



Increasing the Effectiveness and Sustainability of the Nation's Entitlement Programs

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Contents

Executive Summary	1
Summary of Recommendations	4
The Fiscal and Programmatic Urgency of Entitlement Reform	7
Social Security for the Current Century	14
Bringing Market Discipline to Health Entitlement Spending.....	24
Improving the Safety Net: An Agenda to Expand Opportunity.....	32
The Federal Budgetary Implications of Reform Recommendations.....	45
Notes	48
About the Authors.....	53

Executive Summary

The United States faces a large and growing fiscal challenge that is being ignored by most of the nation's policymakers. The Congressional Budget Office (CBO) projects that debt held by the public will reach 100 percent of gross domestic product (GDP) in 2039.¹

The primary cause of the problem is the steady, decades-long rise in entitlement spending. Over the past 75 years, the United States has built a vast and sprawling network of social welfare protections and programs—the entitlement state. These programs' cumulative costs now threaten to push the federal government past the point of insolvency.

However, it is insufficient to base a push for reform on a fiscal rationale alone. Reforms must be—and must be understood by the public as—good ideas that improve the programs' effectiveness and efficiency, separate and apart from budgetary effects.

Although entitlement programs vary greatly in their roles and design, the important themes for reform should be:

- **Promotion of Work.** Much of the federal safety net is designed to help households that have inadequate resources from earned income. But it is counterproductive when government programs discourage work and thus create unnecessary dependence on public support.
- **Personal Responsibility.** Most working-age households with middle-class incomes (or higher) could save and provide for their own retirement without subsidization from other taxpayers. Entitlement reform should proceed on the assumption that limited public resources should provide a solid safety net against poverty in old age, but that those who can afford to save for retirement should be expected to do so.

- **Innovation and High Quality in Health Care.** Slowing cost escalation in health care without undermining the quality of care requires higher productivity and more efficiency in how care is provided to patients. That can be achieved only with a functioning marketplace.

The federal government's entitlement spending is concentrated in Social Security, health care programs, and the safety net for lower-income households. Reforms are necessary in all three areas.

Social Security. The current Social Security program provides benefits to nearly all retired Americans, including those with higher incomes, based on their preretirement earnings. Social Security, however, does a poor job of preventing poverty in old age.

Social Security should move toward providing a universal flat benefit, set initially at the federal poverty line, to all US residents age 65 and older. In effect, Social Security would shift toward becoming a guarantee against poverty in old age rather than a scheme for partially replacing preretirement earnings for middle- and high-earning households. There would be a long transition from the current formula to the new benefit to ensure no one lost accrued benefits. This new benefit would eliminate old-age poverty and would be sustainable over the long run with a lower payroll tax rate.

The flat benefit would provide lower Social Security benefits to middle and higher earners. They could offset this income with additional private savings, facilitated with reforms promoting automatic 401(k) enrollment and simplified 401(k) plans for small employers. In addition, a reform plan should eliminate the 12.4 percent Social Security payroll tax at age 62, thus removing a major disincentive to continue working at older ages. This change could be coupled with increasing the early

retirement age (now 62) to age 65 during the transition to the flat benefit.

Health Care. With the passage of the Affordable Care Act (ACA) in 2010, the federal government assumed even more control over the allocation of resources in the nation's system of health insurance and health care. Over time, this will result in lower-quality health care. What is needed instead are market-based reforms that empower consumers to pursue high-value and low-cost care.

The starting point for building such a marketplace is to move away from open-ended federal subsidization of insurance toward a defined-contribution approach. The ACA would be replaced with a program with much less regulation. Employer coverage would remain as it is today, with no mandates or requirements. The “Cadillac” tax of the ACA would be replaced with a more rational upper limit on the federal tax preference for employer plans.

Households without access to employer coverage would get a tax credit (refundable for those with low incomes). The credit could be used to enroll in any state-approved plan. People who stay continuously insured would be protected against high premiums or restricted coverage based on a previous episode of expensive care.

The Medicare program would be converted into a premium support program, with a fixed level of support that beneficiaries would use to offset the cost of a plan of their choosing. Medicaid would be separated into two components (for the able-bodied and children and for the disabled and elderly) and converted into fixed, per capita federal payments to the states for the two enrolled populations. States would have substantial flexibility to manage the program according to their preferences.

The rules for enrolling and contributing to health savings accounts (HSAs) would be liberalized to encourage widespread participation and thus also bolster the consumer role in the marketplace.

Safety-Net Programs. The federal government spends about \$400 billion annually to fight poverty (not counting health care programs), with unsatisfactory results.² The existing array of support programs improves lower-

income households' material well-being and enables them to meet their daily needs, but it does not help families lift themselves out of poverty and up the income ladder with better-paying jobs. A major impediment is the lack of coordination among the many federal and state initiatives that have been created over the years.

Reforms to safety-net programs should emphasize work as the key to improved economic prospects, greater state control over resources to allow for innovation and coordination, and the elimination of wasteful spending.

Two major reform concepts—block grants and wage subsidies—should be tested in several states. States could opt to receive a large portion of existing federal funding for safety-net programs in the form of a block grant, based on historical spending patterns. They could then design better-coordinated programs that move as many beneficiaries as possible into employment. Some states would also be allowed to use the block grant to provide direct wage subsidies to lower-income households, effectively giving them a raise that the beneficiaries would see directly in their paychecks. The federal government would help facilitate the testing of this reform.

Since this would be a significant departure from the status quo, demonstrations of this approach would need to be carefully evaluated and show evidence of helping low-income Americans before it is adopted on a wide scale. In the meantime, existing safety-net programs have many problems in need of improvement. Targeted reforms are needed to eliminate unnecessary spending, close loopholes around work requirements, support low-income workers, and target resources on those most in need of assistance.

Federal Budgetary Effects of Reforms. The CBO projects that both federal spending and revenue will rise over the coming 25-year period, but spending growth will outpace the rise in revenues. Today, all noninterest federal spending equals about 19.2 percent of GDP. The CBO expects federal spending, excluding net interest payments, to rise to 21.2 percent of GDP by 2040. This projection assumes a major downsizing of the nation's defense capabilities and deep cuts in domestic appropriations. Neither is likely to occur.

At the same time, current projections show spending on major entitlements—Social Security, Medicare, Medicaid, and the subsidies for health insurance provided in the Affordable Care Act—increasing from 10.3 percent of GDP today to 14.2 percent of GDP in 2040—a large bump in a relatively short time. Revenue is expected to rise from 18.4 percent of GDP today to 19.5 percent of GDP in 2040.

Entitlement reform is essential to avoid a fiscal crisis, poorly conceived counterproductive cuts in defense spending, and tax increases. The target for savings should be ambitious but achievable.

The flat-benefit proposal (and associated reforms) has been analyzed using a model developed by the Policy Simulation Group and was found to generate a 75-year actuarial surplus. This implies that the flat-benefit plan would more than eliminate Social Security's long-term deficits, based on the projections from the Social Security Trustees. In 2050, the reform plan would improve Social Security's financial position by about 1.3 percent of GDP.

The Center for Health and Economy evaluated the health entitlement reforms and found they would reduce the federal budget deficit by \$230 billion in 2025. Although the center generally does not produce longer-term estimates, for purposes of this proposal, the cost estimate showed potential annual savings growing to around \$400 billion annually by 2035. Savings of this magnitude would equal about 1 percent of GDP.

The reforms recommended for safety-net programs have not been evaluated for their federal budgetary effects. However, the reforms, which are aimed at improving independence, encouraging work, and eliminating waste, certainly will reduce overall program costs.

The savings estimated from the combined effects of these reforms almost certainly understate federal savings, particularly in the health programs. It is difficult to fully anticipate the savings from intense market competition, but the health system has significant waste that could be reduced with better incentives and more cost-conscious consumers.

Summary of Recommendations

Principles for Reform

1. The cause of the nation's current and future fiscal problems is spending on entitlement programs.
2. Fiscal policy should be focused on closing the long-term gap between revenue and spending, not short-term balance.
3. An effective and affordable set of social welfare programs and protections is a highly valued and necessary component of democratic capitalism.
4. Entitlement reform must improve the fiscal outlook, but budgetary savings are not a sufficient goal; reform should be based primarily on programmatic and societal goals, not merely saving money.
5. Entitlement reform should promote work, personal responsibility, and market discipline in health care and should direct limited resources mainly to households with limited means.

Social Security Reforms

1. Transition to a flat-benefit structure:
 - Set benefit to eliminate old-age poverty.
 - Protect all accrued benefits in current program.
2. Modify indexing to help low-income seniors and reduce benefits for higher earners.
3. Retain the payroll tax, but with modifications:
 - Eliminate payroll tax for those 62 and older.
 - Lower the payroll tax for all workers in the long-term.
 - Cover all new state and local workers with payroll tax.

4. Facilitate private savings and widespread enrollment in 401(k)s.
5. Move the early retirement age to 65.
6. Reform the disability insurance program to promote work.

Health Care Reforms

1. Affordable Care Act Replacement:
 - Retain the tax preference for employer-paid premiums, with an upper limit.
 - Provide refundable tax credits to households without access to employer coverage.

- Allow states to regulate insurance offerings and to establish mechanisms for consumer choice of plans.
 - Provide HealthCare.gov architecture free of charge to states.
 - Provide “continuous coverage protection” for persons with preexisting conditions.
 - Allow states to adopt a default enrollment program.
 - Allow for a gradual transition from ACA subsidies.
2. Medicaid Reforms:
- Pursue separate reform strategies for Medicaid’s two distinct parts.
 - Finance Medicaid with fixed federal funding per Medicaid enrollee.
 - Establish a default Medicaid reform template with substantial state flexibility.
 - Integrate acute-care Medicaid into market-driven health insurance reform.
 - Empower the disabled and the frail elderly.
3. Medicare Reforms:
- Adopt the premium support reform model.
 - Improve the competition between Medicare Advantage and FFS.
 - Promote consumer decision making.
 - Modernize Medicare’s benefits.
 - Reform Medigap and other supplemental coverage.
 - Require better coordination of Federal Employees Health Benefits for retirees with Medicare.
 - Reform Medicare’s payment policies, and eliminate unnecessary bureaucratic controls.
 - Provide greater administrative flexibility in local markets.
 - Gradually raise the eligibility age to 67.
4. Health Savings Accounts:
- Provide a one-time federal tax credit matching enrollee contributions to HSA accounts.
 - Eliminate the minimum deductible requirement for a universal HSA contribution allowance of \$2,000 or \$4,000.
- Increase the maximum contribution limits for persons with HDHPs by the universal allowance.
 - Allow HSAs to use nontraditional payment methods (non-FFS).
 - Include HSAs in Medicaid reform.
 - Integrate HSAs into Medicare.
 - Allow tax-free withdrawals at age 75+ (above a minimum balance).
 - Allow tax-free HSA rollovers to designated HSA accounts at death.
- ### Reforms to Safety-Net Programs
1. Testing Block Grants and Wage Subsidies:
- Establish voluntary, multiple-state participation in a multiyear demonstration program.
 - Test state block grants with and without wage subsidization.
 - Provide state flexibility on which federal programs would be included in the block grant.
 - Involve the federal government in wage-subsidization administration.
 - Assess demonstration results independently, using rigorous evaluation designs.
 - Create a process to automatically expand concepts to other states.
2. EITC Reforms:
- Reduce the error rate.
 - Increase information sharing between SSA and IRS.
 - Increase requirements for self-preparers.
 - Allow the IRS to take more time to process EITC claims.
 - Provide an increase for workers without dependent children.
3. SNAP Reforms:
- Establish a universally applied federal asset test of \$7,000.
 - Require states to promote employment and earnings for able-bodied adults receiving SNAP.

INCREASING THE EFFECTIVENESS AND SUSTAINABILITY OF THE NATION'S ENTITLEMENT PROGRAMS

- Require reduced benefits for recipients who decline an offered job.
 - Remove sugar-sweetened beverages from allowable purchases list.
4. TANF and SSI Reforms:
- Eliminate TANF work-requirement loopholes.
 - Encourage states to help the nonworking poor find employment and connect with services.
 - Use outcome measures in TANF to evaluate state job-placement and job-retention efforts.
 - Develop mandatory transition plans for SSI child clients before age 18.
 - Exempt child clients' wages from SSI income.
- Extend the EITC to recipients leaving SSI for work.
5. Child Support Enforcement and Child Care Reforms:
- Require states to refer single-parent SNAP recipients to the child support program.
 - Prioritize parental financial responsibility for children.
 - Allow states to use federal child support funds for noncustodial parent work programs.
 - Better match existing child care assistance with the labor market.
 - Smooth benefit cliffs in child care subsidies.

The Fiscal and Programmatic Urgency of Entitlement Reform

Principles for Entitlement Reform

1. The cause of the nation's current and future fiscal problems is spending on entitlement programs.
2. Fiscal policy should be focused on closing the long-term gap between revenue and spending, not short-term balance.
3. An effective and affordable set of social welfare programs and protections is a highly valued and necessary component of democratic capitalism.
4. Entitlement reform must improve the fiscal outlook, but budgetary savings are not a sufficient goal; reform should be based primarily on programmatic and societal goals, not merely saving money.
5. Entitlement reform should promote work, personal responsibility, and market discipline in health care and should direct limited resources mainly to households with limited means.

The United States faces a large and growing fiscal challenge that is being ignored by most of the nation's policymakers. The Congressional Budget Office (CBO) projects that debt held by the public will rise from 74 percent of gross domestic product (GDP) in 2015 to 86 percent in 2026.³ In the summer of 2015, before Congress and the president agreed on legislation to add trillions of dollars to deficits in coming years, the CBO's long-term forecast showed debt held by the public reaching 100 percent of GDP in 2039.⁴ An updated forecast, incorporating the recently enacted legislation, will almost certainly show an even faster deterioration of the nation's fiscal position.

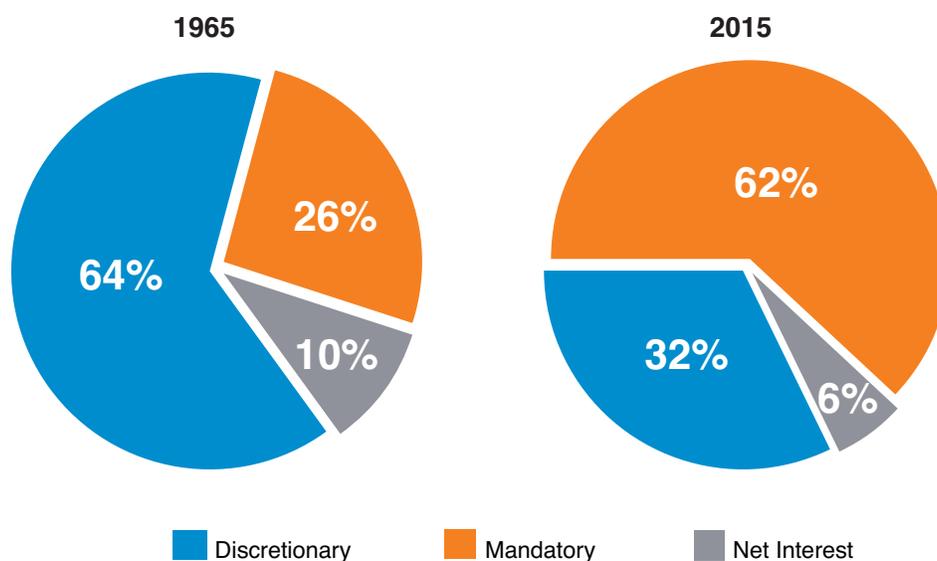
The primary cause of the problem is the steady, decades-long rise in entitlement spending. Over the past 75 years, the United States has built a vast and

sprawling network of social welfare protections and programs—the entitlement state. These programs—providing a safety net, retirement support, and health care—have grown steadily in both their reach and expense. They now thoroughly dominate the federal budget.

It is common to hear politicians rail against growing deficits and debt and then suggest that the solution lies in eliminating waste, foreign aid, and congressional pay. But these budgetary line items are trivialities, as are most programs that receive annual funding through the congressional appropriations process.

Most spending is now going to big entitlement programs, and it occurs automatically, without further congressional action. The spending authority for these programs is written into permanent law and is generally

Figure 1. The Changing Distribution of Federal Spending



Source: Congressional Budget Office, Historical Tables.

open-ended, meaning that the agencies that administer the programs can spend whatever is necessary to meet the requirements of the law’s benefit promises. Over many years, this open-ended authority for spending has rapidly increased program costs, especially for health programs. Congress has also steadily liberalized the eligibility rules for many programs.

Without a change in direction, the rising costs of entitlements will drive federal debt to levels that most economists agree would be unsustainable and could lead to a severe economic crisis. Taking corrective steps to head off the possibility of such a crisis is imperative. Waiting and procrastinating will make the necessary adjustments only more abrupt and painful.

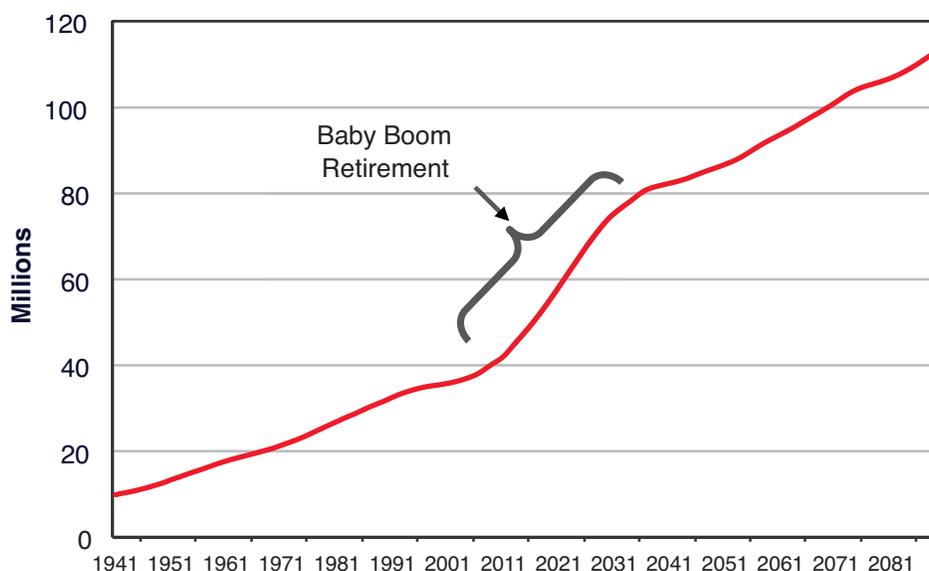
While fiscal considerations are the most pressing reason for entitlement reform, the case for reform and the reforms themselves need to be based much more on programmatic considerations. Concerns about fiscal matters certainly worry the electorate, but voters are even more concerned about their own personal financial security. Moreover, many households depend heavily on entitlement support to make ends meet. Prior attempts at entitlement reform have failed in part

because the arguments for reform were based mainly on meeting budgetary goals.

To succeed, reforms to entitlements must demonstrate that they would improve the programs themselves, helping them to achieve the goals they are supposed to serve. An improved fiscal outlook must be an important byproduct of the effort. But the reforms themselves must be—and must be understood by the public as—good ideas, separate from their budgetary effects.

Entitlements Are the Reason for the Nation’s Fiscal Challenge

The federal budget has undergone a fundamental transformation over the past half century. As shown in Figure 1, in 1965, 64 percent of the federal budget was devoted to so-called “discretionary” spending, meaning the funds were provided through annual appropriations bills. This portion of the budget is heavily focused on the military and associated defense spending but also includes funding for health research, education, national parks, and the federal bureaucracy.

Figure 2. Population Age 65 and Older

Source: 2015 Social Security Trustees' Report (intermediate assumption).

The rest of the budget, other than the portion for interest payments on the debt, is for entitlement programs (sometimes called “mandatory” spending). In 1965, spending on mandatory programs, or entitlements, accounted for 26 percent of the federal budget. Net interest payments on the national debt accounted for the final 10 percent of federal spending.

By 2015, the relative positions of discretionary and entitlement spending had flipped. Discretionary spending is now about one-third of all federal spending (32 percent) while entitlement spending takes up more than three-fifths of the entire budget (62 percent).

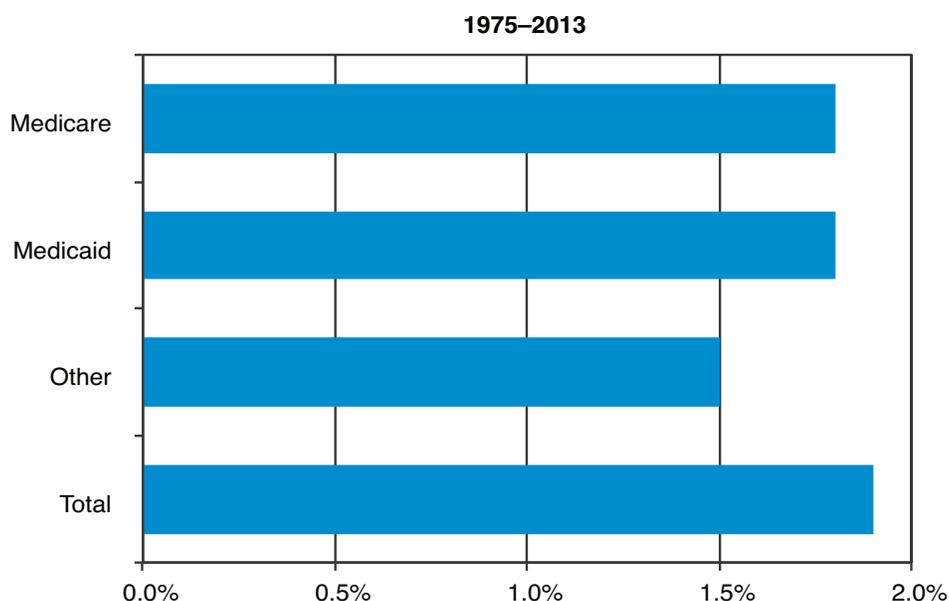
The decline in spending on discretionary accounts as a portion of the overall budget is the result of a rapid reduction in defense appropriations following the conclusion of the Cold War. In 1965, defense spending accounted for 41 percent of all federal spending. But after the demise of the former Soviet Union, spending on the military began to decline rapidly as a percentage of the national economy and as a percentage of the federal budget. In 2015, spending on defense-related accounts was just 16 percent of the federal budget.

The rapid rise in entitlement spending has been driven by many factors, among them the liberalization of eligibility rules for many programs, including those providing support to lower-income households. But the most important factors have been demographic changes and health care cost pressures.

Over the past half century, the American population has been getting older, and that trend is about to accelerate with the retirement of the baby boom generation, as shown in Figure 2. In 1970, there were more than five people age 20 to 64—the working-age population—for every person age 65 and older. By 2014, there were four working-age people for every person age 65 and older.⁵ From 2010 to 2035, the population age 65 and older is expected to rise from 41 million to 79 million people.

As the country has been aging, health costs have risen at rates that far outpace economic growth. As shown in Figure 3, the CBO has compared the pace of health-spending escalation on a per-person basis to the growth rate of GDP per capita. From 1975 to 2013, health spending rose at an average annual

Figure 3. Historical Growth in Per Capita Health Spending



Note: Excess Cost Growth is the average annual per capita spending growth rate in excess of average annual per capita GDP growth.
 Source: Congressional Budget Office, *The 2015 Long-Term Budget Outlook*, June 2015.

rate that was 1.9 percentage points above per capita GDP growth. The compounding effect of this growth-rate differential over nearly four decades has been immense.

In recent years, health spending has grown more moderately than it has historically, largely because of the deep recession of 2008 to 2009 and the softness of the labor market during the post-recession expansion. As the economy has improved, health spending has begun to accelerate again, growing by 5.3 percent in 2014, well above the growth rate in the broader economy.⁶

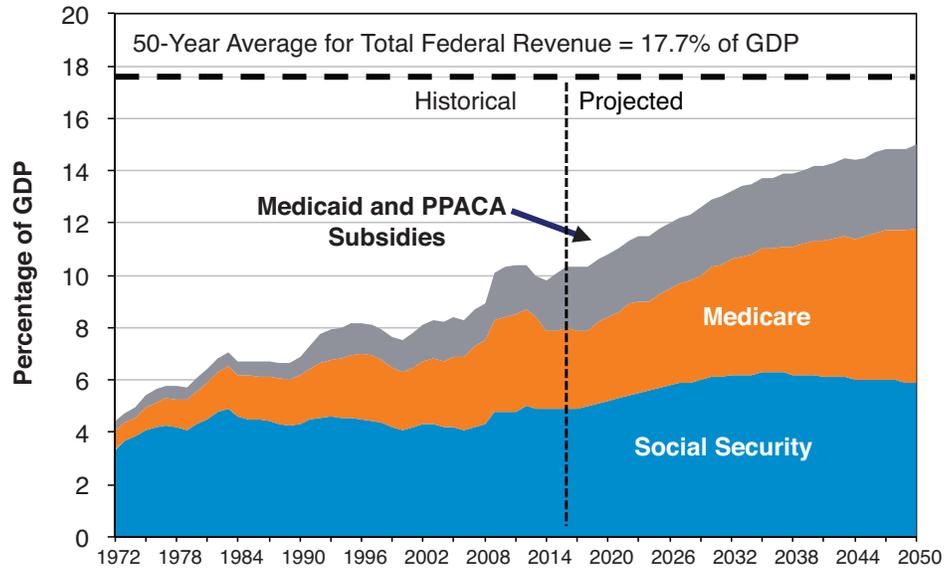
The aging of the population will continue in the coming decades as baby boomers retire, and the CBO expects health spending to continue rising rapidly as well. This combination—a surge of new beneficiaries and rapid increases in spending per person—will cause entitlement spending to accelerate dramatically in coming years. As shown in Figure 4, the CBO projects that, under current law, spending on Social Security, Medicare, Medicaid, and the health subsidies provided in the ACA will rise from about 10 percent of GDP today to 14.4 percent of GDP in 2040.

In recent decades, federal revenue has averaged 17.7 percent of GDP. If spending on the major entitlements goes much higher than current levels, virtually no room will be left in the budget (absent large and damaging tax increases) for other kinds of federal spending. Indeed, the constant pressure to implement further reductions in defense spending and other appropriated accounts is driven by many policymakers' view that restraining entitlements in any meaningful way is impossible.

The continued rapid escalation in entitlement spending will create the potential risk of a debt crisis should foreign lenders lose confidence in the US government's willingness and ability to service its debts. As shown in Figure 5, federal debt has already risen during the Obama administration to levels that are unprecedented in peacetime. But because of continued rapid escalation in spending, federal debt is set to soar in the coming years. The only question is how fast it will rise.

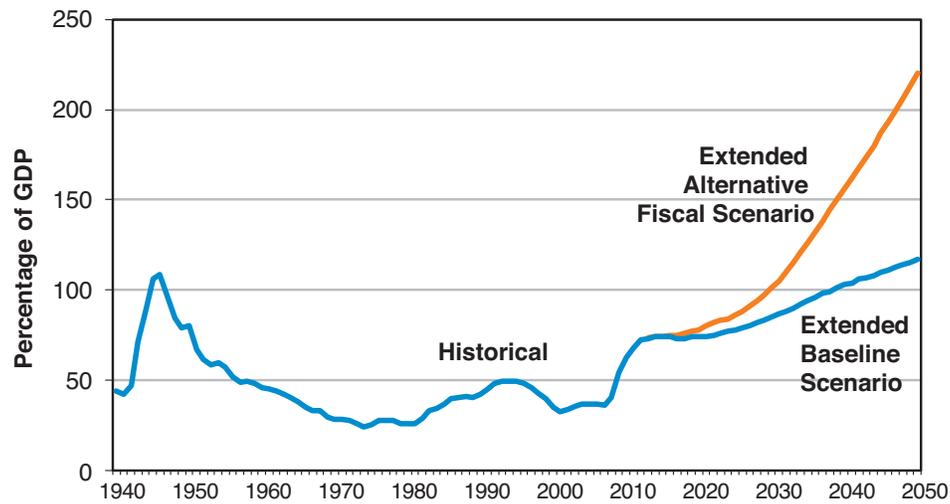
Under the CBO's "extended baseline scenario," federal debt will reach 100 percent of GDP in 2039. The CBO has also created an "extended alternative fiscal scenario" in which some of the most unrealistic

Figure 4. Entitlements and Fiscal Pressure



Sources: Congressional Budget Office, Historical Tables; and Congressional Budget Office, *The 2015 Long-Term Budget Outlook*, June 2015 (extended baseline scenario).

Figure 5. Debt Held by the Public (US)



Source: Congressional Budget Office, *The 2015 Long-Term Budget Outlook*, June 2015.

assumptions in current law are relaxed. Under that scenario, federal debt will exceed 100 percent of GDP in 2030.

The debt levels projected in either CBO scenario are unsustainable. At some point, interest payments become so high that the government will find it impossible to meet all of its commitments.

It would be far better for the country to take steps today to reduce the chances of a crisis ever emerging. Policy changes could then be phased in gradually, thus providing ample time for people to adjust their planning based on new governmental policy. If, on the other hand, policymakers wait for a crisis to implement changes, then the cuts will be abrupt and painful and will cause far more economic pain.

Focus Should Be on Long-Term Reform

Although the nation's fiscal position has deteriorated significantly in recent years, it is not necessary, or even desirable, to establish a goal of budgetary balance in the near term. Establishing that as the goal would distort policymaking to maximize near-term savings at the expense of long-term change. What is needed is not across-the-board cost cutting that simply reduces the size of existing programs, but rather fundamental reform that changes the dynamics of how the programs work and thus how much they cost.

Far-reaching reforms generally cannot be implemented quickly, often not even within a 10-year budget window. Among other things, policymakers are very reluctant—and rightly so—to change eligibility and benefit rules for people who have planned their lives around existing entitlement arrangements. This is one very important reason that it is nearly impossible to significantly change benefits for retirees who are already eligible and enrolled in Social Security and Medicare.

In addition, many reforms would take years to implement because of their complexity. For instance, converting Medicare into a program of consumer choice and competition—sometimes called “premium support”—could potentially reduce program costs, but only over the long run. In the near term, phasing in the change will take several years, and most advocates of

this model recommend exempting existing beneficiaries and those about to enroll in the program.

The fiscal problem has been building for decades. It will also take many years to implement reforms that will ease cost pressures in ways that are acceptable to the electorate.

Toward a Stronger Safety Net

Proponents of entitlement reform must also communicate clearly to the public that the goal is to strengthen the programs that provide Americans in need with safety-net protection, support in retirement, and access to health services. We need to rethink many aspects of the existing programs to modernize them and help them better address today's economic challenges—not abandon those goals.

Indeed, a strong and durable safety net should be seen as an essential part of a vibrant, market-driven economy. In the United States over the past two decades, many industries have undergone substantial restructuring under the pressures of a global market. Some companies have thrived in this environment, but many have failed, which has consequences for workers and their families. It will not be possible to sustain policies that promote growth, competition, and free markets if there is not also a reliable set of social protections to help people when disruption and change occurs.

In addition, there is not a major, advanced economy in the Western world that does not help its citizens achieve a secure retirement and provide mechanisms for ensuring access to health services. The United States is also expected by its citizens, in its own way, to take steps to achieve these goals.

Guiding Reform

Fiscal policy concerns are the reason why entitlement reform is so necessary and why policymakers will ultimately be forced to pay attention and take action. But even if there were no fiscal concerns, many entitlement programs would be in need of reform because of other major deficiencies and shortcomings. Although reform

of individual programs will often be determined by the existing program's effectiveness and specific, unique characteristics, some universal principles should provide overall guidance to the effort.

Work. Much of the federal safety net is designed to help households that have inadequate resources from earned income. That is certainly appropriate, because the lack of earned income is generally the reason to have and sustain an effective safety net. But the design of programs providing support should not discourage participants from working or seeking better-compensating employment opportunities. Scores of studies have demonstrated that the key to breaking the cycle of poverty is employment, so it would be foolish to design, or retain without reform, support programs that undermine that larger goal.

Personal Responsibility. The federal government should not be taking on responsibilities that most persons could readily handle with appropriate prudence and care. This is especially relevant with retirement support and health care.

Most working-age households with middle-class incomes (or higher) could save and provide for their own retirement without needing subsidization from other taxpayers. Entitlement reform should establish a strong safety net that guarantees against poverty in old age, but it should also establish an expectation that middle- and upper-income households will save

enough of their own earnings to provide for themselves in retirement.

Innovation and High Quality in Health Care. A more cost-effective system of health care provision is central to slowing the pace of rising entitlement spending. But reform must proceed based on improving the quality and value of health care, not simply containing the cost.

What is needed is not across-the-board cost cutting that simply reduces the size of existing programs, but rather fundamental reform that changes the dynamics of how the programs work and thus how much they cost.

It would be relatively straightforward to cut costs in health care if we were not concerned about the quality of the care provided to patients. The government could lower payment rates and constrain the supply of practitioners. But this is inconsistent with improving quality. Reform should instead identify steps that will eliminate waste and inefficiency and improve productivity, thus allowing better care to be delivered at a lower cost.

Social Security for the Current Century

Social Security Reform

1. Transition to a flat-benefit structure:
 - Set benefit to eliminate old-age poverty; and
 - Protect all accrued benefits in current program.
2. Modify indexing to help low-income seniors and reduce benefits for higher earners.
3. Retain the payroll tax with modifications:
 - Eliminate payroll tax for age 62 and older;
 - Lower the payroll tax for all workers in the long-term; and
 - Cover all new state and local workers with payroll tax.
4. Facilitate private savings and widespread enrollment in 401(k)s.
5. Move the early retirement age to 65.
6. Reform the disability insurance program to promote work.

Social Security was founded in 1935, and its design was rooted in the view that, as Martha Derthick wrote in her famous chronicling of the program's early years, "a program for the poor is a poor program." Derthick explained that Social Security's designers believed "the ideal program for old-age security should benefit everyone, poor and nonpoor. Benefiting all classes, it would have the support of all classes."⁷ President Franklin D. Roosevelt followed this advice and made it clear as he pushed for passage of the program that Social Security would be different from what was then known as "relief" and what we today might call "welfare."

That founding philosophy is reflected in the Social Security benefit formula that applies to retirees today. Participants must work 10 years just to qualify for

benefits, a long vesting period that would be illegal for a private pension plan. Similarly, unlike a welfare program in which benefits phase out as the beneficiary's income rises, Social Security benefits increase with the worker's earnings.

Benefits are progressive, meaning that low-wage earners generally receive a higher ratio of benefits to pre-retirement earnings than do higher-wage earners. Nevertheless, a worker earning the maximum taxable wage of \$118,500 still receives a benefit 3.5 times that of a worker in the bottom fifth of the earnings distribution.

Social Security's founders were correct that "earned benefits" strengthen Social Security's political support. Even today, the perception that benefits are earned rather than granted protects them from budgetary pressures that affect other programs.

However, this approach to social insurance has several significant downsides. To begin, a plan that pays significant benefits to middle- and upper-income households can become unaffordable as demographics change. As late as 1950, roughly 16 workers were paying into Social Security for each person collecting benefits. Thus, paying benefits to a broad group of retirees was affordable even with payroll tax rates far lower than the 12.4 percent paid today.

But with the worker-to-beneficiary ratio falling to 3:1 today and 2:1 in the future, the program will become significantly less affordable. Assuming similar benefits over time, a decline from 16 workers for each beneficiary to 2 workers implies an eight-fold increase in the costs borne by each worker. In dollar terms, most of the increase in Social Security's costs comes from paying higher benefits to higher-earning households.

Moreover, the profile of poverty has changed over time. At the time of Social Security's founding, most households were composed of a married couple with an adult male who worked. This implied that even poor families would tend to qualify for benefits in retirement. But old-age poverty in the 21st century has different causes than in the past.

Individuals who work at a low-wage job every year of their lives—which in reality is quite rare—will retire with benefits that, while certainly not opulent, will keep them out of poverty in retirement and enable them to maintain their preretirement standard of living. In reality, most people retiring poor today had only sporadic attachments to the labor force during their working years. As a result of short work histories, roughly one-fifth of the poorest quintile of retirees fail to even qualify for Social Security, and nearly one-third of those who do qualify receive a benefit below the poverty line.

The poorest retirees can fall back on the Supplemental Security Income program, but this means-tested welfare program also pays a subpoverty-level benefit, and its strict tests for income and assets effectively prohibit recipients from working or saving. The result is an elderly poverty rate of 10 percent, despite Social Security spending that is sufficient to pay *every* American over age 65 a benefit roughly 12 percent above the

poverty threshold. This is a very expensive way to fail to protect against poverty.

For Social Security to be both affordable and successful in the 21st century, the program needs to evolve and adapt to conform to today's economic, fiscal, and labor-market realities. The starting point for reform should be the adoption of a flat-benefit plan, which is similar to the retirement systems of Australia, New Zealand, and the United Kingdom.

While that “program not just for the poor” philosophy may have been justified at the time of Social Security’s enactment, it does not make for a successful and sustainable program today.

The philosophy underlying this idea deserves attention. The current Social Security program is founded on an earnings and payroll tax base in which middle- and upper-income households receive substantial benefits but the very poorest often receive little or nothing. While that “program not just for the poor” philosophy may have been justified at the time of Social Security's enactment, it does not make for a successful and sustainable program today.

Social Security should transition toward an approach in which the federal government and the individual each has a role and knows its role. The federal government should focus on poverty protection, helping to assure a basic minimum income in retirement for all Americans. Individuals, for their part, should save additional amounts to produce a total retirement income sufficient to maintain their preretirement standard of living. Such an approach can reduce poverty in old age while restoring Social Security to a sustainable financial footing.

It will require that middle- and high-income earners save more for retirement. But this is something they are capable of doing, just as previous generations of Americans saved, and federal policies can help expand opportunities for adequate retirement savings.

How Would a Flat-Benefit Plan Work?

The current Social Security program provides a retirement benefit as a progressive replacement of average preretirement earnings. At the normal retirement age, the basic benefit is equal to 90 percent of a worker's first \$826 in average monthly preretirement earnings, 32 percent of monthly earnings between \$826 and \$4,980, and 15 percent of monthly earnings over \$4,980. In addition, Social Security sometimes pays benefits based on a spouse's earnings. However, Social Security offers no minimum retirement benefit, and to qualify for any benefit at all, an individual must have worked and contributed to Social Security for at least 10 years.

These facts are important in analyzing the value of Social Security as a social insurance program protecting against poverty in old age. About 20 percent of the bottom quintile of lifetime earners fail to even qualify for Social Security benefits,⁸ and nearly one-third of retirees who do qualify receive a Social Security benefit that is below the poverty threshold of about \$950 per month.⁹ Even when other sources of income are included, about 10 percent of retirees have a total income that is below the poverty line. That level of poverty might be considered high, given that Social Security pays out more than \$600 billion to retirees each year, an average of about \$1,075 per month for every American retiree.¹⁰

The flat-benefit plan would work differently. Beginning immediately, every retiree who had been legally residing in the United States for 40 years would receive a guaranteed benefit at the normal retirement age equal to the poverty threshold of a single person over age 65, which is currently around \$950 per month. As with Canada's Old Age Security minimum pension benefit, individuals who had been legal residents for between 10 and 40 years would receive a benefit on a graduated scale.¹¹

In future years, the minimum benefit for new retirees would increase along with economy-wide wage growth, maintaining the value of the minimum benefit relative to seniors' preretirement standard of living.¹² Therefore the minimum benefit in the future would actually be above the current poverty threshold, which is indexed from year to year only with inflation. The

flat-benefit plan would expand eligibility for benefits, increase benefits for about the bottom third of retirees who currently do qualify, and effectively eliminate poverty in old age, at least for long-term, legal US residents.

Over a period of several decades, however, the maximum benefit paid by Social Security would also be lowered, such that eventually every retiree would receive the same flat dollar benefit.¹³ There is no point beating around the bush on this: this reduction in benefits means that middle- and upper-income households would need to save more for retirement.

To assist in that saving, the plan would require all 401(k) plans to automatically enroll employees, although workers would have the option to withdraw. It would also include auto-escalation, which gradually increases employee contribution rates, and would reduce employers' costs of providing 401(k)s to expand pension coverage among small employers. Finally, the plan would include provisions designed to reduce the cost to small employers of providing 401(k) plans, such as "Starter 401(k)s" and multiple-employer defined-contribution plans, which allow small employers to establish 401(k)s with a single provider.¹⁴

If younger workers increased their 401(k) contributions by about 3 percentage points—say, from 6 percent of pay to 9 percent—and earned just the government bond rate of return on that money, the additional savings would be sufficient to make up for reduced future Social Security benefits.

How to Transition to a Flat Benefit

Beginning in 2018, the flat-benefit plan would institute a minimum monthly benefit of \$958, equal to the poverty threshold for a single person over age 65. The benefit would be paid beginning at the full retirement age for all retirees who have legally resided in the United States for 40 years. For individuals who resided in the United States for 10 to 40 years, the minimum benefit would be provided on a sliding scale. The benefit would not apply to disability or survivors benefits.

The minimum benefit would be indexed to wage growth, meaning that it would rise about 1 percent

faster than inflation each year. For instance, by 2030 the minimum benefit would rise to about \$1,050 in today's dollars. This would establish a minimum benefit at the poverty line without affecting benefits received by middle- and higher-income participants.

Beginning in 2020, the Social Security replacement factors—90, 32, and 15 percent—would gradually be reduced, such that they would reach zero by 2075. This implies that over time, a greater share of beneficiaries would rely on the minimum benefit rather than a benefit calculated under the traditional benefit formula. Thus, while the minimum benefit would be increased immediately, the maximum benefit would be reduced over several decades.

The phaseout of the traditional formula would be calibrated so that, to an approximation at least, Social Security would honor the benefits that participants have already accrued under the current benefit formula. The goal is for this reform to not cut benefits that participants already have earned and paid for, but instead alter the terms under which participants earn new benefits.

Policy Goals

The flat-benefit approach is designed to solve several problems with the current program. First, the current Social Security benefit formula is highly complex. Even many Americans on the verge of retirement have little idea what they will receive from the program, making it more difficult to plan how much to save or when to retire. Only about one-third of near-retirees can guess their Social Security benefit within 15 percent, and many dramatically overestimate or underestimate what they will receive.¹⁵ The flat benefit is far simpler and provides younger individuals with a clearer idea of what they will receive from the government and what they must provide through their own savings.

Second, due to this complexity, Social Security often pays very different benefits to households with the same lifetime earnings and payroll tax contributions, based on the relative earnings of spouses (single-earner couples are favored over dual-earner couples) and the length of their working careers (all else equal, workers

with shorter working careers are favored over those with longer careers). This problem is particularly acute among low-earning households.¹⁶

The flat benefit, combined with supplementary saving in a 401(k)-type plan of 3 percent of annual earnings, provides total benefits that roughly match the generosity and progressivity of the current benefit formula, but with much smaller variation in benefits among households with similar lifetime earnings. This would provide more reliable social insurance protections against insufficient income in old age.

Only about one-third of near-retirees can guess their Social Security benefit within 15 percent, and many dramatically overestimate or underestimate what they will receive.

Third, as discussed earlier, Social Security offers relatively weak protections against poverty in old age. For the federal government's largest spending program to leave so much of its target population in poverty while paying increasing real benefits to middle- and upper-income households is an inefficient and unfair use of federal resources.

Other Provisions of the Proposal

The flat-benefit plan would include several other provisions.

Eliminating the 12.4 Percent Social Security Payroll Tax at Age 62. Under the current Social Security program, near-retirees who delay retirement continue to pay taxes but receive almost no extra benefits. Cutting the payroll tax rate would encourage individuals to delay retirement and make older workers more attractive to employers.¹⁷ While this provision would reduce Social Security revenues, it is affordable within the plan's overall financing.

Near-retirees are particularly sensitive to changes in after-tax wages, because unlike middle-aged workers, they often have the option to retire. Increased labor supply from near-retirees in response to the payroll tax cut would increase revenues collected by federal income taxes, Medicare payroll taxes, and state income taxes. Based on academic research on labor supply by age, we estimate that increases in federal income taxes and Medicare taxes would offset roughly two-thirds of the decline in Social Security payroll taxes.

Progressively Boosting Benefits for Current Retirees.

Current retirees would not be eligible for the guaranteed minimum benefit, which applies only to new beneficiaries. However, the proposal would adjust annual Cost-of-Living Adjustments (COLAs) to enhance benefits for lower-income retirees.

Retirees with benefits below \$950 would receive a higher COLA tied to the Experimental Consumer Price Index for the Elderly (CPI-E), which is based on the purchasing habits of individuals over 65. The CPI-E generally rises about 0.2 percentage points per year faster than the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W), which is currently used to calculate COLAs but is based on the purchasing habits of working-age individuals.

Retirees with benefits between \$950 and \$1,350 would continue to receive the standard CPI-W-based COLA. Retirees with monthly benefits above \$1,350 would receive a COLA based on the Chained-Weighted CPI, which generally rises about 0.3 percentage points more slowly than the CPI-W. This policy would generate small savings for Social Security while reducing the number of current retirees receiving subpoverty-level benefits.

Gradually Restoring the Early Retirement Age to 65.

Raising the early retirement age would have only minor effects on Social Security's finances, but it would encourage longer work lives and prevent workers from claiming reduced benefits that last throughout their lives. Self-reported health status is improving, and the number of Americans with physically demanding jobs has declined.¹⁸

The normal retirement age, which is currently 66, would not be increased relative to current law.

Disability Insurance (DI) benefits would continue to be offered for individuals below age 65. In addition, the eligibility age for Supplemental Security Income (SSI) for the elderly, a means-tested welfare benefit for the poor, would be lowered from 65 to 62. Together, DI and SSI benefits would maintain the safety net from ages 62 through 64.

Enrolling Newly Hired State and Local Government Workers in Social Security. State and local government employees in several states are not covered by Social Security, but instead rely on pension plans sponsored by their state governments. While these public plans on average provide generous benefits, they have several downsides.

First, public plans generally are not portable between jobs, meaning that short- or medium-term employees receive very low benefits relative to full-career workers. Second, these public plans are highly underfunded, meaning that individuals who rely wholly on them for retirement income face financial risk. And third, these plans threaten to destabilize the finances of state and local governments because of excessive investment risk that governments have taken in an attempt to improve their plans' finances.

Enrolling all newly hired state and local government workers in Social Security would provide those employees with a retirement benefit that is portable between jobs and would diversify their retirement income beyond the heavily underfunded state and local government pensions on which they currently rely.¹⁹

Reforming Disability Benefits. The DI program is part of Social Security, but in many ways faces distinct problems. The share of working-age Americans receiving DI benefits has doubled over the last three decades, in part because Congress loosened eligibility standards in the 1980s. Most people who go on DI never return to the workforce.

Yet much of the eligibility decision for benefits is arbitrary: research finds that many DI applicants have at least some ability to work, yet if their case is examined by a lenient judge, they are likely to be admitted to the rolls. Reforms should tighten eligibility criteria, while increasing incentives for employers to accommodate

workers with disabilities. The Netherlands successfully reformed its disability program by “experience rating” employer payroll taxes, such that employers who keep workers with disabilities on the job pay lower tax rates while those that “dump” disabled employees on the government program pay higher rates. In addition, increasing the Earned Income Tax Credit (EITC) for single individuals would raise the rewards of work relative to going on the disability rolls.

The savings from such reforms are uncertain and thus are not incorporated into the budgetary outline for this plan. Nevertheless, reforms to the Social Security disability program remain extremely important.

How the Flat-Benefit Plan Differs from Other Reform Approaches

The flat-benefit plan differs in some key technical respects from most existing reform plans. Very few, including those proposed by progressives, would significantly enhance benefits for low earners, and even fewer would scale back benefits as extensively for middle- and high-earning households. Several reform plans include a payroll tax cut for older workers, but none would reduce the payroll tax as much as the flat-benefit plan would. No other reform plans have a progressive COLA to boost benefits for the poorest current retirees while restraining benefit growth for those receiving the highest benefits.

And yet, the main difference between the flat-benefit plan and more traditional reform approaches is not so much in the technical details as in how those policies were conceived.

The flat-benefit approach began from a blank-slate perspective. It seeks to answer the question, “If we were designing Social Security from scratch for a young individual entering the workforce today, what would that program look like?” Our answer is that the government would provide a guaranteed minimum benefit to protect against poverty, while individuals would save on their own to provide a retirement income above that guaranteed minimum. If we assume that such an approach would apply to individuals who are entering the workforce today and thus have neither paid taxes

nor accrued benefits under the current Social Security rules, the policy challenges are to design the specifics of such a plan and then to adjust Social Security benefit rules to gradually transition from the current approach to the flat-benefit paradigm.

This approach to reform contrasts with that used by most reformers to date. The traditional approach to Social Security reform begins with the current Social Security benefit formula and then asks, “How can the formula be changed over time to make the program cheaper or to pay benefits more progressively?” Note that the phrases “cheaper” and “more progressively” are made with reference to the current program, not to how generous or progressive a well-designed retirement program *should* be.

Discussions of traditional reform plans generally focus not on how well or poorly they would serve participants but on how this or that aspect of them compares to current law.

Discussions of traditional reform plans generally focus not on how well or poorly they would serve participants but on how this or that aspect of them compares to current law. The result is incremental changes to the current benefit formula that are difficult to describe in layman’s terms and that can have unintended effects.

The proposal for so-called “progressive indexing,” advanced in 2005 by the Bush administration, helps illustrate these differences. Progressive indexing begins with the current benefit formula. The current formula, as noted previously, replaces 90 percent of a worker’s first \$826 in average monthly preretirement earnings, 32 percent of earnings between \$826 and \$4,980, and 15 percent of average earnings over \$4,980. These dollar figures in the benefit formula are referred to as “bend points.”

Progressive indexing added a fourth bend point, set at the 30th percentile of the earnings distribution—currently, around \$2,333 in monthly earnings. It then

gradually lowered the 32 and 15 percent replacement factors. The intended result was that benefits for future workers who earned the maximum taxable wage each year would rise only with inflation, while benefits for workers at the 30th percentile of the earnings distribution would rise from cohort to cohort with wages, which tend to grow slightly faster than inflation each year.

The traditional approach to reform, as illustrated by progressive benefit indexing, has significant “political” shortcomings compared to the blank-slate approach that produced the flat-benefit plan. Both the mechanics of progressive indexing and the policy justification for enacting them are far more difficult to explain to policymakers and the public than is the flat-benefit plan.

The flat benefit can be described in English rather than in actuarial jargon. A layperson can describe what will happen (retirees will rely on a guaranteed poverty-level government benefit, plus their own personal savings) and when it will happen (the plan would be fully implemented for a person entering the workforce today). Progressive indexing, by contrast, is almost impossible to explain to a non-specialist. Practically no one understands the Social Security benefit formula, nor do people think about how benefits increase from one birth cohort to the next, nor do they really understand the difference between wage and price growth.

The same criticisms can be applied to most other conventional Social Security reforms: they are incomprehensible in their technical details and have no clear policy rationale. Unless reformers first decide where they want the reform to end up—that is, what kind of Social Security program they want future generations to participate in—incremental reforms are extremely difficult to explain to the American people, who must ultimately choose to accept them.

Universal Versus Means-Tested Benefits

Even if one has decided on a social insurance paradigm that combines a government-guaranteed minimum retirement income with individuals’ personal savings, there are two basic ways to go about implementing such a plan. One approach, which is similar to the

Australian model, is to require every worker to save for retirement and then to provide a supplement to those workers whose savings are insufficient for some stated minimum income in retirement. A second approach, which is closer to what New Zealand practices, is to pay a minimum benefit to all retirees regardless of income and then build individual savings on top. Each approach has pros and cons.

An Australian-style approach is potentially cheaper, because government assistance is targeted on the truly poor. However, a means-tested minimum benefit raises several political and administrative issues. First, this approach assumes the political will and legal ability to require individuals to save. In practice, neither may exist. Second, government must monitor individuals’ savings closely so that retirees cannot spend down their accounts so as to qualify for the means-tested minimum. This has been a challenge in Australia. Third, a guaranteed minimum benefit may encourage individuals to take excessive investment risk with their own savings, because the government bears the costs if they lose. And fourth, a means test imposes an “implicit” tax on work and savings that might discourage a person with income and assets just above the minimum benefit thresholds from raising their incomes.²⁰

A New Zealand-style approach, which the flat-benefit plan adopts, eliminates the need for a savings requirement, reduces the need for government to monitor how households manage their savings, and eliminates implicit taxes on work and savings that raise incomes above the poverty-level minimum. A universal benefit is more expensive than a means-tested benefit. But given that providing a universal poverty-level benefit to all retirees is easily affordable within the existing revenues allocated to Social Security, it offers the better alternative.

Impact of a Flat Benefit on Preretirement Work and Saving

If Social Security guarantees retirees against poverty, wouldn’t Americans work and save less during their preretirement years? This is a perfectly reasonable question,

especially given that public policy generally aims to encourage work and saving. However, the flat-benefit plan would almost certainly significantly increase total retirement saving and encourage extended work lives, which contribute to economic growth.

We can group participants in Social Security into two broad classes. Lower-income households—which on average have less education, little personal retirement savings, and lower financial literacy—will usually rely on Social Security benefits for the vast majority of their retirement income. These types of households generally do not alter their personal savings in response to changes in government pension benefits because they have so little personal savings and income to begin with. Nor are they likely to alter their current work efforts much in response to benefits that will be paid years or decades in the future. These are households whose financial decisions are made on a short-term basis. Simply put, these are the types of Americans for whom Social Security was created.

Middle- and upper-income households, by contrast, combine Social Security benefits with personal savings to provide for themselves in retirement. Because these households are calibrating their personal savings with their Social Security benefits to reach an adequate total retirement household income, they are on average far more responsive to changes in government benefits. They effectively treat Social Security benefits and personal savings as substitutes. If benefits are increased, these households will tend to save less on their own. But if their future benefits are reduced, middle- and upper-income households will increase their saving to make up most of the difference. This has been demonstrated in the United States and in other countries.

For instance, research on saving in the US finds that households with greater education and those with retirement savings accounts tend to offset about 70 percent of a change in Social Security benefits through changes in other household wealth. In other words, these generally higher-income households could be expected to make up most of lost future Social Security benefits by increasing their own saving. But less-educated households and those without retirement plans—who, again, would tend to be lower earners—do not respond strongly to changes in Social Security benefits.²¹

Experience in other countries leads to similar conclusions. For instance, a 1999 reform to the Polish pension system reduced benefits for people ages 50 and under. In response to these reforms, more-educated individuals—which generally means those with higher incomes—saved substantially more for retirement to compensate for lower promised government benefits, while less-educated individuals did not respond to changes in benefits.²²

Similar research looked at reforms to the UK pension system. Changes to the program's redistributive welfare component were found to not affect the personal saving of low-income beneficiaries. However, middle- and upper-income households reacted to changes in the UK's earnings-related pension system, increasing their saving by 65 to 75 cents for each dollar in reduced future government benefits.²³ Similarly, when Canada raised taxes for its own retirement program, the Canada Pension Plan, Canadian households reduced their own personal saving on an almost dollar-for-dollar basis.²⁴

Given this distinction, the logical policy conclusion is to provide a reasonable safety-net benefit for lower-income households that are likely to be highly dependent on the government in retirement, while requiring higher-income households that can, would, and should save more on their own to do so. Social Security's current benefit structure, which pays about two-thirds of total benefits to households in the top two quintiles of lifetime earnings, almost certainly reduces national saving and economic growth. It also makes middle- and high-earning households more dependent on government benefits than they need to be.

In addition, reducing benefits for middle- and upper-earning households, combined with eliminating the payroll tax at age 62 and gradually increasing the early retirement age from 62 back to 65, is likely to encourage individuals to extend their work lives. For instance, academic research suggests that individuals delayed retirement by about six months on average in response to the one-year increase in the normal Social Security retirement that took place beginning in 2000.²⁵ Moreover, the CBO estimates that raising the Social Security early retirement age from 62 to 64 would by itself increase GDP in 2035 by about 0.5 percent, indicating that the flat-benefit reform package as

a whole would likely produce substantially larger gains in economic output and long-run living standards.²⁶

The Flat-Benefit Plan and the Payroll Tax

As we have outlined, in the flat-benefit plan, the current 12.4 percent Social Security payroll tax would be retained, except for the payroll tax cut for older workers. However, the flat-benefit structure is also compatible with comprehensive tax reforms.

Raising the Social Security early retirement age from 62 to 64 would by itself increase GDP in 2035 by about 0.5 percent.

Some countries, such as the United Kingdom, have retained a payroll tax even as their government retirement plan has shifted toward a flat-benefit approach. Others, such as New Zealand and Australia, fund guaranteed minimum retirement benefits out of general tax revenues, meaning principally income taxes. The flat-benefit plan works with either approach.

Under the flat-benefit plan, Social Security would return to payroll tax surpluses around the year 2050. This would allow the option of lowering payroll tax rates or increasing benefits while still keeping the program solvent over the long term. In other words, future generations would inherit a Social Security program that was solvent and sustainable, not one that faced significant funding shortfalls.

If the Social Security trust funds were given borrowing authority—meaning that they could draw on the Treasury as needed during times of deficits, provided the program could repay that borrowing in following years—then payroll tax rates could be reduced immediately rather than waiting until 2050. For instance, eliminating the payroll tax rate for those under age 21 could cost the program about 0.08 percent of taxable payroll over 75 years, an amount that is well within the flat-benefit plan's long-term actuarial surplus of about

1 percent of payroll. A broader-based reduction in the payroll tax rate or an exemption for initial earnings would also be possible.

The Politics of Social Security Reform

Passing a Social Security reform plan through Congress and having it signed by the president is unquestionably difficult, regardless of the specific reforms being proposed. That difficulty applies to both political parties: Americans neither wish to pay more taxes nor receive lower benefits, even if the program's underlying mathematics make choosing one or both inevitable. But a reform plan has to overcome these obstacles, because Americans can reap the benefits of a sustainable and effective Social Security program only if reform legislation can actually be passed.

The flat-benefit plan shares some of the political pitfalls of traditional fiscally conservative plans: that is, it restores Social Security's solvency by reducing benefits rather than raising taxes, and for that reason it would be accused of "cutting benefits." To be sure, most future retirees would receive higher benefits than retirees today, and even cuts in Social Security's promised—but unpayable—benefits could be made up through additional saving in 401(k)s or other plans. Nevertheless, the charge of cutting benefits will be made.

But from a political perspective, the flat-benefit plan has some unusual attributes that other fiscally conservative plans do not share. Most previous Social Security reform plans have attempted to minimize opposition from older voters by exempting current and near-retirees from benefit reductions. The flat-benefit plan also would phase in reductions to scheduled benefits so as not to disrupt the saving plans of near-retirees. But whether these exemptions actually soften near-retirees' fears of Social Security reforms is unclear.

The flat-benefit plan seeks to change that dynamic by giving current and near-retirees a reason to support reform. Under the plan, every new retiree would be guaranteed a benefit at least equal to the single, over-65 poverty threshold. Many previously ineligible workers who had paid into Social Security for up to 10 years would now be eligible for benefits. And many

low-earning workers who would have received a Social Security benefit below the poverty line would receive a benefit increase. That is something that other reform plans have not offered.

Likewise, the plan would have benefits for current retirees. First, COLAs for retirees with benefits below the poverty line would be increased, providing a boost to benefits that competing plans do not offer. And second, the Social Security payroll tax would be eliminated for individuals age 62 and over, making work more profitable for seniors and making seniors more attractive to employers.

Finally, while the benefit enhancements and payroll tax cut would take place immediately, reductions

to benefits for middle- and high-earning individuals would be scaled in over several decades. This would give affected individuals a long period to adjust their saving and retirement plans. Even middle- and upper-income households sometimes suffer from fears that they will fall into poverty in retirement. The fact that Social Security will offer, and can afford to pay, a true guarantee against poverty in old age may help address their fears concerning reform.

Together, these provisions have the potential to change the political dynamic on Social Security reform. Current and near-retirees would have an incentive to actively support a reform plan, rather than merely standing aside as others debate how to fix Social Security.

Bringing Market Discipline to Health Entitlement Spending*

Principles for Health Care Entitlement Reform

1. Citizens, not government, should control health care.
2. Government subsidies should come in the form of defined-contribution payments.
3. Power and control should be shifted from the federal government to individuals, families, and states.
4. Suppliers of medical services must have more freedom to innovate and provide better services to patients and consumers.

Debates over health care policy are divisive because there are serious disagreements among analysts and policymakers about how to increase health care quality while moderating cost escalation.

The authors of the Affordable Care Act (ACA), which was passed in 2010, were animated by the view that the problem is a lack of central government control. The new law therefore shifts significant power and authority from individuals, states, and employers to the federal government.

But this increase of federal control is not likely to successfully address the basic problem of the inefficiency of American health care and its therefore unsustainable cost. The problem with centralizing control over a sector of the economy as complex and vast as health care is that no person or bureaucracy could possess the requisite knowledge to properly

set the dials of control to achieve the best balance of cost and quality. Moreover, what is understood about effective medical care is changing far too rapidly for a governmental bureaucracy to keep up.

What is needed instead is a real market in which insurers compete for consumers and therefore have a reason to offer attractive, patient-centered products and services at a low price and in which consumers have strong incentives themselves to seek out the best, most cost-effective ways of getting the care they want and need. This kind of market would empower health care providers to find more efficient, innovative ways of organizing their work.

The major federal health entitlement programs—Medicare and Medicaid—do not constitute the entirety of the nation's insurance system. Many reforms can be implemented in these programs separate and apart

* This section is drawn from a longer monograph titled "Improving Health and Health Care: Agenda for Reform," authored by Joseph Antos, James C. Capretta, Lanhee J. Chen, Scott Gottlieb, Yuval Levin, Thomas P. Miller, Ramesh Ponnuru, Avik Roy, Gail R. Wilensky, and David Wilson and released by the American Enterprise Institute in December 2015. The full monograph is available at <https://www.aei.org/wp-content/uploads/2015/12/Improving-Health-and-Health-Care-online.pdf>.

from the larger system. But the program was also connected in important ways to the operation of the larger system, and therefore it makes more sense to articulate a vision for reform that encompasses all of health care, including the major entitlements.

The key principles for such a reform are:

- **Empowered Citizens.** A market cannot function without empowered, cost-conscious consumers. In health care, most decisions today are made by employers and governments. That needs to change, with power shifted to individuals to make choices for themselves.
- **Defined-Contribution Payments.** Any federal subsidization of health care should take the form of defined contributions to support consumer choices in highly competitive open markets, rather than defined benefits to control provider behavior in highly restricted captured markets. Such a subsidy would not vary based on a person's choices of coverage or where they get their care. Those selecting more expensive options would pay for the added cost out of their own pockets.
- **Decentralization.** Reform should proceed based on a genuine federalist approach, with states, as well as consumers, given much more authority. Federal rules should be as few and flexible as possible.
- **Freedom to Innovate.** Advances in information technology and in what is known about human health have the potential to revolutionize the way medical care is delivered to patients over the coming decades. For that to happen, however, US health care will need to move steadily away from the insurance-centric and government-bureaucratic models of resource allocation and control. Suppliers of services must be given the freedom to meet consumer demand with products that improve the convenience, efficiency, and effectiveness of medical care in maintaining and improving patients' abilities to live fully functioning lives.

Replacing the ACA

Summary of Key ACA Replacement Provisions

1. Retain the tax preference for employer-paid premiums, with an upper limit.
2. Provide refundable tax credits to households without access to employer coverage.
3. Allow states to regulate insurance offerings and to establish mechanisms for consumer choice of plans.
4. Provide HealthCare.gov architecture free of charge to states.
5. Provide "continuous coverage protection" for persons with preexisting conditions.
6. Allow states to adopt a default enrollment program.
7. Allow for a gradual transition from ACA subsidies.

The starting point for renewing American health care must be replacing the ACA with a genuine, consumer-driven approach to expanding health insurance coverage.

Employer Coverage. Most Americans get their health insurance today from their employers, and that should not change with a new reform plan. Employers should be free to organize health insurance offerings that are attractive to their workers. The existing federal tax break for employer-paid premiums should be retained. The only modification should be an upper limit to inject additional cost discipline into the most expensive plans.

Refundable Tax Credits. Those Americans without access to employer coverage should be given a refundable, age-adjusted tax credit that is set roughly equal to

the average tax break for an employer plan. These tax credits could be used to purchase any health insurance plan approved for sale in a state.

Continuous Coverage Protection. All Americans should be given “continuous coverage protection” in an ACA replacement plan. This rule would protect persons with preexisting conditions from being charged more or denied coverage based on their health status, so long as they have not experienced long breaks in insurance enrollment, which the tax credit would enable them to avoid.

State Regulation. States would regain the authority to regulate health insurance, including rules regarding the allowable variation in premiums and required coverage.

Default Insurance. States could also boost insurance enrollment by assigning persons who are eligible for the tax credits but have failed to pick an insurance policy to a default insurance plan. The upfront deductibles for these insurance plans would be set as necessary to ensure the premiums for enrollment would be equal to the federal tax credit, thus guaranteeing that no additional premium would be required from a person assigned to a default plan.

Transition. There should be a reasonable transition from the ACA to the new reform approach. In particular, households getting subsidized coverage under the ACA should not be forced out of their existing plan. The new rules should apply to new applicants, with natural turnover ensuring a gradual changeover to the new rules.

Medicaid Reform

Medicaid has experienced rapid cost growth over many years, even as the services it provides to lower-income households are far from adequate. A fundamental problem is the program’s split financial responsibility. The federal government pays for about 60 percent of all state Medicaid spending, with no upper limit on total cost. The federal government points to its financial

Summary of Medicaid Reforms

1. Pursue separate reform strategies for Medicaid’s two distinct parts.
2. Finance Medicaid with fixed federal funding per Medicaid enrollee.
 - Establish a default Medicaid reform template with substantial state flexibility.
3. Integrate acute-care Medicaid into market-driven health insurance reform, including:
 - Medicaid coordination with federal tax credit support;
 - Defined-contribution payments; and
 - State-determined benefits and mechanisms for beneficiary enrollment.
4. Empower the disabled and the frail elderly.

stake in the program as a rationale for imposing an extensive web of rules on the states. At the same time, states find it easier to maximize federal Medicaid funding than implement difficult measures to improve the program’s cost-effectiveness.

Restructuring Medicaid Financing. Medicaid reform must begin with a restructured relationship between the federal government and the states. Medicaid funding could be divided into two funding streams, one for the disabled and elderly and the other for everyone else. This would allow states to pursue separate reforms for these very different populations, which have very different needs in terms of medical and social services.

Federal funding should be converted into levels of federal support for each person enrolled in the program, based on historical spending. That would provide budgetary certainty and strong incentives to the states to manage the funding prudently. All the savings from rooting out waste and efficiency would accrue to state taxpayers. Under this approach, states would not be at risk for increased enrollment in the program because the per capita payments would be made for all enrollees.

Integrating Medicaid with Health Insurance Reform.

States would have great flexibility to pursue program changes without needing federal approval. However, federal law should provide a basic template for reform that would serve as a default structure. This template's objective for the nondisabled and their children should be full and seamless integration with the health insurance reforms contained in the replacement plan for the ACA.

The federal tax credit proposed in the ACA replacement plan could serve as the foundation of federal support for the Medicaid population as well. Medicaid would supplement the federal tax credit. The amount of Medicaid support beyond the federal tax credit would be based on a combination of household income and some measure of the premium necessary for an average-cost plan.

States would set the terms of the insurance offerings made available to subsidy-eligible program participants, just as they would under the ACA replacement program. States could also choose to have a separate insurance enrollment program for their Medicaid populations or to integrate Medicaid recipients into whatever arrangement is established for the tax-credit-eligible state residents.

The ACA's Medicaid Expansion. The ACA included a provision for expanding Medicaid coverage to all persons with incomes below 138 percent of the federal poverty line, which in 2015 was \$33,465 in annual income for a family of four. So far, 30 states and the District of Columbia have taken the option to expand, while 20 states have not. States that have expanded their programs are now receiving substantial additional federal funding for their Medicaid programs compared to the states that have declined to expand.

Moving toward per capita payments to the states should be based not only on historical spending in the states but also on a fair standard for basing enrollment in the program across all states. The most sensible approach is to provide a transition over five years to a new standard, which would be below the expansion included in the ACA but above the levels observed today in nonexpansion states. Any person who signed up for Medicaid under the ACA's rules should be allowed to stay on the program until they cycle off naturally.

Reforming Medicaid's Long-Term Care Program.

We do not recommend a universal template for state reform of the part of Medicaid assisting the disabled and elderly. However, many states have been pursuing reforms over the past decade to give disabled and elderly Medicaid recipients more control over the resources devoted to supporting their daily activities and medical needs, and with per capita federal payments, states could more aggressively pursue these reforms and try new approaches without federal interference.

Medicare Reform**Summary of Medicare Reforms**

1. Adopt the premium support reform model.
2. Improve the competition between Medicare Advantage and FFS.
3. Promote consumer decision making.
4. Modernize Medicare's benefits.
5. Reform Medigap and other supplemental coverage.
 - Require better coordination of FEHB retirees with Medicare.
6. Reform Medicare's payment policies and eliminate unnecessary bureaucratic controls.
7. Provide greater administrative flexibility in local markets.
8. Gradually raise the eligibility age to 67.

Medicare is pivotal to effectively reforming American health care because of its dominant regulatory role. Medicare's rules for paying hospitals, physicians, and other providers of services heavily influence how care is delivered to all patients, not just Medicare enrollees. The program would improve if there were fewer regulations and more emphasis on market-based reforms.

Adopt Premium Support. Converting the traditional program's uncapped entitlement and distorted fee-for-service structure to a premium support model is the centerpiece of a consumer-focused, market-oriented reform of Medicare. Premium support relies on the concepts of competition, choice, and a defined-contribution subsidy.

Under premium support, all beneficiaries would receive a uniform subsidy to purchase insurance from competing health plans, including Fee-for-Service (FFS) Medicare. The subsidy amount would be based on the plan bids, with each plan offering at least a core set of benefits. Subsidies could be adjusted according to the beneficiaries' financial circumstances and health conditions, but they would not be increased for more expensive plans. Beneficiaries choosing more expensive plans would pay any extra premium themselves. This gives seniors an incentive to select lower-cost plans and provides plans with an incentive to provide appropriate services in a cost-effective manner.

Improve Competition Between Medicare Advantage and FFS. Currently, Medicare FFS is the default option for beneficiaries who do not overtly select coverage. Like many other markets, Medicare displays "status quo" selection bias. That is, once a beneficiary is in a plan, he or she tends to stay there, even when switching would make sense. So the current system, with FFS as default coverage, is biased toward more FFS enrollment.

A remedy would be to change Medicare's default rules. The Medicare program could randomly assign new beneficiaries who do not make an overt selection to MA plans instead of automatically placing them into FFS. To minimize undue financial hardship and unexpected surprises, those default options might be limited to the two low-cost Medicare plan options.

The current MA bidding system is also flawed. All beneficiaries, including those in MA plans, must pay the Medicare Part B premium, which is generally deducted from the amounts otherwise payable to the beneficiaries in their Social Security checks. MA plans are permitted to provide premium rebates to beneficiaries as a way of attracting enrollment, but

current policy requires those rebates to come in the form of adjusting the Part B premium withheld from Social Security checks. This is not attractive to the MA plans because it obscures the benefits of economizing on Medicare coverage.

The competition between MA and FFS could be improved by allowing MA plans to send a rebate check directly to enrollees. This would encourage MA plans to bid lower, and the beneficiaries would see the savings clearly, rather than having it hidden in the computation of their monthly Social Security check.

Promote Consumer Decision Making. One key reason for the inefficiency of the health care market is the lack of information that consumers can use in selecting their health plan, their doctor, and their course of treatment. The Centers for Medicare and Medicaid Services (CMS) offers several online decision-support tools to help beneficiaries sort through their plan options, but the current tools produce overly complicated and incomplete information. A reformed Medicare program must commit itself to developing consumer-friendly information on the cost of alternative plan options, provider-performance measures (including patient-satisfaction scores), and likely out-of-pocket costs for specific treatments.

Reduce Fraud and Abuse. Medicare fraud and abuse is a serious problem that can cost taxpayers billions of dollars while putting beneficiaries' health and welfare at risk. New efforts are needed to shift beyond a "pay and chase" approach to prevent fraud before it happens. In addition, the federal government should collaborate with the private sector, law enforcement, and states to harness best practices in the fight against fraudulent and wasteful depletion of Medicare's resources.

Modernize Medicare's Benefits. Medicare's benefit structure was designed in the mid-1960s and needs to be modernized. The starting point should be merging parts A and B into a single program with a single premium and deductible and a uniform 20 percent coinsurance requirement on all services, similar to mainstream insurance. Medicare would also

add catastrophic protection, which limits the total cost-sharing that a beneficiary must pay in a year. One option to reduce the federal cost of this new benefit and to provide greater protection for those most in need is to vary the cost-sharing limit by income.

Reform Medigap and Other Supplemental Coverage. Supplemental coverage drives up Medicare costs by blunting the effects of beneficiary cost-sharing without measurably improving the quality of care. The Medicare Access and CHIP Reauthorization Act, passed in April 2015, limits Medigap coverage to costs above the Part B deductible amount, beginning in 2020.²⁷ That limit could be raised to a higher amount and extended to private supplemental insurance offered by employers to retirees. A minimum out-of-pocket payment requirement could apply only to beneficiaries in FFS Medicare with third-party insurance, including Medigap. It would not apply to amounts the beneficiary pays out of a health savings account, which is equivalent to a cash payment for out-of-pocket costs.

A New Integrated Delivery Option. Medicare should give beneficiaries a new integrated delivery option within FFS (a successor program to the current Accountable Care Organization arrangement). Beneficiaries selecting this option would get a reduction in their part B premium and would be allowed to combine the coverage with generous supplemental insurance, covering more cost-sharing than standard coverage.

Reform Medicare Payment Policies. Medicare has been moving toward a bundled-payment approach to FFS since the adoption of prospective payment for hospital inpatient services in the early 1980s. More recently, CMS has been experimenting with new payment and delivery models, including bundled payment for broader episodes of care, pay-for-performance, and competitive bidding. Similarly, private insurers have also been testing better ways of paying for and delivering care.

CMS should continue to test new approaches while adopting a more flexible approach to such projects.

Plans and providers participating in these demonstration projects should be encouraged to adapt these models to local conditions. The program should be more open to new business models that can deliver care more efficiently.

Give Medicare Greater Flexibility in Local Markets. Medicare operates as a national program, but health care is delivered locally. Traditional FFS Medicare should be restructured so that it can adjust its policies to local conditions. Subdividing the program into regional plans within the overall Medicare framework would make it easier to develop and implement innovations that can reduce costs or improve value. Such regional plans could operate with more independence from the central bureaucracy and thus be more capable of responding in a timely fashion to developments in the local market.

Gradually Raise the Medicare Eligibility Age. The Medicare program has maintained an eligibility age of 65 for its nondisabled enrollees since the program was enacted in 1965. During that time, average life spans have increased considerably. In 1965, the average male could expect to live to nearly 78 years old if he reached age 65. Today, he should live to age 83. The improvement in longevity at age 65 has been similar for women, from an average age at death of just over 81 in 1965 to nearly 86 today.²⁸

The 1983 Social Security amendments raised the normal retirement age for that program to 67 over a transition period of two decades. That change left in place the option for persons to continue to receive Social Security benefits at age 62, albeit with lower monthly payments. The failure to raise the Medicare age means that the program will be paying for an ever-increasing portion of lifetime health care costs, even as the tax base for the program grows much less rapidly than the eligible population.

The increase in the eligibility age could proceed in two steps. First, there could be a gradual increase to reach age 67. Second, periodic additional adjustments could keep the age of eligibility consistent with overall life expectancy for those who have lived to age 60 or 65.

Promoting Enrollment in Health Savings Accounts

Summary of HSA Reforms

1. Provide a one-time federal tax credit matching enrollee contributions to HSA accounts.
2. Liberalize the rules for HSA contributions:
 - Eliminate the minimum deductible requirement for a universal HSA contribution allowance of \$2,000 or \$4,000; and
 - Increase the maximum contribution limits for persons with HDHPs by the universal allowance.
3. Allow HSAs to use nontraditional payment methods (non-FFS).
4. Include HSAs in Medicaid reform.
5. Integrate HSAs into Medicare.
6. Allow tax-free withdrawals at age 75+ (above a minimum balance).
7. Allow tax-free HSA rollovers to designated HSA accounts at death.

HSAs should be a central component of health care in the United States. The accounts provide strong incentives for their owners to seek the best value for their health care dollars and a ready vehicle for protecting against high medical expenses.

Provide a One-Time Federal Tax Credit for HSA Enrollees. To rapidly increase enrollment in HSAs, a tax credit of up to \$1,000 should be provided to all persons who have established an account and have contributed to it by the end of 2017. The credit would provide a matching contribution of \$1 for every \$2 contributed to an account in 2017, up to the maximum credit of \$1,000. This would ensure that tens of millions of Americans who today do not have an HSA

would take the steps necessary to learn about them and establish one.

Liberalize the Rules for HSA Contributions. HSAs successfully serve as a vehicle for savings for future unknown contingencies and for health and medical services not covered by insurance. Currently, however, only persons enrolled in a qualified high-deductible health plan (HDHP) are eligible to make tax-preferred annual contributions.

We recommend allowing all Americans to establish and contribute up to \$2,000 per year for individuals and \$4,000 per year for families (both indexed to the CPI), independent of their participation in a qualified HDHP or any insurance program. Participants in a qualified HDHP would continue to be eligible to make contributions up to the allowable amounts under current law, in addition to the base \$2,000 or \$4,000 contribution allowed for all Americans.

Allow HSAs to Be Used for Nontraditional Payment Methods (Non-FFS). Today, HSA withdrawals must be directly tied to a service for the withdrawal amount, which hinders the development of models that would work better for the enrollees, the integrated delivery plans, and other direct-pay physician relationships that require payment methods other than FFS. HSA rules should be altered to allow payment from the accounts for services organized by integrated plans and financed with creative payment plans.

Include HSAs in Medicaid Reform. Indiana has pioneered the use of HSA-like accounts in Medicaid, through a waiver program negotiated with the federal Department of Health and Human Services.²⁹ Participants get a high-deductible insurance plan and an HSA-like account (called a Personal Wellness and Responsibility account). The state pays for the insurance and deposits funds in the account for the Medicaid enrollee to use. Program participants with incomes above the federal poverty line are also required to make their own contributions to the account. Independent evaluations of the program have shown that it has reduced costs and that the program participants highly value the accounts they now own.³⁰

There is no reason why HSAs could not be featured prominently in every state Medicaid program. Under the reform plan presented in this volume, Medicaid would be converted into defined-contribution support, with the program participants deciding what kind of insurance plan they would like to secure with the available funds. One of those options should be an HDHP-HSA combination, similar to what is being offered in Indiana. Enrollees electing this option would be able to keep their accounts as their earnings rise and they exit Medicaid and could very likely keep their HDHP too.

Integrate HSAs into Medicare. Today, Medicare allows for a medical savings account (MSA) option within the Medicare Advantage program, but it is underutilized for several reasons. Among other things, it is run separately from any HSAs that Medicare beneficiaries may have from their working years. Moreover, Medicare precludes beneficiary contributions to an MSA or HSA while enrolled in Medicare.³¹ Additionally, retirees can also make penalty-free withdrawals from their HSAs for nonmedical uses when they reach age 65, which also lessens the incentive to retain HSA funds as a cushion for health care expenses into retirement.

HSAs could be made a much more prominent and viable part of the Medicare program through two important steps. First, the Medicare MSA program should be modified to explicitly build on the HSA model. Second, HSA holders should be allowed to continue to make tax-free contributions even after they become eligible for Medicare. The purpose of HSAs is to provide additional financial security for the account holders. It makes little sense to restrict seniors' ability to save for their future health care needs in the years that

they are most likely to see a surge in expenses, inclusive of long-term care.

Allow Withdrawals Tax-Free at Age 75+ Above a Minimum Balance. HSAs could be an important source of protection against the high cost of nursing homes and other long-term care needs in retirement if account holders had an incentive to grow their balances and maintain them for this purpose. One way to do that would be to set a minimum HSA balance, roughly equal to two years' worth of nursing-home care (or about \$75,000) and allow anyone age 75 and older with balances that exceed that amount to make withdrawals (up to a certain limit, perhaps \$75,000) that are tax- and penalty-free. This would reward people who, over a lifetime, saved and provided for their own health care needs with the ability to spend a portion of their savings on their other priorities. Setting the minimum balance would allow these HSAs to also be used to pay for a significant amount of nursing-home care, which should lessen reliance on the Medicaid program.

Allow HSAs to Be Rolled Over Tax-Free to Other Family Members with Designated HSAs at Death. Under current law, when an HSA holder dies, the HSA balance automatically goes to a spouse and is kept as an HSA. If there is no spouse, then the HSA balance is distributed through either an estate or other designated persons and is fully taxed at that point. The law should be amended to allow HSA holders to designate family members who are not spouses as recipients of their HSA balances at death. The balances would retain the HSA designation for the new owners and could be added to the balances of any HSAs they already own.

Improving the Safety Net: An Agenda to Expand Opportunity

The federal government spends about \$400 billion annually to fight poverty (not counting health care programs), and for all that money, the country is getting unsatisfactory results.³² Not only has the official poverty rate risen since the early 2000s, but also significant opportunity gaps persist: among children born in the bottom fifth of the income distribution, 43 percent remain stuck there as adults.³³ Policymakers serious about fighting poverty and expanding opportunity must recognize the flaws in our current safety net and fight to improve each major program with an approach centered on the importance of work.

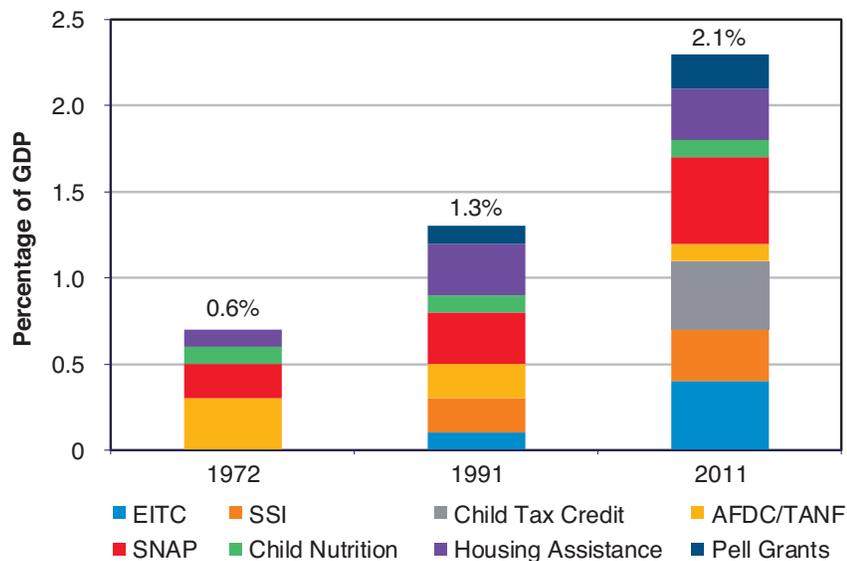
The safety net as we know it today was launched by President Lyndon B. Johnson 50 years ago when

he “declared all-out war on human poverty.” Johnson pledged “not only to relieve the symptoms of poverty, but to cure it.” He acknowledged that “the war will not be won here in Washington” and announced that his plan would empower every American to fulfill his or her hope for a full-time job.³⁴

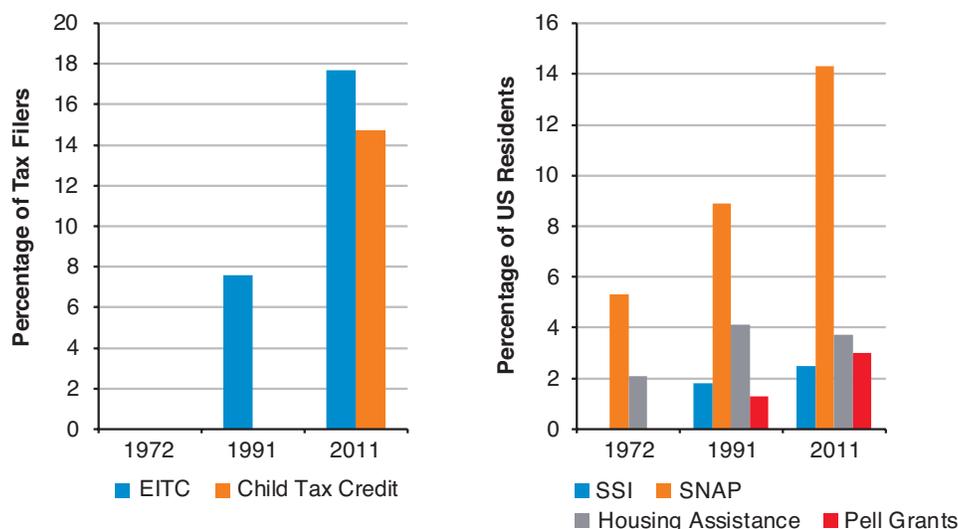
As shown in Figure 6, the current array of federal antipoverty efforts has grown in expense over the past four decades. The federal government spent 0.6 percent of GDP on the major programs in 1972, 1.3 percent in 1991, and 2.1 percent in 2011—more than three times the level of support from four decades earlier.

As shown in Figure 7, the growth in spending has been driven heavily by growth in program enrollment,

Figure 6. Federal Funding of Major Low-Income Support Programs (Excluding Health Care)



Source: Congressional Budget Office, *Growth in Means-Tested Programs and Tax Credits for Low-Income Households*, February 2013.

Figure 7. Participation in Major Low-Income Support Programs (Excluding Health Care)

Source: Congressional Budget Office, *Growth in Means-Tested Programs and Tax Credits for Low-Income Households*, February 2013.

which in turn has generally been because both Congress and program regulations issued by executive-branch agencies have liberalized eligibility rules. The major tax-credit programs (the EITC and the child tax credit) were not enacted until well after the initial wave of Great Society programs was started. In 1991, less than 8 percent of all tax filers qualified for the EITC; by 2011, nearly 18 percent did.

Growth in enrollment in Supplemental Nutrition Assistance Program (SNAP) has been similarly dramatic. In 1972, 5.3 percent of all US residents participated in the program; by 2011, enrollment had increased such that 14.3 percent of all US residents were receiving benefits from the program.

Despite the steady growth in spending and enrollment in programs aimed at supporting lower-income households, the overall system has fallen short of the lofty goals President Johnson set for it. This is not to say that antipoverty programs have failed completely; better measures of poverty make it clear that these programs are very important because they do in fact substantially improve material well-being, especially for those who work.³⁵ But Americans have always wanted a safety net that does more than just treat poverty's

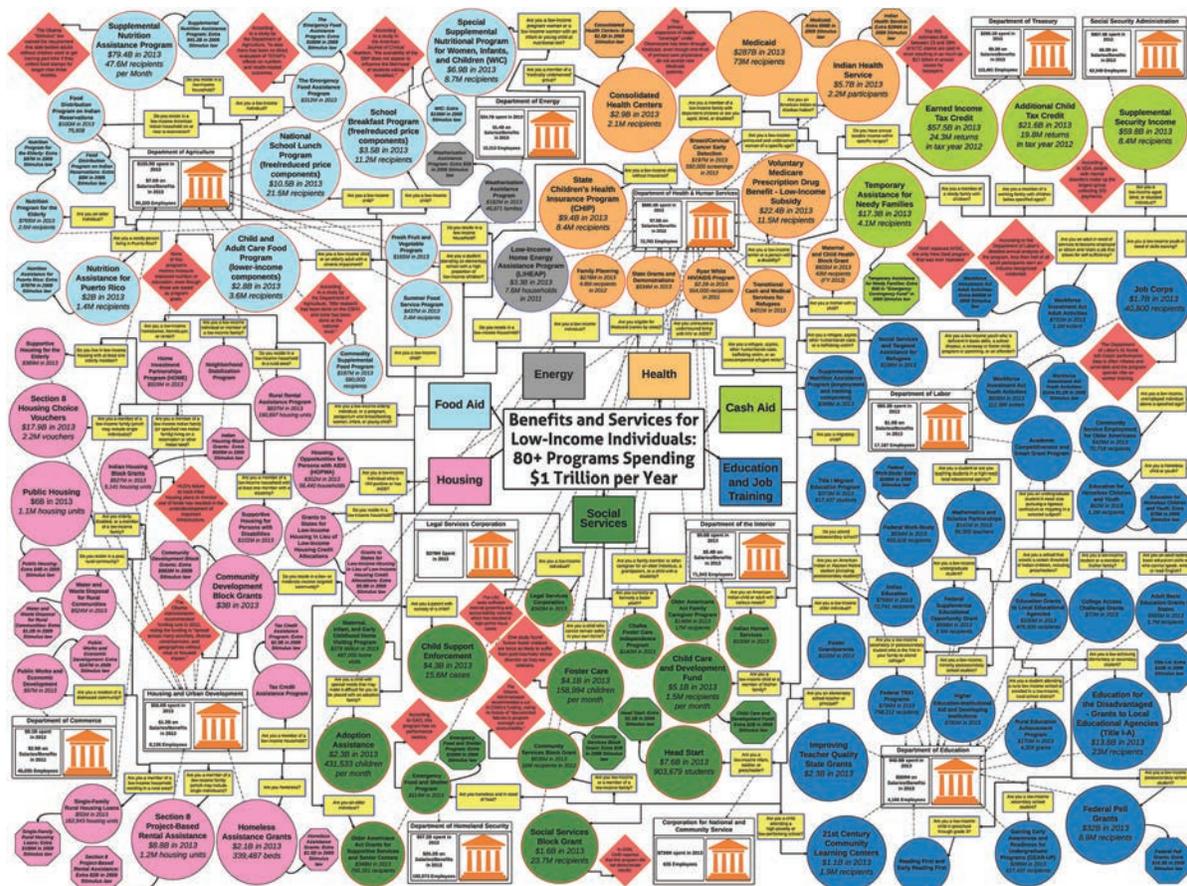
symptoms or make them less painful. We want a safety net that helps people improve their economic prospects so that, eventually, they will no longer need to rely on government assistance to provide for their families.

The official poverty rate includes earnings but ignores many of the benefits the government provides low-income Americans. Since 1965, the official poverty rate dropped from 17.3 percent to 14.8 percent in 2014. Even so, Americans are struggling to earn their own success much more today than in the recent past.

We are six years into an economic recovery, and the most recent Census Bureau report showed that 46.7 million Americans still lived in poverty in 2014. The poverty rate remains 2 full percentage points above what it was in 2007. If the poverty rate in 2014 were the same as in 2000, nearly 11 million fewer Americans would have been in poverty.³⁶

Ironically, Johnson's initial push pointed toward the problems that would eventually become evident in our major social programs: too much authority vested in a distant and bureaucratic federal government and too little emphasis on work and improving employment prospects across the board. The federal government's tendency is to stack new programs on top of each other,

Figure 8. Current Low-Income Support Programs



Source: House Ways and Means Committee Staff, using Congressional Research Service reports and other data, <http://waysandmeans.house.gov/wp-content/uploads/2015/11/WM-Welfare-Chart-AR-amendment-110215-jpeg.jpg>.

leading to the poorly coordinated system seen in Figure 8. It is difficult for low-income Americans to navigate such a complicated system. There is little focus on helping recipients plot a strategy for escaping poverty.

This web of uncoordinated programs also helps explain the lack of emphasis on work. With more than 80 programs, it is difficult to send a clear message about the expectation of employment. Each program treats one specific symptom, so no caseworker can help a recipient develop a comprehensive plan for gaining employment and moving up. This is disappointing because work is the most important tool we have for reducing poverty: only 3 percent of working-age adults

who work full-time year-round are in poverty, compared with 33.7 percent of adults who do not work at least one week.³⁷

Further, our antipoverty programs have lost control of what Oren Cass calls the “income gap” between what full-time work pays and what can be obtained through government benefits.³⁸ Expenditures on public benefits for low-income Americans have risen substantially in the past decade, and as Casey Mulligan has documented, recent changes to some programs have decreased work incentives.³⁹ Because programs operate in their own silos, little consideration is given to how programs combine to create serious work disincentives.

Meanwhile, new economic realities have made it difficult for many low-skill workers to succeed in the labor market.⁴⁰ With benefits increasing and work incentives declining, it should be no surprise that labor force participation among those ages 25–54 is stuck near a 30-year low.

Testing a Block-Grant and Wage-Subsidy Proposal

Testing Block Grants and Wage Subsidies

1. Establish voluntary, multiple-state participation in a multiyear demonstration program.
2. Test state block grants with and without wage subsidization.
3. Provide state flexibility on which federal programs would be included in the block grant.
4. Involve the federal government in wage-subsidization administration.
5. Assess demonstration results independently, using rigorous evaluation designs.
6. Create a process to automatically expand concepts to other states.

The goal of a safety-net reform effort—welfare reform 2.0, if you will—should be rationalizing the vast array of existing federal programs by shifting a substantial amount of power and control over the design of the safety net to the states, along with a renewed and persistent focus on work as the primary means of helping families improve their economic prospects with new opportunities.

State flexibility and promotion of work are the priorities of reform templates put forward by House Speaker Paul Ryan and Senator Marco Rubio, among others. They are also the focus of reform plans designed explicitly to incentivize work, in particular the wage-subsidy concept proposed by Oren Cass and others. The

wage-subsidy proposal would provide explicit and direct supplements to earned income in workers' paychecks, using funds that currently go to existing safety-net programs, including the EITC and SNAP.

It must be noted that there is some tension between the concept of a flexible state block grant and wage subsidies. A block grant is supposed to allow states to decide how to use the funds. States may choose to emphasize work supports, training, case management, or family stability. A wage-subsidy effort, on the other hand, would explicitly shift most resources toward one purpose, with much less flexibility to use the funds for other purposes. Moreover, wage subsidization might be most easily carried out using federal rules and administration, as many states have limited capacity to implement what would necessarily be a complicated program.

Both ideas are also highly controversial and would radically depart from the status quo. In 1996, Congress passed a sweeping and historic welfare reform bill that also deviated from prior practice, but it was based on a series of state efforts approved through federal "waivers" of otherwise applicable laws and rules that had largely proven the concept was sound before Congress adopted it.

The best way to proceed, therefore, is by testing both block grants and wage subsidies in the states with carefully designed demonstration programs. The basic framework for such an effort could be designed as follows:

- **Voluntary Participation from Multiple States in a Multiyear Demonstration Program.** The law authorizing the testing of the block grants and wage subsidization should allow states to opt in to the effort voluntarily. No state should be required to participate. The test would last for approximately five years.
- **Separate Tests of Block Grants with and Without Wage Subsidies.** Sufficient flexibility should be built into the program to allow states to test a block grant without wage subsidization or one with wage subsidization as a primary use of the funds. The number of states participating in each type of program would be based mainly on

state interest in testing the concepts, but ideally at least three or four states would be testing both approaches. The authorizing legislation should permit up to 10 state demonstrations.

- **Provide Flexibility on Programs Included in a Block Grant.** States should be given substantial discretion over which federal programs would be included in their block grants. The law authorizing the test would provide a list of all potential programs, but the states would ultimately decide which to include. Programs not included in the block grant would continue to be administered as under current federal law. The amount of federal block-grant support to the state would be based on historical spending patterns for the programs a state chose to include in the demonstration effort.
- **Federal Participation in Wage-Subsidization Administration.** Providing direct wage subsidization to workers at lower hourly compensation levels is a complicated administrative undertaking, requiring coordination among employers and state and federal governments. The federal government, via the IRS, currently has existing regulatory relationships with employers through the federal payroll tax system. It may be easiest if the administrative design of wage subsidization is addressed by the federal government and not the states. States choosing to test the concept under a block grant would then work with the federal government to use block-grant resources to provide wage subsidization through a federal infrastructure.
- **Independent Assessments of Demonstration Results.** Both reform concepts—a block grant with and without a wage subsidy—would be thoroughly evaluated by independent experts to determine their effects on the economic well-being of the families in those states. Important measures for the evaluation would include the income and resources available to low-income residents, work participation and wages, and the educational outcomes of household members. The evaluations

will be required to use rigorous designs including use of random assignment in most cases.

- **Process for Automatic Expansion of Concepts to Other States.** The law authoring the testing of the block grants and wage subsidization should provide for the automatic expansion of these reform approaches to other states, on a voluntary basis, if the initial findings show positive results for the affected populations.

Earned Income Tax Credit

Summary of EITC Reforms

1. Reduce the error rate.
2. Increase information sharing between SSA and IRS.
3. Increase requirements for self-preparers.
4. Allow the IRS to take more time to process EITC claims.
5. Provide an increase for workers without dependent children.

While pursuing fundamental reforms to help lower-income households is important, it is just as important to ensure that existing programs perform far better in the future than they do today. All the major safety-net programs have significant flaws that need to be addressed, starting with the EITC.

The EITC, despite some serious flaws, is arguably the nation's most effective antipoverty program at the moment because it provides substantial benefits to low-income Americans who work. In 2014, 27.5 million people received \$66.7 billion in support from the EITC. Research shows that these funds successfully encourage work and reduce poverty. One new study finds that a \$1,000 increase in the EITC leads to a 7.3 percentage point increase in employment and a

9.4 percentage point reduction in the after-tax poverty rate among single women with children.⁴¹

These twin successes have understandably led to calls to increase the credit for workers without dependent children, who currently get very little from the EITC. Young men in particular have struggled in the labor market over the last decade, and enhancing the credit for these workers could draw more of them into the labor force and increase their earnings. This outcome would be good for these young men and the country. In addition, it might increase marriage rates, because greater financial stability makes marriage more appealing and sustainable.

Such proposals should be supported, but only in combination with offsets provided by serious reform of the EITC's principal weakness: its high rate of improper payments. A recent Government Accountability Office report found that a shocking 27.2 percent of outlays were erroneous (\$17.7 billion).⁴² Before expanding the program, as both Paul Ryan and President Obama would like to do, it must be reformed to lower the mispayment rate. Misused public dollars can be put to better use, and a program that so blatantly mispends taxpayer dollars undermines public support for the safety net.

One idea for increasing compliance is to better facilitate information sharing between the Social Security Administration (SSA) and the IRS, the agency that administers the EITC.⁴³ Other options worth exploring include giving the IRS more time to process and verify claims and forcing self-preparers to answer the same eligibility questions as paid preparers. These efforts may necessitate increased funding of the IRS.

Supplemental Nutrition Assistance Program

The SNAP program, formerly known as Food Stamps, is a valuable program that provides needed assistance in a targeted way. It reduces poverty by 16 percent by one calculation and is particularly effective at combating deep poverty.⁴⁴ After welfare reform, it also came to be used as a work support, with the crucial role of helping the wages of low-income working families go further.

Summary of SNAP Reforms

1. Establish a universally applied federal asset test of \$7,000.
2. Require states to promote employment and earnings for able-bodied adults receiving SNAP.
3. Require reduced benefits for recipients who decline an offered job.
4. Remove sugar-sweetened beverages from allowable purchases list.

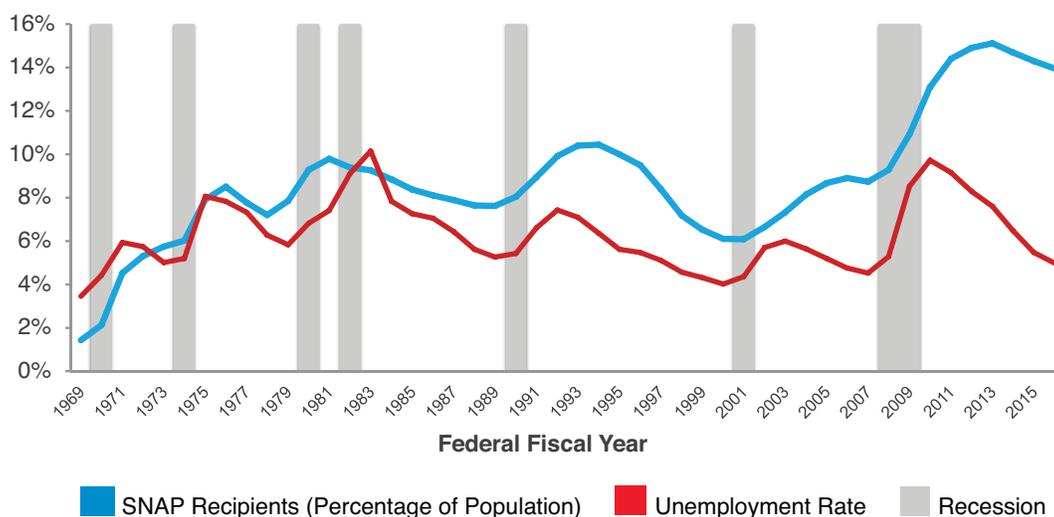
However, in recent years the program has not been performing as it should. Enrollment has remained high even as the economy has significantly strengthened, and for many, this intended work support has become a work replacement. SNAP caseloads have risen dramatically since the recession ended, from 33.5 million in 2009 to 45.8 million in 2015. Even though the unemployment rate has fallen, the SNAP caseload remains high by historical standards.

Figure 9 plots the difference between the percentage of the US population receiving the SNAP benefit and the unemployment rate. The chart shows a common pattern in all recessions before 2000; namely, as the unemployment rate rises during the recession, so does the SNAP participation rate. Then, as unemployment begins to fall as the recession winds down, the SNAP participation rate falls as well.

By contrast, following the 2008 recession, as unemployment fell, the SNAP participation rate continued to rise for many months, and the gap between the unemployment rate and the SNAP participation rate grew larger than ever. From 1980 to 2000, the average gap between the unemployment rate and SNAP participation rate was 2.3 percentage points. The gap was 8.8 percentage points in 2015.⁴⁵

While some argue that this problem is only a reflection of a still-weak economy—and there is some truth to that—policy changes have also played a role. In one study, James Ziliak found that policy reforms accounted

Figure 9. SNAP Enrollment and the Unemployment Rate



Sources: USDA Food and Nutrition Service Participation Data; US Bureau of Labor Statistics, Civilian Unemployment Rate (retrieved from FRED); and US Census Bureau, Total Population (retrieved from FRED).
 Note: FY2016 includes enrollment and unemployment data from October 2015 to January 2016.

for nearly 30 percent of the caseload increase after the Great Recession.⁴⁶ States have been given flexibility in recent years to set eligibility criteria that differ from the federal requirements. For example, as broad-based categorical eligibility has spread to 39 states and the District of Columbia, asset tests have been effectively waived in many states.⁴⁷ This is problematic because the long-standing asset test limits the program to those without significant resources of their own and ensures an upfront check of assets, preventing applicants with income-producing assets from being inappropriately approved for benefits.

While current asset tests are set too low—discouraging savings of even small amounts—having no asset test at all is also a mistake. Congress should establish and uniformly enforce a reasonable asset test of \$7,000, which will lead to greater protections against fraud and abuse and ensure that benefits are provided to only those in need.

Changes to reporting requirements made it easier for recipients in many states to continue to receive SNAP even after their incomes rise.⁴⁸ And since the economic downturn, the vast majority of states have been waiving

the work requirement for able-bodied adult recipients without dependent children. While none of these reforms fully explain the rapid divergence of the caseload from the unemployment rate, the combination of these changes to the program, the current state of the labor market, and USDA's increased promotion of the program has likely led to this troubling trend.

Many SNAP recipients could be working but are not. While it is true that many of the 46 million people receiving SNAP today cannot work because they are children, seniors, or disabled, an increasing number of able-bodied, working-age adults are receiving SNAP and have no earnings. An analysis of USDA quality-control data finds that the number of nondisabled, nonelderly adults who have no earnings has risen from 4.1 million in 2000 to 13.2 million in 2013.⁴⁹ Large numbers of nonworking SNAP recipients may have been justifiable during the economic downturn, but this far into a recovery, we should be doing better getting recipients into work.

As the recently completed bipartisan report of the National Commission on Hunger unanimously recommended, USDA must bring a much greater focus

on employment to SNAP by requiring states to provide employment services at initial application and recertification to nonworking, nondisabled applicants. In addition, USDA should be required to report annually and on a state-by-state basis the share of working-age, able-bodied SNAP recipients who do not report earnings and are not receiving benefits from the Temporary Assistance for Needy Families program (another unanimous recommendation of the Hunger Commission).

It was a step in the right direction that the most recent Farm Bill provided for 10 state-level SNAP demonstration projects focusing on increasing employment among SNAP recipients. Hopefully these projects will identify some useful ways to encourage work. But the most effective way to move SNAP recipients into employment is to have clear statutory language requiring states to reduce benefits for those working-age, non-disabled recipients who refuse to take an offered job.

Finally, despite being created to provide *nutritional* assistance, SNAP is failing to address successfully the primary nutritional challenge facing low-income Americans—obesity. Forty percent of all SNAP recipients are obese, and among adult recipients, only 25 percent are classified as having a healthy weight.⁵⁰

Scientific research suggests that consuming sugar-sweetened beverages, such as soda or sports drinks, can lead to serious negative health consequences, including obesity and diabetes.⁵¹ A recent analysis of National Health and Nutrition Examination Survey data found that 83 percent of SNAP recipients consumed sugar-sweetened beverages on the day before the interview.⁵² Excluding sugar-sweetened beverages from the list of allowable purchases with SNAP benefits would help the program provide more effective nutritional assistance.

Temporary Assistance for Needy Families

Since the welfare reform of 1996 created Temporary Assistance for Needy Families (TANF), cash welfare has been a more effective program in helping individuals move from welfare to work than the old Aid for Families with Dependent Children system was. The new TANF program, created by a bipartisan effort,

Summary of TANF and SSI Reforms

1. Eliminate TANF work requirement loopholes.
2. Encourage states to help the nonworking poor find employment and connect with services.
3. Use outcome measures in TANF to evaluate state job-placement and job-retention efforts.
4. Develop mandatory transition plans for SSI child clients before age 18.
5. Exempt child clients' wages from SSI income.
6. Extend the EITC to recipients leaving SSI for work.

provided states the funds to design their own welfare systems as long as they required recipients of cash welfare to work, placed time limits on TANF receipt, and enhanced child support enforcement.

In a 2015 National Bureau of Economic Research literature review of the program, James Ziliak found that the weight of evidence indicates that welfare reform increased employment and earnings and reduced caseloads.⁵³ Despite predictions of disaster from some politicians and pundits, the poverty rate among single mothers and their children fell from 44 percent in 1994 to 33 percent in 2000—a decline of 25 percent.⁵⁴ While the booming economy of the late 1990s certainly helped, studies show that a significant portion of the caseload reductions came from the new rules, which advanced a work-first approach.⁵⁵

We should not turn away from the pro-work philosophy of the 1996 law. However, after 20 years, we have learned lessons that call for improvements. For instance, states should be required to meet a real work participation rate (WPR) that is not vulnerable to state manipulation. Under TANF, states must engage 50 percent of their recipients in work activities to avoid losing funds.

Many states game the system by manipulating federal rules that allow states to lower their required WPR by reducing the number of recipients or by claiming that state spending on related activities justifies a reduced WPR. Other states provide very small benefits to workers to boost their work-engagement numbers. These loopholes should be closed.

Eroding the work requirement would undermine the work-first approach that made the 1996 reform so successful in helping people move up.

The biggest problem scholars have identified in TANF is that an increasing number of poor, single-parent families are not receiving cash assistance and report no earnings. For instance, Kathy Edin and Luke Shaefer find that the number of families living on less than \$2 per person per day has more than doubled from 636,000 in 1996 to 1.65 million in 2011.⁵⁶ The magnitude of this problem may be overstated: underreporting of cash welfare receipt and earnings is endemic in the surveys used to study this issue.⁵⁷ Even so, the evidence does suggest that more of these single parents are not being helped into the labor force in the way that they could be.

Donna Pavetti and others have shown that some states have made it unnecessarily difficult for poor families to access TANF benefits.⁵⁸ To take one egregious example described by Edin and Shaefer, applicants for benefits in Chicago were told that if they were not in line by 7:30 a.m., they would be denied assistance.⁵⁹ This type of behavior must be addressed by federal officials responsible for the oversight of the program, and any legislative reforms of TANF must take into account some states' failure to adequately help their residents avoid deep poverty.

The vast majority of these families are not completely disconnected from assistance. They are recipients of SNAP benefits and Medicaid. In fact, the Department of Agriculture estimates that in 2013, 99 percent of eligible individuals with no income were

participating in SNAP.⁶⁰ Clearly, they have an ongoing connection to a government program providing aid. It should be possible for state welfare agencies to find and engage them more actively.

To address this problem, some have proposed modifying TANF work requirements to increase the number of families receiving cash aid. This is potentially problematic. Eroding the work requirement would undermine the work-first approach that made the 1996 reform so successful in helping people move up. Softening these requirements would likely draw people into the program who would have sought and secured work in the absence of an alternative that offers benefits without work.

A better solution would be to require state TANF or workforce agencies to actively engage families receiving SNAP who report no (or very low) earnings.⁶¹ A certain percentage of the TANF block grant could be designated for reaching out to these SNAP recipients, assessing their situation, and referring them to employment and child support enforcement services as needed. States should experiment with different approaches for engaging this struggling population and be required to report annually on their efforts.

Among other ideas for improving TANF, incorporating outcome measures into state evaluations that track job placement and job retention would keep states focused on what matters: moving individuals into work. The federal government should also provide for demonstration projects with rigorous evaluation requirements and a What Works Clearinghouse through the Administration for Children and Families that can push states toward more evidence-based approaches.

While these would be meaningful improvements, policymakers should be especially wary of proposals that would weaken a rare success in American social policy. For example, loosening or eliminating the work requirement or the distinction between work and non-work activities would change TANF from a work-first program (one that prioritizes directing recipients to employment) to one with an education focus. This would be a mistake, as evidence shows that a work-first approach is more successful in increasing employment and earnings and reducing welfare receipt.⁶²

Work-first, of course, does not have to mean work-only. Many training and educational programs can help struggling Americans move up, but in the TANF program, these should be available alongside employment, not in place of it.

Reformers should also make sure that strong verification processes remain in place to ensure that recipients are actively participating in work programs. It may be an administrative burden, but welfare reform's success rests on ensuring that recipients are engaged in productive activities on a daily basis.

Supplemental Security Income

One of the worst-performing pieces of our safety net is Supplemental Security Income (SSI), a program that provides cash income and medical care to adults with disabilities and little or no work history, the poor families of children with disabilities, and the poor and disabled elderly.

SSI is distinct from the other major federal disability program, Social Security Disability Insurance (SSDI). SSDI is a social insurance program funded through payroll taxes that pays out benefits to workers who have paid into the system for some time but who suffer an impairment that prevents them from working. SSDI has many of its own problems; it contains substantial disincentives to work, and the program is partly to blame for falling labor force participation, especially among older men.

SSI is quite different. It serves an especially vulnerable population—the vast majority of recipients are poor, have little work experience, and received other forms of public assistance even before the onset of a disability. But even for this struggling population, outcomes are dismal. SSI offers little incentive for recipients to work, and once on the program, very few leave. SSI receipt is too often a ticket to a lifetime of benefit receipt at near-poverty levels, not a ticket to moving up.

SSI has grown rapidly in recent years, almost doubling from 4.8 million recipients in 1990 to 8.3 million in 2014.⁶³ Even as the rate of self-reported work impairment in the general population has remained flat over the past decades, the share of the general population

receiving SSI has increased substantially.⁶⁴ This suggests that the program's troubling growth may be the result of policy changes and liberalized eligibility rules, not worsened health among low-income Americans.⁶⁵

The rising number of beneficiaries is a concern in part because of the program's cost, but primarily because outcomes for those in the program are poor, especially for younger beneficiaries. One-third of those who receive disability payments as children do not qualify at age 18 for the adult SSI program, which uses more strict criteria.⁶⁶

The program does not adequately prepare these youth for transition to adulthood and independence: according to one study, more than 30 percent of SSI youth drop out of high school, and by age 19, about half have been arrested at least once.⁶⁷ Few progress to higher levels of education, and few have any experience with the labor market before aging out. As of December 2014, only 2,488 youth SSI recipients had earnings. To put this in perspective, there are 177,400 child SSI recipients age 16 and 17.⁶⁸ It is no surprise that SSI youth removed from the rolls at age 18 struggle to replace the benefit with earnings.⁶⁹

Those who remain on the program into adulthood or who enter as adults struggle too. Adults receiving SSI benefits rarely integrate into work or mainstream American life. They often remain on SSI for decades with zero earnings or earnings below the poverty level and little chance at a better life. In 2014, only 4.7 percent of SSI recipients ages 18–64 had any earned income.⁷⁰

These results are particularly discouraging because in general, Americans with impairments are just as likely as their able-bodied peers to want a job.⁷¹ If anything, the substantial medical and technological gains made over the past decades in assisting the disabled in the workplace should allow more SSI recipients than ever to participate in employment and grow their skills. This is not happening, and policymakers need to address it.

Reforms should ensure that work effort is encouraged and that it always pays. Changes should start with the youth population. First, youth recipients should not be required to report their earnings to the SSA. (Imagine dealing with this agency at age 16.) Few youth currently work and report it, so the lost offsets would be minimal.

Second, SSA should be required to identify those who are likely to exit the program at age 18 far in advance. They have the data to do this. Those deemed likely to leave the program should be required to meet with an SSA counselor to develop a transition plan well before turning 18.

Third, we ought to extend the EITC to those transitioning off of the program at age 18. An extra incentive to enter the labor force, especially for those with little experience in it, is important.

Finally, the program should provide more effective training, rehabilitation, and support to those who could work. This approach has actually shown evidence of success. SSA's Youth Transition Demonstration provided employment services and enhanced work incentives for SSI recipients between the ages of 14 and 25, with statistically significant positive effects on employment and earnings.⁷²

Americans with impairments are just as likely as their able-bodied peers to want a job.

The adult program could also be improved. An expanded EITC should be extended to those who choose to work but do not have children. The SSA should clearly communicate to all recipients the trade-offs between work and benefits, helping them better understand that they can engage in some work without losing their benefits. Pilot programs aimed at identifying those with work capacity and helping them find employment should also be pursued.

The program has larger problems that must also be addressed, but those are beyond the scope of this paper. The incentives for states to move difficult-to-serve individuals onto the federally funded SSI program is concerning. The medical-listing criteria for determining eligibility are severely outdated. The decision-appeals process is one-sided—applicants can retain counsel to argue their case, but the federal government cannot present the counterargument.

SSI does a good job of ensuring that those on the program receive a minimum level of financial and

medical security. The program does little to encourage or assist those receiving benefits to use the skills they do have to move up. Those with work impairments deserve to be recognized for and encouraged to use the skills they do have—not defined by those they do not. Policy must do a better job of recognizing that.

Child Support Enforcement

Summary of Child Support Enforcement and Child Care Reforms

1. Require states to refer single-parent SNAP recipients to the child support program.
2. Prioritize parental financial responsibility for children.
3. Allow states to use federal child support funds for noncustodial parent work programs.
4. Better match existing child care assistance with the labor market.
5. Smooth benefit cliffs in child care subsidies.

One antipoverty program that emphasizes personal responsibility over government dependency is child support enforcement. The program holds nonresident parents responsible for providing for their children; results in valuable cash payments to single parents, usually mothers; and is linked to declines in nonmarital births and poverty and to greater paternal involvement in parenting.⁷³

Despite the importance of child support payments, in 2013 only 46.1 percent of custodial mothers living in poverty had child support orders, compared to 55.7 percent in 2001.⁷⁴ This drop-off reflects decreased enforcement efforts. Further, in inflation-adjusted terms, total distributed collections from the IV-D caseload peaked in 2008 and have been declining since.⁷⁵

An improved child support enforcement program would place greater emphasis on collections. Part of the recent decline in payments to custodial parents is the result of decreasing TANF rolls. Single mothers on TANF are required to identify the noncustodial parent and cooperate in establishing an order of support as a condition of receiving the cash benefit. The federal statute should be updated to require states to refer single parents receiving SNAP to the child support program.

Another reason for the decline is that the Obama administration has diluted the focus on personal responsibility. The administration has emphasized a “paradigm shift” in the program away from holding absent parents accountable for providing financial support to their children. As a result, the program focuses on reaching out to absent parents for the purpose of debt reduction and right-sizing orders. By increasing administrative attention to those areas, focus on collections has naturally decreased.⁷⁶

Recently proposed regulations from the administration would further weaken enforcement efforts by limiting each state’s ability to set minimum order amounts for absent parents who refuse to appear at hearings and by making it easier to classify cases as “uncollectable.” This change incentivizes states to give up on the most difficult cases. While the specific amounts sought should be responsive to noncustodial parents’ economic situations, the next administration should reinvigorate the enforcement of child support. It should be made clear that noncustodial parents bear a responsibility to contribute financially to the well-being of their children.

We should also ensure that parents who are struggling to meet their child support obligation have improved access to jobs. An important way to satisfy this objective is to allow states to use federal funding for child support enforcement to establish job-training programs for noncustodial parents. Regrettably, the Obama administration chose to pursue this goal through regulation that bypassed Congress to overturn long-standing policy. The next administration should accomplish this policy goal properly—by asking Congress to authorize the use of child support funding for employment programs.

Child Care Assistance

In recent years, it has become clear that child care assistance is the weakest of the work supports in our safety net. In 2013, 1.5 million children received care funded by the Child Care and Development Block Grant, and federal spending on child care, combining funds from the block grant and TANF, totaled \$11.3 billion.⁷⁷ However, only 15 percent of federally eligible children were receiving Child Care and Development Block Grant–funded care in fiscal year 2012, and only 33 percent of eligible children in families below the poverty line received subsidies.⁷⁸ This is despite research that shows that child care assistance is correlated with mothers’ employment levels⁷⁹ and that quality child care is associated with improvements in socioemotional development for children.⁸⁰

The way child care assistance is currently administered fails a large portion of low-income workers, and reforms are needed that respond to the realities of today’s labor market. Although the main child care assistance program, the Child Care Development Fund (CCDF), uses block grants to give states flexibility in how subsidies are administered, research shows that subsidies are more likely to be used at day care centers, in part because some states do not allow subsidies for informal child care.⁸¹ Research suggests that this negatively affects mothers who work outside of regular business hours because they have difficulties accessing traditional day care centers and therefore are less likely to receive child care assistance.⁸²

Increasingly, today’s economy requires workers to be working outside of regular business hours. We need to ensure that the CCDF is administered in a way that provides maximum flexibility for parents who work a variety of schedules. Not only will this ensure that workers are available to meet business demands, but also it will better incentivize employment among low-income families while helping parents find child care that is safe and secure. This involves encouraging states to provide subsidies for informal providers, to increase the flexibility of subsidies for the individual (for example, encouraging states to split vouchers across providers), and to explore alternative ways to provide child care assistance to workers with nonstandard hours, such as refundable tax credits.

Policymakers should also address the massive benefit cliffs present under current law. Many low-income workers fear taking a higher-paying job because of the possibility that they could lose their child care benefit and end up worse off than they were before the raise. Reforms should address this benefit cliff, ensuring that families are always encouraged to take a raise or a better-paying job.

One approach would be to model benefits on the British Universal Credit, which was designed to slowly and rationally taper benefits to avoid massive work disincentives.⁸³ More gradually phasing out child care benefits to address the benefit cliff might cost more, but it could enable future net gains by improving

the financial situation of families. In addition, better coordinating the phasing-in and phasing-out of the EITC, child tax credit, child care tax credit, and CCDF subsidies could lessen the marginal tax rates for low-income families.

Conclusion

The next administration has an obligation to improve our safety net and help it better encourage work and earned success. By addressing the major deficiencies of each major means-tested program, policymakers could take a big step toward promoting opportunity for all.

The Federal Budgetary Implications of Reform Recommendations

The reforms recommended in these pages for the major entitlement programs should be assessed first for what they will mean for the effective operations of the programs themselves. That is the only way to garner public support. Even so, entitlement reforms must also help steer the nation away from the fiscal crisis that is almost certain to occur absent a course correction.

The starting point for evaluating the fiscal effects of various reforms is understanding what current projections show is likely to occur absent reform. Figure 10 summarizes the fiscal situation today and in 2040, assuming current policy. Both federal spending and revenue are projected to increase rapidly in the coming 25-year period, but spending growth will far outpace the rise in revenues. Today, all noninterest federal spending equals about 19.2 percent of GDP. The CBO expects federal spending excluding net interest payments to rise to 21.2 percent of GDP in 2040, but that assumes a major downsizing of the nation's defense capabilities and deep cuts in domestic appropriations. Neither is likely to occur.

At the same time, current projections show spending on major entitlements increasing from 12.6 percent of GDP today to 16.6 percent of GDP in 2040—a large bump in a relatively short time. Revenue is expected to rise from 18.4 percent of GDP today to 19.5 percent of GDP in 2040. This revenue increase is driven heavily by taxes enacted in the ACA that would generate increasing revenue each year because of their design. These tax increases, however, are both unwise for economic reasons and unlikely to survive in their current form because of the onerous burdens they will impose in future years.⁸⁴

Entitlement reform is essential to reducing spending pressure within the federal budget so that irrational and counterproductive cuts in defense spending and poorly

designed tax increases can be reversed, even as the gap between total revenue and spending is also narrowed.

As shown in Table 1, the target for savings from entitlement reform needs to be ambitious but also achievable. Reforms to Social Security and health entitlement spending should reduce projected spending in these programs by about 4.1 percent of GDP. Even with this level of savings, spending on these programs in 2040 would exceed what it is expected to be in 2016. Much smaller savings, around 0.2 percent of GDP, would be needed in safety-net and other entitlement programs.

Savings of this magnitude in entitlement spending would allow for a far more rational assumption of funding for defense requirements and nondefense appropriated accounts. And tax revenue in 2040 could stay much closer to the historical norm of around 18 percent of GDP.

The entitlement-reform recommendations included in this volume are more than sufficient to meet the savings goals outlined here.

The Budgetary Effects of the Social Security Reforms

Under the Social Security Trustees projections, Social Security will run an actuarial deficit of 1.68 percent of taxable payroll over the next 75 years. This implies that an immediate and permanent payroll tax rate increase of 1.68 percentage points, from 12.4 percent to 14.08 percent, would be needed to keep the combined Social Security trust funds solvent for 75 years if no changes in spending were enacted. The CBO projects a larger 75-year deficit of 4.4 percent of taxable payroll, while a recent expert Technical Panel appointed by the bipartisan Social Security Advisory Board projected a 75-year shortfall of 3.42 percent of payroll.⁸⁵

Table 1. Long-Term Federal Budget Projections and Targeted Savings

	Percentage of GDP		
	2016	2040	
	Current Policy Projection	Current Policy Projection	Target with Reform
Defense	3.3%	2.3%	~4.0%
Non-Defense Discretionary	3.3%	2.3%	~2.8%
Social Security and Health Care	10.3%	14.4%	~10.5%
Other Entitlements	2.3%	2.2%	~2.0%
Total Non-Interest Spending	19.2%	21.2%	~19.3%
Revenue	18.4%	19.5%	~18.0%

Source: Authors' calculations.

The finances of the flat-benefit plan proposed in this volume have been analyzed relative to the Trustees projections using a set of models developed by the Policy Simulation Group.⁸⁶ Relative to the Trustees baseline, the flat-benefit plan generates a 75-year actuarial surplus of approximately 0.9 percent of taxable payroll. This implies that the flat-benefit plan would more than restore long-term solvency under the Trustees and the Technical Panel projections, although not under the more pessimistic CBO projections.

Relative to the Trustees baseline, the flat-benefit plan would keep the trust funds solvent for 75 years and would be expected to maintain solvency thereafter, a condition referred to as “sustainable solvency.” Beginning around 2050, Social Security would be expected to run payroll tax surpluses. These surpluses would present policymakers with decisions regarding whether to increase benefits or reduce the payroll tax rate.

It is important to pass on to future generations programs that are expected to be financially sustainable. This would provide those generations with options regarding plan design, rather than confronting them with only painful decisions about how to address unfunded benefit obligations accrued under prior generations.

In terms of the overall federal budget, annual figures are generally more helpful. At present, Social Security costs 4.98 percent of GDP annually and is running dedicated tax shortfalls equal to about 0.46 percent of

GDP. By 2050, Social Security’s Trustees project the program to cost 5.93 percent of GDP and run a tax deficit of 1.19 percent of GDP.

Under the flat-benefit plan, program deficits would peak in 2028 at 0.81 percent of GDP, although the program’s trust fund would remain solvent and thus allow for full benefit payments at that time. By 2050 Social Security would run a program surplus of 0.11 percent of GDP under the flat-benefit plan, rising to 1.39 percent of GDP by 2075. Thus, in 2050, the flat-benefit reform alone would improve Social Security’s financial position by about 1.3 percent of GDP. We expect the savings to be slightly less in 2040, but not substantially so.

The Budgetary Effects of the Health Care Reforms

Many of the major reforms in health entitlement spending proposed in this volume have been independently evaluated by the Center for Health and Economy, particularly the replacement of the ACA and Medicare changes.⁸⁷ That cost estimate showed that the reforms would substantially reduce federal spending and deficits over the coming decade. The net budgetary impact of the many substantial policy changes would reduce the federal budget deficit by \$230 billion in 2025.

Although the center generally does not produce longer-term estimates, for purposes of this proposal, the cost estimate showed potential annual savings growing to around \$400 billion annually by 2035. Savings of this magnitude would equal about 1 percent of GDP.

This estimate almost certainly underestimates the savings from these reforms because there is substantial uncertainty around the savings achievable from a significantly more market-oriented approach to delivering entitlement benefits. There is widespread agreement that much of current health spending is wasteful. The only question is how much of that wasteful spending can be eliminated with various reforms.

We believe the recommendations made in this volume would produce even greater savings than estimated by the center because of the strong incentives for consumers to forgo low-value and ineffective care. But if those savings do not occur, it will still be possible to adjust the program after initial enactment to cut costs further. This would generally entail raising the eligibility age for Medicare above 67, reducing even further the benefits provided to upper-income retirees, and

asking all program participants to pay for a larger share of the health care premium in retirement.

The Budgetary Effect of the Safety-Net Reforms

The needed savings from the safety-net reforms are far less than what will be required from Social Security and the health entitlement programs. By 2040, savings of only 0.2 percent of GDP are required in the budget plan outlined here.

The reforms we recommend have not been evaluated for their cost-saving effects. However, we are confident that the reforms, all of which are aimed at improving independence, encouraging work, and eliminating wasteful spending, will reduce overall program costs. We fully expect the savings from this effort to produce savings far in excess of the goal, much like the welfare reform program passed in 1996 produced more long-term savings than was expected at enactment.

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