The Social Security explosion

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SOCIAL insurance programs of all kinds—including Social Security retirement benefits, unemployment insurance, and the federal government programs of health insurance—have exploded in magnitude during the past two decades of The Public Interest's existence. Today these programs cost more than $300 billion a year and account for more than half of all federal government spending on non-defense programs.

Twenty years ago, the total cost of these programs was only $19 billion. Even after adjusting for the general rise in prices, real outlays have increased sixfold between 1965 and 1985. As a result, the share of GNP spent in this way rose from 2.9 percent in 1965 to 7.7 percent now. For most American families, the taxes paid to finance these social insurance programs exceed the family's total income tax payments.

The economic impact of social insurance programs is not limited to their budget cost and the resulting effect on tax liabilities. The explosion of government-provided health insurance has caused health care costs to skyrocket. Unemployment insurance has increased layoffs and caused higher unemployment rates. And the Social Security retirement program has forced individuals to retire earlier than they would truly prefer and has reduced the nation's rate of capital accumulation.
Although these criticisms of the social insurance programs would have been an almost unthinkable heresy twenty years ago, expert opinion and informed judgments have changed significantly during these two decades. The adverse consequences of high levels of social insurance benefits have been carefully documented in a substantial number of statistical studies by economists and other social insurance experts. While there is not a consensus on all of the empirical issues, there has no doubt been a major shift in the center of gravity of professional thinking about social insurance.

The common assumption when these programs were founded (the 1930s for unemployment insurance and Social Security and the early 1960s for Medicare and Medicaid) was that social insurance programs were dealing with events that were beyond the control of the individuals involved. According to this view, individuals simply and unavoidably find themselves unemployed, or retired, or lacking resources in old age, or faced with expensive medical bills. In such circumstances, it appears that the only question for a humane society is what level of support is fair to the taxpayers and adequate for the beneficiaries.

Now there is widespread agreement that the conditions of unemployment, retirement, a low level of accumulated assets, and high medical bills are in part the result of rational choices by the individuals affected. It is recognized that the social insurance programs themselves distort incentives and thereby contribute to the very problems that they are intended to solve. Thus, for example, high unemployment benefits induce unemployed individuals to wait longer before taking a new job and induce employers to organize production in ways that increase the frequency of layoffs since the availability of unemployment benefits causes employees to place less value on job security.

A high level of benefits in any social insurance program provides more protection to those in need but it does so at the cost of distorting behavior in harmful ways. The key lesson that is reinforced by the past two decades of experience is that the appropriate design of social insurance programs requires a balancing of protection and distortion. Too little protection leads to economic hardship and human suffering. But protection that is too complete causes distortions that reduce the overall level of economic well-being.

Of course, the design of a social insurance program involves more than setting the level of benefits. A health insurance program includes schedules of deductibles and co-payments. An unemployment insurance program combines benefits based on past earnings
with benefits based on the number of dependents. In general, a well-designed social insurance program will incorporate features that achieve as little distortion as possible for any degree of protection.

Although economists and other social insurance experts have now come to recognize the importance of balancing protection and distortion, the practice of social insurance has been little affected. The major social insurance programs have greatly expanded in the past two decades without regard to the adverse consequences of poorly designed programs. More recently, however, responsible policy officials have shown an increased awareness of the need to redesign social insurance programs in ways that reduce their distorting effects. The next twenty years may see more fundamental reforms of social insurance.

This article traces the general developments of the past two decades in the three major areas of social insurance: health insurance, unemployment insurance, and old age retirement benefits. For each area, I summarize the expansion of benefits that has taken place, indicate the nature of the new thinking about social insurance, and point to some of the recent policy debates that offer hope that the next two decades may see a more rational development of social insurance policy.

Health insurance

Twenty years ago, the federal government's spending on the provision of health care was limited to a few special groups like American Indians, military dependents, and some veterans. Then, in 1966, the government introduced Medicare to pay for the health care of the aged and Medicaid to pay for the health care of low-income individuals of all ages. By the current fiscal year, health care spending through the Medicare and Medicaid programs alone has reached $88 billion, 15 percent of total federal non-defense spending and 2.3 percent of GNP.

At the time that Medicare and Medicaid were introduced, health care specialists and government officials assumed that these programs would have little or no effect on the total volume of health services and on the cost of those services. They saw the programs as paying the bills that would otherwise have to be paid by the aged, the poor, and their families.

In fact, the introduction of Medicare and Medicaid caused a sharp jump in the price of health services and in the total volume of health care spending. The price of a day of hospital care jumped by 45 percent between 1966 and 1969 at a time when consumer prices
in general increased only 13 percent. The sharp rise in the prices of health care services, and especially of hospital care, reflected a combination of the increased pressure of demand and the decisions by hospitals to raise wages and to increase the comfort and sophistication of care in the knowledge that the higher costs would be reimbursed by the government.

The rise of health care costs increased the financial risk of illness and therefore induced the working age individuals to increase their private health insurance coverage either through direct purchases or employer plans. Although the American government does not provide health insurance for the general working population, the special tax treatment of employer payments for health insurance is a kind of indirect provision of social insurance. Employer payments for health insurance are considered a deductible expense for employers but are not included in the taxable compensation of employees. This special tax rule, which reduces 1985 tax collections by some $40 billion, substantially lowers the net cost of buying health insurance. A taxpayer who faces a combined income and Social Security tax rate of 40 percent foregoes only 60 cents’ worth of other consumption to buy a dollar’s worth of health insurance. This massive subsidy increases substantially the demand for very comprehensive health insurance. By 1980, the combination of public and private health insurance paid more than 90 percent of the cost of hospital care. It is not surprising therefore that the demand for hospital care and its price rose dramatically during the past twenty years.

Between 1965 and 1984, the cost of a day of hospital care rose 1,047 percent. Even after adjusting for the overall increase in the price level, the rise in the relative cost of a day of hospital care was more than 282 percent during these twenty years. Experts say that as a result the aged now pay more for hospital care than they did before Medicare was introduced.

The rapid rise in hospital costs threatens to end the current system of health care in which individuals and their doctors are free to decide the amount of care that is in the patient’s best interest. A substantial regulatory process has already developed under Medicare to control the construction of hospital facilities and the acquisition of equipment. President Carter proposed a detailed program of limits on price increases. And more recently, President Reagan proposed and Congress enacted the diagnostic related group (DRG) method of hospital reimbursement.

Under the DRG system, hospitals are reimbursed a fixed amount for each of more than 300 types of cases. In the short run, this limits
the amount that a hospital can afford to spend on caring for each
type of patient and denies the patient the opportunity to buy better
care by spending a bit more. In the longer term, hospitals are likely
to develop ways to circumvent the DRG reimbursement systems by
admitting “profitable” patients for short stays or classifying patients
with complex diagnoses in more highly paid categories. The govern-
ment will be forced to respond to these problems with more detailed
controls on hospital admissions and treatments. In the end, a mar-
ket that is distorted by excess health insurance will lead inevitably
to detailed government controls.

In retrospect, it is easy to see that a misdesigned system of Medi-
care and Medicaid and an unlimited tax subsidy for private pur-
chases of health insurance would cause an excessive demand for
expensive health care and raise the cost of medical services. To pro-
vide protection against the financial hardship of large medical bills
without as much distortion of health care demand, the Medicare
and Medicaid programs should have been designed with significant
cost-sharing by patients.

An appropriate health insurance program would combine a re-
quirement that patients share part of each dollar of health care costs
—in order to make patients and their doctors more sensitive to the
cost of care—with a limit on the maximum out-of-pocket expendi-
ture for any family. Because only a relatively few cases incur very
large medical costs, it would be possible to structure the co-payment
and out-of-pocket limit in a way that keeps the vast majority of
households sensitive to the cost of medical care while still limiting
the maximum out-of-pocket cost to a modest share of family income.

Similarly, appropriate tax rules would restrict the tax subsidy to
health insurance policies that meet prescribed standards with respect
to minimum co-payments and maximum out-of-pocket outlays.

There is evidence that policymakers are beginning to understand
the kinds of changes that need to be made to achieve protection
against health care costs with less distortion of demand. In 1983,
the Reagan administration proposed to introduce very modest co-
payments for Medicare and Medicaid patients and to limit the
amount that employers could deduct for purchases of health insur-
ance. Unfortunately, neither proposed change was enacted. In
1984, the Treasury again proposed to limit the amount of health
insurance that employers could deduct but then dropped this pro-
sal in the president’s revised 1985 tax plan. There are however a
number of congressional leaders who understand the need to re-
structure the Medicare-Medicaid benefits and to limit the tax incen-
tives for purchasing excessive private health insurance.
There is reason to be optimistic that progress will be made in the next decade. The rising costs of health care in general and the increased cost to the government in particular provide a strong incentive to reform. With Medicare-Medicaid outlays projected to exceed $120 billion a year by 1988 and the current tax treatment of health insurance projected to cost more than $40 billion a year in lost revenue, Congress will be looking hard for ways to control health care costs. That search may lead them to a more appropriate redesign of both the Medicare-Medicaid programs and the special tax treatment of health insurance.¹

Unemployment compensation

The unemployment compensation program was created in the 1930s at the depth of the Depression. The unemployment rate was 25 percent and many men had not seen steady work for a year or more. Individual resources were exhausted and the prospects for finding work were generally bleak.

The structure of the unemployment compensation program has remained essentially unchanged since the 1930s even though the nature of unemployment has changed radically. In recent years, most unemployment has been relatively short with more than half of the spells of unemployment ending in less than six weeks. Nearly half of the unemployed did not become unemployed by losing their previous job but are either young people who are looking for their first job, or people returning to the labor force after a period in which they were neither working nor looking for work, or people who quit their last job in order to look for something better. And more than one-quarter of those who are officially classified as "job losers" are actually on temporary layoff from firms where they have regular jobs and expect to be recalled.

Under current conditions, unemployment compensation raises the rate of unemployment. The most obvious effect of unemployment compensation is to increase the length of time that individuals remain unemployed. Some individuals use the period of compensated unemployment to have a little extra vacation and do odd jobs around the home. Others are induced by unemployment compensation to keep waiting in the hopes that a better job will come along while still others don't bother to take temporary work that would reduce their total unemployment.

¹ For a discussion of these issues, see my "A New Approach to National Health Insurance," The Public Interest No. 23 (Spring 1971), pp. 93-105. More generally see my Hospital Costs and Health Insurance (Cambridge MA: Harvard University Press, 1981).
The current unemployment compensation system also encourages employers to lay workers off for short periods of time instead of finding other ways to smooth production and employment by varying inventories or cutting prices. And the presence of unemployment compensation makes it easier and cheaper for employers to find people willing to take temporary or seasonal jobs that add to the unemployment rate.

Although the absolute level of unemployment benefits is not high, the benefits are large relative to the lost wages that they replace. In most states, unemployment benefits are set at 50 percent of the individual's past wage, with additional benefits for dependents paid to about one-third of the unemployed. Although there is a limit on the weekly benefit, most beneficiaries do receive benefits that equal or exceed half of their past wage.

Until the late 1970s, unemployment benefits were completely free of tax. The high marginal tax rates on wages meant that untaxed unemployment compensation frequently replaced 75 percent or more of lost net income. In a 1973 article in The Public Interest I gave the following example:

Consider a worker in Massachusetts in 1971 with a wife and two children. He earns $500 per month or $6000 per year if he experiences no unemployment. She earns $350 per month or $4200 per year if she experiences no unemployment. If he is unemployed for one month, he loses $500 in gross earnings but less than $100 in net income. How does this occur? A reduction of $500 in annual earnings reduces his federal income tax by $83, his Social Security payroll tax by $26, and his Massachusetts income tax by $25. The total reduction in taxes is $134. Unemployment compensation consists of 50 percent of his wage plus dependents' allowances of $6 per week for each child. Total unemployment compensation is therefore $302. This payment is not part of taxable income. His net income therefore falls from $366 for the month if he is employed (i.e., his $500 gross earnings less $134 in taxes) to the $302 paid in unemployment compensation. The combination of taxes and unemployment compensation imposes an effective marginal tax rate of 87 percent—i.e., the man's net earnings fall by only 13 percent of his gross pay ($64) when he is unemployed for a month.²

The balance between protection and distortion was clearly wrong. The protection of the standard of living of the unemployed was so complete that there was little incentive to find work or to avoid unemployment. Substantial statistical evidence has accumulated during the past decade that indicates that individuals who are eligible for higher unemployment benefits relative to their net wage

² "The Economics of the New Unemployment," The Public Interest No. 33 (Fall 1973), p. 31.
have longer durations of unemployment, are more likely to become unemployed, and require relatively higher wages as a condition of accepting new employment.

In 1978 the Carter administration proposed and Congress enacted a partial taxation of unemployment compensation for upper-income taxpayers. That taxation has now been extended to full taxation of all benefits for married taxpayers with total income over $18,000 and single taxpayers with incomes over $12,000. Although benefits are still exempt from the Social Security payroll tax (with a combined employer-employee rate of more than 14 percent) and from many state income taxes, subjecting benefits to the federal income tax is a significant step toward reducing distortion and increasing the fairness of the unemployment compensation system. Recent studies have shown that the average duration of unemployment declined for individuals whose benefits became taxable while remaining unchanged among individuals whose incomes kept benefits exempt from taxation.

There is certainly no logic to the current rule that taxes the benefits received by a family with $19,000 of income but not the benefits received by a family with $17,000 of income. Of course, higher income taxpayers should pay more tax on any given amount of benefits and individuals with low enough income should be completely exempt from taxation of any type of income. But that is exactly what would happen if unemployment benefits were treated just like every other type of taxable income.

The Reagan administration, in the tax reform plan released by the Treasury in November 1984, proposed taxing all unemployment compensation. Unfortunately, this proposal was eventually dropped in an effort to make the final plan politically more attractive. It is noteworthy, however, that the leading Democratic alternative, the Bradley-Gephardt bill, would tax all unemployment compensation. It is probably only a matter of time before all benefits are taxable.

The effect of the unemployment compensation system depends not only on the relative level of benefits but also on the way that the program is financed.

The method of financing unemployment benefits can either reduce or exacerbate the distortion of incentives that leads to higher unemployment. Employers now pay more than $25 billion in special payroll taxes to finance the unemployment compensation benefits. Each firm's tax is in principle related to the benefits collected by workers who were laid off by that firm. If this system of experience rating were fully effective, each firm would face the full cost.
of the unemployment benefits that result from its layoffs. A combination of full taxation of benefits to employees and a complete experience rating of firms would eliminate the incentive for excess layoffs and for an excessive amount of temporary and seasonal jobs.

In practice, however, the experience rating system is far from complete. Firms with high layoff rates pay a relatively low maximum rate of unemployment compensation tax that does not increase or decrease as they raise or lower their layoff rates. To make up for the taxes not paid by firms with high layoff rates, firms with very good unemployment experience must pay a relatively high minimum rate of tax. Because this minimum tax cannot be lowered by better unemployment performance, these firms also have no incentive to reduce their layoff rate.

An improvement in the method of experience rating could improve incentives for higher employment without reducing the protection to unemployed workers or to firms. A good start would be to require firms to pay 100 percent of the first month’s unemployment compensation.

Some progress has been made in correcting the balance between protection and distortion in the unemployment compensation system. The legislation to tax unemployment compensation that has been enacted is clear evidence that policymakers at last understand that the current system causes unnecessary unemployment. The next steps should take us toward full taxation of benefits and a more complete method of experience rating.

Social Security

I have saved the biggest and most important of the social insurance programs for last. The Social Security program of benefits for retirees and surviving dependents will pay $182 billion in fiscal year 1986. Benefits of $182 billion represent 4.4 percent of the gross national product and one-third of the federal government’s outlays for all non-defense programs.

Social Security benefits are projected to rise rapidly in the decades ahead as the population ages and the number of retirees increases. Under current law, benefits thirty-five years from now would be about $2 trillion or 5.6 percent of GNP.

The payroll tax that finances the benefits of retirees and survivors has increased from just 2 percent of the first $3,000 of wages when Social Security began in 1937 to 11.4 percent of wages up to $39,600 in 1985 (including the portion that finances disability insurance, but excluding the Medicare portion). The majority of Ameri-
can families now pay more in employer-employee payroll taxes for Social Security than they do in personal income taxes. And the Social Security Administration now predicts that that tax will increase during the next twenty-five years to 12.4 percent of wages up to some $56,000 in 1985 dollars.

Although Social Security is widely regarded as the most popular of the major government programs, young workers are frequently critical of Social Security and generally believe that they will not get back in benefits what they have paid in taxes. There is no paradox in this contrast. The economic environment of Social Security has changed dramatically since the program began a half-century ago. As a result, Social Security no longer offers the good deal to young workers that it did to their parents and grandparents. 3

Social Security was established in the 1930s at a time when millions of Americans had lost their life savings and were without work or the prospect of work. The original Social Security program was designed for those conditions. The program then expanded dramatically during a period when earnings were much lower than they are today and when private pension coverage was rare.

Conditions are now very different. The level of real per capita income has tripled since Social Security began and is likely to double again during the next thirty years. Private pension assets have grown from less than $10 billion in 1945 to more than $1 trillion in 1985. The vast majority of working families now expect to receive substantial private pension benefits when they reach retirement age. And the recent availability of tax-favored Individual Retirement Accounts has been enthusiastically received and has led to substantial deposits of retirement savings. In short, the current and future environment is very different from what it was when the present Social Security program was shaped in the 1930s, 1940s, and 1950s.

The Social Security program was a bonanza for those who got in on the ground floor. Those who retired in the past several decades and those who will retire in the near future will get back in benefits far more than they and their employers paid in taxes. The return that they earned on their tax "contributions" was far greater than they could have gotten by putting those funds in the bank or buying government bonds.

The principal reason why Social Security was such a good deal for the early cohorts of retirees is that the Social Security payroll tax

The rate rose from only 2 percent at the start of the program to more than 10 percent today. Since Social Security is financed on a pay-as-you-go basis, the rise in the payroll tax rate and therefore in total Social Security tax collections made it possible to increase benefits at a very rapid rate.

In the future, Social Security will no longer be a good deal for the vast majority of workers. Young people who have begun work in the past decade or who will enter the workforce in the future will not get nearly as much back for their Social Security contributions as they could get by investing those funds in government bonds or corporate securities. The unfunded pay-as-you-go character of Social Security means that the implicit return of Social Security contributions is far less than on alternative investments.

For example, a 36-year-old worker now has to contribute about $3,000 in employee-employer payroll taxes to earn $9,000 of benefits (in 1985 dollars) at age 66. If instead of paying those $3,000 in taxes the individual invested that same amount in government bonds, the $3,000 would grow to $15,000 by the time he reached age 66. Or to look at that same arithmetic in a slightly different way, he could finance $9,000 of retirement benefits by investing only $1,800 in government bonds instead of the $3,000 that he is now required to pay in Social Security taxes. If Social Security taxes and benefits were lower, the generations born since World War II could have both more consumption while they are still working and more income after they have retired.

The current Social Security program also reduces the living standard of some individuals by forcing them to retire earlier than they would otherwise have preferred. Under current law, a worker who postpones retirement after age 65 effectively throws away a large part of his potential benefits. Although future benefits are raised slightly for those who postpone retirement, the increase is far less than would be actuarially fair. In many cases, working after age 65 would add little or nothing to total income. It is not surprising therefore that the proportion of individuals who retire by age 65 has increased dramatically in spite of improved health and increased longevity.

From a national perspective, the current provision of Social Security benefits reduces aggregate saving by individuals and employer-provided pensions. Since Social Security is financed on a pay-as-you-go basis, there is no accumulated Social Security capital fund to offset the reduction in private capital accumulation. As a result, the nation's capital stock is substantially smaller than it would otherwise be. Workers lose not only because they are forced to accept the
low rate of return on Social Security contributions but also because the resulting smaller capital stock means lower productivity and therefore lower real wages.

In thinking about the appropriate Social Security program, these adverse effects of Social Security must be balanced against the desirability of protecting those who would otherwise save too little for their own old age either directly or through employer-provided pensions. So again the problem of designing the right social insurance program comes down to balancing protection and distortion: in balancing protection against poverty and hardship in old age against the distortion to saving and retirement decisions.

I believe that the level of Social Security benefits that correctly balances these two considerations is much lower than the level of benefits that prevails today and that will prevail in the future under current law. Benefits that replace as much as 60, 70, or even 80 percent of previous net wages impose too high a cost on those who would otherwise have saved for themselves.

It would be appropriate to reduce benefit replacement ratios for future retirees who are middle- and upper-income wage earners. The lower benefits would permit lower tax rates, leaving workers with extra income that could be invested at higher rates of return. A greater reliance on the Supplementary Security Income program of means-tested benefits for aged individuals would strengthen the protection against poverty in old age without imposing the current large costs in terms of reduced saving and lower returns for those who would otherwise provide adequately for their own old age.

Other useful improvements in the design of Social Security would be a move to a closer matching of taxes and subsequent benefits. The current system is much more favorable for single-earner couples than it is for two-earner families and single individuals. A combination of actuarial fairness for different kinds of families and means-tested benefits that reflect the number of dependents would reduce the distortions in the current system.

Although there is growing recognition of the distortions caused by the current Social Security program, there has been relative little political action to improve the balance between protection and distortion. When the Reagan administration in 1982 proposed reduction of benefits for those who retire before age 65, the Senate expressed its disapproval by unanimous vote. The 1983 bipartisan President's Commission on Social Security Reform agreed that the Social Security program faced a $175 billion gap between receipts and benefits during the remainder of the decade but reduced benefits by only about 2 percent, filling the rest of the gap by advancing
tax rate increases, bringing employees of nonprofit organizations and new federal employees into the program, and including a portion of the benefits of high income retirees in taxable income. More recently, the attempts to include reductions in the growth of Social Security benefits as part of the deficit reduction actions of 1985 met with overpowering resistance from President Reagan and from both Democrats and Republicans in the House of Representatives.

But there are some signs of political courage and of a willingness to begin tackling the reform of Social Security. A significant number of senators and congressmen did publicly support proposals to slow the growth of Social Security in order to shrink total government spending. Congress in 1983 did enact legislation that will postpone the retirement age from 65 to 66, although even this modest change will not take effect until the next century. Congress also enacted legislation to eliminate the penalty for delayed retirement by raising the benefits of post-65 retirees at an actuarially fair rate, although the effective date for this improvement is also many years in the future.

The next twenty years

In the past two decades, social insurance benefits have increased at such a dramatic rate that they are now larger than all other federal non-defense spending combined. Economists, policy analysts, and government officials are at last beginning to realize the enormous impact that these programs have on the economy. They are no longer looked upon as benign transfers of funds but are seen as the source of powerful incentives that affect employment, unemployment, capital formation, and health care costs.

With this new perception comes a new concept of the appropriate design of social insurance programs: balancing the protection to those who would otherwise suffer financial hardship against the distortions that result when protection levels are set too high or benefits are badly structured. As economic and social conditions change, the appropriate level and structure of benefits in any social insurance program will also change.

The challenge for the next two decades will be to apply this new understanding to reform our existing social insurance programs. Although the prospective gains from reform outweigh the costs and the prospective beneficiaries outnumber those who would lose, reform inevitably generates stiff political resistance from those who do not want to see benefits reduced. The process of reform will be a critical test of our political system.