Finally, because variation in the use of ancillary services is particularly sensitive to the types of patients treated, a ceiling that included ancillary services would have to be adjusted for case mix. While extensive work has been conducted within the Health Care Financing Administration to develop a methodology for such adjustments, there is some concern about the accuracy of the diagnostic data that would be employed.

PROVIDE INCENTIVES TO STATES FOR HOSPITAL COST CONTAINMENT (A-550-d)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	0	-5	-20	-50	-95	-170
Outlays	0	90	250	460	650	1,450

Hospital costs, which increased about 15 percent a year between 1968 and 1980, rose at an even faster 19 percent annual rate during the first ten months of 1981. These increases have contributed to growing federal outlays for Medicare and Medicaid.

State programs to set maximum rates for hospital charges have been effective at restraining increases in hospital costs. The six states with mandatory rate-setting programs experienced a 48 percent increase in per capita community hospital expenditures between 1976 and 1980, compared with a 68 percent increase for other states.

The 1981 reconciliation act rewarded the six states; if their rate-setting programs continue to succeed, their federal Medicaid grants will not be reduced as much as those for states without such programs. But because this provision applied only to existing programs, it did not offer other states an incentive for initiating rate controls.

Under the option discussed here, the federal government would encourage more states to adopt rate-setting programs, by returning one-third of the resulting Medicare savings to them. This could reduce not only federal outlays, by as much as $1.5 billion during 1983-1987, but also payments by states and private purchasers of hospital care.

Savings to the federal government under this proposal would depend upon the number and size of the states initiating rate-setting programs, the effectiveness of the programs, and the details of the incentive formula. The estimate presented above assumes that states accounting for 25 percent of hospital expenditures would implement new programs in response to the proposal and that they would be as successful as the six programs already in operation. Under different assumptions, the proposal could increase rather than decrease federal outlays.

A drawback to this proposal is that the success of rate setting might come at the expense of quality of care. Stringent controls may lead hospitals to cut back the adoption of new services that have the potential to improve care. The extent of this problem in existing state programs has not been studied.

REDUCE FEDERAL SUPPORT FOR BIOMEDICAL RESEARCH
(A-550-e)

Savings from CBO Baseline	Annual Savings (millions of dollars)					Cumulative Five-Year Savings
	1983	1984	1985	1986	1987	
Budget Authority	370	395	420	440	470	2,095
Outlays	160	345	395	425	450	1,775

The federal government spends about $4.1 billion per year to support biomedical research, 90 percent of it through the National Institutes of Health (NIH). If appropriations for NIH research were reduced by 10 percent, the 1983-1987 savings would total about $1.8 billion.

Some believe that federal spending for biomedical research is excessive. They point to the rapid growth in federal spending in this area--about 225 percent in the overall NIH budget between 1970 and 1980, and 450 percent for cancer research in the same period. Other proponents of this budget reduction disagree that spending has been excessive, but see no valid reason for exempting biomedical research from a general need to cut federal spending.

Opponents argue that cuts of this magnitude could have long-term adverse effects on the country's biomedical research efforts. They contend that researchers unable to obtain funding would leave the field and would not be available if spending was boosted in the future.

Given the nature of research supported by NIH, it is doubtful that private funding would increase significantly to offset lower federal support. Private support for biomedical research would have to double, from $300 million to $600 million a year, to offset a 10 percent reduction in NIH funding. Most observers believe that such an increase is unlikely over the next five years.

LENGTHEN THE SOCIAL SECURITY AIME COMPUTATION PERIOD BY THREE YEARS
(A-600-a)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	a/	a/	a/	a/	a/	a/
Outlays	10	100	200	300	500	1,110

a. Changes in budget authority are not presented because rapidly declining trust fund balances make the interest payments resulting from these savings uncertain.

Social Security retirement benefits are based on workers' Average Indexed Monthly Earnings (AIME) in employment covered by the system over most of their working lives. The number of years that currently must be included in the benefit computation formula is determined in part by the year in which the retiree reaches age 62.[1] The option discussed here, advanced by the Administration in May 1981, would add three years to the AIME computation base period, bringing it to age 65. Lengthening the averaging period would generally lower benefits, particularly for early retirees, by requiring more low-earnings years to be factored into the benefit computation. This proposal, applied for persons turning 62 after December 31, 1982, would save $1.1 billion in the next five years.

Analysts who favor a longer computation period argue that the number of years included in the calculation of AIME should be based on the age of eligibility for full benefits, not for reduced early-retirement benefits. Moreover, the shorter averaging period--which would mean that persons who retire before age 65 do not have any extra years of low or zero earnings counted in their AIMEs--might

1. Specifically, the length of the computation period is five years less than the number of years after 1950 or attainment of age 22, whichever is later, and before age 62. Wages earned after a worker reaches age 62 may replace earnings from earlier years if this increases the benefit received.

create an incentive for early retirement. Finally, lengthening the averaging period would reduce the advantage that workers with fluctuating earnings have over those with relatively smooth earnings histories.

Opponents of this proposal view it as a means of hiding benefit reductions behind a technical change in the benefit computation. They also argue that, because many beneficiaries elect early retirement for such reasons as poor health or unemployment, a longer computation period would reduce benefits for those recipients who are least able to continue working. Other workers who stand to be disproportionately affected include women who stop or interrupt their careers to bear and raise children. The same would apply to other workers who, for whatever reasons, incurred long periods of unemployment.

DELAY THE SOCIAL SECURITY COST-OF-LIVING ADJUSTMENT
BY THREE MONTHS
(A-600-b)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	a/	a/	a/	a/	a/	a/
Outlays	2,800	3,400	3,300	3,400	3,500	16,400

a. Changes in budget authority are not presented because rapidly declining trust fund balances make the interest payments resulting from these savings uncertain.

Under current law, Social Security benefits are adjusted each July if the Consumer Price Index (CPI) has changed by at least 3 percent between the first quarter of that calendar year and the corresponding quarter of the previous year. If the cost-of-living adjustment (COLA) were made every October instead of July, 1983 savings would amount to $2.8 billion; for 1983-1987, they would total $16.4 billion.

Over the last few years, Social Security outlays have grown both in real terms and as a proportion of both GNP and the federal budget. One can argue, therefore, that Social Security recipients should share some portion of the effort to lower federal spending. A three-month delay of the COLA would spread the reduction in benefits over the entire beneficiary population, rather than concentrate it on one group.

Opponents of delaying the COLA assert that even very small benefit reductions could cause hardships for some persons whose only source of income is Social Security. Further, if indexing delays were extended to other income support programs such as Supplemental Security Income (SSI), the recipients of which typically have incomes already below the poverty level, substantial difficulties could be caused for most program participants.

REDUCE AUTOMATIC SOCIAL SECURITY COLA TO TWO-THIRDS OF THE CPI INCREASE, BUT INSTITUTE A DISCRETIONARY SUPPLEMENT (A-600-c)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	a/	a/	a/	a/	a/	a/
Outlays	5,400	9,700	14,900	20,300	26,000	76,300

NOTE: Based on change in COLA entitlements only; disregards any allowance for discretionary COLA increases.

a. Changes in budget authority are not presented because rapidly declining trust fund balances make the interest payments resulting from these savings uncertain.

Social Security recipients are currently entitled each July to cost-of-living adjustments (COLAs) based on the full percentage increase in the Consumer Price Index (CPI) between the first quarter of that year and the corresponding quarter of the previous year. In the past few years, COLAs have become a major factor in the growth of entitlement program costs in general and in Social Security benefit costs in particular. As a result, there have been a number of proposals to limit future COLAs. If the automatic COLA were limited to two-thirds of the increase in the CPI beginning in 1982, for example, savings in 1983 would be $5.4 billion. (This estimate does not include offsetting increases in income support programs, such as Supplemental Security Income (SSI) and food stamps.) Under this approach, a supplemental discretionary COLA could also be proposed by the Administration each year and voted on by the Congress. If a supplement were approved, it would reduce the savings shown in the table above.

The argument for this proposal is that it would help to control the growth of entitlement programs, while still allowing COLAs to be tailored to a year's particular economic conditions. If in a given year prices were rising faster than wages, for example, the COLA in that year could be limited to the increase in wages (as long as it was at least two-thirds of the increase in prices). At the same time, a substantial--though not full--adjustment for inflation would continue to be guaranteed.

A change from fully automatic to partially discretionary COLAs would not necessarily ensure large savings, however. Before automatic indexing of benefits began in 1975, ad hoc benefit increases generally exceeded CPI increases. For example, the total of the four benefit increases made between 1966 and 1972 raised benefit levels by 72 percent, compared with a 29 percent increase in the CPI over that period.

Under current CBO projections, limiting the COLA to two-thirds of the CPI increase through 1987 would result in a decrease in real benefits of 11.8 percent. Had this provision been in effect for the 1979-1981 period--with that period's higher inflation rates--real benefits would have been 10.1 percent lower. Such reductions could cause hardships for some Social Security recipients, especially those without other financial resources. In addition, if COLA reductions were extended to income support programs such as SSI, the recipients of which typically have incomes below the poverty level, substantial difficulties could be caused for a large proportion of beneficiaries. Since the President and the Congress would review discretionary increases each year, however, any sizable reductions in real benefits would reflect repeated decisions over time rather than a single decision.

LIMIT RETIREMENT COST-OF-LIVING ADJUSTMENTS
TO CORRECT FOR PAST OVERINDEXATION
(A-600-d)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
	Civil Service Retirement--Function 600					
Outlays	169	572	1,005	1,415	1,799	4,960
	Military Retirement--Fuction 050					
Outlays	111	299	472	623	745	2,250
Total Savings	280	871	1,477	2,038	2,544	7,210

NOTE: Data for Social Security not available.

Several mechanisms built in at various times to the federal civilian and military retirement systems and Social Security have led to what many observers regard as excessive yearly outlays for annuities.

Military and civilian federal personnel who retire in 1982 will receive smaller pensions than their counterparts who retired during the 1970s at the same grade levels and with the same length-of-service records. For example, a military E-7 who retired in 1972 after 25 years of service now receives an annuity of $12,800; in contrast, an E-7 retiring this year after 25 years will receive an $11,400 annuity. A civilian GS-7, step 10, who retired in 1972 after 25 years receives $13,000; his 1982 counterpart will receive $9,000.

There are two reasons for such pension disparities. First, a statutory provision that applied from 1970 until 1976 caused each cost-of-living adjustment (COLA) in federal pensions to reflect not only the full change in the Consumer Price Index (CPI) but also an additional one percentage point. Although the Congress withdrew the one-percentage-point add-on in 1976, it did not make the rescission retroactive. Thus, the add-on continues to affect the size of current COLAs for pre-1977 retirees. The other reason for the pension disparity is that, in recent years, federal active-service white-collar pay has lagged behind the CPI; this is also the case for military pay, though to a lesser extent. In short, pensions have kept up with the CPI, but pay has not.

If future COLAs were held to half the CPI change for military and civilian retirees whose annuities exceeded those payable to current retirees with the same federal work histories, savings over the next five years would total over $7 billion. (For the most part, this change will affect employees who retired after 1969.) The short-run effect would be gradually to recapture the overcompensation made by the 1970-1976 indexing formula, and to eliminate the disparities caused by wage increases falling behind price increases. The long-run effect would be, in general, to limit federal retirement COLAs to the lesser of percentage changes in the CPI or federal pay.

Proponents of such a change argue that, in times of budgetary stringency, limiting future COLAs of retirees who benefited from the overindexation that prevailed for six years would be appropriate and fair; these retirees have been and otherwise will continue to be overprotected against inflation. Retirees since 1977, on the other hand, have not been similarly benefited, although they enjoyed greater protection than their counterparts still in the active federal workforce. If this greater protection continues, federal workers--particularly those at the highest grades and in periods of high inflation--would have strong incentives to elect early retirement as soon as they are eligible. This would have the dual effect of prematurely depriving the government of experienced employees and adding in the longer run to federal retirement costs.

Opponents of this option could argue that the Congress took sufficient action in 1976 in ending the overindexation of federal retirement benefits. After so many years, it would now be unfair to require annuitants to pay back extra income by limiting future COLAs. In response to the criticism that federal annuities have been rising faster than pay (thus encouraging early retirements), some observers would hold that this is a price of the Congressional policy to restrain pay raises for budgetary reasons. The solution, they would contend, is not to reduce retirees' protection against inflation, but rather to set compensation for active employees at levels that will attract and retain the desired workforce.

If the Congress decided to reduce future COLAs for federal retirees benefiting from the indexing formula abandoned in 1976, it might also look to an analogous change in Social Security benefits. The Social Security Amendments of 1972 contained a technical flaw that resulted in overindexing the initial benefits of newly eligible retirees. That flaw was corrected in 1977 Social Security legislation, but its effects persist. The flaw is in large part responsible for the recent increase in replacement rates (that is, the retirement benefit as a percentage of earnings) for workers retiring at age 65 with average covered wages, from 41 percent in 1974 to 51 percent in 1980.

As with federal retirement, the Social Security overindexing could be corrected over time by limiting future COLAs for the group affected, which is perhaps 30 percent of the Social Security beneficiary population.

Opponents of such a change in Social Security would pose some of the same arguments that federal retirees could make. In addition, the change would be extremely difficult to administer in the case of Social Security, and its effect would fall on a group with lower average incomes than federal retirees, hence on people less able to absorb a reduction in the COLA.

ELIMINATE MOTHER'S AND FATHER'S SOCIAL SECURITY BENEFITS WHEN YOUNGEST CHILD ATTAINS AGE 6
(A-600-e)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	a/	a/	a/	a/	a/	a/
Outlays	50	170	300	410	530	1,460

a. Changes in budget authority are not presented because rapidly declining trust fund balances make the interest payments resulting from these savings uncertain.

Under the 1981 reconciliation act, Social Security survivor benefits may be paid to a mother or a father with children under age 16, as opposed to age 18 under prior law. A further restriction of parental eligibility to cases in which the youngest child is under 6 would reduce Social Security outlays by about $1.5 billion during the 1983-1987 span. This proposal, which would apply to families becoming eligible after September 1982, would not affect the surviving child's benefit, nor the one-third of these families who would still receive the family maximum benefit.

The rationale for this proposal is that the role of women has changed substantially since these benefits were added to the Social Security system, and one can no longer assume that surviving mothers of school-aged children will not be employed. In fact, some analysts argue that it has become the norm for mothers with no children younger than 6 to work; thus, the benefits are no longer so necessary as they once were. This rationale has been used, for example, to impose a requirement that AFDC recipients with no children under age 6 register for work. Furthermore, under current law, survivor households may suffer a substantial decline in income when the youngest children reach age 16. If the surviving mother has not worked before, she may be forced into the labor market quite late in life, which may result in both relatively low wages and reduced opportunities to accumulate entitlements to pension benefits based on her own employment.

Elimination of survivor benefits to mothers and fathers of older children could be opposed on the ground that survivors' benefits are an integral part of the Social Security program. This proposal could result in major financial hardships for many beneficiary families, with perhaps as many as 15 percent of those affected suffering an income loss of 20 percent or more. In addition, child-care services for after-school hours may be inadequate, and this may limit employment opportunities for mothers of older children to part-time jobs. Finally, in families with no children under age 6 at the time a parent dies, the immediate reduction in income could cause drastic changes in the family's standard of living. One way to mitigate this proposal's effect on such families would be to provide benefits to the surviving parent for the first two years following the death of his or her spouse, even if the youngest child is over age 6.

INDEX "BEND POINTS" IN THE SOCIAL SECURITY BENEFIT COMPUTATION FORMULA BY ONLY 50 PERCENT OF WAGE INCREASES OVER FIVE YEARS (A-600-f)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	a/	a/	a/	a/	a/	a/
Outlays	25	200	500	1,000	1,900	3,625

a. Changes in budget authority are not presented because rapidly declining trust fund balances make the interest payments resulting from these savings uncertain.

Social Security retirement benefits are calculated by applying a three-stage formula to a summary measure of a worker's lifetime earnings, called Average Indexed Monthly Earnings (AIME). For a worker retiring at age 62 in 1982, for example, the basic benefit (before actuarial reduction) would be equal to 90 percent of the first $230 of AIME, plus 32 percent of AIME between $231 and $1,388, plus 15 percent of AIME over $1,388. The points at which these percentages change--$230 and $1,388--are known as "bend points." These points are currently indexed to the annual change in average covered wages, and so they rise every year by the same percentage as wages.

Under a plan similar to one proposed by the Administration in May 1981, the bend points would be raised by only half of the increase in average earnings each year for the next five years. For most recipients, this would mean that a larger proportion of their AIMEs would fall into the upper brackets of the formula, in which the percentage of AIME "replaced" by benefits is the lowest; average benefits would therefore decline relative to current law. Almost all new Social Security beneficiaries would be affected, with the largest relative declines experienced by persons with the highest covered earnings. On average, new benefit awards would be lower by about 10 percent over the next five years than if current law were continued.

The major arguments in favor of this proposal are that it would generate very large long-run savings in Social Security outlays while maintaining payments to persons with very low benefit levels. Total savings under this proposal would solve most of the Social Security system's projected long-term financing problems.

On the other hand, this proposal would affect only new beneficiaries, who are already expected to have lower wage replacement rates than those who retired in the late 1970s; thus its enactment would widen disparities between these two groups. In addition, benefits for recipients with high covered earnings, which are already lower relative to total contributions than are benefits received by workers with low earnings, would decline further.

RETAIN EARNINGS TEST FOR SOCIAL SECURITY
BENEFICIARIES AGED 70 AND 71
(A-600-g)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	a/	a/	a/	a/	a/	a/
Outlays	400	570	610	650	690	2,920

a. Changes in budget authority are not presented because rapidly declining trust fund balances make the interest payments resulting from these savings uncertain.

Social Security benefits received by retirees younger than age 72 are subject to an earnings test; this reduces benefits by $1 for every $2 earned above an exempt amount ($6,000 a year in 1982 for beneficiaries aged 65 to 71). The age at which benefits are no longer reduced for earnings had been scheduled to fall to 70 in 1982, but the 1981 reconciliation act postponed the change until 1983. Savings of about $2.9 billion would result from a further postponement, to 1988 or later.

Advocates of continuing to postpone the reduction to age 70 argue that working Social Security recipients generally have higher incomes than most other beneficiaries; thus, working recipients may be better able to adjust to the withdrawal of an expected liberalization in benefits. Retention of the earnings test can also be supported on the ground that persons with significant earnings are not in fact retired; accordingly, they should not be entitled to full Social Security benefits.

On the other hand, another postponement of the scheduled change might discourage older workers from seeking employment. If the earnings test were removed for those aged 70 to 72, with the overall labor force expanding as a result, some additional payroll and federal income tax revenues would be generated. Such an increase in tax receipts might be small, however, since most people over 70 face substantial obstacles to employment because of poor health and limited job opportunities.

ELIMINATE SOCIAL SECURITY BENEFITS FOR CHILDREN
OF RETIREES AGED 62-64
(A-600-h)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	a/	a/	a/	a/	a/	a/
Outlays	30	200	400	500	600	1,730

a. Changes in budget authority are not presented because rapidly declining trust fund balances make the interest payments resulting from these savings uncertain.

The child of a retired worker, as long as he or she is unmarried and under age 18, is currently eligible for Social Security benefits; the benefit is equal to one-half of the parent's basic benefit, subject to a dollar limit on the maximum amount receivable by any one family. If such benefits were eliminated for the children of retirees aged 62 through 64, the savings would total about $1.7 billion over the next five years. Some 150,000 beneficiaries would be affected.

The rationale for eliminating children's benefits while a retiree is younger than 65 is that it would encourage some retirees to stay in the labor force longer. Benefits for retired workers and their spouses are actuarially reduced if retirement occurs before age 65, but children's benefits are not reduced. Further, the younger workers are, the more likely they are to have children under 18 years old; thus, there may be an incentive for workers under age 65 to retire while their children are still eligible for benefits.

On the other hand, in many cases only a small reduction in benefits would result from this proposal because of the operation of the abovementioned family maximum. The maximum varies from 150 percent to 188 percent of the parent's basic benefit and would therefore affect most households with more than two recipients--a worker and spouse, for example--receiving benefits based on the same earnings record. Thus, the increase in a household's total benefits attributable to the presence of eligible children would generally be quite limited, and the work disincentive effects of these benefits might not be large.

Elimination of children's benefits could cause some hardships for young children's parents who retire early because of poor health or unemployment. This problem could be addressed by a partial measure, such as retaining the benefit but making eligibility for it subject to a means test.

LIMIT COMBINED FEDERAL DISABILITY BENEFITS
(A-600-i)

Savings from CBO Baseline	Annual Savings (millions of dollars) 1983	1984	1985	1986	1987	Cumulative Five-Year Savings
Budget Authority	a/	a/	a/	a/	a/	a/
Outlays	400	400	450	450	450	2,150

a. Changes in budget authority are not presented because rapidly declining Social Security trust fund balances make the interest payments that result from these savings uncertain.

Workers who became entitled to Social Security Disability Insurance (SSDI) benefits before September 1981 can collect payments--without reductions--while also receiving benefits under one or more of the following federal programs: veterans' service-connected compensation, military disability retirement benefits, civil service disability retirement benefits, and black lung program (Part B) benefits. Approximately 6 percent of SSDI beneficiaries--165,000 people--receive duplicative payments from these other programs. Almost one-half of them were awarded federal payments greater than their average highest pre-disability, pre-tax earnings. If the combined benefit were limited to 80 percent of average pre-disability earnings, 1983 savings would be $400 million and cumulative savings over the 1983-1987 period would approach $2.2 billion.

The 1981 reconciliation act imposed just such a cap on combined disability payments of certain SSDI beneficiaries--those disabled after February 1981. The intent was to improve work incentives and to promote equity in family benefit levels, which vary widely among beneficiaries of different programs, while reducing high benefit levels. But the law did not apply to payments of current beneficiaries, nor to recipients of veterans' compensation. Extending the 1981 law to cover these persons would bring about uniform treatment of current and future beneficiaries. The option would affect about 97,000 persons in 1983.

Opponents of the proposal argue that current beneficiaries count on these benefits and might face hardship if they were cut.