

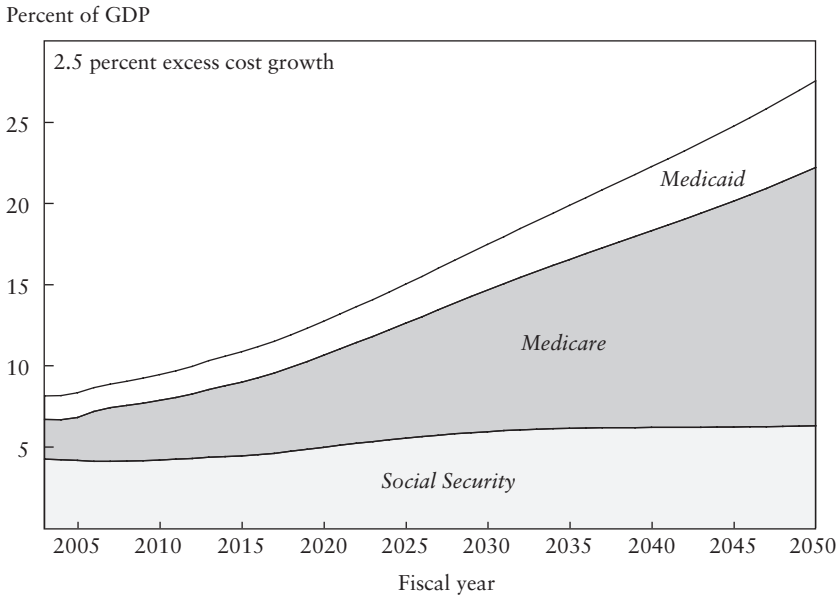
Overview

Sometimes good news poses hard choices. Over the next several decades Americans will be forced to make difficult decisions necessitated by the good news that people are living longer and that medical care has become far more effective (albeit more expensive) than ever in history. These choices will require adjustments by almost everyone—families, communities, employers, and older people themselves—but they will be most starkly evident in the federal budget.

More than two-fifths of the federal budget is currently devoted to Social Security, Medicare, and Medicaid. Increased longevity, the retirement of the large baby boom generation, and rapidly increasing medical costs will drive spending on these programs sharply upward over the next three decades unless their current structure is radically changed (figure 1).

These projections dramatize that the current course is simply not sustainable.¹ Promises made to the elderly, especially about medical care, cannot be kept unless a way can be found to control or pay for the rise in health care costs. Even if medical costs grow more slowly, the cost of promises to seniors will force Americans to come to grips with very tough

Figure 1. *CBO Projection of Social Security, Medicare, and Medicaid Spending*



Source: CBO, "The Long-Term Budget Outlook," December 2003.

budget choices. Unless taxes are raised to levels that are unprecedented in the United States, promises to the elderly will have to be dramatically pared back or other activities of the government will have to be slashed.

Much current debate focuses on the solvency of Social Security, but Medicare's fiscal problems dwarf the shortfalls in Social Security. Restoring long-run solvency to Social Security—whether by benefit cuts, revenue increases, or a combination of the two—would actually do relatively little to change the overall budget picture over the next several decades.

Although demographic and medical cost pressures will rise gradually over the coming quarter century, postponing action would be reckless and short-sighted. The sooner adjustments are made—whether in taxes or spending—the less drastic and disruptive they need to be. Moreover, responding to the longer-run imperatives is complicated by the fact that in fiscal year 2004 the federal government spent \$412 billion (3.6 percent

of GDP) more than it collected in revenues. These deficits are unlikely to decline substantially without changes in current policies.

Running an ongoing deficit of this magnitude is inappropriate in an economy that has recovered from recession and is growing at a healthy pace. Persistent deficits risk undermining the future growth of the economy, which will make it more difficult to deal with the demographic and medical cost pressures that loom ahead.

This book is designed to help the reader understand the dimensions of the budget problem, both in the near term and the longer run. Besides describing the problem, we offer a variety of concrete solutions. Some of these solutions will appeal to those who believe strongly in limited government. Others will appeal to those who favor expanding the government's role. Some will attract those who want to sort out what government does best from what it does less effectively. And some will appeal to those who are concerned about investing in children and in the future of the nation. Our objective is not to argue for one particular solution, but to demonstrate the magnitude and nature of the choices that will be required.

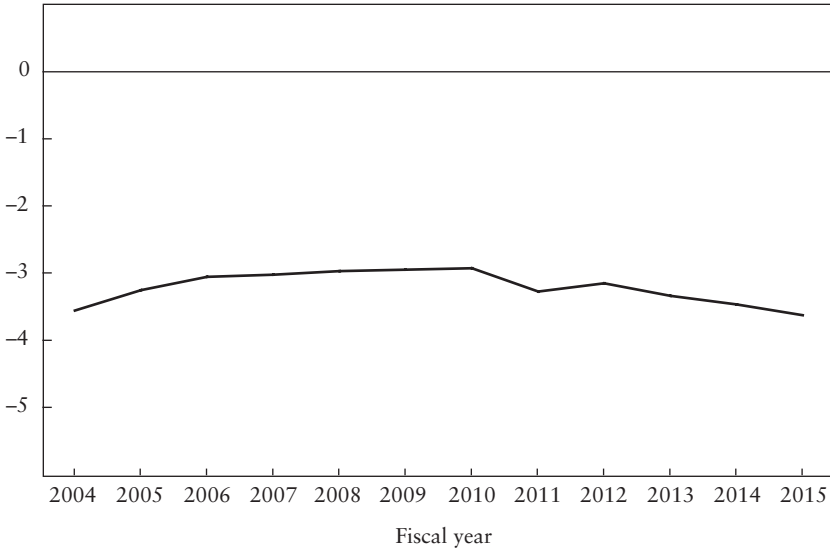
Budget Outlook for the Next Decade

As recently as fiscal year 2000 the federal budget was running a surplus of \$236 billion, and was expected to stay in the black for the next decade or more. Then came the stock market crash, the recession of 2001 and the large tax cut that same year, the terrorist attacks on September 11, 2001, the wars in Afghanistan and Iraq, and the additional tax cuts in 2002 and 2003. By fiscal year 2004, the surplus had turned into a deficit equal to 3.6 percent of GDP. The most dramatic changes were on the revenue side. Federal revenues fell from 20.9 percent of GDP in 2000, the highest percentage since World War II, to 16.3 percent in 2004, the lowest percentage since 1959. Meanwhile, federal spending, which accounted for 18.4 percent of GDP in 2000, climbed to 19.8 percent in 2004.

A deficit of 3.6 percent of GDP would not be worrisome if it were expected to disappear as the economy grew faster, but, unfortunately, that is not the case. As detailed by Rudolph G. Penner and Alice M. Rivlin in

Figure 2. *Projected Deficit as a Percentage of GDP, 2004–15*

Deficit as percent of GDP



Source: See adjusted baseline in table 1-1 on page 19.

chapter 1, projections based on reasonable assumptions show persisting deficits declining slightly in the next few years, but rising again toward the end of the ten-year period. Their projection for 2015 is a deficit of \$715 billion, still around 3.6 percent of GDP (see figure 2).

Many people hope that economic growth will shrink or eliminate these deficits. Our projections are based on a 3.1 percent rate of real growth. Indeed, if the United States were lucky enough to enjoy a real growth rate of 4.3 percent over the coming decade—instead of the 3.1 percent assumed in our projection—the deficit would likely disappear by 2015.² However, rates of economic growth high enough to eliminate the deficits projected for the following decade (when aging and medical costs combine to increase spending) are not conceivable. Indeed, one of the surest ways to promote growth and improve future standards of living is to encourage national saving by reducing current borrowing by the federal government.

Deficits and National Saving

Deficits reduce national saving, which in turn reduces the income available to Americans in the future. The reduction in future income can come in two ways. In a relatively closed economy (one with few exports and imports) that is not in recession, large-scale government borrowing puts upward pressure on interest rates and other costs of capital. With investment more expensive, the economy will be deprived of the rapid growth of technology, equipment, and new skills that raise productivity and future incomes. But the U.S. economy is far from closed. In recent years, massive amounts of capital have flowed in from around the world, financing much of America's federal deficit, as well as its international (or current account) deficit, and mitigating any rise in interest rates that might have resulted from federal borrowing. This inflow of foreign capital has kept investment in the American economy strong, but it means that Americans are accumulating obligations to service these debts and repay foreigners out of their future income. As a result, the future income available to Americans will be lower than it would have been without the government deficits.

Foreign borrowing also makes the United States vulnerable to the changing whims of foreign investors. Opinions differ about how risky it is to rely on foreigners' continuing to purchase large portions of U.S. treasury bonds. Asian central banks, which are currently absorbing a large share of net U.S. treasury bonds issued, have a strong incentive to invest their growing reserves in dollar securities. This keeps their currencies from appreciating against the dollar and makes their exports attractive to Americans. This "co-dependency" could go on for years.³ However, there is a risk that Asian central banks, or other large purchasers of dollar securities, will lose confidence in the ability of the United States to manage its fiscal affairs prudently and shift their purchases to euros or other currencies. Such a shift could precipitate a sharp fall in the value of the dollar, which could cause a spike in interest rates, a plunge in the stock and bond markets, and possibly a serious recession. The risk of such a fiscal meltdown is unknown, but it seems foolish to run this risk in order to perpetuate large federal deficits, which will ultimately reduce Americans' standard of living.

The aging of the population makes it especially urgent to increase national saving and grow the economy as quickly as possible. As the baby boomers retire and average longevity continues to increase, workers will be supporting a larger number of retirees unless working lives are extended and retirement deferred. There is no way to stockpile food, medical care, entertainment or other goods and services for use in a future year. The goods and services consumed by retirees, as well as by workers and their families, will all have to be produced in future years. The only way to increase that production is to increase national saving and invest that saving as productively as possible in knowledge, skills, and physical capital. This need to grow the future economy to accommodate more retirees means that proposals for reform of Social Security (see chapter 3), Medicare and Medicaid (chapter 4), and taxes (see chapter 5) should be judged in part by their contribution to increasing national saving.

Budget Outlook for the Longer Term

While the near-term budget picture shows a share of revenues that is low by historical standards and spending that is near the historical average, the picture changes quickly as the baby boom generation begins to retire. Longer-term budget projections are dominated by the spending pressures that flow from the combined effect of aging and the rising cost of medical care.

Social Security outlays are a relatively small part of the projected increase in spending associated with aging (see figure 1). Far larger increases in spending are expected in Medicare, as well as in Medicaid, which currently pays much more than half of the cost of long-term care for the elderly. How rapidly Medicare and Medicaid spending will rise depends, in turn, on the general rise in medical care costs. Past history is not encouraging because medical spending has been rising faster than the economy for decades. If medical care costs continue on their historic track (rising 2.5 percentage points faster than GDP), the increase in Medicare and Medicaid spending by 2030 will be more than four times the increase in Social Security spending. Even if medical care costs rise only 1 percentage point faster than GDP in the future, increased spending on

Medicare and Medicaid will be two-and-a-half times the Social Security increase between now and 2030.

The budget challenges from federally sponsored health programs are hard enough, but, as chapter 4 indicates, the nation faces an even larger challenge. Medicare and Medicaid are just part of the overall system of paying for health care. Successful modifications in Medicare and Medicaid will require reform of the entire health care system to rein in cost increases that threaten private as well as public budgets. Chapter 4 presents a menu of approaches to slowing the growth of health care spending. Unfortunately, the authors hold out little hope that the changes they examine will slow spending growth more than briefly. Many reforms might succeed temporarily, but acceptable steps are unlikely to have a large, sustained effect on the rate of growth in those outlays, which are driven primarily by new treatments and drugs that improve health and well-being.

Budget projections make clear that Americans face stark choices about what they want the federal government to do and how they want to pay for it. The long-run baseline projection we use, derived from the Congressional Budget Office (CBO), assumes that federal spending on all other programs (including defense) grows less rapidly than the economy and hence gradually falls as a percent of GDP, from about 10 percent at present to 7 percent in 2030 (table 1). Even with other spending declining, however, the projected spending increases in Social Security, Medicare, and Medicaid will drive federal spending to unprecedented levels. Total spending (less interest) would reach at least 24 percent of GDP in 2030 if medical costs continue their historic trend, and 21 percent if aggressive action succeeds in holding the increases to less than half the historic rate (table 1).

Revenues, in contrast, are not expected to grow commensurately. Over the past half century, federal revenues have averaged about 18 percent of GDP. When inflation, rapid economic growth or a booming stock market pushed revenues above 19 percent, tax rates were cut (for example, in 1981 and 2001), and the percentage dropped again. Hence even if revenues return to their historic average from their current low point, an unsustainable gap of about 6 percent of GDP (24 percent minus 18 percent) will remain between projected noninterest spending and revenues. Once interest payments on the debt are added to spending, the gap

Table 1. *Projected Federal Spending, 2030^a*
Spending as a percent of GDP

Category	Current (2005) ^b	Base- line ^c	Smaller govern- ment ^d	Main- taining the Social Contract ^e	Investing in the Future ^f	Larger govern- ment ^g
Medicare and Medicaid ^h	4.2	11.5	5.7	11.5	8.4	11.5
Social Security ⁱ	4.2	5.9	5.5	5.9	5.7	5.9
Defense	3.8	2.8	2.0	2.0	2.8	2.8
Other federal spending ^j	6.2	4.3	2.9	2.4	6.1	5.8
Total primary spending	18.4	24.5	16.2	21.8	23.0	26.0
Interest spending ^k	1.5	2.0	2.0	2.0	2.0	2.0
Total spending	19.8	26.5	18.2	23.7	24.9	28.0

Note: See sources and notes to table 2-2 on page 41.

widens. The additional 2 percent of GDP shown in table 1 is premised on the optimistic assumption that the budget will be balanced over the coming decade. If balance is not achieved in this time frame, the gap will be still wider. Either way, Americans will have to choose whether they want to raise taxes enough to fill the gap between spending and revenues, drastically cut back on promises to the elderly, slash other activities of the federal government, or some combination of these approaches.

How does the gap between projected spending and the historical level of revenues translate into household incomes? In 2030, the average household will have an estimated mean income of \$96,000 a year (in today's dollars) or 43 percent more than the \$67,000 the average household had in 2005, assuming the economy grows at the rate projected by CBO. However, to pay for growing commitments to the elderly without decimating the rest of government or running large deficits, taxes would have to rise by more than 6 percentage points.⁴ The average household's federal tax bill in 2030 would have to increase by about \$7,000 relative to what it would have been with no growth in government. Fortunately, after-tax income would still rise from about \$53,000 in 2005 to about \$68,000 in 2030, or by 28 percent.⁵ In short, households would be devoting some of their increased affluence to paying for a larger government and to eliminating current deficits. Alternatively, of course, they could choose a smaller government and a bigger increase in household incomes. Other choices are described below and summarized in table 1.

Short- and Long-Run Budget Choices

Last year, in *Restoring Fiscal Sanity: How to Balance the Budget*, we illustrated three plans for achieving balance in the federal budget by 2014.⁶ One was a “smaller government plan,” which relied primarily on cuts in nondefense spending to achieve balance. One was a “larger government plan,” which kept most current government programs, added moderate amounts of spending for health care, child care, and other programs favored by progressives, and required substantial tax increases to get to balance. One was a “better government plan,” which reallocated federal spending, but kept it at about its current level. This plan achieved balance with less drastic spending cuts than the smaller government plan, and required a smaller revenue increase than the larger government plan. (Details can be found in last year’s volume and in chapter 2.)

This year, we have applied a similar approach to the far more daunting problem of long-run budget choices (see chapter 2 by Alice M. Rivlin and Isabel Sawhill). Our smaller government scenario extrapolates the spending cuts from last year’s volume out to 2030 and dramatically restructures the entitlement programs in a way that would require the elderly to pay for a much larger share of their own health and retirement expenses. The scenario assumes that most commercial and agricultural subsidies are eliminated; responsibility for education, housing, job training, the environment, and law enforcement is devolved to the states; real defense spending is kept below \$400 billion; Social Security is indexed to prices instead of wages; and the rate of growth in health care costs is held equal to the rate of growth in the economy. Under this scenario, it is possible to reduce the size of government and provide modest additional tax cuts.

Our larger government scenario maintains current commitments to the elderly, provides for a more robust defense, and invests an additional 1.5 percent of GDP in a set of programs favored by many progressives. These investments include providing subsidized health care and child care for low- and moderate-income families, more access to higher education, universal pre-kindergarten programs for all children under age five with sliding-scale fees, additional wage supplements for low-income working parents, more funding for teacher training and other primary education needs, flexible grants to states for a variety of local needs, and a big boost

in international aid to combat global poverty. However, investing in the future while simultaneously funding current promises to the elderly requires a hefty tax increase of 8 percentage points (from 18 to 26 percent of income).

Our two intermediate scenarios illustrate that holding tax increases to more moderate levels requires difficult choices. One scenario fulfills commitments to the elderly, but severely restricts other spending. The other scenario devotes resources to the kinds of investments contemplated in the larger government scenario, but still keeps tax burdens at a more reasonable level by restraining spending on the elderly. Options for achieving such restraint are presented in chapter 3 on Social Security and chapter 4 on health care.

Social Security

In chapter 3, Peter R. Orszag and John B. Shoven argue that there are no painless solutions to the projected imbalance in the Social Security system. Either benefits must be reduced or taxes increased. These two authors do not agree on the balance between the two choices or on the desirability of diverting some payroll tax revenues into private accounts. However, they agree that reforms should come sooner rather than later, that individual accounts will not by themselves solve the problem, that any reforms should be designed to increase national saving rather than rely on massive new borrowing by the federal government, that the elderly should be able to count on inflation-protected lifetime benefits that are not a dramatically reduced share of a worker's previous earnings, and that earnings for the most vulnerable (such as low-wage workers) should be protected. Orszag and Shoven present a menu of options for reform including increasing the retirement age, changing the benefit formula, and raising payroll taxes. Each of the authors favors a specific plan to achieve solvency and these plans are briefly described at the end of the chapter.

Health Care

Chapter 4, by Henry J. Aaron and Jack Meyer, provides more detail on the escalating cost of health care and the need to either curtail Medicare

and Medicaid benefits sharply or raise taxes. In their view, neither a more efficient health care system nor reductions in spending on other government programs can plausibly fill the fiscal gap created by the rising cost of care. Moreover, unless the nation were to adopt lower standards of care for the elderly and others dependent on public programs, any changes in public programs would have to be part of a larger agenda that would revamp the health care payment system as a whole.

The authors emphasize the importance of multiple policy changes to improve efficiency and slow the growth of health care spending. Such measures could include greater use of computers to dispense medications and maintain patient records, well-designed malpractice reform, and greater market incentives for individuals and providers to be more selective in the kinds of treatments they choose to use. In addition, reforms of Medicare and Medicaid have some potential to reduce federal health care outlays. As examples, the authors discuss reforms that raise the age of eligibility for Medicare, require recipients to pay higher premiums, and encourage people to buy private long-term care insurance instead of relying on Medicaid to pay for nursing-home care. However, Aaron and Meyer believe these and other reforms discussed in their chapter will take years to implement and are unlikely to slow cost growth significantly even if they temporarily reduce the level of spending.

Revenues

The long-term fiscal gap could be reduced if the public were willing to pay more taxes, but increasing the level of revenues would put additional strain on a tax system whose structure is far from ideal. In chapter 5, William G. Gale and C. Eugene Steuerle address both the structure of the tax system and the need to align revenues with whatever level of spending is chosen. They argue that the tax system should be simpler, fairer, less intrusive, and more conducive to economic growth and efficiency. Gale and Steuerle discuss a variety of options, including replacing the current system with a consumption-based tax such as a national retail sales tax or a value-added tax. They also discuss reforms to the current system such as broadening the tax base by eliminating various deductions and exclusions, increasing incentives to save, fixing the alternative minimum tax,

integrating corporate and individual taxes so that income is taxed only once, reducing the regressivity of the payroll tax, moving toward return-free filing, and providing the IRS with more resources for enforcement. All of these reforms are desirable regardless of the level of government spending, but tax burdens will obviously vary with the size of government. Under the smaller government scenario described in chapter 2, tax rates could be cut. But under all of the other scenarios, including those that trim spending, but are less draconian than the smaller government scenario, taxes would have to be raised. This could be achieved by allowing current tax cuts to expire, by aggressively reducing tax expenditures (deductions and exclusions), by introducing a value-added tax, or by pursuing some combination of these actions. For example, the larger government scenario could be paid for by introducing a 10 percent value-added tax, allowing the current tax cuts to expire, and closing a variety of tax loopholes.

The Opportunities These Budget Choices Create

Current public discussion of these challenges alternates between denial and alarm. Some of those in denial believe that faster economic growth will solve future budget problems painlessly. Others point out that projections are notoriously unreliable, and we can always hope for unexpected good fortune. Those who view the outlook with alarm, by contrast, sound as though the country were facing overwhelming disaster. They paint a picture so apocalyptic that solutions appear hopeless.

We believe both denial and panic are inappropriate and counterproductive. In the near term denial is risky, because sustained deficits will reduce the future income available to Americans and might precipitate a financial crisis. In the longer run denial is impossible. The aging population and the rising cost of medical care will certainly require changes in major federal entitlement programs or big increases in taxes or some combination of each. On the other hand, these challenges are not insurmountable. The United States is a rich, productive country with a flexible, adaptable economy. Moreover, the American population is not aging as fast as that

of other industrial countries, such as Germany or Japan. In the United States, birth rates are higher, immigration is larger, and workers retire later.

Rhetoric that suggests the sky is falling impedes thinking about constructive solutions to problems that are, in fact, manageable. Indeed, these fiscal challenges can provide a much needed opportunity for reexamining and restructuring basic systems that are urgently in need of reform. The federal budget covers many programs that, once enacted, rarely get seriously reviewed. Some federal spending programs have outlived their usefulness, no longer address high priority needs, or foster inefficient activities. The relationship between the federal government and the states is affected by the accumulation of past actions made under other circumstances and in response to priorities that may have changed. (Some approaches to rethinking the federal role are considered in chapter 2.) Retirement and pension programs, both public and private, were created in an era when the labor force was growing much faster than the number of retirees and may no longer be appropriately structured for an aging society. (Social Security reforms are discussed in chapter 3.) Similarly, the way health care is delivered and paid for in the United States is a complicated patchwork of public and private mechanisms that favors high-cost care, results in extremely uneven standards, and leaves millions without health insurance coverage. Americans spend a larger fraction of their national resources on health care than other industrial countries, but have inferior health outcomes. (Health care policy options are discussed in chapter 4.) The federal tax code is also riddled with provisions that have accumulated over the years as Congress responded to current priorities or to the pleas of interest groups for tax relief. The result is a tax system that reduces economic growth by distorting economic choices, treats taxpayers in similar circumstances differently, and is widely perceived as both unfair and inordinately complex. (Tax reform is addressed in chapter 5.)

In short, each of these systems is a messy, incoherent accumulation of past incremental policies that would greatly benefit from rethinking and restructuring. Whether the American political system can face up to this challenge is another matter. As emphasized by Isabel Sawhill and Ron Haskins in chapter 6, making progress on reducing deficits or on restructuring entitlements or taxes has always been difficult, and appears to be

especially difficult in the current political environment. Past agreements that have produced such progress, such as the Social Security reforms of 1983, the tax reforms of 1986, and the budget bills enacted in 1990, 1993, and 1997, have depended for success in varying degrees on presidential leadership, bipartisan support, a high degree of public concern, the use of outside commissions or other unorthodox processes to provide political cover for elected officials, and rules that have helped these officials to maintain fiscal discipline. Interviews conducted for this book with twenty Washington insiders from both parties, all of whom have participated in past negotiations on these fiscal matters, suggested two conclusions. The first is that without presidential leadership, an aroused public, and bipartisan support, major change is highly unlikely. The second is that the unwillingness of the majority party to put taxes on the table, or to cut spending in any major way, is impeding current progress. For these reasons, serious deficit reduction is unlikely to occur unless a perceived crisis forces the public and its representatives to rethink entrenched positions.

In our view, neither major party alone can resolve these challenges. Solutions will require ideological flexibility and a degree of bipartisan cooperation that has not been seen in recent years. For example, it is unrealistic to think the federal budget can be balanced either entirely by cutting spending or entirely by raising taxes. The necessary spending cuts would be unacceptable to many in both parties, and so would the necessary tax hikes. As in the 1990s, bringing currently projected deficits under control will require a series of bipartisan legislative packages involving a mix of spending cuts and revenue increases, reinforced by healthy growth in the economy. Similarly, reducing medical cost increases will entail increased reliance on market forces, which Republicans favor, combined with some government regulation (say, of pharmaceutical prices) more acceptable to Democrats. And if Republicans want to introduce private accounts into Social Security, they will have to give the Democrats something they want in return, such as allowing some current tax cuts to expire.

In the rest of this book we explore options for resolving the fiscal challenges facing Americans, and the opportunities for reform they present. Where we have preferences we do not hide them. Our main objective,

however, is to show that solutions are possible and to stimulate dialogue that can lead to workable, bipartisan solutions.

Notes

1. Three publications from non-partisan government sources were used as the basis for projections throughout the volume. “The Budget and Economic Outlook: Fiscal Years 2006 to 2015,” published by the Congressional Budget Office in January 2005, provided the initial baseline estimates for 2005 and the subsequent ten-year period. (The authors of this volume adjusted the CBO baseline based on likely changes to current law.) Another CBO report, “The Long-Term Outlook,” published in December 2003, was used as the basis for cost estimates for the four spending scenarios in 2030 that are found in chapter 2. The “2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds,” published in March 2004, provided many of the projections about Social Security’s financial status and also was used to estimate growth in Medicare costs due to changes in life expectancy.

2. Authors’ calculation based on the Congressional Budget Office’s 0.1 percent “rule of thumb” growth sensitivity analysis. See Congressional Budget Office, “The Budget and Economic Outlook: Fiscal Years 2006 to 2015,” January 2005, Appendix A.

3. Catherine L. Mann, “Managing Exchange Rates: Achievement of Global Re-balancing or Evidence of Global Co-dependency?” *Business Economics*, July 2004, 20–29.

4. Specifically, they would have to increase by 7.2 percentage points. The difference reflects the fact that GDP is about 20 percent higher than personal income. The primary reason for the difference is depreciation, which is a nontaxable expense to businesses.

5. At 18 percent of GDP, taxes are roughly \$14,000 per household ($0.18 \times 1.2 \times \$67,000$) and after-tax income is \$53,000, on average. By 2030, taxes would need to be about \$28,000 ($0.24 \times 1.2 \times \$96,000$) and after-tax income would be \$68,000 under the maintaining the social contract scenario. With no growth in government, taxes would need to be about \$21,000 ($0.18 \times 1.2 \times \$96,000$) in 2030 and after-tax income would be \$75,000.

6. Alice M. Rivlin and Isabel Sawhill, eds. *Restoring Fiscal Sanity: How to Balance the Budget* (Brookings, 2004).

