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Dimensions of the Budget Problem

RUDOLPH G. PENNER AND
ALICE M. RIVLIN

The nation is headed for a fiscal train wreck. Unless entitlement growth is curbed or tax burdens are raised to unprecedented levels, exploding deficits will threaten economic stability—probably within two decades. In the shorter run the deficit outlook is not as dire, but deficits are large enough to have a corrosive impact on economic growth. Moreover, it would be beneficial to keep the public debt as low as possible, to provide flexibility as budget problems grow in the future.

An aging population and rapidly rising medical costs will lead to budget problems in the future. Social Security, Medicare, and Medicaid will be most affected, and to the extent that their growth is left unchecked, other government programs may be squeezed out of the budget. In confronting this problem, Americans will be forced to make basic choices about what they want their federal government to do and how they want to pay for it. In the process, they will also have the opportunity to redesign some basic building blocks of public policy, such as the federal tax code, the health care payment system, and the division of responsibilities between the federal government and the states.

In this chapter we describe the dimensions of the budget dilemma facing the administration and Congress, both over the next decade and over the longer run. We explain the risks posed by escalating deficits and the benefits of addressing budget issues sooner rather than later. We argue that the budget choices facing Americans are manageable, especially if the country acts quickly, but hard choices are inescapable. Over the next several decades, the fundamental question is how Americans will react to growing budgetary pressures. Will they choose to maintain the benefits promised to the elderly without cutting other activities of the federal government significantly? If so, will they be willing to pay commensurately higher taxes? Or will they pare back benefits for older people and shift more responsibilities onto the states and the private sector, in order to avoid higher taxes at the federal level? These options are explored in greater detail in subsequent chapters.

The Budget Outlook: The Next Ten Years

Although the future is always uncertain and all projections are hazardous, any informed discussion of budget choices must start with projections of what is likely to happen to the budget if current policies are continued. Our starting point is the most recent baseline projection of the Congressional Budget Office (CBO). That baseline is too optimistic, however, because the CBO is forced by law to assume that discretionary spending is frozen in real terms and that current tax law is extended. Current tax law implies, among other things, that recent tax cuts will be allowed to expire. We therefore used an “adjusted” baseline that assumes that nondefense real discretionary spending grows with the population; that defense spending is consistent with continued outlays on Iraq, Afghanistan, and the war on terrorism; and that the tax cuts now in place will be extended—as strongly recommended by President Bush (table 1-1). The adjusted baseline also assumes that the alternative minimum tax will not be allowed to affect a rapidly growing proportion of income taxpayers.¹

As may be seen in figure 1-1, the official CBO baseline shows the deficit declining from \$412 billion (3.6 percent of gross domestic product)

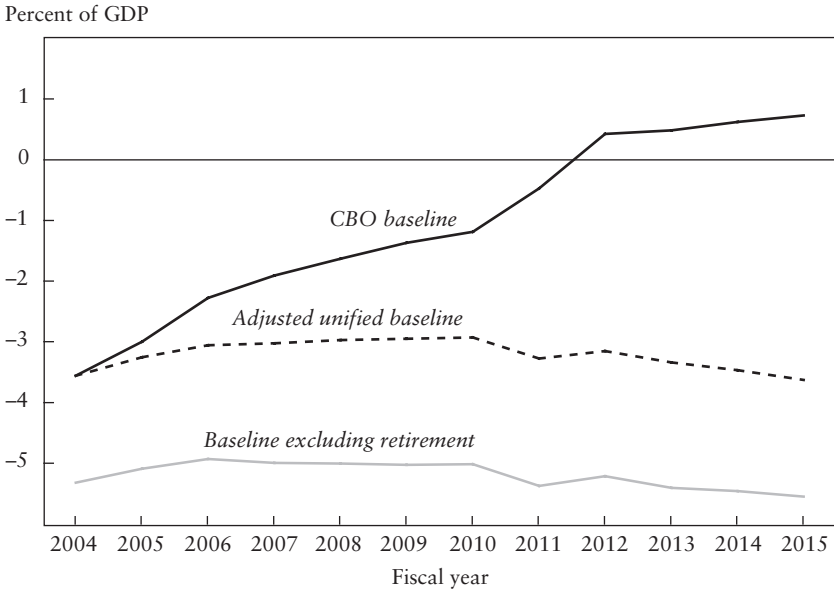
Table 1-1. CBO Baseline and Adjusted Baseline, 2004–15^a

Item	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
<i>CBO baseline</i>												
Spending												
Defense	454	464	438	435	447	457	468	484	488	504	516	529
Appropriated	441	466	476	485	493	502	511	523	534	546	559	572
Mandatory	1,237	1,317	1,380	1,450	1,529	1,620	1,713	1,824	1,896	2,028	2,159	2,303
Subtotal (excluding interest)	2,132	2,248	2,294	2,369	2,469	2,580	2,693	2,830	2,918	3,078	3,234	3,403
Net interest	160	178	213	249	274	289	303	311	314	311	308	303
Total	2,292	2,425	2,507	2,618	2,743	2,869	2,996	3,142	3,232	3,389	3,542	3,706
Revenue	1,880	2,057	2,212	2,357	2,508	2,662	2,806	3,062	3,303	3,474	3,657	3,847
Deficit or surplus	-412	-368	-295	-261	-235	-207	-189	-80	71	85	115	141
<i>Adjusted baseline</i>												
Spending												
Defense	454	494	512	518	536	554	572	594	605	629	650	672
Appropriated	441	466	481	494	507	520	534	551	568	586	604	623
Mandatory	1,237	1,317	1,380	1,450	1,529	1,620	1,713	1,824	1,896	2,028	2,159	2,303
Subtotal (excluding interest)	2,132	2,278	2,373	2,461	2,572	2,694	2,819	2,969	3,069	3,243	3,413	3,597
Net	160	178	216	259	292	319	345	372	401	431	464	499
Total	2,292	2,456	2,589	2,720	2,864	3,013	3,164	3,341	3,470	3,674	3,877	4,096
Revenue	1,880	2,056	2,194	2,307	2,438	2,568	2,701	2,799	2,925	3,070	3,222	3,381
Deficit or surplus	-412	-399	-395	-413	-427	-445	-463	-542	-545	-604	-655	-715

Source: Authors' calculations; Congressional Budget Office (CBO), "The Budget and Economic Outlook: Fiscal Years 2006 to 2015" (Washington, January 2005); and William G. Gale and Peter R. Orszag, "The Outlook for Fiscal Policy," *Tax Notes*, February 14, 2005, pp. 841–54.

a. The adjusted baseline modifies the CBO baseline to extend expiring tax provisions, adjust the alternative minimum tax, and keep per capita discretionary spending constant, and includes supplementary spending on Iraq, Afghanistan, and the war on terrorism derived by inflating the CBO's estimated peak cost by inflation and population growth.

Figure 1-1. *Baseline and Adjusted Outcomes as a Percentage of GDP, 2004–15*



Source: CBO, “The Budget and Economic Outlook: Fiscal Years 2006 to 2015.”

in fiscal year 2004 and turning into a surplus of \$141 billion by fiscal year 2015. However, the adjusted baseline makes the deficit picture look far less rosy. The difference is primarily due to the assumed extension of the large tax cuts enacted in 2001 and 2003. In the adjusted budget, the unified deficit (including Social Security and Medicare) declines in dollar terms early in the period, but rises again toward the end of the period because of the extended tax cuts. The estimated unified budget deficit for 2015 is \$715 billion, or about 3.6 percent of GDP in that year. In other words, the unified deficit in the adjusted baseline is about the same size in relation to the economy in 2015 as in 2004. Moreover, the unified budget projections give a misleadingly optimistic view of the deficit over the next decade, because temporary surpluses in the Social Security and Medicare trust funds offset the deficits in the rest of the budget. If these temporary surpluses in the retirement programs were pulled out of the

budget, the deficit in 2015 would rise to \$1,093 billion, or about 5.6 percent of GDP.

President Bush's budget recommendations for fiscal 2006 show much lower deficits in the short and medium term than those in our alternative baseline. He proposes severe restraints on domestic discretionary spending, similar to those he recommended for 2005 for all domestic spending outside homeland security. For that year, Congress pretty much accepted his recommendations for total domestic spending; if it does so again for 2006 and there are no domestic supplemental appropriations, the discretionary spending path will be somewhat lower than is assumed in our alternative scenario. The president would also like to reform the alternative minimum tax in a way that is "revenue neutral," although revenue neutrality has not been precisely defined.

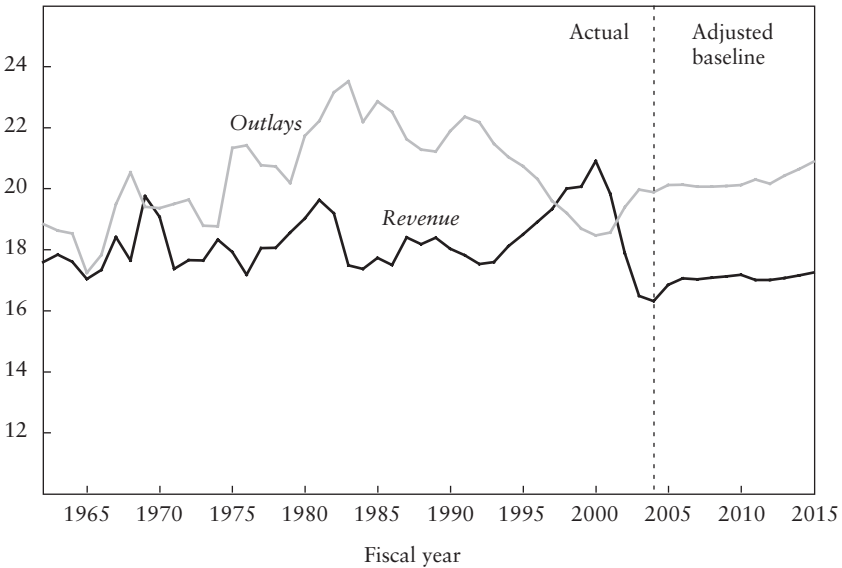
In addition to the proposals contained in his budget, the president has proposed a reform of Social Security that would divert payroll taxes into personal accounts. Although much of this diversion would have to be paid back by the account holder over the very long run, it would significantly increase the unified budget deficit for several decades.

It is not clear how successful the president will be in pursuing his budget and Social Security goals, and it is even more uncertain what will happen once he leaves office. If the president fails to sell his Social Security reform but is even moderately successful in convincing Congress to implement his spending reductions, the deficit is likely to be lower than in our alternative path. Nevertheless, if the tax cuts are extended, our alternative path is still likely to be closer to reality than is the CBO baseline. The economic and technical assumptions underlying both paths could, of course, turn out to be wrong in either direction.

Current deficits, and those projected for the coming decade, do not reflect historically high rates of federal spending. As may be seen in figure 1-2, federal spending has varied over the years, but has averaged about 20 percent of GDP, approximately its current share. Federal revenues have also varied, averaging about 18 percent of GDP.² As the result of tax cuts and the end of the stock market boom of the 1990s, revenues had fallen to 16.3 percent of GDP for 2004—the lowest share since 1959—and they are not expected to rise appreciably faster than the economy over the decade.

Figure 1-2. *Total Revenue and Outlays as a Percentage of GDP, 1962–2015*

Percent of GDP



Source: See figure 1-1.

Short-Run Risks to Economic Growth and Stability

Although deficits helped to stimulate the economy as it recovered from the recession that began in 2001, there is strong consensus among economists that large continuing deficits are inappropriate when, as now, the economy is growing at a healthy clip and approaching full employment. There is considerable controversy, however, about whether deficits of the range projected for the coming decade should be a major cause for alarm. The question is whether the damage such deficits might do in the next few years is worth the pain inherent in closing them by raising taxes and reducing spending.

Those who are most concerned about deficits—including the authors of this chapter—focus on the facts that federal deficits reduce national

saving, make the United States increasingly dependent on the willingness of foreigners to hold increasing quantities of U.S. Treasury bonds, and load the cost of current federal spending onto future taxpayers. Private saving in the United States has declined over a long period and is considerably lower than that in most industrial countries. When private domestic saving is low, large scale increases in public debt certainly put some upward pressure on interest rates. It may not take a very large increase in interest rates to discourage investment or make housing more expensive. But focusing on the interest rate effect misses the most important impact of deficits. Whatever the effect on interest rates, deficits will reduce national wealth in the long run by absorbing scarce private saving and increase our liabilities to foreigners by sucking in foreign investment. Lower national wealth implies lower investment in new factories and equipment, which in turn slows productivity growth and reduces future standards of living. A higher foreign debt implies that more of our national product has to be devoted to servicing that debt. And a higher domestic public debt implies that government has to devote more of its tax revenues to paying interest on government bonds and has less revenue left to pay for public services.

In recent years, the willingness of public and private investors to buy and hold large quantities of American securities has allowed the American economy to live beyond its means. Even through the 2001 recession and its aftermath, huge amounts of money have flowed into the United States to finance both private investment and public borrowing. In particular, Asian central banks have chosen to hold large fractions of their growing reserves in U.S. Treasury bonds. Part of their motivation has been to protect their own countries' exports by preventing the appreciation of their currencies with respect to the dollar. The big uncertainty now is how long the rest of the world, especially Asian central banks, will continue to be willing to buy the U.S. Treasury bonds that finance our federal deficit. Recent declines in the value of the dollar, especially with respect to the euro and the pound, suggest that foreign investors, including Asian central banks, may be becoming less sanguine about holding increasing quantities of dollar-denominated assets.

Those who argue that projected deficits are manageable point out that the recovering U.S. economy is still an attractive place for global investors

to put money, and U.S. Treasuries continue to be rated the safest securities in the world. They regard the recent decline of the dollar as a normal correction that will stimulate U.S. exports, control imports, and reduce the current account deficit, not a danger sign for the future.

However, there is no denying that the continuous U.S. government borrowing of more than 3 percent of GDP to finance current federal spending makes the United States vulnerable to changes in perceptions of U.S. fiscal responsibility and of the future value of the dollar. If those perceptions turn negative, they could become self-fulfilling. Currency markets often overshoot. A sharp plunge in the value of the dollar could trigger a flight from dollar securities (including U.S. Treasuries), a spike in interest rates, and possibly a serious recession. Even if the chance of such a financial meltdown is low, it is foolish to take the risk. It is especially foolish when known demographic pressures dictate that the need to attract foreign capital to finance U.S. deficits will grow, not diminish, after the end of the ten-year window.

In sum, while the United States might be able to continue running deficits in the projected range (between 3 and 4 percent of GDP) for some years without financial catastrophe, no one can be sure. Such a policy makes us vulnerable to the whims of international investors and passes the burden of paying for current government services to future federal taxpayers, whose burdens will also be increased by the aging of the population and rising medical costs.

Demography, Health Costs, and the Budget

Domestic federal spending is, in large part, driven by demographics. Almost one-half of nondefense spending outside interest goes to people aged sixty-five and over.³ Social Security and Medicare are the most important elderly programs, by far. (They also serve the disabled, and Social Security provides for survivors.) Nevertheless, heavy spending on the aged can be found throughout the budget—in long-term care expenditures by Medicaid, in civilian and military retirement programs, and in welfare programs such as Supplementary Security Income. Thus the aging of the population combined with soaring health costs will create severe

budget pressures for the foreseeable future. Although this issue is often associated with the aging of the baby boom generation, whose members will begin applying for Social Security in 2008, continued increases in life expectancy are quantitatively more important in the very long run. The impact of aging on the budget will not disappear when the last baby boomer passes from the scene.

The average age of the population is also increasing because the number of young people is growing so slowly. The baby boomers did not produce enough potential taxpayers to support them well in their old age, and the immigration of younger workers, while growing rapidly, has not increased enough to make up the labor force shortfall. The growth in the number of retirees would not present a serious problem were it not for the slowing growth of the labor force. Of course, only a budget wonk would emphasize the bad news in all this. The really good news is that more and more people are leading longer and healthier lives.

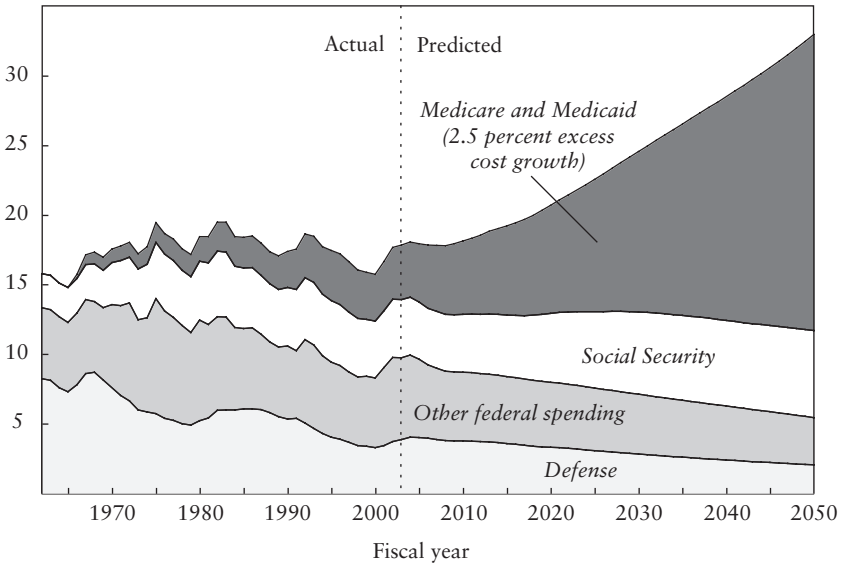
Long-Run Budget Scenarios

The fact that such a large share of federal spending is devoted to programs for the elderly, especially the health care of the elderly, guarantees enormous upward pressure on federal spending over the next several decades. Long-run spending scenarios published by the Congressional Budget Office in 2003 dramatize this point. In its most pessimistic scenario, the CBO assumes that per capita medical care costs will rise 2.5 percent faster a year than GDP over the foreseeable future. This is the rate of excess growth experienced over the period 1960–2001. Under this assumption, spending for Social Security, Medicare, and Medicaid would rise from about 8 percent of GDP at present to 11 percent in 2015 and 17 percent in 2030.

As shown by figure 1-3, spending for Medicare and Medicaid dominates federal spending projections. Projected increases in Social Security spending seem relatively minor in comparison. Even if the Social Security benefits promised in current law are paid over the whole period, Social Security outlays are only expected to rise from 4 percent to 6 percent of GDP between 2005 and 2030. In fact, between 2030 and 2050, Social

Figure 1-3. *Historical and Projected Components of Federal Spending, 1962–2050*

Percent of GDP

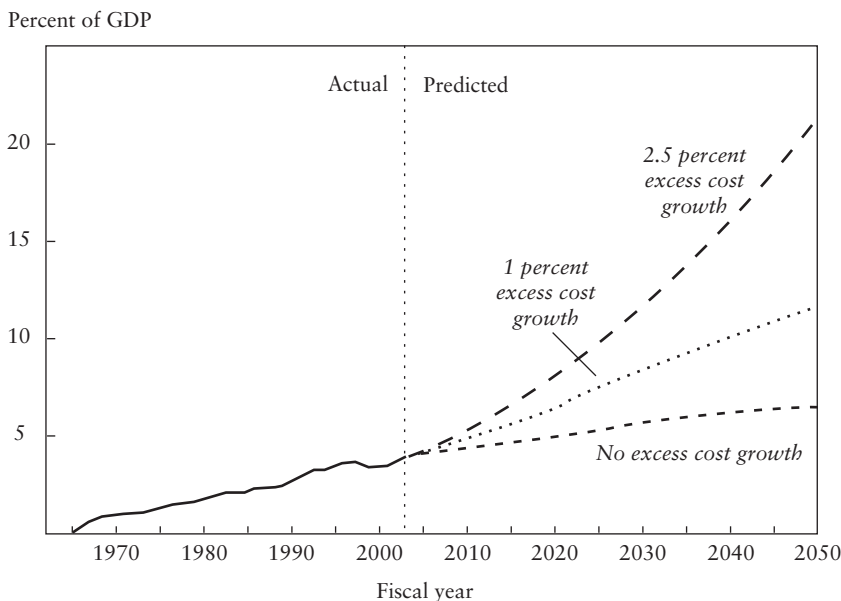


Source: CBO, “The Long-Term Budget Outlook” (Washington, December 2003).

Security outlays come close to stabilizing relative to GDP, rising only about 0.4 percent of GDP over those two decades.

The assumption that excess health cost growth exceeds 2.5 percent a year is more pessimistic than that used by the trustees of the Medicare system. They assume that excess growth eventually slows to 1 percent per year. This assumption is, however, based more on a hope than a promise. There is no indication that health cost growth will slow in the future, except that health costs will take up an implausibly large share of the GDP if there is no deceleration. As shown in the figure 1-4, the difference in assumptions has a large impact on long-run budget projections. With 2.5 percent excess growth, Medicare and Medicaid spending will absorb 11.5 percent of the GDP by 2030. With 1 percent excess growth, “only” 8.4 percent of GDP will be absorbed. This result dramatizes the crucial importance of making an extraordinary effort to reduce the historic rate of health care spending increase (see chapter 4).

Figure 1-4. Total Federal Spending for Medicare and Medicaid under Different Excess Cost Growth Assumptions



Source: See figure 1-3.

The CBO projects that the rest of federal spending (that is, total federal spending less Medicare, Medicaid, and Social Security) will actually decline as a share of GDP over the next several decades. Indeed, even in its highest spending scenario, the rest of federal spending (excluding interest) declines from 10.0 percent of GDP in 2003 to 8.2 percent in 2030 and 7.5 percent in 2050.⁴ The decline occurs primarily because defense spending is assumed to stabilize eventually at a constant real level. One wonders whether a constant real level of defense spending is plausible, given that it would most probably imply a gradual decline in force levels, which may not prove feasible unless the world becomes substantially less threatening in the future.

Combining the CBO's long-run spending scenarios with assumptions about future revenues illustrates the magnitude of the fiscal train wreck implicit in the combination of aging and rapidly growing health costs. Suppose that the overall tax burden is allowed to drift upward until it

reaches the average of the last thirty years—18.4 percent of GDP. When this revenue assumption is combined with the CBO's most pessimistic spending path (the one that assumes that excess health spending will remain at its historic rate of 2.5 percent above GDP), deficits skyrocket and the nation's public debt grows at an accelerating rate. The implied ratio of debt to GDP, 37 percent in 2004, reaches 100 percent by 2027. Even when excess spending is restrained to 1 percent above GDP growth, the debt still grows at an accelerating rate and it reaches 100 percent of GDP by 2037. A debt explosion is avoided only when there is assumed to be no excess health cost growth. Given past history, it is hard to imagine this outcome without a radical reform of our entire health care system.

In a debt explosion, much of the problem is caused by the interest charges required to service projected debt. As debt starts to grow rapidly, interest charges grow faster than annual revenues. There is a powerful compounding effect as the government is forced to borrow more to cover a growing interest bill, and that in turn causes the interest bill to grow at an ever faster rate. The various CBO scenarios illustrate that the timing of the consequent debt explosion is sensitive to relatively small changes in spending and tax assumptions. Nevertheless, a calamity occurs in all cases. It is like the difference between falling off a twenty- and a sixty-story building: the end result is the same, even though it takes longer to get there if the building is taller. It is important to emphasize that absent reform, a financial collapse is likely to occur long before the Social Security trust fund is expected to be unable to pay current benefits (around 2042). In other words, we face an overall budget problem, not just a trust fund problem.

Dealing with Past Entitlement Growth

In reflecting on the challenges involved in dealing with a 6 to 9 percent increase in the cost of Social Security, Medicare, and Medicaid relative to GDP by 2030, it is useful to look back over the past fifty years and ask how growth in these programs was dealt with previously. Fifty years ago, Medicare and Medicaid had not been invented and Social Security outlays absorbed only a tiny portion of GDP. Now, the three programs absorb

over 8 percent of GDP. However we dealt with this growth, it did not seem too painful. Can't we do the same thing again?

We did not deal with past growth by raising taxes. Indeed, the 2004 tax burden, at 16.3 percent of GDP, is almost identical to that in 1951. More generally, the tax burden has been remarkably constant, with significant tax cuts following whenever the tax burden has crept above 19 percent of GDP. It is more difficult to say how much of the burden was financed by an upward trend in the budget deficit, because the deficit tends to be highly erratic. However, the deficit today is less than 4 percent of GDP, and though they were smaller than today's, deficits were not unknown in the 1950s. Therefore, it would be hard to argue that as much of one-half of the growth was financed by the deficit's upward trend.⁵

By far the most important source of financing for the growth in Social Security, Medicare, and Medicaid has been a secular downward trend in defense spending. Defense accounted for about 10 percent of GDP after the Korean War; today it is only about 4 percent of GDP, despite wars in Iraq and Afghanistan. In the CBO's scenarios the decline continues, but even this projected decline, which we suspect is highly optimistic, is not nearly sufficient to finance future growth in spending for the elderly.

The overwhelming conclusion is that the United States cannot deal with future budget pressures using past practices. The alternatives are clear: tax burdens will have to be raised far beyond the levels experienced in the past (and that will probably require a substantial tax reform); or programs for the elderly and other health programs will have to be radically reformed; or the rest of government will have to be squeezed to almost nothing; or deficits will reach intolerable levels.

The Response of Financial Markets

Should the budget follow any of the disaster scenarios just described, it is interesting to ask when international financial markets would become alarmed. Would they wait until a debt explosion was under way, or would they be impressed when an explosion began to show up in the CBO's ten-year budget projections? If the latter, financial markets could become unstable in the next decade. But there are already many projections of a

debt explosion. Why are financial markets so sanguine, and why is U.S. sovereign debt given the highest possible rating by debt rating services?

There are two possible explanations. Either investors have great confidence in the United States' ability to reform, or they do not believe the projections.⁶ The latter would not be surprising, since five-year estimates of the budget imbalance implied by constant policies have an average error of over 3 percent of GDP—almost \$450 billion at 2009 levels of GDP. One can see why markets may be skeptical about twenty-five-year forecasts when economists have grave difficulty getting it right for much shorter periods. But our fear of a financial calamity is based to a considerable degree on demographic projections that are unlikely to be wildly wrong—certainly not wrong enough to obviate the conclusion that the present situation is unsustainable.

The Accuracy of Long-Run Projections

In fact, long-run forecasts of Social Security spending tend to be highly accurate. Social Security policies have been quite stable over the past twenty years, and almost all the people that will be drawing benefits over the next thirty years have already been born. The annual forecasts for the benefit-to-GDP ratio in 2000 made by the Social Security trustees from 1985 varied over a range of less than 0.7 percent of GDP. One reason that estimates of benefits relative to GDP are so accurate is that initial benefits are indexed to wages. Hence, overestimates of GDP growth tend to be accompanied by overestimates of benefit growth, and underestimates of GDP growth by underestimates of wages.

Admittedly, forecasts of health costs are much less accurate, and errors in this area are often a major source of error in short-run forecasts of the budget balance. But although the health cost forecasts used in the above analysis may be quite wrong, it is less likely that they err on the side of pessimism. The most pessimistic spending path assumes that excess cost growth will equal the average over the previous forty years. There is no reason to think that the rate of innovation and technical change in health care has slowed. It is very difficult to argue that the assumed spending

paths are overly gloomy, especially when the health cost assumptions are combined with the CBO's modest path for defense spending.

False Promises

Although the vast majority of budget analysts agree that current budget policy is unsustainable, there are a few dissenters who would argue that our analysis is far too pessimistic. For example, some argue that the U.S. economy can grow its way out of the problem if marginal tax rates are kept low and regulation unobtrusive. We do not think that this is a plausible argument. While there is no doubt that good tax and regulatory policies can enhance growth, the effects would have to be unbelievably large to solve the problem. Increased growth would reduce the Social Security problem only marginally. The problem is that initial benefits are indexed to wages. Faster wage growth causes faster benefit growth, and so the promises become more expensive as the economy grows more quickly. Faster growth helps a little, in that the benefit computation is not indexed to wage growth after age sixty, and benefits grow only at the rate of price increases after retirement. But it is impossible to imagine growth fast enough to completely solve the Social Security problem.

The relationship between economic growth and the Medicare and Medicaid problem is somewhat more complex, but no more reassuring. We believe that faster growth would increase the demand for health services because the standard of living would increase. Increased demand is likely to increase excess cost growth, not reduce it.

Other observers have suggested that the answer lies in increased immigration. There is no doubt that immigrants play an important beneficial role in the U.S. economy. Without immigration and high birth rates among recent immigrants, the labor force would be declining in the long run and the country's demographic problems would begin to resemble the much more severe problems faced by Europe and Japan. But immigrants grow old, too. Unless immigration constantly grows relative to the size of the labor force—and we find this politically implausible—it cannot help much in the very long run.

The Importance of Acting Quickly

There are three major reasons for acting quickly. First, necessary benefit reductions can be phased in more gradually, thus providing an early warning for those approaching retirement. Future retirees can then plan to save more or work longer. The increase in the full retirement age implemented for Social Security in 1983 was a model for providing ample warning. It was phased in so slowly that it did not affect anyone over the age of forty-five. If future benefit reductions are to play a significant role in stabilizing the long-run fiscal outlook, they will have to start relatively soon. Unfortunately, it is already too late to provide the seventeen-year warning contained in the 1983 reform.

If action is taken early, it is also easier to maintain the average real Social Security benefit enjoyed when the reform is implemented. The decision to index initial benefits to wages in the late 1970s reflected the philosophy that benefit growth should keep pace with wage growth, that is to say, the replacement rate for retirees should be kept constant automatically. As a result, current law implies almost a 40 percent increase in the average real benefit between 2003 and 2030. But today's payroll tax structure, together with today's surplus, are sufficient to finance an increase of about 8 percent in the average real Social Security benefit between 2003 and 2030.

The political debate is really about how much to let the replacement rate erode over time. Advocates of the current system want relatively minor reductions, whereas others would let the replacement rate erode substantially, perhaps replacing traditional benefits with individual accounts (see chapter 3 for an elaboration of this debate). Abstracting from the controversial issue of individual accounts, a political debate over how much to raise benefits as living standards increase should be much less painful than a debate over how much to cut real benefits. Unfortunately, there is not much time left to talk. Average real benefits are being increased every year, and the financial condition of the system is growing worse. If we wait until after 2010 to reform, it will no longer be possible to maintain real benefits through 2030 without raising payroll taxes.

A third reason for acting quickly is to reduce the level of the national debt. With a lower debt, the burden imposed by interest costs can be lowered substantially, because interest cost savings compound quickly. If the growth rate of revenues were increased by 0.1 percent a year starting in 2004, the revenue increase in 2015 would be \$35 billion, but all else equal, the indirect interest saving would be \$10 billion that year. In other words, the indirect interest effect, or “bonus,” amounts to 28 percent of the direct effect of the tax increase.⁷

Lower deficits would also bring a higher rate of economic growth. But the benefits of growth are not so straightforward. We have already noted that faster economic growth does not much reduce the burden imposed by Social Security, Medicare, and Medicaid. Still, one might expect people to be less resistant to tax increases and cuts in promised benefits as living standards rise. Unfortunately, history shows no sign of that. As already noted, federal tax burdens have remained remarkably constant since World War II as living standards have soared. And while Social Security benefit growth was cut in 1977 and in 1983, it was because the system was under financial duress, not because people were willing to give up benefits as living standards rose.⁸ Indeed, Congress and the president have just added massively to the generosity of Medicare by passing a prescription drug program in 2003.

Conclusions

The budget numbers are bleak. Few deny that current fiscal policies are unsustainable. Yet, reform should not be as hard as it seems to be. As budget problems grow, society will be becoming ever more affluent. The debate will be about how to use that growing affluence, not about how to impoverish either the elderly or nonelderly population. Some may not wish to tolerate significantly higher taxes to support the most affluent portions of the population in ever longer retirements. Others may feel that considerably higher tax burdens are justified to maintain something close to the present system. There is much room for compromise between these extreme positions. However, one cannot argue that Americans can

maintain today's benefit structure while continuing to enjoy tax burdens lower than the average of the last thirty years.

Notes

1. Our adjusted baseline is based on the analysis of William Gale and Peter Orszag, modified to include continued defense spending on Iraq, Afghanistan, and the war on terror (see table 1-1). William G. Gale and Peter R. Orszag. "The Outlook for Fiscal Policy," *Tax Notes*, February 14, 2005, pp. 841–54.

2. Congressional Budget Office averages 1962 to 2004. CBO, "The Budget and Economic Outlook: Fiscal Years 2006 to 2015" (Washington, January 2005), historical tables F-2.

3. CBO, *Federal Spending on the Elderly and Children* (Washington, June 2000).

4. Calculations exclude Medicare offsets from "the rest of government" percentages.

5. Rudolph G. Penner, *Errors in Budget Forecasting* (Washington: Urban Institute, 2001).

6. Sentiments about the ability to reform can be found in reports on the credit-worthiness of the U.S. government. For more details, see Rudolph G. Penner, "The Financial Consequences of Fiscal Paralysis," *National Budget Issues 2* (Washington: Urban Institute, June 2004).

7. Calculations are based on the adjusted baseline in table 1-1.

8. In 1983 the Social Security trust fund had no more assets. In 1977 the system was not in as much trouble; that year's reform corrected a flaw in indexing that caused benefits to rise faster than intended as inflation rose. Left uncorrected, it would have created severe financial problems in a very few years.