CONVERSATIONS WITH AN EXPERT

PRIVATE ENTERPRISE RESEARCH CENTER
TEXAS A&M UNIVERSITY

Dr. John Cogan was the spring, 2018 recipient of the Kirby Distinguished Visiting Professorship. On April 19, he gave a presentation on his book, "The High Cost of Good Intentions: A History of Federal Entitlement Programs." During his visit, Dr. Cogan was interviewed by PERC's Dr. Andrew J. Rettenmaier.

You have been active in public policy for much of your professional career. What would say are the most consequential reforms or policies you have been involved in?

Probably the most consequential is a reform at the state, as opposed to the federal, level. In the late 1980s, Oregon had a statewide ballot initiative that abolished the state's main welfare programs and replaced those programs with a single program in which individuals were required to work at about the minimum wage for their benefits. Oregon is not really known as conservative state, but the ballot measure passed with overwhelming numbers. To implement the new law, the state had to decide all those details that have to go along with actually establishing the new program. Who's going to be required to work? Is anyone going to be exempted from the new program's requirements? What services are going to be provided along with the work requirement?

I was part of a small team that worked with the ballot initiative's sponsors to develop and implement legislation. We ended up working on it for about two years and, eventually, we crafted legislation that passed the Oregon legislature overwhelmingly. The Oregon welfare reform plan became one of several state level forerunners of national welfare reform. The Oregon plan and other state plans were so successful that they gave members of Congress confidence that states could administer welfare programs perhaps better than the federal government could. These state plans led directly to the historic 1996 welfare reform measure that Bill Clinton signed into law.

At the federal level, one of the most important reforms I was involved in was restructuring of the Medicare hospital reimbursement system. Prior to this reform, Medicare provided hospital reimbursement on a cost-per-day basis. This reimbursement system's incentives led to excessively high costs per day and long hospital stays for patients. The reform was a prospective payment system in which hospitals are reimbursed on a per-patient basis. This fundamentally changed the incentives that hospitals operated under. Hospitals now had a financial incentive to lower the cost per day of treating patients and reduce patients unnecessarily long hospital stays. Such actions would lower their costs without reducing their Medicare reimbursements. We incorporated these cost saving incentives into the system and they are still working today – it is a long lasting reform.

I want to ask you about the future of two programs in particular – Social Security and Medicare. Social Security's last reform was in the early '80s. At that time, you were working at the Department of Labor, then later in the Office of Management and Budget. Were those reforms thought of as a permanent or a temporary solution? Those reforms produced surpluses until 2009 that were credited to the program's trust fund. How has the existence of the trust fund affected the sense of urgency to reform the program?

Most of the changes in the 1983 legislation were meant to deal with the immediate insolvency problem that Social Security faced at the time. In fact, the only long term change to the program was to gradually increase the retirement age. It was a very instructive time for me. Social Security reform rarely happens. There have been only two significant Social Security reforms since the end of World War II and the 1983 reform was one of them. That reform only happened because of the strong leadership of President Ronald Reagan and the willingness of members of Congress in both parties

to engage in a bipartisan effort to fix the program. The experience showed me that successfully reforming a major entitlement program takes strong presidential leadership and congressional bipartisanship.

There's also a misimpression about longer-term objectives of the 1983 reform. Congress did not adopt a policy of attempting to build large future surpluses that could be subsequently used to finance future benefits. The policy maintained the system as a pay-as-you-go system. The members of Congress that worked on that reform knew very well from Social Security's history that a large surplus in the fund would generate dangerous pressures to expand benefits. Temporary surpluses caused by strong economic conditions led Congress to expand benefits throughout the '50s, '60s, and '70s. These liberalizations created the Social Security crisis of the late 1970s and early 1980s.

Today, the Trust Fund accounting system is acting as a deterrent to reform. As long as the Trust Fund is able to continue paying benefits, members of Congress have an excuse for not dealing with the program's financial problem, regardless of what those consequences are for the federal budget. For example, Social Security Trustees reported that there is almost $3 trillion dollars in the Trust Fund. Yet, this year, Social Security benefit outlays exceed the payroll taxes that are collected to finance those benefits by $100 billion. The funds required to finance that shortfall have to be borrowed from the public. Thus, the Trust Fund accounting system is masking the true problem, but it serves as a convenient political excuse for doing nothing.

The Social Security Trust Fund is forecasted to be exhausted by 2034. Come 2034, legislatively and legally, we hit a definite decision point. Before that point in time, when will the rubber meet the road and policy makers do something about this problem?

My sense is that the rubber will meet the road sooner rather than later. There is a growing awareness of how Social Security interacts with the rest of the federal budget and that these cash deficits are contributing to the overall federal budget deficit. If you go back in time and ask "In earlier reforms, when did Congress begin to deal with the problem of insolvency?" In 1977, when Jimmy Carter and Congress reformed the system, the program was expected to become insolvent five years later. Back then, Social Security was a much smaller part of the federal budget. Its financial shortfalls had much less of an impact. Members of Congress could think about Social Security as a program that was separate and distinct from the federal budget. Now, Social Security and Medicare account for about 40% of spending. You can't divorce the financial problems that Social Security and Medicare faces from the problems that the overall federal budget faces.

When you think about the principles for reform, how do you talk to policymakers about Social Security and Medicare because both affect retirees' consumption? What are your ideal reforms and where might we land when we think of actual reforms while taking into account the total political economy?

When people talk about the coming fiscal problems, they immediately say that it's caused by the aging of the population. Baby boomers are retiring in greater and greater numbers and their Social Security and Medicare benefits will place an enormous burden on the federal budget. But demographics are only part of the problem. The other part is the rising real level of benefits of Social Security and Medicare to each recipient. Estimates show that between a third and a half of the overall problem of Social Security and Medicare is due to rising real benefits. The rest is due to demographics. Demographic change is a fact of life. There is nothing we can do policy-wise to alter it, so focusing on it doesn't lead us to reform. Focusing on real levels of benefits per recipient, in contrast, points us toward policy solutions. The increase is caused by the design of each of the programs and the design can be changed by policy.

The first objective of reform in order to lighten the fiscal burden of Social Security and Medicare should be to slow the growth of benefits. For Social Security recipients that are on the rolls now, benefits are going up only by inflation. For those who are coming on rolls in the next 10 to 20 years, inflation-adjusted benefits will be much higher. The reason for the rising level of real benefits is that Social Security's benefits are designed to replace a certain fraction of an individual's pre-retirement earnings. As inflation-adjusted earnings grow from one age cohort to another, inflation-adjusted benefits grow. The first objective should be to eliminate that inflation-adjusted growth and instead provide future Social Security recipients the same level of benefits in terms of purchasing power that today's retirees are receiving. It won't solve the cash crisis that Social Security faces in the near future, but it will take care of most of the program's long term solvency problem.

In addition, we need restructure benefits for future retirees to get back to Social Security's original purpose, which was to provide a measure of economic security against old age poverty. Benefit levels should be changed to make Social Security more of a poverty protection program and less of a middle-class and upper-class benefit program. What that means, of course, is shrinking the benefits received by those at the upper end of the income distribution and perhaps slightly raising benefits at the lower end of the income distribution.

Third, I don't think one can solve the Social Security problem without also providing young individuals greater opportunities to save so that they can rely more on their own savings than on this system that may or may not be solvent when they retire. On the margin, the savings rate of young people can really be improved by giving them a special tax incentive. We, as economists, are always emphasizing tax incentives – and for good reason. People respond to them. Finally, we need policies that encourage senior citizens to continue working.

When you talk about the real benefit growth of Medicare relative to Social Security, Medicare's is quite a bit higher. What would you do to address Medicare?

JOHN COGAN

Leonard and Shirley Ely Senior Fellow at the Hoover Institution

Faculty member in the Public Policy Program at Stanford University

Research is focused on U.S. budget and fiscal policy, federal entitlement programs, and health care

Assistant secretary for policy in the U.S. Department of Labor, associate director in the U.S. Office of Management and Budget (OMB) and was appointed Deputy Director in 1988

Served on the California State Commission on the 21st Century Economy and the California Public Employee Post-Employment Benefits Commission

Served on President George W. Bush's Commission to Strengthen Social Security, the U.S. Bipartisan Commission on Health Care (the Pepper Commission), the Social Security Notch Commission, and the National Academy of Sciences' Panel on Poverty and Family Assistance

Member of the Board of Directors of Gilead Sciences

Chairman of the Governance Committee and member of the board of trustees of the Charles Schwab Family of Funds

Recipient of the Stanford-in-Government's Distinguished Service Award

Awarded the Manhattan Institute's Hayek Prize for his latest book, "The High Cost of Good Intentions"

From a policy perspective, Medicare reform is far more difficult than Social Security. Medicare's real growth per participant is due to three factors. One factor is improving healthcare quality, which is something we want to preserve. Second, the high cost of the U.S. healthcare system is driving Medicare costs higher. Third, the design of Medicare encourages the overutilization of healthcare services and, thereby, causes a run-up in the costs per Medicare participant. I would focus on changing the incentives within Medicare to reduce the extent of this overutilization. Medicare is primarily a fee-for-service program with low copayments. This structure encourages overutilization and so the policy fix is to restructure Medicare benefits by raising the copayments. Higher copayments will give patients more "skin-in-the-game" and encourage more cost conscious behavior. But, in order for this policy to be successful in curtailing overutilization, we have to do something about Medigap insurance. For most Medicare recipients, Medigap plans pay their copayments. Without changing Medigap, a policy of raising Medicare copayments will have little impact on utilization.

Adding Medigap plans that don't provide for copayment coverage, but instead provide more catastrophic coverage that Medicare doesn't provide would help. With the sizable growth in the assets that seniors have now compared in 1965, a health care program for seniors that provides more in the way of asset protection, or catastrophic insurance coverage, would be worth more to them. They would benefit more from an insurance component of Medicare as opposed to a prepayment Medicare type plan. A Medigap plan that provides catastrophic illness coverage would be quite attractive to seniors who are concerned that such an illness will deplete their assets. On the provider side, the fee-for-service model, especially one with low copayments by individuals, is a recipe for high costs. Physicians have very little incentive to restrain their use of procedures and services. Moving, as the private sector has, towards more capitated payments would be a good idea. Under a capitated reimbursement system, health plans receive a fixed amount for reimbursement per enrollee, as opposed to receiving a flow of funds depending on the number of services that are provided. Those two changes, one affecting the copayments participants face and one affecting how health plans are reimbursed is a good combination for dealing with Medicare's incentives for the overutilization of services.

A third change is to allow seniors to develop better savings plans to finance their own healthcare expenditures. Right now, Medicare recipients cannot contribute to HSAs. Why not allow them to do so? Given that the typical senior lives about 20 years beyond Medicare's eligibility age, they have a sufficiently long time to benefit from a savings model. This policy change would have the additional benefit of mitigating some of the sting of higher copayments contained in my aforementioned policy change.

We've covered a lot of policy ground on Medicare and Social Security – the two elephants in the room – but I would like to switch gears. What advice do you have for students who want to work on economic public policy issues?

For students interested in public policy, the more you understand the fundamentals of economics, the better you are going to be at policymaking. Students should understand the basics of economics: what drives behavior? What drives our economic system? After college, there are many ways to stay involved in public policy. One way, of course, is to go to Washington D.C. or your state capital, but I don't recommend that for persons just out of college. Instead, private sector experience provides a first-hand understanding of the way the world works and the way our economy works. Once that experience and knowledge has been attained, it can then be applied in public service to making government policy. Individuals with this experience and knowledge are in a far better position to make policies that improve the private sector's performance and avoid making policies that harm our business sector and our economy.

In my own career, I was a young academic when I received an offer from President Reagan to join his Administration as a policy official. Milton Friedman was one of my mentors, so I asked him "Milton, is this a good thing for me to do, or not?" He replied, "I think it's a great thing for you to do. You will learn an awful lot about the way that government works. It will help you in your research on public policy. But don't stay in Washington for longer than two years because your mind will turn to mush." I'm living proof that Milton was right. I stayed for five years and my mind did become a bit mushy. In any event, Milton's advice was good advice. I think public policy and the private sector both benefit from individuals who spend part of their careers in the private sector learning how the economy works and part of their careers in public service applying what they have learned to policy making.

Kirby Distinguished Visiting Professorship

First awarded in 1988, PERC's Kirby Distinguished Visiting Professorship brings internationally acclaimed scholars, including Nobel Laureates to Texas A&M University to interact with faculty and students.

Private Enterprise Research Center

Funded through the generosity of former students, foundations and corporations, the Private Enterprise Research Center is committed to developing market-oriented solutions to major public policy issues though research, analysis and academic support.

PRIVATE ENTERPRISE RESEARCH CENTER
TEXAS A&M UNIVERSITY