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# Perspectives On the Long-Run Fiscal Outlook

*At the 2007 SIEPR Economic Summit Alice Rivlin and Michael Boskin shared their views on the long-run fiscal outlook. The following Policy Brief is an edited version of their presentation. We hope you find this summary informative and interesting.*

## *By Alice M. Rivlin*

Since Mike Boskin and I have been asked to talk about long-run fiscal policy, I will start with a simple principle that I believe ought to govern long-run fiscal policy: Citizens should pay for the services they ask their government to provide. If Congress and the president, on behalf of the voters, decide to spend money — on defense or health care or roads or parks or scientific research or anything else — they ought to vote the revenues to pay for it. In other words, the budget should be balanced, on the average, over the long run.

One can accept this principle without being a balanced budget fanatic. Deficits are appropriate

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## *By Michael J. Boskin*

Let's begin with a few basic facts and concepts about budget deficits and the national debt. First, the deficit is the difference between revenue and spending (a surplus, if positive), each of which, especially revenue, depends on the cyclical state of the economy. In fact, the impact of the economy is surer, swifter and larger on the budget than the impact of the budget on the economy, as important as that is. Second, the national debt is the sum of all previous surpluses and deficits, the net sum of all that history, those previous tax and spending decisions. It's what economists call a stock, an accumulation over many years (such as assets), rather than a single

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## About The Authors

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in recessions, because revenues drop and trying to balance the budget by raising taxes or cutting spending only makes a recession worse. Moreover, having some national debt isn't all bad. In 2001 my former colleague, Alan Greenspan, worried that the large budget surpluses projected at the time would reduce the national debt to zero in a few years. He thought that was undesirable both because the Federal Reserve would have to conduct monetary policy without a Treasury bond market and because the Treasury would have to invest the surplus in non-government assets, which might give it undue influence over private enterprises. I never thought that paying off the debt was an immanent worry, but there was merit in his argument that it is useful to have some federal debt.

The deficits we are running currently, although not huge by historical standards, seem to me inappropriate, shortsighted and morally indefensible, but the case that they are dangerous to the future of the economy is far from overwhelming. Deficits are fiscally inappropriate at present because we're not in a recession and haven't been for some time. The economy is growing and unemployment is low. We are simply ***choosing*** to spend more on government services than we collect in taxes and passing the bill to future taxpayers. Burdening our children and grandchildren with our debts strikes me as immoral. Sustained borrowing is also risky, whether by governments or individuals, because the borrower has to pay interest on the growing debt. Government borrowing, other things being equal, raises interest rates for the rest of us, although the effect is attenuated when other countries are happy to lend us money. But borrowing from foreigners makes us vulnerable to changes in their willingness to lend. Moreover, we ought to be saving more in this country, and the most straight-forward way to increase national saving is to cut the government's negative saving.

How risky are current levels of federal borrowing? Nobody knows. We might get away with this risky, immoral behavior for a few more years without disastrous consequences. I suspect we could. But we know for sure that we cannot stick with our current policies for long because federal spending is on track to rise rapidly in just a few years under Medicare, Medicaid and Social Security. These three programs already account for more than 40 percent of the federal budget and are growing faster than anything else except interest on the debt. The dominant fact about the future of the federal budget is that we have made promises to older people that cannot be kept unless we change the laws that specify the benefits to be paid and the taxes to be collected.

One can tell this story in different ways, but there isn't any doubt about the nature of the problem, only about whether the fiscal future looks scary or really, really scary. My friend, David Walker, the controller general of the United States, is an accountant by training and likes to add up the net present value of the liabilities we're incurring under these programs — something like $50 trillion by his calculation. Fifty trillion doesn't mean much to me, except it's a very big number. I'm an economist, so I like to tell the same story in terms of the percent of our total production (our GDP) that we will devote to these programs in a few years if we don't change the rules. Over the last four or five decades Americans have allocated a bit more than 18 percent of everything we produce to federal taxes. That percentage goes up and down, but right now we are close to the long-run average. By the early 2030s, Social Security, Medicare and Medicaid are likely, if they stay on their current track, to cost more than 18 percent of the GDP or about the same amount as the historical allocation to total revenues. If we stay this course, we have to close down the rest of the government, raise taxes a lot — continuously — or do some of each. The only way to make these choices less painful is to change the promises that we have made under these programs or reduce the growth rate of medical spending.

Paying for the medical programs is a much bigger problem than paying for Social Security. The projected growth of Social Security is mostly associated with the retirement of the baby boomers. If we pay all of the benefits now promised, Social Security will go from something like 4 percent of the GDP at present to about 6 percent and then grow pretty slowly after that. We could raise taxes by 2 percent of GDP to pay for the benefits promised under Social Security or we could lower future benefits from their projected levels by indexing the initial benefits to wages rather than prices, as President Bush has proposed, or we could combine various approaches. The point is that paying for Social Security is manageable. If you locked Michael Boskin and me in a room and said we could not leave until we agreed on a compromise solution, we would accomplish the task pretty quickly. We would doubtless argue about how big a role to give individual accounts and how to pay for them, but we could work out a compromise on that, too.

However, we would have a lot harder time figuring out what to do about the health care programs. Medicare and Medicaid are projected to grow much faster than Social Security and to keep on growing even after the boomers pass from the scene. The aging of the population is a less important driver of spending on Medicare and Medicaid than the projected continuation of increases in the cost of providing medical benefits per beneficiary. For the last 40 years, medical spending has gone up about 2-1/2 percentage points faster than the GDP. That statement applies both to federal health spending and all health spending. It is not surprising that federal spending tracks the rise in general health spending. Doctors and hospitals do not treat Medicare patients differently from other patients. If someone is seriously ill, the doctors have a protocol, and they do what is indicated, no matter who pays the bill. If the 2.5 percent excess health spending growth persists, the Congressional Budget Office projects that by the early 2040s, Medicare and Medicaid alone will cost more than the 18 percent of GDP historically allocated to federal revenues. Obviously, if we could cut this excess spending growth from 2.5 percentage points to 2 — or better still, 1.5 or even 1 — the problem of future budget deficits would be a lot easier to solve. But as long as the health care programs continue to grow faster than the economy, it follows that they will grow faster than revenues under any likely set of taxes. Hence, we will have a problem financing health care over time. If health spending grows faster than other spending, paying for the government share will require continuously increasing tax rates.

The growth of health entitlements in the federal budget is not new, but we have not felt its impact until recently, for two reasons. One is that the share of GDP devoted to other types of government spending, especially national defense, declined from the end of the Cold War until recently. The other is that the share devoted to servicing the debt was reduced by the surpluses of the 1990s and relatively low interest rates. But we cannot count on either of those offsets in the future.

The basic problem is not that federal health spending is rising so fast; it's that ***all*** health spending is rising so fast. The United States is spending almost 17 percent of GDP on health care now, and the Council of Economic Advisers projects that we will be spending 20 percent by 2015 and that the share will keep on rising. That would not be so worrisome if we were clearly getting our money's worth. However, despite the undeniable excellence of much American health care, there is plenty of evidence that we are not spending all these vast resources wisely. Americans devote a considerably higher portion of their total resources to health care than other advanced countries and our health outcomes are not as good as theirs. Our relatively high spending reflects the fact that we pay doctors more, use specialists more and have somewhat more high-tech equipment. It also reflects the high administrative and selling costs of our complicated system. Whatever the reasons, we spend more than other advanced countries, we fail to cover about 47 million people and our health outcomes are nothing to brag about. Moreover, there is ample internal evidence that the American health care delivery system is inefficient and wasteful in many respects, including some remarkable studies suggesting that for a given diagnosis, super-intensive care

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may yield worse outcomes than less-intensive care.

The principal challenge to achieving a sustainable long-run fiscal policy turns out to be reducing the rate of growth of health spending — all health spending, not just the federal or federal/state portion — and an obvious place to start is with improving the efficiency of the system. Cutting Medicare and Medicaid benefits and restricting eligibility will shift the burden, but it won't reform the health care system in ways that could improve the effectiveness of health care or slow the growth of total spending. And therefore, the important federal policy question is how can we use the federal programs most effectively to move the whole system toward greater efficiency, effectiveness, broader coverage and better health outcomes. Since the federal programs are so large, their leadership is essential in engineering systemic reform.

A group of colleagues and I addressed this question in a recently published book titled, *Restoring Fiscal Sanity: The Health Spending Challenge* (Alice M. Rivlin and Joseph A. Antos, eds.). I have to warn you, however, that we found no silver bullets. Many people seem to believe that if only we changed some one aspect of the health system all would be well. In talking with diverse groups about health care, I have heard lots of "if only" ideas. These include if only the health care system made better use of information technology; if only tort reform would reduce malpractice premiums; if only health providers used evidence-based medicine or were rewarded for their performance; if only drug companies did not make such high profits; if only we emphasized prevention and adopted healthy lifestyles; if only we did not spend so much on the last year of life; and if only we covered the uninsured. These are all important ideas that can contribute to better health and more efficient use of health resources, and we ought to work hard on all of them. But on close examination none appears likely to be the solution to slowing the rapid increase in health care spending.

Nor did we find a single strategy that could be relied on to slow health care spending and improve efficiency. Many people argue for exclusive reliance on either a market or a regulatory strategy. *Market strategies* rely on informed consumers (armed with reliable information about costs and outcomes) making cost-effective choices and on providers responding to the market by improving the effectiveness of care and lowering cost. *Regulatory strategies* rely on administrative rules governing reimbursement rates, provider performance or total health spending to accomplish the same ends. As a practical matter, any viable health reform must blend both strategies, although the emphasis may differ. Improved information about costs and outcomes is crucial to both strategies.

To have a sustainable fiscal policy in the future — and a viable economy — we will have to be serious about a wide range of health policies designed to restrain spending growth and increase efficiency. Federal programs can provide leadership in multiple dimensions:

- Collecting and analyzing data on effective treatment and practices
- Designing reimbursement rates that provide incentives to use best practices
- Standardizing and subsidizing interoperable health information systems
- Broadening coverage in ways that help contain costs.

The bottom line is — long-run fiscal policy is a health policy problem. There are no silver bullets and no single strategy will solve the problem. We will have to do everything we can think of and keep doing it. This is not a public policy problem that will melt away. It will be with us for the foreseeable future.

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year's flow (such as income). Third, the government has lots of assets, e.g., buildings, computers, planes, land and mineral rights. In fact, the value of the federal government's explicit assets is almost as large as the national debt held outside the government. Fourth, the notes and bills and bonds comprising the national debt are explicit legal obligations of the federal government. The government is required to pay the interest and, when the bonds mature, return the principal. Fifth, each dollar of deficit today creates a dollar of government bonds and therefore a dollar in present value of future interest payments, which implies either future tax increases or spending reductions equal to a dollar.

Sixth, the level, composition and structure of spending and taxes are in some sense more fundamental than their difference (the deficit) or the accumulated difference (the national debt). An easy way to think about that is to suppose a law was on the books passively raising taxes to pay for the projected immense increases in entitlement costs. The huge increase in spending and taxes would seriously damage the economy (see below), so the fundamental problem cannot just be the fiscal gap between future spending and taxes. Focusing on the gap conveys the impression that it doesn't matter how the gap is closed, whether by slowing spending growth or raising taxes. That is a dangerous notion.

Seventh, because of real economic growth and inflation, nominal GDP grows substantially through time (in recent years at 5 percent or 6 percent a year), so it is useful to relate fiscal magnitudes to the size of the economy. Otherwise, absolute nominal dollar sums as vast as the trillions of dollars of federal government spending and taxes, or even the hundreds of billions of dollars of budget deficits, are difficult to compare at different points in time. Eighth, because most of the obligations of the government are in current nominal dollars, not inflation-adjusted dollars (most bonds pay nominal interest), it is at a minimum desirable to convert everything to constant dollars, what economists call real rather than nominal magnitudes. What does this mean for the deficit? Since inflation erodes the real value of the previously issued bonds comprising the national debt, at a 2 percent inflation on a $4-5 trillion national debt, the first $80 billion or so is not a real deficit at all. (There are many other conceptual problems with the usual deficit measures; see my "Sense and Nonsense about Federal Deficits and Debt," SIEPR Policy Brief, November 2004.)

Ninth, the enormous long-run projected deficits are primarily due to the projected large increases in real benefits per recipient in Social Security and Medicare, not demography. The demographic transition (the baby boom generation's retirement and the rising life expectancy of the elderly) aggravates the problem, but is not its central cause. Demography accounts for less than half of the long-run deficit in Social Security and less than a quarter in Medicare. Tenth, the costs are back-loaded. They grow exponentially, and the fiscal imbalances grow progressively more acute through time.

Let's turn to spending, taxes, deficits and debt in the short, medium and long run. Last year's actual and short-term future projections of spending and taxes are reported in Table 1. Revenues are running slightly ahead of the historic average of 18.3 percent of GDP, but fall considerably short of spending. Still, the deficit of 1.9 percent of GDP last year and the projection in the 1.3 percent range this year are below the historic average. The current level of the national debt held outside the government (see Figure 1) is slightly under 40 percent of GDP. If the economy grows on average at about 5 percent (3 percent real, 2 percent inflation), with a 40 percent debt-GDP ratio, the deficit would have to exceed 2 percent of GDP (0.4 debt-GDP ratio times the 5 percent growth rate of GDP) to increase the debt ratio. Thus, the current deficit will decrease the debt-GDP ratio! President Bush's 2001-2003 tax cuts are currently due to expire in 2010 (Table 1) with a big jump in the tax share of GDP in 2011. The president's budget, which makes the tax cuts permanent and imposes more spending restraint, still shows a slightly declining debt-GDP ratio.

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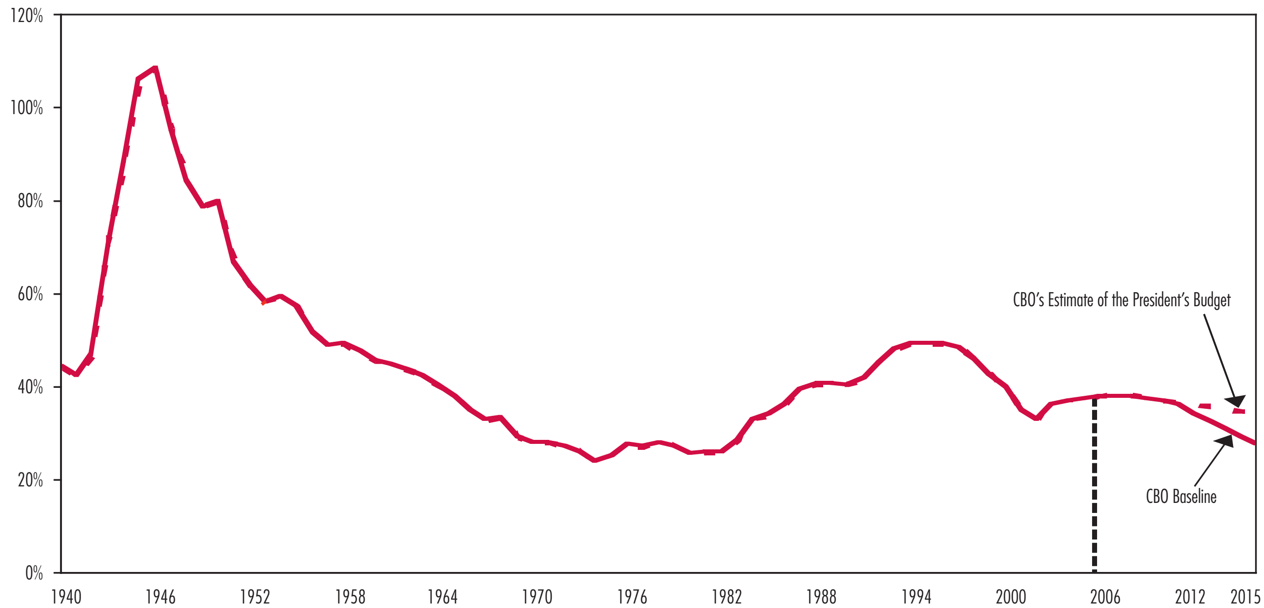
## TABLE 1
### CBO's 10-Year Budget Projection

| | Actual 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | Total, 2008-2012 | Total, 2008-2017 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | In Billions of Dollars | | | | | | | |
| Revenues | | | | | | | | | | | | | | |
| Revenues | | | | | | | | | | | | | | |
| Individual income taxes | 1,044 | 1,144 | 1,259 | 1,311 | 1,380 | 1,584 | 1,730 | 1,830 | 1,928 | 2,036 | 2,149 | 2,269 | 7,263 | 17,473 |
| Corporate income taxes | 354 | 368 | 374 | 360 | 336 | 339 | 349 | 333 | 340 | 349 | 360 | 373 | 1,758 | 3,513 |
| Social insurance taxes | 838 | 875 | 914 | 958 | 1,004 | 1,052 | 1,100 | 1,149 | 1,198 | 1,249 | 1,301 | 1,354 | 5,029 | 11,281 |
| Other | 172 | 155 | 173 | 181 | 181 | 192 | 226 | 239 | 251 | 263 | 275 | 289 | 954 | 2,270 |
| Total | 2,407 | 2,542 | 2,720 | 2,810 | 2,901 | 3,167 | 3,405 | 3,551 | 3,718 | 3,896 | 4,085 | 4,284 | 15,003 | 34,537 |
| On-budget | 1,799 | 1,905 | 2,051 | 2,107 | 2,164 | 2,395 | 2,597 | 2,707 | 2,838 | 2,979 | 3,130 | 3,290 | 11,313 | 26,258 |
| Off-budget | 608 | 638 | 669 | 703 | 738 | 773 | 808 | 844 | 880 | 917 | 955 | 994 | 3,690 | 8,279 |
| Outlays | | | | | | | | | | | | | | |
| Mandatory spending | 1,413 | 1,454 | 1,536 | 1,625 | 1,714 | 1,832 | 1,870 | 2,009 | 2,131 | 2,264 | 2,449 | 2,580 | 8,576 | 20,009 |
| Discretionary spending | 1,016 | 1,029 | 1,046 | 1,062 | 1,078 | 1,100 | 1,112 | 1,140 | 1,166 | 1,194 | 1,227 | 1,250 | 5,398 | 11,376 |
| Net interest | 227 | 236 | 251 | 256 | 266 | 270 | 268 | 263 | 258 | 252 | 246 | 237 | 1,312 | 2,567 |
| Total | 2,655 | 2,719 | 2,833 | 2,944 | 3,058 | 3,202 | 3,250 | 3,411 | 3,555 | 3,710 | 3,921 | 4,067 | 15,286 | 33,951 |
| On-budget | 2,233 | 2,268 | 2,366 | 2,458 | 2,552 | 2,676 | 2,699 | 2,830 | 2,942 | 3,062 | 3,233 | 3,336 | 12,751 | 28,154 |
| Off-budget | 422 | 451 | 467 | 486 | 506 | 526 | 551 | 581 | 613 | 649 | 688 | 731 | 2,535 | 5,797 |
| Deficit (-) or Surplus | -248 | -177 | -113 | -134 | -157 | -35 | 155 | 139 | 163 | 186 | 163 | 217 | -283 | 586 |
| On-budget | -434 | -363 | -315 | -351 | -388 | -281 | -102 | -123 | -104 | -82 | -104 | -46 | -1,438 | -1,897 |
| Off-budget | 186 | 186 | 202 | 217 | 232 | 247 | 257 | 263 | 266 | 268 | 267 | 263 | 1,155 | 2,482 |
| Debt Held by the Public | 4,829 | 5,010 | 5,137 | 5,285 | 5,455 | 5,502 | 5,358 | 5,229 | 5,075 | 4,895 | 4,737 | 4,525 | n.a. | n.a. |
| Memorandum: | | | | | | | | | | | | | | |
| Gross Domestic Product | 13,065 | 13,645 | 14,300 | 15,014 | 15,742 | 16,465 | 17,205 | 17,973 | 18,764 | 19,582 | 20,425 | 21,295 | 78,726 | 176,766 |
| | | | | | | | As a Percentage of Gross Domestic Product | | | | | | | |
| Revenues | | | | | | | | | | | | | | |
| Individual income taxes | 8.0 | 8.4 | 8.8 | 8.7 | 8.8 | 9.6 | 10.1 | 10.2 | 10.3 | 10.4 | 10.5 | 10.7 | 9.2 | 9.9 |
| Corporate income taxes | 2.7 | 2.7 | 2.6 | 2.4 | 2.1 | 2.1 | 2.0 | 1.9 | 1.8 | 1.8 | 1.8 | 1.8 | 2.2 | 2.0 |
| Social insurance taxes | 6.4 | 6.4 | 6.4 | 6.4 | 6.4 | 6.4 | 6.4 | 6.4 | 6.4 | 6.4 | 6.4 | 6.4 | 6.4 | 6.4 |
| Other | 1.3 | 1.1 | 1.2 | 1.2 | 1.2 | 1.2 | 1.3 | 1.3 | 1.3 | 1.3 | 1.3 | 1.4 | 1.2 | 1.3 |
| Total | 18.4 | 18.6 | 19.0 | 18.7 | 18.4 | 19.2 | 19.8 | 19.8 | 19.8 | 19.9 | 20.0 | 20.1 | 19.1 | 19.5 |
| On-budget | 13.8 | 14.0 | 14.3 | 14.0 | 13.7 | 14.5 | 15.1 | 15.1 | 15.1 | 15.2 | 15.3 | 15.5 | 14.4 | 14.9 |
| Off-budget | 4.7 | 4.7 | 4.7 | 4.7 | 4.7 | 4.7 | 4.7 | 4.7 | 4.7 | 4.7 | 4.7 | 4.7 | 4.7 | 4.7 |
| Outlays | | | | | | | | | | | | | | |
| Mandatory spending | 10.8 | 10.7 | 10.7 | 10.8 | 10.9 | 11.1 | 10.9 | 11.2 | 11.4 | 11.6 | 12.0 | 12.1 | 10.9 | 11.3 |
| Discretionary spending | 7.8 | 7.5 | 7.3 | 7.1 | 6.8 | 6.7 | 6.5 | 6.3 | 6.2 | 6.1 | 6.0 | 5.9 | 6.9 | 6.4 |
| Net interest | 1.7 | 1.7 | 1.8 | 1.7 | 1.7 | 1.6 | 1.6 | 1.5 | 1.4 | 1.3 | 1.2 | 1.1 | 1.7 | 1.5 |
| Total | 20.3 | 19.9 | 19.8 | 19.6 | 19.4 | 19.4 | 18.9 | 19.0 | 18.9 | 18.9 | 19.2 | 19.1 | 19.4 | 19.2 |
| On-budget | 17.1 | 16.6 | 16.5 | 16.4 | 16.2 | 16.3 | 15.7 | 15.7 | 15.7 | 15.6 | 15.8 | 15.7 | 16.2 | 15.9 |
| Off-budget | 3.2 | 3.3 | 3.3 | 3.2 | 3.2 | 3.2 | 3.2 | 3.2 | 3.3 | 3.3 | 3.4 | 3.4 | 3.2 | 3.3 |
| Deficit (-) or Surplus | -1.9 | -1.3 | -0.8 | -0.9 | -1.0 | -0.2 | 0.9 | 0.8 | 0.9 | 1.0 | 0.8 | 1.0 | -0.4 | 0.3 |
| On-budget | -3.3 | -2.7 | -2.2 | -2.3 | -2.5 | -1.7 | -0.6 | -0.7 | -0.6 | -0.4 | -0.5 | -0.2 | -1.8 | -1.1 |
| Off-budget | 1.4 | 1.4 | 1.4 | 1.4 | 1.5 | 1.5 | 1.5 | 1.5 | 1.4 | 1.4 | 1.3 | 1.2 | 1.5 | 1.4 |
| Debt Held by the Public | 37.0 | 36.7 | 35.9 | 35.2 | 34.7 | 33.4 | 31.1 | 29.1 | 27.0 | 25.0 | 23.2 | 21.2 | n.a. | n.a. |

Source: Congressional Budget Office.
Note: n.a. = not applicable.

**FIGURE 1**
National Debt as Percentage of GDP




Source: CBO, budget projections, January 2006, and "analysis of the President's Budgetary Proposals for Fiscal Year 2008," March 2007.

Large deficits relative to GDP have usually been associated with the collapse of revenue in and just after recessions (as in the last three recessions in 2001, 1990-91 and 1981-82), or with massive military spending requirements as in World War II. Indeed, the majority of World War II was debt-financed. Sized to today's economy, $10 trillion of debt was incurred.

Turning to the medium-term, the ten-year budget window used by the Congress, the projections are consistent with a debt-GDP ratio that stays somewhat below the historical post-World War II average and far below Euroland and Japan. This hardly conjures up a scenario of financial panic from fear that rising debt will force the FED to inflate in this time frame. Digging behind the numbers, however, we see that a substantial tax increase will occur automatically unless the law is changed. Taxes rise because of real bracket creep, the alternative minimum tax spreading to more taxpayers, expiration of the Bush tax cuts and other factors, which would drive the tax share in GDP from a little more than 18 percent to almost 20 percent in a decade (and to almost 24 percent thereafter), without any changes in the payroll taxes dedicated to the social insurance programs, the spending on which is the source of the longer-run deficits.

Turning to the longer-run outlook, Figure 2 presents six CBO scenarios, under various spending and revenue assumptions. Over the next few decades, if spending is strictly controlled, there would be virtually no deficit (and hence a large reduction in the debt/GDP ratio). It is in the high spending case that large deficits ensue. When we look behind the high spending scenario to the programs likely to cause it, the focus is clearly on Social Security and Medicare.

Starting with Social Security, it is currently running a surplus (Figure 3), which is being used to finance the rest of government. The political consequences begin next year, when the Social Security surplus starts to shrink, and hence fewer additional funds will be available to finance the

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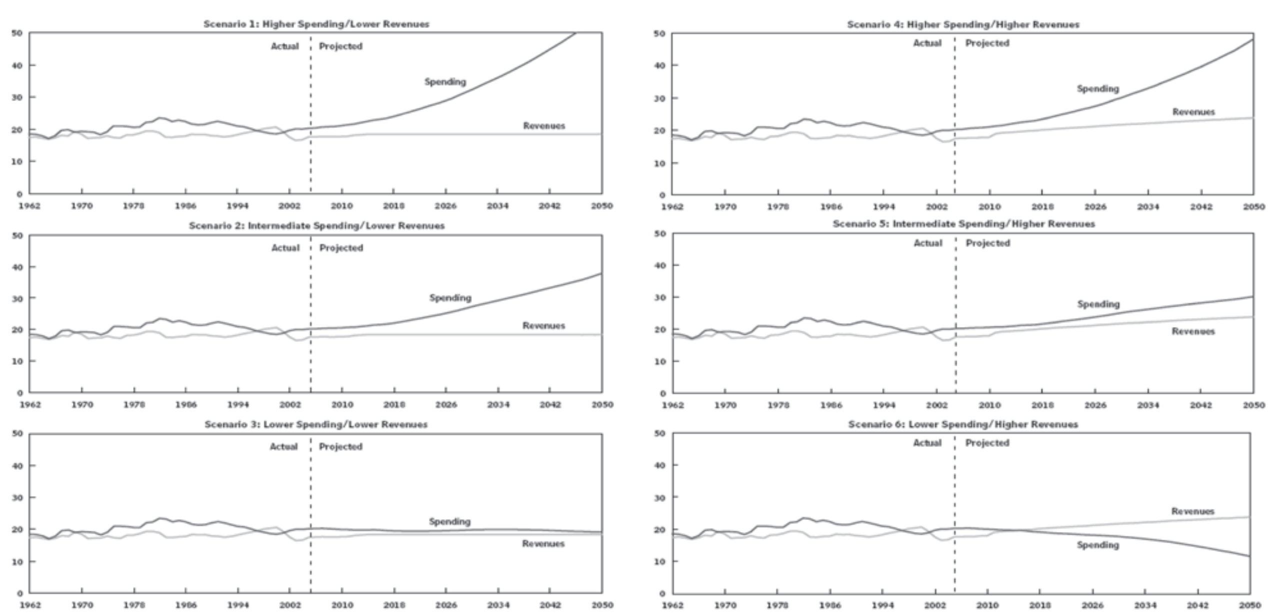
rest of government. It is also the first year a baby boomer is eligible for Social Security. By 2018, Social Security will be spending more than it is taking in and drawing on the so-called trust fund, which means it will be redeeming its special obligation bonds and the rest of government will be forced to cut spending, raise taxes or incur additional debt. If we decompose the projected increase in benefits into that which reflects rising real benefits per beneficiary and that which reflects rising beneficiaries relative to the working population, demography is important, but not the main source of the financial shortfall. Rising real benefits per beneficiary account for the majority of the gap. Initial Social Security benefits are indexed by the average growth of wages in the economy, which rise with productivity growth plus inflation. Only once you retire are benefits indexed solely by the change in the Consumer Price Index, a rough measure of inflation that still overstates inflation somewhat. These indexing formulae were put into place in the 1970s, when price inflation was rampant and there was little productivity growth. Now it's 30 years later and the future that this has wrought is a program that will soon strain itself, the federal budget and the national income over time. There are ample resources with the current tax rate to fund these rising real benefits or the demographic transition, but not both. If we passively wait to fund benefits by raising taxes, we will need at least a 50 percent increase in the payroll tax.

There are two reasons why it is important that something be done soon. The first is economic, for both individuals and the entire economy. Any sensible solution to these problems should phase in slowly after a grace period and then cumulate to a sizable impact in the distant future so, many decades from

**FIGURE 2**

**Total Federal Spending and Revenues Under Different Long-term Budget Scenarios**




Source: CBO, Long-Term Budget Outlook, December 2005.

now, the problem would be eliminated. This would have virtually no effect on people who are currently retired, very little on people soon to retire. But people who are young now and those not yet in the labor force would have a system in the future that would be on secure financial footing, and they could plan for that expectation now rather than face the uncertainty caused by the insolvency. Many approaches to accomplishing this goal have been suggested, from switching from wage to price indexing while helping those at the bottom, to small increases in retirement age in the distant future.

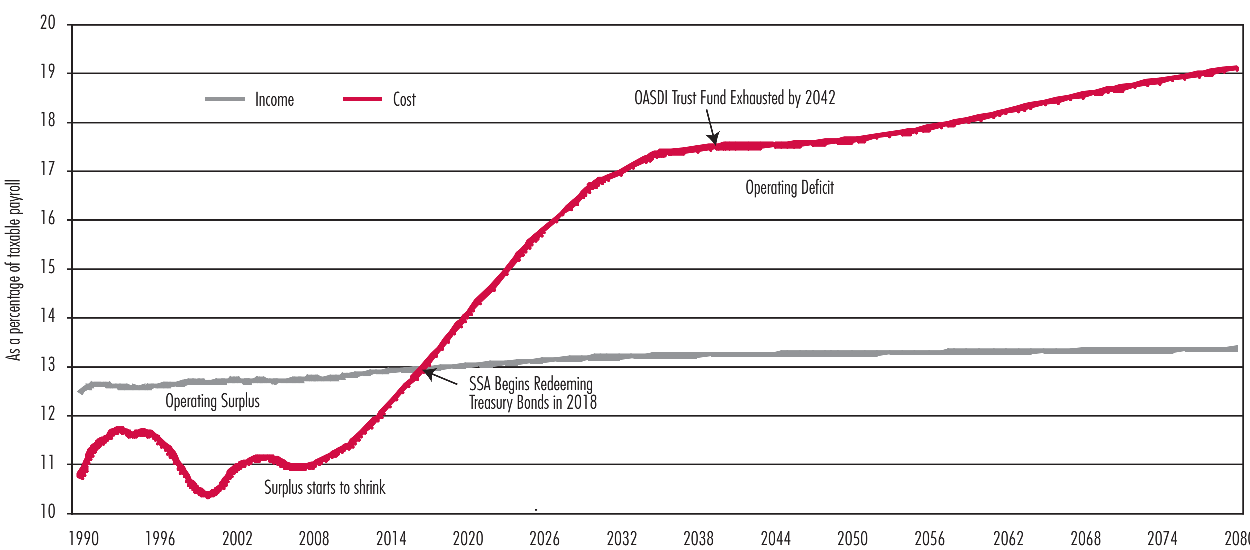
Second, because these costs are back-loaded, there is a temptation to wait. This is an important program; it has helped reduce poverty among the elderly from three times the national average to below the national average. About one-third of the elderly population relies almost exclusively on Social Security benefits. They are a large fraction of the income of yet another one-third. Many young people say they do not expect Social Security to be there when they retire. So the second reason to do something about the problem is that every year we delay, the ratio of people paying taxes to the government relative to the people getting income back from the government will decline. That is unhealthy for a democracy and it will become progressively more difficult to enact reforms. Waiting implies that the changes would have to be so abrupt as to disrupt families and derail the economy.

Many of the same comments apply to Medicare (Figure 4 is the hospital insurance part). The projected growth in spending is a large multiple of that in Social Security. Total health care spending, not just Medicare, is projected to grow from 17 percent of GDP to more than 30 percent. Thus, the additional income will be spent mostly on medical care, which translates to a marginal propensity to consume health of 70 percent or more.  Let's hope, if that indeed happens, we're actually getting enough better health and longer life to make it worthwhile.

But because the payment system shields people from paying at the point of service for most medical care, it is very hard to figure out what people really want, and are willing to pay for, from the medical system. Health care spending will gobble up the budget, making

**FIGURE 3**

**Social Security Cost and Income** (% of Taxable Payroll, Historical and Projected)




Source: SSA Trustees Report, 2006

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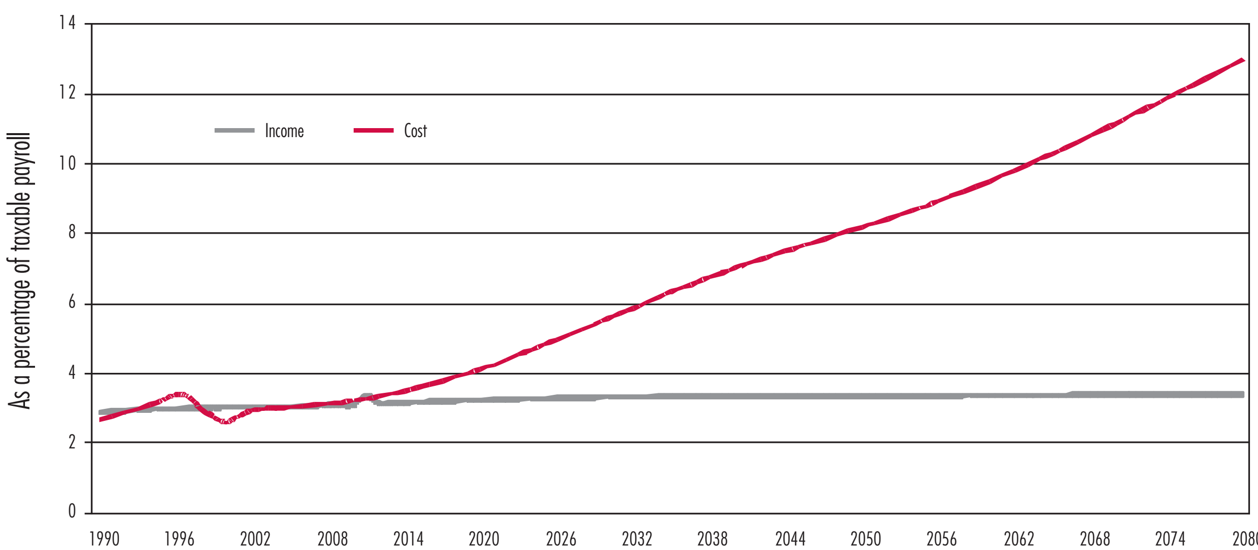
it impossible to fund other governmental programs, and then national income, leaving little room to increase spending on other important household items, from transportation to education, to housing, to food, etc. Even if we cut the projections down substantially or for various reasons they prove to be overstated, they will still be huge. Payroll taxes would have to be raised by 50 percent or more to finance increasingly generous Social Security benefits to a larger and larger recipient population. The increases in payroll and/or income taxes to fund Medicare costs would have to be much larger.

As mentioned above, the United States currently spends a little more than 30 percent of GDP in federal, state and local taxes and expenditures. The European economies spend much more: France, 50 percent; Germany, the high 40s; etc. There is NO large heterogeneous society whose economy has been successful for the last quarter-century with such high tax burdens. The more advanced welfare states have much larger social insurance payroll taxes and much higher national taxes on goods and services, particularly value-added taxes. Their individual and corporate income taxes are a little higher than ours.

What have they gotten for these high taxes and spending? Despite higher taxes, their deficits have been larger than ours. There is a clear negative relationship between economic growth in the last quarter-century and the tax or spending burdens in the OECD countries. The standard of living is about 30 percent higher in the United States than in Western Europe, and this big-government-equals-slow-growth relationship accounts for a large fraction of the difference. Of course there are many reasons why economies are successful or unsuccessful. Taxes are only one of the impediments. The Europeans have more rigid labor market regulation, much larger welfare benefits and higher trade barriers. These are all of a piece. More people leave the productive work force and collect government transfer payments; there is more need to raise taxes; and a vicious cycle ensues, resulting in a stagnant economy. Higher taxes have not led to balanced budgets, just more spending and slower growth.

**FIGURE 4**

**Medicare HI Income Cost (% of taxable payroll, historical and projected)**




Source: SSA Trustees Report, 2006

These basic facts lead to the overwhelming conclusion that we must embed the debate over long-run fiscal policy and the future of Social Security and Medicare in a much broader discussion of our nation's future. These programs must be able to support the legitimate needs they serve, but if we desire a dynamic, flexible economy that provides rising standards of living, upward economic mobility, especially for those who haven't yet made it up the economic ladder, it is important to prevent an explosion in spending and taxes. These programs need to be restructured soon, in a manner that has little effect on current retirees or those soon to retire but cumulates to a significant reduction in the rate of growth of real benefits. The projected benefits and taxes are just that: projections. Their difference, often called an unfunded liability and frequently compared (even added) to the national debt, is best thought of as a projected potential liability. Unlike the bonds that comprise the national debt, the Supreme Court has ruled they are not a legal obligation. Clearly, the notion of a political promise has, and should have, great force for those already retired and those near retirement. They made their own saving and retirement plans based on expectations that the current benefit formula would be changed little if at all; it would be quite difficult for most of them to return to work or to adjust their own saving at this stage by very much. At the other extreme are those not born yet who will be retiring toward the end of the 75-year projection period. We certainly should be trying to bequeath them a strong economy and sensible social insurance program, but it is a stretch to claim, as some politicians have done, that there is a promise not to change any features of these programs to make them more efficient, effective and affordable.

It is therefore vital to begin making gradual reforms in these programs to prevent the economy from sliding toward a European-style social welfare state and its concomitant economic stagnation. Who among us wants to have the next generation ask us in a couple of decades, "How did you let this happen?"

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