論 文

Spending and Sources of Finance in the American Welfare State: Options for Reform (II)

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IV Public Assistance

Programs offering assistance to poor families are unpopular in the United States. In fact, they are among the least popular programs administered by the federal and state governments. Public spending on the poor has nonetheless increased almost without interruption since the early 1960s. Most of the increase from 1960 through 1980 was caused by the introduction of new programs to help the poor, such as food stamps and medicaid, or the liberalization of old ones, such as housing assistance and cash aid to the aged and disabled poor. Much of the increase since 1980 has been the result of worsening labor market conditions for poor workers and changes in U.S. family structure that have increased the number and reduced the incomes of poor families. These trends have increased the percentage of Americans (especially young Americans) who have low income and hence qualify for aid.

Several public programs to help poor families have been reformed in recent years (see Burtless, Weaver, and Wiener, 1997). In a few cases the reforms are so recent that the full consequences of reform are not yet clear. This section of the report will briefly outline the most important programs and then describe recent reforms and their rationale. The most significant reforms have affected programs that provide assistance to working-age adults and their children. These reforms have had two principal goals. First, assistance payments have been reduced to families with a working-age adult if the adult does not work. The goal of this kind of reform is to reduce long-term dependency on public assistance. The most important reform of this type was passed by Congress and signed by President Clinton in August 1996. The reform fundamentally changed the structure and funding of cash assistance programs for low-income children and their adult caretakers.

Second, programs that provide government benefits to *working* poor adults with children have been expanded. For example, eligibility requirements for medicaid health insurance have been liberalized to cover children of low-wage workers. In the past, most of these children would not have been eligible to receive benefits under the medicaid program unless their parents actually received public assistance benefits. Even more important, the Earned Income Tax Credit (EITC) program has been greatly expanded. This tax rebate to families with low earnings provides several thousand dollars per year to low-income workers with child dependents. Other programs that help low-income working adults with children have also been expanded. Government spending on child care subsidies has recently increased, for example.

In effect, public policy has been transformed to reduce public benefits to working-age adults who do not work and to improve public benefits to low-income families which have a working breadwinner.

Programs and spending. Trends in federal spending on the major forms of means-tested aid are displayed in Table 7. The table divides spending into two broad categories—cash and in-kind assistance—and shows three types of spending in each category. The table provides an incomplete tally of public spending on the poor. Some smaller federal income transfer programs are excluded from the table, and state and local spending is also excluded. Federal spending on family support payments and medicaid is supplemented by financing from state and local governments. In 1995, for example, state and local

governments paid $70 billion of the cost of medicaid and about $12 billion of the cost of AFDC, or roughly 45 percent of the total cost of the two programs.

AFDC was abolished by the welfare reform law passed in 1996. Established in 1935 as part of the Social Security Act, AFDC was one of the first federally supported assistance programs. The 1996 welfare reform legislation replaced AFDC with block grants to states. The replacement program is called Temporary Assistance to Needy Families (TANF). Before the 1996 reform the federal government offered state governments open-ended grants to pay for cash welfare payments to needy children and their adult caretakers. States were free to define need, establish basic benefit levels, and determine eligibility as they saw fit. As a result, there was a great deal of interstate variation in the generosity of benefits. This will remain true under the new federal-state TANF program. For example, in 1994 the basic monthly grant for a three-person family in AFDC ranged from a low of $120 a month in Mississippi to a high of $923 a month in Alaska, with the median state offering a little less than $370 a month or a bit more than 38 percent of the federal poverty line (U.S. House of Representatives, Committee on Ways and Means, 1994, pp. 366–67). Benefit levels were lower than average in southeastern states and higher than average in the northeast and upper midwest. Because the new TANF block grant allocates funds to the states based largely on historical funding levels, this pattern of uneven benefit generosity will almost certainly continue after the 1996 law has become fully effective.

A crucial feature of the old AFDC program was the financing arrangement providing federal payments to states. The federal government reimbursed state governments for a percentage of the cost of AFDC benefit payments. The federal matching rate was inversely related to each state's per capita income. States with low average incomes received more generous federal reimbursement of benefit costs (they could receive reimbursement for up to 83.33 percent of benefit payments). The lowest matching rate (available to high-income states) was 50 percent. An identical matching formula was used to calculate federal reimbursement for state spending on medicaid. The 1996 welfare reform eliminates this matching formula for cash assistance payments to needy families, but the old formula is still used to determine federal reimbursement rates for state medicaid spending.

Supplemental Security Income, or SSI, is available to people age 65 or older, and to disabled and blind children and adults who meet federally determined standards of need. An eligible person must have assets and annual countable incomes below very low limits in order to qualify for benefits. Unlike cash assistance for needy dependent children, the SSI program is federally funded and administered, but most state governments modestly supplement the basic federal benefit.

Table 7. Federal Spending on Selected Means-Tested Programs, Fiscal Years 1965–2000

Billions of 1995 dollars

Program	1965	1970	1975	1980	1985	1990	1995	2000*
Cash programs								
AFDC	$12.5	$15.4	$14.2	$13.7	$13.1	$14.1	$17.1	$17.1
SSI	7.9	7.5	11.9	10.7	12.4	13.3	24.5	31.7
EITC	–	–	–	2.4	1.6	5.1	15.2	19.1
In-kind programs								
Food and nutrition	1.3	3.8	18.3	24.6	23.7	24.6	33.5	33.0
Housing assistance	1.0	1.8	5.8	10.2	15.9	18.4	25.5	21.7
Medicaid	1.3	10.1	18.9	26.3	32.3	47.5	89.1	106.3
Total	$24.0	$38.6	$69.1	$87.9	$99.0	$123.0	$204.9	$229.0
Total as % of GDP	0.8%	1.0%	1.6%	1.8%	1.8%	1.9%	2.9%	

* Projected.

Source: OMB and Economic Report of the President, 1996, p. 367.

State and local governments are left with sole responsibility for providing cash assistance to indigent adults who are neither old nor disabled. The programs that do this are called general assistance. General assistance programs differ widely among states, both with respect to eligibility criteria and benefit generosity. Most states do not offer very generous benefits to nonaged, nondisabled, and childless adults, and several states have cut back on their programs over the past decade. Most states are unlikely to expand their general assistance programs to cover adults and children who lose cash assistance or food stamp benefits as a result of reforms in federal assistance programs. In a few states, however, some people who lose federal benefits will be eligible to receive state general assistance payments.

While most cash assistance is received by people who do not work, the earned income tax credit (EITC) goes only to low-income people who *do* work. Enacted by Congress in 1975 to offset social security taxes and encourage poor people to find jobs, the EITC provides cash subsidies or income tax reductions to wage earners and self-employed people with low or modest incomes. As recipients earnings rise above a moderate threshold (about $12,000 in 1996), the credit is gradually phased out. It is eliminated altogether when a family's income reaches about $24,000 a year if the breadwinner has one child and about $28,500 a year if the breadwinner has two or more children. Liberalized in 1986 and twice in the 1990s, the EITC in 1996 provides as much as $3,556 in refundable income tax credits to a breadwinner with two or more dependents (U.S. House of Representatives, 1996, p. 700).

Although the federal government supports a number of assistance programs aimed at improving the diets of low-income Americans, by far the most important is food stamps. Until passage of the 1996 welfare reform legislation, this program was unique in offering assistance to all categories of the poor working and nonworking, disabled and nondisabled, young and old, and families with and without children. The 1996 legislation restricted food stamp eligibility for childless adults between the ages of 18 and 50 to three months of benefits over a three-year period, unless they are working or participating in a workfare, education or training program. In addition, it denied eligibility to legal immigrants who are not citizens (previously, only illegal immigrants were denied benefits).

Food stamps are provided as coupons which can be used to purchase food in most grocery stores. Benefit levels and eligibility rules are determined by the federal government, but the program is administered by state and local welfare departments. A person who has no other income is eligible to receive a monthly allotment of food stamps that will permit the purchase of an inexpensive but nutritionally adequate diet. People who have other sources of income are expected to spend roughly a quarter of their cash monthly income on food. The food stamp program provides enough coupons to purchase the additional food needed to consume a nutritionally adequate diet. In effect the food stamp program is a negative income tax or guaranteed income plan in which the tax rate is very low (roughly 25 percent), the guaranteed income amount is generous enough to buy a basic diet, and the payment is issued as food coupons rather than cash. Benefits provided in the food stamp program, like those available in SSI and medicaid (and, formerly, in AFDC), represent an entitlement. That is, persons or families with incomes and assets low enough to be eligible for benefits are automatically entitled to receive coupons.

Over the past few decades, the nation has established a number of housing programs to assist low-income families. Unlike food stamps, SSI, and medicaid, housing assistance has never been available as an entitlement to all eligible families with low incomes. The majority of poor households do not receive any earmarked government aid to help them pay their shelter costs.

Reforming the assistance system. In order to slow the increase in spending on assistance programs, Congress has modified several programs in recent years. As noted above, the most important reforms have transformed the cash assistance programs that provide benefits to indigent children and their parents. These reforms will be described in greater detail below. Changes in the medicaid program were discussed in the previous section. In August 1996 Congress modified the cash assistance program for disabled and aged persons in two ways. Many immigrants who are not yet

U.S. citizens were made ineligible for benefits. In addition, eligibility requirements for disabled children were tightened in order to reduce the number who collect cash benefits. The food stamp program was also modified. Congress denied food stamps to many immigrants who are not yet U.S. citizens and reduced food stamp allotments to adult citizens between the ages of 18 and 50 if they do not have child dependents.

The changes in housing assistance are relatively simple to describe. As noted above, most poor families do not receive any government aid to help them pay their housing costs. Instead, the federal government appropriates money to build publicly subsidized housing projects or to help pay the rents of a fixed number of families living in private rental housing or the mortgage interest of low-income home buyers. Each year the Congress appropriates funds for a specific number of new commitments. In the past these commitments ran from 5 to 50 years, and an appropriation was spent gradually over several years or decades. New commitments expand the pool of available aid and thus increase the number of subsidized households. Since the early 1980s, Congress has slowed the future growth in spending by reducing or eliminating new subsidy commitments. This step has not produced immediate or large reductions in annual spending because the government is still obligated to pay for earlier commitments. In the past few years the length of new commitments has been shortened to just 1 to 5 years and the number of new commitments has been reduced sharply. These steps will drastically slow the future increase in spending on housing subsidies and may even lead to actual reductions in spending.

The most important reforms in assistance programs have been those involving the cash assistance programs for needy children. Some recent reforms have greatly expanded the assistance available to poor families with children, but others have reduced or even eliminated assistance to families where the adult caretaker does not work. The new welfare law Congress passed in August 1996 changed the nature, organization, and financing of a major part of the American safety net. Under AFDC, the federal government offered states open-ended grants for cash welfare benefits for needy children and their adult caretakers. States had to match the federal dollars to get the grants, but federal spending had no fixed limit.

The new law replaces AFDC with a federal block grant (TANF). Though minor exceptions will be made for low-income states with fast-growing populations and states with high unemployment, most states' TANF grants will be determined by the level of their federal AFDC payments during over the period from 1992 through 1995. The new law ends the automatic "entitlement" to benefits. Under the old law, families containing children that had incomes and assets below specific thresholds were automatically entitled to receive benefits.[6] Under the new state programs, poor children may no longer be automatically eligible to receive cash benefits. The new law gives states more program flexibility in many areas, but it also imposes some additional federal requirements. For example, each state must ensure that a rising percentage of its adult aid recipients engages in approved work. The head of each family on welfare will now be required to work within two years after cash payments begin. Work hours requirements are stringent, and states will face increasingly harsh penalties for failing to meet them.

States cannot use the new TANF block grant to pay benefits to a family for more than 60 months, and states can limit benefits to fewer than 60 months if they choose. States can use existing federal social service funds to provide vouchers or other noncash benefits to families after 60 months. Up to 20 percent of a state's caseload can be exempted from the 60-month limit for hardship reasons. The new law does not require—but does permit—states to impose family caps (withhold additional monthly payments for families into which children are born while the parents are receiving welfare) and to deny eligibility to unmarried teen mothers.

Several provisions in the new law represent marked changes from previous practice. Ending the automatic *federal* entitlement to benefits is particularly important. (State governments are still free to make cash assistance a *state* entitlement if they wish to do so.) Disparities among states in defining eligibility for cash benefits will almost surely increase. Some states may decide to vary eligibility within their borders, for example, by allowing county or municipal

governments to establish different eligibility requirements. If states do not make cash assistance a legal entitlement, low-income children will have no assurance of receiving benefits, even if they are very poor. Monthly benefits may fluctuate in some states that decide to operate within a fixed welfare budget. The distribution of cash assistance within and across states could become quite erratic.

The new law contains two kinds of time limits on the benefits an individual family can receive. Under the old law, states were required to provide assistance to poor children for as long as the children remained poor. Under the new law, states must force adults into work not later than 24 months after cash benefits begin. Federal funds cannot be used for cash aid to families whose adult head has received aid for more than 60 months. These limits send a clear signal to beneficiaries that they must become self-sufficient in the labor market, and they set an unambiguous timetable for achieving that goal.

Many adult recipients will not become self-sufficient in the foreseeable future, however, so this requirement may lead to real hardship. Most adult welfare recipients lack skills, some have no work experience, and others face family circumstances or health problems that make steady work impossible. The inherent instability of many jobs in the low-wage labor market makes it inevitable that many current and future aid recipients will suffer repeated spells of unemployment. If no government-financed cash assistance is available when these adults become unemployed, strict time limits could cause destitution and even homelessness among unskilled parents and their children. Medicaid and food stamps will usually continue, at least for children in the household, even after cash assistance payments are stopped as a result of the time limits on cash aid.

No one yet knows what will happen to the families who lose their cash benefits as a result of time limits. Some families will turn to their friends or relatives for support, and a few may even move into the households of relatives. Families which do not have relatives who are willing or able to help them may face severe depravation. Under state child welfare laws, public officials can remove children from the care of their parents if the parents are judged unfit or negligent. These children may be placed in the homes of relatives or foster parents or may be put up for adoption or (much more rarely) placed in an orphanage. When time limits on cash benefits become fully effective in 1999 or 2000, it seems likely that most states will see a rise in the number of child negligence cases.

To reduce the hardship that may result from time limits on benefits, the law could be modified to permit states to provide cash assistance after five years to adults willing to work in government-provided, low-wage jobs. The new law allows states to set time limits shorter than five years. This feature of the law is particularly risky. Some states may be tempted to export their welfare problem by adopting tighter time limits than neighboring states. To avoid a "race to the bottom" in time limits, states could be required to get federal approval to impose time limits that are shorter than five years.

Unlike the old AFDC system, the new welfare law features stiff work requirements. Work requirements enjoy overwhelming support among the American public and some support among assistance recipients themselves. These requirements are probably essential to maintaining voter support for cash assistance programs over the next few decades. Research shows that work requirements combined with job search help and workforce training can increase both earnings and work among welfare recipients. However, the resulting gains in employment and earnings are not enough to allow most welfare recipients to become economically self-sufficient. Many recipients suffer long spells of unemployment after completing a work-training program. Without access to publicly provided jobs and supplemental aid, such as child care, some single mothers will find it impossible to support their children.

Unlike other industrial countries, such as France, Japan, and Sweden, the United States does not provide or subsidize a network of child care centers where parents can be assured that their children will receive good care. Most organized child care is provided in private nonprofit or for-profit centers and nursery schools. A large amount of informal care is provided in the homes of relatives, friends, or acquaintances of working parents, usually at lower cost than the care

available in formal child care centers. Many low-income parents receive subsidies that cover part or all of the cost of formal care, and the amount of federal and state subsidies has been significantly increased during the 1990s. Welfare recipients are usually assured that they will be eligible for child care subsidies for at least the first 12 or 18 months after they leave the welfare rolls to accept a job. After this initial eligibility period is completed, however, single parents in many states may have a hard time finding affordable care for their children. (A few states have established or will soon establish a program of subsidized child care for all or most low-income single parents. The majority of states probably will not establish such a system, however.)

Under the new block grant formula, states are free to reduce their welfare spending significantly, thereby risking a race to the bottom in eligibility and benefits. To qualify for full federal block grant funds under the new law, states that meet the work participation targets are required to spend only 75 percent of what they spent in the past. (States that fail to meet the work targets must spend 80 percent.) The "maintenance-of-effort" requirements are even less stringent than they appear because states can spend part of the TANF block grants on services that may not be received by low-income dependent children or their parents. In addition, inflation will progressively reduce the real value of past state spending levels, making the requirement easier to achieve over time.

The shift to block grant funding for cash family assistance, combined with continued availability of federally financed food stamps, offers states a powerful incentive to reduce cash benefits. By cutting cash benefits and spending some of its TANF grant on other services once funded by state tax dollars, a state can free up money for tax cuts or other nonwelfare spending. The amount of the state's federal block grant would remain unchanged, and the cut in assistance payments would be partially offset because food stamp payments, which are based on families' cash income, will grow. (Food stamp benefits are paid for entirely by the federal government; state governments help to administer the program but do not pay for benefits.)

The temptation for states to reduce spending on cash assistance and shift the funds to other purposes or tax relief will be particularly strong in the next couple of years. AFDC caseloads in many states have dropped dramatically from their peak in the early 1990s, but future state block grants are determined by the federal AFDC payments states received when caseloads were at their peak. With more federal money than they need to maintain benefits for current caseloads, many states will be able to shift some welfare spending to other needs. But in the next recession, when welfare will again become a pressing fiscal problem, states will find it politically difficult to boost spending on cash assistance.

A good case can be made for strengthening state maintenance-of-effort requirements. Effective programs that move recipients toward self-sufficiency are costly. So, too, are the new administrative arrangements needed to implement time limits and other features of the new system.

State funding allocations. The federal formula to determine state grants under the new family assistance block grant has three big shortcomings. It provides uneven levels of federal support to children in rich and poor states. It is not responsive to states' changing demographic needs. And it is not be very responsive to high state unemployment. At least in the short run, states have enjoyed significant gains under the new grant formula. In 1995, states and the federal government spent about $25 1/2 billion on AFDC benefit payments and administration. The federal government paid for 54 percent of the total cost, while state governments paid for 46 percent. In 1997, the federal government's TANF grants to state governments totaled about $16 1/2 billion, roughly 20 percent more than 1995 federal spending on AFDC. If states spend the minimum amount required on TANF under the new law, their 1997 spending would amount to less than $10 1/2 billion, about 11 percent *less* than their 1995 spending. The state share of spending on cash assistance for needy children will drop from 46 percent to just 39 percent.

The first two flaws of the new funding formula grew out of Congress's decision to allow states to choose the highest of their 1994, 1995, or average 1992-94 spending levels as the basis for their block grant allocations. The decision was not based on careful

thought about appropriate incentives for influencing state government behavior. Instead, it was guided by Congress's political need to avoid visible winners and losers among the individual states. The formula will lock into place a distribution of federal funds that heavily favors wealthy states and works to the disadvantage of poor children in low-income states. In 1995, for example, the federal government spent $1,800 per poor child on AFDC in Connecticut but only $300 in Mississippi. (Connecticut is the state with highest income; Mississippi has the lowest income. Average income in Mississippi is about half the level in Connecticut.) If the block grant financing system is going to be retained, Congress should make the formula more equitable. For example, over a 10-year period the allocation of federal funds should be revised so that spending is based on the number of poor children in a state, not on the amount of federal spending in the first half of the 1990s.

To address the problem of recessions, Congress should increase the contingency grant fund. The new law established a small contingency fund for recessions. The fund will be available to states with high and increasing unemployment and states with food stamp caseloads that are rising sharply. The fund is too small. When recessions occur, state tax revenues typically decline. Since state constitutions prevent state governments from borrowing funds to pay for normal government operations, they often slash spending on selected programs to avoid major tax increases in a recession. The federal matching grants to help states pay for medicaid and AFDC gave states an incentive to maintain their spending on the poor. The new block grant for cash assistance eliminates this incentive. To compensate states for recession-related burdens, the fund should probably be doubled or tripled. States using money from the fund should also be required to maintain pre-reform funding levels and to match federal dollars they draw from the fund.

Summary. Few public programs arouse as much passion—or antipathy—as welfare. Broad dissatisfaction with welfare has led to many calls for reform over the past quarter-century. Some reform efforts have yielded modest adjustments in the structure of welfare, but until 1996 none produced fundamental change.

The 1996 welfare reform act was a decisive break with the past. It removed the guarantee of federal support for cash aid to indigent children and their parents, thus eliminating a pillar of social protection that lasted more than six decades. Although the new law conforms with the deeply held American belief that able-bodied adults should work, at least eventually, to earn the right to public support, it has major shortcomings. By abolishing the entitlement of needy children to cash assistance, it places a large and extremely vulnerable population at risk. By allowing states to cut spending on welfare, it tempts them to divert resources to other uses, including tax reductions or benefits for more affluent citizens. It offers scant fiscal relief to states falling into recession.

Sensible reform can correct these defects. If state governments fail conspicuously in their efforts to protect the interests of poor children, the impetus for additional reform will be strong. Because states are most likely to fail when facing economic hard times, crucial aspects of the new law should be revised before the next recession. One policy choice in the new law is unlikely to be reversed anytime soon. For the foreseeable future, able-bodied parents will have to show tangible evidence of their willingness to work if they hope to obtain continuing aid.

The sustained and enormous expansion of the EITC since 1986 represents a second major shift in U.S. social policy. Low-wage workers can now receive substantial cash help from the government to help supplement the wages they earn. Since real earnings levels of low-earning breadwinners have fallen between 15 percent and 25 percent since the mid-1970s, this help has created an important incentive to bring unskilled workers into the job market. In combination with the expansion of government-funded health insurance to low-income children, the policy has significantly improved the attractiveness of low-wage work to less skilled workers with dependent children. The effect of these reforms was reinforced by the cash assistance reforms passed in 1996, which restricted parents' ability to collect welfare payments unless they also worked. All these reforms have sent a powerful signal to America's low-income working-age population: It is now financially unacceptable as well

as socially unacceptable to obtain cash assistance without working, but it is easier to support a family through paid work, even when the only attainable jobs pay extremely low wages.

Part Two

Japan faces some of the same problems as those faced by the United States in financing social welfare programs. Both countries are rich industrial societies with per capita incomes that are far above the world average. The populations in both countries have above-average educational attainment, even in comparison with other rich industrialized countries. Both nations offer their citizens a wide variety of social welfare protections, though the protection is significantly more limited than that available in much of Western Europe. The Social Development Research Institute estimates, for example, that 1992 social welfare spending (excluding education) absorbed a total of 15 percent of Japanese national income and 19 percent of U.S. national income. The comparable percentages in the United Kingdom, Germany, and France were 27 percent, 32 percent, and 36 percent, respectively (Social Development Research Institute, 1996, p. 11).

Both the Japanese and American populations are growing older. Population aging is occurring much faster in Japan than the United States, however (see Table 8). The faster growth of the Japanese population past age 65 is due mainly to slower population growth. The United States has a significantly higher total fertility rate than Japan (2.1 versus 1.5 children per woman over the period from 1990 to 1995), and immigration into the United States is much larger than immigration into Japan (Bosworth and Burtless, 1997b). The Japanese also enjoy significantly longer life expectancy than Americans. For example, in 1990 male life expectancy at birth was 75.9 years in Japan but only 72.0 years in the United States. Life expectancy rose much faster in Japan than in the United States during the past 30 years, contributing to the Japan's faster rate of population aging.

There are two important differences between Japan and the United States that make their social welfare financing problems rather different, however. Japan has been far more successful than the United States in restraining the growth of health care expenditures, at least in relation to average incomes. And the trend toward wider income and wage inequality has been much slower in Japan than in the United States. Thus, Japan has not experienced the same rapid growth in the poverty population that has afflicted the United States.

Table 8. Dependency Rates and Growth of Aged and Nonaged Populations in Japan and the United States, 1960–2050

	1960	1990	2000	2010	2020	2030	2050
Dependency Rate [a] (percent)							
Japan	8.9	17.3	25.1	34.1	43.2	43.5	50.2
United States	15.2	18.7	18.7	19.1	24.8	31.9	33.5
Elderly Population, 65^{+} (1990=100)							
Japan	36	100	146	186	220	215	211
United States	54	100	111	124	165	213	233
Working Age Population, 15–64 (1990=100)							
Japan	70	100	101	95	88	86	73
United States	66	100	110	121	125	125	130

a) The dependency rate is the ratio of the number of persons over age 64 to the number of persons aged 15–64.

Source: Bosworth and Burtless (1997b).

Japan and the United States confront very similar problems in financing social welfare benefits to their aged populations. Most of these benefits are in the form of publicly provided pensions and health insurance. The remainder of this paper focuses on this common financing problem.

Pensions. Japan has a two-tier public pension system consisting of a flat-rate basic benefit and an earnings-related pension. The first-tier pension is available to all residents of Japan, and currently covers about 80 percent of the workforce. In 1995 it provided a maximum pension of about 65,000 yen per month at age 65 for an individual who had contributed for 40 years. The program offers separate pensions to dependent wives of retired employees. The actual average first-tier pension was closer to 45,000 yen, or about 12 percent of the average wage. Workers can retire as early as age 60, though early retirees receive a reduced pension. The first-tier benefit amount is adjusted over time in line with consumer price inflation rather than average wages. If Japanese real wages continue to rise, the first-tier pension will therefore fall over time in comparison with the economy-wide average wage. The financing method for the first-tier pension is unusual among advanced industrialized countries. The pension is financed with a flat tax on each insured person(equal to 12,300 yen per month in 1996) that is supplemented with a subsidy from general government revenues.

The second-tier system covers only private-sector employees. It is rather fragmented because companies can opt out of the public program if they provide their own pension program.[7] Second-tier benefits are paid beginning at age 60 on the basis of each worker's average lifetime real wages. The pension formula consists of two parts. The first part is related to the number of months of the worker's coverage under the system; the second part is related to the contributor's average wage. The pension accrues at the rate of 0.75 percent of the average wage per year of contribution. A worker with 40 years of service would receive an earnings-related pension equal to 30 percent of the lifetime wage. Past earnings are adjusted for inflation in the computation of the initial benefit using an index of the economy-wide average wage. Pension payments in later years of retirement are adjusted to reflect price inflation. In addition, the second-tier program pays the first-tier national pension for workers who retire before age 65 and are not yet eligible for the flat-rate benefit. Most Japanese workers can therefore retire at age 60 with a full pension. This concession to early retirees is scheduled to be phased out early in the next century when the first-tier pension will be limited to those who have attained age 65. The earnings-related pension is financed by a payroll tax that is strictly proportional to workers' covered wages.

The projected costs of the public pension system will grow much faster and reach a higher level in Japan than in the United States (see Table 9). Japan will encounter serious financing problems in its public pension program within the next two decades. Without reform, the share of national income devoted to spending on public pensions will double by 2040. In comparison with the financing problem faced by Japan, the one facing the United States is comparatively small. The United States will experience a smaller increase in the dependency rate than Japan, and its basic public pension is relatively modest.

The differences between Japan and the United States are highlighted by a comparison of the present value of the net pension liability (future pension benefits minus projected future contributions). The present values of these net liabilities have been calculated by the International Monetary Fund. The IMF calculations show that for Japan the estimated unfunded liability exceeds current GDP (see line 4 in Table 9). In contrast, the net liability of the U.S. public system is only about one quarter of GDP.

Health care spending. Cost projections that focus solely on the public pension system significantly understate the fiscal burden associated with population aging. This is because they exclude the cost to the government of providing health care to the aged. In the United States, spending on the main health care program for the aged (medicare) may exceed spending on the public pension program by about 2020. In all advanced industrialized countries, medical care needs rise sharply with age, particularly after age 70. Per capita medical care spending on individuals over age 65 typically exceeds spending for persons under 65 by a

Table 9. Cost of Public Programs Affected by Population Aging in Japan and the United States, 1995–2040

	Japan	United States
1. Public Pension costs–1995 (Percent of GDP)	8.6	5.1
2. Net Replacement Rate [a] (Percent of previous wage)	55	50
3. Pension Cost Projections (Percent of GDP)		
2000	11	5
2010	14	5
2020	15	6
2030	16	7
4. Present Value of Net Pension Liabilities (Percent of GDP)	105	25
5. Health Care Spending in 1994 (percent of GDP)		
Total (public plus private)	7.1	13.7
Public spending	5.6	6.1
6. Effects of Aging on Public Health Costs [b] (Percent of GDP)		
1994	5.6	6.1
2000	5.9	6.0
2010	6.6	6.2
2020	7.2	7.1
2030	7.3	8.1
2050	7.6	8.4

a) After-tax value of public pension as a percent of after-tax wage while at work for average-wage worker.

b) Estimated public medical care spending on aged and nonaged assuming that ratio of public spending per aged person to public spending per nonaged person remains unchanged and health spending per nonaged person rises at the rate of per capita income growth.

Source: Bosworth and Burtless (1997b), Table 3, and Fukawa (1997), p. 9.

ratio of between 3:1 and 5:1. Thus, medical care is an important item in public budgets that will be dramatically affected by population aging.

Japan enters the era of population aging with a major advantage over the United States. Japanese public and private outlays on health care are far smaller in relation to GDP than they are in the United States (see line 5 in Table 9). Estimates by Fukawa (1997) suggest that in 1994 Japan devoted a bit more than 7 percent of national income to health care spending, while the United States spent almost 14 percent of national income on health care.

The impact of aging on public medical care spending is illustrated at the bottom of Table 9. The statistics shown under line 6 of the table show projections of public health spending out to 2050 based on the current age distribution of public medical spending. The cost estimates at the bottom are obtained by combining information about the current age pattern of spending and population projections of the World Bank (for Japan) and the U.S. Social Security Administration (for the United States). These are crude and conservative estimates of future costs because they assume no further increase in Japanese or American health care prices relative to the growth in per capita income. In many countries, but particularly in the United

States, medical care cost inflation has substantially exceeded nominal income growth (see Figure 2).

The impact of aging on public medical care spending is especially pronounced in the United States because of the sharp division between privately-financed programs for those below age 65 and publicly financed health insurance for the aged. Per capita *public* spending on the U.S. elderly population is about twelve times that for the non-aged. Thus, even though the United States will experience less aging than Japan, it has a larger projected increase in public health care spending. This spending will rise more than one-third by 2030, even assuming medical price inflation is the same as non-medical inflation and medical utilization rates remain stable. In view of the extraordinarily high levels of health care spending in the United States, the projected public cost of its program for the aged may exceed the public cost of providing medical care for the *entire population* in some other rich countries. Yet the cost increases due to aging alone are less than half the growth anticipated by official government projections that incorporate continued medical care inflation.

Reform alternatives. As noted earlier in the earlier discussion of reform in the United States, policy makers confront a choice among four basic reform alternatives. Three—cutting benefits, increasing contributions, or lifting the age of retirement—can be implemented within the present pay-as-you-go financing system. A fourth alternative moves away from pay-as-you-go financing toward advance funding of future pension and health insurance obligations. This move can occur either within the current public system or in a new privately owned and managed pension and health insurance system. I briefly review the major reform alternatives.

In Japan as in the United States, public pensions are now the main source of income for most retirees, providing nearly 55 percent of total retirement income. Because many old people have modest incomes, neither Japan nor the United States can reduce minimum pensions without increasing poverty, perhaps by a significant amount. Many proposals for reducing benefits therefore emphasize mean-testing or modifying the inflation index.

Moving from an earnings-related to a flat-rate benefit would significantly trim pension costs, but this method of cutting benefits introduces important incentive problems. Severing the link between a worker's earnings (and tax contributions) and his retirement pension discourages work and encourages tax evasion. It will be opposed by high-wage workers, who would pay a tax proportional to their earnings but receive only a minimum, flat-rate pension. To keep the contribution rate down under a flat-rate system, high-income workers would almost certainly use their political influence to keep the basic pension low, placing many old people at greater risk of becoming poor.

Means-testing public pensions on the basis of retirees' current income can also significantly reduce costs. As we have seen, however, it would discourage private pensions and saving.

Benefits can also be trimmed by reducing the annual inflation adjustment. To justify that step, some observers argue that nonmedical consumption needs decline with age. But reducing the annual inflation adjustment would progressively reduce the real benefits of retirees' as they grow older. Because most other retirement income is not indexed, this would exacerbate a pattern in which retirees' real income declines with age—and poverty rates rise.

Raising contribution rates for pensions and old-age health insurance is a second option. But tax rates are already thought to be high in Japan, so that increasing them further would be very unpopular and, possibly, counterproductive. The tax rate for old-age pensions applies only to a tax base that is less than 100 percent of total labor compensation. Fringe benefits (including annual and semi-annual bonuses) are untaxed. Broadening the tax base could obviously close some of that gap. But some of the extra revenue would be offset by higher pension payments to workers credited with higher average wages.

Increasing immigration or the birth rate could also add contributors and revenue to Japanese pension and health insurance systems. But large-scale immigration has never been permitted in Japan. And it is not obvious how public policy changes could boost Japan's very low fertility rate. The success of existing childbearing incentives in Europe is questionable. For example, Germany now offers major incentives for childbearing,

but it is hard to see any effect on its birth rate. In addition, childbearing incentives may encourage some women to stop working so they can raise children, partially offsetting the intended effect of a higher birth rate.

Increasing the retirement age is another way to reduce pension costs. Although expected Japanese longevity at age 60 has increased more than one-third since 1960, the earliest age for claiming pensions has been left unchanged. Both Japan and the United States plan to raise the age of entitlement for a full pension, but the scheduled increase is much less than the increase in expected life spans over the past few decades. Because more and more workers might continue to retire before the "normal" retirement age, raising the age of entitlement for full benefits without raising the early retirement age amounts to reducing benefits.

Increasing the retirement age can certainly cut costs. The United States could erase its 75-year social security deficit by raising the retirement age to 67 today, increasing it gradually to 70 in 2030, and lifting the early retirement age from 62 to 67. Delaying the retirement age is widely unpopular, however, especially among workers in physically demanding jobs. The evidence of the past few decades suggests, in fact, that workers in both Japan and the United States have an increasing preference for *earlier* retirement. Nonetheless, to keep the costs of pension and retirement health benefits affordable, it is inevitable that both Japan and the United States will consider further increases in the age of entitlement for public pensions and publicly financed old-age health benefits.

It might be possible to increase future national income that will finance the consumption needs of future workers and retirees. To achieve this, the current generation must increase its saving to finance more of its own retirement. Larger accumulations in retirement systems, whether public or private, over the coming decades would raise the nation's capital stock and boost national output. In the next century, the nation would spend more on public pension and retirement health programs, but finance them out of a larger economic pie, leaving a bigger slice of the pie for future workers.

As noted, the current pay-as-you-go system of financing public pensions does not increase national saving. In both Japan and the United States, payroll taxes from today s workers go almost entirely to pay for pensions to today's retirees. During the 1950s and 1960s, pay-as-you-go financing looked like a good idea. The labor force was growing, and real wages were climbing 2 to 5 percent a year. The return on contributions once the system was mature was expected to be 4 to 7 percent a year, far more than ordinary workers could earn on their own savings.

Declining labor force growth and the dramatic slowdown in labor productivity growth have eliminated those advantages of a pay-as-you-go system. In fact, the Japanese working-age population is expected to fall substantially over the next five decades (see Table 8). The rate of return in a mature pay-as-you-go system will fall below 2 percent a year and may even become negative. Private investment alternatives offer workers and pension fund managers real returns that exceed 3 percent a year. In view of the difference in expected rates of return, many of today's workers and young voters would choose prefunded retirement accounts over a pay-as-you-go system.

But the pay-as-you-go system has inescapable consequences, as noted earlier. The Japanese and U.S. governments have accumulated huge pension liabilities to retirees and older workers. Neither country is likely to default on these obligations. Over the next several decades, current and future workers will pay for the promised pensions, regardless of whether the governments adopt new advance-funded systems. Younger workers will be reluctant to assume the double burden of paying off those obligations *and* saving in advance for their own retirement.

Nonetheless, today's workers could increase the portion of retirement income they expect to derive from capital income and reduce the portion coming from payroll contributions of future workers. Japan could move toward partial funding of future retirement obligations either by modifying the current public system or by converting it fully or partially to a funded, private system. In either case the central question is whether the increment to funding would really add to national saving and capital formation and boost future national income or whether it would be offset by reduced public or private saving elsewhere.

Conclusion. All of the major industrial countries

will experience significant population aging over the next several decades. The projected rise in the aged dependency ratio is larger in Japan than in other rich countries, and is significantly greater than the increase in the United States. The cost of financing income transfers and medical care for the elderly will place major pressure on Japan s public sector budget at a time of substantial decline in the size of its workforce. While aging is an issue of common concern to both Japan and the United States, there are significant differences in the size and timing of the demographic changes in the two countries. The implications for public sector budgets also differ between the two countries because of major differences in the structure of public transfer programs for the elderly.

For most industrialized countries the projected public-sector costs of population aging are so large that governments will be forced to make significant changes in the structure of programs that provide income and health care to the elderly. This will force governments to increase public revenues or reduce publicly financed benefits to the aged, possibly by increasing the earliest entitlement age for benefits. One possible change in public policy to meet the challenge of population aging is a significant and sustained increase in the net national saving rate. A sizable increase in saving would be needed to offset the burden on future workers of financing the extra spending on public programs for the aged.

A policy of higher saving would be successful in offsetting some of the future burden of population aging, whether the extra saving is invested in government debt or private marketable securities, whether it is invested at home or abroad. However, a policy that forces workers to boost their saving in private, individual pension accounts will have very different distributional consequences than one in which the extra accumulation takes place in a single public fund. Both the private and the public strategies can raise saving and future incomes, but only to the extent that they induce some sacrifice of consumption in the near term. The crucial question for voters and policymakers is whether the near-term sacrifice is worth the long-term gain.

Note

6) Other programs, such as housing subsidy programs for the poor, are not entitlements. Poor families can only obtained subsidized housing if their incomes are low enough to qualify for a subsidy *and* if housing authorities can find an opening in the limited number of subsidized units that Congress has authorized.
7) Public employees are covered by "Mutual Aid Associations," which provide earnings-related pensions.

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