



Sharing the Pain of Social Security and Medicare Reform

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AS THE BABY BOOMERS LEAVE THE WORK-force, additional stress on programs designed to support retirees will build, and some combination of benefit reductions and tax (or other revenue) increases will be necessary to maintain fiscal balance in both Social Security and Medicare. Benefit reductions might involve further increases in the Social Security retirement age, selected reductions in cash benefits, or increases in Medicare cost sharing. Revenue increases could involve general revenue transfers to finance either the cash benefit or hospital insurance programs directly or to fund a transition to individual accounts, or a more traditional payroll tax increase.

Both approaches would require financial sacrifice from some segment of the population. Relative to current trends, the income after taxes of either the working-age population or of the elderly population—or both—will have to be reduced. To date, too little attention has been paid to how different adjustment approaches affect who gets stuck with this financial sacrifice.

This brief explores a couple of these distributional consequences. It focuses first on the impact of Social Security and Medicare financing policies on the distribution of the gains from economic growth and then on the impact these policies would have on intergenerational transfers.

A growing economy will allow both workers and beneficiaries to be better off in the future than they are today, but the relative rate of improvement for each group will depend on the particular tax and benefit

changes that are used to balance Social Security and Medicare. This analysis finds that using increases in the payroll tax rate to close the projected Social Security and Medicare financing gaps would allow workers and beneficiaries to share the gains of future economic growth equally without imposing an undue burden on future workers.

DISTRIBUTING THE GAINS FROM ECONOMIC GROWTH

When the current indexing rules were adopted in 1977, Congress decided that initial Social Security benefits should rise over time at the same rate as average earnings. Economic growth was to translate into equal percentage increases both in the average wage earned by workers and in the average initial benefit paid to beneficiaries.¹ Six years later, the changes the Greenspan Commission developed to restore short-range financial stability were also advertised as part of a balanced approach. Of all the financing changes made between 1983 and 1989, 50 percent were payroll tax increases, 40 percent were benefit reductions, and 10 percent involved accelerating previously scheduled general fund payments.

Two aspects of the 1983 amendments have continuing implications for the relative growth rates of future wages and benefits, however. First, the package developed by the commission was not as balanced in the long run as it was in the short run because the tax increases were temporary, whereas the benefit reductions were not.² In particular, the taxation of benefits is phased in over several decades, altering the relationship between wage growth and benefit growth for some time.³ Second, Congress increased the normal retirement age from 65 to 67, reducing the monthly benefit payable at any given actual retirement age.⁴ It could be argued that this was meant to clarify that it is expected lifetime benefits, rather than monthly benefits, that are to rise in proportion to future wage growth.

If the Trustees' projections of future health care costs and Medicare spending are accurate, two additional factors will also reduce the economic well-being of future retirees. Premiums for Part B of Medicare (Supplementary Medical Insurance [SMI]), which usually are deducted from Social Security benefits, and Hospital Insurance (HI) deductibles will rise more rapidly

than Social Security cash benefits, consuming an increasing fraction of beneficiary income. Moreover, the cost of medical items not covered by Medicare, particularly prescription drugs, will probably also rise more rapidly than future benefits. These cost increases impose a particular burden on beneficiaries, both because the elderly spend more on health and because Medicare is less effective in covering health costs than are the policies covering most of the working-age population.

The financial situation of future workers will also be affected by rising health care costs. Increases in employer health costs will slow the future growth rate of money wages, out-of-pocket costs for items not covered by employer health plans will increase, and the cost of financing SMI will force an increase in general-fund taxes. Moreover, although no increases in the payroll tax rate are currently scheduled, future workers' financial status would be reduced if such increases became necessary to finance either HI or Social Security cash benefits.

Table 1 provides an example of the impact of these various factors on future workers and beneficiaries, allowing a comparison of the fiscal impact on each.⁵ The workers are assumed to have earned Social Security's average wage; the beneficiaries to have retired at age 65 after having always earned the average Social Security wage. The estimates are either taken from the intermediate projections of the 2000 Trustees' Reports or consistent with these projections.

The Trustees project that average real earnings under Social Security will rise by 62 percent over the next 50 years, from \$31,685 in 2000 to \$51,288 (measured in 2000 prices) in 2050. If the payroll tax rate remained unchanged, real earnings net of payroll tax payments would also rise by 62 percent.

Future adjustments will be needed, however, to deal with rising SMI costs. The Trustees project that total SMI spending will rise from 0.94 percent of GDP to 2.17 percent of GDP over the next 50 years. If this rising cost is financed through higher personal income taxes, increased tax payments will offset a portion of the projected wage increase, lowering the real gain after taxes to 59 percent.

Rising health costs will also increase the cost of both health insurance for employers and out-of-pocket health spending among the working-age population. The Trustees' baseline projection incorporates the impact of rising employer health care costs on future wage levels, but additional adjustments are needed to reflect the impact of increases in out-of-pocket spending.⁶ Out-of-pocket health spending by an average middle-income, nonelderly household is now about 3.5 percent of the household's total earnings; this calculation assumes that such spending will grow at the same rate as out-of-pocket spending by the elderly over the next 50 years. After adjusting for rising health spending and the income tax increases needed to finance SMI, inflation-adjusted net earnings in 2050 are 56 percent higher than net earnings in 2000.

The Trustees also project the retirement benefits that an average earner retiring at either the normal retirement age (the age at which full-rate benefits are payable) or at age 65 can expect to receive in the future. They project that the benefit payable at the normal retirement age to a worker who has always earned the average wage will increase by 77 percent in real terms between now and 2050, some 12 percentage points faster than their projected increase in the gross average wage.⁷ However, the legislated increase in the retirement age will reduce the value of the benefit payable at any specific age. The Trustees project that real benefits payable to average earners retiring at age 65 will rise by 52 percent over the next 50 years.

When the impact of rising health costs on the elderly is considered, a substantial gap opens between the projected financial gains for future workers and those for future beneficiaries. The SMI projections described earlier imply that inflation-adjusted premiums will rise by 142 percent between 2000 and 2050, trimming 5 percentage points off the projected net benefit increase. Maxwell, Moon, and Segal (forthcoming) estimate that Medicare copayments and deductibles will cost a typical beneficiary in 2000 some \$849 and that other out-of-pocket expenditures (chiefly for prescription drugs and Medigap insurance policies) will amount to another \$1,556 per year. When we use assumptions consistent with the Trustees' projections about Medicare cost growth in general, the rapid increase in out-of-pocket health spending reduces benefit growth by another 21 percentage points. Taken together, rising health costs appear to consume half of the real benefit increase projected for 65-year-old retirees.

Two additional adjustments complete the estimate of the impact of current trends on the net retirement incomes of future average earners. Gradually introducing Social Security benefits into the federal personal income tax base reduces net benefits by another 10 percentage points. This places the 2050 benefit just 16 percent above the level prevailing this year, after adjusting for tax and health cost increases. But the Trustees also project that 65-year-olds can expect to live three and a half to four years longer in 2050 than today, thereby increasing the value of any given Social Security monthly benefit. If each year's monthly benefit is converted to an annuity equivalent, longer life spans produce the equivalent of a 21 percentage point increase in benefits, partially offsetting the various factors that reduce benefits.

These projections suggest that current policies will *not* allow workers and retirees to share equally in the economic growth of the next 50 years. Under the assumptions used in the most recent Social Security and Medicare cost projections, current policies will produce a 56 percent increase in inflation-adjusted earnings (net of tax and health cost increases) for workers earning the average wage under Social Security. By comparison, after we adjust for tax and health cost

TABLE 1.

Projected Trends in Earnings and Benefits of Workers Who Earn the Social Security Average Wage, 2000 Trustees' Report Assumptions

	2000 (constant 2000 dollars)	2050 (constant 2000 dollars)	Percent Change
Current Path			
Workers			
Gross average wage	31,685	51,288	62
Less: Employee Social Security tax	2,424	3,923	—
Net wage	29,261	47,365	62
Less: Income tax increase to finance SMI	—	839	—
Wage net of tax increases	29,261	46,526	59
Less: Out-of-pocket health spending	1,062	2,430	129
Wage net of health spending	28,199	44,096	56
Beneficiaries			
Benefit at normal retirement age	11,875	20,985	77
Benefit at age 65	11,875	17,997	52
Less: SMI premium	546	1,320	142
Net benefit received	11,329	16,677	47
Less: Medicare cost sharing	849	1,702	100
Other out-of-pocket health spending	1,556	3,730	140
Benefit net of health expenditures	8,924	11,245	26
Less: Income tax on benefits	—	872	—
Benefit net of taxes and health expenditures	8,924	10,373	16
Annuity value of net benefit	110,000	150,000	36
Tax Increases to Close Current Funding Gap			
Workers			
Wage net of health spending	28,199	44,096	56
Less: Payroll tax increases	—	2,616	—
Wage net of health and all tax increases	28,199	41,481	47
Impact of Prescription Drug Benefit			
Workers			
Wage net of health and other tax increases	28,199	41,481	47
Less: Tax increase to finance drug benefit	—	277	—
Earnings net of all charges	—	41,203	46
Beneficiaries			
Benefit net of health expenditures	8,924	10,373	16
Plus: Value of drug benefit	—	713	—
Revised net benefit	8,924	11,086	24
Annuity value of revised net benefit	110,000	160,000	45

Sources: OASDI Trustees' Report (2000), CBO (1999), Bureau of Labor Statistics (1998), and Maxwell, Moon, and Segal (forthcoming).

increases, the inflation-adjusted monthly benefit payable to the average earner retiring at age 65 rises by only 16 percent—and its annuity value rises by only 37 percent.⁸

Future economic growth would be distributed more equally if the current Social Security and Medicare financing gaps were closed through tax increases rather than through benefit reductions. Benefit reductions would widen the gap between workers' and beneficiaries' gains, while tax increases would narrow the gap.

The impact of additional payroll tax rate increases is shown in table 1. For the purposes of this illustration, it was assumed that rate increases were used to balance both Social Security and Medicare over the 75-year projection period. The SMI increase is assumed to be 0.9 percent for both employer and employee and to take effect in 2015, while the Social Security increase is assumed to be 1.65 percent for both employer and employee and to take effect in 2020.⁹ Even if the worker pays both shares, the rate increase cuts only 9 percentage

points off the projected increase in net earnings, leaving earnings growth substantially ahead of benefit growth.¹⁰

If a prescription drug benefit were introduced under Medicare, prescription drug coverage would lead to an increase in the tax payments of future average workers and would reduce future beneficiaries' out-of-pocket health spending (see table 1). For the purposes of these calculations, it was assumed that a drug benefit would result in a net shift of 35 percent of the cost of prescription drugs from beneficiaries as a group to general-fund taxpayers as a group.¹¹ The net effect would equalize the growth rates of net earnings and the annuity value of net benefits and would narrow the gap between earnings growth and growth in monthly benefits.

INTERGENERATIONAL TRANSFERS: ARE PAYROLL TAXES FAIR?

Social Security is frequently analyzed as if it were a program of mandatory, individual retirement savings accounts whose most important attribute was the rate of return earned on past contributions. However, the program is more appropriately characterized as an intergenerational compact that socializes the traditional responsibility of children to take care of their elderly parents. Institutionalizing this responsibility through a third party makes retirement incomes more secure and obligations more enforceable, spreads the cost of supporting the elderly more equitably across the income distribution, preserves the dignity of both beneficiaries and contributors, and integrates old-age protection with disability and young-survivor protection.

Social Security is only half of the traditional pattern of intergenerational transfers, however; the transfers that flow from parents to children within each family make up the other half. Assessing Social Security's impact on net intergenerational transfers requires comparing the magnitude of these two financial flows.

Using data from the 1990-92 Consumer Expenditure Survey, Lino (1999) estimates that a middle-income family of four spent an average of \$8,705 per year on each child in 1998 out of an average pre-tax income of \$47,900. He estimates that a higher-income family spent an average of \$12,705 per child per year out of an average pre-tax income of \$90,700.¹² These estimates form the basis for the calculations in table 2.

Lino's estimates suggest that the present value of total parental transfers to a child born into an average-income household in 2000 would amount to some \$154,000 by the time the child turned age 18. If we assume that the child born into the higher-income household is a dependent through age 22 and goes to a college that requires additional outlays of

TABLE 2.

Estimated Intrafamily Transfers, 1998 Birth Cohort (present value in 2000 dollars)

	Transfers
Average-Income Family	
Parents' spending per child, age 0-18	153,778
Children's Social Security and Medicare tax payments, 43 years	111,961
Net	41,817
Higher-Income Family	
Parents' spending per child, age 0-22	267,963
College expenses (\$15,000 per year, four years)	47,154
Total	315,118
Social Security and Medicare tax payments, 42 years	313,890
Net transfer to parents	1,228

Sources: Rows 1 and 4: Lino (1999) Table ES-1, increased by projected growth in average wages and discounted to 2000 using the government bond rate.

\$15,000 a year, the present value of the parental transfers comes to \$268,000.¹³

The present value of the payroll taxes that the children in these households can expect to pay is also shown in table 2. In each case, tax payments include both the employer and employee share of Social Security and Medicare payroll taxes. Tax rates are set at the pay-as-you-go level for all years after the currently projected exhaustion date of the respective trust funds. The individual from the middle-income household is assumed to work for 43 years (beginning at age 18 and continuing through age 61) at the average Social Security wage and to make tax payments totaling \$112,000. The individual from the higher-income household is assumed to work for 42 years at the maximum taxable earnings level (beginning at age 22 and continuing through age 64) and to pay taxes totaling \$314,000.

These estimates suggest that the present value of the initial transfer from the parents to the children in a typical middle-income household is likely to be comfortably above the present value of the transfers—in the form of future payroll taxes—from the children to the parents, even if payroll tax rates are increased to close the Social Security and Medicare financing gaps. The transfer from the higher-income parents to their children seems to more closely approximate the transfer back in the form of future payroll taxes. The pattern of intergenerational transfers apparently reinforces other elements of the Social Security and Medicare systems that redistribute funds from higher- to lower-income households.

SHARING THE BURDEN

A growing economy allows for both future beneficiaries and future workers to enjoy improved standards of living. When Congress set up the current benefit indexing rules in 1977, it attempted to ensure that the benefits of a growing economy would be shared proportionately between the two groups.

In light of recent trends in taxes and health costs, however, current Social Security and Medicare policies do not appear to further this goal. The combination of recent and projected health care cost trends and the income tax changes adopted in 1983 is likely to slow the growth of net benefits (benefits net of both taxes and health costs) relative to the growth of net wages, providing future beneficiaries a less-than-proportionate share of the fruits of economic growth, at least over the next 50 years.

This analysis suggests that restoring fiscal balance in Social Security and Medicare exclusively through payroll tax rate increases would narrow, but not completely eliminate, the gap currently projected between net benefit growth and net wage growth. The remaining gap appears large enough to allow the addition of a modest prescription drug benefit to Medicare without disadvantaging future workers relative to future beneficiaries, even when the value of future benefits is adjusted to reflect longer projected retiree life spans.

Considering the size of the intergenerational transfers between parents and children that occur within a typical family, the burden of the payroll tax rate increases that would be needed to finance Social Security and Medicare over the next 60 to 65 years does not appear unreasonable. Most of today's children would still be net recipients of intergenerational transfers.

ENDNOTES

¹ An alternative indexing method that would have caused real benefits to rise more slowly than real wages was proposed by some members of the Senate Finance Committee, but it was rejected by Congress as a whole. After retirement, Social Security benefits are adjusted for price increases rather than wage increases, but this affects the time path of benefits during retirement rather than the relationship between wage growth rates and the growth rate of benefit entitlements.

² About two-thirds of the tax increases came from rescheduling the effective dates of rate increases that had been enacted in 1972 and 1977. This increased the tax rates in effect in 1984 and 1988–89 but had no effect on payroll tax rates after 1989. The rest of the tax increases came from extending coverage to federal civil service employees. Since the previous civil service pension program was largely unfunded, the change imposed a one-time transition cost on the general fund. In effect, cohorts working during the 1980s and 1990s bore the burden of both the revenue increases and the subsequent benefit cuts (Thompson 1983).

³ At present, Social Security benefits are exempt from all income taxes for single people with total incomes below \$25,000 and couples with total incomes below \$32,000. The exemption thresholds are not indexed, however, so over time a growing fraction of the benefit of average earners will be subject to income taxes. The other major benefit reduction was a delay in the effective date of cost-of-living adjustments. The impact of this grows proportionately with benefits. It alters the value of the benefit package associated with any given earnings history but does not change the relationship between future wage growth and future benefit growth.

⁴ The normal retirement age is the age at which an individual qualifies for a full rate benefit (a benefit equal to 100 percent of the "Primary Insurance Amount"); those first drawing their benefits at younger ages receive monthly benefits that are permanently reduced by an actuarial reduction factor. The legislated increase in the retirement age was actually simply an increase in the age required to receive benefits at the full rate. It will still be possible to begin drawing benefits earlier, but the reduction factor will be larger. For example, whereas a person retiring at age 64 received a monthly benefit equal to 93.3 percent of the full-rate benefit before the retirement age was increased, someone retiring at age 64 after the increase was fully implemented would get a benefit equal to only 80 percent of the full-rate benefit.

⁵ Gross wages (row 1) are from table III.B.1, 2000 OASDI Trustees' Report, and current law tax (row 2); wages net of tax (row 3) are calculated. The tax increase needed to finance the increase in SMI costs (row 4) was calculated in several steps. The increase over 2000 in SMI spending as a share of GDP was taken from table III.B.1 of the HI Report. It was assumed that 75 percent of this increase would be financed by equal percentage increases in income tax rates. The figure shown is the effect on a household with \$30,000 to \$40,000 in income based on 1998 incomes. CBO (1999) contains estimates of the distribution of personal income tax payments by household income level in 1996. Here, it is assumed that the distribution will remain unchanged (in relative terms) in the future. Out-of-pocket health spending is from the 1998 Consumer Expenditure Survey. It is estimated mean spending for households with heads under age 65.

Gross benefits (rows 8 and 9) are from OASDI Report table III.B.5. The 2050 SMI premium (row 10) is derived from the projections of SMI spending as a percentage of GDP. 2050 GDP is from OASDI table III.B.1. The premium is calculated as 25 percent of total spending divided by the sum of the projected number of DI beneficiaries in 2050 (table II.F.19) and the population over the age of 65 that year (table II.H.1). Medicare cost sharing (row 12) and other out-of-pocket spending (row 13) are from Maxwell, Moon, and Segal (forthcoming). Their estimates were extended from 2030 to 2050 by assuming that spending in each category increased at the same rate as total Medicare spending per beneficiary was increasing. (Total Medicare spending per beneficiary was calculated using the same data and approach used to calculate the SMI premium.) The income tax (row 15) was calculated as 7.5 percent of the amount by which the average benefit exceeds the 2050 threshold; the result is an average tax rate of 4.8 percent. (The Trustees project that aggregate 2050 tax income to OASI will amount to 4.9 percent of aggregate 2050 OASI expenditures.) The annuity value (row 17) is for a single male at age 65. The 2050 value uses the life tables underlying the 1999 Trustees' Report, adjusted to reflect the 2000 mortality assumptions by the ratio of the present value of a stream of benefits received for the time corresponding to the 2050 life expectancy in the respective reports (table II.D.2). Use of either female life expectancy or joint and survivors annuities would have produced a smaller offset since male life expectancy is assumed to improve more rapidly than female life expectancy over the next 50 years.

The payroll tax increase required to balance OASDI and HI (row 19) was derived by comparing the present value of the tax revenues generated by rate increases becoming effective in the specified future years to the present value of the tax revenues generated by a rate increase instituted in 2000 and equal to

the projected long-range deficit in the respective programs. The estimated cost and impact of a prescription drug benefit (rows 22 and 25) was derived by assuming that the benefit reduced Maxwell et al.'s estimate of out-of-pocket spending on prescription drugs by 35 percent. The income tax increase required to finance it was derived through a procedure similar to that used to calculate the income tax increased to finance SMI.

⁶ The projections assume that the cost of employer fringe benefits will rise more rapidly than wage payments, in large part due to rising health care costs. As a result, they project that total wage payments will grow more slowly than total labor compensation, which is one reason that total taxable payroll is projected to decline as a fraction of GDP.

⁷ The workers' benefits at the normal retirement age rise more rapidly than earnings because two more years of earnings are entered into the formula at the nominal rate. The projections are sensitive to relatively small differences in the average growth rate of money wages between the year the worker turns 62 and the year of retirement.

⁸ This analysis uses 2000 as its starting point. Moving the starting point back to 1982, the year when the 1977 amendments first became effective for 65-year-olds, would increase the projected gap between retiree and worker well-being. Since 1982, the benefit of an average earner net of SMI premiums has grown more slowly than the average Social Security wage net of payroll taxes. The employee payroll tax rose from 6.70 percent in 1982 to 7.65 percent of earnings in 2000, while SMI premiums rose from 1.9 percent of the average worker's 1982 benefit to 4.6 percent of the average worker's benefit in 2000. Between 1982 and 2000, average real earnings under Social Security grew by 22.5 percent before taxes and by 21.3 percent after taxes. For technical reasons related to the high inflation rates of the early 1980s, the benefit payable at age 65 to an average earner has grown far more slowly over the same 18-year period. Even if it had grown at the same rate as gross wages, however, rising SMI premiums would have reduced the growth in net benefits to 19.2 percent over the same 18 years.

⁹ The rate increases are sufficient to balance the respective programs over the current 75-year projection period, but their size and timing are arbitrary. Had the effective date been delayed a few years, the size of the rate increase would have been larger.

¹⁰ Arguably, the employer share should have been excluded in these calculations. In principle, some increase in employer charges for social insurance is already built into the baseline projection of average wage growth.

¹¹ For example, this might take the form of a benefit that covered half the cost of prescription drugs but required that beneficiaries as a group cover 30 percent of the cost through higher premiums.

¹² Lino estimates expenditures on children in each of six different age groups. For the average-income household, they range from \$8,240 for children under 3 to \$9,340 for children ages 15 to 17. For the high-income household, they range from \$12,260 for children under age 3 to \$13,510 for those ages 15 to 17. These estimates are for a married couple with two children. The actual average income in the "average-income" household was \$47,900, 1.65 times the average 1998 Social Security wage, making it consistent with a two-earner family in which one adult earns around the average wage and the second earns 65 percent of the average. Average income in the higher-income group was 1.32 times the taxable maximum, which may be a little low for a household rearing a child assumed to earn the maximum immediately after college.

¹³ In each case, age-specific average spending per child is assumed to grow at the same rate as wages are growing, as is the extra cost of a college education. Spending on children over 17 is assumed to be the same as spending on those ages 15 to 17. Future costs are discounted at the government bond rate assumed in the Trustees' Reports.

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T H E R E T I R E M E N T P R O J E C T

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