Fixing Social Security and Medicare for Good*

by

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I'm delighted and honored to address this conference on improving social insurance programs. Before I begin, let me make a small confession. I love listening to the sound of my own voice, particularly when I can force others to enjoy it as well. So I chose the title for my talk, "Fixing Social Security and Medicare for Good," for purely selfish reasons, namely to maximize attendance.

I figured that those who hate Social Security and Medicare would think that the only way one could definitely fix the programs was to get rid of them completely, and that this contingent would be dying to hear how I'd do it. And I figured that those who love the programs would be dying to hear how I'd preserve them for all eternity in precisely their current form. As for those who neither love nor hate Social Security and Medicare, I realized they'd come just to hear the screaming from whichever side I decided to make nuts.

But now that I've got you here, I'm going to disappoint you all by arguing that those who profess to hate Social Security and Medicare and those who profess to love these programs actually agree on fundamentals and have been arguing with each other, like my kids argue, primarily for the fun of it. Well it's high time for all of us to stop acting like children, to really start really listening to one another, and to look at the fundamental features of our proposals.

Being neither an open Republican nor an open Democrat, neither a professed conservative nor a professed liberal, and neither a self-proclaimed libertarian nor a self-proclaimed socialist, I've been viewed by all sides over the years as ripe for recruitment. Consequently, I've been invited to numerous social insurance conferences sponsored by the far left, the far right, the middle right, the middle left, and the upside down and the inside out.

What I've learned from going to all these meetings, apart from the great importance of avoiding the food, is that all sides are actually saying very much the same thing and are in basic agreement on the following ten principals.

1. Old people should not be allowed to starve to death.
2. Old people should not be deprived of basic medical care.
3. Workers should be forced to save for retirement.
4. Workers should have basic life and disability insurance.
5. Poor people should be given a break.
6. Women and minorities should be treated fairly.
7. Social insurance programs should be transparent.
8. Social insurance programs should be efficient.
9. Social insurance programs should not bankrupt the next generation.
10. Social insurance programs should not destroy the economy.

Ok, ok, I'll be honest. When I go to the Cato conferences, there are always a couple of participants who openly thrill at the idea of leaving people completely free to screw up their financial lives. And yes, when I go to the Brookings conferences, there are always a couple of participants who will swear until they're blue in the face that each and every one of Social Security's 2528 rules for paying benefits was delivered to Moses on Mt. Sinai.

But these people are clear minorities. When you actually look at the reform plans emanating from the Cato Institute and the Brookings Institution -- when their members are forced to get down and dirty and spell out exactly what they'd like to see done -- the plans satisfy each of the ten principals. In particular, the folks at Cato agree that we need to force people to save and insure, and those at Brookings agree that we need to cover, in full, the liabilities of whatever forced saving and insurance programs we put in place.

Now if Social Security and Medicare were minor programs that were in good financial shape, I wouldn't have been invited here to regale you with my marvelous wit and deep wisdom. But both programs, as you well know, are really big and slated to get a whole lot bigger thanks to the baby boom, the baby bust, and the increase in longevity.

Close you eyes for a moment and think about the entire country being older than current-day Florida. Think about filling up all of New York and Los Angeles with the old old – those age 85 and older. And think about filling up all of Boston with centenarians – those age 100 and over. Finally think about who is going to pay the benefits promised to all these oldsters that are heading inexorably into America's future.

If thinking about this makes you very very scared, you've got your thinking cap screwed on right. According to the *Treasury Papers*, continuing with current policy is a prescription for national bankruptcy. The hard reality is that under current policy we face future bills, coming in large part from Social Security and Medicare, which far outstrip the future receipts we can expect to collect from all government income sources. Indeed, the gap between the future bills and the future receipts amounts, in present value, to $45 trillion!

So what are the Treasury Papers? They refer to the comprehensive, long-term fiscal analysis that was a) commissioned by former Treasury Secretary Paul O'Neil, b) conducted last Fall in meticulous detail by then Deputy Assistant Treasury Secretary for Economic Policy, Professor Kent Smetters, and then Treasury consultant, Dr. Jagadeesh Gokhale, and c) censored by the administration the minute Secretary O'Neill was sacked.

$45 trillion is a lot of money by anyone's standard. One way to comprehend it is to look at the following menu of pain – the alternative immediate and permanent fiscal policies needed to eliminate this fiscal gap. The menu contains the following equally indigestible entrées. The first is raising federal income taxes, personal and corporate, by 60 percent. The second is raising payroll taxes by 95 percent. The third is cutting federal discretionary spending by 106 percent. And the fourth is cutting Social Security and Medicare benefits by 45 percent.

The Menu of Pain

Policy	Immediate and Permanent Percentage Change
Increase Federal Income Taxes	69
Increase Payroll Taxes	95
Cut Federal Purchases	106
Cut Social Security and Medicare	45

Source: Jagadeesh Gokhale and Kent Smetters, "Fiscal and Generational Imbalances: New Budget Measures For New Budget Priorities," Washington, D.C.: The American Enterprise Institute, 2003.

Bear in mind that these figures aren't coming from alarmists like me. They are coming straight from the United States Treasury and are so scary that the administration has gone to remarkable lengths to deny the study was ever commissioned, produced, or censored. Fortunately, Smetters and Gokhale have released the study through the American Enterprise Institute at great risk to their future employment with Republican administrations.

In pointing out the perfidy of this administration, I don't want to give you the impression that I'm Arnold Schwarzenegger – a closet Democrat with a fantastic build. As I keep telling my wife, I do have a fantastic build, but I'm not a closet anything. The fact is that protecting us from the truth about our true fiscal condition is not just a Republican responsibility or practice. The Clinton Administration did precisely the same thing back in 1993 when it censored a careful OMB generational accounting study that was slated to appear in the FY94 Federal budget.

Now, I'm sure that some of you aren't scared by the menu of pain because you just don't trust long-term projections. Well, ok, I can understand that. Long-term projections are subject to lots of uncertainty. There are lots of assumptions involved and choices to make about discount rates, etc. So for you doubting Thomases and Thomasinas, I recommend a quick visit to the CBO's website where you can peruse the CBO's August 26th short-term budget projections. In addition to forecasting a half trillion deficit for the next fiscal year, the CBO indicates that if discretionary spending grows with the economy, if expiring tax provisions are extended, if the alternative minimum tax is reformed, and if a Medicare drug benefit is enacted -- all of which appear highly likely -- the 2002-11 deficit will total $4.6 tillion! That's $11.4 trillion more in debt than the CBO predicted for the same period prior to the last election. And in 2011, the baby boomers will just be starting to collect their Social Security and Medicare benefits! By 2030, when all the boomers are retired, we'll have twice the number of oldsters but only 18 percent more workers to pay their benefits. No amount of poo-pooing projections will change our short-term fiscal mess or that longer-term demographic reality.

The bottom line is that if you aren't scared about the enormous generational storm we're facing, you must be on a particularly high dose of Prozac.

So what's to be done? My answer is two reform proposals –one for Social Security and one for Medicare -- that satisfy each of the 10 universally accepted principals outlined above and are, in my view, the only reasonable things to do. Both are simple plans. Indeed, as you can see from the handout, both can fit on the back of a postcard, meaning they can accommodate most politicians' attention spans.

Adoption of the two proposals would eliminate roughly half of our long-term fiscal gap and represent a huge step toward fiscal sanity. I've also got some ideas for how to eliminate the rest of the fiscal gap, but I'll leave those to the end.

Reforming Social Security

Here's my 3 inch by 5 inch Social Security plan. The first thing to notice is that the plan shuts down, *at the margin*, the retirement or Old Age Insurance (OAI) portion of Social Security. Current retirees continue to receive their full OAI benefits, and current workers receive, *in retirement*, all the OAI benefits owed to them as of the date of the reform. But once the reform is implemented, the accrual of additional OAI benefits is history.

The Personal Security System

1. The accrual of additional Social Security retirement (OAI) benefits is eliminated.
2. Current retirees and current workers receive their accrued Social Security retirement benefits.
3. The OAI payroll tax is eliminated and replaced with equivalent compulsory PSS contributions.
4. A new federal retail sales tax is used to pay off OAI accrued liabilities.
5. Workers' PSS contributions are shared 50-50 with their spouses.
6. The government contributes to PSS accounts on behalf of disabled and unemployed.
7. The government matches PSS contributions on a progressive basis.
8. All PSS balances are invested in a single, market-weighted global index fund.
9. The government guarantees the real principle contributed to PSS accounts.
10. At retirement, PSS balances are gradually sold to buy inflation-protected annuities.
11. Prior to retirement, workers' PSS accounts are bequeathable.

So what exactly would current workers receive from Social Security in retirement benefits in exchange for their past contributions to the system? They'd receive exactly what they'd get under the current system if they opted to become beach bums and never work another day in their lives. In this case, they'd show up at retirement with zeros in their Social Security earnings records indicating they'd had no covered earnings since the time they hit the beach. Under the PSS plan, workers would have zeros filled in their earnings records from the date of the reform onward. So in retirement, they'd receive the OAI benefits accrued as of the reform, but nothing more.

For workers close to retirement, their accrued Social Security retirement benefits are very close to what they'd received under the current system. But for today's young workers, their accrued Social Security benefits are very small. This means that over time (actually, over about 45 years), the aggregate amount of Social Security benefits that will need to be paid each year will decline to zero.

The next thing to see is that the plan doesn't mess with either survivor (SI) or disability (DI) benefits. It also leaves in place the payroll taxes needed to finance these two programs. Workers would continue to make SI and DI contributions and they and their survivors would continue to receive precisely the same SI and DI benefits as under the current system.[1]

Provisions 3 and 4 in the plan deal with funding a new retirement saving system and paying off accrued OAI benefits over the next roughly 45 years. Provision 3 eliminates the OAI payroll tax, but requires workers to contribute the money they'd otherwise pay in OAI taxes to PSS accounts. Provision 4 introduces a new federal retail sales tax to pay off OAI benefits during the transition. Since the total amount of OAI benefits needed to be paid would gradually decline to zero, this retail sales tax, which would start out at roughly 12 percent, would also phase out through time, although not to zero as discussed shortly.

Before any of you start screaming that a sales tax is regressive and will hurt the poor, remember that sales taxes are, in part, wealth taxes because when rich people spend their wealth to buy caviar, BMWs, yachts, face lifts, etc. they end up spending part of their wealth on taxes. Also, please realize that the elderly poor who are living solely off of Social Security will be completely insulated from the effects of the retail sales tax. The reason is that when the tax raises consumer prices, the Social Security benefits of the poor and everyone else will be automatically adjusted for a simple reason: Social Security benefits are indexed to inflation by law.

Ok, so what about the young and middle-aged poor? Well, they'll have to pay the sales tax, but they will be spared having to pay the OAI payroll tax. If you're a card-carrying and are worried I'm pulling a fast one on the working poor, please ask yourself whether you think a minimum wage worker would prefer to a) pay roughly 8 percent of her wages in Social Security OAI payroll taxes now, with the prospects of that tax rate doubling through time and of her future Social Security benefits being slashed, or whether she'd b) prefer to pay a 12 percent sales tax now, with the sure knowledge that the sales tax rate will decline through time to around 3 percent and that her retirement income will be much more secure.

I figure you card-carrying liberals will opt for b particularly when you realize that the reason the plan can spare poor workers higher future taxes and, indeed, can lower the taxes they face through time, is by forcing today's and tomorrow's middle class and rich elderly to shoulder a much bigger fiscal burden than is now the case. This is the really nice thing about a sales tax. Apart from the elderly poor, the tax hits everyone – old and young, and rich and poor. This is much different from the payroll tax that it would replace – which is paid only by young and middle aged workers and is paid only up to a ceiling, which currently is $87,000. Because of this ceiling, the nation's 2.1 million millionaires and its 57,000 super richies – those with more than $30 million in assets -- pay a pittance, if any, of their annual incomes in OAI payroll taxes. But these people sure do know how to shop, and everything they buy, including all those incredibly expensive tickets for choice Superbowl seats, would be subject to the new federal retail sales tax.

Provisions 5 and 6 are designed to protect non-working spouses, spouses who are secondary earners, the disabled, and the unemployed. The idea is that every American adult would have a PSS account. Married workers would have to split the contributions 50-50 with their spouses, so each would end up with an equal sized PSS account. The government would contribute on behalf of the disabled and the unemployed, so these people too would end up with secure retirements. Thanks to provision 5, spouses who don't work and spouses who work, but earn a lot less than their partner, receive the same retirement income. In addition, divorced spouses walk away with their own accounts.

The 7th provision calls for the government to make matching contributions to PSS accounts on a progressive basis. The new retail sales tax would finance these matching contributions as well as cover contributions on behalf of the disabled and unemployed. That's why it would never fall all the way to zero. The current OAI system provides benefits on a progressive basis. The government's matching contributions would be structured to ensure the same degree of progressivity in the new PSS system as under the current OAI system.

Provisions 8 and 9 indicate that PSS account balances would be invested in the global financial market, but that the government would insure the downside of this invesment; i.e., it would guarantee that workers never lose the real principal that they invest in their accounts. The worst they could experience is a zero real rate of return. This means that all workers would hit retirement with account balances equal to at least the value of their past contributions adjusted for inflation.

A critical feature of the plan is the requirement that all account balances be invested in a single security – a global index fund of stocks, bonds, and real estate. Yes, we know that many Republicans members of Congress think workers should be able to invest personal account balances any way they'd like. And yes, we agree that the freedom to make a killing on the market or lose every penny you own is a cherished American right when it comes to private saving. But we aren't talking here about a private saving system. We're talking here about replacing an outmoded, inequitable, and inefficient compulsory saving system with a modern, equitable, and efficient one, whose entire raison d'etre is to make sure workers have solid financial support in old age.

With complete investment discretion, Joe Sixpack and Sally Corona Light might make precisely the same contributions to their PSS accounts each year, but end up with vastly different living standards in retirement because Joe took his uncle's stock tips and lost his shirt and Sally selected a diversified portfolio that yielded a good return. On the other hand, were Joe to accidentally make a killing, Sally would feel she was an idiot to have played it safe. She'd also feel vaguely mistreated. After all, she'd made the same contributions as Joe, but he ended up living the life of Riley (who the heck was Riley anyway?), and she ended up scrimping on her prescription drugs.

Government-mandated retirement income security means different things to different people. But it surely doesn't mean that Uncle Sam drives Joe and Sally over to the local casino, gives them the same amount of money, points to the slot machines, and says "Good luck securing your retirement." No Democrat, who deserves the name, will ever agree to turning Social Security into a crap shoot. On the other hand, no Republican, who deserves the name, believes that Social Security should continue to be run as a Ponzi scheme/chain letter that steals from the young to give to the old and placates the young by promising to give them a share of the future loot.

Provisions 8 and 9 reconcile both sine qua nons. The Republicans get a fully funded retirement saving system that's invested in the market. The Democrats get a system that is equitable, as they define equity, and that protects workers from the downsize risk of investing in volatile financial instruments.

One reason to include provision 8 – investing all PSS balances in a single global index fund -- is that our friends on Wall Street aren't going to like it one bit. They've been having wet dreams for years about the prospect of reaping huge fees, loads, and commissions from investing Social Security contributions for America's workers. Under the PSS plan, our Wall Street buddies won't get their fat little hands on any of our money. Instead, a single computer, situated in the Social Security Administration, would, be programmed to buy and sell securities to ensure that the share of each security in the PSS global index fund always equals that security's share of the total value of the global financial market. The Social Security Administration would also take care of all the PSS paper work, including sending workers annual reports about their account balances.

Am I being too restrictive in not letting workers have some choice/control over their portfolio allocations? No, I'm not. Economic theory indicates that all households should be highly diversified in their asset holdings. I'm recommending the most diversified portfolio available. Giving workers the option to switch between different securities or even large classes of securities, like stocks and bonds, will lead them to try to time/play the market even were they permitted to make trades only once or twice a year. And the transactions costs of allowing such gambling will eat up too much of the available return.

By providing a lower limit of zero on the real return workers can earn, the proposal provides what amounts to portfolio insurance for the PSS accounts. The cost to the government of providing this insurance appears to be very low. But its inclusion in the plan is imperative to raise the comfort level of those scared by the short-run volatility of financial markets.

What's the rationale for including foreign stocks and bonds in the PSS index fund? It's diversification. By investing abroad, the fund will lower the riskiness of the return of the PSS index without lowering its average return. What I have in mind here is that fund would invest in all major internationally traded securities. I'm not talking here about holding shares of the Almalty stock market. (Almalty, by the way, is the capital of Kazakhstan.) What I'm talking about is investing in the London, Paris, Frankfurt, Tokyo, Hong Kong, and other major foreign stock and bond exchanges. Who would decide what constitutes the global index fund? I'd leave that decision to the Social Security Trustees who would ultimately be responsible for overseeing the new PSS system. In making that decision, they'd have to weigh the transactions costs of purchasing foreign securities against the diversification advantage.

The plan's 10th provision involves the sale of each participant's account balances at retirement and using the proceeds to purchase annuities. This sale of PSS balances would start at age 57 and continue each day for 10 years until the participant reaches age 67. By liquidating PSS balances in this very gradual manner there is much less risk of selling when the market is temporarily low. The sale would be organized by the Social Security Trustees, and participants would receive inflation-projected pensions (annuities) starting at age 62 reflecting the proceeds of all account balances sold prior to age 62. Each year between ages 62 and 67 the amount of annuities provided to the participant would be increased based on that year's sale of the participant's remaining holdings of the global index fund.

The trustees would provide the annuities to all members of an age cohort on equal terms given the cohort's life expectancy. In providing these annuities, the Trustees would invest the proceeds from the sale of the participants' global index funds exclusively in long-term inflation-indexed government bonds. This will permit the annuities that are provided to incorporate a 2 to 3 percent real return in addition to the return arising from the mortality rates of cohort members.

The PSS plan's final provision specifies that all non-annuitized PSS account balances are bequeathable. So if a participant dies at age 55, his spouse or, if his spouse agrees in writing, his other designated heirs, would inherit his entire account balance. If a participant dies at, say, age 63, his spouse or designated heirs will inherit his remaining account balances, i.e., those funds not yet annuitized.

So, What's Not to Like?

Let me recap the PSS plan's advantages. The plan's progressive. It protects spouses. It protects divorcees. It protects the disabled. It protects the unemployed. It protects minorities and others with early checkout times. It provides everyone with the same return. It puts everyone in the market. It limits the downside risk of investing in the market. It minimizes transactions costs. It keeps investment bankers and insurance agents from getting their paws on our money. It provides everyone with the same annuity deal. It limits the market risk of annuitizing one's assets. It ensures ongoing, inflation-indexed income for the elderly as long as they live. It achieves maximum portfolio diversification. It precludes huge Social Security payoll tax hikes. And it distributes in a reasonable and fair manner the burden of paying off the benefits owed by the old system.

In short, it's a really great idea that everyone, even the politicians, seem to be willing to accept right up to the point where I mention the bit about paying off the Social Security benefits owed under the old system. This is where the politicians in particular start getting queasy. Here's their reaction:

> *Introducing a new tax is political suicide. What's to ensure the retail sales tax rate will actually fall through time? Can't the market yield on the fund cover the costs of the old system? How can workers afford both to pay the new tax and contribute to the new accounts?*

Here's my response:

> *I'm eliminating an old tax at the same time I'm introduce a new tax, so relax about this being a tax hike. The retail sales tax could be entered into the Constitution, for all I care, to make sure it's not used for extraneous purposes. No, the market yield on the fund is risky, so there is no guaranteed excess return on the market that can be used to pay transition costs. Workers who are already saving outside of Social Security in, say a private account of through a 401(k) plan, can choose to reduce that other saving in response to the establishment of PSS accounts. And workers who aren't saving anything outside of Social Security need to do so, and the compulsory contributions to PSS accounts effectively compel that outcome.*

Well, have I convinced you? If not, this may do the trick. Of the $45.5 trillion 2003 fiscal gap, $7.2 trillion is attributable to Social Security's unfounded liability, again, using the government's fiscal taxonomy. This figure includes the unfunded liabilities of the survivor and disability programs. Consequently, the PSS plan wouldn't reduce the fiscal gap by the full $7.2 trillion, but by more like $5 trillion. Still, that's a ninth of our problem and every trillion dollars in this business counts for a lot.

Whether of not I've sold you on the PSS plan, it's now time to cure Medicare.

Curing Medicare

The government has tried for years to slow down Medicare spending. It's tried lots of different approaches. It's tried limiting the amounts doctors and hospitals receive for particular procedures. It's tried giving doctors and hospitals fixed amounts of money based on their patients' medical problems. And it's tried to get Medicare participants to enroll in health maintenance organizations.

None of these approaches has succeeded to reign in Medicare costs for more than a year or so. In 2001, the last year with solid data, real Medicare benefits per beneficiary grew by a staggering 8 percent. Real wages in that year hardly grew at all. Since lowering real Medicare benefits once they've been increased is well neigh impossible, everyone now collecting Medicare and everyone who will ever collect Medicare got a big bonus for free in 2001. In particular, all 77 million baby boomers can expect 8 percent higher real Medicare benefits when they retire.

The root of the Medicare growth problem is the program's "fee for service" structure. This stands for the fact that health care providers can charge Medicare a fee when they provide Medicare participants a service. One might think that capping the fees would limit total expenditure, but doctors and hospitals simply change the classifications of the services they provide to ones that provide higher fees. Or they schedule more visits. Or they order more expensive tests. Or they do all of the above.

Moving away from the "fee for service" system is essential to keeping a lid on Medicare spending. Congress was on to this when it tried to give the HMOs fixed sums to take Medicare beneficiaries off the government's hands. The notion was that HMOs would have every incentive to limit unnecessary medical care because, at the margin, they'd have to pay for it. The hope was that HMOs would introduce enough competition into the medical sector that Medicare would also save money on participants who remained in the traditional fee for service program.

Things didn't work out as expected. The HMOs realized what Congress was up to and sought out the healthiest Medicare participants. And the least healthy Medicare participants realized that joining HMOs would mean facing restrictions on their access to care. So they stayed away. The result was that the government overpaid many HMOs for taking on the relatively healthy and inexpensive Medicare beneficiaries who actually signed up.

In the case of HMOs who accidentally found themselves with particularly sick and expensive Medicare beneficiaries, the solution was simple – ask the government for more money. When the government refused, these HMOs simply kicked out their existing Medicare patients and stopped taking in new ones. In recent years, half of the HMO programs established by private companies to enroll Medicare participants have closed. In so doing, they told 1.1 million Medicare beneficiaries to get lost.[2]

Having failed miserably to enlist the private sector to keep it from spending ever more on Medicare, the government is in the process of trying to do the exact same thing, with two exceptions. This time it plans to provide a larger bribe to HMOs to enroll Medicare recipients as well as a larger bribe to Medicare participants to switch to HMOs. The former bribe is straightforward – just provide Medicare participants with what amounts to a larger voucher to enroll in an HMO. The later bribe comes in the form of prescription drug benefits that the Administration and Republican members of Congress want to make more generous if participants join HMOs.

The House and Senate are now trying to reconcile their two prescription drug benefit bills. Whatever compromise bill emerges, it will be incredibly expensive. According to George Will, it represents "the largest expansion of the welfare state since the Great Society 40 years ago."[3]

George Will may not be your cup of tea, but on this one, he's got it right. The Treasury Papers, anticipating the passage of a Medicare prescription drug benefit, included $6 trillion of present value costs for the new program. But according to its authors -- Gokhale and Smetters -- the legislation now being contemplated will raise that figure at least to $7 trillion and, possibly, to as high as $12 trillion. At the $12 trillion price tag, the fiscal gap will rise to $51 trillion!

The only explanation for this fiscal lunacy is that the Administration and members of Congress are, themselves, on drugs. Mind you, I agree 100 percent that the elderly need prescription drug insurance. And I think it should be a key part of Medicare. What I don't agree with is engaging in a major expansion of Medicare when the government is completely broke, when it has no idea how to pay for the Medicare program we've already got, and when the elderly who are to receive this insurance have not the slightest intention of paying any of its costs.

Getting Real

It's time to get real. There is just no way that we can maintain Medicare's fee-for-service method of paying the elderly's health care bills. We can't maintain that program in full. And we can't maintain it in part. Doing so will always leave the system open to adverse selection, with private insurers trying to enroll healthy oldsters and ditching unhealthy ones.

On the other hand, closing down the fee for service program (traditional Medicare) and simply handing each Medicare participant a fixed sum of money, in the form of a voucher, with which he or she can purchase health insurance is also no solution, again because of adverse selection. The insurance companies will force people who want to join their plans to reveal their health status and charge an arm and a leg to those with pre-existing medical conditions. And if potential enrollees refuse to take a medical test or hand over their records, the insurance companies will assume the worst and charge them for the risk they pose. Either way, those who need health insurance coverage the most will be least able to afford it

There is one and only one way out of this. Fortunately, it's very simple. Its key risk-rating idea has been advocated for quite a while by Dr. John Goodman, the Director of the National Center for Policy Analysis (NCPA), and by Dr. Peter Ferrara, Senior Fellow of the NCPA.[4]

I call the plan The Medical Security System or MSS. Its eight provisions are listed in the following postcard.

The Medical Security System

1. The traditional fee-for-service Medicare system is discontinued.
2. Medicare participants receive vouchers to purchase health insurance coverage.
3. Voucher amounts are participant-specific and depend on the participant's health status.
4. New vouchers are issued annually, and participants can change plans annually.
5. Insurers/HMOs cannot deny coverage, nor delay service.
6. Insurers/HMOs must provide basic coverage, including prescription drug benefits.
7. Insurers/HMOs are free to market additional coverage at additional premiums.
8. Government sets voucher amounts to limit per capital MSS growth to that of real wages.

The idea here is to close down the fee-for-service program, provide all Medicare participants with vouchers, but make those vouchers *individual-specific*. Participants would receive a voucher each year, say on October 1st, to use to purchase insurance coverage for the following calendar year. The size of the voucher would be based on the participant's current medical condition. Hence, a perfectly healthy 67 year-old might get a voucher for $3,000, whereas an 85 year old with pancreatic cancer might get a voucher for $100,000. Because those in the worst medical shape would have the largest vouchers, insurance carriers would be just as happy to have them as customers as their healthy contemporaries.

The key thing from a cost perspective is that the government can establish the values of the vouchers each year such that the total expenditure on vouchers per MSS beneficiary grows only as fast as real wages. This would slice $17 trillion or so off the fiscal gap without any of the elderly feeling they'd been hurt. Indeed, they wouldn't be hurt. Their real medical benefits would continue to rise, but not as fast as in the past. And instead of worrying about the future collapse of the system, they could rest assured that the government would be able to pay their basic health costs through time.

The government would, of course, have to collect up-to-date records about participants' medical records. But given current computer technology, establishing such a system seems straightforward. And because the government would maintain this information, one could be confident that it would be kept confidential and provided only to insurance carriers at the request of the Medicare participant.

All insurance carriers who wished to enroll Medicare participants would be required to provide a basic set of benefits, including prescription drug coverage. But the insurers would be free to sell additional coverage at premiums they would set for these additional services.

The Medicaid Bonus

After Social Security and Medicare, the largest federal government transfer program is Medicaid, which pays for medical care to the poor, including the poor elderly. In the case of the poor elderly, Medicaid pays for nursing home care and picks up those bills left unpaid by Medicare.

Total Medicaid and Medicare expenditures are quite close in magnitude, but the federal government covers only about three fifths of the program's costs. The rest is paid by state governments under matching arrangements. These arrangements differ across states. In some states, like Mississippi, the federal government matches the state government's Medicaid expenditures on a roughly 4 to 1 basis. In others, the matching rate is 1 to 1. The two programs have experienced and are projected to experience quite similar growth rates.

Like controlling long-term Social Security and Medicare spending, getting Medicaid spending under control is critically important. Medicaid is not only helping bankrupt the federal government, it's the key cause of the burgeoning red ink in most state government budgets. As in the current Medicare system, Medicaid is structured to ensure that the federal government has no ultimate control over the total amount it ends up paying for the program. In Medicaid's case, the states know that the feds will reimburse them between 50 cents and 80 cents on ever dollar they spend on health benefits for the poor. This artificially lowers the costs to the states of expanding Medicaid. In addition, in most states Medicaid is still run on a fee for service basis, leaving participants free to utilize as much of the available medical system's services as they'd like with no need to worry about the costs associated with that usage.

The nice thing about the Medical Security System proposed to replace Medicare is that it could equally well be used to replace Medicaid. The federal government, in conjunction with the state governments, could simply provide each Medicaid participants with an individual-specific voucher each year that the participant would use to purchase health insurance.

Getting to Yes

If you've kept count, you know that even if we implement the two proposals here advanced for Social Security and Medicare reform we'll still be left with a, roughly, $23 trillion fiscal gap. How do I intend to close that?

First, I'd extend the Medical Security System reform to Medicaid. This would save another $10 trillion in present value. Second, I'd eliminate all three of the Bush tax cuts. This would shave roughly $9 trillion off our $23 trillion target. The third thing I'd do is limit federal discretionary spending to 6 percent of GDP, which is the ratio of federal spending to GDP that prevailed when President Bush took office. Since this spending is now running at 7.4 percent of GDP, we could save another $8 trillion in present value through this channel. These three steps would more than cover the remaining $23 trillion fiscal gap.

So, yes, there is a way out of the morass. It involves fundamental reforms of Social Security, Medicare, and Medicaid, the enactment of a new retail sales tax, the elimination of the unaffordable tax cuts, and restraining discretionary spending. None of these steps will be easy, but each is essential if we hope to preserve the American dream for our children, grandchildren, and generations of Americans yet to come.

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[1] I.e., for purposes of computing survivor and disability benefits the Social Security administration would not enter zeros into workers' earnings records post the reform.

[2] See "Private Plans Again Seen as Aid to Medicare," *The New York Times*, July 5, 2003, p. 1.

[3] Will, F. George, "Bush's Bad News for the Right," *The Boston Globe*, Thursday, July 24, 2003, p A11.

[4] See Ferrera, Peter, John C. Goodman, Gerald Musgrave and Richard Rahn, "Solving the Problem of Medicare," National Center for Policy Analysis Policy Report No. 109, Jan. 1984, and Andrew Rettenmaier and Thomas R. Saving, "Saving Medicare," National Center for Policy Analysis Policy Report No. 222, Jan.1999.