RESTORING RETIREMENT SECURITY: THE MARKET CRISIS, THE "GREAT RISK SHIFT," AND THE CHALLENGE FOR OUR NATION

Jacob S. Hacker, Ph.D.

The recent economic downturn has cast in stark relief the uncertainties associated with retirement and health care for older Americans. Yet, before the downturn even began, the economic landscape was already shifting in ways that concentrated more risk and responsibility on Americans planning for retirement and health care in old age. In this Article, Professor Hacker addresses the current risks faced by aging Americans, moving from the historical retirement framework of the "three legged stool"—Social Security, private pensions, and personal savings—to the current reality where pensions are few and far between. In doing so, he pays particular attention to special issues faced by working- and middle-class Americans. Additionally, drawing upon his knowledge of the health care system, Professor Hacker delves into the increasingly important role health care costs play in retirement planning, and how retirement planning should take into account potential future health care costs. Finally, he suggests a series of changes to restore retirement security by alleviating the problems produced by the disappearance of private pension plans and increases in health care costs.

Jacob S. Hacker, Ph.D., is the Stanley B. Resor Professor of Political Science at Yale University and a Resident Fellow at the Institution for Social and Policy Studies. Professor Hacker received his B.A. from Harvard in 1994, and Ph.D. from Yale in 2000.

We live in the waning days of the Golden Age of Retirement. Like a telescope vision of distant planets whose light took years to reach us, the image of retirement we see today is already many years in our past, a product of both public and private policies that are either largely defunct or highly vulnerable to future cutbacks. In a very real sense, today's retirees are living in a world that is already gone, a world of widespread retirement security that pools a substantial amount of risk across workers and generations. Their children and especially their grandchildren are coming of age in a fundamentally different world—one that involves much greater individual risk and responsibility and which promises much more unequal retirement prospects.

Consider the changes. A generation ago, if a worker had been offered a retirement plan by his or her employer, it would have been a traditional guaranteed pension that looked much like Social Security. Today, those workers who are lucky enough to receive a pension—and more than half the workforce continues to lack a pension at their job—are almost universally enrolled in individual account plans like 401(k)s, in which returns are neither predictable nor guaranteed.

A generation ago, the assumption was that Social Security would provide a strong foundation of retirement planning for decades to come. Today, despite reforms in the late 1970s and early 1980s, the program is projected to run short of the funds necessary to pay full benefits, and there are widespread calls for fundamental restructuring.

A generation ago, Medicare covered most of the much more modest medical costs of the aged. Today, Medicare and private supplemental plans leave many retirees facing a growing burden, as costs have continued to outstrip Medicare's relatively limited protections. Additionally, huge gaps remain when it comes to one of the greatest risks for older Americans—the costs of long-term health care.

In these respects and others, retirement security provides a powerful example of a larger economic transformation that I call the "Great Risk Shift," the massive long-term transfer of economic risk from broad structures of insurance—whether sponsored by the corporate sector or by government—onto the fragile balance sheets of

American families.[1] Increasingly, Americans find themselves on a shaky financial tightrope, without an adequate safety net to catch them if they fall. This shift has occurred across nearly all major facets of Americans' economic lives—their jobs, their health care, their balancing of work and family, their assets, and, yes, their retirement—and it has fundamentally reworked Americans' relationships to their employers, their government, and each other.

To a significant extent, the new world of retirement (in)security is unavoidable, embedded in the limited savings and less secure benefits of younger workers. Nothing can quickly reverse decades of erosion in traditional sources of guaranteed retirement income. As the debate about long-term deficits escalates—symbolized by the release of blueprints for budgetary austerity by not one, but two major deficit-reduction commissions in the last year—difficult trade-offs will have to be confronted.[2] And yet choices that we as a society make today will help shape how the costs and benefits of our current framework are distributed. More important, they could usher in a new era of broad retirement security—if our policies are updated to reflect new social and economic realities.

This Article is about the principles and ideas that should guide these choices. It begins with an exploration of why retirement security as we have come to know it is in peril—why we have transited from the Golden Age to a much more uncertain and unequal world. Central to this story is the replacement of the traditional "three-legged stool" of Social Security, traditional private pensions, and private savings with a much more wobbly "two-legged stool" of Social Security and private savings (both inside and outside of individual defined-contribution retirement accounts).

The Article then takes up the independent but linked challenge of rapidly rising health care costs, which hit the aged far harder than the young, despite the universal health coverage offered by Medicare

1. *See* JACOB S. HACKER, THE GREAT RISK SHIFT: THE NEW ECONOMIC INSECURITY AND THE DECLINE OF THE AMERICAN DREAM (Oxford Univ. Press. rev. ed., 2008).

2. *See* NAT'L COMM'N ON FISCAL RESPONSIBILITY & REFORM, THE MOMENT OF TRUTH (2010), *available at* http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12.1.2010.pdf; SENATOR PETE DOMENICI & DR. ALICE RIVLIN, DEBT REDUCTION TASK FORCE, BIPARTISAN POLICY CTR., RESTORING AMERICA'S FUTURE: REVIVING THE ECONOMY, CUTTING SPENDING AND DEBT, AND CREATING A SIMPLE, PRO-GROWTH TAX SYSTEM (2010), *available at* http://bipartisanpolicy.org/projects/debt-initiative/about (follow link "Click here to download the Full Report").

to those older than sixty-five. Those nearing retirement (the so-called near elderly) and those in need of long-term services, such as nursing home care, are particularly vulnerable. What is clear is that reducing the growth of health care costs, and shielding vulnerable segments of the aged from those costs, may be more important than income replacement for future retirement security. A second implication is that the erosion of retirement security, while rooted in deep demographic and economic trends, rested fundamentally on changes in public and private policy that can be revisited.

The final part of the Article considers several alternative responses to the increased shift of retirement-income and health-cost risks onto workers. None of the frequently proffered "solutions"—from simply raising the retirement age at one extreme, to expanding Social Security on the other—really grapple with the underlying challenges posed by the erosion of the traditional system, much less with the rise of new inequalities, such as the increased disparity in life expectancy between higher- and lower-income Americans. Inevitably, a mixed package of reforms will be required, and I offer one such package, building on the thoughtful proposals of leading experts.

At least as important as finding a solution, I argue, is a clear diagnosis of what has gone wrong and what is at stake in the debate over the future of retirement. Thinking about how to restore the broad pooling of retirement risks is essential if the United States is to reclaim "retirement security" before the phrase, like our traditional retirement security system, becomes an anachronism viewed only by looking back into our increasingly distant past.

I. The Golden Age and Its Discontents

To grasp the foundations of the Golden Age requires understanding America's distinctive public-private system for providing economic security.

We often assume that the United States does little to provide economic security compared with other rich capitalist democracies. This is only partly true. The United States does spend less on government benefits as a share of its economy, but it also relies far more on private workplace benefits, such as health care and retirement pensions. Indeed, when these private benefits are factored into the mix, the U.S. framework of economic security is not smaller than the average system in other rich democracies—it is actually slightly larg-

er.[3] Moreover, private employment-based benefits are extensively subsidized through the tax code—mainly through the forgiveness of income and payroll taxes on non-cash compensation.[4] With the help of hundreds of billions of dollars in tax breaks, American employers serve as the first line of defense for millions of workers buffeted by the winds of economic change.

A. From a Three-Legged Stool to a Two-Legged Stool

America's framework for providing retirement security was historically referred to as a "three-legged stool." Social Security, private pensions, and personal savings—each "leg" was supposed to carry an important part of the weight of securing workers' retirement. For lower-income workers, Social Security was far and away the most important leg of the stool.[5] But for middle- and higher-income workers, tax-favored private pensions were assumed to be vital for achieving a secure retirement—especially after the Employee Retirement Income Security Act of 1974 put in place rules designed to ensure that defined-benefit pension plans would be properly run, broadly distributed, and secure.[6]

The problem is that this unique employment-based system is coming undone, and in the process, risk is shifting back onto workers and their families. As recently as twenty-five years ago, more than eighty percent of large- and medium-sized firms offered a defined-benefit plan; today, less than one-third do, and the share continues to

3. JACOB S. HACKER, THE DIVIDED WELFARE STATE: THE BATTLE OVER PUBLIC AND PRIVATE BENEFITS IN THE UNITED STATES 13–16 (Cambridge Univ. Press, 2008) ("The United States . . . ranks last according to the traditional measure of social welfare effort. But once we adjust for relative tax burdens, tax expenditures, and publicly subsidized private benefits . . . its net private spending, at 24.5 percent of GDP, is above the average. . . ."). More recent figures for social expenditures of various countries are provided in Excel format by the Organization for Economic Co-operation and Development. *Social Expenditure, in Percentage of GDP at Factor Cost, 2007*, ORG. ECON. CO-OPERATION & DEV. (2007), http://www.oecd.org/dataoecd/41/7/41771656.xls.

4. *See* 26 U.S.C. §§ 105(b), 106(a) (2010); JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2008–2012, JCS-2-08, at 14 (2008).

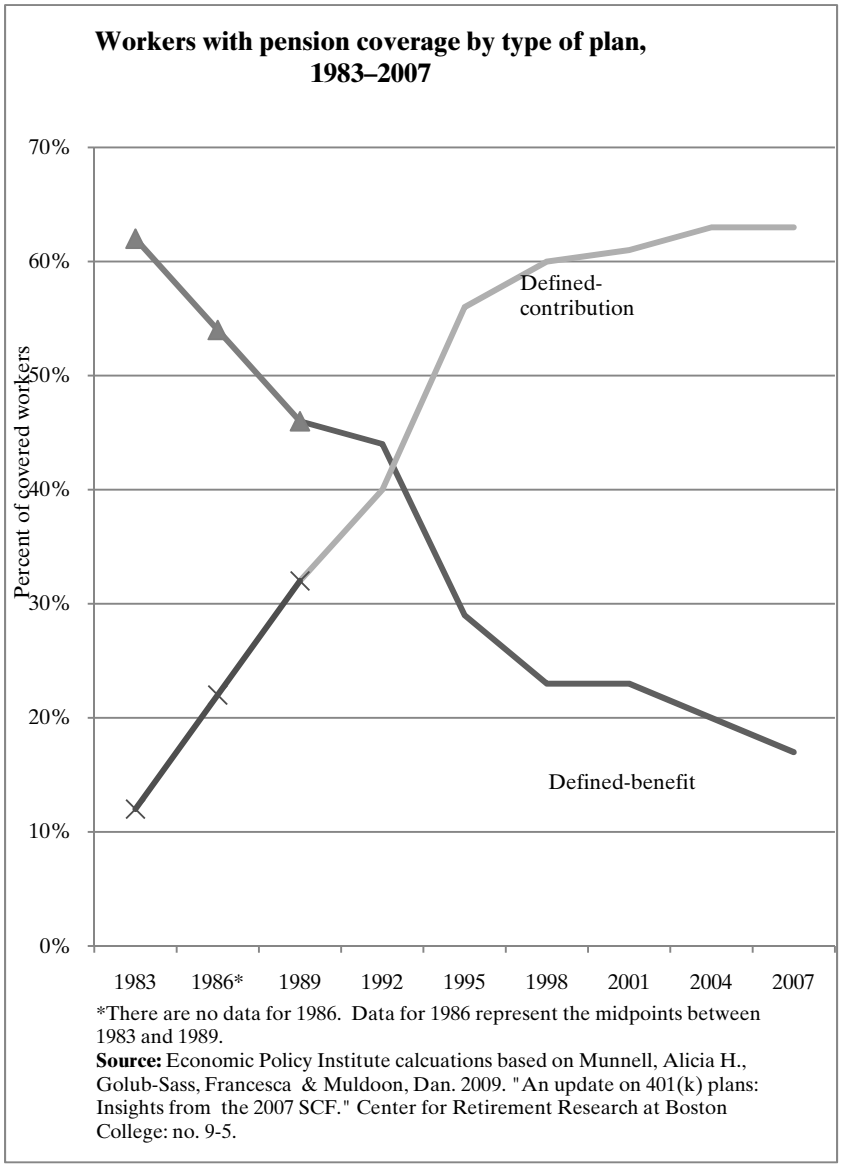
5. LAWRENCE A. FROLIK & RICHARD L. KAPLAN, ELDER LAW IN A NUTSHELL 282-83 (5th ed. 2010).

6. PATRICK PURCELL & JENNIFER STAMAN, CONG. RESEARCH SERV., RL 34443, SUMMARY OF THE EMPLOYEE RETIREMENT INCOME SECURITY ACT 3, 54 (2009), *available at* http://aging.senate.gov/crs/pension7.pdf.

fall.[7] Companies are rapidly "freezing" their defined-benefit plans (that is, preventing new workers from joining the plan) and shifting them over to alternative forms (such as the so-called cash-balance plan) that are more like 401(k)s. For workers fortunate enough to receive a pension, 401(k) plans have become the default source of private retirement protection.

7. John H. Langbein, Understanding the Death of the Private Pension Plan in the United States (Apr. 2006) (unpublished manuscript) (on file with author at Yale Law School).

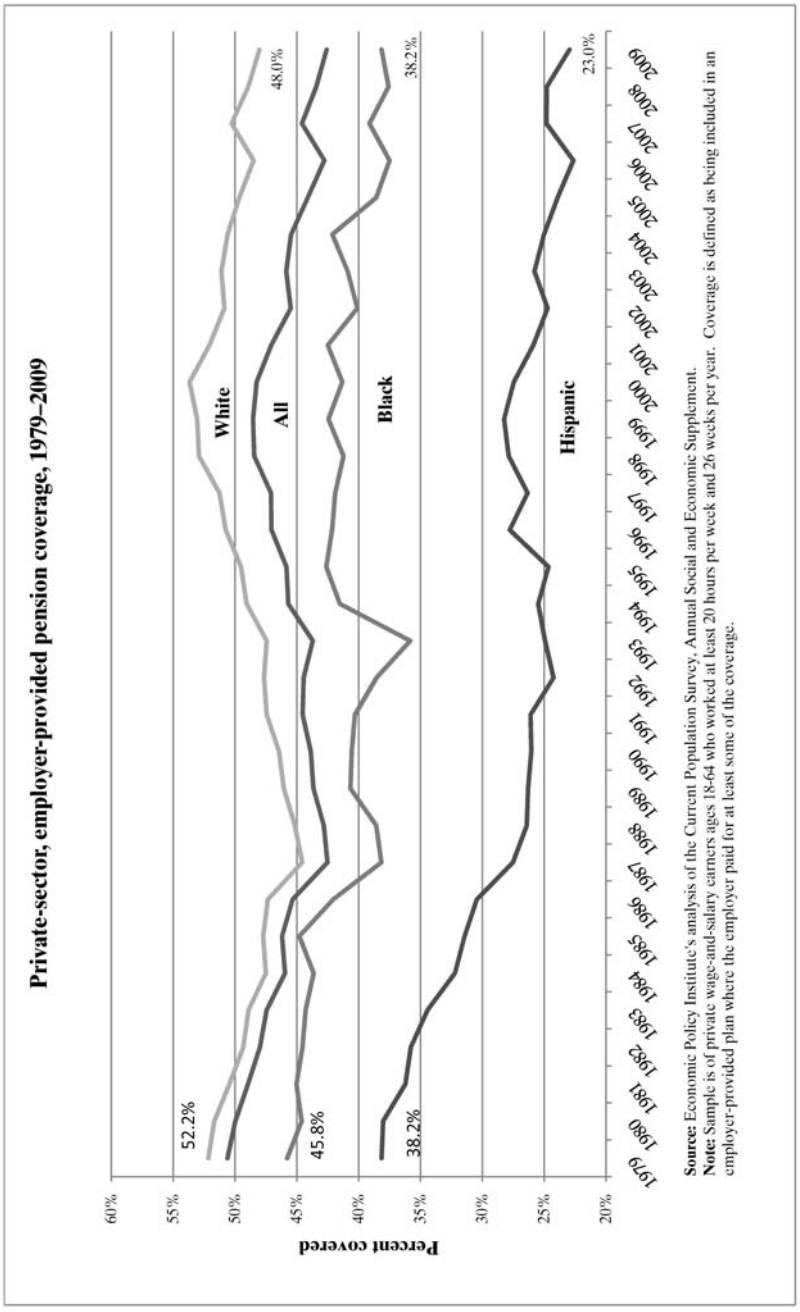
FIGURE 1



The expansion of 401(k)s has not led to an overall increase in pension coverage. Instead, 401(k)s have largely substituted for traditional pension plans, and the share of workers offered any pension at their place of work has actually declined. In 1979, just over half of

private wage and salary workers aged eighteen to sixty-four who worked half-time or longer were covered by a private workplace pension. (See Figure 2.) Thirty years later, the share fell to less than forty-three percent. (See Figure 2.) For younger private workers, even college-educated workers, defined-benefit pensions are essentially unavailable; they are lucky if they have access to a 401(k).

FIGURE 2


Private-sector, employer-provided pension coverage, 1979–2009
Percent covered
60%
55%
50%
45%
40%
35%
30%
25%
20%
1979
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
White
All
Black
Hispanic
52.2%
45.8%
38.2%
48.0%
38.2%
23.0%
Source: Economic Policy Institute's analysis of the Current Population Survey, Annual Social and Economic Supplement.
Note: Sample is of private wage-and-salary earners ages 18-64 who worked at least 20 hours per week and 26 weeks per year. Coverage is defined as being included in an employer-provided plan where the employer paid for at least some of the coverage.

The one exception to this story is, of course, the public sector, where defined-benefit pensions remain the norm—almost certainly because of the much higher rates of unionization in the public sector than in the private sector.[8] Recently, these pensions have become a source of controversy for two reasons. First, in part because of the severe downturn of 2007–2008, many states' plans are substantially underfunded.[9] The scale of this shortfall is frequently overstated. But states will have to increase contributions to plans going forward (which currently represent a little less than four percent of state expenditures) or reduce future outlays (which is difficult given union contracts) to achieve adequate funding.[10] It is crucial to note, however, that "state and local plans do not face an immediate liquidity crisis; most plans will be able to cover benefit payments for the next 15–20 years."[11]

The second reason for controversy is more political than economic. As private defined-benefit pensions have disappeared, the argument that the public sector should follow suit becomes increasingly powerful. Yet, assessing the virtue of such a shift requires examining the shortcomings of 401(k)s and other defined-contribution plans alongside the financial problems faced by public defined-benefit plans.

401(k) plans are not "pensions" as that term has been traditionally understood: a fixed benefit in retirement. They are essentially private investment accounts sponsored by employers.[12] As a result, they greatly increase the degree of risk and responsibility placed on individual workers in retirement planning. Traditional defined-benefit plans are generally mandatory and paid for largely by employers (in

8. ALICIA H. MUNNELL, KELLY HAVERSTICK & MAURICIO SOTO, CENT. FOR RET. RESEARCH, WHY HAVE DEFINED BENEFIT PLANS SURVIVED IN THE PUBLIC SECTOR? 2–3 (2007), *available at* http://crr.bc.edu/images/stories/Briefs/slp_2.pdf.

9. Matthew Dalton, *Crisis Forces Look at Pension Reforms*, WALL ST. J., Jan. 28, 2011, *available at* http://online.wsj.com/article/SB10001424052748704721104576106870540913668.html.

10. IRIS J. LAV & ELIZABETH MCNICHOL, CTR. ON BUDGET & POLICY PRIORITIES, MISUNDERSTANDINGS REGARDING STATE DEBT, PENSIONS, AND RETIREE HEALTH COSTS CREATE UNNECESSARY ALARM: MISCONCEPTIONS ALSO DIVERT ATTENTION FROM NEEDED STRUCTURAL REFORMS 3–4 (2011), *available at* http://www.cbpp.org/files/1-20-11sfp.pdf.

11. Alicia H. Munnell, Jean-Pierre Aubry, & Laura Quinby, *Public Pension Funding in Practice*, 14 (Nat'l Bureau of Econ. Research, Working Paper 16442, 2010), *available at* http://www.nber.org/papers/w16442.pdf.

12. *401(k) Plans*, IRS.GOV, http://www.irs.gov/taxtopics/tc424.html (last visited Apr. 27, 2011).

lieu of cash wages).[13] Thus, they represent a form of forced savings. Defined-benefit plans are also insured by the federal government and heavily regulated to protect participants against mismanagement.[14] Perhaps most important, their fixed benefits protect workers against the risk of market downturns and the possibility of living longer than expected (so-called longevity risk).[15]

None of this is true of defined-contribution plans. Participation is voluntary, and many workers choose not to participate or contribute inadequate sums.[16] Plans are not adequately regulated to protect against poor asset allocations or corporate or personal mismanagement.[17] The federal government does not insure defined-contribution plans, and defined-contribution accounts provide no inherent protection against market or longevity risks.[18] Indeed, some features of defined-contribution plans—namely, the ability to borrow against their assets, and the distribution of their accumulated savings as lump-sum payments that must be rolled over into new accounts when workers lose or change jobs—exacerbate the risk that workers will prematurely use retirement savings, leaving inadequate income upon retirement. Perversely, this risk falls most heavily on younger and less highly paid workers, the very workers most in need of protection.

In essence, we have moved from the traditional three-legged stool of retirement security to a two-legged stool—Social Security and private savings (inside and outside of 401(k)s). Needless to say, this stool is much less stable than the last.

The transformation of private retirement pensions from relatively secure income guarantees into individualized accounts makes a guaranteed foundation of retirement savings all the more important. As defined-benefit pensions vanish, Social Security is the only guaranteed pension left. Yet, the role of Social Security has declined in the

13. FROLIK & KAPLAN, *supra* note 5, at 361–63.

14. *Id.* at 363.

15. John Broadbent et al., *The Shift from Defined Benefit to Defined Contribution Pension Plans – Implications for Asset Allocation and Risk Management* (Comm. on Global Fin. Sys., Working Paper, 2006), *available at* http://www.bis.org/publ/wgpapers/cgfs27broadbent3.pdf.

16. Alicia H. Munnell & Annika Sundén, *401(k) Plans Are Still Coming Up Short*, ISSUE IN BRIEF, Mar. 2006, at 2–3, *available at* http://crr.bc.edu/images/stories/Briefs/ib_43.pdf.

17. *See* Susan Stabile, *Freedom to Choose Unwisely: Congress' Misguided Decision to Leave 401(k) Plan Participants to Their Own Devices*, 11 CORNELL J. L. & PUB. POL'Y 361, 369–70 (2002).

18. Regina Jefferson, *Rethinking the Risk of Defined Contribution Plans*, 4 FLA. TAX REV. 607, 616–18 (2000).

last twenty years. The wealth represented by expected Social Security benefits fell in the 1980s and 1990s, due both to the maturation of the program and cutbacks that occurred in the late 1970s and early 1980s.[19] Looking forward, Social Security is expected to replace a smaller share of pre-retirement income than it did in the past.[20] That is true even if Social Security pays promised benefits—an assumption that is safer than Social Security's doomsayers believe but still hinges on favorable economic and demographic trends and some adjustments in the program.[21]

As private risk protections have eroded, in sum, workers and their families have had to bear a greater burden.[22] Rather than enjoying the protections of pension and retiree health plans that pool risk broadly, Americans are increasingly facing these risks on their own. This transformation has at once made retirement savings less equal and more risky.

B. Unequal Retirement

Social Security still provides a guaranteed foundation of retirement security for low- and middle-income workers. But private pensions no longer provide the risk protections they once did to a

19. EDWARD WOLFF, RETIREMENT INSECURITY: THE INCOME SHORTFALLS AWAITING THE SOON-TO-RETIRE 7 (2002); Sally Sherman, *Public Attitudes Toward Social Security*, SOC. SECURITY BULL., Dec. 1989, at 2–3 (discussing the cutbacks of the late 1970s and early 1980s and their effects), *available at* http://www.ssa.gov/policy/docs/ssb/v52n12/v52n12p2.pdf.

20. CONG. BUDGET OFFICE, UPDATED LONG-TERM PROJECTIONS FOR SOCIAL SECURITY 1 (2005), *available at* http://www.cbo.gov/ftpdocs/60xx/doc6064/03-03-LongTermProjections.pdf.

21. *Compare id.*, Sen. Bernie Sanders, Op-Ed., *Defending Social Security*, THE HILL (Mar. 2, 2011), http://thehill.com/opinion/op-ed/147153-defending-social-security (explaining that adjustments should be made, such as raising the cap on taxable income), *and Keep Social Security Strong*, AARP (June 23, 2010), http://www.aarp.org/work/social-security/info-08-2009/keeping_Social_Security_strong.html?cmp=RDRCT-STRSS_JUN23_010, *with* Bruce Bartlett, *The 81% Tax Increase*, FORBES.COM (May 15, 2009), http://www.forbes.com/2009/05/14/taxes-social-security-opinions-columnists-medicare.html (explaining "every taxpayer would have to pay 13% more just to make sure that all Social Security benefits currently promised will be paid").

22. Incidentally, none of these efforts was foreseen or intended. When Congress added section 401(k) to the tax code in 1978 to resolve some longstanding disputes over profit-sharing plans offered by employers, no mention was made of the change, except a brief note in the congressional report on the 1978 legislation indicating that the effects would be "negligible." STAFF OF JOINT COMM. ON TAXATION, 95TH CONG., GEN. EXPLANATION OF THE REVENUE ACT OF 1978, at 84 (Comm. Print 1979).

large chunk of less-affluent workers. Moreover, private retirement savings are virtually nonexistent among moderate-income families.[23]

This is not a coincidence. The incentives for higher-income Americans to save have ballooned with the expansion of tax-favored investment vehicles like 401(k)s. Yet, because the tax breaks for these benefits are skewed toward higher-income Americans, most Americans receive modest benefits from these costly tax breaks.[24] (In 2011, tax breaks for retirement pensions and accounts cost the federal government over $140 billion in forgone tax revenue).[25] Roughly eighty percent of these tax subsidies for retirement saving accrue to the top twenty percent of the population.[26] Only seven percent accrue to the bottom sixty percent of the population.[27]

The reasons for this stark disparity are threefold. First, lower-income Americans face much lower marginal tax rates, making tax exclusions and deferments worth much less to them. Second, lower-income Americans are least likely to have access to tax-favored accounts (and low-wage employers have less reason to provide such accounts, because the tax advantages for their workers are so much more limited).[28] And third, lower-income Americans have the least discretionary income to contribute to tax-favored accounts. Living paycheck to paycheck, they need the greatest incentive and assistance to save. Instead, the tax benefits for retirement are structured so that they provide the greatest rewards to higher-income workers.

These skewed incentives are reflected in 401(k) account balances. It is often claimed that the "average" American has tens of thousands of dollars in their 401(k), but in fact, roughly three-quarters of account

23. According to a recent analysis of families with earnings between two and six times the federal poverty level ($40,000 to $120,000 for a family of four) and headed by working-age adults, more than half of middle-class families have no net financial assets whatsoever, excluding home equity, and nearly four in five middle-class families do not have sufficient non-housing assets to cover three-quarters of essential living expenses for even three months should their income disappear. Essential living expenses include food, housing, clothing, transportation, health care, personal care, education, personal insurance, and pensions. JENNIFER WHEARY, THOMAS M. SHAPIRO & TAMARA DRAUT, BY A THREAD: THE NEW EXPERIENCE OF AMERICA'S MIDDLE CLASS 2 (2007), *available at* http://www.demos.org/pubs/BaT112807.pdf.

24. Seth Hanlon, *Tax Expenditure of the Week: Tax-Deferred Retirement Savings*, CTR. FOR AM. PROGRESS (Mar. 7, 2010), http://www.americanprogress.org/issues/2011/01/te_011911.html.

25. *Id.*

26. *Id.*

27. *Id.*

28. *Id.*

holders have less than the widely cited average of $60,000.[29] The median among account-holders is less than $20,000.[30] Additionally, all these figures include only those who *have* 401(k)s; only half of workers have access to a defined-contribution pension plan and only around a third contribute to one.[31] Overall, around seventy percent of defined-contribution pension and IRA assets are held by the richest fifth of Americans.[32]

Even those who do contribute adequately to 401(k)s tend to make common investing errors like putting their money in low-yield bonds, neglecting to rebalance their accounts periodically, and over-investing in their own company's stock.[33] As behavioral economists have increasingly documented, these errors reflect fundamental biases in retirement planning that are deeply ingrained in the human psyche. Studies suggest, for instance, that simply automatically enrolling workers in 401(k)s rather than requiring that they opt in doubles initial participation in 401(k) plans, increasing it to nearly ninety percent.[34] Because of how they are subsidized and structured, 401(k)s are almost tailor-made to produce insufficient retirement savings for ordinary workers—and indeed, this is one reason they are relatively inexpensive for employers to run.

Much ink has been spilled comparing the returns of 401(k)s and old-style pensions (according to a study of returns between 1985 and 2001, defined-benefit pension plans have actually won, earning returns that exceed those of their upstart competitors by about one percent a year).[35] But the central issue for retirement security is not the

29. Jack Van Derhei et al., *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2006*, EMP. BENEFIT RES. INST. ISSUE BRIEF, Aug. 2007, at 13, *available at* http://www.ebri.org/pdf/briefspdf/EBRI_IB_08-20073.pdf.

30. *Id.* at 15.

31. Elizabeth Dietz, *Access to Defined Contribution Retirement Plans Among Workers in Private Industry, 2005*, BUREAU OF LAB. STAT. (Apr. 26, 2006), http://www.bls.gov/opub/cwc/cm20060425ch01.htm.

32. *Progressivity and Savings: Fixing the Nation's Upside-Down Incentives for Savings: Hearing Before the H. Comm. on Educ. & the Workforce*, 108th Cong. 5 (2004) (statement of Peter R. Orszag, Joseph A. Pechman Senior Fellow, The Brookings Institute), *available at* http://www.brookings.edu/views/testimony/orszag/20040225.pdf.

33. *See* Richard H. Thaler & Shlomo Benartzi, *The Behavioral Economics of Retirement Savings Behavior*, AARP PUB. POL'Y INST., Jan. 2007, at 16–17, *available at* http://www.retirementmadesimpler.org/Library/The%20Behavioral%20Economics%20of%20Retirement%20Savings%20Behavior%20-%20Full.pdf.

34. Brigitte C. Madrian & Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116 Q. J. ECON. 1149, 1159, 1180 (2001).

35. ALICIA H. MUNNELL & ANNIKA SUNDEN, COMING UP SHORT: THE CHALLENGE OF 401(K) PLANS 75–77 (2004).

return, but the risk. Retirement wealth has not only failed to rise for millions of families, it has also grown more risky as the nation has shifted more of the responsibility for retirement planning from employers and government onto workers and their families.

C. Risky Retirement

The private retirement fortunes of all but today's oldest workers are dependent on the fate of 401(k)s. This means, in turn, that private retirement fortunes are dependent on the future of financial markets. As the recent gyrations of the stock market reveal, financial markets provide an inherently risky basis for retirement planning.

To be sure, there is nothing that requires that 401(k)s be invested in stocks. Workers are free to buy bonds or a conservative mix of stocks and bonds, and indeed, a significant share of workers invest their 401(k)s too conservatively for their age (not surprisingly, these tend to be lower-income workers).[36] Still, stocks do deliver a higher overall return.[37] The problem is that this return comes with higher risk, and 401(k)s place all of this higher risk on workers, offering little of the investment guidance and none of the protections against economic loss that are inherent in defined-benefit pensions.

The risks posed by 401(k)s go beyond investment risks to encompass nearly all of the managerial and savings responsibilities imposed on workers. Indeed, by far the greatest problem posed by 401(k)s is the simplest—they encourage insufficient savings. This contrasts starkly with defined-benefit plans. Because of their typical universality within workplaces and usually substantial employer contributions, defined-benefit pensions represent a powerful form of forced prefunding of retirement. Savings in 401(k)s, by contrast, are much more spotty, even when workers have them and employers match their contributions. Behavioral economists have extensively identified the myriad reasons why workers "are slow to join advantageous plans, make infrequent changes, and adopt naïve diversification strategies" that leave them without enough income on which to retire.[38]

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36. *Id.*

37. CORI E. UCCELLO, 401(K) INVESTMENT DECISIONS AND SOCIAL SECURITY REFORM 10, 14 (2000) (discussing 401(k) stock investment statistics and risk decisions associated with investment choices), *available at* http://www.urban.org/Uploadedpdf/401k_investment.pdf.

38. Thaler & Benartzi, *supra* note 33, at 23.

Consider one of the most distinctive features of defined-contribution plans: the ability of workers to take their pension as a "lump sum" (that is, in the form of cash) when they leave an employer. As a means of protecting retirement wealth, this is of considerable benefit to workers who change jobs frequently—but only if they save the money. Unfortunately, "[t]he vast majority of people who receive lump sum distributions do not roll over the funds into qualified accounts," such as IRAs and other 401(k)s—despite the fact that they must pay taxes on all their benefits, [39] as well as a penalty of ten percent if they are younger than fifty-five.[40]

A clue to the source of this seemingly irrational behavior is provided by research on what affects workers' use of lump sum distributions. Workers who are laid off are nearly forty-seven percent less likely to roll over their distributions.[41] Workers who relocate to get a new job are fifty percent less likely to rollover.[42] Workers who leave work to care for a family member are seventy-seven percent less likely.[43] "Overall," as one economist concludes, "the evidence suggests that pension assets have been used to buffer economic shocks to the household."[44] Workers are beggaring long-term retirement security to deal with short-term shocks.

Finally, it is not so easy to turn a retirement account into a lifetime guaranteed income of the sort that Social Security and defined-benefit pensions provide. To protect oneself against this risk requires purchasing an annuity. Yet most people do not use their 401(k) accounts to buy an annuity—in part because of inherent weaknesses of the annuity market, in part because their balances are too small to make the transaction worthwhile, and in part because they discount the possibility that they will outlive their assets.[45]

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39. LEONARD E. BURMAN ET AL., WHAT HAPPENS WHEN YOU SHOW THEM THE MONEY: LUMP SUM DISTRIBUTIONS, RETIREMENT INCOME SECURITY AND PUBLIC POLICY 4 (2001), *available at* http://www.brookings.edu/~/media/Files/rc/papers/2001/0103saving_gale/20010103.pdf.

40. *Id.* at 1.

41. Gary Engelhardt, *Reasons for Job Change and the Disposition of Pre-Retirement Lump-Sum Pension Distributions*, 81 ECON. LETTERS 333, 337 (2007).

42. *Id.* at 337 tbl.2.

43. *Id.* at 337.

44. *Id.* at 334.

45. *Restoring Retirement Security: The Market Crisis, the "Great Risk Shift," and the Challenge for Our Nation: Hearing Before H. Comm. on Educ. & Labor*, 110th Cong. 4 (2008) (statement of Jacob S. Hacker, Ph.D.).

D. The Fallout

The true effects of the 401(k) revolution on income in retirement have yet to be seen. We will only know them with certainty when today's younger workers start retiring. But even before the recent economic downturn, the signs were deeply troubling. Among Americans aged sixty-four to seventy-four in 2005 (that is, born between 1931 and 1941), nearly one-third lost fifty percent or more of their financial wealth between 1992 and 2002—a rate of wealth depletion that will soon leave them confronting a complete exhaustion of their assets, a much-reduced standard of living, or both.[46] The rate of wealth depletion was even higher among those who reported they were in poor health.[47]

At the same time, debt is rapidly growing among families with heads of household older than fifty-five. Between 1992 and 2007, the median debt level among older families with debt rose from $15,923 to $43,000 (in 2007 dollars), with the largest percentage increase occurring among the oldest of the aged (seventy-five or over).[48] The share of older families with debt also rose substantially—from fifty-four percent to sixty-three percent.[49]

A significant part of this rise is represented by credit-card debt—the most costly form of credit for most consumers. During the 1990s, credit-card debt grew by around half among all consumers, but it grew by 200% among seniors aged sixty-five to sixty-nine.[50] Research on the cause is limited, but the basic realities are clear: relatively fixed and modest incomes alongside rapidly rising medical costs.[51] In addition, during this recent severe downturn, many older Americans found themselves in the position of providing financial support to their children.[52] (The threats to retirement security posed by medical

46. Craig Copeland, *Changes in Wealth for Americans Reaching or Just Past Normal Retirement Age*, EMP. BENEFIT RES. INST., Jan. 2005, at 18, *available at* http://www.ebri.org/pdf/briefspdf/0105ib1.pdf.

47. *Id.*

48. Craig Copeland, *Debt of the Elderly and Near Elderly, 1992–2007*, EMP. BENEFIT RES. INST. NOTES, Oct. 2009, at 2–3, *available at* http://www.ebri.org/pdf/notespdf/EBRI_Notes_10-Oct09.DebtEldly.pdf.

49. *Id.* The share of older families with debt was 53.8% in 1992 and has increased nearly ten percentage points since. *Id.*

50. Donna S. Harkness, *The Credit Card Act of 2009: Welcome Relief or Too Little, Too Late for Vulnerable Seniors?*, 29 BANKING & FIN. SERV. POL'Y REP. 12, 12 (2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1748560 (follow link "One-Click Download").

51. *Id.*

52. *Id.*

costs and intergenerational support, as well as other large variable expenses, will be discussed later.)

These results suggest that while much attention has been paid to the accumulation of assets *for* retirement, far less has been devoted to the issue of how Americans manage their assets *in* retirement. Defined-benefit plans and Social Security ensure that workers receive a relatively stable income as long as they live. There are no such guarantees when it comes to IRAs and 401(k) plans, and there is every reason to think that many retirees will exhaust their accounts well before they die.[53]

The other side of the coin of wealth depletion is asset accumulation—and retirement savings in 401(k)s is, ironically, both inadequate and excessively at risk. The risk of market volatility has been driven home by the stock market gyrations of recent years. Just between mid-2007 and October 2008, an estimated $1 trillion in retirement wealth was lost in 401(k)s and individual retirement accounts.[54] A 2009 survey found that two-thirds of adults aged fifty to sixty-four years lost money in mutual funds, individual stocks, or 401(k) accounts, with the vast majority losing more than twenty percent of their investments (most who had no losses had no investments).[55]

To be sure, we cannot yet know how sustained these losses will be. After all, the market has recovered markedly since the stock-market downturn of 2007 and 2008. Moreover, those nearing retirement are potentially the most vulnerable to market risks insofar as they have the least time to recover losses before they retire. The point is that market volatility is a serious threat to retirement security, and coping with it is left almost entirely up to 401(k) holders. As with rising debt levels of the aged, what we know is that even among those with at least one foot in the Golden Age of Retirement, retirement insecurity is becoming more common.

What we also know is that these signs of strains are only the tip of an emerging iceberg, for they appear amid a long-term decline in

53. Jeffrey R. Brown, *How Should We Insure Longevity Risk in Pensions and Social Security?*, ISSUE IN BRIEF, Aug. 2000, at 2, *available at* http://crr.bc.edu/images/stories/Briefs/ib_4.pdf.

54. *The Effects of Recent Turmoil in Financial Markets on Retirement Security: Hearing Before the H. Comm. of Educ. & Labor*, 110th Cong. 2 (2008) (statement of Peter R. Orszag, Director, Congressional Budget Office), *available at* http://www.cbo.gov/doc.cfm?index=9864 (follow link "PDF").

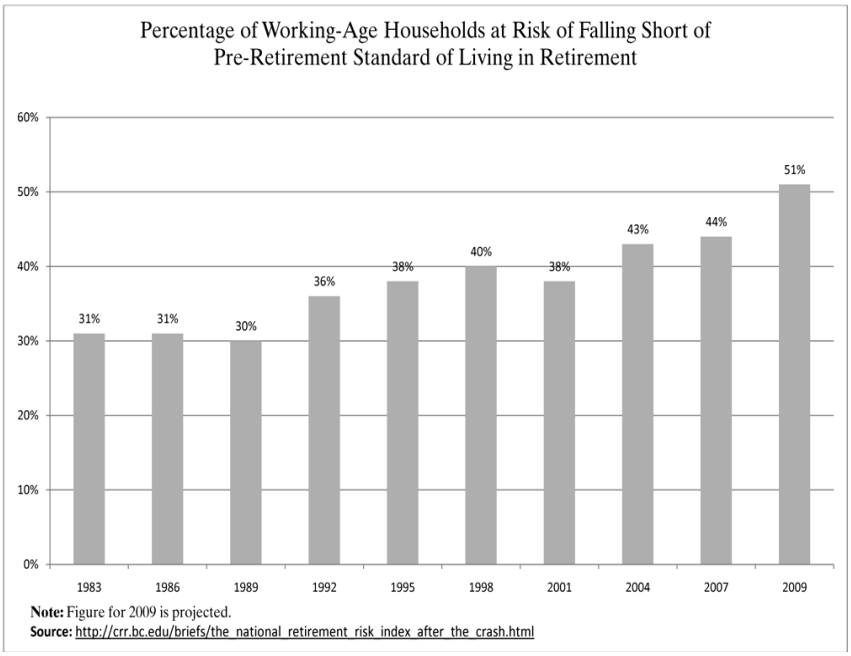
55. Rich Morin & Paul Taylor, *Not Your Grandfather's Recession – Literally: Different Ages, Different Downturns*, PEW RES. CTR. PUBL'N (May 14, 2009), http://pewresearch.org/pubs/1223/not-your-grandfathers-recession-literally.

the retirement-preparedness of younger Americans. According to researchers at Boston College, the share of working-age households that are at risk of being financially unprepared for retirement at age sixty-five has risen from thirty-one percent in 1983 to forty-three percent in 2004, and a projected fifty-one percent in 2009. (See Figure 3.) Younger Americans are far more likely to be at risk than older Americans: roughly half of those born from the mid-1960s through the early 1970s are at risk of being financially unprepared, compared with thirty-five percent of those born in the decade after World War II.[56] In every age group, low-income Americans are the least financially prepared.[57]

56. Alicia H. Munnell et al., *The National Retirement Risk Index: After the Crash*, ISSUE IN BRIEF, Oct. 2009, at 4–7, *available at* http://crr.bc.edu/images/stories/Briefs/IB_9-22.pdf.

57. *Id.*

FIGURE 3



II. The Growing Challenge of Medical Costs

As striking as the rise in retirement risk is, it is important to recognize that the risks discussed thus far concern only potential income shortfalls in retirement, with shortfalls defined as failure to achieve a certain share of preretirement income. As a result, none of the prior discussion tackles one of the most salient risks to the economic security of older Americans—namely, health care costs.

A. Why Health and Long-Term Care Costs Are Special

Medical expenditures are distinct from other spending in key respects. They are substantially nondiscretionary, they are heavily influenced by professional advice rather than personal taste, they can be extremely large, and they are highly variable, both across individuals and over time.

The nondiscretionary aspect is the most important for the current discussion: most people do not believe that failing to go to a doctor or take prescribed medicines is a reasonable response to economic

strains. Rather than a discretionary expense, such spending is best thought of as a *constraint* on disposable income—a significant, unpredictable, and more or less unavoidable part of the family budget. In this vein, the National Academy of Sciences has recommended that calculations of who is poor should subtract medical costs from income, a recommendation recently implemented by the Obama administration in its development of alternative poverty measures.[58]

For older Americans, health care spending takes two main forms. First, there are the costs of medical care itself—a substantial share of which, despite the universal Medicare program for the aged and disabled, are financed by the elderly directly.[59] These out-of-pocket costs include not only the expense of medical services and goods not covered by Medicare or by supplemental insurance, but also the copayments and other forms of cost-sharing required by these coverage sources, as well as the directly paid premiums for these forms of coverage. The Medicare Part B premium, for instance, is now set to pay at least twenty-five percent of program costs, and it rose by sixty percent between 2002 and 2007.[60] Since Part B premiums are directly deducted from Social Security for most people, the effect is to make Social Security income smaller than it would otherwise be.

Despite its mounting cost, Medicare has not kept pace with skyrocketing health expenses for the aged, leaving the aged spending a growing share of income on out-of-pocket medical costs. Today, seniors are actually paying a larger share of their income on medical care than they did at the time of Medicare's passage.[61] In 2000, they spent an average of $3526 out-of-pocket on medical costs—or twenty-two percent of their incomes on average—with low-income seniors spending nearly one-third of their income.[62]

58. MEASURING POVERTY: A NEW APPROACH 68–69 (Constance F. Citro & Robert T. Michael, eds., 1995). *See also* Amy Goldstein, *New Formula to Give Fresh Look at U.S. Poverty*, WASH. POST., Mar. 3, 2010, at A02.

59. Dana P. Goldman & Julie M. Zissimopoulos, *High Out-of-Pocket Health Care Spending by the Elderly*, 22 HEALTH AFF. 194, 194 (2003), *available at* http://content.healthaffairs.org/content/22/3/194.full.pdf?ck=nck.

60. TERESA GHILARDUCCI, WHEN I'M SIXTY-FOUR: THE PLOT AGAINST PENSIONS AND THE PLAN TO SAVE THEM 298 (2008).

61. MARILYN MOON, MEDICARE NOW AND IN THE FUTURE 10 (2d ed. 1996).

62. Heather C. McGhee & Tamara Draut, *Retiring in the Red: The Growth of Debt Among Older Americans* 6 (Demos, Borrowing to Make Ends Meet Briefing Paper No. 1, 2nd ed., 2004), *available at* http://archive.demos.org/pubs/retiring_2ed.pdf.

At the same time, private employment-based coverage for retirees has experienced a tailspin even steeper than have defined-benefit pensions. In 1993, forty-six percent of employers with more than 500 workers offered health insurance to early retirees, and forty percent offered supplemental coverage for retirees on Medicare.[63] In 2009, only twenty-eight percent of these large employers offered retiree health coverage, and just twenty-one percent offered supplemental benefits.[64]

The second major health care expense faced by older Americans is the cost of what is called "long-term care," which includes medical services but is primarily made up of the costs of institutionalization in nursing homes or assisted living facilities (including food, housing, and daily assistance) or the costs of assistance and care in a senior's own home.[65] These costs can be substantial indeed—in 2009, the average annual rate charged for a semi-private nursing home room was more than $70,000—and they are only partially covered by public programs and private insurance.[66] Medicare does not cover long-term care to any significant degree. Thus, the main source of public protection is Medicaid, the joint state-federal program providing health care to the indigent, which funds nursing home care and, to a lesser extent, home care for elderly Americans with little or no income or assets.[67]

Meanwhile, private insurance is very limited in the area of long-term care, with only about one-tenth of Americans older than fifty-five covered by any private long-term care plan.[68] Part of the reason for the low coverage is that people notoriously underestimate the risk of needing long-term care. Experts even have a name for this misper-

63. Craig Copeland, *Employee Tenure, 2008*, EMP. BENEFIT RES. INST. NOTES, Jan. 2010, at 14 Fig.1, *available at* http://www.ebri.org/pdf/notespdf/EBRI_Notes_01-Jan10.Tenure_Ret-Hlth.pdf.

64. *Id.*

65. METLIFE MATURE MKT. INST., MARKET SURVEY OF LONG-TERM CARE COSTS 6 (2010), *available at* http://www.metlife.com/assets/cao/mmi/publications/studies/2010/mmi-2010-market-survey-long-term-care-costs.pdf.

66. *Id.*

67. Stephen A. Moses, *The Fallacy of Impoverishment*, 30 GERONTOLOGIST 21, 21 (1990). *See also* FROLIK & KAPLAN, *supra* note 5, at 110.

68. Andrew E. Scharlach & Amanda J. Lehning, *Government's Role in Aging and Long-Term Care*, in SHARED RESPONSIBILITY, SHARED RISK: GOVERNMENT, MARKETS, AND SOCIAL POLICY IN THE TWENTY FIRST CENTURY (Ann O'Leary & Jacob S. Hacker, eds. 2011); CTR. FOR POLICY & RESEARCH, LONG-TERM CARE INSURANCE PARTNERSHIPS: NEW CHOICES FOR CONSUMERS—POTENTIAL SAVINGS FOR FEDERAL AND STATE GOVERNMENT 1 (2007), *available at* http://www.civicenterprises.net/pdfs/policysample-ahip.pdf.

ception: "the 5% fallacy."[69] The name comes from the confusion of the cross-sectional incidence of long-term care—one in twenty elderly Americans is in a nursing home at any point in time—with the likelihood of needing nursing home care *at some point*, which is about fifty percent, or home health care, which is about seventy percent.[70]

Lack of awareness is only one barrier. The existence of Medicaid coverage for elderly Americans with limited assets means that less affluent seniors have scant incentive to buy private policies. In addition, private insurance has inherent difficulties dealing with the risk of long-term care. Conventional insurance protects people against risks, such as car accidents, that vary among individuals but average out across a large population. As Harvard economist David Cutler has explained, long-term care is different: it is almost impossible to predict how costly the care in future decades will be.[71] Insurers face equally serious uncertainties about how much they must put aside to pay future bills. As a result, coverage is riddled with exceptions and escape clauses[72]—without which long-term care policies would be highly vulnerable to collapse when insurers found themselves unable to pay promised claims. Little wonder, then, that less than one percent of nonelderly Americans hold a private long-term care policy. Of course, future costs are easier to predict for people at or near retirement. At this point, however, policies become much more expensive, and for older Americans most in need of long-term care, either unavailable or prohibitively costly.[73]

Once medical expenses and long-term care costs are brought into the picture, the future of retirement security looks even more threatened.

69. Andrea L. Campbell & Kimberly J. Morgan, *Federalism and the Politics of Old-Age Care in Germany and the United States*, 38 COMP. POL. STUD. 887, 892 (2005), *available at* http://cps.sagepub.com/content/38/8/887.full.pdf+html.

70. *Id.*

71. *See* David M. Cutler, *Why Doesn't the Market Fully Insure Long-Term Care?* 3–4 (Nat'l Bureau of Econ. Research, Working Paper No. 4301), *available at* http://www.nber.org/papers/w4301.pdf.

72. *See generally* FROLIK & KAPLAN, *supra* note 5, at 145–48.

73. *See* AM. HEALTH INS. PLANS, GUIDE TO LONG-TERM CARE INSURANCE 3 (2004), *available at* http://www.pueblo.gsa.gov/cic_text/health/ltc/guide.pdf.

B. Health and Long-Term Care and Retirement Income Adequacy

Health care costs are rising much faster than other costs of living,[74] and the elderly consume much more health care than the young. Therefore, incorporating the high rate of increase of medical costs into projections of future income needs necessarily results in more working-age Americans being counted as "at risk" of inadequate retirement income.

Just how many more is the difficult question, with the answer dependent on future medical cost growth. The researchers at Boston College who developed the index of retirement risk discussed earlier calculate that retiree health costs increase the share of the nonelderly population at risk in 2006 from forty-four percent to sixty-one percent, indicating that an additional seventeen percent of Americans younger than sixty-five are at risk of inadequate income in retirement when health care costs are taken into account.[75] Adding in long-term care costs increases the share at risk even further—to around sixty-five percent of nonelderly Americans.[76] These projections are based on the estimates of the Medicare Boards of Trustees, which predicts that costs will rise substantially faster than general inflation in the future but somewhat slower than they have in recent decades.[77]

C. Health and Long-Term Care and Retirement Income Risk

In addition to being a large constraint on income for older Americans, medical expenditures are unpredictable and lumpy. While generally increasing with age, they are quite different across older individuals due to variance in health status and ability to carry out daily activities, and they may change significantly from year to year. As a result, they may quite suddenly and substantially constrain the other uses to which retirement income can be put.

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74. *Insurance Premiums Still Rising Faster Than Inflation and Wages*, N.Y. TIMES BLOG (Sept. 15, 2009, 10:00 AM), http://prescriptions.blogs.nytimes.com/2009/09/15/insurance-premiums-still-rising-faster-than-inflation-and-wages/.

75. ALICIA H. MUNNELL ET AL., CTR. FOR RET. RESEARCH, LONG-TERM CARE COSTS AND THE NATIONAL RETIREMENT RISK INDEX 1 (2009).

76. *Id.* at 6.

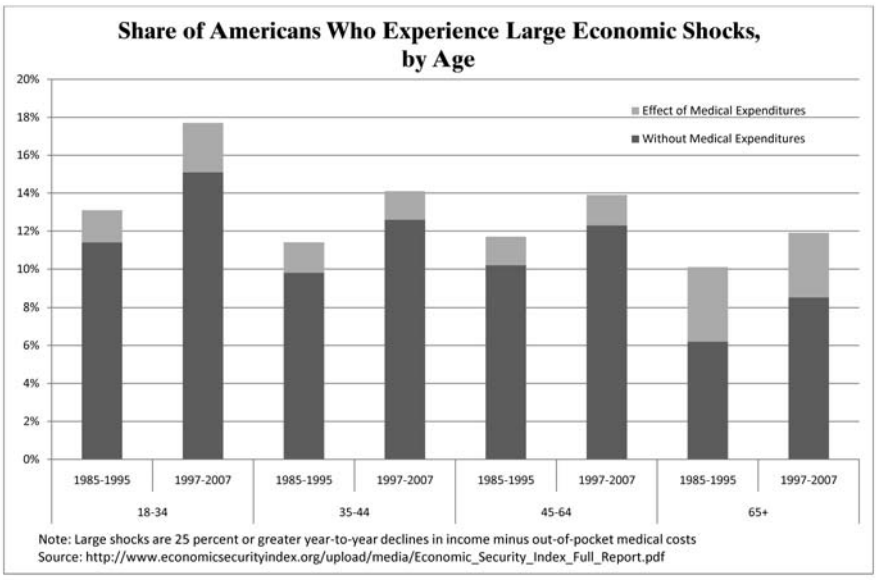
77. *See* CTRS. FOR MEDICARE & MEDICAID SERVS., DEP'T OF HEALTH & HUMAN SERVS., 2010 ANNUAL REPORT OF THE BOARDS OF TRUSTEES OF THE FEDERAL HOSPITAL INSURANCE AND FEDERAL SUPPLEMENTARY MEDICAL INSURANCE TRUST FUND 45 (2010), *available at* http://www.cms.gov/ReportsTrustFunds/Downloads/tr2010.pdf.

In this respect, a major change in out-of-pocket costs is not so different from a major drop in income—both reduce the resources that can be used for other expenses. In fact, this is the way in which a team of researchers and I treat out-of-pocket medical spending in the comprehensive Economic Security Index (ESI) we have developed with the support of the Rockefeller Foundation. The ESI, available from the early 1980s through 2007, is a measure of the share of individuals whose household income *after* factoring out out-of-pocket medical spending declined by more than twenty-five percent from one year to the next.[78] (We excluded from the count those who had sufficient financial wealth that they could make up the loss until they recovered to their prior income level.) Thus, for example, people are counted as insecure if their income remained constant but their medical spending increased by twenty-five percent or more of their income.

This turns out to be very important when examining the economic security of the aged. Older Americans are often thought to be relatively immune from major economic threats given the strong role of Social Security and the virtually universal health insurance provided through Medicare. The ESI suggests otherwise. While older Americans are indeed less likely to experience large income losses than younger Americans, large medical spending burdens substantially offset their advantage on the income side. As Figure 4 shows, Americans aged sixty-five and over remain the most secure group according to the ESI because their incomes are so stable. But factoring in variable medical costs makes them appear much more vulnerable to year-to-year changes in their economic standing.

78. JACOB S. HACKER ET AL., THE ROCKEFELLER FOUND., ECONOMIC SECURITY AT RISK: FINDINGS FROM THE ECONOMIC SECURITY INDEX 3 (2010), *available at* http://economicsecurityindex.org/upload/media/Economic_Security_Index_Full_Report.pdf.

FIGURE 4



D. Related Threats to the Economic Security of the Aged

Medical costs are not the only large, variable expense financed by the aged. As part of the Economic Security Index project, the ESI team of researchers and I also commissioned a unique two-wave representative survey of Americans that was fielded between March 2008 and September 2009: the Survey of Economic Risk Perceptions and Insecurity (SERPI). The SERPI measures economic insecurity in four domains of economic life: employment, medical spending, family needs, and wealth. Through its lens, it is possible to examine not just the share of Americans experiencing substantial economic shocks, but also that imprint of these shocks on Americans' lives, their ability to meet basic needs, and their expectations and concerns.

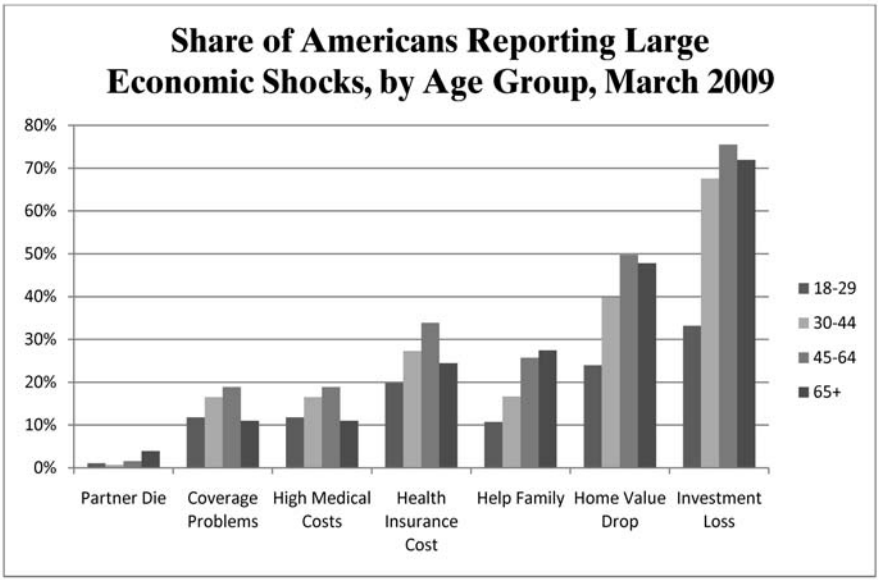
The first finding of SERPI to note is that having adequate savings for retirement is the leading worry of Americans, exceeding concerns about medical costs, employment, debt, health insurance, and housing. In March 2009, more than half of Americans said they were "very" or "fairly" worried about "having enough money to retire on." Among those nearing retirement (aged forty-five to sixty-four), nearly four in ten (thirty-eight percent) are "very" worried. This high level of concern is mirrored in other sources—for example, the Retirement Confidence Survey of the Employee Benefit Research Institute, which

found workers more pessimistic about their retirement income prospects in 2011 than at any time during the two decades that the survey has been conducted.[79]

SERPI also allows us to look at current retirees' vulnerability to large economic shocks. The picture is mixed, befitting the relatively secure position of today's retirees relative to past cohorts—or, as I have argued, to future ones. On the one hand, those over the age of sixty-five report a very low rate of economic shocks due to divorce, the loss of health insurance coverage, and cuts in retirement benefits (they are also quite obviously less likely to experience the loss of job). On the other hand, as Figure 5 shows, they are roughly as likely as younger age groups to experience substantial health care or health insurance costs, have major cuts in their health insurance coverage (presumably supplemental coverage from former employers or private carriers), or see a major drop in their home or asset values. And they are more likely—not surprisingly, given their age—to have a spouse die. Perhaps more notable, older Americans are more likely to find themselves offering substantial financial assistance to extended family members than are younger Americans. This is one respect in which the Great Risk Shift has reached into the lives of even Americans living in the Golden Age of Retirement: during hard economic times, they are pressed to serve as a safety net for younger Americans who are more exposed to the vagaries of the job market and cuts in medical and pension benefits.

79. HELMAN ET AL., THE 2011 RETIREMENT CONFIDENCE SURVEY: CONFIDENCE DROPS TO RECORD LOWS, REFLECTING "THE NEW NORMAL," EMP. BEN. RES. INST. ISSUE BRIEF 5 (2011), *available at* http://www.ebri.org/pdf/briefspdf/EBRI_03-2011_No355_RCS-2011.pdf.

FIGURE 5



III. Restoring Retirement Security

The promise of private retiree benefits at their heyday was a secure retirement income that, when coupled with Social Security, would allow older Americans to spend their retired years in relative comfort. That promise is now in grave doubt. But reforms to our pension and health care systems could make private retirement accounts work better as a source of secure retirement income for ordinary workers and their families while offering greater protection against future medical costs.

Restoring retirement security requires a three-pronged approach. First, Social Security needs to be strengthened as a foundation for retirement planning. Second, 401(k)s should be fixed so they adequately supplement Social Security for all workers, not just a fortunate few. Third, the challenge of rising health care costs for the aged must be tackled head on.

None of these proposals will be costless or easy to put in place, but they are consistent both with public views of retirement policy and with the imperatives of fiscal responsibility. Indeed, each of these proposals—especially the last, addressing future health costs—would

improve the long-term budget situation of the United States without putting retirement security at greater risk.

A. Strengthening Social Security

In the context of the financial crisis and increased private risk-bearing, securing our one guaranteed system of retirement security, Social Security, is all the more essential. To do this, however, will require addressing Social Security's funding shortfall. Although the program has run a surplus since the early 1980s, it will soon start drawing down this surplus—which requires remitting special government bonds held by the program (and, thus, will increase strains on the rest of the federal government).[80] If no changes are made in the program, it is projected to be able to pay only around three-quarters of promised benefits after the mid-2030s.[81]

The last two decades have been consumed by a debate over "privatization" of Social Security—that is, its whole or partial replacement by mandatory individual savings accounts.[82] The push for privatization failed spectacularly in 2005 in the face of public resistance to risks inherent in the movement toward individual private accounts, as well as to the borrowing and benefit cuts required to set up the new system.[83] But as the debate over Social Security's future heats up again, these proposals are resurfacing.

Private accounts by themselves do nothing to improve Social Security's fiscal standing. Indeed, since Social Security now pays benefits with the revenue raised by current workers' contributions, diverting contributions by younger workers into private accounts makes the program's finances worse rather than better. If Social Security was to become a system of private accounts, into which current workers put some or all of the money that they would have paid in taxes, the funds needed to pay promised benefits would have to come from some-

80. Lawrence A. Frolik, *Elder Law: Economic Planning for the Golden Year*, 1 PHOENIX L. REV. 325, 328 (2008).

81. Soc. Sec. & Medicare Bds. of Trs., *Status of the Social Security and Medicare Programs: A Summary of the 2010 Annual Reports*, SOC. SEC. ADMIN. (Aug. 5, 2010), http://www.ssa.gov/oact/TRSUM/index.html.

82. *See generally* PETER J. FERRARA & MICHAEL D. TANNER, A NEW DEAL FOR SOCIAL SECURITY (Cato Inst. 1998); SOCIAL SECURITY AND ITS DISCONTENTS: PERSPECTIVES ON CHOICE (Michael D. Tanner ed., Cato Inst. 2004).

83. *See* Jonathan Chait, *Blocking Move*, THE NEW REPUBLIC (Mar. 21, 2005, 12:00 AM), http://www.tnr.com/article/blocking-move (discussing the opposition to President George W. Bush's Social Security privatization plan).

where else—or, more precisely, from new taxes, new benefit cuts, new borrowing, or some mix of the three. The only way to pay these "transition costs" is to take something away from someone—either retirees in the form of lower benefits, all Americans in the form of higher taxes or reduced spending on other valued ends, or future generations in the form of new government debt.

Even more important, privatization proposals would seriously undermine Social Security's role as an insurance program. Because it pools risk across millions of citizens and uses the power of government to guarantee against the major threats to family income during (and, in some cases, before) retirement, Social Security simply does not have the kind of inherent uncertainty built into it that private accounts would. It offers a guaranteed benefit in retirement that is more generous to families with low lifetime incomes, to families whose heads are disabled or pass away, and to those who have the good fortune to live a long time after retirement (elderly widows are the chief example).[84] The program protects families not just against these risks, but also against the risk of large drops in their assets due to stock-market or housing-price instability, as well as the risk of unexpected inflation, which can devastate families on fixed incomes.[85]

Virtually all of these protections would be undercut or eliminated by privatization. Workers would see their guaranteed benefits largely replaced by the returns on their accounts, which could vary greatly from person to person. Those disabled before retirement, those who end up living a long time after retirement, those with low incomes, those who retire when the stock market drops—all might end up with less than they would have enjoyed had they received the guaranteed benefit. In short, a social insurance program would be replaced by a system that would shift much more risk onto the shoulders of individual workers and their families—precisely the transformation that has taken place in the private sector with such negative consequences for retirement income and security.

Some of these risks might be worth imposing if fiscal realities made massive changes in Social Security unavoidable. But dealing

84. HACKER, THE GREAT RISK SHIFT, *supra* note 1, at 132.

85. Theodore R. Marmor & Jerry L. Mashaw, *The Future of Entitlements*, *in* THE OXFORD COMPANION TO POLITICS OF THE WORLD 246, 248 (Joel Krieger & Margaret E. Crahan eds., 2001) (describing various entitlement programs and stating: "The American Social Security system protects workers against inflation risks, bankruptcy risks, and market risks.").

with the future financial threats to Social Security simply does not require abandoning the core elements of the program: guaranteed lifetime benefits paid on retirement, provided as a right, and linked to lifetime earnings. The funding shortfall within the program—substantial, but hardly insurmountable—can be closed relatively easily by making Social Security benefits and the payroll taxes that fund them modestly more progressive and by tying benefits to future longevity so that fortunate generations that live longer than the last receive slightly less from the program than now promised.[86]

What this means in detail should be up for debate, but four important considerations should guide these discussions. First, the early retirement age for Social Security (now sixty-two) should only be raised in tandem with increased longevity of the least advantaged workers. This is because most of the gains in average life expectancy over the last generation have been enjoyed only by higher-wage workers.[87] Less affluent workers (who are most reliant on Social Security) are not living markedly longer than they used to,[88] so raising the retirement age could impose substantial hardship on them. Absent an increase in early-retirement age, moreover, raising the age at which full benefits are received (now sixty-five and slated to rise to sixty-seven in future years) amounts simply to a blunt cut in benefits, since workers receive reduced benefits if they retire before the normal retirement age.[89] Thus, other benefit trims—for example, a small downward shift in the cost-of-living adjustment or a slight increase in the progressivity of the benefit formula—should be considered before raising the retirement age. Raising the retirement age, it is worth noting, is also among the least popular reform options in opinion polls.[90]

Second, the financing of Social Security should be made more progressive. As wages have grown more unequal over the last generation, more and more of the highest wages are exempt from the Social

86. *See, e.g.*, Peter A. Diamond & Peter R. Orszag, *Saving Social Security: The Diamond-Orszag Plan*, 2 THE ECONOMISTS' VOICE 1, 3–4 (2005), *available at* http://www.brookings.edu/papers/2005/04saving_diamond.aspx.

87. Joyce Manchester & Julie Topoleski, *Growing Disparities in Life Expectancy*, CONG. BUDGET OFFICE (Apr. 17, 2008), http://www.cbo.gov/ftpdocs/91xx/doc9104/04-17-LifeExpectancy_Brief.pdf.

88. *See id.*

89. *Full Retirement Age*, SOC. SEC. ADMIN. (Feb. 9, 2011), http://www.ssa.gov/retirement/1960.html.

90. *Higher Taxes, Budget Cuts Needed to Reduce Deficit: CNBC Poll*, CNBC.COM (Nov. 30, 2010), http://www.cnbc.com/id/40417458/Higher_Taxes_Budget_Cuts_Needed_to_Reduce_Deficit_CNBC_Poll.

Security payroll tax, which is capped at around $100,000 in annual earnings.[91] Because of the progressive benefit structure (high-income workers receive the lowest rate of return from the program), raising the cap results in far more revenue flowing into the program than new spending on benefits. In fact, eliminating the payroll-tax cap would by itself close the long-term Social Security funding shortfall.[92] To reduce opposition from high-income taxpayers, as well as to preserve the link between contributions and benefits, I would be wary of a complete removal of the cap. Nonetheless, it should be significantly raised.

Third, there is a strong case for taxing capital income as well as wage income—as was recently done for the Medicare portion of the payroll tax,[93] which, importantly, is not capped like the Social Security tax. Another alternative would be to dedicate a portion of a restored estate tax, one that would tax a larger portion and share of the richest estates than the current tax, to Social Security's long-term financing.

Finally, serious consideration should be given to investing a portion of the Social Security trust fund in private equities. Certainly, there are risks to direct public investment in the stock market. Other countries, however, have successfully created models for passive investment that have allowed them to increase the returns of the prefunded portions of their system.[94]

The advantage of such pooled investment—which is similar to what traditional defined-benefit pensions do but on a broader scale and with a much greater capacity to spread risk—is that it allows for the diversification of market risk, both across individuals and over time, something that cannot be done with voluntary private accounts. As pension expert Alicia Munnell argues:

> In general, efficient risk sharing requires individuals to bear more risk when young and less when old. However, the young often hold no risky, high-yielding assets, and their implicit asset—Social Security—is invested in bonds. Introducing equities into

91. *Automatic Increases: Contribution and Benefit Base*, SOC. SEC. ADMIN. (Dec. 28, 2010), http://www.ssa.gov/oact/cola/cbb.html.

92. Virginia P. Reno & Joni Lavery, *Options to Balance Social Security Funds Over the Next 75 Years*, SOC. SEC. BRIEF 1, 3 (2005), *available at* http://www.law.cornell.edu/socsec/course/topic13/SS_Brief_18.pdf.

93. FROLIK & KAPLAN, *supra* note 5, at 58.

94. *Social Security Privatization: Experiences Abroad: Hearing Before the H. Comm. on the Budget*, 106th Cong. 2–7 (1999) (statement of Dan L. Crippen, Director, Congressional Budget Office), *available at* http://www.cbo.gov/ftpdocs/12xx/doc1283/052599.pdf.

> the Social Security system has the potential to shift risk from the old to the young and could make all generations better off.[95]

B. Fixing 401(k)s

Even with a secure Social Security system, today's workers will need other sources of income in retirement. 401(k)s as they are presently constituted are not the solution. Too few workers are offered them, enroll in them, or put adequate sums in them—a reflection of perverse incentives built into their very structure—and they place too much of the risk of retirement planning onto individuals, with too little information and insurance to help them build a secure retirement.

Three main options for the reform of 401(k)s vie for consideration: incremental fixes, large-scale reforms, and complete replacement. The first approach is exemplified by the Pension Protection Act of 2006, which tried to encourage employers to automatically enroll their workers in 401(k)s.[96] The research is clear that workers required to opt out of 401(k)s rather than opt in are much more likely to participate in plans.[97]

So far, however, results of the Act have been mixed, with surprisingly few employers adopting automatic enrollment.[98] Moreover, automatic enrollment does little to address other key concerns with 401(k)s, including the skewed tax subsidies for them, low contribution rates, leakage from the system due to lump-sum distributions, and, most fundamental of all, the reality that many employers do not offer a 401(k) at all.

On the other extreme, thoughtful pension experts have proposed mandatory government managed accounts with a guaranteed rate of return that would supplement Social Security, forming a "second tier"

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95. Alicia Munnell, *Bigger and Better: Redesigning Our Retirement System in the Wake of the Financial Collapse*, *in* SHARED RESPONSIBILITY, SHARED RISK: GOVERNMENT, MARKETS AND SOCIAL POLICY IN THE TWENTY FIRST CENTURY 23–24 (BERKELEY CTR. ON HEALTH, ECON., & FAM. SEC., 2009), *available at* http://www.law.berkeley.edu/files/chefs/10.16.09_Presenters_Research_Summary-_Pamphlet.pdf.

96. *Pension Protection Act Overview*, THE MONEY ALERT, http://www.themoneyalert.com/PensionProtectionAct.html (last visited Apr. 27, 2011).

97. David K. Randall, *401(k) Rethink*, FORBES.COM (Aug. 19, 2009, 6:00 PM), http://www.forbes.com/forbes/2009/0907/investing-retirement-ira-saving-401k-rethink.html.

98. *See* S. KATHI BROWN, AM. ASS'N OF RETIRED PERSONS RESEARCH & STRATEGIC ANALYSIS, AUTOMATIC 401(K) PLANS: EMPLOYER VIEWS ON ENROLLING NEW AND EXISTING EMPLOYEES, EXECUTIVE SUMMARY 1, 1 (2010), *available at* http://assets.aarp.org/rgcenter/econ/auto401k.pdf.

of compulsory retirement savings.[99] Contributions would be required, but unlike Social Security, benefits would be fully prefunded and there would be no redistribution from high-income to low-income workers. Instead, existing tax breaks would be restructured or replaced to provide a subsidy for low-income workers. These proposals generally envision that 401(k)s would gradually cease to exist.

Though these second-tier ideas have considerable merit, they also face serious political and logistical obstacles. Instead, I propose a middle way: a more robust version of plans for "universal 401(k)s" that have received substantial notice in recent years.[100] Universal 401(k)s should be available to all workers, whether or not their employer offers a traditional retirement plan. Employers would be encouraged to match employer contributions to these plans, and indeed, government could provide special tax breaks to employers that offered better matches to lower-wage workers.

Automatic enrollment would be required of all these plans, and the default contribution rate would be set at a level that would finance an adequate retirement along with Social Security. Existing tax breaks for 401(k)s would be replaced with a retirement savings credit that would be placed in the accounts of all workers. Such a credit would be the same for all workers and, hence, a much larger share of the income of low-wage workers.

To be sure, higher-income workers would be free to fund retirement accounts with after-tax dollars. In return for pre-committing resources to retirement, they would receive the benefit of not having their interest earnings taxed until withdrawals were made, allowing them to accumulate retirement savings tax-free. However, they would no longer be able to make tax-free contributions (as in 401(k)s and traditional IRAs) or receive final benefits tax-free (as in so-called Roth 401(k)s and Roth IRAs, which require after-tax contributions but keep accounts free from future taxation).[101]

Since universal 401(k)s would be offered to all workers, there would cease to be any problem with lump-sum payments when workers lost or changed jobs. All benefits would remain in the same

99. Munnell, *Bigger and Better*, *supra* note 95, at 25.

100. *See, e.g.*, *15 New Ideas: Universal 401(k)*, AM. PROGRESS, http://www.americanprogress.org/projects/15newideas/pensions.html (last visited Apr. 27, 2011).

101. COLLEEN E. MEDILL, INTRODUCTION TO EMPLOYEE BENEFIT LAW: POLICY AND PRACTICE 104–05 (3d. ed. 2011).

account throughout a worker's life. As with 401(k)s today, this money could only be withdrawn before retirement with a steep penalty.

Unlike the present system, however, 401(k)s would be governed by the same rules that now protect traditional pension plans against excessive investment in company stock. Moreover, the default investment option under 401(k)s should be a low-cost index fund with a mix of stocks and bonds that automatically shifts over time as workers age to limit market risk as workers approach retirement.

To help workers plan ahead, moreover, 401(k) balances should be reported to account holders not simply as a cash sum, but also as a monthly benefit amount that workers would receive when they retired if they had average life expectancy—just as Social Security benefits are reported.

After my criticism of 401(k)s, it may come as a surprise that I think universal 401(k)s are the best route forward. However, the difference between universal 401(k)s with strong incentives for contributions and the present system are profound. What is more, I recommend one dramatic additional change to improve 401(k)s that would transform them into a source of guaranteed retirement income. Under this proposal, 401(k) accounts would be converted into an annuity at retirement—unless workers specifically requested otherwise and could show they had sufficient assets to weather market risk. One reasonable concern about mandatory annuitization is that some demographic groups (such as African Americans) might end up receiving much less back than others because of shorter life spans. On the one hand, if annuities were based simply on average life expectancy at retirement, they would generally favor healthier and higher-income groups. On the other hand, it would be impracticable and undesirable (and in the case of some characteristics, like race, illegal) to have annuities based on very specific health and demographic characteristics. A reasonable medium ground would be to have annuities based on a few key characteristics that life insurers are now legally permitted to take into account that correlate strongly with life expectancy. In addition, annuities could have a provision providing some stream of payments to the surviving spouse or heirs of those who live for a very short period after retirement.[102]

102. I am grateful to Chad Henson, a University of Illinois law student, for raising this concern and clarifying my thinking about an appropriate response.

These new annuities could be provided by private firms under strict federal rules or directly by the federal government. (Interestingly, this proposal is not so different from an idea that was seriously considered by the developers of the Social Security Act in 1935, who argued that the post office should sell low-cost annuities to those who needed them.[103]) In essence, universal 401(k)s along these lines would bring back something close to a guaranteed private pension, with government, rather than employers, pooling the risk.

C. Confronting Health Care Costs

Health care security and retirement security are inextricably intertwined. Without serious efforts to control future health care costs faced by retirees, no pension system will prove adequate over the long term. At the same time, key distortions in our pension system reflect the growing challenge of retiree health care. For example, retirees are often loathe to take out reverse mortgages on their home or convert their savings into an annuity because of the possibility of having to finance very large health care expenses.

This is an area, however, where effective public and private efforts could make an enormous difference. As the economist Henry Aaron has shown, America's long-term budget challenge is principally a health care cost challenge.[104] Social Security, antipoverty benefits, discretionary social spending—all of these pale in comparison to the rising costs of Medicare and Medicaid. Failing to rein in costs means not just less income for retirees, but also federal and state budgets that are unable to accommodate necessary investments in education, infrastructure, technology, and other critical sources of future growth.[105]

Nonetheless, the focus cannot be simply on reducing federal expenditures on Medicare. While Medicare's costs are rising rapidly, the main reasons have little to do with Medicare and much to do with American health care. In fact, since payment controls were first introduced into the program in the early 1980s, Medicare's costs per pa-

103. *See Legislative History: Social Security Act of 1935*, SOC. SEC. ADMIN., http://www.ssa.gov/history/35acviii.html#Sale (last visited Apr. 27, 2011).

104. Henry J. Aaron, *Budget Crisis, Entitlement Crisis, Health Care Financing Problem—Which Is It?*, 26 HEALTH AFF. 1622, 1625 (2007), *available at* http://www.unmc.edu/publichealth/docs/Henry%20Aaron%20article.pdf.

105. *See generally The Long-Term Outlook for Medicare, Medicaid, and Total Health Care Spending*, CONG. BUDGET OFFICE, http://www.cbo.gov/ftpdocs/102xx/doc10297/chapter2.5.1.shtml (last visited Mar. 10, 2011) (finding that total health care pricing will be thirty-one percent of GDP by 2035).

tient have risen slower, on average, than private health insurance spending per patient.[106] In recent decades, Medicare has contracted with private health plans to provide insurance to some beneficiaries[107]—which, if you believed the rhetoric about Medicare's inefficiency, should have cut costs. Yet, every reputable study has shown that Medicare loses money when beneficiaries enroll in private plans (in large part because the beneficiaries who enroll in private health plans are healthier than those who do not).[108]

This is not to deny that Medicare faces serious strains. Because it covers only the aged, its spending will be driven up by the retirement of the baby boom generation in the coming years (although this is far less important than the general increase in costs per retiree). Medicare spends hugely different amounts on patients in different parts of the country reflecting longstanding, but unnecessary, regional variations in medical costs and practice patterns that Medicare could do much more to reduce than it does.[109] Medicare has also moved much too slowly in introducing measures that might make it better able to judge the efficacy of treatments and coordinate care for the chronically ill (although, revealingly, it still remains ahead of most of the private sector on both scores).[110]

Nonetheless, the common critique of Medicare—that it is overly generous—is untrue. Medicare coverage is substantially less generous than the norm in the private sector.[111] What is more, Medicare provides this relatively ungenerous coverage for less than the private sector would charge for the same benefits.[112] If we as a nation cannot "afford" Medicare, then we as a nation cannot afford to provide basic health care to the aged. Few Americans, I am certain, are ready to ac-

106. *See generally* Chapin White, *Why Did Medicare Spending Growth Slow Down?*, 27 HEALTH AFF. 793–802 (2008).

107. *See* CTRS. FOR MEDICARE & MEDICAID SERVS., *Your Guide to Medicare Private Fee-for-Service Plans* 1–3 (2007), *available at* http://www.medicare.gov/Publications/Pubs/pdf/10144.pdf.

108. J. TIMOTHY GRONNIGER & ROBERT A. SUNSHINE, CONG. BUDGET OFFICE, MEDICARE ADVANTAGE: PRIVATE HEALTH PLANS IN MEDICARE 4–6 (2007), *available at* http://www.cbo.gov/ftpdocs/82xx/doc8268/06-28-Medicare_Advantage.pdf.

109. MEDICARE PAYMENT ADVISORY COMM'N, REPORT TO THE CONGRESS: MEASURING REGIONAL VARIATION IN SERVICE USE 2–3 (2009), *available at* http://www.medpac.gov/documents/Dec09_RegionalVariation_report.pdf.

110. HACKER, THE GREAT RISK SHIFT, *supra* note 1, at 188.

111. DALE YAMAMOTO ET AL., KAISER FAMILY FOUND., HOW DOES THE BENEFIT VALUE OF MEDICARE COMPARE TO THE BENEFIT VALUE OF TYPICAL LARGE EMPLOYER PLANS? 3 (2008), *available at* http://www.kff.org/medicare/upload/7768.pdf.

112. *Id.*

cept this dismal conclusion—not at least in the world's richest nation—and rightly so: almost every other advanced industrial country provides insurance not just to the aged, but to all citizens, while spending much less on a per-person basis than the United States' incomplete system does.[113] Many of these nations, furthermore, have much older populations than we do,[114] have citizenries that go to the doctor more often,[115] and have better basic health outcomes.[116] Despite this, the overall health spending in these nations remains far below ours and, in many, has also been growing more slowly.[117]

Controlling Medicare spending can only be done in one of two ways. The first way is controlling how much Medicare pays for care. The second is by shifting more of the costs of care onto Medicare beneficiaries. Given that Medicare coverage is less generous than the private-sector norm and that most elderly and disabled Americans have modest incomes—median income of the aged is around $18,000—shifting costs and risks would seem the very last option to embrace.[118] Nevertheless, shifting costs and risks is precisely what many Medicare reform proposals now call for, under the label of "premium support."[119]

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113. HACKER, THE GREAT RISK SHIFT, *supra* note 1, at 189.

114. *See generally* Gerard F. Anderson & Peter Sotir Hussey, *Population Aging: A Comparison Among Industrialized Countries*, 19 HEALTH AFF. 191–203 (2000).

115. Jacob S. Hacker, *Yes We Can? The New Push for American Health Security*, 37 POL. & SOC'Y 3, 14 (2009).

116. *See, e.g.*, Ellen Nolte & C. Martin McKee, *Measuring the Health of Nations: Updating an Earlier Analysis*, 27 HEALTH AFF. 58, 59–63 (2008).

117. Hacker, *supra* note 115, at 6, 7.

118. EMP. BENEFIT RESEARCH INST., HOW INCOME OF THE ELDERLY HAS INCREASED OVER TIME 1 (2010), *available at* http://www.ebri.org/pdf/FFE172.14July10.Inc.Eld.Final.pdf.

119. CONG. BUDGET OFFICE, CONG. OF THE U.S., DESIGNING A PREMIUM SUPPORT SYSTEM FOR MEDICARE 1 (2006) [hereinafter DESIGNING A PREMIUM SUPPORT SYSTEM], *available at* http://www.cbo.gov/ftpdocs/76xx/doc7697/12-08-Medicare.pdf. In April 2011, House Republicans passed a budget that contains a version of premium support—though one quite different from the proposals of the 1990s. It would convert the current Medicare program into a system in which seniors received vouchers with which to buy private health plans. The traditional Medicare program would cease to be an option for those turning sixty-five after 2021. The vouchers would grow over time at the rate of general price inflation, which is well below the projected rate of growth of medical costs for the aged. The result, according to a recent analysis by the Congressional Budget Office, is that "[m]ost elderly people would pay more for their health care than they would pay under the current Medicare system." Indeed, according to the CBO, the share of the costs paid directly by beneficiaries in the form of out-of-pocket payments and their portion of the premium would be nearly seventy percent by 2030—more than twice as large as projected under present law. CONG. BUDGET OFFICE, LONG-TERM

Under premium support proposals, people who are enrolled in Medicare would be given a fixed amount to either buy into traditional Medicare coverage or purchase a private alternative.[120] Much as in a defined-contribution pension plan, Medicare would cease to guarantee a specific benefit at a particular price, but rather offer a guaranteed level of support ("premium support") for the purchase of private options or traditional Medicare coverage.[121] If a particular plan were to cost more than the premium support amount, the remainder would be the responsibility of Medicare beneficiaries—even if those beneficiaries remained in the traditional Medicare program.[122]

The premium support approach threatens to shift more risk onto seniors' shoulders—which is why it is such a central challenge to the existing structure of Medicare. To understand this, it helps to remember that the costs of health care are extremely concentrated on the small portion of Americans who incur major health expenses in any given year.[123] As it is currently constructed, Medicare essentially pays for the high costs of these unfortunate Medicare beneficiaries by spreading the costs across all Medicare beneficiaries—and through taxes, across all Americans. Yet, if Medicare was a system of multiple private plans competing with the traditional Medicare option, then it would be much harder to spread costs in this way. Some plans would get a healthy group of patients while others—almost certainly including traditional Medicare—would not. Even with adjustments to account for this brute fact, the premium support would still create a substantial amount of sorting of patients that would undermine the ability of traditional Medicare to pool risks and perhaps even to survive.

These are not idle speculations. The entire history of private health insurance in the United States—from the abandonment of broad pooling by Blue Cross and Blue Shield, to the hyper-segmentation of the market in the 1980s and 1990s because of the exodus of large employers from the private risk pool—illustrates the

ANALYSIS OF A BUDGET PROPOSAL BY CHAIRMAN RYAN (2011), *available at* http://www.cbo.gov/ftpdocs/121xx/doc12128/04-05-Ryan_Letter.pdf.

120. DESIGNING A PREMIUM SUPPORT SYSTEM, *supra* note 119, at 1.

121. *Id.*

122. Jonathan Oberlander, *Is Premium Support the Right Medicine for Medicare?*, 19 HEALTH AFF. 84, 86 (2000).

123. Mark W. Stanton, *The High Concentration of U.S. Health Care Expenditures*, RES. IN ACTION, June 2006, at 2, 3.

dangers.[124] Advocates of premium support often point to the Federal Employees Health Benefit Program. But there are huge discrepancies in the premiums of plans within the federal employee's program due simply to the health of the patients they enroll.[125] Such discrepancies would be much greater, and much more worrisome, in the context of Medicare, especially if they meant that senior citizens who wanted to remain in traditional Medicare were not able to enroll in the program they once benefited from because of its higher cost.

At heart, then, proposals to "modernize" Medicare by introducing premium support are about shifting the risk of rising health costs from the government onto senior citizens, and this shift will not be a one-time occurrence. If Medicare moves from a guaranteed package of benefits to a system that merely provides a fixed amount of support, then it will be much easier down the road to control Medicare costs by simply trimming the level of the fixed contribution. This is all the more true because Medicare beneficiaries would suddenly face very different premiums and enjoy very different benefit packages, undermining the unified constituency of Medicare beneficiaries that has made direct cuts in Medicare so difficult in the past.

Rather than making Medicare look more like private insurance, we should do almost exactly the opposite: simultaneously make Medicare more cost-effective and open it up to younger Americans, which would create competitive pressures on private insurers to adopt innovations in cost control and care management as well. Those who are familiar with my work on the "public option" will recognize that this is the proposal I advocated with regard to the Affordable Care Act of 2010.[126] Although the public option—which would have allowed

124. HACKER, THE DIVIDED WELFARE STATE, *supra* note 3, at 244, 257.

125. MARK MERLIS, INST. FOR HEALTH POLICY SOLUTIONS, KAISER FAMILY FOUND., MEDICARE RESTRUCTURING: THE FEHB MODEL 39 (1999), *available at* http://lobby.la.psu.edu/004_Risk_Adjuster/Organizational_Statements/Kaiser_Foundation/KFF_Medicare_Restructuring.pdf.

126. *See generally* JACOB S. HACKER, THE CASE FOR PUBLIC PLAN CHOICE IN NATIONAL HEALTH REFORM: KEY TO COST CONTROL QUALITY COVERAGE (2008); JACOB S. HACKER, HEALTH CARE FOR AMERICA: A PROPOSAL FOR GUARANTEED, AFFORDABLE HEALTH CARE FOR ALL AMERICANS BUILDING ON MEDICARE AND EMPLOYMENT-BASED INSURANCE (2007), *available at* http://www.sharedprosperity.org/bp180/bp180.pdf; JACOB S. HACKER, HEALTHY COMPETITION: HOW TO STRUCTURE PUBLIC HEALTH INSURANCE PLAN CHOICE TO ENSURE RISK-SHARING, COST CONTROL, AND QUALITY IMPROVEMENT (2009), *available at* http://www.ourfuture.org/files/Hacker_Healthy_Competition_FINAL.pdf; JACOB S. HACKER, PUBLIC PLAN CHOICE IN CONGRESSIONAL HEALTH PLANS: THE GOOD, THE NOT-SO-GOOD, AND THE UGLY (2009), *available at* http://www.ourfuture.org/files/Hacker_Public_Plan_August_2009.pdf; Jacob S. Hacker, *Healthy Competition – The*

nonelderly Americans without workplace coverage to enroll in a Medicare-like public plan—was not enacted as part of the 2010 reform legislation, it remains an essential tool of cost control that should be reconsidered.

This tool, of course, will only work if the public sector can better control costs than the private sector and if there is a mechanism for allowing enrollment in Medicare (or a Medicare-like national public plan) that would not undermine the federal government's fiscal standing. To take the second problem first, simply allowing people to enroll in a new public plan will create tremendous threats to federal finances. Proposals to allow the near-elderly to enroll in Medicare on a voluntary basis, for example, make good sense in that older Americans who do not enroll in employment-based coverage face higher health care costs and difficulty finding private coverage until they turn sixty-five. (Medicare is distinct from Social Security in that one cannot gain access to it before age sixty-five—one reason why raising the Medicare eligibility age is a much more serious and undesirable change than raising the normal retirement age under Social Security.) The drawback of voluntary buy-in proposals is that the least healthy near-elderly will have the greatest incentive to enroll. Such "adverse selection" could undermine Medicare or any similar public plan.

Fortunately, the Affordable Care Act contains a mechanism for allowing enrollment that is less subject to adverse selection—namely, the health insurance "exchanges" that will be established at the state level (or on a multi-state basis if states desire) under the law. The exchanges are open only to those without workplace insurance who meet certain minimum standards, and, in a number of ways, they reduce the chance of adverse selection. For example, the amount plans are paid is "risk-adjusted" to reflect the expected cost of subscribers (so a plan would receive less if they enrolled a healthy young person than if they enrolled an older person with a chronic disease), and marketing and enrollment are regulated to discourage plans from selecting only healthier people.[127] Allowing younger Americans to enroll in Medicare or a Medicare-like public plan would, therefore, be

Why and How of Public-Plan Choice, 360 NEW ENG. J. MED. 2269 (2009), *available at* http://www.nejm.org/doi/full/10.1056/NEJMp0903210; Jacob S. Hacker, *Poor Substitutes – Why Cooperatives and Triggers Can't Achieve the Goals of a Public Option*, 361 NEW ENG. J. MED. 1617 (2009), *available at* http://www.nejm.org/doi/full/10.1056/NEJMp0907659.

127. JACOB S. HACKER, THE CASE FOR PUBLIC PLAN CHOICE IN NATIONAL HEALTH REFORM: KEY TO COST CONTROL QUALITY COVERAGE 17 (2008).

as simple as offering it as a choice within the new health insurance exchanges.

As simple as it would be in principle, this single reform would have major benefits. It would increase the federal government's ability to control costs as well as its ability to monitor and improve the quality of care, it would even out the nation's commitments between young and old, and it would make future federal costs less frightening because they would not rise as sharply as the baby boom generation retires. Of course, Medicare would have to be upgraded to work for younger Americans, putting more emphasis on prevention and limiting out-of-pocket costs—but this would be good for older Americans, too.

The other side of the equation—and the most important over the long term—is cost control. No one who has studied the private medical market in recent years can fail to recognize the unhealthy consolidation that has taken place on both the demand (insurer) and supply (provider) sides. In 2009, a single private insurer held seventy percent or more of the private market in twenty-four of the forty-three states examined (up from eighteen of forty-two just a year earlier).[128] On the provider side, large physicians' groups and flagship hospital systems have gained increasing power to drive up prices, even when faced with dominant insurers.[129]

The federal government has far greater leverage to hold down price increases. Medicare, for example, has held annual spending growth (for comparable services) at a level two-to-three percentage points below private insurance over the past fifteen years or so.[130] By contrast, as a recent report on California's health care market notes, private insurers' "payment rates to hospitals and powerful physician groups approach and exceed 200 percent of what Medicare pays, with annual negotiated double-digit increases in recent years."[131]

Medicare's record, while hardly unblemished, reflects the dominant form of cost containment in the advanced industrial world—

128. *AMA Study Shows Competition Disappearing in the Health Insurance Industry*, AM. MED. ASS'N, http://www.ama-assn.org/ama/pub/news/news/health-insurance-competition.shtml (last visited Apr. 27, 2011).

129. Jacob S. Hacker, *Health-Care Reform, 2015*, 18 DEMOCRACY J. 19, 19 (2010).

130. *Id.*

131. Robert A. Berenson et al., *Unchecked Provider Clout in California Foreshadows Challenges to Health Reform*, 29 HEALTH AFF. 1, 2 (2010), *available at* http://hspm.sph.sc.edu/Courses/Econ/Classes/provider%2520clout.hlthaff.2009.0715v1.pdf.

payment control. In most nations, payments for specific services or treatment of patients with particular diagnoses are set through a negotiated process in which insurers, providers, and government officials have a seat at the table.[132] By consolidating bargaining power on the demand side and limiting the ability of providers to play one payer off another, these systems both create lower and more uniform payments and restrain the increase in service prices over time. Revealingly, health care costs have risen much faster in the United States than in other nations since the introduction of these sorts of payment controls in most rich democracies in the 1980s.[133]

Besides the savings created by a public plan with no need to earn a profit and large numbers of subscribers over which to spread administrative expenses, a public option would restrain costs in two additional ways. The first and simplest is by building on Medicare's success in restraining prices and improving care. Indeed, the public option could be the prime means for extending to nonelderly Americans the innovations in payment and care management that will be used to slow Medicare spending growth in the coming years. Payment reforms would not have to be limited to setting rates for individual services; they could also be extended to more complex payment methods, such as payment for entire episodes of care (e.g., treatment of a heart attack).

The second means by which a public plan available to the nonelderly will hold down costs is by serving as a competitive benchmark for private plans. Offered through the state exchanges, the public option would represent a simple, affordable plan available on similar terms throughout the nation, reassuring Americans newly required to have insurance that they can gain access to a transparent insurance product that offers a broad choice of providers. As such, it is likely to be an attractive alternative to private plans, pressing insurers to work harder to restrain their own premiums and to showcase their own merits. In today's weakly competitive market, even a modest spillover of the public plan's cost-control efforts into the private sector could have major effects.[134]

132. Chapin White, *Health Care Spending Growth: How Different is the United States from the Rest of the OECD?*, 26 HEALTH AFF. 154, 160 (2007), *available at* http://content.healthaffairs.org/content/26/1/154.full.pdf+html.

133. *See id.* at 157.

134. JOHN HOLAHAN & LINDA J. BLUMBERG, THE URBAN INST. HEALTH POLICY CTR., IS THE PUBLIC PLAN OPTION A NECESSARY PART OF HEALTH REFORM? 1 (2009), *available at* http://www.urban.org/uploadedpdf/411915_public_plan_option.pdf.

The public option is often seen—by detractors as well as some supporters—as an alternative to relying on private insurance. Although it will certainly cover some Americans who would otherwise enroll in private plans, it is best thought of as an alternative to relying exclusively on *regulation* to make private plans act in the public interest. The public option is a means of allowing the private and public sectors to operate in cooperative tension with each other, without putting excessive faith in the ability of regulators to make the private sector behave in fundamentally different ways.

Lastly, a public plan available to the aged and young alike could ultimately be a key means of providing long-term care. The present system relies too heavily on Medicaid, burdening states and requiring that the elderly impoverish themselves to receive benefits.[135] In recent years, rising complaints have centered on Medicaid's long-term care benefits, with critics arguing that the current system creates perverse incentives for older Americans to hide or divest themselves of assets to obtain nursing home care.[136]

The fundamental problem, however, is not well-off senior citizens gaming the system. Rather, it is that few Americans have reliable and effective insurance options that can protect them if they require long-term care. Simply put, private long-term care insurance will never work for millions of Americans. Even with major changes in the market, private policies are likely to continue to be complex, costly, and often inadequate.

Because the private market does not work well, efforts to reduce Medicaid spending by shifting the burden onto private markets will not work well either. Tightening Medicaid rules might reduce public spending slightly, but it will not eliminate the underlying costs, and it certainly will not distribute the burdens with greater dignity or fairness. The cold truth is that taxpayers will have to foot much of the bill for long-term care. Currently, we pay the bill through a program that was not designed to cover these costs effectively—Medicaid. The alternative would be to provide at least basic long-term care benefits

135. ELLEN O'BRIEN, KAISER COMM'N ON MEDICAID AND THE UNINSURED, LONG-TERM CARE: UNDERSTANDING MEDICAID'S ROLE FOR THE ELDERLY AND DISABLED 11 (2005), *available at* http://www.kff.org/medicaid/upload/Long-Term-Care-Understanding-Medicaid-s-Role-for-the-Elderly-and-Disabled-Report.pdf.

136. *See, e.g.*, Tyler Cowen, *Means Testing, for Medicare*, N.Y. TIMES, July 20, 2008, http://www.nytimes.com/2008/07/20/business/economy/20view.html.

through a public program of insurance available to everyone, preferably one that requires that people contribute over their working lives.

The Affordable Care Act includes a limited program of this sort: the Community Living Assistance Services and Supports (CLASS) Act.[137] The CLASS Act is a voluntary public insurance program for long-term care.[138] It would allow all workers and full-time students to contribute; after five years, workers would be eligible for benefits.[139] Thus, the program would cover long-term care for the younger Americans in need of support services, as well as the aged.

The CLASS Act, however, has serious problems. Because it is voluntary, it is likely to be subject to adverse selection. In particular, workers with long-term care needs will be most likely to sign up (after five years of contributions, they can receive benefits for the remainder of their lives). As a result, the Act could be seriously underfunded, limiting the benefits that will be provided.[140] Those benefits, moreover, are envisioned as a relatively modest cash grant that would not come close to covering the cost of nursing-home care.

The alternative is as obvious as it is difficult: the federal government should pay for a basic level of long-term care through Medicare, openly, for every American. That would staunch the fiscal bleeding that forces states to cut important services. It would also protect all workers from one of life's most frightening risks. There would still be an important place for private insurance as a supplement to basic public benefits, but the foundation of planning would be a universal public program, financed through taxes paid during one's working life. Nations that have instituted universal long-term care programs, such as Germany, have defied the dire predictions—their programs have generally been both affordable and effective.[141]

Medicare is the most natural institutional repository for such a program. Indeed, the majority of older Americans mistakenly believe

137. Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 8001, 124 Stat. 119, 828 (2010) (to be codified at 42 U.S.C. § 300ll).

138. *Id.*

139. *Id.*

140. *See* Richard L. Kaplan, *Analyzing the Impact of the New Health Care Reform Legislation on Older Americans*, 18 ELDER L.J. 213, 231–32 (2011).

141. *See generally* A.E. Cuellar & J.M. Wiener, *Can Social Insurance for Long-Term Care Work? The Experience of Germany*, 19 HEALTH AFF. 8 (2000), *available at* http://content.healthaffairs.org/content/19/3/8.full.pdf+html.

that Medicare covers long-term care costs already.[142] Moreover, Medicare already has a mechanism for advance funding in the Medicare payroll tax (which, as noted, is more progressive than Social Security's tax financing).[143] Ultimately, Medicare parts A (hospital insurance), B (outpatient care), and D (prescription drug coverage) should be merged into a single program financed by a relatively stable mix of payroll contributions, general revenues, and premiums paid by the aged. The only way to make that mix stable and sustainable, of course, is to control spending on the program.

As my proposals for Medicare reform suggest, the policy changes that we need should be bold, integrated, and guided by a commitment to shared fate. Today, when our fates are often joined more in fear about our present economic troubles than hope about our shared economic future, it is sometimes hard to remember how much we all have in common when it comes to our economic hopes and values. Indeed, we are more linked than ever, because the great risk shift has increasingly reached into the lives of all Americans. What recent market events remind us of is that, in a very real sense, all of us are in this together. Reforms to our embattled framework of retirement security should reflect that.

The rise of retirement security in the twentieth century represents one of the most prominent embodiments of the idea of shared fate in U.S. social policy. This momentous transformation was no accident. It was the reflection of a set of deliberate policies that pooled some of the most threatening risks to retirement income, created strong incentives for younger Americans to adequately prefund their retirement, and integrated health and economic security so that older Americans did not see their finances or their health grievously undermined by the predictably higher costs of health care in later life.

Over the last generation, these policies have come undone—gradually yet consistently and, again, not by accident. With many employers less interested in offering guaranteed pensions and many policymakers eager to create private accounts as supplements (and, ultimately perhaps, alternatives) to Social Security, the "three-legged stool" of retirement security (Social Security, private defined-benefit pensions, and private savings) has given way to a much less stable

142. AARP, THE COSTS OF LONG-TERM CARE: PUBLIC PERCEPTIONS VERSUS REALITY IN 2006, at 30 (2006), *available at* http://assets.aarp.org/rgcenter/health/ltc_costs_2006.pdf.

143. FROLIK & KAPLAN, *supra* note 5, at 57.

two-legged stool (Social Security, private savings) that is being forced to bear the increasing burden of health care costs in old age.

It is fashionable to say that these changes are inevitable, that they reflect inexorable demographic and budgetary challenges that dictate ever more risk-shifting onto Americans. This Article has argued otherwise. The future of retirement security rests in our hands; it will depend on the decisions we make. Rather than calling for massive cutbacks in Social Security and Medicare, I have argued instead for redirecting the vast amounts spent to subsidize private retirement accounts that do not work well or equitably while seriously tackling health care costs—the greatest threat to the long-term economic security of the aged. The picture of retirement that we see today is a vision of the past. But that does not mean we cannot develop a new image of retirement for the future that, like the old, provides people with the means to enjoy broad economic security both during their working lives and during retirement.