” generation retires has focused on the attitudes of people who are now close to retirement. I wonder whether there have been any surveys of people who are now in their early 40s concerning how long they anticipate staying in the work force.

MR. SALISBURY: There have been a number of surveys, and they consistently indicate that people want to retire, are looking forward to retiring, and are not looking to work on and on. There are some references to these surveys in the papers included in this forum as well as in a book the Employee Benefit Research Institute published, *America in Transition: Benefits for the Future*.

MS. YOUNG: Have the figures been broken out for the “baby boom” cohort?

MR. SALISBURY: All of the surveys are age specific and broken out that way. Another component of this issue that has also been mentioned is the response to surveys that asked recently retired individuals—across the age spectrum—whether they had an intense desire to work. A very small proportion said yes.

The first real survey of that kind was done by National Council on Aging, and some others go back to the late 1960s. The National Council survey found that approximately 9 percent of retirees said that they would like to be doing some work. And about 1 percent of that group said they had made an effort in the previous 12 months to obtain work.

MR. SEIDMAN: We have a smaller percentage of retirees who want to work, and the reason for that, in my judgment, is that we have a larger percentage who are receiving supplementary pensions.

Social Security Taxes Not Regressive

MR. JACKSON: I wanted to take issue with the assumption that I feel is implicit in this discussion: that if everyone pays a 6 percent Social Security tax, somehow this is a regressive tax; it is not progressive.

If one individual earns \$1,000 and pays \$60, and another earns \$10,000 and pays \$600, it seems to me that it is not regressive. There is a lot of emphasis on the fact that the person who earns \$40,000 is

not paying anymore than anyone else, and this is unfair. The average citizen assumes that this refers to dollars, but it does not; it refers to percentages. Our Social Security system is not based on a regressive tax; it has a tariff. Everyone pays the same percentage. I do not know what is fairer than that.

MR. SALISBURY: Up to a certain percentage.

MR. SEIDMAN: What most people do not realize is that when the system started out, it was virtually a proportionate tax, because it taxed approximately 93 percent of the workers. Then it went way down to about 65 percent—or lower than that at one stage—and now it has come back again to where it was in 1936. So it is back to about 92 or 93 percent, which means that it is virtually a proportionate tax.

MR. PILENZO: If we have not reached the point at which Americans are unwilling to be taxed, then why are all of the proposals for long-term care based on taxing the employer or on raising the Social Security wage base for higher income workers?

Legislators in Washington must be sensitive to the fact that the average working person does not want his or her taxes raised much more, because these proposals are not aimed at this group. They are aimed at the employer and at the higher-income worker—using the transfer of wealth system, in effect.

The Characteristics of the Future Work Force

MR. MERRICK: One of the unquestioned premises of this forum is that economic growth is going to be a requirement if future benefits are to be adequate. I am a bit puzzled as to why there is so little focus on the work force that will be producing that economic growth, and particularly, the kinds of benefits that would enhance the quality of the work force during the next two or three decades.

MR. SALISBURY: You have just described part three of the forum.

MR. MERRICK: I was wondering if we were going to see something like that. But thus far the work force does not seem to be front and center in most people's thinking and concerns. Is that a misperception, or is it just because the discussion has veered in other directions?

MS. PATTERSON: I will address that. It seems to me that one thing we have neglected in this discussion about early retirement and when people want to retire, is to look at the work force that will retire in

10 or 20 years. I think it is going to be a far different kind of a work force than we have retiring now. These workers have generally tended to save less. Are they going to be able to afford to retire? Many of these people are in two-income families, and they are not necessarily given to belt-tightening. They are possibly in a pattern of high consumption. And because of the increase in the old, old category of the elderly, some of these people are going to need additional income coming in to support very elderly parents,

It seems to me that we ought to be thinking about these kinds of issues and demographic trends in terms of direct benefits. We may find that 10 or 15 years from now the idea of a health insurance policy that would help finance your elderly parents' long-term care may be much more important than a very rich health plan or another kind of savings plan.

I agree with you, we may not be looking as broadly as we should at what will be appealing in the future. We are possibly too concerned with what people like now and what attitudes are now.

PART THREE

EMPLOYER AND UNION RESPONSES TO ECONOMIC AND DEMOGRAPHIC CHANGES

Part Three examines some of the issues that employers and unions are confronting as they work with a new work force during a time of transition.

The economic and public policy challenges we face as a nation in the 1990s and beyond are not unique to the United States. In chapter XI, Kenneth J. Brown describes Canada's experience in developing a strategy to provide medical care to all of its citizens, after it became apparent that the traditional approach was no longer adequate.

The turning point in Canada came, according to Brown, during the 1960s, when it became clear that the private sector could not, by itself, provide the population with universal and comprehensive hospital and medical care. After much deliberation, the federal government passed the Canadian Health Care Act of 1967, under which each province established its own hospital and medical insurance plan, with 50 percent of the cost provided by the government and the remainder covered by each province.

Brown describes the how the Canadian system works, with special emphasis on the Ontario plan, and points out its weaknesses as well as its strengths. There are a number of problems: balance billing persists despite the fee-for-service approach on which the system is based; users experience long delays in scheduling elective surgery and making appointments with specialists; there is a shortage of urban clinics; and cost containment efforts have been disappointing. Nevertheless, Canada has succeeded in providing affordable first-rate, prepaid health care to all its citizens, who overwhelmingly support the national plan.

In chapter XII, Robert B. Friedland examines the likely effects of changes in life expectancy and fertility on the labor supply and labor compensation, including employee benefits, and on publicly financed social insurance and welfare programs.

A decline in the growth of entry level workers and an eventual overall decline in employment growth are likely to raise the cost of labor, Friedland says. In addition, the changing composition of the work force—older, with a larger percentage of women—may exert

pressure on employers to provide a different mix of employee benefits, which could also raise the cost of labor. For example, some form of elder care assistance may be necessary for the increasing number of workers (mostly women) who are caregivers for chronically disabled elderly parents. The need for long-term care insurance is also increasingly being recognized.

Employers, employees, and retirees participate in financing Social Security, Medicare, and Medicaid through payroll, income, and other taxes. Longer periods of retirement and a larger number of retirees are likely to keep a persistent upward pressure on average Social Security program costs per beneficiary, according to Friedland, who cites Social Security actuarial data indicating that, in real terms, the average cost per beneficiary will increase nearly 70 percent over the next 10 years.

Similarly, technological advances in medicine, coupled with a growing number and proportion of persons aged 85 or older, are likely to increase real Medicare program costs per beneficiary. Expenditures for this program are expected to more than double during the period from 1988 to 1998.

Between the present and the year 2000, the U.S. economy will continue to be transformed by new technologies, international competition, and industrial shifts, according to William B. Johnston in chapter XIII. He estimates that the total number of manufacturing jobs will shrink by 2.2 million by the year 2000, while the economy adds 24 million new service jobs. Technological change will continue to be a major source of turbulence as new information tools transform jobs. Millions of new jobs will be created, yet millions of others will be lost.

Because the work force of the 1990s and beyond will be defined by diversity and will be markedly different from earlier work forces, employee benefits will have to change. For example, working mothers may want to work fewer hours and are concerned about day care, and many educationally disadvantaged immigrants and members of minority groups will require employer-sponsored education and training programs.

In general, benefit programs will become more flexible and more tied to individuals and their personal and financial concerns than they have been in the past, according to Johnston. He predicts that more firms will offer defined contribution plans and cafeteria plans in the future and that employees will desire flexible schedules that give them increased control over when and where they work.

Thomas E. Wood presents a kaleidoscopic view of employee benefits in chapter XIV. Wood identifies several issues such as the high cost of medical insurance for active employees; employers' huge postretirement medical liabilities; vesting schedules that do not meet the needs of the work force; and misconceptions about the role of capital accumulation plans as primary retirement vehicles that form the basis for employee benefits change in the future.

Wood proposes a series of general design concepts that create a framework of a benefits system; then he fills the framework with a specific detailed picture. The concepts include the establishment of a basic "safety net" of benefits to cover financial hazards associated with old age, death and disability, and catastrophic medical expenses, with supplementary benefits offered on a defined contribution basis. To encourage the intelligent use of benefits, particularly in the medical area, he suggests that employees share in the costs, and he proposes measures to ensure equity and recommends that there be no integration of private plans with Social Security.

Wood concludes with a discussion of sound planning and describes the major phases of the creative planning process. A key element of this process is for planners to obtain as much intelligent input as possible from other employers, key managers, and employees themselves. He believes that the more the user or employee is involved in creating programs, the more likely the plans are to succeed.

Chapter XV, contributed by James S. Ray, discusses the future of employee benefits from the union perspective. Ray notes that unions have a long history of dealing with tradeoffs among cash wages, employee benefits, and jobs and he recommends collective bargaining as the most effective approach to cost control and other job-related issues.

Unions will support cost control efforts such as programs to prevent illness, reduce injuries, or encourage participants in health plans to use preferred provider organizations or other alternative health care delivery-systems. However, other cost cutting measures, such as the move to defined contribution plans, are likely to continue to meet union resistance, Ray says, because they are seen as mechanisms to shift costs and risks from employers to the employees.

Ray adds that if the government does not provide tax incentives necessary to maintain the private employee benefit system, it will eventually have to develop programs of its own to replace the non-functioning system.

In chapter XVI, Ronald C. Pilenzo offers a broad view of how work,

workers, and benefits will continue to evolve from the present to the 21st century.

Because he expects the current rapid rate of obsolescence in jobs to continue, Pilenzo emphasizes the importance of more responsive education, along with training and retraining. Today 10 million employees participate in 18 million courses at a cost of \$40 billion. According to Pilenzo, this investment will need to double by the year 2000. Moreover, since most small businesses cannot afford training programs, there will be pressure on the educational system to offer more job-related training options.

The most productive employees in the new, information-based economy of the 21st century, according to Pilenzo, will be individuals who are able "to work for themselves" within their organizations, exerting more control over job tasks and the work environment than workers have done in the past. The employer/employee relationship will become more of a working partnership.

To attract and retain the best employees, employers will need to respond to workers' needs for assistance with such responsibilities as child care and elder care, Pilenzo asserts. Employees, on their part, will increasingly share in the financing of these new benefits.

In chapter XVII forum participants focus on some of the questions raised in Part Three. They discuss the advantages and disadvantages of different retirement plans in terms of a changing economy and an increasingly mobile work force. In this context some cite the importance of faster vesting and pension preservation. The low U.S. saving rate concerns many, including one participant who suggests that the three-legged stool—pensions, Social Security, and personal savings—which has traditionally provided retirement income for most older Americans may be threatened because of the lack of incentives for younger Americans to save.

XI. What We Can Learn from the Canadian Health Care System*

PAPER BY KENNETH J. BROWN

Introduction

When Otto Von Bismark launched a National Health Insurance Law for the German people in 1883, he was concerned with the need for healthy young men to fill the ranks of the army. Given the fact that frequent wars with neighboring states was a way of life, or even survival, the great chancellor was responding, with a long-range plan, to the complaints of his recruiting officers.

One might conclude from this example of government action on a major social program that you need not be a socialist to see merit in a national health insurance plan.

In fact, government involvement in efforts to provide medical and hospital care through grants of public money has a long history on this continent, whether in states, provinces, or municipalities. The Great Depression of the 1930s made it all too clear to the medical profession that "God's poor" in such great numbers required public financing for care and treatment. Thus, "God's poor" became the states' poor.

We were soon firmly launched on a course carefully guarded and nurtured by the medical associations in both the United States and Canada permitting "fee for service" to those who could afford to pay. Private charitable efforts, coupled with public financing, were left with the task of taking care of the problem of elderly high risk groups, along with our society's low income and poor population.

Has the System Worked?

The United States spends more money per capita on total health care than any other nation in the world. We have among the world's best medical research and we have excellent medical technology. We

*Editor's note: This chapter on the development of the Canadian health care system is presented as background for subsequent chapters that discuss how we as a nation can meet similar challenges in the future.

have superb physicians and surgeons, and yet at least 37 million Americans are without any health care insurance. One-half of that group are employed full time but cannot afford to pay the costly premiums. In addition, an estimated 50 million individuals are inadequately covered by insurance.

Congress debates stopgap measures to moderate the problem while constrained by an enormous federal deficit. Insurance companies are busily designing "gap" policies that are expensive and thus attractive only to those who can afford them.

The dramatic inflation of health care costs is exacerbated by the shifting of costs from Medicare and Medicaid to the private sector and thus to insurance premiums.

More and more people are being squeezed out of the system as companies cut back on employee coverage, transfer a larger share of medical insurance costs to employees, and cut back or even cancel medical coverage for retirees, often seriously threatening their financial security.

The requirement under Medicaid that a participant must "spend down" his or her assets to receive long-term care is a particularly odious method of applying a means test. It means that the cost of dying for the elderly, low-income person, is almost invariably preceded by financial collapse.*

I suggest that health care coverage for Americans is a matter of right, not a matter of privilege. Given that view, the question becomes how to find the system to deliver this coverage.

The Canadian Experience

Any examination of the developments in health care delivery experienced in Canada before the passage of a National Health Care Act would reveal some striking similarities to the United States:

- There was very rapid development after World War II of prepaid health care insurance through the insurance companies on an indemnity basis.
- The medical profession sponsored many third-party service companies that operated on a nonprofit prepaid premium basis.
- A demand was growing for more public financing through government grants to provide hospital and medical service for the elderly, high-risk patients, and low-income and poor persons.

*Editor's note: Under the Medicare Catastrophic Coverage Act of 1988, the income of the spouse of an institutionalized, Medicaid eligible individual is protected up to a specified amount.

It became increasingly clear in Canada that the private sector could not, by itself, provide universal and comprehensive hospital and medical care for all Canadians.

In 1964, after several years of study, a Royal Commission set up by the federal government stated: "What we seek is a method that will provide everyone in Canada with comprehensive coverage regardless of age, state of health, or ability to pay, upon uniform terms and conditions."

The insurance industry and the medical profession wanted the private sector to serve those who could afford to pay for service and the government to provide the funds through which their companies could receive premiums for the elderly and low-income and poor persons. This amounted to socialism for the health care industry with the public purse underwriting the profit.

Three years later, the federal government passed the Canadian Health Care Act of 1967, which simply provided that each province would establish its own hospital and medical insurance plan, with 50 percent of the financing provided by the federal government and the balance to be covered by each province.

Certain principles had to be met to qualify for federal funding, and each province had to develop universal and comprehensive coverage; fee for service arrangements with the doctors, with no extra billing; uniform terms and conditions for the patient; and portability.

Politically, the federal government and the provinces were on very safe ground, since any number of polls and surveys showed overwhelming public support for government underwritten, prepaid health care coverage for all Canadians.

The provinces have various methods of financing their portion of costs; for example, Ontario has a combination of general revenue and individual premiums. In this province, single persons pay \$350 annually for premiums, married persons pay \$700, and those over age 65 pay no premiums.

Most significant is the fact that the total revenue from 8 million participants is \$1.7 billion per year, just under 10 percent of the total health care budget for the province.

It should be noted that Ontario residents pay approximately as much per year in health care insurance premiums as Americans pay per month. This is a fairly terse way of saying that all of the people of Ontario, through a modest form of income redistribution, are assured of first-rate health care without the fear of financially crippling medical expenses.

The Ontario Health Insurance Plan (OHIP) is publicly administered

and provides first dollar coverage on hospital, medical, and surgical benefits.

Senior citizens and the unemployed receive all prescription drugs without charge. Senior citizens are also entitled to nursing homes for the aged, ambulance service, dental care in hospitals, and the services of optometrists, physiotherapists, chiropractors, osteopaths, and chiropractists.

Unemployed persons may apply for a waiver of premiums, as may persons who are ill or on layoff or strike.

Studies make clear that since the advent of national health care, physicians and surgeons have increased their income beyond the rate enjoyed by others in the province. The 1987 billings from doctors averaged \$154,000 per year, not including income from their private practices, which is permitted and customary. The surge of income for doctors is understandable in a situation where all citizens are covered by insurance and the doctor's bill is paid.

The administrative apparatus for OHIP provides for a management commission with representation for the medical profession, health care industry, and the public, and government fee schedules are negotiated by the commission with the Ontario Medical Association (OMA), the Pharmaceutical Industry, pharmacists, and other health service providers.

The Gatekeepers of the System

The Canadian health care plan has not solved all of the problems related to the delivery of a comprehensive program to the public. Despite the "fee for service" approach taken to keep the medical profession satisfied, some doctors, particularly specialists, have persisted in extra billing even beyond the schedule of rates set by their own medical association. Nurses are underutilized, overworked, and underpaid, which has led to a decline in the number of young persons interested in a nursing career.

Long delays are common in scheduling elective surgery, and there are delays in appointments with specialists. A shortage of appropriate outpatient facilities and treatment has led to greater pressure on available hospital beds and services.

Many of the problems are associated with working under the unilateral rules of the medical profession, which controls referrals, chiropractic treatment, and the more extensive use of nurses or paramedics.

For example, in urban areas there is a need for clinics that can provide patients medical evaluations and advice, tests, and prescriptions. The OMA is resisting such clinics for fear that they will lead to an increase in the number of salaried doctors and thus weaken the fee for service concept.

Cost containment is not much more effective in Ontario than in the United States, although the inflation rate in health care services for 1987 was somewhat less than the 20 percent rate south of the border. Doctors' billings continue to increase more rapidly than any other single medical item.

Despite these and other problems faced by the Canadian health care program, the system is successful in the eyes of Canadians, and woe unto any political party that would dare to tamper seriously with it or try to eliminate it.

Even the Canadian Medical Association has said, "The reluctant partnership of federal and provincial governments and providers of health care services has not always been harmonious, but it has produced an almost unparalleled success story in the provision of an essential social service on a national basis."

XII. Shifts in the Tide: The Impact of Changing Demographics on Employers, Employees, and Retirees

PAPER BY ROBERT B. FRIEDLAND

Introduction

The age distribution in the United States has been undergoing a persistent and fundamental change. Most of this change has been caused by changes in life expectancy and fertility, or birth, rates. Changes in family structure and in labor force participation have compounded the complexities of the changing age distribution. In addition, the labor force participation of women and mothers has increased while workers demonstrate a propensity to retire earlier. Earlier retirement, in conjunction with longer life expectancies and changing family structure, has brought into focus the issue of income security in retirement.

This chapter examines these changes as they are likely to affect employers, employee compensation, and economic security programs for retirees.¹ Most of the demographic factors examined coalesce around the baby boom and the baby bust cohort, or group, as it moves first into the labor market and later into retirement. Since children born today will enter the labor market as the baby boom generation retires, the demographic composition of the future work force is largely determined, signaling some of the changes likely to affect employers and public programs. These changes may have an impact on the labor supply and labor compensation, including employee benefits, as well as on publicly financed social insurance and welfare programs. Employer, union, and employee responses to demographic change could lead to a restructuring of labor compensation and possibly tailoring employee benefits to better accommodate the changing work force.

The Potential Impact on Employers

Employers are likely to be affected by these changes in a number of different ways. First, employers are likely to experience a slower

¹Portions of this chapter are from Robert B. Friedland, *Financing and Delivery of Long-Term Care* (Washington, DC: Employee Benefit Research Institute, forthcoming).

rate of growth in the labor force, which will tend to exert upward pressure on the cost of labor. Second, the changing composition of the work force—older, with a larger percentage of women—in conjunction with declines in the rate of labor growth, may exert pressures on employers to provide new employee benefits. Unless employee compensation is restructured, the addition of new benefits will also raise the cost of labor. Third, employers with unfunded postretirement medical benefits may find their labor costs relative to sales or profits increasing as the proportion of retirees to active workers increases. Fourth, as taxpayers, employers are likely to continue to pay for Social Security, Medicaid, and Medicare—including any expansion in these programs to cover long-term care. Barring reductions in benefits, the growing number of beneficiaries and recipients relative to the base of financial support could lead to tax increases, including increases in corporate income and property taxes.

The Pool of Employees: Tighter Labor Markets—Firms that have traditionally relied on new entrants into the work force (fast food outlets and grocery stores) have already experienced rising labor costs as they compete for workers under age 24—children of the baby bust cohort (Bernstein, et al., 1987). Projections through the year 2000 indicate that between now and then the labor force will increase at a slower rate than at any time since the Great Depression (Hudson Institute, Inc., 1987), growing on average 1.2 percent per year—less than one-half the average growth rate throughout the 1970s. Between 1986 and the year 2000 the number of workers age 16 to 24 in the labor force is projected to remain roughly constant (table XII.1).

The National Institute on Aging's macroeconomic-demographic model (MDM) estimates demographic change and economic growth simultaneously to produce macroeconomic projections between 1980 and 2055. The model projects that there will be 6.3 million fewer persons in the labor force by the year 2000 than the more recent Department of Labor (DOL) projections, but depicts similar *rates* of growth: 1.14 percent between 1980 and 2000. Between 2000 and 2010, the MDM projects that the annual rate of growth in the labor force will be 0.69 percent, and during the time when the baby boom is retiring (between 2010 and 2030), the labor force is expected to grow 0.15 percent annually (computed from table XII.2). Before 2010, the MDM projects annual growth rates in employment to be greatest among women age 25 to 64; after 2010, employment is expected to grow the fastest among men age 65 and older. Compensation is expected to grow at a slower rate after 2010, while the total number of hours worked will decline at a faster rate than before 2010.

TABLE XIII
Civilian Labor Force by Sex, Age, Race, and Hispanic Origin,
1986 and Moderate Growth Projections, 2000

Group	Level (in thousands)		Percent Change 1986-2000	Percent Distributed Projected 2000	Growth Rate 1986-2000
	1986	Projected, 2000			
Total, 16 and Over	117,837	138,775	17.8	100.0	1.2
Men, 16 and Over	65,423	73,136	11.8	52.7	0.8
16 to 24	12,251	11,506	-6.1	8.3	-0.4
25 to 54	44,406	53,024	19.4	38.2	1.3
55 and over	8,766	8,606	-1.8	6.2	-0.1
Women, 16 and Over	52,414	65,639	25.2	47.3	1.6
16 to 24	11,117	11,125	0.1	8.0	^c
25 to 54	35,159	47,756	35.8	34.4	2.2
55 and over	6,138	6,758	10.1	4.9	0.7
White, 16 and Over	101,801	116,701	14.6	84.1	1.0
Black, 16 and Over	12,684	16,334	28.8	11.8	1.8
Asian and Other, ^a 16 and Over	3,352	5,740	71.2	4.1	3.9
Hispanic, ^b 16 and Over	8,076	14,086	74.4	10.2	4.1

Source: Fullerton, Howard N., Jr., "Labor Force Projections: 1986 to 2000," *Monthly Labor Review* 9 (September 1987): 19-29.

^aThe "Asian and other" group includes American Indians, Alaskan natives, Asians, and Pacific Islanders. The historic data are derived by subtracting "black" from the "black and other" group projections and made directly.

^bPersons of Hispanic origin may be of any race. Labor force data for Hispanics are not available before 1976.

^cThe rate is -0.05 to 0.05 percent.

TABLE XII.2
Projected Employment by Age and Sex and Total Labor Market Variables, 1980-2055

Year	Employment (millions)						Total Labor Market Variables				Average Annual Compensation (1972 dollars)		
	Male			Female			Em- ploy- ment (mil- lions)	Labor Force (millions)	Hours Worked per Worker	Compen- sation Rate (1972 dollars)			
	16-24	25-64	65 or over	16-24	25-64	65 or over						Sub- total	Sub- total
1980	12.1	44.4	1.9	58.4	9.7	28.2	1.1	39.0	97.4	105.5	1,508	\$ 5.51	\$ 8,312
1990	10.8	53.0	2.1	65.9	9.3	36.2	1.4	47.0	112.9	119.1	1,509	6.25	9,434
2000	11.1	55.9	1.8	68.8	10.8	45.1	1.1	57.0	125.8	132.5	1,471	7.47	10,998
2010	12.5	56.7	2.1	71.3	12.2	50.6	0.9	63.6	134.9	142.0	1,426	8.62	12,287
2020	11.8	56.4	2.9	71.0	11.5	52.9	1.1	65.6	136.7	143.4	1,397	9.59	13,398
2030	12.8	55.4	3.4	71.8	12.6	53.9	1.3	67.8	139.6	146.3	1,369	10.82	14,806
2040	12.8	57.0	3.4	73.2	12.6	57.2	1.2	71.1	144.3	150.8	1,344	12.79	17,185
2050	13.0	57.1	3.7	73.9	12.8	58.0	1.3	72.2	146.1	152.3	1,309	15.37	20,123
2055	13.4	57.3	3.9	74.5	13.2	58.2	1.4	72.8	147.3	153.5	1,291	16.86	21,763

Rate of growth	
1980-2010	0.11% 0.82% 0.33% 0.67% 0.77% 1.97% -0.67% 1.64% 1.09% 1.00% -1.19%
2010-2055	0.15 0.02 1.39 0.10 0.18 0.31 0.99 0.30 0.20 0.17 -0.22
1980-2055	0.14 0.34 0.96 0.33 0.41 0.97 0.32 0.84 0.55 0.50 -0.21
	1.50% 1.31%
	1.49 1.26
	1.50 1.29

Source: U.S. Department of Health and Human Services, Public Health Service, National Institutes of Health, National Institute on Aging, *Macroeconomic-Demographic Model* (1982 version), tables 10-8 and 10-9.

The decline in the growth of entry level workers and the eventual overall decline in employment growth is likely to raise the cost of labor. In fact, the MDM projects that total compensation as a share of Gross National Product (GNP) will increase dramatically between now and 2055. Average annual rate of growth in GNP is projected to be 1.12 percent from 1980 to 2055 while total compensation is expected to increase 1.84 percent per year.² The unemployment rate during this time is projected to decline from 7.7 percent to slightly over 4 percent.

The rising cost of labor is likely to encourage employers either to alter their mix of capital (plant and equipment) and labor or move their plants to another country. Industry, product demand, and technology will determine the degree to which an employer will be able to substitute capital for workers. Substituting more sophisticated capital for labor might reduce the total cost of labor but raise the unit cost of labor as lesser-skilled employees are replaced by fewer higher skilled employees. If the demand for employees to maintain the more complicated machinery grows relatively faster than the supply of employees, per unit labor costs will either be bid up directly (through wages) or indirectly (through higher training costs).

Postretirement Medical Benefits—Health insurance as a retirement benefit is an important source of insurance coverage for retirees and their dependents. In 1984, an estimated 3.1 million retirees age 45 to 64 and 6.0 million retirees age 65 or older and their dependents had insurance from a postretirement medical plan. Among the elderly not employed, 21 percent had some form of supplemental insurance from a previous employer (Chollet, forthcoming). At least 76 percent of all current full-time health plan participants in medium and large establishments have access to a postretirement medical benefit before age 65, and 68 percent have coverage after age 65 (DOL, 1987).

Virtually all employers finance these benefits on a current-cost basis, rather than funding accruing liability by setting aside funds during the employee's active work career. Estimates of accrued unfunded liability vary from as little as \$98 billion in 1983 for current workers age 40 and older (DOL, 1986) to more than five times that amount. Amortizing the estimated accrued liability of \$98 billion over 20 years would more than double employers' 1985 postretirement

²Author's tabulations of projections from the National Institute on Aging, *Macro-Demographic Model* (1982 version), tables 10-4 and 10-8.

medical benefit plan costs, from an estimated \$4.6 billion to \$10.8 billion (DOL, 1986).

The magnitude of the unfunded liability is directly related to future health care costs and the number of retirees. Financing on a current-cost basis becomes more or less expensive, depending on the company's relative growth. For instance, the current cost of postretirement medical benefits per active employee will be relatively smaller if health care costs do not increase and the proportion of active workers to retirees increases. However, if this ratio decreases—the situation for most employers—the cost of the postretirement plan per employee will increase. Rising health care costs further accelerate plan costs.³

Longer life expectancies, regardless of whether the plan is financed on a current basis or is prefunded, will increase the cost of retiree health insurance plans. For plans that prefund, the propensity of workers to retire earlier also raises plan costs, as the funding period is shortened and the benefit period is lengthened.⁴

New Employee Benefits Needs—Longer lives are not always free of chronic disabilities. Increasingly, death is likely to be caused by chronic medical conditions, such as heart or respiratory conditions, arthritis, or rheumatism. Currently, among the U.S. population, three out of four deaths are caused by degenerative diseases, which primarily affect the elderly (Olshansky and Ault, 1986; U.S. Congress, 1985b; and Manton, 1982). Many of these persons need help that can vary from being driven to the grocery store to assistance with such essential daily activities as eating or using the bathroom. This type of assistance is often necessary for persons with cognitive dysfunctions and degenerative brain diseases such as Alzheimer's disease or related dementias.⁵

Consequently, to stay out of an institution, more parents are likely to become dependent on their children. As more workers help to care

³From 1985 to 1986, employer costs for health insurance increased four times faster than general price increases.

⁴For a sensitivity analysis of the actuarial assumptions necessary to measure and fund postretirement medical benefits, see Doran, et al., 1987.

⁵In 1980, the number of persons with Alzheimer's disease and related disorders was estimated at 2 million. Without changes in prevention or treatment, there could be 3.8 million persons with a degenerative brain disease by the year 2000 and 8.5 million by the year 2050 (Brody, Brock, and Williams, 1987b). Depression and other mental illness are also common among the elderly, but not much is known about their impact on death and disability, although the elderly have higher rates of suicide than any other age group. It has been suggested that the rate of suicide among the elderly has been increasing faster than for any other age group because of the increase in the length of time older persons suffer from chronic illness (Manton, et al., 1987).

for their parents or other relatives, productivity on the job is likely to be affected. When employees use sick leave, come in late, leave early, extend their lunch hours, or need to make personal telephone calls because they are trying to juggle two or three roles at once—employee, parent, and caretaker or care coordinator—their work probably suffers. Productivity can also be impaired when an employee refuses to accept a promotion, reduces his or her hours, or quits to care for a chronically ill dependent. Between 12 and 30 percent of employees with an elderly, chronically ill parent have quit their jobs to become full-time caregivers (Brody, et al., 1987a). At least two large employers have found that about 30 percent of their employees are caring for an elderly relative.

Recognizing that caregiving among their employees may lower productivity by affecting emotional and physical well-being, employers or unions might begin considering the restructuring of employee benefits programs. Information and referral services, counseling, time off to care for a dependent, and alternative delivery or financing options such as adult day care and long-term care insurance are ways employers have begun to address the problems employees experience as caregivers. At least 35 employers have publicly announced benefit changes or enhancements that provide some form of elder care assistance.

Employers have also been discussing the feasibility of offering long-term care insurance. At least one employer has been offering long-term care insurance to its retirees for more than a year, and no less than 12 others have either begun or publicly announced plans to offer access to long-term care insurance for active workers, retirees, and, in most cases, workers' parents. Many other employers are quietly discussing what can be done. In a survey of 144 large corporations conducted in 1987 by the Washington Business Group on Health, 55 respondents said they either were investigating the feasibility of offering long-term care as an employee benefit or had done so in the past two years. Among those who had not undertaken an investigation, 38 said they anticipated doing so in the next two years (Levin and Frobrom, 1987).

The market for long-term care insurance is in its infancy—but nearly all large insurance carriers are either planning, testing, or selling some form of long-term care insurance, including an employment-based group product. A survey of insurance carriers found that in April 1987, 73 companies were selling individual long-term care insurance policies (U.S. Department of Health and Human Services, 1987b). Although market penetration was relatively insignificant—

since less than 2 percent of the elderly had purchased policies—the rate of growth has been phenomenal, in large part because only a handful of companies were in the market just a few years earlier.

The market for long-term care insurance has been inhibited by the absence of sound actuarial data and a lack of consumer interest. Furthermore, insurance regulation and tax laws have been viewed as obstacles, partly because they have not explicitly defined long-term care. For most people, long-term care is a new concept; but as more people learn about the extent of Medicare and Medicaid coverage of long-term care, this market is likely to expand.

Similar to employer-provided health insurance, employer-provided long-term care insurance is likely to offer advantages to consumers and could also lead to a relative reduction in public expenditures for long-term care.⁶ A group product might provide better coverage than an individual product at the same cost. Insurance sold to a large employee group broadens the risk pool to include younger, healthier populations, which can reduce adverse selection and also lower marketing and administrative costs. Furthermore, the development of large buyers of long-term care (insurance carriers) is likely to facilitate the development of a delivery system capable of providing a continuum of appropriate health care.

Pressure on Employers from Publicly Financed Programs

Three publicly financed programs, Social Security, Medicare, and Medicaid, are the most important sources of retirement income security for the elderly. The financial health of these programs is likely to affect employers, employees, and retirees. Workers who qualify for Social Security can obtain benefits at age 65 or at an actuarially reduced rate after 62. Medicare provides protection against the high cost of acute and ambulatory health care. Medicaid, which is a means-tested health care program for poor persons in specific categories, pays for health care for many elderly persons including most who receive Supplemental Security Income and many whose health care costs are high in relation to their income (Medicaid “spend-down”).

Medicare, which is generally available to Social Security recipients age 65 or older, pays for acute health care expenditures (hospital care and skilled nursing care) under Part A and ambulatory physician

⁶The feasibility of long-term care insurance as an employee benefit is discussed in Chollet and Friedland, forthcoming.

services under the optional Part B program. Like Social Security, Part A of Medicare is financed from current payroll taxes essentially on a pay-as-you-go basis. That is, current workers finance current benefits. One-quarter of Medicare Part B is financed through the premiums paid by beneficiaries, and three-quarters is financed from general revenues. Almost 32 million persons, approximately 13 percent of the U.S. population, were Medicare beneficiaries in 1987, and total expenditures for the program were \$78.9 billion (U.S. Department of Health and Human Services, 1988a).

Medicare does not pay for many services needed by chronically disabled elderly persons. Most of this care is provided informally by family members or is paid for directly out-of-pocket, expenses that can easily exceed a family's resources. Medicaid has become an important source of coverage for these services and especially for nursing home care. In 1986, 10 percent of the elderly received assistance from Medicaid.⁷ Fifty percent of all nursing home expenditures for the elderly in 1984 was paid directly out-of-pocket; Medicaid paid for 42 percent; and Medicare paid for 2.1 percent (Waldo and Lazenby, 1984).

Medicaid is operated by the states, which are entitled to federal funding of between 50 and 83 percent of their expenses for medical services provided in accordance with federal Medicaid guidelines. States have a great deal of latitude in establishing specific eligibility rules and provider reimbursement methods and rates and in determining the scope of covered services. They are also free to cover groups of persons and services not eligible for federally matching funds. Consequently, each state's Medicaid program is different. Individuals eligible in one state might not be eligible in another. Medicaid eligibility is not conferred automatically on persons whose income falls below federal poverty standards. More than 70 percent of elderly individuals with incomes below the poverty level do not receive assistance from Medicaid.⁸

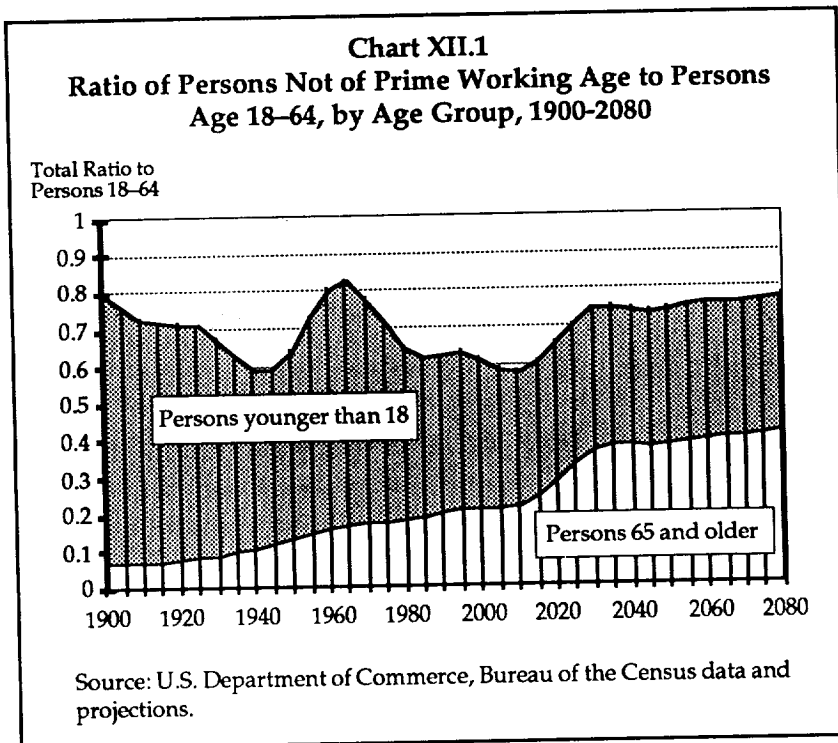
Employers, employees, and retirees participate in the financing of these three programs. Payroll taxes from employers and employees finance current Social Security recipients and Part A of Medicare. Federal income taxes finance three-quarters of Part B of Medicare and the federal portion of Medicaid expenditures. The state portion of Medicaid funding comes from general revenues, mostly property, sales, and income taxes. Therefore, the ratio of beneficiaries to active

⁷EBRI tabulations of the March 1987 Current Population Survey.

⁸Ibid.

workers can directly affect the cost per worker or taxpayer. Unless the average age of retirement increases, public programs financed by active workers on a pay-as-you-go basis will continually require either greater contributions from employers and active employees, contributions from beneficiaries, or a combination of both.

The potential consequences of a growing number of elderly persons and declining fertility on the financing of pay-as-you-go programs can be seen in the ratio of persons who are not of prime working age to those of prime working age (age 18 to 64). Over the next 65 years, the proportion of "dependents" (children under 18 and adults age 65 or older) to the number of people of primary working age is expected to decrease gradually as the last members of the baby boom generation enter their working years (chart XII.1). The proportion of potential dependents to the working age population is projected to decline from 62 percent in 1985 to 58 percent in 2010—a level similar to the decade prior to 1945. As the baby boom generation begins to retire,



this proportion is projected to increase rapidly, reaching 75 percent in 2035.

Although referred to as a “dependency ratio,” the ratio actually exaggerates the extent of dependency across generations. In particular, it does not adjust for the number of employed “dependents.” Nor does it adjust for the lifetime accumulation of assets, including funded pensions, held by individuals age 65 or older or for differences in individual health. On the other hand, a dependent parent is potentially likely to require more assistance for a much longer time than a dependent child.

Some of the shortfalls in the measurement may be compensated by other measures of “dependency.” The Social Security actuaries, for example, estimate the ratio of workers paying Social Security payroll taxes to beneficiaries. From 1960 to 1985, the ratio dropped from 5.1 to 3.3. Their estimates through 2060 show that the ratio will remain above 3 until about 2015 (under the intermediate assumptions) and then drop to below 2 in 2035 after the entire baby-boom has retired.

The National Institute on Aging’s macroeconomic-demographic model, however, projects a slightly different sense of economic dependency: between 1980 and the year 2000 the proportion of labor force participants age 16 and older to all persons not in the labor force will increase slightly, from 40 percent in 1980 to 49 percent. After the year 2000, dependency by nonworkers on those in the labor force is expected to increase dramatically, however, as the proportion of labor force participants to all other declines to 29 percent by 2055 (HHS, 1984).

The Fiscal Condition of Social Security—In 1975, Social Security benefit payments were greater than revenues received from payroll taxes. Reserves established for contingencies under the program were eroding, and it appeared that the program would be bankrupt in the early 1980s. Despite legislation enacted in 1977 to secure the trust fund for 75 years, other measures were soon needed. The Social Security Amendments of 1981 permitted, as an interim measure, inter-fund borrowing from the Disability Insurance fund and the Hospital Insurance fund. The 1983 Social Security Amendments raised taxes and cut benefits, which staved off immediate bankruptcy once again and left the program financially sound, by the Social Security Board of Trustees’ estimates, until at least 2030.⁹

⁹Under the Social Security actuaries intermediate assumptions, revenue for the program from payroll taxes and taxation of benefits will not meet costs as early as 2020;

Longer periods of retirement and more retirees are likely to keep a persistent upward pressure on average Social Security program costs per beneficiary. Social Security actuarial data suggest that, in real terms, the average cost per beneficiary will increase nearly 70 percent over the next 10 years, from \$5,551 to 8,693 (in 1987 dollars). Continued reliance on payroll taxes to keep annual revenues equal to annual expenses could necessitate an increase in the Old Age, Survivors, and Disability Insurance (OASDI) portion of the payroll tax from the current 12.1 percent (for employers and employees combined) to about 20 percent by 2030, using the Social Security actuaries "pessimistic" assumptions. Under the intermediate assumptions, the payroll tax would need to be nearly 16 percent in 2030.

Meeting Medicare's Expenses—Technological advances in medicine, coupled with a growing number and proportion of persons age 85 or older, are likely to increase real Medicare program costs per beneficiary. Among those enrolled in programs for the aged, expenditures per enrollee are expected to more than double, from \$1,595 in 1988 to \$3,784 by 1998 and to more than triple by 2005 (table XII.3). Among the disabled, expenditures per enrollee are projected to triple. In real terms (constant 1987 dollars), expenditures per enrollee in the program for the aged are expected to increase by 86 percent (from \$1,482 to \$2,760). Per capita expenditures for disabled enrollees are projected to increase 75.8 percent in real terms (from \$1,730 to \$3,041). Consequently, the financial problems experienced by the Social Security program in the early 1980s are expected to arise in the Medicare program within the next 10 years. Projections of Medicare's financial status, under intermediate assumptions, suggest that the Hospital Insurance trust fund will begin to experience deficits in 1998. Under pessimistic assumptions, deficits appear in 1994. Under both assumptions, the trust fund will be technically bankrupt around the turn of the 21st century (HHS, 1988b). To keep Medicare solvent, under intermediate assumptions, payroll taxes would have to increase to 3.7 percent in the year 2005 and to 6.2 percent in the year 2030 from 2.9 percent today.

The financial shortfall in the Medicare program, assuming no changes in Medicare law, has been projected to be more than \$5 billion in 1990 (Holahan and Palmer, 1987). By the year 2000, the annual revenue shortfall may be nearly 0.6 percent of GNP, or \$34 billion (in

however, the contingency fund will not be depleted until 2048. Under pessimistic assumptions, revenues will be less than costs in 2015, with the trust fund technically exhausted in 2026.

TABLE XII.3
Projected Medicare Expenditures per Enrollee by Type of Enrollment, 1988-2005

Year	Number of Enrollees (in thousands)		Benefit Payments (in millions)		Expenditures per Enrollee	
	Aged	Disabled	Aged	Disabled	Aged	Disabled
1988	29,006	3,052	\$46,273	\$5,683	\$1,595	\$1,862
1989	29,562	3,187	50,861	6,333	1,720	1,988
1990	30,100	3,287	56,722	7,140	1,884	2,172
1991	30,606	3,361	62,382	7,882	2,038	2,345
1992	31,090	3,440	68,316	8,661	2,197	2,518
1993	31,552	3,524	74,698	9,519	2,367	2,701
1994	31,983	3,618	81,501	10,469	2,548	2,894
1995	32,375	3,722	88,751	11,528	2,741	3,097
1996	32,722	3,835	96,415	12,688	2,946	3,308
1997	32,998	3,912	104,397	13,855	3,164	3,542
1998	33,215	3,998	112,975	15,129	3,401	3,784
1999	33,436	4,076	122,237	16,501	3,656	4,048
2000	33,677	4,142	132,097	17,940	3,922	4,331
2001	33,917	4,238	142,188	19,516	4,192	4,605
2002	34,178	4,335	152,975	21,248	4,476	4,901
2003	34,483	4,427	164,600	23,105	4,773	5,219
2004	34,812	4,522	176,849	25,084	5,080	5,547
2005	35,169	4,625	189,582	27,186	5,391	5,878
2006	35,597	4,731	203,403	29,470	5,714	6,229
2007	36,171	4,838	218,616	31,933	6,044	6,600
2008	36,874	4,942	235,974	34,640	6,399	7,009
2009	37,573	5,033	254,089	37,410	6,763	7,433
2010	38,196	5,128	271,492	40,158	7,108	7,831

Source: Unpublished data from the U.S. Department of Health and Human Services, Health Care Financing Administration, Medicare Actuary Division, Office of the Actuary, 1987.

1990 GNP terms), and by the time the first half of the baby boom has become eligible for Medicare (2020) the annual shortfall will be more than \$90 billion.¹⁰

Containing Medicaid Expenditures—Longer life expectancies, without reductions in the probability of chronic disability, ensure that more individuals will need long-term care assistance. Over the next 25 years—before most of the baby boom generation is age 65—the demand for institutional long-term care services is projected to increase 73 percent, and the demand for noninstitutional care is projected to increase 66 percent over the amount of care now provided (Manton and Liu, 1984). Shortages of services in light of this growing demand will continue to put upward pressures on the cost of these services.¹¹

Medicaid is not likely to avoid increases in these costs. In 1986, more than 36 percent of the \$44 billion in total Medicaid payments went to pay for nursing home care (HHS, 1987a). Most of these expenditures were generated by just over 6 percent of Medicaid's 21.8 million recipients. Estimates of Medicaid expenditures through the year 2000 made by the Health Care Financing Administration (HCFA) indicate that Medicaid will reduce its portion of financing hospital, physician, and nursing home care but will increase its portion of financing all other care, including home health care (HHS, 1987a). Total Medicaid expenditures, however, are expected to increase over the next 14 years at a slower rate than the projected overall increase in health care costs through the year 2000. However, this is predicated on the assumption that states will continue to contain their health care costs.

¹⁰This is in 1990 GNP terms, based on applying the projected percentage of the shortfall as a percentage of GNP in that year to the expected GNP in 1990 (Holahan and Palmer, 1987).

¹¹The average cost of a day of care in an intermediate care nursing facility varied in 1985 from a low of \$43.83 in the South to a high of \$63.33 in the Northeast or, on average nationwide, \$1,442 a month (Strahan, 1987). Changes in nursing home staffing imposed by OBRA 1987 that go into effect in 1990 are also likely to raise the cost of providing nursing home care. The cost of home health care varies, depending on the duration and scope of services for each visit, but can easily range from \$10 a visit to more than twice the daily cost of a nursing home stay. Cumulatively, the cost of long-term care can be expensive. Since 43 percent of the elderly have incomes that are less than twice the federal poverty level, it is not surprising that nursing home care can lead to impoverishment. A study of nursing home admissions in Massachusetts found that 63 percent of persons aged 66 or older living alone and 37 percent of couples with a spouse admitted to a nursing home were impoverished and qualified for Medicaid benefits within 13 weeks after the admission. Within one year, 57 percent of couples and 83 percent of individuals were impoverished (U.S. Congress, 1985a).

States have been able to contain their Medicaid costs in large part by reducing access to health care services. Access can be denied either by lowering income or asset eligibility standards for potential recipients or by restricting the availability of services. Availability of long-term care services can either be restricted directly by denying approval for the construction or license of the service or by providing a reimbursement rate that does not allow for a normal or market rate of return.

Unless there are substantial improvements in the elderly's health status, increased numbers of very old persons are likely to demand services and bid up the cost for long-term care services, beginning long before the baby boom generation becomes elderly. Higher costs for these services are likely to increase Medicaid expenditures for those currently eligible for Medicaid and also to increase the possibility of more persons becoming impoverished and joining the Medicaid program. State legislators may find themselves in a situation in which access to long-term care requires either authorizing a larger portion of the state's budget to the Medicaid program or increasing the state's overall budget by raising taxes.

Mounting Pressures on Employees and Retirees

Demographic and familial changes and employer and public policy responses to them will directly affect employees and retirees. Labor market costs that initiate changes in the way goods and services are produced could result in the displacement of workers with inadequate or obsolete skills. Employees will also be affected by any necessary increases in taxes to support public expenditures, while retirees are likely to be affected by any changes in public program benefits. In the meantime, more persons will be affected by the issues surrounding dependent and long-term care.

Providing long-term care for aging family members particularly affects women: more than 70 percent of informal caregivers are women.¹² As mothers, women who leave the work force to raise children typically lower their earnings potential (Fuchs, 1983). Consequently, as daughters or daughters-in-law, they may have fewer disincentives to leave the labor market again (since their wages are likely to be lower than their husbands') to care for an elderly parent. As younger spouses, women are also more likely to become caregivers

¹²EBRI tabulations of the 1982 Long-Term Care Survey, public use data base, U.S. Department of Health and Human Services.

of their ailing husbands. As spouses and as widows, women are more likely to bear the financial burden of uncovered expenses incurred by a husband's illness.¹³ Women tend to marry men older than themselves, and, because of their longer life expectancy, will continue to comprise a disproportionate share of the single elderly. Among persons age 65 to 74 living in the community, the ratio of women to men in 1985 was 1.3, and among persons age 85 or older, the ratio of women to men was 2.0.¹⁴

Women who reduce their work hours, change jobs, or leave the labor force to become caregivers may be less likely during their retirement years to afford health care that is not covered by Medicare (other health insurance). In addition, such women are more likely to need long-term care, since they tend to report lower health status and more chronic conditions than men of the same age (Verbrugge, 1982).

As employees more fully recognize the strain that caregiving places on their own as well as their families' lives, they may place pressure on employers to make changes in benefits that accommodate caregiving. Moreover, as more employees and the public recognize the limits to Medicare and private insurance coverage, there may be a growing pressure to expand long-term care financing mechanisms—both public and private.

Conclusion

Prolonged declining fertility rates, reduced mortality without commensurate declines in illness, increased labor force participation of women, and the propensity to retire earlier are the primary demographic trends likely to affect publicly financed programs, employers, and, consequently, employees and retirees. Longer life expectancies and earlier retirement increase the duration of retirement, while reduced mortality without commensurate declines in illness means that more retired persons will need assistance with activities essential for independent living.

The increase in the number of persons with chronic disabilities who are likely to need assistance has focused attention on financing options for long-term care. Long-term care for chronic disabilities is

¹³Using longitudinal data, it has been estimated that widows have a 30 percent greater likelihood of becoming impoverished than they would have if their husband had not died (Holden, Burkhauser, and Myers, 1986).

¹⁴EBRI tabulations of the Bureau of the Census March 1985 Current Population Survey.

the single source of health care expenditures that is likely to be catastrophic for the largest number of persons. Private options for insuring against the financial costs of long-term care are becoming available, but many elderly persons will be unable to afford the premiums or are ineligible for the insurance because of their age or health status. Long-term care insurance is much more likely to be affordable if persons are willing to purchase it early in their lives; however, most persons have not had much exposure to this insurance or are just beginning to become aware of it as the market emerges.

For many, the inability of the private market to facilitate widespread insurance protection, particularly for middle income Americans, will likely be viewed as a market failure that necessitates direct public intervention. Long Term Care '88, for example, was a national campaign of 83 organizations, including the American Association of Retired Persons (AARP), that brought long-term care into the political platform of the presidential candidates.

Declining fertility rates, combined with longer life expectancies, have increased the number of elderly persons in relation to the non-elderly. In 1900, 4 percent of the population was age 65 or older; in 1988, the elderly represent more than 12 percent of the population. As the number of elderly persons grows relative to the number of nonelderly, the financing of public programs such as Social Security, Medicare, and Medicaid becomes an increasingly important public policy issue. Social Security benefits have already been reduced and taxes increased by the 1977 and the 1983 Social Security Amendments to help maintain the program's financial integrity through at least 2030. Medicare is projected to experience financial difficulties by 1995, and Medicaid, despite the growing number of persons likely to need assistance, is expected to continue to contain program expenditures by restricting access to health care.

The insolvency of the Medicare program and actions by states to contain Medicaid expenditures will precede the retirement of the baby boom generation that is now between age 22 and 42. Population projections indicate that in 2030 the retirement of this cohort will increase the elderly population by 140 percent, increase the portion of elderly by 21 percent, and increase the proportion of persons age 85 or older to 5 percent of the population.

Declining fertility rates will also slow the growth rate of the labor force and therefore reduce the number of potential taxpayers and consumers. Projections to the year 2000 place the annual growth rate at around 1.2 percent—less than one-half the average growth rate throughout the 1970s. Projections of annual growth rates beyond the

year 2000 are even smaller (0.27 percent through 2055). Relatively tighter labor markets are likely to raise the cost of labor to employers. Employer responses to these increases are likely to vary—depending partly on the products produced—but for most employers the cost of production is likely to rise.

Tighter labor markets could also result in lowered minimum hiring standards. Concern about the quality of future workers has already prompted some larger employers to focus attention and money on the public school system. More than 64 percent of 130 major corporations recently surveyed ranked primary and secondary education as their major concern, an increase from 42 percent two years earlier (The Conference Board, 1988). Even if wages are not driven up, training costs (including remedial education) may raise the unit cost of labor.

As the composition of the labor force changes, employers are likely to experience new pressures from employees to consider a different mix of employee benefits. Two aspects of this change include the larger number of working mothers and the increased number of adults with a chronically ill parent or family member. Most of the growth in the labor market has been among women in general and women with children in particular. Since women born during the baby boom are still in their childbearing years, the demand for day care is likely to increase in the short run.

Declining fertility rates not only reduce the growth of new employees and new taxpayers but also mean that there will be fewer adults to assist parents and family members with chronic disabilities. Longer life expectancies without commensurate reductions in illness ensure that more persons will need long-term care. Increasing numbers of employees will become caregivers. Recognition that Medicare, supplemental Medicare insurance (Medigap), or other forms of health insurance do not cover long-term care and that coordinating this care is confusing, stressful, and time consuming may also encourage the formation of new employee benefits.

As members of the baby boom generation advance to senior positions in their firms while providing long-term health care at home, employers are more likely to evaluate the actual and potential needs of their employees as caregivers. A growing share of employees may be willing to see their compensation restructured to include some form of long-term care insurance or elder care benefits. The absence of this development, however, is likely to intensify pressure to either establish or expand public programs or mandate that employers provide this sort of assistance.

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XIII. Benefit Policies in a Turbulent Economy

PAPER BY WILLIAM B. JOHNSTON*

Introduction

The United States, like most other developed nations, is undergoing major economic and demographic changes with far-reaching implications for national benefit policies. The economy is shifting gradually to services, while technology and trade are creating and destroying jobs, companies, and even industries at a rapid rate. Meanwhile, the labor force is becoming more predominantly middle-aged and increasingly concerned with stability and job security. The challenge to policymakers is to bridge these conflicting trends while preserving the dynamism that has been the hallmark of the U.S. economy for two centuries.

National benefit policies, which have evolved on a company-by-company basis in response to different concerns, will need to change to respond to these new realities. Future benefit systems will need to be far more flexible and portable than today's, with programs that are tailored and tied to individuals replacing systems that are built solely around corporate goals.

The Changing Economy

Between now and the year 2000, the U.S. economy will continue to be transformed by new technologies, international competition, and industrial shifts. After years of suffering from an overvalued dollar and inflated production costs, U.S. manufacturers are poised to reassert their presence in world markets. With the dollar now at one-half its value relative to the Japanese yen and also trending down against most other currencies, American production locations have achieved significant competitive advantages. At the same time, the painful process of eliminating excess people and facilities in response to foreign competition has left U.S. manufacturers leaner and more competitive. As a result of these two trends, the U.S. trade picture in the early 1990s will be dramatically improved compared to the dismal results of the mid 1980s (table XIII.1).

*Presented by Arnold Packer.

TABLE XIII.1
Projected U.S. Trade Balance, 1980–2000

	1980	1985	1990	1995	2000
Current Account					
Balance (\$ billions)	+1.8	-116.4	-88	-19	+14

Sources: U.S. President, *Economic Report of the President: The Annual Report of the Council of Economic Advisors* (Washington, D.C.: U.S. Government Printing Office, 1988), table B.102; Hudson Institute.

Despite this extraordinary rebound in the competitiveness of U.S. manufacturers, the American economy will continue to shift toward service employment throughout the 1990s, as it has been doing for the last several decades. Goods production, which occupied 41 percent of the work force in 1946, requires only 24 percent today. By 2000, this share will have dropped to 20 percent. Because of rapid productivity growth in factories, the total number of manufacturing jobs will shrink by 2.2 million, while the economy adds 24 million new service slots (Hudson Institute, Inc., 1987).

Finally, although the importance of technological change has been so often noted that it has been almost trivialized, it will continue to be a major source of economic turbulence. New information tools are transforming jobs throughout the economy. Today's administrative assistant is surrounded by word processors, Xerox machines, fax machines, and voice mail switchboards that were unimagined by the telephone and typewriter secretary of two decades ago. Enormous enterprises spring up in a few years to dominate or revolutionize industries based on new technologies or organizational methods. Not only such recent examples as Apple computer and Federal Express but such "ancient" companies as Xerox, McDonald's, and Texas Airlines did not exist in the early 1950s. And as surely as technology has created it has destroyed: Osbourne Computer and People Express Airlines rose meteorically and disappeared even faster.

These changes mean that the turbulence that has characterized the economy since the early 1970s is far from over. Millions of new jobs will be created, yet millions of others will be lost. In manufacturing, job gains in new high technology, export-oriented industries will be offset by greater job losses in older, less competitive industries. Between 1977 and 1982, for example, the U.S. economy lost about 1.1 million jobs. But this net loss came despite the creation of 4.2 million new manufacturing jobs (table XIII.2).

TABLE XIII.2
Gains and Losses in Manufacturing Jobs, 1977-1982

Gains and Losses	No. of Jobs (millions)
Job Gains in New Plants	+ 2.5
New Jobs in Expanding Plants	+ 1.7
Job Losses in Closed Plants	- 2.6
Job Losses in Declining Plants	- 2.7
Net Job Loss	- 1.1

Source: U.S. Department of Labor, *Economic Adjustment and Worker Dislocation in a Competitive Society: Report of the Secretary of Labor's Task Force on Economic Adjustment and Worker Dislocation* (Washington, D.C.: U.S. Government Printing Office, 1986).

In the rapidly expanding service sector, most of the new jobs will be created by small businesses, as has been true historically. For example, between 1976 and 1982, companies with fewer than 20 employees, mostly in service businesses, created 39 percent of the new jobs even though they accounted for only 21 percent of employment in 1976, according to the Small Business Administration. But these small firms are not only prolific job generators, they are also major job destroyers simply because so many young, small companies fail. As a result, the continuing shift to service employment promises to exacerbate the turmoil in labor markets and to create continuously high levels of job displacement.

The Scope of the Dislocation Problem

The pattern of future jobs gains and losses may differ from those of recent history because fewer jobs will be lost to imports and more will be created in export-oriented manufacturing industries. Still, the historical record of job displacement provides some insight into the changes ahead.

The most widely used definition of displaced workers counts only those who have previously been employed at least three years and whose jobs were eliminated. Using this standard, surveys by the U.S. Department of Labor in 1984 and 1986 counted approximately 1 million workers per year who were displaced between 1979 and 1986.

If all workers whose jobs were abolished are counted (without consideration for how long these workers had held their jobs), the numbers of displaced workers are approximately twice as large. Among the 10.8 million workers whose jobs were abolished between 1981

and 1986, approximately 318,000 remained out of work after 52 weeks at the time of the survey in 1986.

Dislocated workers tend to have been employed in manufacturing (49 percent) and to have had blue collar occupations (56 percent). Two-thirds are men, and 17 percent are black or Hispanic.

These workers experience varying levels of difficulty in adjusting to their dislocation. Among all those displaced, the median weeks without work is about 18, but 19 percent are unemployed for more than a year. More than one-half of all workers who were reemployed at the time of the survey in 1986 had changed occupations or industries. Typically, reemployed workers accepted wage levels in their new jobs that were 10 to 15 percent below their previous wages.

The greatest earning losses were experienced by older, longer tenure workers from unionized industries. The longest periods of unemployment were typically concentrated among less educated, older, and long tenure employees. Women and blacks also had greater difficulty returning to work.

Education was a particularly important determinant of reemployability. Among those who lost jobs during the early 1980s, for example, approximately 60 percent were reemployed at the time of the Labor Department's survey in 1984. But only two-fifths of those with elementary school educations had found new jobs, compared to almost four-fifths of those with college degrees (table XIII.3).

During the early 1980s, layoffs and closures affected firms in the Midwest more than those elsewhere in the country. According to a General Accounting Office survey in 1986, 9 percent of all large Midwestern firms had suffered layoffs affecting 20 percent or more of their work forces, compared to a national average of 7.8 percent (table XIII.4).

TABLE XIII.3
Workers Displaced, 1979-1984, Reemployed, 1984

Education Level	Number Displaced (thousands)	Percent Reemployed
Elementary School	519	41.1
1-3 Years High School	755	49.6
4 Years High School	2,425	60.8
1-3 Years College	814	67.5
4 or More Years College	578	77.4

Source: U.S. Department of Labor, Bureau of Labor Statistics, *Displaced Workers, 1979-1983*, Washington, D.C. (U.S. Government Printing Office, 1985), table B-3.

TABLE XIII.4
Firms with More Than 100 Employees That Laid Off 20 Percent of
Their Workers, 1983-1984

Region	Rate of Occurrence
Total	7.8%
Northeast	7.6
Midwest	9.0
South	7.5
West	7.0

Source: U.S. General Accounting Office, *Dislocated Workers: Extent of Business Closures, Layoffs, and the Public and Private Response* (Washington, D.C.: Government Printing Office, 1986), p. 12.

In addition to these significant dislocations resulting from plant closings and layoffs, a growing fraction of the work force is apparently shifting toward part-time and temporary work. For example, between 1970 and 1986, the share of the work force holding part-time jobs (less than 20 hours per week) rose from 16.7 percent to 19.2 percent. Most of this increase came from growth in the numbers who were working part-time because they could not find full-time jobs, although the number of voluntary workers also grew (U.S. Department of Labor, 1986, 1988). Since part-time work often provides few benefits and is most vulnerable to layoffs when the economy turns down, this trend toward greater use of part-timers underscores the uncertainties in the current economic climate.

The combination of shifts in the structure of employment, the changing industrial mix, international competition, technological change, and the dynamism of the economy means that jobs in the modern economy are increasingly less secure. The concept of lifetime employment with a single firm, if it was ever possible, has become a complete anachronism as the pace of change has accelerated. Most individuals entering today's economy face a work life that will surely include many job changes and which may require moving frequently to new firms, new occupations, new locations, or new industries.

The Changing Work Force

The rapid changes underway in the economy are paralleled by major demographic shifts occurring in the work force. During the 1990s the work force will become older and include more women. It will also be composed increasingly of minorities and immigrants.

The benefits that these workers need and want are likely to be different in kind and structure from those most firms offer today.

An Aging Work Force and Fewer Young Workers—The aging of the baby boom generation (those born between 1946 and 1961) will cause the American work force to become much older, on average, throughout the balance of the century, rising from a median of 35 years in 1984 to about 39 in 2000. Most of this aging will be the result of huge increases in the numbers of middle-aged Americans while the numbers of young and older workers decline. The number of workers age 35–54 will rise by more than 25 million, 5 million more than the total increase in the work force. Meanwhile, the number of workers younger than age 34 will drop by almost 5 million while their share shrinks from one-half to less than two-fifths of the work force (table XIII.5).

The Impacts of Aging—Some of the impacts of the aging of the work force will be quite favorable for the economy. For example, workers will generally be more experienced, stable, reliable, and productive. Their initial education will be completed, and this stored human capital should pay dividends throughout the 1990s. On the other hand, many of the characteristics of a more mature work force may prove to be costly or unproductive for some employers, saddling them with a group of expensive, hard-to-retrain workers unsuited for the new challenges of the evolving economy. At the same time, the shrinking numbers of young workers may mean that companies accustomed to hiring young workers at cheap wages may find that they must raise wages, reach further down the labor queue, invest in labor saving technology, or all three, in order to succeed.

The prospects of increased rigidities in the economy are not based simply on sociological speculation. For example, older people are

TABLE XIII.5
Age of the Work Force, 1970–2000
(in millions)

Age	1970		1985		2000	
	Number	Percent	Number	Percent	Number	Percent
16–34	34,882	42.1	56,960	49.5	52,061	38.6
35–54	33,386	40.3	43,242	37.6	68,357	50.7
55+	14,505	17.5	14,748	12.8	14,532	10.8

Source: U.S. Department of Labor, Bureau of Labor Statistics, *Handbook of Labor Statistics, 1985* (Washington, D.C.: U.S. Government Printing Office, 1986), table 4; and unpublished data.

much less likely to move than younger ones (table XIII.6). As the baby boomers reach the middle years of mortgages and children in school, their willingness to pull up stakes in response to new opportunities or changing conditions will decline. Similarly, the proportion of individuals who are willing to be retrained or who move between occupations declines steadily with age. For example, workers over age 45 were less than half as likely to change occupations between 1982 and 1983 than workers age 25 to 44 (table XIII.7).

TABLE XIII.6
Percentage of Workers Moving Outside Their County between 1976 and 1979

Age					
20-24	25-34	35-44	45-64	65-74	75+
Percentage of workers moving					
28.1%	28.7%	16.0%	9.6%	7.8%	6.5%

Source: U.S. Department of Commerce, Bureau of the Census, *Demographic and Socioeconomic Aspects of Aging in the United States*, Current Population Reports, Series P-23, no. 138 (Washington, D.C.: U.S. Government Printing Office, 1984), table 4-6.

The dearth of young workers may hamper the ability of companies to grow rapidly or to respond to change. With the absolute numbers of new workers age 16-34 declining, many companies may find themselves unable to move rapidly to hire large numbers of new workers to respond to changing economic conditions. The overnight creation of a Federal Express, an MCI, or an Apple Computer Company may become more difficult as the numbers of young people drop. The traditional process of "creative destruction" by which a company uses new hires to start a new division while laying off older workers in slowly growing sectors may become much more difficult. Not only

TABLE XIII.7
Percentage of Workers Changing Occupation, by Age, 1982-1983

Age					
25-34	35-44	45-54	55-64	65+	Average
Percentage Changing Occupations					
11.7%	7.2%	4.8%	3.4%	1.7%	7.5%

Source: National Commission for Employment Policy, *The Education, Training and Work Experience of the Adult Labor Force from 1984 to 1995* (Washington, D.C.: National Commission on Employment Policy, 1985).

will early retirements be more expensive but wages of young workers may be higher.

Many companies with older work forces may find that their aging, higher-paid workers make them uncompetitive. This will be particularly true of companies in slowly growing industries or ones in which productivity is defined by production systems rather than by worker knowledge or skills, for example, automobiles, metals, and transportation. With no way to recover higher pay scales, higher pension charges (primarily as a result of vesting rather than actual retirements) and higher health care costs, companies may seek to roll back traditional seniority systems and other institutional arrangements for granting higher pay to older workers.

The job squeeze among middle-aged workers may become more intense. The large increase in the numbers of middle-aged workers may collide with corporate efforts to reduce middle management or to reduce vulnerability to demographic noncompetitiveness. Because a large fraction of the skills and productivity of older workers is valuable only to the firms they work for, older workers who lose jobs will have a particularly difficult time matching previous salaries when they find new jobs. A turbulent economy in which many firms are expanding and contracting in response to market conditions will be especially difficult for middle-aged and older workers. The long-standing pattern of increasing earnings until retirement may be substantially altered as a result. And demands for more secure and more individually oriented benefit programs will be likely to increase.

Continued Feminization of the Work Force

Over the next 15 years, women are expected to continue to join the work force in substantial numbers. By the year 2000, approximately 47 percent of the work force will be women, and 60 percent of women will be at work (table XIII.8). Women will comprise about 63 percent of the new entrants into the labor force between 1985 and 2000.

Much of the increase in the number of women in the labor force has come from increased participation by women with children. Of the 14.6 million married women who joined the labor force between 1960 and 1984, 8 million came from families with children. During that time period, the proportion of married mothers at work grew from 28 to 61 percent. In families with children under age six, the proportion of working mothers grew from 19 to 52 percent.

The flood of women entering the work force during the last three decades has been driven by powerful social and economic trends.

TABLE XIII.8
Women as a Share of the Work Force, 1950–2000

	1950	1960	1970	1980	1990	2000
	<u>Number (in thousands)</u>					
Number of Working Women	18,389	23,240	31,543	45,483	55,507	63,380
	<u>Percentage</u>					
Female Labor Force Participation Rate	33.9%	37.7%	43.3%	51.5%	56.6%	59.7%
Female Share of the Work Force	29.6	33.4	38.1	42.5	45.2	47.0

Source: U.S. Department of Labor, Bureau of Labor Statistics, *Handbook of Labor Statistics, 1985* (Washington, D.C.: Government Printing Office, 1986), tables 4 and 5; and unpublished data.

Slow economic growth has made two earners a necessity for many families striving for a middle class lifestyle. Technology has simplified homemaking at the same time that society has redefined the role of women to include paid employment as the norm for most.

These working mothers are demanding different employment conditions and different benefit programs. Most importantly, working mothers want to work less than they do now. According to a recent Gallup poll, only 13 percent of working women with children want to work full-time, regular hours, although 52 percent of them hold full-time jobs. Six of ten working mothers want part-time employment, flexible hours, or stay-at-home jobs, and 16 percent would prefer not to work at all. Only one-half of all women believe that they can adequately fulfill their responsibilities to their children if they work full-time. If employers fail to provide sufficient jobs with flexible working arrangements, more mothers may choose to leave the labor force during their child-rearing years, reducing the numbers of new workers.

Day care, whether provided by the employer, subsidized by government, or arranged for by individuals, is also a growing concern in families in which the mother works. As evidence accumulates concerning the positive impacts on children of high-quality day care, the pressure for ever-higher standards will grow. Day care, like health care during the 1970s, will claim a rising fraction of national income. By the year 2000, it may be routine for employers to subsidize or directly provide care, and school systems may have lowered the age for starting school to five or younger. Federal day care programs for

children of welfare mothers, early childhood education for disadvantaged children, and tax subsidies for child care may be substantially expanded.

The work force may become less flexible as two-career families become less willing to move. Corporations will be forced to provide more relocation assistance to spouses as the two-career trend reinforces the rigidity that develops because of aging. Middle-aged, two-career families will become geographically immobile.

Minorities as a Growing Share of the Work Force

Over the next 15 years, blacks, Hispanics, and other minorities will make up a large share of the expansion of the labor force. Nonwhites, for example, will comprise 29 percent of the net additions to the work force over the next 15 years and will be more than 15 percent of the work force in the year 2000 (table XIII.9). Black women will comprise the largest share of the increase in the nonwhite labor force. In fact, by the year 2000, black women will outnumber black men in the work force, a striking contrast to the pattern among whites, where men outnumber women by almost three to two.

TABLE XIII.9
Nonwhites as a Share of the Work Force, 1970–2000

Worker Characteristics	1970		1985		2000	
	No. ^a	Percent	No. ^a	Percent	No. ^a	Percent
Working Age Population (16+)	137.1		178.2		202.6	
Nonwhite	14.9		24.2		31.8	
Nonwhite share		10.9%		13.6%		15.7%
Labor Force	82.8		115.0		135.0	
Nonwhite	9.2		15.1		20.9	
Nonwhite share		11.1		13.1		15.5
Labor Force Increase over Previous Period			32.1		20.0	
Nonwhite			5.9		5.8	
Nonwhite share				18.4		29.0
Youth Labor Force (Ages 20–34)	27.6		49.3		43.9	
Nonwhite	3.5		7.1		7.3	
Nonwhite share		12.7		14.4		16.7

Source: U.S. Department of Labor, Bureau of Labor Statistics, *Handbook of Labor Statistics, 1985* (Washington, D.C.: Government Printing Office, 1986) tables 4 and 5; and unpublished data.

^aIn millions.

By almost every measure of employment, labor force participation, earnings, and education, black and Hispanic minorities suffer much greater disadvantages than whites (table XIII.10). For employers, the greater numbers of minorities among the pool of new entrants into the work force will present new challenges in terms of training and education. Not only can employers expect to invest more in many of their new hires in order to bring them up to required standards of competence in basic skills, they may also be forced to become much more involved with the public school system in order to assure themselves of a supply of qualified workers.

Benefit Programs in the Next Decade

The demographic and economic trends that are occurring will have significant implications for the development of benefit programs during the next decade. In general, the changes ahead will reshape benefits to be more flexible, more diverse, more tightly tied to individuals, and more oriented toward personal educational and financial development than traditional programs. The most important changes that can be anticipated include the following.

Pension programs are likely to shift dramatically toward defined contribution plans. In a turbulent economy, workers will be forced increasingly to change employers and even careers. Employers will be required to hire and fire with greater regularity. In such an economic environment, it will be more and more in the interests of both parties to provide guaranteed contributions toward a fully portable retirement income program, rather than assured streams of retirement

TABLE XIII.10
Characteristics of Blacks and Hispanics in the Labor Market, 1983

Labor Force Participation	Unemployment Rate	Median Family Earnings*	Percent below Poverty	Median Years of Schooling
		White		
64.3	8.4	\$487	12.1	12.8
		Black		
61.5	19.5	\$348	35.7	12.5
		Hispanic		
63.8	13.7	\$366	28.4	12.1

Source: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of the Census.

*Weekly.

income in return for a specified period of employment. As the work force becomes more predominantly middle-aged and concerned with its retirement, and as public retirement programs lose their ability to grow in the budget constrained environment of the 1990s, employees are likely to become less and less tolerant of retirement plans that are based on uncertain promises rather than cash deposits in the employee's name. Once workers have participated in a defined contribution plan in which they can see annual increases in their retirement nest egg, they are likely to view defined benefit programs, with their distant, conditional payoffs, as frauds. This will be especially so in the case of women and young workers who enter and leave employment and change jobs frequently. As these workers become a greater proportion of the work force, their demands are more likely to be met by employers.

Flexible, or cafeteria, plans will become the rule in most companies. The growing diversity of the work force, coupled with the rising demands from working parents for child care and increased time away from work to tend to the needs of their families and children, will lead employers to restructure their benefits offerings. Rather than rigid plans that offer benefits of no value to some workers and great worth to others, benefit policies are likely to be restructured to enable each worker to choose from a menu of health, retirement, leave, and other benefits, subject only to a dollar limitation. Under such plans, a single parent might choose more day care, health, and flexible leave options, while a middle-aged household might choose more insurance, retirement, or savings programs. These plans will have the added benefit of deflecting legislative mandates for such things as pregnancy leave, day care, or enriched health programs. Employers will be able to cap costs and address the widely varying needs of their work forces while responding to public pressure for an expanded range of benefits.

Jobs are likely to be restructured to offer more flexibility in terms of when and where work is done. The 5-day, 40-hour, 50-week, 30-year work life at the office is an anachronism of the industrial era. Increasingly, work can be accomplished at the home, in the car, at the airport, on evenings and weekends, and in "retirement;" leisure can be taken in the middle of the day, the week, the year. Cafeteria benefit plans will be followed by cafeteria styles of employment and cafeteria careers in which employees will increasingly control when and where they wish to work. For these schemes to work, there must be better systems of measurement of productivity, of course. But as technology increases the range of possibilities, and the work force becomes more

various in its needs and situations, the structure of employment will have to respond and adjust.

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XIV. A Kaleidoscopic View of Employee Benefits

PAPER BY THOMAS E. WOOD

Introduction

During half of a century of employee benefit growth, we have witnessed change of an evolutionary nature. The first Social Security benefits were paid in the 1940s; the program was expanded to include death and disability benefits in the 1950s; Medicare/Medicaid was added in the 1960s; primary retirement benefits were enlarged dramatically in the 1970s; and the system faltered in the 1980s. Private retirement plans were introduced in the 1940s and 1950s, liberalized in the 1960s, controlled by the Employee Retirement Income Security Act (ERISA) in the 1970s, and have faltered in the 1980s. Health care, death, and disability benefits have experienced similar patterns. Establishment, enlargement, and faltering. What is this picture we call the employee benefit program of the late 1980s?

In preparing for this discussion I reviewed carefully the material presented and deliberated at the 1986 Employee Benefit Research Institute (EBRI) forum.* There was not much with which I could disagree. What then could be presented less than two years later that would add a different perspective or provide unique guidance for future planning—for creative design of employee benefits? Demographics do not shift quickly. A slow growth economy does not come as a surprise, especially after five years of healthy growth. Global competition does not come on us suddenly, nor does the resultant pressure to conserve pay and benefit dollars. The trend in government thinking on the limitation of benefits is not a surprise. The resurgence of explosive health care costs was predictable and has occurred as expected. What then is new and different about this forum and its timing that suggests there may be something new that has a bearing on the future for employee benefits and on planning? One obvious answer is that those who sponsor this forum, present papers, and participate must feel enough has happened, or will happen, to war-

*Editor's note: See Employee Benefit Research Institute, *America in Transition: Benefits for the Future* (Washington, DC: Employee Benefit Research Institute, 1987).

rant such a discussion just 18 months after the last one. In other words, there is general recognition that change must be occurring very rapidly and that response to change must be developed and considered.

As a vehicle for discussion, I created an imaginary kaleidoscope through which I could picture employee benefits. First, I took a look at things today. Then I shook it several times to see how things might be in the future, first from a personal perspective and then with a view to how benefits might develop differently, with a planning process more appropriate to the future. As a transition from present to future, I have shaken up a few images of past creative planning.

A View of the Present

Not all that we see in our first view into the kaleidoscope is pleasing to the eye. The pattern is a shocking array of color and design. More aptly, a disarray of color and design elements. Problems fall into several sectors.

Medical Care Benefits—Costs for active employees are again skyrocketing and all the effort toward cost containment or reduction appears to have run its course. This is, in large part, because the medical delivery system has learned to cope with both the government's and private industry's cost restraint efforts.

New medical technology, delivery mechanisms, and coverage areas threaten the ability of the employer to continue to provide coverage without severe limitations. The result is diminished employee security.

Liabilities for terminated employees have been added through the Consolidated Omnibus Budget Reconciliation Act of 1985.

Postretirement medical liabilities loom huge for the future without the necessary vehicles or tax incentives to advance fund for them, and realistic responses cannot be proposed without the ability to project cost increases.

Long-term care and elder care are issues, or elements, to be examined and considered in this already unsightly view of the present.

Retirement Benefits—Vesting schedules, even at the five-year levels, will not meet the needs of the majority of our work force, in which the average woman worker stays in one job less than three years and the average male about four.

Liberalized early retirement practices (whether through liberalized actuarial penalties or through early retirement "windows") run counter

to improvements in life span and counter to the increase in normal retirement age from 65 to 67 under Social Security. And they are certainly in conflict with age discrimination laws that are intended not just to stop discrimination but to encourage extended work life.

There are growing misconceptions about the potential role and abilities of capital accumulation plans as primary retirement vehicles.

Bureaucratic shaping of national retirement policy is occurring in the absence of congressional leadership. Note the limitations on benefits under the banner of "discriminatory practice" as a way of directing the private retirement system.

Retirement funds are manipulated for short-term gain regardless of the long-term nature of the pension commitment.

The direction of the individual retirement account (IRA) is confused. Originally, IRAs were for those not covered by private plans; they should have stayed that way. And, for those needing such plans, contribution limits were and are unrealistic.

Work Force Characteristics

In another sector of this not-so-pretty picture of the present, there are elements of the work force. Here one sees increased use of part-time, temporary, and contract employees (including "cottage workers") whose employee benefit needs have not yet been well addressed. In fact, part of the purpose of using such labor is to hold down direct labor cost and not pay for benefits.

There is a significant decrease in employee loyalty within the work force for understandable reasons: companies and divisions are bought and sold, plants are closed or moved, or the work force reduced. Unemployment is low, but so is job continuity. The impact of this loss of continuity is onerous on many aspects of the work force but may become most severe in the area of employee loyalty.

In other sectors of this kaleidoscopic view of benefits today I find equally displeasing design and color. Death, disability, time off, and minor benefits are all misshapen against the backlighting of today's needs. Even the noble attempt to satisfy individual employee needs through selection among benefits has been misconfigured by placing too much emphasis on the notion of tax-advantaged compensation versus the goal of appropriate allocation of total compensation dollars.

Future Plan Design Concepts

Let us now shake the kaleidoscope to see if we can rearrange the elements in a manner more pleasing to the eye. We will look at design concepts, not the detailed elements, and the focus is on areas that I would alter profoundly even though the overall theme of employee benefit security is satisfying and worthy. The concepts are not necessarily new or even mine. They fit the future, though.

Concept 1. There should be a safety net of economic benefits that provides economic protection against the financial hazards that stop or place a heavy burden on the paycheck. The government has both a provider and an encourager role here. I define "safety net" as a modest level of protection in the areas of old age, death, and disability benefits and substantial but comprehensive protection against catastrophic medical expenses.

Concept 2. Beyond the basic level of protection, individual employees should have the opportunity to supplement coverages, or add them, in areas they deem appropriate. This concept suggests that all monies beyond that needed for the safety net be on a defined contribution basis for welfare or group benefits as well as for supplementary retirement benefits. The government has a role of encourager here.

We need to eliminate the notion that there can be withdrawals under active plans, even for medical, education, or special emergencies. When we try to mix a loan system or a withdrawal or banking system with a national retirement objective, we fly in the face of the plan's purpose and dilute that purpose.

Concept 3. There would be no concept of "discrimination" and thus, there would be no integration between private plans and Social Security. Balancing this would be the elimination of any limitation on employee benefits as long as all workers at all pay levels could be treated equally.

Concept 4. Employees have an obligation to use employee benefits intelligently and therefore they should help pay their cost. Especially in the medical care expense area, 100 percent reimbursement should not be allowed. If employees have an obligation for intelligent use, and if they are responsible for providing for a significant portion of their security needs, they should also have the opportunity to participate in the design of benefits.

Concept 5. Benefit pay should be equitable. The distinction by age, sex, or family status should not be a significant factor in determining the amount of total compensation an individual receives. The exception to this rule might be in the retirement area, where the basic

safety net objective is best met through a defined benefit rather than a defined contribution approach. Here, equity may be best defined as equity of accrual rate rather than equity of pay contributed.

If the preceding kaleidoscopic view of the future is reasonable in concept, what might be a creative response in design? Without going into detail, here are a few glimpses.

Basic Retirement:

- Defined benefit, nonintegrated
- Career average pay
- Accrual rates that develop about 1 percent \times years of final average pay.
- Normal retirement at 67
- Actuarial reductions for early retirement
- Actuarial increases for delayed retirement
- Full vesting after three years' service with vested amounts rolled over to individual IRAs, inaccessible until retirement

Supplemental Retirement:

- Available to all employees
- Provision for possible success sharing additives
- State-of-the-art investment provisions and administration
- Equity in contribution levels (no limitations on higher paid versus lower paid)
- Rollover required on termination
- Extreme penalty for withdrawal

Health Care Benefits:

- Deductibles and co-insurance required
- Duplicate coverage (acquired privately or through a working spouse) of never more than 90 percent reimbursement.
- HMOs experience rated; deductibles and co-insurance required
- Post-retirement medical coverage purchase plans

Other Group Benefits:

- Disability benefits related to service
- Multiple levels and types of life insurance
- Broad application of Section 125 and spending accounts (forfeiture acceptable for all but medical)
- True group auto insurance
- Group homeowners insurance
- Long-term care coverage or prefunding on an individual basis
- Education investment plans

I believe this concept conveys the idea of broad flexibility in many benefit areas and of the need for a considerable number of significant changes in our basic picture of benefits.

New Approaches to Benefit Planning

Let us take a quick shake of the kaleidoscope and consider some innovative approaches to benefit planning. One of the most important moves in the retirement area was made when Congress cut federal employees' pensions and added a supplementary voluntary capital accumulator. What is so dramatic about it? The plan now looks like a standard corporate configuration of a pension plus 401(k) arrangement.

The importance is twofold. Congress reduced the level of pension accrual (which most private employees have not done), and did it for hundreds of thousands of employees. Much press attention has been given to the fact that relatively few eligible employees have opted for the new program—an observation that overshadowed the significance of the move as it applies to those employees younger than the option age. One should also note that the choice of changing was put before the employee (a) shortly after the biggest stock market plummet in history, and (b) decisions had to be made during the holiday season, always a tough time to launch a benefit change.

Another dramatic switch in the retirement area was the move by Bank of America from its generous program of benefits to a "cash balance" plan. I do not happen to agree with the efficacy of such plans (the underlying pension formula is miniscule, and thus the employers' major dependency is on the capital accumulation portion of the system), but it did represent a very major shift from traditional approach to an innovative one intended to help make the bank's future more secure.

As to the largest retirement system of all, Social Security, we are likely someday to see a new and innovative approach. Although politics is not a part of this paper, it was refreshing to see one presidential aspirant willing to face up to the problems that exist in the Social Security system, namely, that it will go broke as the baby boom population moves into retirement. During the deliberations of the National Commission on Social Security Reform, I proposed to Harry Kapnick, then chairman of Arthur Andersen & Company and a member of the commission, a new approach to Social Security, based on the following:

- A 5 percent contribution would be required by each employer and worker.
- An additional 5 percent would be required if the employer has no pension.

- An additional voluntary 5 percent contribution could be made by the employee.
- All monies would go into individual accounts for investment in “approved” funds sponsored by insurance companies, trust companies, and the government.
- The employer’s contribution would go into government retirement bonds. The employee would have the choice of three or four investment vehicles.
- Death and disability benefits would be required and underwritten by private insurers.
- A general tax would pay off the liability for existing retirees and those nearing retirement.
- As capital accounts built up, the “floor” primary benefits would recede.

Such a system could give individuals a sense of well-being and control over their own futures, pour billions into capital formation, and get us out of Social Security debt in about 50 years rather than have the system go broke at that time.

Another innovation in the private retirement area is the 100 percent offset plan. As long as we must live with the concept of Social Security integration, the 100 percent offset approach is as good as any scheme around. The 100 percent effect works off a schedule that simply states monthly earnings in one column and monthly benefits in the next, including 100 percent primary Social Security.

The formula/schedule has the advantage of needing updating periodically to remain properly integrated, as does a standard career average plan to accommodate increasing pay levels, so the employer is able to go to its employees periodically with a positive message—much like GE or IBM do with their career average updates every few years. This concept was used by a major employer to bring a variable annuity retirement program back into line with an original objective of 85 percent pay replacement after it had gotten out of line by nearly 25 percent of pay. We gauged that the 100 percent offset would get the plan back to its original objective in 15 years. This was in the late 1970s and, with surging inflation, the plan actually achieved the goal in five years.

In a union situation a few years ago, a demand was put on the table for a thrift plan, on top of an already generous pension of 2 percent of pay \times service, but the fact that bargaining took place every other year created a pension plan that was actually a final one-year plan in operation. We proceeded to bargain the thrift plan, but at \$.25 on

the dollar, with a proviso that the accumulation would offset the pension (thus, as accounts grew and as the \$.25 was negotiated up, the pension liability would diminish). The strategy has been working in just that way.

There are many examples of creative planning in the health care field. The La Habra plan was one of the most innovative, and the notion of cash bonus, or deferral of unspent amounts, served to remind the employees that medical cost savings were essentially their monies and wise spending was to their gain.

Appropriate Benefits for the Future Work Force

Unfortunately, we tend to use a short focal plane when thinking creatively about benefits. We often fail to see the broader picture. Our focal plane needs to be of good length to cope with tomorrow's benefit problems. We need to look at the whole, rather than just its parts, and look well into the future. Let me give an example concerning part-time workers or temporary employees. The idea of a cottage industry, of contract workers, of permanent part-time employees, or extensive use of temporary help will not continue to grow without Congress recognizing that it creates a severe problem demanding attention. Already we are required to cover an increasingly wide spectrum of employees. Unfortunately, the employers most likely to make heavy use of such labor pools are the employers least likely to want to take voluntary action in providing employee benefits, so the corporate response is usually to do no more than is required by law. It is difficult for the labor movement to organize such workers in a traditional way because the workers are too scattered. The workers themselves are not likely to join a union when there is no contract to assure that their services will be used.

What is the appropriate response? More legislation reducing the number of hours of work per week required? Coverage for contract employees under employers' plans for full-time staff? These are the logical evolutionary measures. What might some revolutionary measures be? For one, the concept outlined for a modified Social Security system would do in the retirement area. Private insurance for death and disability could be provided on a group purchasing, or group risk, basis with underwriting by private insurers who might bid for the business just as private companies bid for administration of Medicare and Medicaid.

Perhaps unions should set up association divisions and invest in membership solicitation as the American Association of Retired Per-

sons (AARP) has done; AARP has been highly successful in building membership.

Perhaps Congress should look at the system it used in promoting the development of health maintenance organizations (HMOs) through the HMO Act of 1973. Congress provided some funding to get more HMOs started, but the main thing it did was to require an employer to offer employees an HMO as an alternative to conventional medical insurance, if one was available. The tactic has been highly successful, given the number of HMOs now competing for business and doing so without further government funding. The parallel is that part-timers, contract employees, cottage workers, etc. would have available employee benefit group purchasing organizations to which they and/or their employers would contribute for benefit coverage. Many professional organizations already do this, as do certain trade organizations.

I do not advocate further government action, but a Medicare administrative network is already in place. If medical coverage is required, why not give the part-timer or contract employee the choice of a catastrophic plan with perhaps two or three choices of deductible levels. As in a flexible compensation plan, the worker would choose the level of self-insurance.

Elder care and long-term care are particularly knotty problems facing our society, for several reasons. With a standard of living that is already declining for the average American worker, it is difficult for most people to take on the task of caring for parents financially. And, with most homes with two or more adults also having two or more income earners, no one is home to look after a child, let alone a parent needing special attention. The private business response has been, "Wait a minute, this is not our responsibility . . . it is the individual's." However, just as employers opposed to day care centers have discovered, in certain labor markets they cannot get employees to come to work unless such services are provided.

Is it the private employer's role to provide benefits for nearly every conceivable need of every segment of our working society? We have two distinct generations in our work force who, for the first time in our history, have been told—through government action, union action, and employer action—that their needs would be cared for by the government or their employer. Until 1980, we have hammered into the minds of these workers that we not only would provide the things needed, but that each year would bring "improvements," a word that should have been banned in benefit communication years ago. After nearly five decades of these messages, we should have come

to realize that as employees' needs change, they will expect the employer to offer an appropriate response. It is not logical to think that employers can get across the idea that there is a limit to what they will provide. We must, therefore, find ways of solving these new problems. How do we go about doing that?

Creative Planning

Once again, let us look into our kaleidoscope to see if there is a good picture of planning for the future. The creative planning process includes four major phases: input, assessment, planning, and appraisal.

Input—The input phase has several elements. The least important aspect of this phase is knowing what others are doing, but employers probably want such input, whether for the purpose of assessing competitor cost or for considering new approaches in design. Knowing where one program stands vis à vis others is helpful input, but rarely should it be the major criterion in planning, certainly not in creative planning.

Input from other segments of the business is essential. Where is the enterprise or institution headed? What are its plans for the future? What major business will the enterprise enter? What competitive pressures are likely to exist, today and tomorrow? What about geographic location, work force composition, and availability? What is the organizational mission and strategic plan and, in turn, how does the human resource strategic plan fit in and, most importantly, how does the employee benefit strategic plan fit within the broader context?

For all that has been written and spoken about setting objectives and strategic planning of employee benefits, the field still is dominated by "survey and react." Probably fewer than one-quarter of the major manufacturing and financial organizations in the country have a well-articulated plan or statement of where they are headed with their benefit programs, despite the fact that 40 percent of basic payroll costs are for employee benefits. There are statements about cost restraint; there are philosophical shifts from first dollar to comprehensive health care plans; and some organizations have modified, and even cut, benefits in selected areas. A few employers have terminated their pension plans in favor of capital accumulation, too often not knowing the potential dangers of defined contribution during periods of falling markets or high inflation or the inability of such

plans to function effectively for those hired midcareer or for the fast-track employee.

An intrinsic part of the creative planning process is, therefore, to obtain as much intelligent input as possible in an orderly manner. In addition to finding out what other employers do, a second element of input is to seek the best thinking from other key managers. Our planning process is often too inbred, with benefit professionals (external and internal) working with management to develop recommendations to be presented to the executive office, committee, or the board. We miss a valuable element in the planning process when we do not involve other members of senior management in the crystallization of goals for benefit programs.

The third element of input is from the employees themselves. Today, the opportunity for employee involvement is with us in a unique way:

- Older workers are, rightly, concerned about their jobs and paycheck security. We read about the older worker who passes up the early retirement offering only to live in fear that the employer will find some other way to downsize by getting rid of older workers. Psychologically, is early retirement not a more acceptable alternative than being terminated for incompetence?
- Leading baby boomers have the key jobs and are somewhat secure in their employment, but they have lost company loyalty in the constant concern over takeover, merger, or a failure of their employers to keep up with the global war of economic competition.
- Middle and later stage baby boom workers are a frustrated lot. Their bosses are only a few years their seniors and the intense job market is not bright. Moving to another employer may be their best alternative.
- Certainly this is an environment that discourages "company loyalty." The baby bust group is mainly loyal to itself.

One can look at these diverse segments of the work force and analyze them in different ways: single parents, male versus female, two-income household, black, Hispanic, Asian, oriental, or white, provider for parents, etc. What an array this view into our kaleidoscope presents! And what better circumstance is there for seeking input from employees or involving them in the design of benefits. Certainly, the kaleidoscope presents a picture that cannot be accommodated by a universal or traditional common denominator benefit program.

On the issue of involvement, I do not mean to suggest that we conduct an attitude survey on how employees react to the current benefit program (with a few lines added to allow employees to make

comments and suggestions). Nor do I mean to have employees go through a "drachma" spending test to see which of our choices they would choose. I am talking about real involvement in the design concept, the kind that lets a sampling of employees rebuild the benefit program from scratch. The process probably was first used at Parker Pen in the mid 1950s. It was done again by Xerox in the early 1970s, and by Cummins Engine. It was done, somewhat restrictively, by TRW when they were considering flexible compensation. What I am suggesting is not intended to solicit from employees the predetermined response the employer wants to hear, i.e., "Would you rather choose your benefits or have them chosen for you" kind of questions. It is intended to encourage open-ended discussion of what is appropriate in the overall design of a benefit program.

I have never forgotten a tongue-in-cheek article by Dr. Charles Hughes and one of his colleagues on the staff of *The Personnel Administrator*. The article read in its entirety: "What is the answer to the question, 'How do employees feel?'" The answer: "Go ask the employees."

If employers want to be responsive to employees, if they want to be creative in the design of benefits, the key is in the employee group itself. Too often we fear that the employee will want everything. As the saying goes, not to worry. The collective employee mind will come up with the alternative appropriate to the times. Let me give some examples. I mentioned Parker Pen in the 1950s. Financial and family security were high priorities in our society then. We were in the midst of the baby boom. Did Parker Pen employees, when asked, put forth the notion of high death benefits for everyone? No, they said death benefit needs varied by age and family status, and they concocted a death benefit program that responded (and was, importantly, much less expensive) than the one in place at the time.

I mentioned Cummins Engine in the early 1970s. When asked to discuss short-term disability protection, did their employees pay themselves full protection from the first days of illness? No, they created an individually self-funded protection program.

I mentioned Xerox in the early 1970s and its attempt to seek from employees what intelligent design of benefits might best suit the needs of all employees. Did they come up with individual choice-making as the appropriate response? No. They tilted in favor of universality, of common denominator, generous benefits. Why? Because they knew that Xerox was doing very well in the early 1970s and sensed that the company could afford a generous program. The various responses at Parker Pen, Cummins, Xerox and others may not be at all appropriate to today's environment; in fact, they probably

would not be, but the point is that when provided the opportunity to give real input, employees come up with innovative approaches.

Assessment—An important early step in strategic planning is an assessment of the environment. Yet, as benefit planners, we too often assess the view of some other assessor rather than of the marketplace itself. So, “go ask the employees.” Lay out the circumstances for them in an honest way. For example, tell them the company might be a good target for being acquired, or that competition from some other company, or country, may well take their jobs (as if they do not already know it), and then let the dialogue take place. We are redefining the words “employee listening” to mean setting them up to tell us what we want to hear rather than using employee listening, or involvement, as an important step in creative planning of benefits.

The second phase of the creative benefit planning process is to assess the input and add to it the most realistic projection of the future. The economy, our society, government, and demographics are all moving targets. We need to anticipate where those target will be, as well as to know where they are today. Very honestly, 20 years ago one could look at the future with a bit more comfort in making predictions about it than one can today. Looking out even five years is difficult. For example, three years ago long-term, or extended, care was not a particular issue. We were aware of it, but it was not on the front burner until 1987, when AARP decided to make it a political issue. That is how fast things can change. Funding postretirement medical benefits was not a significant issue until the accountants put it there. But it has become a very large issue in a very short time. Just as the successful manufacturers today are the ones who can respond to change quickly because they have adopted flexible manufacturing processes, so must the benefit planner be flexible in order to respond to rapid change in the benefit field. Having the necessary input is important; assessing the input and projecting the future is important; but we must remain flexible if we are to meet the new challenges, the challenge of circumstances, as they occur.

Planning—The third phase is design itself. From the input received from employees and other members of management, from assessment of the future and what others have done and what might work, the creative process has already begun. It may be the task of the planner simply to determine what it takes to put it all together and to determine whether to do it all at once or schedule it over a period of time. Once the planner has the input, though, it is time to open up the mind, develop all reasonable ideas unfettered by cost constraints or traditions, and then analyze them against objectives.

Appraisal—The fourth element of creative planning is to go back, after the program has been put into place, to determine how successful it has been in meeting the goals and to make refinements where necessary and continue the planning process as a never-ending cycle.

I have tried to give several kaleidoscopic views of employer benefits today and tomorrow. I created a picture of benefits as they are today, and it is not pretty. I have outlined some personal views of what might be desirable in the future. Those are only my views. What is most important is that I have tried to remind us that beauty is in the eye of the beholder, in this case, the employee or the user of our employee benefits. The more we encourage and involve employees in creating programs, within the frame of realistic knowledge of circumstances, the more likely it is that we will have a successful future in employee benefit planning.

XV. Employee Benefits and Labor Law Reform

REMARKS OF JAMES S. RAY

Introduction

I am happy to announce that I have the solution to all of the problems that we have been considering. The solution is labor law reform: many of the issues of flexibility discussed at this forum are problems that management and labor have faced across the table for many years, through collective bargaining.

The area of employee benefits has become so professionalized over the past few years that we sometimes forget that unions are largely responsible for the growth in group employee benefits in this country.

As the history books show, there were not too many individual benefits until the unions got the right of collective bargaining. And over the years union and management, in most responsible settings, have been able to solve many of the problems. Unions are very sensitive to the tradeoffs among cash wages, employee benefits, and jobs. They have been living with those pressures for many decades.

How a particular union deals with these pressures is closely related to the needs of its particular membership and, yes indeed, the needs of employers. Unions are not a group of thugs who come to the table and say, "Give us this," and are totally insensitive to the needs of the industry or of a particular employer. On the contrary, collective bargaining in this country has largely been a series of problem-solving exercises. Rarely do unions want to see the failure of an employer who, in conjunction with workers, puts bread on the table.

Developing Benefits through Collective Bargaining

Through the mechanism of collective bargaining, unions are going to be able to address many of their members' future needs, such as those for child care and increased training and education. We have a very responsible history of negotiating benefits, such as prepaid legal services, to serve the needs of a particular member or groups of members.

At the collective bargaining table unions have generally been very responsible in cooperating with employers on cost management, es-

pecially in the area of medical care. Unions recognize that increasing health care costs very often mean that less money is available for cash wages, and they have been cooperating with management in cost control programs.

Improving Health Care and Controlling Costs

Beyond the additional cost control mechanisms, unions are becoming increasingly involved in more progressive activities such as employee assistance plans and plans that incorporate preventive care to reduce future health care costs. For example, in the construction field, the Laborers International Union and a group of construction industry-employer associations have put together a national health and safety fund, with the cooperation of several government agencies. This fund will be used to study the death records of laborers in the construction industry, compare them with health problems in the general population, and develop programs designed to correct the particular health hazards experienced by construction laborers. It is believed that, over the long run, these programs will reduce health care costs among construction laborers and lessen the pressure on their health and welfare funds.

The Question of Cost Shifting

Unions have been less willing to participate in cost shifting exercises related to pension funds and health and welfare funds. I think that will continue, at least for the short run. In many cases, employers are simply trying to shift the cost of employee benefit programs to employees, as opposed to making cost shifting a part of an overall cost control management system.

I think union representatives will be much more willing to participate in cost shifting if it is part of an overall package of cost control mechanisms, such as imposing higher deductibles for traditional indemnity plans as a way to encourage use of preferred provider organizations or other alternative health care delivery systems.

But let me assure you that unions and their memberships are not going to be willing to engage in concession bargaining with employers who are, as Tom Wood implied, selfish capitalists. Every day newspapers provide another example of corporate greed and abuse in which employers terminate pension plans and revert the "surplus assets" or unilaterally terminate retiree health care benefits.

If corporate America takes that kind of attitude, employers ought not point the finger across the table at unions and accuse them of not doing their share in terms of controlling employee benefits costs.

Retirement Security

On a slightly different tack, there has been a lot of discussion about the trend toward defined contribution plans. As a general proposition unions oppose, and will continue to oppose, the movement from defined benefit plans to defined contribution kinds of arrangements, in both the pension and the health area. This shift is viewed as a mechanism for, again, shifting costs and risks from employers to the employees.

The labor movement is firmly committed to defined benefit plans as a way of assuring retirement security. When these plans are replaced by defined contribution or savings plans, it is the employees who are exposed to the risks.

And let me make a further prediction, based on the discussion. There has been a push toward defined contribution arrangements that are independent of the employers. Employers may make contributions to these plans, but they deal with them at arm's length. Employees will supposedly float out there, from employer to employer, with individual defined contribution arrangements. I think that ultimately if employees are separated from employers, they will attach themselves to the government, creating a self-fulfilling prophecy: the government will have to provide additional programs to support retirees.

Health Care as a Right

With respect to the discussion about whether health care is a right in this country, I have no doubt that every American has a right to health care. One has only to look at the way society treats education. No one seriously debates any longer that every child in this country is entitled to a public education. It is amazing to me that there is a debate over whether people are entitled to health care. Because, frankly, I would rather have a healthy person sitting next to me than a well educated one.

Tax Incentives and Employee Benefits

Let me conclude with two additional observations. The biggest threat to collective bargaining, in solving many of the problems discussed in this forum, may come from the government, when it takes away the tax incentives that are crucial to the maintenance of the private employee benefit system.

I think the labor movement is committed to a private employee benefit system and is very much committed to collective bargaining. But tax incentives are essential to maintaining private sector programs. If they are taken away, I have no doubt that ultimately the government will have to develop programs to take the place of private systems that have broken down.

The Issue of Competitiveness

The last point I wanted to make is a traditional labor side point that goes back to the New Deal. Every time someone came up with labor standards legislation, whether it be child labor laws, the Fair Labor Standards Act, or other acts of labor legislation that we now take for granted, the employer community has always screamed, "Oh, you can't do that, it will raise our costs, it will make the United States a less competitive player in the world."

I still think that we have a very sound economy, notwithstanding all of its problems. We have not really become a second-rate nation at this point, and I do not think that the solution to the employee benefits problems that we are proposing here are going to sink the United States.

XVI. Benefits Priorities in an Era of Change

PAPER BY RONALD C. PILENZO

Introduction

The task of predicting how we will react to unpredictable and unknown changes in social, economic, and demographic trends is no easy assignment.

In business, change is coming so fast that today's reality is fast becoming tomorrow's history. As Jeffrey Hallett pointed out, even use of the word "trend" is a stretch of the imagination—nothing is around long enough for us to tag that label on it.

I suggest that it is impossible to be specific about responses to changes. That is asking for a mystery beyond a mystery.

Instead, let us focus a little more on the first mystery, the changes. I would rather be vaguely specific about those than be specifically vague about responses. Let us look at three broad predictions—none of which is original—on how work will be different, how workers will be different, and how benefits priorities will be different.

Finally, I will discuss what may be the most maddening part of all this: managing legislative and regulatory change within all the other changes. We have to view developments here in Washington the same way you approach New England weather: If you don't like it, wait a minute.

How Work Will Change

Let us look ahead 20 years, into the 21st century. By then, the phrase "getting ahead in business" will take on a new meaning, as the nature of industry will have become more the work of the mind, not the muscles. In addition, our look ahead must be a global one, because we will be adjusting to the phenomenon of truly international business.

By the year 2000, 88 percent of the work force will be in the service sector, and nearly one-half of all service workers will be involved in collecting, analyzing, storing, or retrieving information. Over 80 percent of all management will be knowledge and information workers. Taking the global view again, we here in the United States will become major exporters of information and information technology.

So rapid is the flow of that information that futurist Marvin Cetron estimates that the half-life of an engineer's knowledge today is five years, and that by the turn of the century, 90 percent of what that an engineer knows will be available from a computer.

With this change in work comes a dizzying rate of obsolescence in jobs. Some of you probably sat through the freshman orientation speech that is the favorite of many college chancellors, where they asked you to look to your left and right, and then said that either one or both of those people would be gone by graduation, depending on the chancellor's own level of pessimism. Do that again now, because by the mid 1990s, the job one of you does now—a third of all current jobs—will be obsolete.

Of course, that will not actually apply to human resources professionals.

Increased Need for Education, Training, and Retraining—If, as some economic and societal forecasters predict, virtually all work will be new 20 years from now, then the responsibility of tomorrow's benefits packages will be weighted heavily with the need for providing more responsive education, along with training and retraining. We may need to rethink our apprenticeship programs as well.

The American educational system has fallen behind the commerce machine it supplies with workers. Our young people are facing a work world of bits and bytes, yet they are being prepared by an educational system still rooted in a work world of bulk and brawn, a world that was dominated by rote learning.

Much has been written about the crisis in American education. The Employee Relations Committee of the Business Roundtable is one of the few national organizations within the business community that is devoting itself to the issue at the K-12 level. The American Society for Personnel Administrators (ASPA) is very much involved in literacy as a work place issue.

Business must forge a coalition with schools and government, a coalition whose crusade it is to give "new education," relevant education, the same priority and urgency as the space race of the 1960s. Only then can our young people truly reach for the stars, even if they are constantly shifting stars.

Since every worker can now expect to be retrained three or four times before leaving a job, our schools must do more than just teach the basics. They must teach the ability to learn, to think, to solve problems, and to assume specific jobs, not merely to handle rote tasks. And they must promote learning as a life-long skill, a skill that will distinguish the movers and shakers from the losers and crawlers.

Schools must also be able to adapt to new educational methodologies and 21st-century technology, such as computer learning, self-paced instruction, inter-active video, and more.

As we provide better education, so must we provide more training and retraining, benefits that will eclipse all others in their importance to the future.

Right now 10 million employees are participating in 18 million courses every year, at a cost of \$40 billion. But that is still not enough. Our investment has to at least double by the year 2000.

Unfortunately, however, even those greater resources will be still be available to only one segment of the work force. Most new jobs are generated by small businesses that cannot afford to pay for training and retraining: one-half of all funding for formal training comes from no more than 300 companies.

That simply intensifies the importance of business working with government and the schools to ensure that tomorrow's educational system will offer more options that are specifically job related.

I am also suggesting that the government be more innovative in its show of support rather than merely providing funding. For instance, the taxing of educational assistance programs is less than encouraging for companies seeking to increase the skills and knowledge of their employees.

By the turn of the century, according to some, nearly 10 percent of the work force will be in job retraining programs. Adults will be working 32-hour weeks and spending most of that gained time preparing for their next jobs. Yes, their next jobs.

That may sound as cold and pessimistic as the chancellor who asked you to look to your left and right, but the reality is that the nature and stability of the work place are already changing.

Reduced Job Security—On the average, most of us at this forum have very little real job security beyond the next three to four years, as the nature and needs of companies and jobs themselves change.

Look at the facts. Already, one in five workers switches jobs voluntarily every year; one in 10 switches careers. According to a recent Lou Harris poll, only 39 percent of workers say they expect to be holding the same job five years from now.

You may criticize that as a view reflecting a lack of commitment, but it is one charged with realism. Employers need to understand that in the arena of megamergers and rapidly changing markets, euphemisms such as "strategic downsizing" or "right-sizing" are fearsome phrases for thousands of workers.

Moreover, as uniformly better educated workers move through the

ranks with a peer group as massive as today's baby boomers, that movement will stall for many. Today, 1 person in 20 will be promoted. By the year 2000, it will be 1 person in 50.

How Workers Will Change

Entrepreneurship is growing, with 2,000 new businesses being started every day. And within organizations we have seen the birth of what author Gifford Pinchot labeled the intrapreneur.

The intrapreneur, today's business hero, has become increasingly attracted to the notion that to be truly productive and satisfied with work he or she must have more voice in and control over job tasks and the work environment. In essence, employees are asking for ways to "work for themselves" within the corporation, pledging—and returning—a renewed spirit, a higher productivity, and fresh new sense of "I am the company . . . the company is me."

Keeping the intrapreneur or the knowledge worker inhouse and maintaining a stable and confident work force requires that employers respond with uncommon flexibility and with options unheard of even five years ago. They must tailor benefits and incentives for growth and retention.

Henry Ford may have been one of the first employers to harbor and nourish intrapreneurs. An efficiency expert he once retained was giving a favorable report on the Ford operations, but said of one worker down the hall, "Every time I go by his office, he is just sitting with his feet up on his desk, wasting your money." Ford smiled and told the expert, "That man once had an idea that saved us millions of dollars. At the time, I believe his feet were planted right where they are now."

Heightened appreciation of people as the most important part of the new, information-based economy will be the hallmark of companies that survive and prosper to the 21st century and beyond.

Restructuring Benefits

In terms of how these changes directly affect a benefits package, employers must begin looking at their social contract with employees as more of a family agreement, a pact that recognizes the full value of the individual in enhancing the company's competitive position.

Analysts such as Jeffrey Hallett have concluded that as much as 80 percent of what any organization does today can be done equally well by any competitor. The arena of distinction—that critical remaining

20 percent—is represented by the people brought to the competition, the employees who make it all work.

If an employer's attitude—as reflected in a benefits package, for example—is that nothing is more important than the company's employees, then the pass-along advantages grow rapidly. The ripple of an employer's attitude grows into commitment and increased productivity from the employees and then ends with a wave of maximum competitiveness in the world marketplace.

Just as with every so-called trend we have talked about here today, employee priorities concerning their benefits will also continue to change rapidly. And, benefits packages which do not evolve quickly enough to stay relevant will find disfavor with the best employees first.

One change that is already emerging is greater attention to family care concerns. Specifically, among the most attractive benefits will be those associated with child care and elder care.

Child Care—It is easy to imagine the typical American family as something from an old Donna Reed show: Dad is on the scene and working, Mom is busy in the house, waiting for the school bus to bring their 2.1 children home, and "child care" means a bobby-soxed baby sitter one Saturday night a month. But reality is day-care centers, both licensed and unlicensed. Reality is latch-key kids. Reality is that only 6 percent of American families today have a mother at home full time.

The rest are double-income families or single-parent families. And the double earners are not merely trying to support BMWs and Saabs—almost 75 percent of working mothers work solely as a means of family support. In 1976, the Census Bureau said 31 percent of new mothers went back to work before the child's first birthday. Within two years, that number will be up to 50 percent. According to the Children's Defense Fund, by 1995 three-quarters of all school-age children, or 34 million, will have working mothers.

Employers need to recognize the growing need for differentiated responses, such as paid or discounted child care, sick-child care, referral services, flex-time scheduling, and job sharing, and for both extended leaves and opportunities for at-home work. Each employer may have a different response, depending on the unique environment and economic conditions. But all of us are compelled to respond. Of that there is little doubt.

Elder Care—At the other end of the chronological profile is the rapidly growing gray wave, a wave that will nearly double the number of elderly Americans within the next 30 years. In the short term,

that already means more employees looking for assistance in the care of aging parents and guardians. In the long term, it will mean the support of more retired employees.

Recent surveys by both Travelers Insurance and the American Association of Retired Persons reveal that 30 percent of employees today have an elder-care responsibility on which they spend an average of 10 hours every week.

According to such groups as the Washington Business Group on Health and Americans for Generational Equity, the average Fortune 500 company in 1974 had 12 active employees for every retiree. Now it has three.

Thirty years ago, nationally, we had eight workers to support each retiree, and our median age was in the late twenties. But 30 years from now, our median age will be in the early forties, and we will have less than two workers to support each retiree.

Employers and Employees as Partners—To meet such demands, both employers and employees will have to give new meaning to the intrapreneurial issue of “personal control” I mentioned earlier. Better benefits will attract and retain the best and most satisfied employees; satisfied employees will increase productivity; and increased productivity will help pay for the support of a growing pool of children, elderly dependents, and retirees.

But employees must contribute to the partnership as well, by sharing in the financing of such benefits packages. They do so by supporting flexible benefits plans, which not only represent the most economically efficient direction available to us but also contribute to employees’ intrapreneurial sense of individual job satisfaction.

A survey by the Employers Council on Flexible Compensation showed that 87 percent of women and 61 percent of men who participated in flexible benefits plans said the plans influenced their decisions not to seek job changes. That kind of popularity has led more than 800 major employers to offer flexible plans today, compared to only eight in 1980.

Legislation and Regulation

Thus, work is changing, workers are changing and have different personal priorities than they had in the past, and the work place is changing. These are major challenges, but I think we can deal with them. However, I am not as sanguine about our ability to deal with a constantly changing legislative and regulatory landscape.

The reason we always seem to be standing on such shaky ground is that every legislative and regulatory decision seems to be driven principally by revenue considerations and the desire to show results to constituents. There is no overall congressional strategy regarding legislation affecting benefits that is based on the substance of the issues.

Where does that put us all? It puts employers and employees alike in a cauldron of unpredictability and instability. It also places employers in the position of having to pay for whatever "good public policy" idea is in vogue with each session of Congress and to pay for mandated benefits that ignore different regional, local, and individual needs and preferences.

Our plea to Congress and the regulatory agencies is a simple one: give us minimum, not maximum, and predictable guidelines and then trust our judgment. Employers know what they need to do to attract and retain the best employees, and they are willing to pay the price, both in benefit costs and fewer tax considerations.

Members of the business community are not always waiting in line with their hands out, looking for tax advantages. Give business stability and predictability in tax legislation, give it more independence in judgment, and it will bear whatever cost is fair.

Conclusion

I would like to close with a final plea. Not to government but to employers, employees, unions, and consultants. We expect sweeping changes, but let us not allow those changes to sweep out common sense. Let us not overreact by throwing out every policy and principle we have developed over decades of effort and then starting all over again.

Industry will change but it will still be recognizable. Workers will change and become more independent, but they will still appreciate and need a solid base of benefits protection. And, when given the freedom to be creative, private employers will still be best able to design flexible packages that meet the specific needs of their individual and sometimes highly unique work forces.

The great American philosopher, Yogi Berra, once said that a nightclub had become so popular and crowded that nobody went there anymore. Let us not overwork, overregulate, and over-tweak benefits so much that they benefit no one.

XVII. Part Three Discussion

The Fungibility of Savings

MR. JACKSON: I think both Thomas Wood and Kenneth Brown are guilty of ignoring what I would call the "fungibility of savings." Kenneth Brown's points to the "spending down" requirement. To me the question is not whether a person should be required to spend down but to what level should he or she be required to spend down, to abject poverty or to some modest level?

If you take the position that an individual should not be required to spend down, then I would ask what is the point of savings? If you are going to sit there with a pot of money and you need some services, why should you not be required to spend this money that you saved for a rainy day?

Tom Wood also addresses this issue by telling the individual who is saving for his retirement that when he leaves a company, he should not be allowed to use this money for anything other than his retirement. He should be required to use it only for the purpose for which it was intended.

But this money could be spent for many things—luxuries, education, or tools. A 40-year-old individual who has multiple sclerosis and only has five years to live might prefer to spend the money on something other than a retirement benefit starting at age 60 or 65.

I also disagree with Kenneth Brown on the question of whether medical care is a right. It is not a right. I think that in any good civilization people will feel an obligation to extend medical care to as many individuals as they can. But the idea that a person is born with a right to walk up to a doctor and say "Serve me," I just think is dead wrong.

Pension Considerations

Arnold Packer suggested that we will end up with defined contribution plans, and this will solve the whole retirement pension problem. It will solve the whole problem until we get everyone into a defined contribution plan and the market goes down to 10 cents on the dollar.

Or alternatively, when people have their money invested in government bonds and inflation reaches 10 or 20 percent. Eventually it

will become obvious why defined contribution plans cannot do the whole job.

There has also been a lot of discussion about vesting and how important this is. The figures that I have seen for large hourly rate groups, for example, suggest that if you lower vesting from five years to one year, you add maybe 1 or 2 percent to the cost of the plan. Now, adding 1 or 2 percent to the cost of the present private pension system is not going to solve the problem they are talking about.

What they really want is a defined contribution arrangement in which the employer contributes 10 or 20 times more for a 20 year old than for an older worker. Taking the defined benefit plans and requiring vesting is merely going to carry forward peanut-sized amounts. For example, a 30-year-old auto worker who left a job with 5 years service in 1955 would have accrued a monthly pension of only \$7.50, to begin at age 65 in 1990. This does not help.

Finally, many people are talking about demographics, and demographics are absolutely irrelevant if you have actuarially sound funding. Absolutely irrelevant. The real problem is that we cannot have actuarially sound funding, because for that we have to have a sound dollar. When we have inflation, we cannot really fund anything in advance. Inflation forces everything back to pay-as-you-go.

We have problems, but I do not think these are the solutions to them.

MR. WOOD: A question for Paul Jackson. What combination do you see that is more effective, if the work force has changed its character so dramatically?

You have been funding peanuts in every actuarial exercise for all the years that you have been doing valuations for younger-short-service workers. But in effect, while the initial amount is no longer there, there is something of the present value of it that remains and that, turned over to the individual, would accrue to some future additional amount.

Now you have turned a defined benefit into a defined contribution scheme, but at least you have some monies accruing. I think there is a bi-modal work force in the United States in which there is a small group of people who will have anywhere from 15 to 30 years in a given company and a much larger group who will have a number of career employments during their working lives.

Clearly, for the person who stays at one work place for 15 years or more, defined benefit is the most efficient form of pension plan. But if that is not what people are doing, if the corporations are laying off

workers, or closing their plants, how do you satisfy the needs of those who are shut out?

MR. JACKSON: You do not do it with vesting.

MR. WOOD: The present value of an average accrued benefit for a very young person, if the amount were vested after two or three years coverage and participation and rolled over to an individual retirement account, is admittedly small. However, at current Pension Benefits Guaranty Corporation (PBGC) rates, even such an amount for a worker age 25 would accrue to a lump sum of 1.75 to 2 percent of final pay at age 67, or enough to provide about 1½ to 1 percent pay replacement, somewhat more if yield is greater than PBGC rates. This no-cost alternative, however, is probably inadequate. Several alternatives with modest cost increases exist, including the use of a present value discount rate, i.e., 2 percent, that is 4 percentage points lower than the assumed yield. Another alternative is to index the vested amount, allowing the employer to continue its control of plan funding and financing. These alternatives would probably cost in the neighborhood of 7 to 8 percent of the basic plan's liability. Stated another way, vesting would cost about 20 percent of the plan's liability with the 7 to 8 percent being the cost over current cost of 12 percent for 5 year vesting.

A third alternative, probably slightly less in cost, would be to require that the present value of the accrued liability, but not less than 3 percent of pay per year of participation, be rolled over. These cost increases would be offset by reductions in the basic benefit formula and deliberalization of early retirement subsidies.

You cannot ignore the part of the work force that is never going to accrue under a pure defined benefit system.

MR. JACKSON: What I was saying was when you value a defined benefit pension plan that costs 10 percent of payroll, you are not putting 10 percent of everyone's pay in the plan. You are taking 0.2 of a percent for the person who is 20 years old and you may be putting 30 or 40 percent of pay in for the person one year away from retirement. And if you start vesting the 0.2 or 0.1 percent of pay, if you replace five-year vesting with one year vesting, you have done very little.

You ask what would solve the basic problem? A change in attitude. To simply say "We've got a problem because there are people who need help, and we are going to get it to them," is not much of a solution.

The way that solution works out is that there are some people who need something, and we, the designers of this system, are going to get what we think they need from somebody else. And that other person has to produce the money to solve what we have defined as the problem.

Increasing Self-Sufficiency and Motivation

In the final analysis, citizens have to be in a position where they can take care of themselves. America at one point was full of self-sufficient people. In a program about the Employee Retirement Income Security Act, I saw an American family, a husband and wife in Arkansas, stand there and almost cry because their Social Security benefit was not enough, and they could not afford to live on it. It was probably true. They were unfortunate, and who knows what happened. Certainly I would be prepared to help them, but basically we look at a situation like that and say, "These people cannot take care of themselves, so we have to take care of them at the government level. We need a program. Let us pass a law, let us tax everybody."

If you tax everyone, then what you are doing is spending everybody else's money, and that is fun. You can play Santa Claus and spend everyone's money until you get to the point where you are taxing at 50 or 60 percent, and people fill out their income taxes, and say, "Damn it, this is not fair. I worked last year and worked hard, and I earned some extra money, and look at how much the government takes. It just is not worth it. The hell with it."

So you have incentives built in, things that we have not even touched on, such as morale, enthusiasm, spirit—these are the things that make successful organizations. And you do not develop them by paying an employee eight dollars an hour only to have the government tax three dollars away for all sorts of wonderful programs. That is not the way to encourage people to come to work.

If medical care is a right, why not food? Why not shelter? I do not want to see anybody go hungry or be without a place to stay or clothing. Why not give it all to them?

Eventually you get to the point of asking, "Why should anybody work?" The answer is, probably for the fun of it. If a person works hard, he is taxed to the point where he is no better off than he would have been with a more moderate effort. The differential has been undermined. We pay people for not working, and if they work, we take money away from them. Why are we surprised that fewer people want to work?

A Minimum Accrual Rate

COMMENT FROM THE AUDIENCE: I agree that going from five-year vesting to intermediate or one year-vesting in the current arrangements of the defined benefits plans really does not get you very much. But why not introduce the concept of a minimum accrual rate, a minimum standard, so that when, as Tom Wood suggests, people with matured service leave the defined benefits plan, they would be entitled to at least some minimum accrual rate, not the current termination assumptions for a full-service employee? Then a 20- or 35-year-old worker would be entitled to some rollover that would have meaning for later retirement income. What do you think of that?

MR. WOOD: I would react favorably to it in some combination. I think in pension evaluation, you almost do not count the people under 40 at all. You can almost discount them entirely because you expect most of them to leave.

I am not suggesting that with some accrual rate the cost would not be greater than one or two percent average liability to the system. But I have traded it off at the other end in some way, by reducing basic benefits, instituting a later retirement age, and eliminating early retirement liberalization. I would rather trade that money off for a more even accrual, over a period of time, covering a person's entire work life, wherever his or her place of work may be.

That is the direction of my thinking.

Defined Contribution versus Defined Benefit Plans

MR. PACKER: A clarification, and maybe I am ignorant about the terms, but are you not suggesting going more toward a defined contribution plan with vesting? It does not make any sense with the defined benefit plan.

MR. WOOD: I think one-half of the population, or two-thirds of it, would end up with what is essentially a defined contribution mechanism.

Why has almost every major company that sponsored a profit-sharing plan during a 25-year period ended up having to revise it? Over a period of time these plans do not work because they cannot correct for the past. They only correct for the future because only contributions go in and the earnings are on a future basis.

Therefore, a defined contribution system is not the best way to approach the retirement problem. A defined benefit solution is. How-

ever, unless you go to an absolute minimum fixed benefit, increase Social Security or design something similar that is an absolute defined benefit over a person's lifetime, too many mobile, multi-career workers will be short changed. In the absence of the most efficient device, you have to substitute something else that would allow for the accrual of some value which the individual can convert to investment purposes.

It takes 6 to 7 percent of pay, going into a plan earning a yield of 2 percent over the percentage of pay going in, to accrue a pension of 1 percent of final average pay times years. That is the magnitude of it.

That kind of money is needed to be paid in over over a period of time. This calculation assumes that everyone has the given amount of money flowing in through their entire working career and that there is no serious damage by inflation at, near, or during the period of retirement. There is a solution in this concept that has to be "in between" because the vast majority of workers will never see a full career with any given company.

To them, perhaps a movement toward defined contribution is a more acceptable posture than having people accruing pensions that they will never collect because, on the average, they are not going to be with the company after five years.

MR. SALISBURY: Tom, in your rule of thumb, I assume you meant 1 percent per year of service?

MR. WOOD: Yes, I did, thank you for the clarification.

MR. HARRINGTON: We keep coming back to defined contributions; why don't we just call it a savings plan?

MR. WOOD: Call it what you want.

MR. HARRINGTON: It is just a straight contribution and the fundamental problem with that is that it does not diversify risk. Every one of the people who are migrating through their working careers is looking for some form of risk diversification. Such risk diversification has to do with inflation, because the dollar is debased; it has to do with asset volatility during the preretirement and postretirement time period. That is the fundamental problem—covering diversification of risk.

I would suggest that as you start looking into defined benefit plans and demand that this type of plan be all things to all people, you will find that it cannot solve every single problem. But before you throw

it out, recognize that for a certain classification of people it does diversify risk and it does solve a lot of the problems.

MR. WOOD: I am not throwing out any plan; they have different roles.

MR. HARRINGTON: When you start mixing defined benefits with defined contribution plans, you wind up with short service vesting, and you start incurring a disproportionate expense in relation to the benefits being delivered. I am not repeating here anything that anyone does not know, but it is that short service concern that everyone is looking to, and if a defined benefit plan does not solve all the problems, you throw it out.

I just cannot see that. I see the combination of plans as a necessity if you want to address all the concerns. You have to pick among them and try to address the fundamental issue of diversification for each of the risk-related events.

International Comparisons

MS. GORNICK: I would just say that I think international comparisons are very interesting. Kenneth Brown's discussion of the Canadian health system helps us to understand our own. I would raise the issue of Japan, but from a different point of view.

I was in Japan about four years ago to study their long-term care health system, which by the way is in a worse state than ours. One of the things that puzzled me was that people kept talking about elderly unemployment. There is practically no youth unemployment, but there is a lot of unemployment among people in their 50s and 60s.

I was very puzzled by this until I began to recognize that the Japanese have a system of long-term careers. By the time workers are in their 50s, their wages are higher than those of the average employee, so managers are anxious to get rid of them. Thus the unemployment; the unemployed elderly continue looking for jobs because they do not have a mature social insurance system, as we have here in America. Obviously, the elderly in our country are far better off because of the social insurance.

MR. PILENZO: At our meeting with a group of American and Japanese personnel executives in Tokyo last November I was interested to hear them comment on that point about retirement and retirement

pay but from another perspective. What they typically do in Japan is cash out employees at age 55 with a lump sum payment.

The essential problem today is that employees are living longer and have less money to fund their retirement. Then they do not want to retire.

MS. GORNICK: There was some payment; on average, it covers two years of salary, and after that they have nothing in the way of a continuing pension.

MR. PILENZO: I was told—and I am not certain that this is correct—that before World War II, the average Japanese male died before age 40. And so what is happening is that people are now living beyond 55, 60 and 65, and the cash out does not work. At the same time, pressure is being exerted by the younger people, who are filling the system at the bottom with no place to go.

Some Japanese executives who recently visited our office told us that their version of the U.S. Social Security system was instituted in 1960 and thus has not had an opportunity to affect the retirement system. But the bottom line was that none of it is working very well.

MR. MERRICK: The Japanese did have an institutional mechanism, and it was called the large family. Since the Second World War, Japan has experienced a very rapid decline in fertility, and their birth rate is way below the Social Security system's worst case scenario. The large family is not there anymore.

The Lack of Incentives to Save

MS. YOUNG: I would like to point out that in our society right now there are absolutely no incentives for younger workers to save. In fact, if you were a worker, or a two-worker family in your 30s, you would have to be crazy to save. And if you do not want to take my word for it, listen to the ads on the radio. When banks tell people, "Don't worry about the new boat you want, don't worry about the vacation you want, just think about how great our home equity loans are," then you realize that there is absolutely no saving.

And even the low savings rate that everyone has been complaining about and designating as one of the three sources of retirement income is not individual saving at all but savings represented by defined benefit or defined contribution plans.

With that given, there is no three-legged stool. There may be one now and for the people who are going to retire in the next 5 or 10

years. But there is no three-legged stool in the future. What you are showing us is that a tremendous gulf is growing between those who want retirement to be provided by the government and those who want it to be done somewhere else. And no one is offering any solutions, and there are no savings.

I think that as long as one is discussing a three-legged stool, we are never going to solve the problem, because there is no stool.

MR. SALISBURY: And you are saying that eventually it is the personal saving leg that . . .

MS. YOUNG: That is gone, it does not exist, and if you are in your 30s now, you have to be an absolute fool to do much in the way of saving, because there are no incentives.

If you put money away for a young child's education, the money will be taxed at your rate, and the child will not be eligible for scholarship aid later on, because you have put money away. If you spend it on a fancy car, that does not matter; then you can go ahead and get aid or loans for that child. That is one area.

As for as medical care, if you are very poor, you can get medical care, or if you are in a situation where your employer provides medical insurance. But not all employers do. J. C. Penney apparently is providing medical care only if a spouse earns less than the employee. In a recent case, an employee earned less than her husband, but her husband had no medical insurance from his employer. J. C. Penney was found justified in the courts and that two-earner couple was left without medical insurance.

What will happen to people who are two-wage earners, with absolutely no savings and no health insurance, the first time they come up against unemployment or any other major problem? Who are they going to turn to? And what are they going to demand?

The Savings Rate: United States and Japan

MR. WALKER: Concerning the comparison of our savings rate with Japan's, clearly there is a need for increased savings, but I would submit that it is not merely a matter of incentives. I spent quite a bit of time in Japan a year ago, and I would argue that there are three reasons that the Japanese save as much as they do. One, they have a need. An example of that is their private pension system; we are way ahead of them in the area of pensions. Their average lifespan is 84. They retire people at age 55, with an average lump sum of \$50,000. They do not have separate trusts, minimum funding standards, or

fiduciary requirements. The situation is a ticking time bomb. And they are going through restructuring just as we are in certain industries.

Second, they have an opportunity to save; their wage structure is fundamentally different from ours at all levels in the private sector. Typically, Japanese workers get two-thirds of their wages in the form of monthly income and one-third in semi-annual bonuses. And, believe it or not, people are more prone to save when they do not get their money in a monthly check.

The third reason is that they do have incentives. One of the incentives that they had, before tax reform at least, was that roughly the first \$100,000 of earned income was allowed to accumulate tax-free. However, I think that provision was repealed as part of tax reform.

I would submit that, yes, we need to save more, and incentives play an important part in accomplishing that objective but only one part. Another part is behavioral and it reflects our consumption oriented society. There is widespread myopia in this country in the form of a propensity—whether by government, corporations, unions, or everyone else—to look only at the short term, rather than at the long term. And we need to change fundamentally.

Quite frankly, I would submit that pension plans, as long-term investments, may be one of the answers to that because they look to the longer term and they encourage investors to do the same.

The Commitment to Learning

MS. HARRINGTON: One of the themes today has been the fundamental need for a commitment to lifelong learning, training, and retooling the labor force. Can anybody offer any models or examples of situations in which that is happening and working now?

MR. PACKER: IBM has a lifelong learning program. They claim to spend \$2 billion a year internally for education. Automobile companies are moving away from an attitude that does not favor smarts on the factory floor to a new team approach that requires more educated workers. UAW-Ford has been cited for literacy and math courses that enable factory workers to participate in discussions with engineers and other professionals.

Estimates of the amount being spent range from \$20 to \$40 billion. High-tech companies that do not sponsor lifelong learning do not stay in business very long. This is, by the way, one thing to think about in terms of defined benefit programs. How do they work when a company goes out of business?

In this vast change that is occurring not only do the workers change jobs but companies also will come and go. The investment in training is extraordinary.

People compare us to Japan, but the IQ in Japan is supposedly 10 or 12 points higher than that in the United States. The percentage of those with IQs over something like 130 is supposedly identical in the two countries. The difference is entirely in the lower half of the distribution. Our school systems and corporate training programs are designed for the 50 percent of Americans who go to college, not for the school dropouts or even the high school graduates who do not continue their education. And perhaps that is the real challenge before the country.

Job Mobility and Productivity

MR. VAUGHN: The discussions in this forum include two givens, which, when put side by side, are sobering.

One is that to be competitive internationally we have to have gains in productivity. And the other is that the 30-year career employee no longer exists; now we expect fewer than five years of service from employees.

In my experience in consulting with organizations, the ones that are most competitive are those with strong employee loyalty and low turnover. That is how they sustain that training investment; it is very expensive to bring people in every two years and retool for jobs.

I do not see how these two phenomena are going to mesh to make us more productive.

MR. PILENZO: I guess my experience is contrary to that; what has happened is that company loyalty has literally gone down the tube. The whole process has been reversed. It is loyalty to my career, loyalty to myself, loyalty to my family, and the company may get whatever is left over.

Years ago it was just the opposite: the company came first. You laid yourself down across the corporate railroad tracks whenever they ask you to. I think that today people do have a loyalty to an organization, but it is a fleeting loyalty. And much of it depends on me and my career and what you are asking me to do for pay. If I like my work, if you pay me reasonably well, if you give me reasons to continue to stay and be excited about the company, chances are that I

will stay. But only as long as these conditions exist. Otherwise, I am gone.

Jobs, Careers, and Security

COMMENT FROM THE AUDIENCE: Mr. Pilenzo, I wanted to ask you about the use of the words "career" and "job." I think you are getting at one of the keys. We talk about the trend of moving from job to job and about the trend toward early retirement. And I wonder if many people perceive that they no longer have a career but merely a job? So they go for the quick dollar. The "me" generation emphasizes money. I think people tend to feel less vested in the larger sense—in terms of the satisfaction of having a career—and they go from job to job to get the money that they can now.

MR. PILENZO: You have two different propositions here. One, we are finding that people are now viewing their careers as being two and three different kinds of careers. Given portability and given an opportunity to leave a company and take something with you, I think that the 30-year employee would not ever be a 30-year employee. After about 15 years, he or she would probably say, "I've had enough of this, I am going to try something else." What we are going to find is that people will have two or possibly three different careers in a lifetime. IBM is a good example. I understand that a group of recent retirees, at the encouragement of the company, started a company, and IBM now purchases their products.

People are doing that sort of thing because they do not see themselves as staying with one employer all their lives. I think job movement is enhancing careers. For example, people who are knowledge workers—accountants, engineers, attorneys and other professionals—tend to think that if they can enhance their knowledge by working for a specific employer, so much the better, but they do not intend to stay with that employer for 30 years. At some point, if another opportunity opens up where they can learn and grow at a faster rate, or in another direction, they will probably leave. They tend to move within a career and between jobs.

MR. SEIDMAN: I am not sure exactly what Ronald Pilenzo meant, and I would not like to leave any ambiguity concerning the question of whether workers are in favor of the shift to temporary or contract employees who receive no benefits. I am sure it is not desired by workers. This practice benefits employers and their bottom line and no one else.

I am convinced that workers are still very much concerned about security. Nobody can tell me that people want to go into this world, in effect, naked without knowing where their next dollar is coming from, without knowing whether they are going to be able to retire with any kind of decent income. I think people are going to continue to look for ways in which they can assure their own security. They are going to find out, and many already know, that you do not achieve that as an individual. You achieve that collectively.

Workers do not want to be ranged against the economic power of the employer as individuals. All you have to do is to look at the people who are now reorganizing, who have been dispersed, to see that.

There is a new factor that makes the penalty for lack of security so graphic in America today, and that we have not seen in 50 years. That is hunger and homelessness. That is the penalty for lack of security. I think that people are going to look for ways of achieving security. That is why I do not think the defined contribution idea is going to go very far. It does not provide any security for people. Even the defined benefit plan does not provide security for people, because it does not protect people against inflation.

I think workers are going to continue to look for ways to preserve their security. Much of the discussion at this forum is based on the assumption that somehow individuals are going to fend for themselves and to like it and that is what they want to do. I do not think that is true, and I do not think that is what we are going to see in the future.

Change as Opportunity

MR. CRABTREE: It has been mentioned several times that there is something very dismal about this discussion, but I have not heard anything that I regard as dismal.

We have been talking about change, but that is nothing but an opportunity. As far as company loyalty is concerned, I think people will have as much loyalty tomorrow as they had yesterday if management will lead.

I agree with Bert Seidman on the things he said about what people want. If there is enlightened, caring management, workers will follow and they will work there 50 years for you.

The benefit structure as we know it today is not threatened; it merely needs to be managed. There are all sorts of opportunities to fit benefits to people's financial and other needs and to make them conform to tomorrow's possibilities. I do not see that as dismal at

all; it is a neat opportunity for us, as management, to recognize that we have to work together with the people we employ.

Pension Preservation

MR. SALISBURY: In closing, I would make a comment on a basic point that Tom Wood made. I was somewhat surprised that there was no reaction to this point because, in the light of the way defined benefit and defined contribution plans are being designed, it was a somewhat revolutionary suggestion. He said it was absolutely necessary to change the law to bring about pension value preservation to go along with portability.

In keeping with much of what was said here today, a defined benefit plan that pays a lump sum distribution to every worker who leaves a company is not definitionally any different, or any better, than a defined contribution plan.

Companies such as RJR Nabisco, Ameritech, and an increasingly long list of others have recently modified their defined benefit pension plans to pay a lump sum to every departing individual, regardless of age, and regardless of dollar amount. They offer them an annuity option, but you know what option they generally take. Approximately 66 percent choose the lump sum.

The situation with defined contribution pensions is the same: the money is not being preserved. I emphasize this point because of the point that Dorcas Hardy and others have made that asset income is a very major component of retirement income as compared to pensions and complementing Social Security.

The way the government defines its data, when an individual gets a lump sum distribution, it is asset income, not pension income. We have no idea how much of the income of current retirees derives from the pension system as distinct from personal savings outside the pension. And with each passing day that distinction is becoming more blurred, making it look as if less income is being produced by the pension system than actually is being produced. If you look at the federal flow of funds, the system is producing more, yet it is being lost in the equation.

Another crucial point that has not been discussed is that as we move to faster vesting, to lump sum distributions, and to "portability"—which will result in increased lump sum activity—unless there are preservation provisions, I think the system will decline. It will not meet people's needs. I think that the preservation issue that Tom Wood raised is absolutely crucial.

When Kenneth Brown, Bert Seidman, and Paul Jackson talk about the strength of defined benefit plans, I think I can fairly read into it that what they are referring to is a post-retirement stream of income and an annuity that may be indexed, if necessary, even if it is on an ad hoc basis. They are not talking about some of the new genre of creatively designed defined benefit plans that are in essence defined contribution plans under another name.

Appendix A. New Directions in Personnel Management

PAPER BY CONSTANCE HORNER

Constance Horner, Director of the Office of Personnel Management, delivered the following address to the American Society for Personnel Administration on June 27, 1988.

I know we are all trying hard to anticipate and plan for the personnel challenges before us, as the new century approaches. The U.S. Department of Labor has produced a volume on the subject, entitled *Workforce 2000*, which I commend to your attention and would like to discuss for a moment.

Workforce 2000 warns us that we face some daunting personnel problems over the next 20 years. According to the report, today's rapid pace of job creation will continue through the end of the century. But the labor force—which expanded by about 3 percent per year in the 1970s—will grow only by about 1 percent annually in the 1990s.

The average age of the work force will rise, while the pool of young workers entering the job market will actually shrink, until it is the lowest since the 1930s.

As former Secretary of Labor William Brock put it, if we continue to create jobs at the same rate for the next 15 years as we have in the last 15, we will be out of people.

The study also suggests that the kinds of jobs being created will require ever higher levels of analytic, quantitative, and verbal skills.

But at the same time, job entrants are expected to be less well-trained and educated and to be less acculturated to the American work place. Women, minorities, and immigrants will account for almost all the additions to the work force between now and the year 2000.

What does all this mean for personnel managers, in both the public and private sectors? It means that we are going to have to deal, directly and explicitly, with a whole range of problems that have only recently become familiar to us:

- problems involving the family, education, health, and moral values;

- problems that are interwoven with the most troubling and perplexing social dilemmas before the nation; and
- problems that seem very far removed, indeed, from the traditional concerns of personnel management.

There may have been a time when we could ignore such issues. There once seemed to be a limitless supply of job candidates with the education and skills we needed for the jobs we offered; the attitudes and values we needed for the workplace; and the support of a traditional family structure, which meant that they could come to the job relatively undistracted by outside, family concerns.

In other words, the surrounding society once seemed to serve up, automatically, candidates ready-made for the jobs we offered, by taking care of fitness, education, values, and family. Personnel managers were able to deal with employees on a relatively narrow range of issues, concerning primarily the exchange of employee services for wages and benefits. Indeed, that used to be considered the only proper arrangement.

Workforce 2000 tells us those days are fading fast, because the work force facing us will be less well equipped educationally, less likely to possess the values necessary for the work place, and less likely to be rooted in a traditional family arrangement whether because they are single or because they are part of a two-career family.

Society, in short, is no longer automatically giving us candidates tailor-made for our jobs. That is because some social institutions are changing dramatically, as is the case with the family. And let us not mince words. *Some* social institutions are failing. That is the only way, for instance, to describe what has happened to education in this country.

But given the shortages in the labor force almost upon us, we will be compelled to deal with these changes and these failures. We will have to go, even more than now, beyond the relatively narrow range of concerns, the pure wage and benefit questions, and grapple as never before with these far more complicated social issues.

That is a challenge indeed, because how we handle it bears critically on the future of our country as a free, decent, productive, and civilized nation.

Today, I would like to share with you some of the basic principles that govern our approach to this challenge in the federal Government, with a few illustrations based on our initiatives over the past several years. I hope they will give you some grist for your mill, to help you think your way through the work place problems we face in common.

At the Office of Personnel Management (OPM), we have identified three broad obligations that we consider as we face the health, education, and family issues before us.

To our employees, we owe flexibility and a new understanding of the demands of their personal lives. We make every effort to adapt work place conditions to the new needs of the individuals we employ.

To ourselves, representing the public, we owe economy, efficiency, and dedication to mission. As we adjust to the new circumstances, we try to do so without incurring high costs and without undermining the purpose of the organization.

And to society, we owe civic-mindedness. We are acutely aware that we are now dealing with some of the most important values and value-generating institutions of our society—the family and education foremost among them—values and institutions that are vital to a free and decent civilization.

But that means—and this is the truly tricky part—that we must accommodate social trends without inadvertently accelerating those we consider harmful. We have to help redress the failures of some of our institutions without thereby weakening them further. In short, we have to learn to help social institutions and individuals without destroying their ability to help themselves. And anyone who has helped a child with homework, as I have, knows how difficult that can be.

Let me illustrate the way we have tried to balance these three obligations—to our employees, to ourselves, to society—by a look at the way we have treated the issue of long-term care insurance at OPM. As *Workforce 2000* makes clear, the overall labor force is aging, and the federal work force along with it. Federal employees are quite well insured, but like most Americans, they do not now enjoy protection against the cost of chronic, long-term illness. Our sense of obligation to our employees dictated that we do something to meet this need.

But severe economic constraints—we are already spending 40 percent of payroll on benefits—make any new major category of benefit expenditure out of the question. So we looked at ways to provide this insurance without additional cost to the taxpayer and concluded that the most attractive, economical way to offer long-term care was to make it an option under our existing life insurance program.

The proposal we have submitted to Congress would thus allow qualifying employees to trade in a part of the face value of their life insurance for long-term care coverage. The program we envision would, for a small additional premium, pay indemnity benefits for up to three years of nursing home care or alternative home health care,

through contracts with one or more insurance companies. The program is designed to be voluntary, cost-free to the taxpayer, and affordable to the employee.

One crucial consideration in our proposal: we knew that, as our national population ages, the temptation would grow ever stronger in Washington to take this issue away from the work place, through an expensive federal long-term care program, or a mandated, private sector one.

Our approach, by contrast, is based on educating employees about the advantages of life insurance conversion, so they can take steps to provide for their own future needs. We are encouraging them to plan ahead to help themselves. While balancing compassion with economy, then, we are at the same time trying to nurture certain personal values that are essential to a free society.

OPM has also had to grapple with another critical health issue: the problem of acquired immunodeficiency syndrome (AIDS). As we began to draft a government wide AIDS policy last spring, we were acutely aware of the controversial and important medical, legal, social, and moral questions surrounding the issue. We chose to premise our policy on the medical truth about AIDS as we know it: normal, nonsexual, person-to-person contact in the work place poses no threat of transmission of the disease.

To us, that dictated a policy of compassion toward those who have AIDS. We determined that they should be treated like any employees with a serious disease and afforded all applicable protections and standards related to nondiscrimination, benefits, and confidentiality.

At the same time, we would not ignore the feelings of those who fear working side-by-side with those who have AIDS. For them, we developed an early, comprehensive, and continuing education program about AIDS. As a result of this program, fear, discrimination, and friction have been kept at a minimum in the federal work place.

The issue of AIDS is a prime example of the way we in personnel are now called on to wrestle with issues that are tied into our nation's fundamental values. We wanted to be compassionate toward, and protect the privacy of, those with the disease without seeming to condone conduct that, if adopted voluntarily as a norm, ultimately undermines the family. At the same time, we wanted to acknowledge the fears of coworkers without giving credence to fear and discrimination. We think our policy meets these criteria. We think it is beneficial for those with AIDS and supportive of sound social values.

I should add that our approach has yet to face the economic chal-

lenge that will be posed to it shortly as costs of financing AIDS care inevitably skyrocket. We therefore have no firm and fast answers for the problem, and are, like you in the private sector, seeking ways to handle it.

A final health issue before us raising a host of social and moral questions is the problem of drug abuse in the work place. As part of his "Drug-Free Federal Workplace" initiative, President Reagan has told us to hold out a helping hand to those who abuse alcohol and drugs.

OPM is working to improve the employee assistance programs that aid employees in identifying substance abuse problems and that provide short-term counseling and referral to appropriate treatment and rehabilitation services. By developing model programs, educational material, and referral sourcebooks, we are gradually increasing the use of employee assistance programs for this purpose within the government. Drug treatment itself can be paid for through our insurance programs.

However, at the same time, we make clear to our personnel that being drug-free is a condition of federal employment. Like so many of you in the private sector, the federal government is embarked on a program of drug-testing for a limited number of positions agency heads consider sensitive. Given the tremendous financial losses and work place dangers associated with drug use, we could not do otherwise. We do not like it. It undermines the sense of trust which should prevail in the work place. But so does a \$90 billion illegal drug industry. We have to do it.

And here again, we seek to be compassionate, but we are at the same time very careful about the moral and social message we send society. We are willing to help individuals become drug free—but only if they are prepared to help themselves and complete successfully a regimen of rehabilitation—or just stop using drugs. If they will not do so, then they are dismissed.

We want to send a message that illegal drug use is not only addictive and dangerous but morally wrong as well and that individuals must be held responsible for their behavior, because that belief in individual responsibility is a value without which no free society can survive.

The need to balance compassion, economy, and civic-mindedness becomes particularly crucial as we turn to the family issues facing the work place. There has, of course, been a significant redefinition of the social and economic roles of men and women over the past 20 years, bringing many more women into the work place and creating

many more two-career families. *Workforce 2000* indicates that this trend will continue: almost two-thirds of the new entrants into the work force between now and the year 2000 will be women.

This means that in the future ever larger numbers of our employees will be balancing jobs with family responsibilities. And by that, I do not just mean responsibilities for children. The family issue of the future is elder care, which in fact consumes more time than child care: women spend an average of 17 years looking after children, while they spend 18 years caring for elderly relatives. As the baby boom ages, elder care will absorb an even larger portion of our energies.

We at OPM are trying to be as flexible and as mindful of family needs as we can, to help our employees meet these new demands. At the same time, we must be attentive to the basic requirements of economy and fulfillment of mission: there will be no massive new dependent care benefit program.

Finally, and most important, we are determined to accommodate ourselves to these changes without undermining further the institution of the family itself, which is held together by what its members can do for each other. Therefore, for instance, we encourage the use of flexitime. We have a generous leave policy for parental and family responsibilities, including leave for childbirth, child care, adoption and foster care, elder care, and various nonemergency family situations. And we have been experimenting with a leave transfer program, permitting federal employees to donate annual leave to coworkers, for medical or family emergencies or other hardship situations.

However, we are opposed to the idea of a legislatively mandated, uniform leave policy. Leave policy is a matter of balancing employee and employer needs, and that is best done through labor-management negotiation.

When we talk today about family issues in the work place, however, most of the attention seems to be focused on the question of day care centers. At OPM, we cosponsor a near-site day care center for our employees, but we have found it to be too expensive for most of them to use even though the space costs are paid by the agency. We also think it is a narrow response to the broad problem of dependent care, which necessarily involves the elderly and children with other needs.

That is why we at OPM are particularly excited about our new dependent care referral service, which is modeled after IBM's highly regarded elder care referral service.

Our employees throughout the nation can call a toll-free number to be put in touch with a dependent care counselor in their own

community. Counselors provide parents with detailed, practical information about quality child care in their area and a minimum of three referrals to the alternative child care programs. The program goes beyond day care, to include infant, summer, and after-school care. It also provides employees with guidebooks and other information about elder care.

The program addresses the full range of dependent care needs and it permits employees to choose for themselves among a great variety of arrangements, settings, and prices. They are not faced with only one alternative as they are when on-site day care is the only program offered.

Our program does not assume the family function of tending to the dependent. Instead, we are helping our employees work out for themselves the solutions that best fit their needs. We are supporting the values of family and self-reliance which a free society requires.

While we scramble to adapt to changes in the institution of family, at the same time we will have to cope with another unfamiliar challenge: education. You know, as well as anyone, that our educational institutions, at all levels, have simply failed—failed our children, failed our employees, failed our society. The statistics are familiar, and they are appalling:

- One out of every four high school students drops out before graduating.
- Fewer than 50 percent of high school seniors read at levels considered adequate for carrying out even moderately complex tasks, and 80 percent have inadequate writing skills.
- A recent study of science skills among 14-year-olds in 17 countries found the United States ranking 14th, tied with youngsters from Singapore and Thailand.

Less quantifiable, but vastly more alarming, is the decline of what E.D. Hirsch calls “cultural literacy.” As Hirsch suggests, one can be technically literate, be able to read, without being able to comprehend what is read: “We know instinctively that to understand what somebody is saying, we must understand more than the surface meanings of the words; we have to understand the context as well.”

And it is precisely context—a rich, substantive understanding of our culture and its history, literature, and ideals—that our students are missing today. They do not know when the Civil War was fought; they do not know who Churchill and Stalin were; they are unfamiliar with the names of standard British and American authors.

This new cultural illiteracy is truly a disturbing state of affairs. It

is disturbing for the work place, because any organization is built on communication, and without context, communication is impossible.

And it is disturbing for our democratic society. Democracy rests on the faith that free individuals can come together, deliberate mutually and meaningfully about public matters, and establish commonly understood laws to govern themselves. But public discussion and deliberation, even more than communication in the work place, requires a thorough context, a rich store of shared symbols, values, and understandings.

Addressing this profound failure in our educational system is a tremendous work place challenge. At OPM, once again, we try to approach it with flexibility, with economy, and with an awareness of our societal impact. Ultimately, this problem can be solved only by parents, schools, and local authorities. We do nothing to relieve them of that responsibility, and indeed, we do anything we can to impress it upon them. Meanwhile, however, we, like you, have to do something to meet our immediate, concrete need for trained employees.

In the Washington, D.C. area, we are already facing a classical *Workplace 2000* situation: a large local pool of inadequately prepared labor, with federal clerical jobs going begging. To prepare some candidates for those jobs, we will launch a clerical apprenticeship program, designed to put high school graduates with marginal skills through a 1-year course of training, both specific job training and writing, basic math, typing, speaking, interpersonal and problem solving skills, and work place values.

As we all know, however, high school is often far too late to intervene successfully. That is why we are now thinking about lifting a page from Aetna's book and establishing a "Saturday School" program for 7th graders, to motivate them to study and, perhaps later, to work for the federal government. But beyond these remedial education efforts in entry level skills, I have a more general suggestion: We must do something to upgrade the "cultural literacy" of our employees—all our employees, especially our managers and supervisors. The fact is that cultural literacy is crucial not only for communicating, it is also crucial for understanding—understanding our work place, our society, and ourselves.

The great works of literature, philosophy and history—the works at the heart of cultural literacy—are in fact the most profoundly illuminating resources available for making sense of the human condition. The Bible, Shakespeare, and Dickens, among other sources,

offer invaluable insights into the human character—insights that are applicable at all times and in all places.

You cannot read Dickens, for instance, and experience his vivid, memorable array of characters without instantly seeing in them people you already know, people you deal with on a daily basis. We all know a Micawber—someone who faces the worst disasters with a cheerful, albeit completely disengaged, optimism. We all know a Uriah Heap—someone working his way up through a cringing, cloying, contrived, duplicitous humility.

In this way, we begin to understand that there are permanent human “character types”—that there are some things eternal and immutable about the human character and condition that we need to know to make sense of our society and our lives and that would make us better managers of personnel.

Without a grounding in these sources, without a liberal education, people are no longer as wide and deep as they once were. They take a naive approach to problems that are centuries old, offering solutions that have been tried, and that have failed many times. They say problems are “unprecedented” when all they really mean is that they do not know the relevant precedents. They simply do not have the insights into human psychology and character that come from a liberal education and that would equip them to deal intelligently with others.

Addressing this deficiency does, indeed, present a challenge to us. For the short run, I might mention a program initiated in OPM’s San Francisco region by director Joe Patti. In conjunction with a local university, Mr. Patti organized a series of seminars for his local managers in the Great Books. One of my favorite sessions was devoted to “the management lessons of King Lear.”

In the longer run, however—to address both remedial needs, and the need for cultural literacy—we are going to have to work for nothing less than a thoroughgoing overhaul of the American educational system. The private sector will have to demand it, and the federal government will have to demand it as well. The work place itself simply cannot be expected to carry the full burden of comprehensive employee training, either in basic skills or in cultural literacy.

I cannot leave the issue of education without saying a word about OPM’s new proposal for civil service hiring, which I hope to have in place by early 1989. We now propose to do something that the private sector has always been able to do, namely, to pursue and recruit top-quality college graduates for our entry-level management positions

without subjecting them to a cumbersome, time-consuming examination procedure.

But we will continue to offer entry through a test for those who wish it, and we are particularly enthusiastic about a new measure we are developing called the Individual Achievement Record. The basic principle of this exam will be familiar to many of you, because it allows us to collect the sort of "biodata" that the private sector has found useful in hiring.

The fully automated test provides information on a candidate's self-discipline, school activities, leadership qualities, and problem-solving ability. In other words, it measures certain qualities that go beyond technical skill, qualities that might be summarized as "character."

But why are we seeking character in civil service managers? For the same reason we would like to see them liberally educated. As I am sure you have found, the best managers possess far more than narrow technical and intellectual skills. They possess certain essential human values and principles as well: perseverance, initiative, self-discipline, prudence, honesty, moral imagination, and human generosity. In short, they possess character.

Such managers have a deeper understanding of—almost a "feel for"—the human condition. They understand their employees. They understand the broader purposes of their organization. They understand their society. They understand themselves. And these are precisely the sorts of personnel managers we will need to meet the challenges posed to the work place by the new century.

It may once have been enough for personnel managers to know only the technical aspects of wages and benefits. But today, faced by the new, complex—I will not say unprecedented—work place problems of health, the family, and education, we are called on to exercise human faculties that go far beyond technical skills.

We need managers who understand the "bottom line," who can deal with these new problems economically and efficiently. But when we look at the profound social and moral dilemmas before us such as drug abuse, AIDS, dependent care, educational failure, it should be clear that our managers need to do, and to be, far more.

They must also have moral imagination. They must be flexible, compassionate, and rigorous when dealing with the new breed of employee.

And they must be civic-minded. They must understand that the way they address the new problems bears directly on some of our most important social institutions and values—self-reliance, individual responsibility, the family—institutions and values that are the

indispensable foundation of a free, decent society. To do too little to help our employees, out of cost-consciousness, would harm that foundation. But so would trying to do too much, out of compassion.

Balancing these competing principles, grappling with the new, complex, demanding problems of the emerging work place, will require personnel managers with a broad range of human skills, qualities, and values that cannot be taught in school, or at least not in the schools as we know them. The human resource manager of the future, in short, must possess character and must be willing and able to make broad human judgments.

Appendix B. Forum Participants

Moderator

Dallas L. Salisbury
President
Employee Benefit Research
Institute

Authors and Speakers

Kenneth J. Brown
President
Graphic Communication
International Union

Pat Choate
Vice President of Policy Analysis
TRW, Inc.

Paul R. Cullinan
Principal Analyst
Congressional Budget Office

Robert B. Friedland
Research Associate
Employee Benefit Research
Institute

Jeffery J. Hallett
President
TRAC, Inc.

Dorcas R. Hardy
Commissioner
Social Security Administration

Constance Horner
Director
U.S. Office of Personnel
Management

William B. Johnston
Vice President for Special Projects
Hudson Institute

Thomas W. Merrick
President
Population Reference Bureau

Arnold H. Packer
Senior Research Fellow
Hudson Institute

John L. Palmer
Senior Fellow
Urban Institute

Ronald C. Pilenzo
President
American Society for Personnel
Administrators

James S. Ray
Partner
Connerton, Ray & Simon

Stanford G. Ross
Senior Partner
Arnold & Porter

P. Royal Shipp
Senior Specialist, Social
Legislation
Congressional Research Service

Paul N. Van de Water
Chief, Projections Unit
Congressional Budget Office

Thomas E. Wood
Partner, Retired
Hewitt Associates

Participants

Carl Anderson
Staff Attorney
Committee on Education and
Labor
House of Representatives

Gary W. Anderson
Senior Vice President
IDS Trust

Tom Arthur
Budget Examiner
Office of Management and Budget

Larry Atkins
Minority Staff Director
Special Committee on Aging
U.S. Senate

Bob Batey
Manager, Benefit Planning
Ameritech

Phyllis Borzi
Counsel for Pensions
Subcommittee on Labor
Management Relations
U.S. House of Representatives

David Bradley
Supervisor, Savings and Stock
Ownership Plans
Southern Company Services, Inc.

Dianne Braunstein
Legislative Affairs Advisor
Social Security Administration

Jon Brightman
Senior Vice President
Harris Trust & Savings Bank

Dr. William S. Cartwright
Chief, Demography & Economics
Office
National Institute on Aging

Scott Corwin
Legislative Assistant
Senator Donald Riegle

Ray Crabtree
Senior Vice President
The Principal Financial Group

Carol Cronin
Vice President, Policy
Washington Business Group on
Health

Scott Daniels
Special Assistant
Social Security Administration

Helen Darling
Legal Assistant
Senator Dave Durenberger

Joe Delfico
Senior Associate Director
U.S. General Accounting Office

Joe Dempsey
Human Resources Analyst
AT&T

Dana J. Domone
BNA Pension Reporter
The Bureau of National
Affairs, Inc.

Joann Duarte
Vice President
American International
Group, Inc.

Lloyd Duxbury
Staff
Special Committee on Aging
U.S. Senate

John N. Feldtmose
President
A. Foster Higgins & Co.

Mary Jane Fisher
Correspondent
Insurance Advocate

John Fleming
Administrative Director
Bakery and Confectionery Union
and Industry International
Health Benefits and Pension
Funds

Jay H. Foreman
Executive Vice President
United Food & Commercial
Workers International Union

Theresa Forster
Legislative Aide
Senator David Pryor

Harry Garber
Vice Chairman
The Equitable Life Assurance
Society of the United States

Lynne Garbose
Special Assistant
Department of Labor

Harper Garrett
Vice President
The Alexander Consulting Group

Marian Gornick
Division Director
Health Care Financing
Administration

Bill Grant
Director, Personnel
Pennsylvania Blue Shield

Jack Greer
Analyst
Graphic Communication

Professor Dan Halperin
Professor of Law
Georgetown University Law
Center

Randy Hardock
Tax Counsel
Finance Committee
U.S. Senate

Donald P. Harrington
Corporate Vice President
AT&T

Marti Harrington
Assistant Vice President
Lincoln National Life Insurance
Company

Larry Hershberger
Senior Vice President
Teachers Insurance and Annuity
Association/College Retirement
Equities Fund

Robert F. Hickox
Co-Publisher
Employee Benefit News

Jack Hoadley
Senior Research Associate
National Health Policy Forum

Richard Hobbie
Professional Assistant
Subcommittee on Public
Assistance and Unemployment
Compensation
U. S. House of Representatives

Daniel M. Hodan
Corporate Manager, Employee
Benefits
Occidental Petroleum Corporation

Michael Hoon
Legislative Assistant
Senator Malcolm Wallop

Neil J. Horgan
Director, Compensation and
Benefits
Sun Company, Inc.

Dalmer Hoskins
Director, Office of Policy
Development
Social Security Administration

Ron Hovis
Director, Benefits
Southwestern Bell Corporation

Richard Hubbard
Attorney
Arnold & Porter

Larry Hyer
Director of Human Resources
Cincinnati Bell Telephone
Company

Paul H. Jackson
Vice President and Director
The Wyatt Company

Suzanne Denbo Jaffe
President
SDJ Associates

Neal Jewell
Senior Vice President
Mutual Life Insurance Company

Judy Miller Jones
Intergovernmental Health Policy
Project
George Washington University

Michael Kahn
Benefits Specialist
National Education Association

Barbara Kaplan
Minority Staff Director
Select Committee on Aging
U. S. House of Representatives

Frank Kleiler
Washington Correspondent
Charles D. Spencer and Associates

Janet Kline
Congressional Research Service
Library of Congress

Kala Ladenheim
Policy Analyst
Project HOPE

Matt Lamberti
Senator Daniel Patrick Moynihan
U. S. Senate

C. William Lee
Director, Compensation and
Benefits Division
E. I. du Pont de Nemours &
Company, Inc.

Mary Nell Lehnard
Vice President
Blue Cross and Blue Shield
Association

Robert F. Leonard, Jr.
District Staff Manager, Benefits
Planning
NYNEX Corporation

Marion Ein Lewin
Senior Staff Officer and Director
of Health Policy Fellowship
Programs
Institute of Medicine
National Academy of Sciences

Jules Lichtenstein
Chief, Applied Policy
Small Business Administration

Arthur Lifson
Vice President
Equicor, Inc.

Sara Malm
Legislative Staff Assistant
Senator Paul Simon

Thomas McQueeney
President
Money Market Directories

Curtis Mikkelsen
Vice President
Morgan Guaranty Trust Company
of New York

John D. Moynahan, Jr.
Executive Vice President
Metropolitan Life Insurance
Company

David Nearpass
Consulting Actuary
Buck Consultants, Inc.

Carol Norman
Manager, Collection, Bargaining
and Compensation
National Educational Association

Craig Obey
Legislative Assistant
Senator Kent Conrad

Daniel E. O'Sullivan
President and CEO
The Union Labor Life Insurance
Company

Martha Patterson
Consultant
William Mercer-Meidinger-Hansen

Robert D. Paul
Vice Chairman
Martin E. Segal Company

Martha Phillips
Staff Director
Budget Committee
U.S. House of Representatives

Donald Pliska Director of Benefits SmithKline Beckman Corporation	Sean Sullivan Vice President New Directions for Policy
Pat Powers Advocate for Health Policy Small Business Administration	R. N. Swilley Director, Benefits BellSouth Corporation
Charlene Quinn Deputy Director Office of Prepaid Healthcare	Ronnie S. Thierman Chief Actuary Pacific Telesis Group
Michael J. Reardon Second Vice President, Issue Management UNUM Life Insurance Company	Richard G. Thomlinson Vice President The Upjohn Company
Michael J. Reynolds President Godwins, Inc.	John Thompson Labor Economist U. S. Bureau of Labor Statistics
Melvyn J. Rodrigues Manager, Benefit Plans Research and Compliance Atlantic Richfield Company	Kathleen Utgoff Executive Director Pension Benefit Guaranty Corporation
John Rother Director, Legislation, Research and Public Policy Division American Association of Retired Persons	Roger L. Vaughn, F.S.A. Executive Vice President and Actuary Brooke & Company
Ray Schmitt Congressional Research Service Library of Congress	David Walker Assistant Secretary U. S. Department of Labor
Bert Seidman Department of Occupational Safety, Health and Social Security AFL-CIO	Howard Weizmann Executive Director Association of Private Pension and Welfare Plans
Jesse M. Smith, Jr. Associate Executive Director American Compensation Association	Anthony Williams Director, Retirement, Safety and Insurance National Rural Electric Cooperative Association
Lois Snitkoff Vice President Citibank, N.A.	Sandy Wise Staff Director Committee on Ways and Means, Social Security Subcommittee U. S. House of Representatives
Katherine Bauer Sommers Scholar Institute of Medicine National Academy of Sciences	Hazel Witte Assistant Chief Counsel, Pension and Employee Benefit Policy Small Business Administration

Thomas Woodruff
Vice President
Mutual of America Life Insurance

Leah Young
Journal of Commerce

Staff

Emily S. Andrews
Director of Research

Charles Betley
Research Assistant

Laura Bos
External Affairs Manager

Shannon Braymen
Education and Communications
Associate

Tim Cerino
Research Assistant

Deborah J. Chollet
Senior Research Associate

Bill Custer
Research Associate

Patsy D'Amelio
Office Manager

Jennifer Davis
Research Assistant

Robert B. Friedland
Research Associate

Deborah A. Holmes
Education and Communications
Associate

Frank B. McArdle
Director of Education and
Communications

Nancy Newman
Administrative Assistant

Bonnie Newton
Director of Publications

Cindy O'Connor
Education and Communications
Associate

Joe Piacentini
Research Analyst

Stephanie L. Poe
Editor
Employee Benefit Notes

Lisa Schenkel
Assistant Director of Publications

Wendy Schick
Research Assistant

Jayne Seidman
Special Assistant

Kevin Ward
Research Analyst and Programmer

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