Should Increasing the Progressivity of Entitlement Benefits be Part of a 21st Century American Social Contract?

November 2009

This paper was developed as part of the work of the Budgeting for National Priorities project with support from the Peter G. Peterson Foundation whose assistance is gratefully acknowledged. The author would like to thank members of the Brookings-Heritage Fiscal Seminar for many discussions of these and related issues. He would also like to thank the Brookings Governance Studies Program. This paper was also released as part of the "Issues in Governance Studies" series.

The Budgeting for National Priorities Project would like to thank the Annie E. Casey Foundation, William and Flora Hewlett Foundation, Charles Stewart Mott Foundation, and The Concord Coalition for their generous support.

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The Issue in Brief

Even as the current federal budget deficit soars toward a peacetime record, budget experts are focusing on the long-term fiscal outlook, in which the gap between projected revenues and expenditures rises to unsustainable levels over the next two decades. Unless we change course, we will be faced with three unpleasant options: record-high levels of taxation; abrupt and steep reductions in public programs; or printing money and borrowing massively from overseas. This bleak outlook presents a challenge that is moral and political as well as economic and fiscal.

Most economists and fiscal experts, conservative as well as liberal, agree that the current economic downturn requires that government use its spending power to boost demand and employment and to mitigate cuts at the state and municipal level. As a result, the federal government is all but certain to run record budget deficits for at least the next two years. At the same time, senior officials in both political parties have emphasized the need for longer-term restraint that will restore the balance between revenues and obligations, a goal that is bound to refocus attention on the largest and most rapidly growing domestic programs—such as Medicare, Medicaid, and Social Security—as well as on our deteriorating and outdated revenue base.

Over the past century, Americans have created their own distinctive social contract. For many reasons, programmatic as well as fiscal, this contract stands in need of fundamental revision. In that context, proposals to tie program benefits more closely to recipients' income may well appear attractive as ways of reducing expenditures while honoring basic principles of social equity and decency. The issue addressed in this policy paper is whether strengthening the relation between need—as measured by income—and net benefits (that is, what individuals receive from social programs minus their contributions to them) could serve in practice as a building block of this revised contract. The principal conclusion is that U.S. social policy could move in this direction without undermining either key policy objectives or the political coalition that sustains our large social programs, but that the mechanisms selected for implementing this shift will make a considerable difference, programmatically and politically.

Background

Even as the current federal budget deficit soars toward a peacetime record, budget experts are focusing on the long-term fiscal outlook. They do not like what they see. The gap between projected revenues and expenditures is expected to average nearly a trillion dollars over the next decade and to rise even higher in the decade after. Unless we change course, we will be faced with three unpleasant options: record-high levels of taxation, which would have negative effects on economic dynamism and growth; abrupt and steep reductions in public programs, which would destabilize legitimate expectations and lower the quality of life for tens of millions of Americans; or printing money and borrowing from overseas, which would increase the power of foreign governments and businesses over our economy while risking the decline of the dollar and ruinous inflation.

This is a fiscal challenge of the highest order, but it is more than that. Over the past century, Americans have created their own distinctive social contract that allocates rights and responsibilities among the public sector, private sector, non-profits, faith-based institutions, families, and individuals. There is a strong case to be made that for many reasons, of which the looming fiscal crisis is only one, this contract stands in need of fundamental revision. Not only government, but also business, is groaning under the weight of obligations it probably cannot honor. As we revise the social contract, however, we must keep in mind the human and moral considerations that led previous generations to craft it in the first place. Just as dynamism and growth are key to a strong economy, and the rule of law and accountability to good government, so fairness and security are to a decent society. No new social contract is acceptable if it loses sight of these organizing principles.

Proponents of public programs in which all participate have long argued that in a political culture that accepts variable and highly unequal market outcomes, there must be counterbalancing forces that not only increase fairness and security but also diminish class divisions and convey the message that "We're all in this together." Programs such as Social Security and Medicare, in which most participate and from which most hope to benefit, constitute some of the strongest such forces our country has devised. Indeed, with the abolition of conscription and the creation of the All-Volunteer Armed Forces, they may well be the most important instruments and symbols of cross-class civic unity that we have inherited from the 20th century. It is in this context that policy analysts are once again debating the extent to which the distribution of social protection should reflect varying needs of individuals rather than their civic equality. The key questions can be briefly stated: Is it appropriate to make more extensive use of need (for which income is the most frequent proxy) as a central building block of a 21st century social contract? And would it be politically feasible to do so?

There is an odd mirror-image symmetry in the long-running debate about the basic structure of domestic policy. Liberals endorse progressivity in taxation while questioning the appropriateness of need as the basis of entitlement benefits; conservatives are uncomfortable with progressive taxation but are willing to accept the

proposition that individuals should receive social support in proportion to their need. It is easy to be cynical about this debate and to squeeze it into familiar categories. Is it news that liberals want to soak the rich and conservatives seek to shrink social spending? On closer inspection, however, the truth is more complicated.

For many current programs, the debate is over size and administration—how much and how—rather than principle; means-testing is built into their design. These programs include Temporary Assistance to Needy Families (TANF), the Earned Income Tax Credit (EITC), food stamps, the Supplemental Feeding Program for Women, Infants, and Children (WIC), housing subsidies, and Medicaid. Surprisingly, even veterans' benefits are subjected to a measure of means-testing: when funding is insufficient to cover all eligible beneficiaries, higher-income veterans are the last in line.

Means-testing is one strategy—not the only one—for building considerations of need into program design. Typically, a means test uses some measure of an individual's economic condition to determine eligibility for participating in a program. Thus, if your income is above a state-determined threshold, you cannot participate in Medicaid-funded health care; if your assets exceed a different threshold, you cannot receive support for nursing-home expenses. But even programs in which everyone participates can use program design to relate income and benefits more or less closely.

Consider the two largest entitlement programs, Social Security and Medicare. Social Security benefits already reflect beneficiaries' means in two key ways. First, the dollars of lower-income wage earners translate into retirement benefits at higher rates than do the earnings of more upscale workers. Second, the rate of taxation of those benefits varies from zero—in the case of low-wage workers—to 85 percent of the normal income tax rate for those at the top. This is a good example of what Theda Skocpol has called "targeting within universalism."

As for Medicare, the Medicare Modernization Act (MMA) of 2003, which established the prescription drug program, also mandated income-relating for the premiums that fund a substantial portion of Part B, which covers out-patient expenses, including doctor's fees. This new provision, which first took effect in 2007, creates a steep payment gradient for higher-income individuals and families. The following official table shows the monthly premiums for 2008:[1]

You Pay	**If Your Yearly Income is**	
	Single	***Married Couple***
$96.40	$82,000 or less	$164,000 or less
$122.20	$82,001-$102,000	$164,001-$204,000
$160.90	$102,001-$153,000	$204,001-$306,000
$199.70	$153,001-$205,000	$306,001-$410,000
$238.40	Above $205,000	Above $410,000

To be sure, the MMA was pushed through at the height of unified Republican government, in one of the most controversial votes Congress has cast in modern history. But the income-relating provision did not spring full-grown from the brow of Tom Delay. The 1993 Clinton health care proposal included a provision that would have income-related Medicare premiums for incomes above $90,000. In July 1997, President Clinton strongly endorsed efforts to charge upper-income citizens more for their medical benefits and promised to defend any Republican lawmaker who voted for the approach. "A big majority of the American people will support this," Clinton said. "They understand how big the baby-boom retirement generation is."[2] Conservative Republicans such as Phil Gramm resisted the idea on the grounds that it amounted to a tax increase. Other Republicans who accepted the idea in principle were fearful that the president's political assessment was wrong, that opposition would solidify as the people learned more about it, and that congressional Democrats would use it as a cudgel against them, whatever the president might want.

They had reason to worry, because many of them could remember a policy fiasco that had sought to strengthen the relation between income and net benefits. In 1988, President Ronald Reagan signed into law the biggest expansion of Medicare since its creation in 1965. As originally enacted, Medicare imposed a ceiling on maximum benefits that individuals could receive. But what about those unfortunate individuals who experienced "catastrophic" costs far above the ceiling? Privately purchased "Medigap" policies proved inadequate, in many cases because insurance companies misrepresented to worried and confused elderly purchasers the benefits they would provide. Congress responded with coverage under Medicare for catastrophic costs. The final bill provided all seniors with full coverage for hospital stays of any length (and their associated doctor bills) and 80 percent coverage for prescription drug costs, plus an impressive array of nursing, home health, and respite care benefits.

Needless to say, this was an expensive proposition. To pay for it, Democrats rejected the option of spreading the burden evenly among beneficiaries. Instead, they adopted an income-relating strategy. Seniors who earned too little to pay federal income taxes would be charged nothing for catastrophic coverage. People earning under $25,000 would pay about $58 a year. By contrast, beneficiaries in the highest tax bracket would pay $800.

As upper-income Americans learned more about the legislation, their anger grew. In one memorable incident, an irate band of seniors assaulted House Ways and Means Committee Chairman Dan Rostenkowski while he was visiting the congressional district he had represented for decades.[3] The minority of aggrieved upper-income beneficiaries proved more powerful than the much larger number of low- and moderate-income seniors who would have received substantial benefits at modest cost. Within a year, Congress repealed the bill. The moral of this story was clear to all participants: while public policy considerations had pushed in one direction, hard politics had pulled in the other, and it had not taken long for politics to emerge victorious.

The appropriateness of a more need-based strategy rests on answers to fundamental, and perhaps imponderable, questions about the role of government in our economy and society. If we assume that resources available to fund rapidly growing public programs are limited, then we will not be able to grant every claim or treat everyone just the same. If so, we need a principled basis for deciding who receives a larger share, and the difference in needs among individuals is one plausible distributive norm. In the absence of such a principle, intensity of feeling, financial clout, or sheer numbers will determine the outcome, as they so often do.

The alternative is to reject the idea of limits, at least for the foreseeable future. After all, some might argue, the share of national resources that the United States devotes to health care has risen relentlessly for two generations, with no end in sight. If that represents a considered national judgment about priorities, why should we place a cap on the public dimension of health care spending? The obvious response is that unless total public expenditures themselves rise indefinitely, health care at some point will squeeze other priorities. (There are signs that this is already happening at the state level.) Still, some might reply, we are far away from that point, and there is no reason to believe that 20 percent of GDP (the current level of health care spending) should represent a permanent ceiling on the activities of the federal government. But even granting that the federal government is likely to be larger in ten years than it is today, long-term projections suggest that our course is unsustainable. The alternative to a carefully considered rebalancing of our priorities is an ugly struggle in which the most powerful groups safeguard their interests at the expense of the weak, the protection of whose interests is a responsibility of decent governments. It is in this context that need-based reform strategies should receive renewed attention.

The Policy and Politics of Need-sensitive Progressivity: A Look at the Evidence

Scholars with social democratic sympathies often contend that beyond a certain point, subjecting broad-based public programs to income-relating is a formula for undermining the political coalitions needed to sustain them. The programs as currently structured, runs the argument, represent the outer limit of what well-to-do taxpayers are willing to transfer to others. If they are asked to pay large sums in taxes for these programs but get little or nothing in return, they will withdraw their support from them. Other scholars—liberal as well as conservative—reply that the public has demonstrated its willingness to fund a wide range of means-tested programs. Why assume that the wealthy inevitably will defect if they are asked to pay more than others for health care during retirement or to receive lower pensions in proportion to their earnings and contributions? Besides, say those who take this side of the debate, current arrangements actually favor a politically powerful, aging middle class rather than younger and more vulnerable groups.

We can bring both historical-institutional and quantitative analysis to bear on this debate. In the American context, the growth of need-based programs from the mid-1960s until the end of the Carter administration gave way to mounting public

skepticism. Ronald Reagan's early success in pruning some of these programs administered a shock to liberal expectations and aroused fears that programs for poor people were likely to be politically vulnerable. The debate over the AFDC program ("welfare") in the late 1980s and early 1990s ratcheted up these fears. Drawing on extensive historical research, Theda Skocpol, a prominent scholar with social democratic sympathies, argued that "when U.S. antipoverty efforts have featured policies targeted on the poor alone, they have not been sustainable."[4] Based on cross-national data from the 1980s, European scholars Walter Korpi and Joakim Palme discerned what they labeled the "paradox of redistribution," arguing that "[t]he more we target benefits at the poor only . . ., the less likely we are to reduce poverty and inequality." They found no evidence, moreover, to support the fear that citizens will balk at the higher tax rates needed to sustain universalistic rather than targeted programs.[5]

By the early 1990s, some scholars had begun to question the social democratic thesis. In a comprehensive review of U.S. social policy during the 1980s, Robert Greenstein noted actual expansions in entitlement programs such as Medicaid, food stamps, child nutrition, and supplemental security income payments targeted to the poor during the 1980s, the epicenter of the alleged retrenchment. The program cuts that did occur affected middle and upper-income children rather than the working class or the poor. (The one means-tested program that failed to recover from the cuts of the early 1980s was AFDC—an exceptional case for many reasons.) Indeed, Greenstein found that from 1983 through 1990, universal rather than means-tested entitlements bore the brunt of the budget cuts. In his analysis, differences in budget status—entitlement versus annual discretionary programs—determined political vulnerability to a much higher degree than did the distinction between universal and targeted programs.[6] In a similar vein, Paul Pierson argued that during periods of retrenchment, means-tested programs have a better chance of surviving, in part because their small size relative to universal programs means that cutting them yields meager fiscal gains. Analyzing social policies in Great Britain and the United States, he found that "if the biggest programmatic losers in the 1980s were often universal programs, the biggest winners were in fact targeted ones."[7]

More recently, two major cross-national analyses of social policy in the OECD over the past two decades have cast further doubt on the social democratic thesis. In a comparison of universal versus targeted programs in eighteen OECD nations between 1990 and 2002, Kenneth Nelson found that they tended to follow similar patterns of growth and retrenchment and that quantitative differences among them were small. He observed some variation among different types of welfare states, however. In nations such as the United States that embraced a "basic security" model of social insurance, means-tested benefits tended to be more resilient. These findings, he concluded, were broadly consistent with Pierson's claim that in countries that provide basic security through social insurance, neither liberal nor conservative governments regard means-tested programs as providing "tempting targets for retrenchment."[8]

In a parallel analysis of twelve wealthy OECD nations—four Nordic, four continental, and four English-speaking—Lane Kenworthy subjected the Korpi-Palme paradox of redistribution thesis to a series of empirical tests. He found no evidence that within countries, targeted programs were cut more than universal programs during the last two decades of the 20th century. Nor did countries that rely more on targeted benefits cut aggregate social expenditures more than did those that emphasize universal programs. Nor did countries that target more redistribute less, as Korpi and Palme had claimed: the relationship they found, based on data from the mid-1980s, had essentially disappeared by 2000.[9]

While Kenworthy emphasized that his data raise as many questions as they answer, they clearly give today's U.S. social policy analysts and elected officials no reason to believe that increased targeting will necessarily undermine key objectives of a new 21st century social contract. Indeed, the weight of the evidence tends to support the claim that, done correctly, targeting can advance key fiscal and social objects while sustaining the needed public support.

Increased Targeting of Net Benefits: Implementation Issues

Universal and targeted programs are examples of what sociologists call "ideal types"—analytical constructs that clarify key features of reality without precisely describing it. As Nelson observes, "Few social benefits are ever purely universal, or solely based on targeting. Rather, they tend to lie somewhere between the two end points on a continuum."[10] In the United States, for example, Social Security is regarded as a universal program, but its benefit formula tilts toward lower-income workers, as does the taxation of benefits received. And when targeted programs use phase-outs to avoid "cliffs" that create perverse incentives, beneficiaries in the upper range of eligibility receive lower benefits than do those lower down. Not only is there targeting within universalism, there is targeting within targeting. Income relating, then, is rarely a matter of yes or no, or of instituting something altogether new. It is almost always a matter of more or less.

This does not mean that increasing a program's income-relatedness is politically easy. Often the debate brings to the fore program features on which the public had not previously focused, with unpredictable results. How many workers know about, let alone understand, the bend points and varying replacement rates used to calculate Social Security benefits? (Social Security is already more progressive than are the public pension systems of many other OECD countries, including Germany, France, the UK, and even Norway and Sweden.[11]) And a larger share for lower-income beneficiaries means a smaller share for those higher up, which means actual benefit cuts for those at the top unless aggregate expenditures are increased. As we have seen, however, that income-relating is difficult does not mean that it is impossible.

If policymakers wish to make net benefits more progressive, they must balance the advantages and disadvantages of the different strategies available to them. For example, if they wish to reduce net benefits for upper-income beneficiaries to free up resources

for those lower down the income scale, they have three options, not mutually exclusive—payments can be increased, benefits can be reduced, or a higher percentage of benefits can be "clawed back" through taxation. It seems likely that these alternative strategies would have somewhat different programmatic consequences and could lead to different individual choices. Focusing on premium increases could mean that well-off beneficiaries would be able to get better coverage at less cost on the private market, leading them to opt out of voluntary programs and weaken the programs' financial base. For mandatory programs, an exclusive focus on contributions at some point could lead wealthier beneficiaries to withdraw their political support.

The existing programmatic baseline also makes a difference. For example, the tax claw-back provisions of Social Security are already robustly progressive, the payroll tax financing the system is strongly regressive, and the benefit schedule is modestly progressive. On the face of it, making the financing scheme more progressive—by lifting or removing the cap on earnings subject to the payroll tax while exempting more earnings at the bottom—might seem to be the most effective course. But as a practical matter, upper income beneficiaries may be more sensitive to tax increases than to benefit reductions. If so, it may well prove more effective to rely on strategies such as progressive indexation, in which the mix of indices determining annual benefits gradually shifts from wages to prices (which tend to grow more slowly) at the higher end of the income scale. Still, policymakers would have to be careful not to break altogether the link between contributions and benefits for upper-income workers.

Different considerations are at work in the arena of health insurance. For example, proposals to eliminate the tax-favored treatment of employer-provided health benefits and to replace them with uniform tax credits represent a substantial move toward progressivity. The reason is simple: the exclusion of health benefits from taxable income is worth more to upper-income than lower-income earners, while the reverse is true for tax credits. The difficulty is that many currently insured workers, who would in fact benefit from the switch, are likely to be mistrustful and may fear that the net consequences of change would work to their disadvantage. One possible response would be to alter the tax-favored treatment of employer-provided health benefits only for those at the top of the income distribution. This would have a number of disadvantages, however: it would raise relatively little revenue for redistribution or deficit reduction, and it would leave current incentives to consume health care intact for most people. A more effective and sustainable possibility would be to cap annual health care outlays—insurance premiums plus co-payments and deductibles—at percentages of adjusted gross income that would vary according to individual earnings: say, 5 percent for low-wage workers, 10 percent for moderate-income workers, 15 percent for the upper-middle class, and no limit for the wealthy.[12]

Much of the argument about increasing the need-sensitivity of large social programs has been qualitative. But fiscally and politically, the quantitative dimension may prove decisive. For example, advocates and critics agree that the recent adoption of income-related premiums for Medicare Part B will affect only the top few percent of households and that the aggregate reductions in net benefits will be modest—no more than 1 to 2

percent of total program costs.[13] But the problem is much larger than that: Medicare has tripled as a share of the federal budget during the past generation[14] and under current policies will double as a share of GDP during the next generation.[15] A leading health economist has estimated that if current trends continue, the tax rate needed to sustain this program would soar to more than 10 percent of GDP by 2035.[16]

If Medicare's growth rate is to be reduced significantly through income-relating, a far higher percentage of beneficiaries would have to participate in that feature. But how much higher, and with what consequences for Medicare's structure and politics? Pauly suggests that to keep the 2035 Medicare tax rate at 4 percent, at least the upper half of all beneficiaries (as measured by income) would have to accept lower net benefits. Critics have argued that applying this approach broadly enough to generate significant reductions in net outlays would prove politically unsustainable.[17] While the progressive premium formula for Part B of Medicare has evoked remarkably little protest thus far, there is no way of determining in advance where the breaking point lies. Clearly, this is a question calling for political judgment rather than theory or policy analysis.

The mechanisms used to establish income-related criteria matter as well. Some kinds of means tests—for example, the asset limits imposed by Medicaid—give potential recipients incentives to transfer homes and other property to their heirs to qualify for Medicaid-funded nursing home care. This practice has forced the government to design detailed regulations intended to prevent this practice. But as we have learned from the income tax code, the ingenuity of individuals who stand to benefit from loopholes is at least as great as that of hard-pressed officials who are determined to stop them.

Some critics have argued that significantly increasing the weight of income-related criteria for entitlement benefits would generate high cumulative marginal tax rates and a range of negative incentives for economic growth. This claim is bound to be true to some extent. The real question is how much of a drag these effects would create relative to the benefits of the overall strategy. Again, this is an empirical question that only experience can settle. One thing is clear: while the gains from income-related net benefits are reasonably predictable, the magnitude of the economic loss is more speculative and harder to calculate. Taken together, these arguments represent a case for moving forward while remaining open to revising the reforms based on solid evidence of their effects.

Conclusion

As the United States begins to recover from the deepest recession in decades, policymakers and the public are turning their attention increasingly to our long-term fiscal problems. A strategy focused solely on revenues would generate levels of taxation that neither the economy nor the American people could easily tolerate. It is inevitable that spending will be in play as well, including the entitlement programs that constitute a large and inexorably rising share of the federal budget. The challenge will be to restrain their growth in a way that meets people's needs and respects their values, thus preserving the broad-based public support required to sustain them long-term.

In the quest for viable strategies, the income-related features of these programs should be carefully considered. The evidence presented in this paper suggests that done right, strengthening the link between income and net benefits would allow these programs to meet essential social objectives without antagonizing upper-income beneficiaries and undermining cross-class coalitions. An accumulation of survey data supports the conclusion that income-related reform strategies are far more publicly acceptable than are the available alternatives, such as age-related strategies. Whatever their merits as public policy, proposals to raise the age threshold for entitlement benefits are resoundingly unpopular. This is not to say that they are out of the question; the 1983 Social Security reforms refute that hypothesis. It is to say that age-related proposals cannot be the dominant feature of any package that hopes to pass the test of democratic accountability.

Spending restraint is never pleasant, of course, and income-relating has its share of perils and critics. On reflection, however, policymakers and the people may well conclude that the alternatives are worse. Even so, the path up the mountain of reform is rocky and steep, and it is unlikely that normal legislative processes can bring us to the summit. One suspects that entitlement reform, of which income-related benefits must be a key element, can occur only through institutional devices such as bipartisan commissions empowered to create agendas to which Congress and the president must respond. In these times of deep fiscal challenge and intense political polarization, the Base Realignment and Closure Commission may well offer the only model with a chance of success. If so, both those who have resisted entitlement reform and those who have rejected all talk of revenue increases will have to relax their intransigence.

Endnotes

[1] U. S. Department of Health and Human Services, Centers for Medicare and Medicaid Services, 2007
[2] Mitchell, 1997
[3] Rasky, 1989
[4] Skocpol, 1991, p. 414
[5] Korpi and Palme, 1998, pp. 681-83
[6] Greenstein, 1991, pp. 440-44
[7] Pierson 1994, p. 103
[8] Nelson, 2007, pp. 41-50
[9] Kenworthy, 2005, pp. 5-8
[10] Nelson, 2007, p. 34
[11] Whiteford, 2007, p. 19
[12] For a version of this proposal, see Furman, 2008, pp. 175-226
[13] Reischauer, 2003; Hacker and Marmor, 2003
[14] Rivlin and Antos, 2007
[15] Rivlin and Sawhill, 2004
[16] Pauly, 2004
[17] Hacker and Marmor, 2003

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