

# The La Follette Policy Report

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## Widowhood in a Reformed Social Security System

by Karen C. Holden and Cathleen Zick

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Widowhood is an economically risky event. As documented in this article, the average household income of married women in the United States falls sharply when their husbands die, even when income measures are adjusted for the reduced consumption of the now smaller household. The share of the couple's prewidowhood income that continues to be paid to the widow is a consequence of both the couple's private insurance choices and the way in which social policy protects married women against the loss of husbands' income upon widowhood.

The current debate over proposed reforms of Social Security that include an individual account component is in large part a debate over the necessity of providing income guarantees to widows. In contrast, some argue that individuals understand income security risks and can be trusted to make the most appropriate long-term insurance decisions for their families and survivors.

This article reviews what we know about the income consequences of widowhood in the United States, the role of Social Security and private pension sur-

vivor benefits in insuring against potential income losses when widowhood occurs, and the implications of these findings for Social Security reform. First, we look at survivor benefit provisions in the current Social Security program. Next we explain regulations that govern survivor benefits of employer-provided pension plans and individual account plans (as defined by federal law). We follow this with evidence on the income consequences for married women of their husbands' deaths. These data separate the income change into two components: (1) the change that can be attributed to the "involuntary retirement" through death of husbands who had not yet retired, and (2) the change that can be attributed to widowhood itself. These two components distinguish the way in which the system insures against the loss of income upon a worker's retirement from how the system regulates the widow's inheritance of her husband's retirement benefits.

Social Security reform proposals that include an individual account component propose different degrees of autonomy over the settlement of these accounts at retirement and death. They are, therefore,



## Director's Perspective

As my term as La Follette director winds down, the activities of the Institute show no sign of diminishing. This past year has been more exciting and stimulating than any before, and I look forward to watching all the projects we've begun come to fruition. My three-year term has gone by quickly. I'll miss the view of Lake Mendota from my director's chair, but am pleased to announce that John Witte will serve as our next director. John is back from a year in Hungary and is serving this year as associate director. Next year he will take the reins of the institute and continue La Follette's teaching, outreach and research work.

The most significant recent development here is the addition of an international public affairs program. To complement our domestic master's degree in public management and policy analysis, the La Follette Institute—beginning in the fall of 2000—will offer a master's degree in international public affairs. This multidisciplinary program will prepare students from the United States and around the world to meet the public policy challenges of our global economy. We are in the midst of hiring faculty from a broad range of disciplines to support this effort.

This issue of the La Follette Policy Report includes another sampling of the kind of research and outreach activities that are centered here but that extend far beyond our house atop Observatory Hill. Professor Karen Holden's lead article in this issue is from a presentation she made at a national gathering of experts on Social Security, in which she argues for regulations that require annuitization and, "in conformity with ERISA, a

default survivor option." These measures would improve the chances that widows would not be worse off if the Social Security system were to be privatized.

Several of our faculty members who study welfare reform include a piece in this issue describing their research on those who have left the welfare system and how they have fared. Several apparent trends were substantiated by their research, including the fact that earnings of immigrants were higher than native-born leavers and earnings of the youngest mothers (age 18-24) were lowest.

My own piece reflecting on the next generation of environmental policymaking has served as a stimulus to industry representatives, public policymakers, and environmental activists. Several policy forums have taken place, and another is scheduled for the spring, in which these stakeholders wrestle to find areas of agreement so that progress toward a cleaner environment can continue.

Donald Nichols, director of the Center for the World Affairs and the Global Economy, publishes another of his economic forecasts in this issue. One of the Federal Reserve Board's most accurate forecasters of economic trends in the Midwest, Nichols suggests a 2 percent growth rate for Wisconsin through the rest of 1999.

We hope you'll enjoy these articles. Feel free to consult our web site for more information about the upcoming international program and for publications resulting from the various outreach activities described in these pages.

likely to lead to a different outcome for widows than does the current program. We estimate these by drawing on results from recent research on pension choices.

### Survivor Benefits: Social Security

The Social Security benefit structure reflects both insurance and income redistribution goals. It accomplishes the former by replacing a percentage of average covered earnings with a defined-benefit pension so that higher average wage earners have larger benefits. Redistribution occurs by using a formula that generates a benefit that is a higher percentage of covered earnings for lower wage workers. Social Security survivor benefits reflect this same mix of insurance and redistributive elements, but are subject to an additional redistributive component—the "dual entitlement" provision that reduces survivor benefits by one dollar for each dollar received from Social Security for any other reason (e.g., because the survivor is eligible for retired-worker or disability benefits).

In effect, the dual entitlement provision shifts survivor benefits from strict insurance against loss of a husband's benefits to an insurance settlement that is capped and may be reduced to zero if the survivor receives other Social Security income. This distinction is illustrated by considering two types of couples. The first couple consists of a single earner who receives a retired-worker benefit and the nonworking spouse who receives 50 percent of that amount. The second couple has two earners who have identical covered-earnings histories and, consequently, each spouse receives an identical retirement benefit. Upon the death of the worker in the first couple, the widow is paid a benefit equal to the deceased worker's benefit, or two-thirds of the combined prewidowhood benefit. The widow of the couple in which spouses worked will receive only her own retirement benefit without additional payments to compensate for the loss of her spouse. This results from a decision in the early years of the program that a guarantee of survivor benefits be provided to women who would otherwise be ineligible for benefits but that when a woman's own Social Security income was assured, survivor benefits were not needed.

Thus Social Security provides an important guarantee of protection to women



who would otherwise be ineligible for retirement benefits, a group that includes not only widows who never worked but also widows with young children. It also promises a benefit supplement to eligible survivors if their own benefits fall short of those for which their deceased spouse would have been eligible.

### Survivor Protection: Employer-Provided Pensions

The 1974 Employee Retirement Income Security Act (ERISA) required that when the primary form of pension plan payout is an annuity, the default payout to married workers must be at least a joint-and-one-half survivor annuity which is actuarially equivalent to the single-life worker pension. An actuarially equivalent pension is one in which total payout for the life of the worker and survivor is equal to the life of the worker alone. Under this provision, a “qualified joint and survivor annuity” must pay a survivor annuity that:

- (1) . . . for the life of the spouse . . . is not less than 50 percent of (and is not greater than 100 percent of) the amount of the annuity which is payable during the joint lives of the participant and the spouse, and
- (2) which is the actuarial equivalent of a single annuity for the life of the participant.

This legislation allowed married workers to choose some other form of payout—a single-life annuity, a lump-sum distribution, or some other option—instead of the default option or to designate an alternative beneficiary without notification to the spouse. Under the 1974 legislation only survivors of those who died either after reaching the earliest age of pension eligibility or were within ten years of the normal retirement age, whichever was earlier, were covered by the default survivor benefit. Survivors of vested workers who died at younger ages were not required to be paid a survivor benefit.

The 1984 Retirement Equity Act (REA) amended ERISA survivorship provisions in two important ways. First, it required the spouse’s notarized signature when the default joint-and-survivor option was rejected or another beneficiary designated. Further, it mandated that the default benefit be paid to survivors of a vested worker, regardless of the worker’s age at death.

However, payment of survivor benefits may be delayed until “the month in which the participant would have attained the earliest retirement age under the plan.” Unlike Social Security, which pegs receipt of benefits to the survivor’s age (e.g., nondisabled women are eligible for benefits at age 60), this provision, based on the age of the deceased husband, would result in variation in eligibility date for survivor benefits. Women married to much older men thus would receive benefits at younger ages.

ERISA’s survivor benefit provisions cover only private plans; public employer-provided plans are not covered by ERISA. Further, the survivor provisions need not be met by “individual account plans” as long as:

. . . such plan provides that the participant’s nonforfeitable accrued benefit (reduced by any security interest held by the plan by reason of a loan outstanding to such participant) is payable in full, on the death of the participant, to the participant’s surviving spouse (or, if there is no surviving spouse or the surviving spouse consents in the manner required under subsection (c) (2) of this section, to a designated beneficiary), [and]. . . such participant does not elect the payment of benefits in the form of a life annuity.

Thus survivorship protection in the United States is composed of four quite distinct regulatory components:

- (1) A Social Security system that pays survivor benefits to eligible survivors (or those with minor children) of retired or active workers but that may reduce those benefits to zero because of a survivor’s labor market earnings or receipt of her own retired-worker benefits from Social Security;
- (2) A private employer pension system mandated to pay survivor benefits as the default form to survivors of retired and active workers, but which must allow beneficiaries to choose a single-life benefit. The system may delay benefits to survivors of younger deceased workers, but it may not reduce survivor benefits because of

other income received by the survivor;

- (3) A public-employer pension system that is not covered by federal survivor benefit mandates and which varies in its offering of default survivor benefits; and
- (4) An individual retirement accounts system (with tax advantages) that can avoid the survivorship provisions by establishing lump-sum distribution as the primary form of payment.

### Widowhood and Income Change

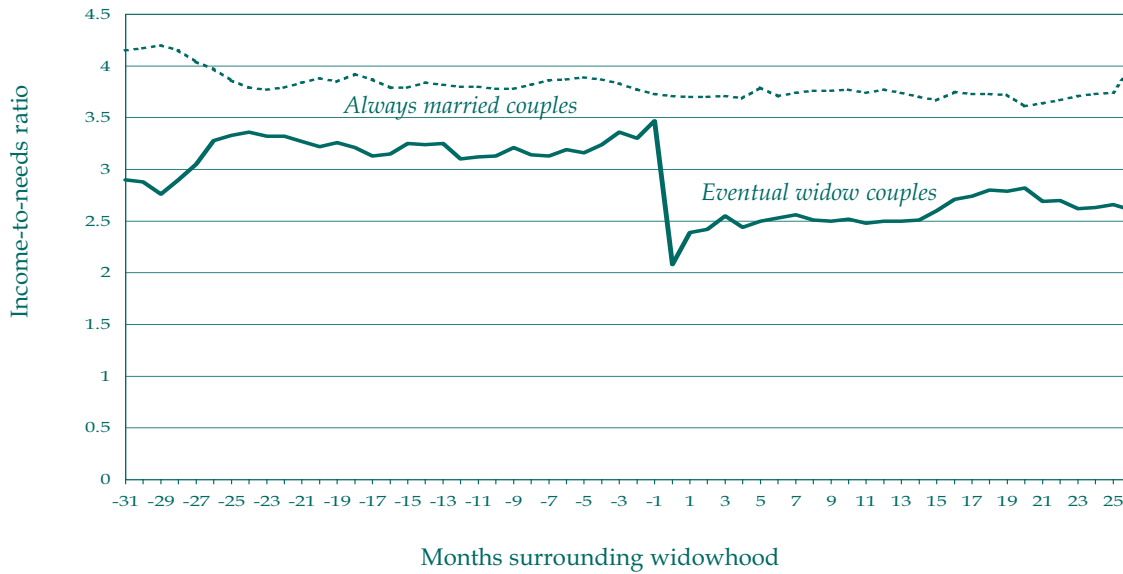
ERISA, passed almost 40 years after the Social Security Act, mandated that private, employer-provided pension plans offer survivor benefits. This legislation was motivated by two persistent findings: (1) women widowed during the 1970s and 1980s were economically vulnerable; and (2) pension receipt was associated with widows’ higher income levels and cushioned the widows’ income decline. Policy-makers expected that requiring pension payout in the form of a joint-and-survivor annuity, unless the worker explicitly rejected it, would increase the share of a couple’s resources going to a woman after her husband’s death. Figure 1 documents the continuation of these income patterns among women who became widows over approximately the 1990-93 period. The figure compares one measure of well being—the income-to-needs ratio—for two groups of women who were interviewed in the 1990, 1991, or 1992 Panels of the Survey of Income and Program Participation (SIPP).

The “eventual widows” (whose data are shown with the lower line) include all women who were age 40 or older and married (husband present) at the first SIPP interview and whose husbands died at some point during the 32-month period. All these women were interviewed at least once as a widow. The economic experience of these women is compared with that of married women 40 and older who remained married throughout SIPP (shown by the top line). The graph shows how the ratio of household income to a consumption needs standard changes over the months of the SIPP survey. The standard of consumption needs used is the U.S. poverty threshold, which varies with



FIGURE 1

### Income Adjusted for Needs: Couples Categorized by Husband's Survival



family size and, consequently, is one indicator of implied changes in household consumption needs as household size changes with the death of a husband.

The monthly data for each eventual widow are centered on the month in which the woman first reported widowhood. Because this may occur at different months during the SIPP interview period, the aggregate data are arrayed over a 64-

month period, even though for any single couple we have a maximum of 32 months of data. A month of "widowhood" is randomly assigned to the latter group of couples, but in such a way that the pattern of death across months is in the aggregate identical for the (weighted) samples.

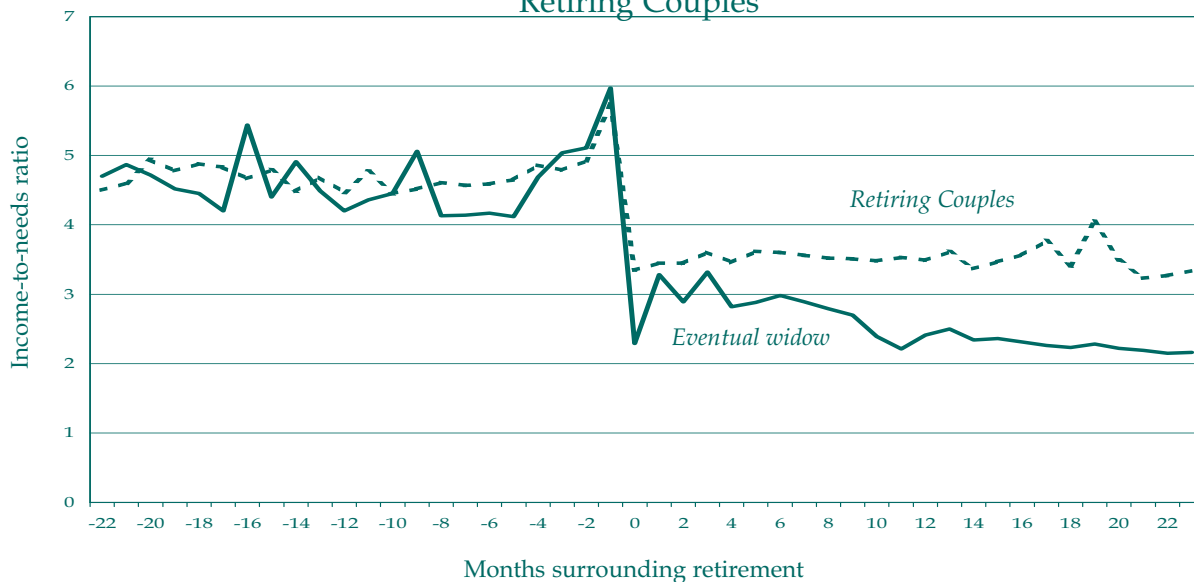
While the continuously married couples are in fact never widowed, an assigned widowhood month allows a comparison

of the experience of these two groups of women over a comparable period of time.

Even prior to widowhood, the income-to-needs ratio of eventual widows is about 15 percent below that of their continuously married counterparts, implying that one component of widows' lower income may be attributed to long-standing prewidowhood differences between the two groups. The eventual widows' average income-to-

FIGURE 2

### Income Adjusted for Needs: Retiring Couples





needs ratio was 3.40 in the two months preceding the death, and that ratio drops and stabilizes at about 2.7, roughly 70 percent of that of the comparison couples.

Average levels, however, obscure important variation among women—specifically, the consequence of differences in prewidowhood retirement probabilities for observed differences in levels and change in income upon widowhood. Eventual widows include two groups. The first is couples in which the husband had already retired prior to death—and whose prewidowhood income reflects the consequences for the couple of his retirement. The second is the group for whom income changes upon widowhood reflect a dual economic hazard—that of the husband’s death and by definition his retirement. The observed lower income of eventual widows prior to widowhood arises in part from the fact that husbands who are about to die are more likely to be out of the work force than are their counterparts. Conversely, the sharp drop observed for some eventual widows comes from the joint effect of the husband’s death and his “forced” retirement.

Figures 2 and 3 contrast these two groups of couples. Figure 2 shows those widows whose husband continued to work during the prewidowhood period, and Figure 3 shows those whose husbands had already retired prior to death. Figure 2 centers the data around the date of

retirement—which is the month in which a husband ceases work for the continuously married couples and is the month of widowhood for couples in which the husband dies. For the eventual widows, prewidowhood income is comparable to that of their married, working peers and, likewise, a large decline occurs upon widowhood, attributable in large part to the (in this case presumably involuntary) retirement of the husband. Nevertheless, widowhood appears to lead to persistently lower income compared with intact, retired couples. Among couples with already retired husbands (whose data are centered around the month of imputed widowhood for both groups), the income-to-needs ratio during the prewidowhood period, when husbands in both groups are not working, is comparable. But for the eventual widows, the husband’s death leads to a reduction in income at permanently lower levels.

The story told by these two figures is that the economic well-being of widows is tied to two insurance components: (1) insurance provided to workers to guard against sharp falls in income and (2) the inheritance by widows of that insurance. The income impact of widowhood is a consequence of both the rate at which pre-retirement income is replaced when both spouses are alive and the rules of inheritance by survivors of the retirement benefits of their deceased spouses.

### Changes in Social Security and Pension Income

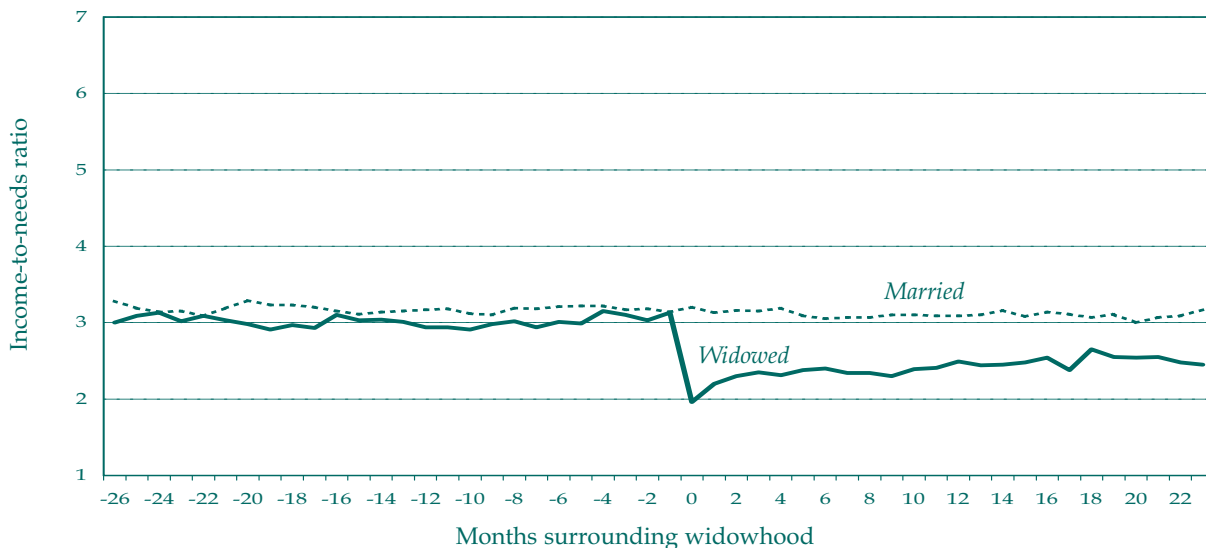
From the eventual widows sample in SIPP we can estimate how Social Security and pension income changes upon widowhood. For this group we do not know the Social Security or pension benefits for which individuals were eligible if they were not yet receiving them. The estimates are based on couples who reported prewidowhood retirement income, who are drawn primarily from the group that was already retired.

Among couples in which the husband was a Social Security beneficiary before his death and the wife received benefits as a widow, Social Security income fell by about 40 percent. The best estimate of the percentage of a husband’s pension that the widow gets comes from couples in which the husband reported prewidowhood pension income and the wife did not, but in which pension income was reported by the widow. For these couples, postwidowhood pension income was 71 percent of the husband’s prewidowhood pension income—implying a selection by husbands on average of a two-third’s survivor benefit. However, only 59 percent of the widows of pensioners received any postwidowhood pension income. Couples in which the husband appeared to reject a survivor pension were worse off in the

*continued on page 10*

**FIGURE 3**

### Income Adjusted for Needs:





# Economic Outlook for Late 1999: U.S. Prospers Amid Worldwide Recession

by Donald A. Nichols

*Professor Nichols is director of the La Follette Institute's Center for Research on the Wisconsin Economy and of the International Institute's Center for World Affairs and Global Economy. He is a frequent adviser to business and banking groups, including the Federal Reserve Board of Chicago.*

The U.S. economy continues to perform strongly despite the drag of a worldwide recession. As recession continues to be the forecast for the major economies of the rest of the world in 1999, we might normally expect that the recession would engulf the United States as well. But the recessionary forces coming from the international economy were also present in 1998 and they were not strong enough to drag our economy down then. Because these forces are likely to be no stronger in 1999 than they were in 1998, I expect real growth in the United States to continue. Specifically, I expect growth here to continue at a rate of  $2\frac{1}{4}$  to  $2\frac{3}{4}$  percent net of inflation during 1999.

A year ago the question was whether the U.S. economy could thrive in a world of recession. The outcome of the confrontation was that U.S. exuberance won. And while a similar tug of war will take place in 1999, the forces at work are likely to be no more violent in 1999 than they were in 1998. Hence the most likely prospect for 1999 is the same as in 1998, which is that growth is likely to continue.

## Do We Need a New Model to Understand the New Economy?

The economy's recent performance has been unusually strong based on historical standards. Most forecasters, myself included, have underestimated its strength repeatedly. Not only have we prospered in the middle of a worldwide recession, but also there has been little evidence of inflation despite a reduction in the unemployment rate to levels that led to inflation in the past.

Increasingly, analysts are appearing who claim that the economy has changed in basic ways and to such an extent that the old methods of analysis no longer apply. The claim is that technology has moved so quickly creating new industries that are based on information and not on physical materials that our old ways of

measuring and thinking about the economy, which are based on a factory system, are no longer appropriate. I disagree with this position.

In my view, the forces responsible for the unusual performance of the economy today are only in part the result of a burst in new technology, and they do not require a new paradigm for us to analyze them. In my view, two forces are responsible for the economy's unusual performance in recent years, and while both are new, they can best be analyzed using the old methods. One is the increasing interdependence of economies around the world—we can call this globalization—and the other is the maturation of the

**Two forces are responsible for the economy's unusual performance in recent years: the increasing interdependence of world economies and the maturation of the baby boom.**

baby boom and its preparation for retirement. Both of these forces have helped to drive stock prices up and interest rates down, making it easy for firms and households to invest in real capital. Hence a major feature of the boom has been a high rate of investment in productive capital (see Figure 1) by firms and a high rate of investment in housing by individuals.

Two paradoxes need to be explained in order to understand today's economy: (1) Why, if the world's economies are becoming increasingly interdependent, has the United States become insulated from the

worldwide recession? and (2) Why, if the baby boomers are getting ready to retire—and hence are presumably saving at high rates—has the overall saving rate fallen to record lows? In my view these are the questions that must be answered if we are to understand the economy's recent performance. I do not see how either of these paradoxes can be resolved by turning to explanations that are based on the criticism that new technologies have emerged and that their importance has been underestimated. A closer look at what happened in 1998 will help us to understand these paradoxes.

## 1998 in Perspective

The economy's performance in 1998 was quite unusual from several perspectives. Two features stand out:

- Real growth remained strong in 1998 despite a huge drag from a large and growing trade deficit.
- Inflation remained low despite a continued tightening of labor markets.

Those forecasters like myself, who accurately foresaw the worsening of the trade deficit, mistakenly thought that its drag would cause a substantial slowdown in the overall economy and might even touch off a recession. Indeed, the trade deficit increased by more than \$100 billion in 1998. That is roughly  $1\frac{1}{4}$  percent of GDP. Normally, a reduction of that magnitude in an economy that grows on average by about 2 to  $2\frac{1}{2}$  percent would slow the overall rate of growth to below 1 percent and might even kick off a recession.

Enter Paradox Number 2. The unusually large reduction in the trade balance was offset by a huge decline in the household saving rate (See Figure 2). Household saving fell to zero in 1998. (Saving was redefined by the U.S. Department of Commerce. On the old basis, the decline was to a rate of about  $1\frac{1}{2}$  percent.) Consumers simply picked up all the slack that was



left by the lost export sales (see Figure 3). Overall, the two forces were a wash, though the switch from exporting to consuming caused a large swing in production away from manufacturing and toward services.

The second unusual feature of the economy's performance in 1998 was the absence of inflation despite tight labor markets. In my view this feature does not signal anything new about inflation though it points up the importance of the forces responsible for Paradox Number 1. Weakness in the world economy led to a decline in the prices of raw materials in 1998. Because of the increasing interdependence of the world's economies, the prices of raw materials used in the United States, whether produced at home or abroad, are set in worldwide markets. In 1998, raw materials prices fell by more than 15 percent at home.

Wages, on the other hand, did accelerate modestly in 1998. Modest acceleration is what history tells us to expect when the unemployment rate falls into the 4-5 percent range. While wage increases below 3 percent were the norm a few years back, wage increases of 4 percent are the norm today. Hence tight labor markets in the United States have led to a modest increase in wage inflation here, just as history suggested would be the case. Because the prices of products sold in the United States depend in part on the price of labor at home – which was getting more expensive – and in part on the prices of raw materials worldwide – which were getting cheaper – prices of finished goods in the United States did not change in 1998. And as a further restraint on inflation, Persian Gulf politics and bountiful harvests worldwide contributed to a decline in oil and food prices.

Note that what was new in 1998 that helps to explain the absence of inflation was not some new badly measured technology, but simply a globalized economy. If we accept the facts that the world's economies are more closely integrated than before, and if we recognize that in 1998 the United States prospered in a sea of recession, it is simply a matter of arithmetic to show that on average U.S. production costs did not rise last year.

### The Oasis of Prosperity Paradox

My last two reports developed in some

detail an explanation of why the U.S. economy is thriving amidst world recession. Alan Greenspan has repeatedly questioned how long we can remain an "Oasis of Prosperity" in a desert of recession. While I will summarize here my previous analyses, fuller explanations of

some features of the Oasis Paradox are found in my previous reports.

Briefly, the end of the cold war has led to a reassessment of the outlooks for the world's major economies. The prospects for the United States have been upgraded substantially by investors and consumers

FIGURE 1

### Private Investment

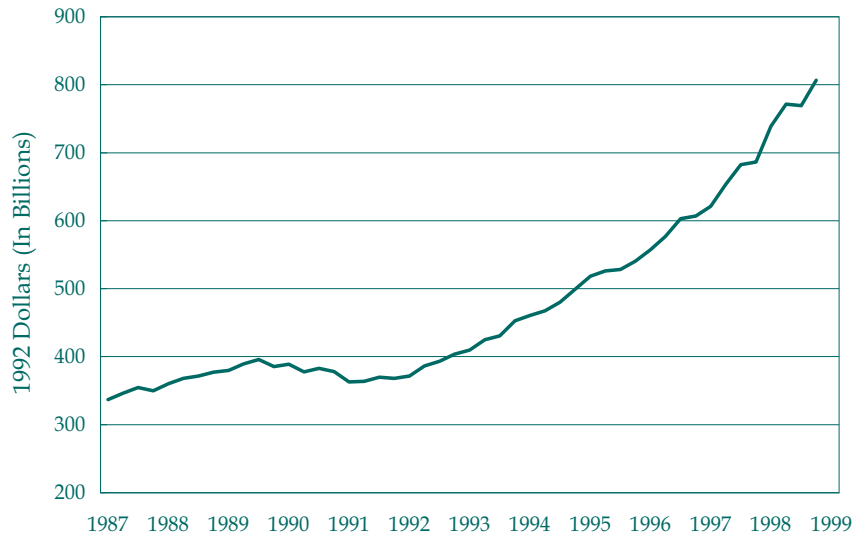
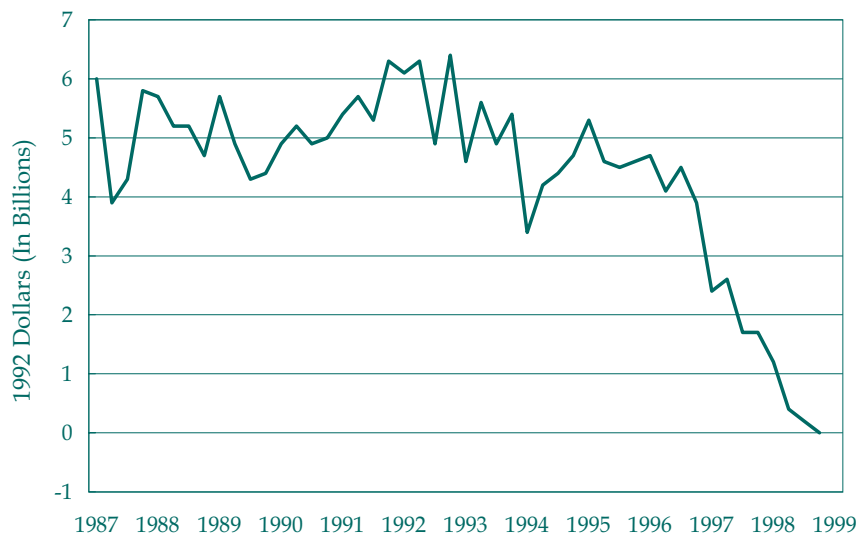


FIGURE 2

### Personal Savings Percent of Disposable Income





worldwide while the prospects for other nations – China excepted – have fallen in relative terms. In particular, they have fallen for Japan, which has been mired in a decade-long slump.

The surge in confidence in the future of the American economy has led to a large

inflow of capital, which has caused the dollar to surge and fed the frenzy in U.S. equity prices. Real investment in the United States by foreign investors has also surged. Because of the worldwide recession, and because of the increasing value of the dollar, the Federal Reserve has not

seen fit to raise interest rates as it normally would in response to the surging U.S. economy. Investment funds remain available at reasonable rates, confidence is high, and high-tech resources are being freed up from military uses.

The resulting boom provides confidence that is self-fulfilling. Meanwhile, collapsing confidence abroad has led foreign consumers to pull in their horns, and the resulting stagnation has also become a self-fulfilling expectation that is now hard to break.

### The Saving Paradox

While I think I have a pretty good grip on the Oasis Paradox, I am a bit more tentative about my explanation of the Saving Paradox. It is quite clear, however, that what is keeping our economy strong at this time is the spending of households. Household spending in turn is being supported by the surge of confidence mentioned above. Consumer confidence in the United States is at a level unseen in forty years. This surge of confidence has helped to drive stock prices to new highs. It has supported a surge of home building (see Figure 4), and it has led to a surge of purchases of consumer durables. The high stock prices have helped to provide a source of finance to households, enabling them to spend freely without interfering with their ability to finance future goals.

The dis-saving of retirees provides the key to understanding the Saving Paradox. Retirees typically dis-save. Indeed, the purpose of their saving while young was so they could dis-save when retired. It is likely that many current retirees are much better off than they had expected to be, and that they are able to spend at a far higher rate than they had anticipated a decade ago. Meanwhile, the younger generation may well be saving at the same rates as previous generations had, but their saving is being offset by the dis-saving of an older generation that has become the lucky generation in the sense of seeing its retirement savings soar in value.

Classroom models show how young individuals can save by buying assets from older generations, even though the society as a whole does no net saving. For example, if each generation of young workers saves for retirement by buying land from retirees, and if each generation of retired workers finances its retirement

FIGURE 3

### Net Exports of Goods and Services

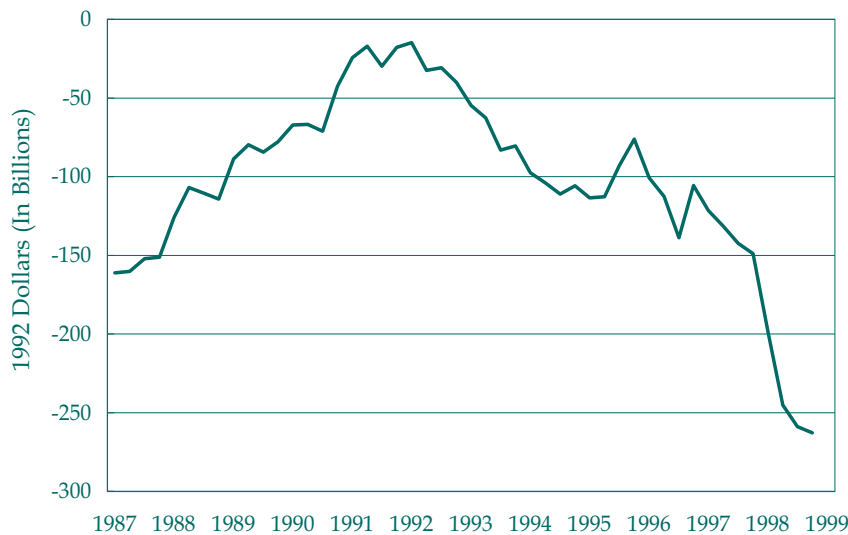
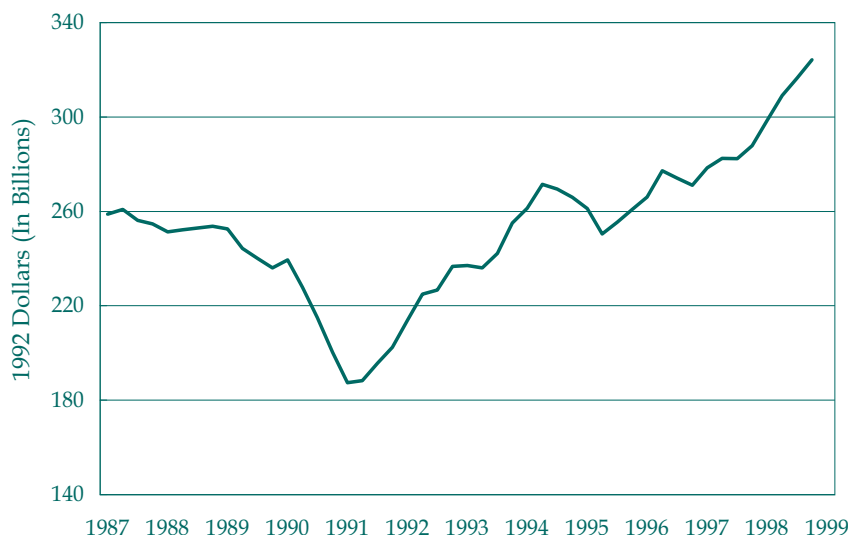


FIGURE 4

### Private Investment in Residential Structures





by selling land to young workers, a system of personal saving can be established in which there is no net aggregate saving even though each individual has saved. Hence an aggregate saving rate of zero does not necessarily indicate that anyone is behaving in an irresponsible way.

The monkey wrench in these classroom systems appears when an extra large generation, like the baby boom, must work its way through the system. This large generation drives prices up when they save and down when they sell. Naturally, their extra saving does not create more land, even in the classroom model, but it does raise the price of existing land.

Something like this is going on now as young workers buy stock from retirees. Perhaps the generations who are saving are putting aside even more today than previous generations did, but their increased saving is simply being offset by increased dis-saving by retirees. Because the young savers want to put larger sums aside than previous generations did, the older generation finds that their stocks have appreciated greatly in value and that they can sell at very high prices. The higher the price at which the older generation sells, the higher its dis-saving.

Whether the household sector as a whole provides net saving depends on both the saving of the baby boom and on the dis-saving of the retired generation (and its heirs.) Net new saving can occur only if new assets are introduced into the financial system that represent new investment. In the United States in 1998, no new shares were issued because mergers and buyouts took shares off the market. (Of course, existing shares increased in real value through retained earnings.) Furthermore, there was a substantial inflow of capital from abroad seeking U.S. investments though there were no new shares to be had. Some of the sales of the retired generation were to foreign investors. In the classroom model, the dis-saving of retirees would exceed the saving of the working generations if there were no new shares to buy and if on net some of the sales of existing shares were made to investors abroad.

The bottom line to this saving and investment equilibrium is that the saving rate in the United States has been driven to zero by soaring stock prices. It is possible for the saving rate to stay at that level

or even to fall further for at least the next few years. Because we are in uncharted territory, however, there is no guarantee that the system won't come unwound by a collapse of stock prices. But the sensible forecast for 1999 is that the collapse won't come in that year. Indeed, there is less reason to expect a collapse in 1999 than there was to expect a collapse in 1998.

### **Can 1999 Repeat 1998's Performance?**

While the trade deficit may worsen in 1999, it is unlikely to worsen by another \$100 billion. Hence the drag from abroad will increase by less in 1999 than it did in 1998.

Saving rates, on the other hand, which have already fallen to lows not seen since the Great Depression, can continue their decline, though there is little basis for any confidence in this prediction. If the decline in saving rates continues, the boom could continue. A conservative forecast, again with little basis, is that the saving rate will stop falling. Hence the outlook for 1999 is that these factors may remain at the

## **Basic materials, such as paper, have been hit very hard by the worldwide recession.**

unusual levels they reached in 1998, but that there is no need to expect them to move by as much in 1999 as they did in 1998.

While there is little basis on which to predict an extension of these unusual factors into 1999, the most likely outcome appears to be continued growth, albeit with a modest acceleration of inflation.

### **Wisconsin**

Wisconsin is a manufacturing state. The major difference between the composition of its employment by industry and that of the nation as a whole is its concentration of employment in durable goods manufacturing and especially in machinery and instruments. For this reason, I predict 2 percent growth in Wisconsin, as opposed to 2½ percent for the country as a whole.

In 1998, Wisconsin's manufacturing employment fared a bit better than average in terms of growth, though the whole

sector slowed down substantially, as anticipated. Where Wisconsin performed more poorly than the rest of the nation in 1998 was in the growth of employment in service industries. Services have never been a strong point for Wisconsin. The switch away from exports and toward consumption is a really a tilt toward services and away from manufacturing. Furthermore, Wisconsin's exports have been concentrated in the capital goods sector, and this sector suffered the most in the decline in exports on a nationwide basis.

Instruments have fared better. High tech medical instruments, for example, continue to be bought by the Japanese medical sector, which is an industry that is partly financed by government. But private sector purchases of capital goods in Japan have fallen sharply.

Basic materials, such as paper, have been hit very hard by the worldwide recession. Paper also suffers from over capacity, a problem that might have existed even without a recession. Farm equipment manufacturers have been hurt by the low prices of grain worldwide. These have hurt American farmers and restricted their demand for new equipment.

The forces that became evident in 1998 are expected to continue in 1999, though on a somewhat reduced basis. That is, the tilt away from manufacturing and toward services—and away from exports and toward consumption—will continue. Furthermore, I expect increased spending by retirees. This bodes well for Florida and Arizona, but not for Wisconsin.

Wisconsin is benefiting more than most states from the decline in oil prices because we import all of our energy. In 1998 Wisconsin benefited from the high level of dairy prices, but these prices have fallen substantially in 1999, indicating that rural areas will not be as buoyant in the future as they have been in the recent past.

Construction was extremely strong in Wisconsin in 1998, and I expect this industry to continue to be strong in 1999. The industry heads into 1999 with a full head of steam and with strong fundamentals.

Consumer confidence is high, the stock market is high, interest rates are low, and the prospects for continued growth in income is good. While further growth from existing high levels may not occur, it is likely that the existing high level of activity can be sustained. ■



Holden and Zick continued from page 5

prewidowhood period than those who appeared to select a survivor pension (income-to-needs ratio of 3.18 versus 3.93), and the average decline in the income-to-needs ratio upon widowhood was larger (to 67% versus 78% of their prewidowhood period).

Thus while 61 percent of the husbands in the sample of those who eventually died received a pension prior to death, only half that many of their wives report a pension as a widow. It remains the case that some women are better protected against the economic consequences of this dual hazard of widowhood than are others. Women who lost pension income experienced the larger fall in income; it does not appear that other insurance options compensated for the loss of husbands' pensions.

### **The Choice of Survivor Benefits in Private Pension Plans**

The widow's decline in income raises the question of whether in a privatized Social Security system married men would voluntarily extend the retirement protection provided to them as retirees to their widows through the selection of a joint-and-survivor benefit. In a defined contribution plan, the selection of an annuity that continues to pay a widow will reduce the monthly benefit paid during the retiree's lifetime (in contrast to the current Social Security system which exacts no reduction for the protection provided to spouses and survivors). Even if workers' own retirement benefits were higher under a privatized Social Security system, some married workers could be expected to choose a single-life annuity, leaving their widows with reduced protection compared with their status under the current Social Security system. Wives with less favorable work careers could be worse off than under the current system if husbands underestimated the risk and income consequences of widowhood.

In a study published by the UW-Madison's Institute for Research on Poverty in 1998, Holden and Sean Nicholson examined who selects an annuity form that would continue pension payments to the widow. Using data from the New Beneficiary Survey (NBS), a panel study that interviewed respondents first in 1982 and

again in 1991, they examined the factors that influence married men's choice of a survivor pension and the effect of ERISA's mandate that this be the default option. Their major conclusions were as follows:

- Married men's choice of a survivor pension is shaped by rational economic factors. That is, husbands whose wives are in greater need of survivor protection (as measured by wives' own probable post-widowhood Social Security benefits and pensions) and husbands more able to afford purchasing this coverage (as measured by their own relatively high wealth) are more likely to choose this option.

## **Survivor protection could be achieved through federal law that would define retirement benefits as marital property.**

- Even after controlling for economic factors that shaped husbands' decisions, the ERISA mandate of a default survivor benefit substantially raised the probability of married men choosing a survivor benefit. This suggests that regulations governing the offer and selection of a survivor benefit are necessary to insure widows' receipt of survivor benefits from a privatized Social Security system.

In the 1982 NBS interview, married pension recipients were asked whether, if they died today, their pension would continue to their spouse. In addition, pensioners were asked the year when their pension was first paid, which makes it possible to determine whether their pensions began prior to or after 1974, the effective date of ERISA. Among the married male pensioners, 62 percent indicated they had elected a pension that would continue to their widow. While only 48 percent of the married men whose pension benefits began prior to 1974 selected a survivor option, this was the case for 64 percent of the married men whose pension began in

1974 or later. This is comparable to the 59 percent of widows in our SIPP sample of women who were widowed in the early 1990s whose husband's pension continued after his death.

The factors that shaped the pension option choice for these married men is described more fully in Holden's and Nicholson's study. There the most relevant findings for Social Security reform are described. As hypothesized, wealthier husbands, as measured by their total wealth including the wealth value of their single-life pension benefit and their own retired-worker Social Security benefits, are more likely to forgo consumption during their own lifetime in return for protecting their wives against the income consequences of widowhood. In addition, the greater the portion of his wealth taken up by his pension (an indicator of how important his pension is in any bequest to the widow) the more likely he is to choose a survivor pension. The greater the need of the widow for additional income from her husband's pension—because she has less wealth of her own (measured by the value of her own pension, Social Security benefits, and other assets held in her name)—the more likely the husband is to choose a survivor benefit.

Demographic and health effects suggest that husbands consider the relative actuarial value to them of the survivor pension reduction. The husband's own poor health, an indicator of his likely earlier-than-average death, increases his chances of choosing a survivor benefit. The older the husband is than the wife, the less likely he is to choose a joint-and-survivor pension, probably a result of the much larger reduction in the single-life pension for such couples. Finally, men making their pension decision after 1973 are more likely to choose a joint-and-survivor pension; for a representative couple in which the wife has no pension of her own, the estimated probability is 27 percentage points higher than for a similar couple making their pension decision prior to 1974.

### **Conclusions and Policy Implications**

Studies of widowhood have found that Social Security survivor benefits are important to the economic well-being of widows, as are benefits from private pension plans. In addition, by disaggregating the decline in income upon widowhood



into two components, we can see the importance for widows of inheriting some share of the husbands' Social Security and pension benefits. The decline in widows' income when husbands were working prior to death is only somewhat larger than the income decline for married couples when the men retire. This decline for men is shaped by Social Security retirement benefits and employer-provided pensions. The absence of inheritance rights to husbands' retirement income could lead to even more severe income declines upon widowhood.

Social Security survivor benefits guarantee widows (including divorced survivors) a Social Security benefit at least equal to the retired-worker benefit for which their husband would have been eligible. For single-earner couples the survivor benefit offer is equivalent to a joint-and-two-thirds annuity. The dual entitlement provision will reduce that percentage for dual earner couples. We find Social Security benefits declined by almost 40 percent from the pre- to postwidowhood period among women widowed during the early part of the 1990s. This percentage is likely to increase as two-earner couples become more prevalent and the dual entitlement provision leaves fewer women in receipt of a supplemental widow's benefit. The diminishing value of Social Security survivor benefits to working women is one point of debate over the structure of the current system. It may be that a system akin to private pensions, which allows dual earner couples to choose a survivor benefit, would make some widows better off. The paper has argued for the importance in a privatized Social Security system of regulations that would diminish the chances of widows being left without any survivor pension.

ERISA mandated that private pensions offer a survivor benefit option which can be declined only with the spouse's approval. Our estimates based on SIPP and NBS data indicate that about 40 percent of married couples did reject the offer. To some degree husbands' pension-option choice is akin to the Social Security system's dual entitlement provision—that is, husbands are less likely to bequeath a share of the pension to their wife when she has income and wealth from other sources.

The difference between the Social Security

system and the ERISA-governed private pension system lies in the ability of workers in a privatized system to choose against a survivorship option even when the widow would have no other pension income. In contrast, the Social Security system assures a post-widowhood benefit at least equal to that of a husband's retirement benefit. The question faced by regulators of a private system is what degree of autonomy they should allow workers in making that choice. While a privatized Social Security system could make some women better off by allowing them to receive both their own and their deceased husband's retirement benefits, non-working wives or those with their own (but small) pensions may be left worse off if the couple has chosen to reject the survivor benefit option. The analysis of men's pension-option choice also suggested that ERISA regulation itself increased the chances that men would select a benefit that would continue to be paid to their widow. Mandates on pension plans to provide the survivor option and to have that be the default form of payout affected the decisions of husbands even when their right to choose against a survivor option was preserved.

What does this mean for Social Security reform? If we move toward a system with greater individual choice, the question arises of what regulations to establish, if any, governing the form in which the accumulations may be distributed. The results reported in this paper suggest that for women, regulations that require annuitization and, in conformity with ERISA, a default survivor option, are important to continuing the survivor protection offered through Social Security.

Our analysis suggests that some regulation of payouts from individualized accounts could increase the protection to survivors provided by these accounts. Mandated annuitization, as proposed in the Individual Account plan, and a default survivor payout form would increase the chances that widows would not be worse off under a privatized Social Security system. Alternatively, survivor protection could be achieved through federal law that defines retirement benefits as marital property. Such a system, which would equally divide a couple's accumulated Social Security accounts, would in effect recognize the couple's shared rights to the

account contributions and earnings during marriage. Divorcing couples would divide these assets—thus retaining for divorced spouses protection that would otherwise be lost—as would long-time married couples when one person retires early. This would, in effect, provide protection to surviving spouses granting a share of all Individual Accounts accumulated through a reformed Social Security program. This would also encode in a major social program an increasingly accepted principle that marriage is a joint economic partnership that ceases upon divorce but continues after the death of one partner and includes shared rights to all property and benefits accumulated during marriage. ■

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## The Market Approach to American Education: An Analysis of America's First Voucher Program

by John Witte

Anchored with chapters on the theory and the history of public education, Witte's new book provides the first thorough analysis of Milwaukee's controversial Parental Choice Program.

He discusses the politics of market-based approaches to education, including a description of the political developments at the national level, in a number of states, and in Milwaukee and Cleveland.

He explains who participates in educational choice programs, how the Milwaukee program worked (and didn't work), and what some of its results were. Special attention is given to the role of the courts and the intense media scrutiny that voucher programs engender.

In the end, Witte defends targeted voucher experiments, but argues vehemently against expanding them to include all families, fearing that such a move will weaken and erode the public school system and will benefit middle- and upper-middle-class children disproportionately.



# Welfare Reform In Wisconsin: Who is Staying and Who is Leaving

by Maria Cancian, Robert Haveman, Thomas Kaplan, and Barbara Wolfe, with the assistance of Sandra Barone and Dan Ross

*This summary of a longer paper was prepared by Jan Blakeslee of the Institute for Research on Poverty at the University of Wisconsin-Madison. It represents the third and final report on this subject to the Assistant Secretary of Planning and Evaluation (ASPE) of the U.S. Department of Health and Human Services. Data were provided by the state of Wisconsin under an agreement between the Department of Workforce Development (DWD) and the Institute for Research on Poverty. The cooperation and assistance of DWD is gratefully acknowledged. All of the authors are faculty of the La Follette Institute and are affiliated with the Institute for Research on Poverty. A complete report is available online at <<<http://www.ssc.wisc.edu/irp/srlist.htm>>>*

Current welfare reform efforts seek to move families from welfare to work. This raises questions both about the characteristics and well-being of those who have left welfare and the characteristics and future prospects of those who remain. While it is too early for the most recent reforms to be evaluated, the experience of Wisconsin detailed here may be illustrative, since by 1996 major state-wide, work-based welfare reform was being implemented. With this in mind, we examined the experience of women who left welfare under these early reforms.

From July 1995 to July 1996, single-parent AFDC caseloads in Wisconsin declined sharply, by 23 percent (from 65,017 to 50,166 cases). Our reports explore the characteristics of those mother-headed families who left AFDC after July 1995 (“leavers”), compared with those who remained (“stayers”), and examines how they fared during the 15 months after they left the Wisconsin AFDC program.

Specifically, we ask:

- What proportion of leavers returned to AFDC, and what characteristics are most closely associated with that return?
- Did AFDC leavers and their families have incomes greater than (1) the maximum benefits they would have received under AFDC or (2) their incomes immediately before leaving AFDC?
- Did leavers and their families escape poverty after leaving AFDC?
- How much did leavers use other public assistance programs, and

what household characteristics most affected the likelihood that they would do so?

- To what extent did leavers work and earn after they left AFDC, and how did these trends compare with the work and earning patterns of the stayers?
- Did the earnings of the leavers grow over time and, if so, to what extent?
- What family and economic characteristics among leavers were most closely related to the probability of working at all, and of obtaining relatively high earnings?
- What kinds of jobs did leavers find, and which jobs seemed to offer the highest wages?

## The Data

Defining “leavers” as those who received no AFDC benefits for two consecutive months in the next year (between August 1995 and July 1996), we identified 26,047 leavers and 28,471 stayers. We tracked leavers for a period of 15 months from the date they left and stayers from August 1995 to December 1997.

These data allow us to study a substantial number of economic and social outcomes for both leavers and stayers. However, they reflect only public assistance and covered earnings received in Wisconsin. We have no measures for individuals who moved out of state, no measures of earnings for those who remained in the state but were self-employed or in other noncovered employment, and no measures of a spouse or partner’s earnings or other income. Furthermore, because we

cannot accurately trace individuals who leave the state for all or part of the period, we cannot distinguish those who receive benefits outside Wisconsin from those who receive no benefits.

An important caveat is that working requires most individuals to incur additional costs, in particular for child care, Social Security taxes, transportation, meals eaten outside the home, and appropriate work attire. These costs are not included in any measure in our data, nor is potential income from the Earned Income Tax Credit, which is designed to defray some of these costs.

## Who left AFDC?

One of the largest differences between leavers and stayers is geographical. Families in Milwaukee were less likely to leave AFDC (36.6 percent) than those in other urban counties (57.9 percent) and in rural counties (66.8 percent).

Families that leave AFDC tend to be those with access to alternative means of support; thus we would expect leavers to include those with the best work and marriage prospects (See Table 1). Women were more likely to leave AFDC if they had the following characteristics:

- were white, or to a lesser extent, Hispanic, and were U.S. citizens;
- had higher levels of education;
- had fewer children, and there were other adults in the household;
- neither the mother nor any child was receiving SSI;
- the mother had more work experience and higher total earnings in the two years (July 1993–June 1995) prior to the July 1995 date when our sample was drawn.

Mothers who had been “sanctioned” for some failure to comply with the AFDC program were also more likely to leave. The longer the current spell of AFDC receipt, the less likely a mother was to leave: 70 percent of those who had been on the rolls less than six months, but only one-third of those who had been on the rolls over two years, left AFDC during the year of study.

## Who returned to AFDC?

Almost half (47.8 percent) of those receiving AFDC in 1995 left the rolls for at least



TABLE 1

**Who Leaves AFDC and Who Doesn't**

Selected Characteristics of Mothers Leaving AFDC	Percent Leaving AFDC
On SSI	22.6
Legal Immigrant	32.7
Sanctioned by AFDC	51.5
Age of Youngest Child	
3-5 Years	48.2
12-18 Years	52.5
Number of Children	
1 child	55.2
3 or more children	39.3
Education of Mother	
11 Years or Less	38.9
12 Years or More	58.8
Age of Mother	
18-24 Years	47.5
40 or more Years	43.2
All	47.8

two consecutive months during the next year. About 70 percent of this group did not return to the program during the 15 months following their exit; 30 percent did so, two-thirds of them within the first four months after they had left.

Overall, the characteristics associated with not returning to AFDC are the same as those associated with leaving it. There are, however, a few exceptions:

- Legal immigrants and mothers receiving SSI were less likely to leave AFDC, but those who left were no more likely than others to return within 15 months.
- Sanctioned mothers, more likely to leave AFDC, were also more likely to return.
- Whereas women with more earnings and work experience were more likely to leave AFDC, they were also more likely to return. This is a puzzling finding.

**The Economic Well-being of Leavers**

This is perhaps the most important issue regarding the Wisconsin reforms. To explore it, we asked and discovered answers to the following questions, each of which reflects some concept of “success”:

*To what extent did leavers and their families have cash incomes that exceeded the*

*maximum benefit they would have received under AFDC?* In answering this question, we paid particular attention to family size. About one-half of all leavers had cash incomes greater than their likely maximum AFDC benefit. Larger families did less well than families with one child: among families with three or more children, about 45 percent had cash incomes greater than the likely maximum benefit.

*Did leavers and their families have incomes that exceeded the income they received just before they left AFDC?* The measured earnings of the average leaver exceeded her earnings while on welfare, but overall income fell. In essence, welfare benefits fell for these people by more than their earnings increased. Among continuous leavers and those with fewer children, only about one-half had incomes above those they had received immediately before they left welfare. If we add in food stamps, about 35 percent of all leavers increased their economic resources; the rest did not.

*To what extent did leavers and their families escape poverty after they left welfare? How did incomes of stayers compare?* All leavers were about twice as likely as stayers to have measured incomes above the poverty level. About 37 percent of those who left AFDC and did not return escaped poverty. Again, family size matters: only about 11.6 percent of all leavers with three or more children had incomes above the poverty line (See Figure 1).

*Did leavers and members of their families remain dependent on welfare programs? What factors are most associated with continued use?* Use of public assistance is one measure of the degree of self-sufficiency achieved by former welfare recipients, and such use steadily declined among all groups of leavers. Fifteen months after they left AFDC, about 30 percent of all leavers and 40 percent of the continuous leavers were receiving no public assistance—not food stamps, nor Medicaid, nor AFDC. The majority of leavers, however, continued to use some form of public assistance, mainly Medicaid. In general, we found that AFDC leavers who had greater human capital and fewer and older children, and who lived in an area where unemployment was lower, were more likely to be independent of other public assistance programs.

*Overall, how did leavers fare compared to stayers?* Many leavers appear to have attained higher levels of living and economic independence than stayers. They were more likely to have incomes greater than the maximum AFDC grant and especially to have incomes that lifted their families above the poverty line. Others were in a more difficult situation—for instance, those with three or more children.

**The Labor Market Experiences of the Leavers**

How have those who left welfare in Wisconsin fared in the labor market? To answer this we asked another set of questions:

*Did leavers work after they left welfare?*

About two-thirds of leavers worked at some time in each quarter during the 15 months after leaving the rolls. Continuous leavers worked 75 percent of the time and those leavers who returned to the rolls worked about 85 percent as much as the continuous leavers.

*How much did leavers earn after they left welfare, and how did this compare to the earnings of those who remained on welfare?* For all leavers, median annual earnings were about \$7,800. Median earnings for continuous leavers were about \$2,400 per quarter worked. Median earnings for leavers who returned to the AFDC rolls were substantially less, about \$1,750 per quarter. Median earnings for stayers with earnings were about \$1,200–\$1,400 per quarter worked.

*Did the earnings of leavers increase over time?* For all leavers, median earnings among workers increased with the length of time off welfare. For those who worked, quarterly earnings increased from less than \$2,400 to more than \$2,600 over this period, an annual growth rate of about 10.4 percent.

*What family and economic factors seem to influence working?* Significantly more likely to have earnings were women whose youngest child was older than 12 years and women who had earnings in the two years before they left welfare. Significantly less likely to have earnings were women on SSI, women who had been sanctioned, minority women, women living in a county with a high unemployment-



ment rate, and women who had shorter or fewer welfare spells.

**What family and economic factors seem related to higher earnings?** Factors closely associated with work effort also affect earnings among leavers. Women who had greater human capital (i.e., more education and prior work experience) and who were living in a county with a low unemployment rate tended to have higher earnings. Among workers, legal immigrants and women with more children had higher earnings—although having very young children reduced earnings. Women who had been sanctioned or had a family member on SSI had lower earnings.

**What kinds of occupations did leavers enter, and how stable were they?** In the first quarter after leaving AFDC, about one-third of leavers with earnings found employment in occupational classifications with median earnings ranging around \$3,000 per quarter: Financial, Insurance, and Real Estate; Manufacturing; Health Services; and Transportation and Communications. Another 40 percent of leavers found jobs in classifications where median earnings were only about \$1,600 per quarter: Hotels and Lodging; Agriculture, Forestry, and Mining; and Temporary Agencies. Not surprisingly,

women were least likely to leave the highest-paying occupational classifications and most likely to leave the lowest-paying. Over time, there is some evidence of movement from lower- to higher-paying occupations.

### Conclusions

Most states have recently experienced substantial welfare caseload declines. The implications of these declines depend to a large degree on the ability of families who have left welfare to remain independent and move to self-sustaining employment. This analysis provides an initial indication of the economic well-being of individuals who left AFDC during the time of early work-based reforms in Wisconsin.

Compared with those who stayed on AFDC, those who left—and especially those who did not return—were better educated, had fewer children, and in particular were more likely to have had earnings during the preceding two years.

Even the one-third of all leavers who returned to AFDC worked a substantial amount after their return. For all leavers who worked, median earnings in the year after they left AFDC were about \$7,800. Median earnings for leavers who did not return to AFDC were \$9,100. Earnings for those who worked grew at a rate of about

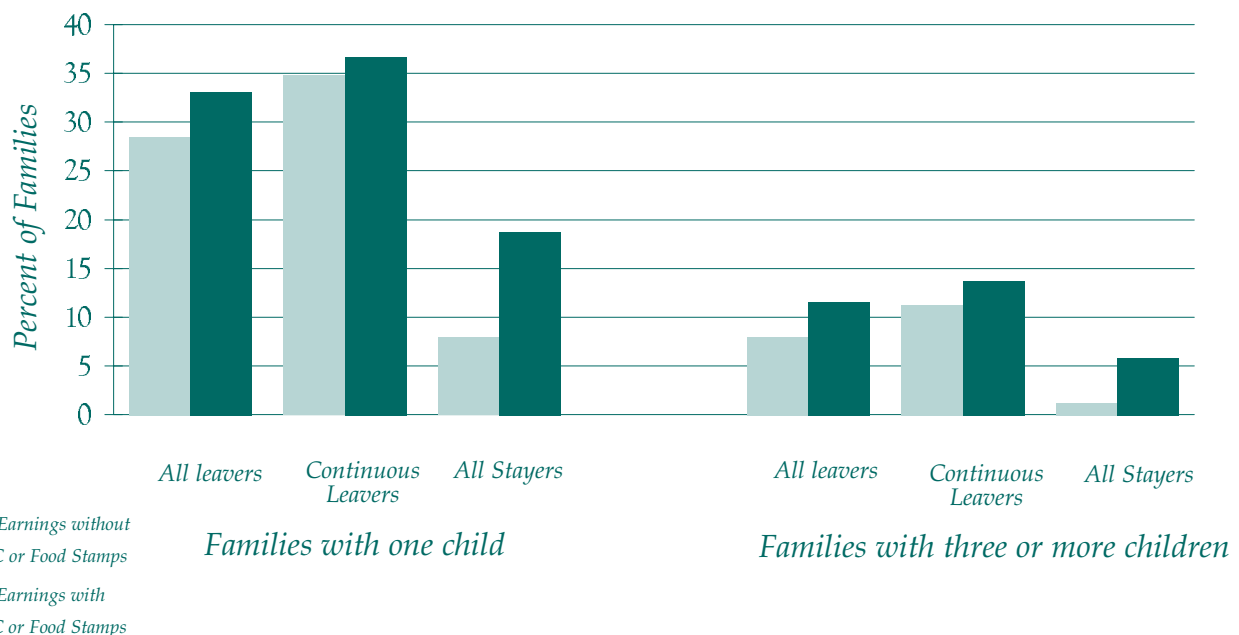
10 percent per year.

Some groups of recipients—those on SSI, those sanctioned, and legal immigrants, for example—were less likely to work; however, the earnings of the immigrants were significantly higher than those of native-born leavers. Those with three or more children were less likely to work than those with fewer children but, among those who worked, earnings were no lower. Earnings were lowest for the youngest mothers (18–24), those with least schooling, and, to a lesser extent, those over 40.

A key question we set out to address concerned the economic well-being of those who left the AFDC rolls. The answer has many aspects. On the one hand, among those who remained off AFDC, more than 55 percent with one child and 45 percent with three or more children had more cash income than if they had remained on AFDC. On the other hand, fewer than half of all leavers achieved incomes greater than their income in the last AFDC quarter. And only about 36 percent of those with one child who stayed off AFDC—less than 14 percent of those with three or more children—generated incomes that exceeded the poverty line in the first year after they left welfare. ■

FIGURE 1

### Percentage of Families Escaping Poverty In the First Year After Exit from AFDC





# Environmental Policy: The Next Generation

by Donald F. Kettl

*Professor Donald Kettl is director of the La Follette Institute and a nonresident senior fellow in the Brookings Institution's Governmental Studies Program. The year 2000 marks the 30th anniversary of Earth Day and the creation of the Environmental Protection Agency (EPA), which has led him to take stock of what our environmental policies have accomplished and the limitations they must now overcome. This article was first published as a Brookings Institution policy brief and is reprinted here with permission.*

As the thirtieth anniversary of the first Earth Day and the creation of the Environmental Protection Agency (EPA) approaches in 2000, a tough question looms: What will the next generation of environmental policy look like? The first generation of environmental policy made substantial progress. Air pollution, for example, dropped substantially even as the nation's population, automobile miles driven, and industrial production grew. But what will constitute the next generation of environmental policies?

There is no support for declaring victory and deregulating the environment. At the same time, however, the costs—economic and political—of current environmental policy have risen to the point that continuation of this regime is unsustainable. How can we maintain the first generation's commitment to a clean environment, develop new strategies for attacking problems that the first generation left unanswered, and crack the tough economic and political dilemmas that the first wave of environmental regulations left in its wake?

## Lessons from the First Generation

The first generation of environmental policy accomplished several things. The regulations unquestionably produced dramatic environmental improvements. Many dirty waters became swimmable, fishable, and drinkable again. Boston Harbor, Galveston Bay, and the Connecticut River are all far cleaner. Even Cleveland's Cuyahoga River, famous for its oily film, obnoxious smell—and for catching fire in 1969—now sports tourist cruise ships and only occasional visible residue. The war on air pollution has reduced smog, even in places like Los Angeles, and some waste dumps have been reclaimed while others have been safely contained.

Despite the wins, the first generation left major economic and political problems. Companies increasingly are complaining about the high cost of com-

pliance. Estimates of the costs of meeting environmental regulations vary widely, from the Office of Management and Budget's estimate of \$144 billion per year to \$185 billion annually, as researchers from Johns Hopkins University contend. These large costs, not surprisingly, engender complaints and often resentment from the businesses that must pay them. These businesses complain that the rules have outlived their usefulness, that they cost jobs, and make American firms less competitive with companies abroad.

Environmental regulations have become so contentious that it is an article of faith in the environmental community that any important regulation will end up in court. The litigiousness of the process increases the costs and aggravation of everyone involved. It makes the EPA hyper-cautious in drafting regulations, companies hyper-concerned about potential impacts, and environmental groups hyper-sensitive about the risk to environmental quality of a process hard to predict, let alone manage. The constant battling and bickering adds enormously to everyone's costs, often without producing significant environmental gains.

The economic and legal costs of the system have increased the political stakes. In 1995, Republicans used environmental regulations as a key example in their campaign to reduce the cost of federal rules. "I am a conservationist," said Tom DeLay (R-Tex.) about the Clean Air Act, "but I do not believe in being a Gestapo-type government imposing regulations on the American public." Democrats capitalized on the Republican campaign to portray themselves as protectors of clean soil, water, and air. When the dust cleared, the EPA's conservative opponents had retreated.

The EPA found itself squeezed between a status quo increasingly hard to defend and new problems that existing policies were inadequate to solve. The EPA will not be killed, but neither can it remain unchanged.

## Challenges for the Second Generation

Although the EPA has fought off political challenges, it faces new problems that it cannot easily attack with its existing tools. While the first generation focused on reducing the kinds of pollution for which sources could be readily identified, the second generation must tackle a dual problem. First, some pollution sources were left relatively untouched by the first generation. Second, the first generation of rules had great difficulty in attacking non-point source pollution—pollution without immediately identifiable origins. The second generation thus faces the tough challenge of devising new, more cost-effective strategies for even more difficult pollution problems.

The great advances in the first generation of environmental policy came in addressing pollution from point sources: cars, factories, and other sources of pollution where regulators could establish a direct link between the cause and the effect. That, in turn, allowed them to develop pollution-reducing technologies. In cars, for example, special canisters and new engine designs have dramatically reduced automobile exhaust pollution. Scrubbers have removed particles from factory smokestacks while new sewage treatment technologies have made rivers cleaner. But while there has been substantial progress in reducing point source pollution, further gains are increasingly costly because the easy victories from technological improvements have already been won.

Reducing automobile and manufacturing pollution has often proven much easier than lessening contamination from large poultry ranches, fertilizer runoff from farms, and the growing environmental risks from homeowners dousing their lawns with pesticides. Such non-point source pollutants pose an important challenge to the continuing campaign to clean



the environment. Fertilizer runoff into rivers, for example, threatens both the balance of life downstream (fish die if water becomes too nitrogen-rich) and the long-run sustainability of agriculture (short-term overuse of fertilizers can disrupt the long-run productivity of the land). Traditional command-and-control regulations work poorly against non-point source pollution problems.

To complicate the problem, such non-point sources are virtually universal and extend from large commercial operations to individual families. More is required than just installing new technology like smokestack scrubbers or catalytic converters. Widespread sources of pollution create a new breed of complex collective-action problems. No strategy can be successful without developing creative new technologies along with broad participation and behavioral changes by almost everyone. Further complicating the problem is the growing recognition of pollution problems such as global warming that know no national boundaries. The collective-action problem is not limited to local communities or even national policies. Reducing non-point source pollution problems, especially greenhouse gases, requires policy strategies that encompass the world. The second generation requires a fresh, boundary-spanning approach: across technologies, geographic boundaries, environmental media, and socio-economic groups.

Non-point source pollution dilemmas also stretch across the EPA's traditional media-based focus, in which regulation has been organized by air, water, and soil. Companies have long complained that the EPA's media-based approach has sent a constant parade of inspectors into their facilities. This multiplies their costs and complicates their operations. Moreover, some environmentalists have begun arguing that such a fragmented approach reduces the effectiveness of environmental regulations and prevents citizens from exercising an effective voice; it is the company's operations after all that are being regulated, not the different media.

Reformers have argued for an approach that is more place- than media-based: one set of environmental standards to cover an operation; one integrated set of permits to regulate them; and one inspector to oversee the overall pattern of compliance. For

an agency that has long been both Washington-based and media-centered, such a geographical focus poses enormous challenges.

First-generation problems remain unresolved as these new second-generation issues arise. Hundreds of Superfund toxic waste dumps remain untreated. Fifty years of nuclear weapons production have left a cold war mortgage that will take perhaps a century to pay. For example, in Hanford, Washington, toxic and radioactive sludge—in many cases the exact composition and potential risks are unknown—are seeping from buried underground tanks toward the Columbia River. Dangerous gases are building in other tanks and threaten to explode. In cases of both Superfund and radioactive waste, the cleanup will require quite literally hundreds of billions of dollars, scores of years, and new approaches that lie beyond currently affordable technology. The savings-and-loan bailout of the 1980s pales in comparison.

## **The second generation requires a fresh, boundary-spanning approach: across technologies, geographic boundaries, environmental media, and socio-economic groups.**

These second-generation problems stretch the EPA far beyond its traditional ways of doing business into complex new partnerships—with other nations, with state and local governments, with private companies, and with citizens. They pose daunting technological—and political—problems. Most important, they focus as much on governance as on management. They require the EPA to chart new relationships with those who share responsibility for environmental quality. Increasingly, that means building partnerships with everyone involved.

### **Second-Generation Strategies**

The central problem for twenty-first century environmental policy is how to

develop new strategies for attacking new environmental problems, how to develop better strategies for solving the old ones, and how to do both in ways that are more efficient, less taxing, and engender less political opposition. The most promising strategies move from a front-end approach, designing and enforcing regulatory systems, to a back-end focus, setting goals and allowing participants to determine how best to meet them. If the first generation of environmental strategies was concerned with compliance, the second generation promises to focus on performance. The EPA is pursuing two strategies: market-based approaches designed to use competition to increase efficiency; and federalism forces designed to build new state-federal partnerships.

One market-based approach with which the EPA is experimenting is emissions trading. Coal-fired and oil-fired power plants and industrial boilers, for example, produce sulfur dioxide, which rises into the atmosphere and later falls as acid rain. Under the EPA's guidance, states establish ceilings on allowable sulfur dioxide emissions.

Some companies have found it cheaper than others to reduce emissions; they get credits, which they can sell to other companies that find the job more expensive. Traditional regulation would have mandated all operations to reduce pollution to the same level, regardless of cost. Emissions trading uses the competitive market to define who can best reduce pollution and how. Through it, the EPA was able to reduce sulfur dioxide emissions by 30 percent, and to reduce compliance costs for boiler operators to less than command-and-control regulations would have permitted. Satisfied with its success, the EPA is planning an expansion of emissions trading to other pollutants, including nitrogen dioxide, a key component of smog.

For all its merits, however, emissions trading has sharp limitations. It works only for pollutants for which markets can be established. This requires the ability to measure the pollutant and clearly identify its origin, which makes the practice difficult to apply to non-point source pollution. It requires agreement on allowable levels of pollution, which makes it difficult to apply to high-risk carcinogens and nucleotides, cases in which even minimal



exposure can prove dangerous. Such judgment calls also make it difficult to apply to pollutants with high political visibility (and, therefore, political risk). Emissions trading requires the ability to isolate the pollutant and its effects, which makes this approach a difficult fit for companies with complex cross-media pollution problems. Finally, it requires the ability to create and sustain a workable market, which limits the technique to large-scale operations with the capacity to cost out their alternatives. (Reduce pollution below the ceiling and sell the credits—or buy credits from other operations because it costs less than meeting the standards?). Small companies are likely to find it difficult to play such a complex game. These problems leave emissions trading an important, useful, but ultimately limited twenty-first-century strategy.

For other problems not readily reducible to pollution markets, the EPA has been quietly exploring new performance-based partnerships with the states. Although the EPA has long devolved operating responsibility for environmental regulations to the states, new experiments give them far greater responsibility for designing and maintaining environmental management systems in exchange for reports on their performance. Over the last 25 years the states have become the EPA's front-line managers for many regulatory programs. The process has often proven just as burdensome to the states as the regulations have been for private companies. The states, not surprisingly, have proven just as fed up as the private sector with the high costs of the current system and have led the charge for performance-based partnerships.

The transformation of environmental devolution from enforcement to performance has been widely attractive. Making it work, however, requires solving two tough problems. The first is building the partnerships and holding them together. The partnerships depend on building trust by measuring performance, but this technology is now rudimentary at best. The strategy, therefore, requires constructing new measurement methodologies.

The second problem is building the confidence of everyone—companies, environmental groups, neighborhood associations, state regulators, the EPA, and elected officials at all levels—in the

process and its decisions. Because performance-based systems tend also to be community-based systems, success depends on getting the groups who often warred in the past to work together. That in turn requires building trust among the participants in both the performance-based process and the results it produces.

## No strategy can be successful without developing creative new technologies along with broad participation and behavioral changes by almost everyone.

Underlying all of these issues is the public interest puzzle: While the battles over environmental regulation often become enmeshed in hypertechnical “how” questions, they typically boil down to critical “who” problems. Who will shape environmental policy? Whose values will prevail? How will the decision process be structured, and whose voices will be heard?

Many environmental groups are quite frank in asserting that they view performance-based regulation as a tactic to turn more decisions over to private industry and to state environmental agencies they have captured. Performance measurement, they fear, is simply an effort to reduce government's commitment to a clean environment. So, along with the big questions of the cost of regulations for all players comes the problem of devising a structure for resolving those questions. Who speaks for citizens, and how should their voice be heard?

The process, then, is not only about reducing the costs of environmental regulation while improving environmental quality, but also about reconstituting the process of environmental debate and defining which values prevail. On one level this is a problem of environmental performance. On a broader level, it is about how reshaped intergovernmental partnerships will affect governance.

## Environmental Policy for the New Millennium

The challenge of environmental policy for the new millennium is to do everything that the first generation of environmental policy did—but to do it better—and to devise a second generation of environmental policy to solve problems that the first generation did not or could not. At the core of the second generation is a shift from inputs (including inspections and rulemakings) to outcomes (most notably performance). It seeks to reduce everyone's costs, lower the political heat, and improve results. But even more important, the second generation of environmental policy revolves around fundamental and richly layered questions of governance:

- *Policy.* What should be the nation's policy toward the environment? How much are we willing to pay for how much environmental improvement?
- *EPA Management.* Since the second generation requires new management technologies, how can the EPA effectively develop and prove these new technologies? And since many of these technologies are experimental, the EPA will have to maintain first-generation regulations while perfecting second-generation strategies. What problems will the EPA face in simultaneously pursuing two so different regulatory approaches?
- *Devolution.* The second-generation strategies involve substantial devolution to private markets and state governments. How can the EPA construct the trustworthy performance systems required to make the market- and federalism-based systems work effectively?
- *Participation.* Because the second-generation strategies heighten the importance of reaching beyond traditional boundaries, how will these boundaries be overcome—and who will reach beyond them? The more second-generation environmental policy problems emerge, the more everyone—governments, companies, and citizens, in the United States and around the world—must come into partnership. How will



these partnerships be created and sustained?

The second generation of environmental policy promises to create the mother of all devolution projects, with implications even greater than welfare reform. The political and administrative relationships are, if anything, more complex. Yet the state of knowledge is far less than in welfare reform.

It is a policy world of massive experimentation, uncertain results, complex relationships, and an inescapable mandate for improvement. It is clear that neither the EPA nor the states can stay where they are. It is equally clear that they must learn to go where no one has gone before. Market incentives are part of the mix, but they fail to attack many of the hardest problems. Those problems are being left to the states, with the states held accountable to national policy through performance measurement. While many states have eagerly seized the flexibility that environmental partnerships offer, many of them so far have used the tool primarily to smooth the paperwork processes. Preventing pollution, improving environmental performance, and integrating approaches across media have lagged behind. The performance-based process, therefore, is more an embryonic idea than a proven practice.

The states will be wending their way through the intricate interrelationships of companies, interest groups, cross-media pollution problems, and technical uncertainties. This devolution requires solving tough political problems—most notably building a consensus that is trustworthy. It also requires increasing management capacity—especially to produce the environmental performance measures on which the system depends.

Within the environmental community, there are powerful forces betting that the states will fail; they are ready to call for a retreat to first-generation command-and-control regulations. Among opponents of environmental regulation, there are powerful forces ready to renew the call for rolling back the rules. Finding a route between these regressive reactions will require skillful navigation. The EPA will be in the wheelhouse to steer the effort, but the states will be handling the oars. ■

## The La Follette Mission is Alive

### *Spring Events Integrate Research, Education, and Outreach*

*While La Follette students undertake policy research for class projects, they also apply their policy analysis and management skills at Institute outreach functions. The first three programs described here incorporate both faculty and student research as they embody the Wisconsin Idea and reach beyond the boundaries of the University of Wisconsin–Madison. The fourth describes a gathering of academicians from around the world who study governance issues. To receive printed publications from the conferences described below, contact the La Follette Institute's Publications Office or check the Institute's web site.*

#### **Poverty: Improving the Definition after Thirty Years** *April 15-17, 1999*

With a proposal for a new poverty measure to be issued by the U.S. Census Bureau in the summer of 1999, academic and government researchers are considering the potential for change in social policies. Ten La Follette students are conducting research on the new measure and are facilitating sessions at this three-day conference. Visiting scholars from federal agencies and nonprofit organizations will discuss the differences in the composition of poverty under a new measure and the political and distributional consequences of changing the way poverty is measured.

#### **Teaming Up On Gangs: Skornicka Seminar for Communities** *April 30 - May 1, 1999*

Five years ago, a group of Wisconsin mayors encouraged the La Follette Institute's Center for State and Local Governance to address the issue of youth violence and gangs in our state. Gangs exhibit signs of activity in many communities, large and small, throughout Wisconsin. Their presence requires a combined effort on the part of policymakers, health officials, social workers, business and religious leaders, and youth. To that end, the Center accepted the mayors' challenge and now joins teams of leaders from five Wisconsin communities to consider strategies and share resources. The five communities involved this year are Janesville, Steven's Point, River Falls, the Oneida Nation, and the Mitchell Point neighborhood of Milwaukee.

#### **The Milwaukee–La Follette Policy Analysis Project** *Spring Semester 1999*

This year's Milwaukee Project involves three teams of students studying issues assigned by the City of Milwaukee's Department of Administration. The 1999 projects include: (1) Making proposals for lowering the number of food inspections in the city while increasing compliance with regulations; (2) Considering how to handle contaminated brownfields that are tax delinquent; and (3) Assessing and formulating policies regarding street repaving. Students conduct policy analyses and present their findings to Mayor Norquist in the first week of May.

#### **Structure and Organization of Government** *April 22-24, 1999*

Globalization means that events occurring in another hemisphere have a direct impact on the policies and politics of federal, state and even local government in the United States. Investment decisions by multinational companies based in Europe affect employment in Wisconsin, for example. Exploring the theme of how international factors and developments are affecting domestic governance, scholars will share research at this event sponsored by the La Follette Institute and the UW—Madison International Institute's Center for World Affairs and the Global Economy.



# Exterminating the Millennium Bug: How Can Local Governments Meet the Challenge?

Information abounds and controversy swirls about the extent to which Year 2000 (Y2K) computer problems, otherwise known as the “millennium bug,” will affect institutions and individuals. Survivalists are certain they will need years’ worth of supplies to outlast the upheaval caused by widespread systems breakdowns; more easygoing types have faith that good old American ingenuity will result in the detection and correction of virtually all glitches with nary a ripple of inconvenience to anyone. Most informed observers believe that reality will be somewhere between the two extremes. The big questions are, Toward which extreme is reality likely to be closer? And what can local governments do to be ready?

A group of students in the Fall 1998 Introduction to Public Management graduate course conducted research and worked closely with the Wisconsin Department of Administration on this

issue, particularly in an effort to provide information to local governments in Wisconsin.\* It is at the local level that many water, sewer, power, and telecommunications systems are administered, and local governments often do not have resources with which to be proactive.

Institutions that have been addressing the Y2K dilemma—at all levels of government and in various parts of the country—suggest following a five-step process:

- (1) Determine how Y2K may affect critical facilities and equipment in your organization;
- (2) Perform an inventory of equipment that will malfunction;
- (3) Establish a plan for making the appropriate and necessary corrective measures and set priorities for the order in which repairs should be made;

(4) Perform simulations, run tests, make necessary further corrections;

(5) Implement the plan. Many experts agree that both institutions and individuals should plan for contingencies in the event that systems fail.

News and information regarding Y2K problem-solving is being generated too quickly for many print publications to keep pace, but we have included below a list of important dates for local governments to consider and an annotated list of selected resources upon which to draw, particularly web sites where information is continually being added and updated.

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*\*The La Follette Institute student researchers on Y2K issues were: Ed Ackerman, Sarah Barry, Carol Hynek, David Miller, and Katie O’Sullivan.*

## Potential Problem Dates

**04/09/1999**

The 99th day of the 99th year

**08/22/1999**

Global Positioning System resets to zero

**09/09/1999**

The date sometimes used as an end of file or to mean “infinity”

**10/01/1999**

Federal government and some others begin fiscal year 2000

**01/01/2000**

New Year’s Day

**02/29/2000**

Leap Year-extra day

**10/10/2000**

The first time date fields will use maximum length of eight digits

**12/31/2000**

A day not in the system if, in February, the Leap Year is not recognized

## Internet Resources

**[www.y2k.state.wi.us](http://www.y2k.state.wi.us)**

State of Wisconsin Y2K site—includes handbook for local governments.

**[www.zdnet.com/anchordesk/story/story\\_3133.html](http://www.zdnet.com/anchordesk/story/story_3133.html)**

**[www.zdnet.com/zdnn/stories/news/0,4586,2173523,00.html](http://www.zdnet.com/zdnn/stories/news/0,4586,2173523,00.html)**

Two sites specifically focused on local government Y2K issues. ZDnet requires a subscription, but it is free.

**[www.nasire.org](http://www.nasire.org)**

National Association of State Information Resource Executives. This site includes a state-by-state survey on preparedness.

**[y2k.ci.lubbock.tx.us](http://y2k.ci.lubbock.tx.us)**

City of Lubbock, Texas—a model of Y2K compliance activity (Note: This site does not use www in its URL).



## Print Resources

DeJager, Peter. “Y2K: So Many Bugs—So Little Time,” *Scientific American*, January 1999, pp. 88-93. A clear, accessible description and explanation of the Y2K issue.

*Government Finance Review*, Vol. 14, No. 6, December 1998. The issue focuses on Y2K preparedness and includes a selected list of appropriate web sites on page 57.

*Government Technology*, Vol. 12, Issue 2, February 1999. John Koskinen, White House Y2K Czar, urges state and local levels to action.

The LaFollette   
**Policy Report**

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