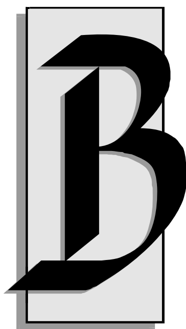

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BROOKINGS WORKING PAPER*

ARTICULATING A POLICY FRAMEWORK FOR LONG-TERM FEDERAL ENTITLEMENT REFORM

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July 2005

Introduction: The Near-Term Fiscal Outlook

President Bush's top first-term objectives -- in the aftermath of the 9/11 terrorist attacks -- were waging and winning the global war on terror, significantly enhancing our homeland security systems, and strengthening economic growth.[1] With sluggish economic growth following the 2001 recession persisting in 2002 and 2003 – due, in part, to the revelation of several corporate governance scandals and the aftermath of technology stock "bubble burst" – the President placed a high premium on tax relief proposals aimed at accelerating the pace of short and long-term economic growth. In this context, it is not at all surprising that large federal budget deficits emerged.

In the aftermath of the 2004 U.S. elections, however, reducing the federal budget deficit in the coming years has become a major issue for the President and Congress.

President Bush has pledged to cut the deficit in half over the period 2004 to 2009 as a percentage of gross domestic product (GDP), and the President's 2006 budget request to Congress includes significant restraint in annual appropriations for non-defense and non-homeland security domestic programs, as well as selected reforms in certain mandatory spending programs, including agriculture price supports, student loans subsidies, and Medicaid.

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A renewed emphasis on near-term budget deficit reduction is clearly necessary and appropriate. In 2004, the federal budget deficit hit $412 billion, or 3.6 percent of GDP, following deficits of $158 billion in 2002 and $378 billion in 2003.[2] Just a few short years after the federal government ran four successive annual budget surpluses, the Congressional Budget Office (CBO) is now projecting sustained deficits for the foreseeable future. CBO's March 2005 baseline projections indicate deficits totaling nearly $1 trillion over the period 2006 to 2015, but that estimate would be much higher if the baseline did not assume termination of costs for the military operations in Afghanistan and Iraq beyond 2005, expiration of the 2001 and 2003 tax reduction provisions, and a revenue gain from Alternative Minimum Taxes (AMT) in the outyears.[3] Using plausible assumptions, the ten-year deficit could easily exceed $3 trillion.

And yet, cutting the deficit in half by 2009 is well within reach if Congress follows the Bush Administration's budget. CBO estimates that the President's budgetary policies will cut the deficit to $246 billion in 2009, or 1.6 percent of GDP, well below half of the 3.6 percent of GDP deficit in 2004.[4] Critics have correctly noted that, if military operations in Iraq in 2009 are as expensive as they are in 2005, it will be difficult for the President to meet the goal of cutting the deficit in half. But making an assumption today regarding the costs of military operations in four years seems speculative at best. Others have suggested that repeal of the AMT – a widely criticized tax – will reduce revenue by some $400 billion over ten years, again jeopardizing the deficit cutting goal.[5] But the Administration does not concede that total revenues will be reduced further in an inevitable legislative effort to rationalize the AMT. Instead, the Administration proposes folding an AMT "fix" into the larger, revenue-neutral tax reform and simplification effort the President has launched.[6]

Although the President's top priorities have not changed and the fight against terrorism remains intense, the economic situation is now much more conducive to a renewed emphasis on spending discipline and deficit reduction. The Labor Department has reported that the U.S. economy produced 1.7 million new jobs in 2004, and consensus economic growth forecasts point toward relatively strong growth in 2005 and 2006.[7] [8] With the balance of leading economic opinion now indicating that the U.S. is more clearly out of the woods of continued sluggish growth, it is time for U.S. policymakers to again make near-term deficit reduction a top priority.

Beyond the macroeconomic arguments for a more balanced fiscal policy, U.S. policymakers need to pursue deficit reduction simply to make our government more adaptable to changing circumstances and to provide some fiscal "margin of error". As the nation discovered after 9/11, a major incident -- terrorist or otherwise -- can have far reaching consequences for the U.S. economy and for the federal budget. As fiscal policy stands today, the nation's budgetary commitments already far exceed projected revenue, making it difficult to absorb unexpected new spending requirements or another substantial economic shock that might slow revenue growth.

Fiscal Policy Focus Should Be on Long-Term Entitlement Reform

Important as it is for the President and Congress to pursue near-term deficit reduction, it is even more important for policymakers to focus, finally, on the coming long-term imbalance in the federal budget and the steps necessary to begin closing the immense gap associated with unfinanced entitlement spending. As Douglas Holtz-Eakin, Director of the Congressional Budget Office, recently put it, "These are the good times…Things will get much tougher."[9]

In fact, one could make the case that growing entitlement spending is already producing distortions in federal spending decisions. As shown in Table 1, mandatory spending – mainly entitlement spending for Social Security, Medicare and Medicaid – has increased from 6.1 percent of GDP in 1962 to 11.6 percent of GDP in 2004. At the same time, discretionary appropriations – spending approved annually by the Appropriations Committees in Congress – has fallen from 12.7 percent of GDP in 1962 to 7.7 percent in 2004. Yet, there is little Congress or the President can do to change the basic trajectory of mandatory spending in the near term, both for political and policy reasons. And so, as more and more resources are spent automatically on Social Security, Medicare, Medicaid, and other entitlements, the President and Congress have focused nearly all of their attention for spending discipline and deficit reduction on domestic discretionary spending -- the part of the budget that is most under control and already shrinking as a percentage of GDP over time.[10] For the Bush Administration, because of the on-going fight against terrorism, the focus for spending discipline has been concentrated on an even smaller slice of the pie – namely non-homeland security domestic appropriations spending, which totaled only $420 billion in 2004, or 18 percent of total federal spending.[11]

Table 1

Federal Spending Shift from 1962 to 2004

	% of GDP	
	1962	2004
Discretionary	12.7	7.7
Mandatory	6.1	11.6

Source: Congressional Budget Office, The Budget and Economic Outlook: Fiscal Years 2006 to 2015, January 2005, Historical Tables

But today's budget pressures are minor compared to what is coming, as entitlement spending is poised to accelerate substantially between now and 2030. The projected growth in entitlement spending can be attributed to two basic factors:

demographic shifts and the relentless growth in federal, and private, health spending per capita above income growth.

Penner and Steuerle explain that the coming dramatic demographic shift has essentially two sources.[12] First, life expectancy for persons at age 65 has increased dramatically. For males, life expectancy at 65 increased by 3.9 years from 1940 to 2000; for females it increased by 5.5 years. Second, the fertility rate fell precipitously in a very short period of time, from an average of 3.6 births per woman during childbearing years in 1960 to 1.77 in 1975.[13] This followed the relatively high birth rate years during the post-war baby boom.

These demographic shifts have been reflected in Social Security and Medicare actuarial projections for many years now. According to official actuarial projections, the number of people over age 65 was 35.4 million in 2000 but that number will grow to 80.8 million in 2050 using intermediate assumptions. This, in turn, will lead to an increase in the aged dependency ratio (the ratio of the number of people over age 65 to the number between ages 20 to 64) from .208 in 2000 to .381 in 2050.[14]

Adding substantial "fuel to the fire" of this coming demographic shift is the rapid per capita health care cost increases reflected in the Medicare and Medicaid programs. The CBO articulated the useful concept of "excessive cost growth" in Medicare and Medicaid as the average annual percentage point growth in Medicare or Medicaid per capita spending above the growth rate in per capita GDP. For Medicare, CBO estimated the excessive cost growth since 1970 has been 3.0 percentage points; for Medicaid, it has been 2.7 percentage points since 1975.[15]

In recent years, as more analysts have examined the coming trends in entitlement spending, useful constructs have been cited more frequently in efforts to summarize the size of the fiscal problem policymakers face. These constructs aim to bring forward information that the current budget process – with a five or ten-year budget window – does not adequately highlight. For instance, in recent years the annual reports of the Social Security and Medicare trustees have included estimates that can be used to calculate the "unfunded liabilities" of these programs. The "unfunded liability" of a federal program can be measured in several ways, depending on the time horizon assessed and the cohorts of workers and beneficiaries which are included in the present value calculations for taxes and benefits. Under one approach, all benefit payments projected to be owed to past, current and future generations are discounted (or brought forward), and all taxes (or, in the case of Medicare, premiums) assumed to be collected from current and future generations are put through a similar calculation. The difference between these two present value assessments is the "unfunded liability". In the 2005 report, Social Security's unfunded liability stands at $11.1 trillion.[16] For Medicare, the unfunded liability is $68.1 trillion across all three parts of the program (parts A, B and D). [17]

Table 2
Social Security and Medicare
Unfunded Liability Assessments

	$	% of GDP
Social Security	11.1	1.2
Medicare		
Hospital Insurance (part A)	24.1	2.5
Supplementary Medical Insurance (part B)	25.8	2.7
New Drug Benefit (part D)	18.2	1.9
Total Medicare	68.1	7.1

Source: 2005 Social Security and Medicare Trustees' Reports

Publicizing and incorporating these Social Security and Medicare unfunded liability estimates into the official Congressional and executive branch budget processes would be a constructive step. It would give policymakers a way to explain in a simple fashion the problem the country faces and a tool to show progress toward a more sound long-term fiscal policy. For instance, legislation to slowly phase in a higher retirement age for Social Security and Medicare would lower the unfunded liability estimates for both programs.

It should be noted that, unlike Social Security, Medicare will get a large general fund contribution to cover a portion of its costs. In fact, the general fund of the Treasury automatically covers 75 percent of Medicare costs for physician and other outpatient services under part B of the program. The unfunded liability concept purposefully excludes these contributions from the calculation because general fund transfers to a trust fund do not, in and of themselves, carry any economic value, as would a tax or premium collected from a worker or a beneficiary. Nonetheless, it is not necessary that Medicare's unfunded liability be reduced to zero because, implicitly, some portion of Medicare's costs can be covered through general income tax collections. But Medicare's current gap between projected spending and dedicated revenues (payroll taxes and premiums) is so wide that there is little doubt that it must be narrowed substantially.

In recent years, CBO has begun to provide to Congress aggregated budget estimates beyond the normal ten-year budget horizon. These estimates – which cover the entire federal budget -- give policymakers a better sense of the overall fiscal outlook in the decades ahead under various spending path scenarios. While the estimates cover the

entire budget, CBO's projections make clear that the long-run fiscal problem resides in the main entitlement programs: Social Security, Medicare, and Medicaid.

As shown in Table 3, CBO projects that, using intermediate assumptions, spending on Social Security, Medicare and Medicaid will increase from 9.0 percent of GDP in 2010 to 14.3 percent of GDP in 2030 and 17.7 percent of GDP in 2050. This intermediate path assumes, however, that the rate of Medicare and Medicaid "excess cost growth" slows to 1.0 percent annually. A more pessimistic scenario, one based on the close-to-historical average "excess cost growth" rate of 2.5 percent annually, leads to spending 17.4 percent of GDP on Social Security, Medicare and Medicaid in 2030 and 27.6 percent in 2050.[18]

Table 3

Social Security, Medicare and Medicaid Spending

	% of GDP		
	2010	2030	2050
Intermediate Assumptions	9.0	14.3	17.7
High Cost Assumptions	9.5	17.4	27.6

Source: The Long-Term Budget Outlook, Congressional Budget Office, December 2003

A Policy Framework for Reform

Reforming these large entitlement programs will be one of the most difficult political challenges for U.S. policymakers in the coming years, as can be seen by the charged atmosphere surrounding the President's push for Social Security reform in 2005. With that in mind, it is helpful to articulate a policy framework that could guide the reform effort across all of the programs. Defining this framework is important for a number of reasons:

- First, reforming entitlements is likely to arouse intense political opposition from advocates who have a philosophical stake in the current program structures. Any top to bottom rethinking of entitlements will bring with it intense attacks. To survive, reformers must be able to demonstrate a coherent policy approach which will guide reform and which a broad cross-section of the public could support.

- Second, reforming entitlements is likely to be a multi-year effort, crossing more than one Congress and probably more than one Presidency. The U.S.

political process, by design, tends to take incremental steps, not large ones. Reforming entitlements is complex, with much uncertainty about the cost consequences of individual measures, and uncertainty breeds caution. Congress and the President will need to compromise and move on what is "doable politically" while also keeping in mind the larger goal, as articulated in the framework.

- Third, it is helpful to think about the project across programs – even across spending and tax provisions – as it helps make clear that policies in one of the programs may need to be connected with a change in another program or in the tax law for the policy to work well.

The suggested policy framework in Figure 1 is based on an approach that recognizes both the need to limit government spending to ensure individual responsibility and to protect economic growth as well as the need to have in place programs that provide a level of security for those who are truly vulnerable. In the remainder of the paper, I elaborate on these suggested policies and provide a number of specific, initial entitlement and tax changes recommended for consideration by policymakers.

Figure 1

Suggested Policy Framework for Long-Term Entitlement Reform

1. Entitlement protection should be provided at the least possible cost to taxpayers.

2. Benefits should not be reduced for those already in retirement or near retirement.

3. The programs should be reformed to encourage longer working lives and later retirement.

4. Workers should have strong incentives for personal retirement savings, allowing economically sound adjustments in entitlement benefits.

5. Gaps in entitlement protection should be closed and the benefits made more generous for the truly vulnerable, with benefit reductions focused on high wage earners.

6. Health care entitlements should be reformed to rely on market-based efficiency as much as possible, with similar reforms instituted in the private sector health system.

Policy #1: Entitlement protection should be provided at the least possible cost to taxpayers.

One important advantage of taking a cross-program look at the long-term fiscal problem is that it makes clear that raising taxes now to help close the financing gap would be a mistake as a policy matter and politically. In particular, it would be unwise to enact tax increases in the context of a 2005 discussion on Social Security before any real plan is debated on reforming and financing the health care entitlements, which are expected to present much more significant cost problems in the decades ahead.

Others have made the point that looking to taxes to solve this problem is also risky from a strictly economic perspective. As Federal Reserve Board Chairman Alan Greenspan stated in Congressional testimony last year, "[Tax] increases of sufficient dimension to deal with our looming fiscal problems arguably pose significant risks to economic growth and the revenue base. The exact magnitude of such risks is very difficult to estimate, but they are of sufficient concern, in my judgment, to warrant aiming to close the fiscal gap primarily, if not wholly, from the outlay side."[19]

It should also not be forgotten that taxes – particularly payroll taxes -- have already been raised numerous times to pay for Social Security and Medicare spending growth. The combined employer-employee Social Security and Medicare tax rate of 15.3 percent today is nearly 60 percent higher than the 1970 tax rate of 9.6 percent.[20]

Closing the financing gaps for Social Security and Medicare Hospital Insurance with tax increases alone would require unprecedented new tax hikes. According to the Social Security and Medicare actuaries, the payroll tax rates would need to be raised from 15.3 percent today to 20.3 percent immediately – a 33 percent tax increase -- to close the 75-year actuarial deficits in the trust funds, and even then large deficits would emerge in both programs by the end of the solvency measurement time frame.[21] Such a high rate of tax would likely raise concerns from many economists worried about the impact on work incentives, but, in any event, such high tax rates are unthinkable politically.

Policy #2: Benefits should not be reduced for those already in retirement or near retirement.

Assuring current beneficiaries that their benefits will not be reduced is necessary as a simple matter of fairness as these retirees have limited ability to adjust their consumption and work behavior based on changing government policy. Moreover, without this assurance from policymakers, the effort will be viewed as inequitable and likely will be defeated before it gets started.

The policy of protecting current and near retirees will require some entitlement adjustments to be phased in by age cohorts, which, in the past, has created the perception of unfairness among some beneficiaries. For instance, the 1977 Social Security amendments corrected a flaw in the benefit formula by phasing in the correction for new retirees only. In the ensuing years, many of these new retirees (so-called "notch babies") complained that they were getting less in benefits than similarly situated workers who

happened to be just a year or two older. The uproar led to the introduction of many bills to undo the correction, as well as several studies by independent parties. In the end, the basic fairness of protecting those already on the rolls and making the change on a prospective basis was upheld by Congress, and AARP opposed efforts to reopen this issue.[22]

Policy #3: The programs should be reformed to encourage longer working lives and later retirement.

A critical feature of long-term reform of Social Security and Medicare is a coordinated approach to encouraging workers to remain in the active labor force longer, with a commensurate reduction in their reliance on public benefits. As Penner and Steuerle have noted, Social Security and Medicare's incentives for retirement are strong, and the consequences are felt not only in extra Social Security and Medicare spending, but also in lost production in the economy and lost tax revenue.[23] Further, even short periods of delayed retirement could have substantial beneficial effects for the retirement income of the worker. A recent CBO analysis indicates that one year of work could add $46,000 to the savings available for a typical couple.[24]

Social Security's Early and Normal Retirement Ages. As discussed in model 3 of the President's Commission to Strengthen Social Security, the early retirement adjustment factor for Social Security does not accurately reflect the full cost of an earlier than necessary retirement, nor does the delayed retirement credit provide sufficient incentives to delay benefits past the normal retirement age.[25] To correct these disincentives, model 3 included a provision to increase the early retirement penalty somewhat, effectively reducing the benefit at the earliest retirement age from 68 percent of full benefits to 63 percent. Model 3 also included a provision to increase the delayed retirement credit from 8 to 10 percent for each year that retirement benefits are delayed beyond the normal retirement age.[26]

Social Security's normal retirement age is currently scheduled to reach age 67 in 2022. The schedule of adding two months to the normal retirement age could be continued beyond 2022 until the normal retirement age hits age 68.

Medicare's Retirement Age. Medicare plays two important roles in providing health insurance coverage to seniors:

- First, Medicare provides access to a community-rated insurance pool. That is, "insured" workers, and their spouses, who paid sufficient payroll taxes into the program have access to a uniformly priced insurance policy, regardless of their health status, from age 65 until their death.

- Second, Medicare heavily subsidizes the premiums for this insurance coverage. According to Steuerle and Carasso, the lifetime subsidy to Medicare beneficiaries for persons turning age 65 in 2030 is $320,000, in constant 2002 dollars.[27]

Understanding this distinction between Medicare's two functions opens up several possibilities for reform because it is the Medicare subsidy, not the creation of community-rated insurance, which is driving long-term cost pressures. Several reforms can be pursued to provide continued access to the government-sponsored insurance coverage for persons age 65 and older while starting the Medicare premium subsidy at a later age and encouraging longer working lives.

To begin, Medicare's retirement age can be increased on an accelerated schedule, for those currently under age 55, to catch up to the current law schedule for increasing Social Security's normal retirement age to 67, and then both Social Security's and Medicare's normal retirement age could be phased-up to age 68. In the future, persons age 65 to 68 would be allowed to pay the full insurance premium for Medicare coverage if they so chose, without a subsidy from the government. In this way, Medicare could continue to assure access to community-rated, group health insurance while providing a strong incentive for workers to remain employed and use employer coverage for as long as possible.

Discontinue Payroll Taxes for Older Workers. Older workers could be given an additional incentive to continue in the labor force by discontinuing payroll taxes after a certain age, perhaps age 65. In nearly all cases, the worker has already qualified for Medicare benefits, so the taxes paid into Medicare do not provide any extra value to the worker. This is also true for most workers in Social Security, although there are some who would get marginally higher benefits by continuing payment of payroll taxes. These workers could be helped by permitting them to make special payroll contributions to Social Security if it will prove beneficial to their retirement benefit. But for many workers, providing a tax incentive to stay active in the labor force and save for their own retirement will be much more valuable to them, and to the economy as a whole, than the small additional benefit they might get under Social Security.

Policy #4: Workers should have strong incentives for personal retirement savings, allowing economically sound adjustments in entitlement benefits.

The private retirement system in the U.S. looks very different today than when Social Security was first created in the 1930's. Large accumulations of investment wealth is concentrated in personal retirement accounts, due in part to the tax incentives that have encouraged individual retirement accounts (IRAs) and employer-based savings (401ks and others), particularly since the 1970s. Further, as the economy and industries have changed, employers have come to rely more on defined contribution retirement plans than on traditional defined benefit plans to provide pension coverage to their workers. This trend is likely to accelerate in the coming years. According to the Federal Reserve Board, aggregate assets held in retirement accounts have increased from $1.5 trillion in 1985, or 35 percent of GDP, to $6.5 trillion in 2004, or 62 percent of GDP.[28]

Voluntary Social Security Personal Accounts. The President has made integration of voluntary personal accounts into Social Security a central feature of his second term agenda.

It must be acknowledged that voluntary personal accounts do not, in and of themselves, improve Social Security's solvency. In fact, personal accounts are essentially neutral in terms of the present value impact on Social Security receipts and spending. Nonetheless, voluntary personal accounts are a central component of reform because they give workers the opportunity to get the best possible return on their contributions, mitigating the political consequences of scaling back the traditional benefit formula.

It is important for policymakers to focus on designing personal accounts well. In particular, the interaction of the personal accounts with the traditional Social Security benefit should incorporate proper economic incentives for the beneficiary.

The best approach, as recommended in model 2 of the President's Commission on Saving Social Security, requires a hypothetical calculation of what would be in the personal account if it earned an annual real rate of return of the Treasury interest rate minus 1 percentage point.[29] The balance is then assumed to purchase an inflation-indexed annuity at the retirement age, and this amount is deducted from the traditional Social Security benefit formula. This approach aligns incentives properly – the account holder knows in advance that he or she must earn at least an annual real rate of return of about 2 percent to get a benefit that exceeds what they would have gotten from Social Security, and any returns above the 2 percent rate accrue to the beneficiary.[30]

Moving toward voluntary Social Security personal accounts will reduce federal payroll tax receipts substantially in the early years of a reformed Social Security program. In a sense, the higher unified budget deficits would reflect the reality that Social Security benefits have been promised to workers paying payroll taxes – the current budget simply does not capture these costs explicitly.

Yet, it must be acknowledged that many Social Security reform plans which include personal accounts will entail many years of borrowing and higher deficits at a time when U.S. fiscal policy is already strained. Is this a problem that should derail adoption of personal accounts? As shown in the 2004 Economic Report of the President, for many economists, the answer is no. Shifting resources from a government account to a personal account can arguably lead to an increase in national savings, as the government would be less able to spend those resources on other activities. Moreover, the loss of payroll tax revenue is matched by a reduction in government spending later, thus directly offsetting the increased borrowing that would occur initially.[31]

The key ingredient for a Social Security plan with transition financing for personal accounts is credibility. Social Security reform must make concrete adjustments in the benefit promises in the decades to come (retirement age increases, lower initial benefits for high earners, and other changes) to assure that the program's long-term spending path is sustainable. And, over the long-run, it is important to maintain the integrity of the Social Security trust funds as a political accounting mechanism, to ensure policymakers are not tempted to use general fund financing as a safety valve to avoid politically difficult adjustments in benefit promises. The practical effect of maintaining trust fund accounting would be to allow Social Security reform plans with personal accounts to borrow funding from the general fund during a transition but require the trust

funds to pay back such borrowing over time as the proceeds of personal accounts and other benefit adjustment reduce Social Security's spending commitments.

The long-term rewards of a credible Social Security reform plan are significant. For instance, Social Security actuaries estimate that the President's Commission on Strengthening Social Security model 2 reform plan would increase unified budget deficits until 2041 and debt held by the public until 2051 but substantially reduce both thereafter. Moreover, the plan would eliminate Social Security's present value unfunded liability of $11 trillion and put the program on a permanently solvent basis. The actuaries estimate that model 2's "income rate" would exceed its cost rate by 1.41 percent of taxable payroll in 2075, approximately 0.5 percent of GDP.[32]

It may be that the political process finds it difficult to digest large transition costs while running large current unified budget deficits. The transition costs of personal accounts can be mitigated somewhat by limiting the age of eligibility for them to workers under a certain age, such as 40 instead of 55 in most Social Security reform proposals. This will reduce costs in the near term but will not alter the basic dynamic that voluntary personal accounts entail a trade between higher near term unified budget deficits and publicly held debt in return for substantial and permanent reduction in the federal government's long-term liabilities.

Tax-Based Retirement Savings Incentives. The President's 2006 budget proposals included a provision to expand and simplify retirement-based savings accounts. The Retirement Savings Account (RSA) would look like a larger version of today's Roth IRAs. Roth IRAs, originally enacted in the 1997 tax law, allow qualified workers with incomes below a certain threshold to place up to $3000 in after-tax resources per year into a savings account, with the internal returns and the base non-taxable if withdrawn in retirement.

The President is now calling for broad tax code simplification and reform and has appointed a panel to develop a comprehensive recommendation for the Treasury Department to use as a starting point for legislative action later this year. It is widely expected that one aim of tax reform will be stronger incentives for savings. One element of such an effort may be to provide a much expanded ability to put earned income into RSA-like accounts.

As proposed in the 2006 Budget, the annual contribution limit to RSAs would be $5000, with no income limits on those qualifying to make annual contributions.[33] These changes would give upper income households strong incentives to save a portion of their incomes in RSAs annually.

As the tax system is altered to encourage more personal retirement savings, it could be coupled with an expectation workers will get less in public entitlement benefits, thereby lowering the government's long-term costs.[34] The connection between tax-favored retirement savings and lower entitlement benefits can be either explicit or implicit. To assure reduction in the government's long-term liabilities, however, it may be necessary to make the connection explicit in the same legislation that creates the tax-

favored accounts. One simple approach would be to increase the Medicare premiums owed by persons who have large balances in tax-favored retirement accounts. A calculation similar to the one used for the voluntary Social Security personal accounts could be used. A hypothetical annuity could be calculated based on the amounts allowed to be deposited into the tax-favored savings vehicles. A portion of the hypothetical annuity could then be added to the person's required Medicare premium in retirement (this requirement would need to be coordinated with the income-related premium provision of the 2003 law to ensure beneficiaries are not charged higher premiums twice for the same retirement wealth and income).

Policy #5: Gaps in entitlement protection should be closed and the benefits made more generous for the truly vulnerable, with benefit reductions focused on high wage earners.

Increase Supplemental Security Income Protection for the Very Old. Some policymakers may not be aware that the U.S. has in place an effective and targeted mechanism for providing income support to the poor elderly. The Supplemental Security Income (SSI) program provides a monthly federal benefit of up to $579 in 2005 to persons over age 65, and the disabled, with very low incomes and few assets.[35] Moreover, the program has in place an administrative structure for assessing income and assets, assuring targeting of benefits on those who truly need it.

This program could be made a more important part of the safety net for the very old by raising the benefit threshold substantially for persons age 80 and older. In today's dollars, an increase of 50 percent, to more than $10,000 annually, from the age 65 benefit standard could substantially increase security for this population. In this way, the government would be making it clear that while persons will be expected to work longer and retire later as Americans live longer, the government will also provide greater financial protection to the very old, many of whom will outlive their resources and the spouses who form their support networks.

Other Benefit Adjustments. The President's Social Security Commission discussed two reforms, one in model 2 and one in model 3, which would have the combined effect of making the Social Security benefit more progressive and better targeted on vulnerable seniors.

The first provision would increase the benefits payable to widows and widowers to 75 percent of the combined benefit that would have been payable to the couple if both were still alive, but only up to the average benefit for retired couples.[36] Under current law, the survivor benefit is generally equal to 50 to 67 percent of the combined benefit. Making this change in the formula would help many survivors who have a work history of their own but who will lose a substantial portion of their retirement support when their spouse dies.

Under the second provision, the initial benefit formula would be altered to lower the highest wage replacement factor from 15 to 10 percent, with a transition period.[37] This provision would reduce benefits only for the highest wage workers.

Policy #6: Health care entitlements should be reformed to rely as much as possible on market-based efficiency, with similar reforms instituted simultaneously in the private sector health system.

As indicated in the cost projections by the Medicare actuaries and CBO, continued rapid cost escalation in the health care entitlement programs threatens to overwhelm our nation's ability to finance them adequately. If health cost escalation does not slow, somehow and someway, it will be virtually impossible to reach some level of fiscal sustainability.

While many health care analysts disagree on proposed solutions, most recognize that large inefficiencies in the U.S. health system exist. The Washington Post recently editorialized, citing data from studies performed by researchers at Dartmouth Medical School, that some parts of the country spend twice as much on Medicare per capita as others without any clear improvement in health outcomes. In theory, up to about 30 percent of Medicare spending could be eliminated without harming care.[38]

Three key federal policies undermine incentives for efficiency in health care and contribute to rapid cost escalation by providing open-ended access to federal resources. Closing off open-ended federal subsidization is a critical step toward ensuring more cost pressure is place on the health delivery system by consumers and is necessary to increase confidence that resources spent on health care are sufficiently valued by consumers to forego other possible uses of the income.

Convert Medicare's Entitlement into Limited Premium Subsidies for Future Retirees. Under current Medicare program rules, beneficiaries are not forced to face higher premiums if they choose to remain enrolled in uncoordinated and inefficient fee-for–service insurance. It is not surprising, then, that roughly 90 percent of beneficiaries are in the traditional fee-for-service program, which provides access to virtually every health care provider in every community.

Many health care analysts have called for altering this financing arrangement to change Medicare's entitlement from an open-ended commitment to fee-for-service insurance to a limited premium subsidy tied to the cost of a relatively efficient health insurance plan as determined by market-based competition in the beneficiary's region.

Restructure the employer exclusion so that it is limited and provide more uniform subsidization of private health insurance coverage through enhancement of the President's health insurance tax credit. A cost-driving dynamic similar to current law Medicare exists in the private, employer-based health insurance system by way of the tax law. Under current law, employer-paid health insurance premiums for employees are completely excluded from the employee's income for purposes of both the income and payroll taxes. As a consequence, there is a strong incentive at the margins to add more health insurance coverage in lieu of cash compensation.

Setting a reasonable, non-indexed dollar limit on the amount of employer-paid premiums that can be excluded from a worker's taxable income would change

substantially the incentives for employers and employees regarding their health insurance choices, ultimately forcing much more cost-consciousness and efficiency from the health care delivery system.

While limiting the employer-paid health insurance exclusion is critical to a well-functioning market, it is also important to continue working toward more stable insurance coverage for those who tend to come in and out of insurance coverage under the current system. The projected increase in taxes due to limiting the employer exclusion could help in this effort. One approach would be to make more generous and widespread the health insurance tax credits proposed in the President's 2006 Budget.[39]

Restructure a Portion of Medicaid Into Health Insurance Allotments to the States. Medicaid's open-ended federal matching rate structure gives states strong incentives to move health care costs from state-only financing to Medicaid coverage and to explore creative mechanisms to maximize the federal match while minimizing legitimate state financing.

The incentive for states to "maximize" federal Medicaid spending has created considerable tension between the states the federal government over the last 20 years. In the late 1980's, the states used so-called "provider tax" schemes to generate federal matching funds. In the 1990's, the schemes were updated under the umbrella term "upper payment limits" or UPLs. In all cases, however, the scheme is basically the same. The state pays a health care provider a substantially higher payment rate for a service than is normal, generating a large federal match. The state and the provider get out from under the state financing requirement by moving funds from the provider back to the state in a transaction that does not count under Medicaid. The Government Accountability Office (GAO) found that these abuses contributed significantly to the 25 percent annual growth in Medicaid spending in 1991 and 1992.[40] In the 2005 Budget, the Bush Administration proposed additional measures to reduce costs using so-called UPL arrangements, and the budget included savings of $23.6 billion over ten years from this provision.[41]

To remove the incentive for states to increase federal matching payments, the program should be reformed along the lines of State Children's Health Insurance Program (SCHIP). Under SCHIP, created in the 1997 Balanced Budget Act, states get a fixed annual allotment of federal resources each year, with great flexibility and accountability at the state level. With changed incentives, states have been much more judicious in their spending habits, and many states built SCHIP reserves over a period of years.

Under a reformed Medicaid program, states would get a fixed allotment for health insurance coverage for low income families by combining their SCHIP allotment with a new Medicaid health insurance allotment. The new allotment program could also be coordinated with expanded health insurance tax credits to ensure the broadest possible expansion of coverage within the available resources. Medicaid financing for long-term care services and for the disabled would remain as under current law. These allotments to the states would be indexed to grow with per capita health care inflation and also would grow as the state's eligible population grew. With fixed allotments, the incentive for the

states will shift from moving costs onto the federal budget to stretching their federal dollars as far as possible.

Health Care Cost Estimates

The health care entitlements are the key to addressing fiscal sustainability. Slow the rate of growth in health care spending – system-wide and in Medicare and Medicaid – and the "fiscal benefits" will be substantial. Conversely, failure to slow spending growth in these entitlements will make balancing the budget near impossible without unprecedented tax increases.[42]

And so, the central fiscal policy question remains: how does the nation slow the rate of growth of health care spending? U.S. policymakers have been engaged in a long struggle over this question for at least two decades now, and the issue remains essentially unresolved. President Clinton made an attempt to move U.S. health policy toward more governmental regulation of health care, with publicly-enforced insurance coverage and more certain cost controls. But he failed in that effort. In the aftermath of that debate, proposals to alter the health system have been more incremental in nature.

Now, however, we may be nearing another important decision point. President Bush and the Republican Congress are generally in agreement that consumer choice and market-based incentives can bring greater efficiency to health care delivery. But today's health system falls short of an effectively functioning market, and part of the problem resides in federal tax and entitlement policy. Moving toward "premium support" in Medicare and setting a limit on the tax exclusion of employer-paid premiums for health insurance would go a long way toward instilling more price sensitive behavior throughout the health system.

CBO and the Medicare actuaries will acknowledge savings from introduction of these policies, as consumers switch from more expensive to less expensive insurance. In fact, the National Bipartisan Commission on the Future of Medicare received cost estimates from the Medicare actuary indicating that "premium support" would reduce Medicare outlays by 2 to 3 percent over the period 2000 to 2030.[43] Currently, Medicare's actuaries project spending on the program will increase from 2.63 percent of GDP in 2004 to 6.77 percent of GDP in 2030.[44] Clearly, shaving 3 percent off projected Medicare spending in 2030 – roughly .2 percent of GDP -- will not fix the entire problem.

But there is great uncertainty surrounding these estimates, as would be acknowledged by the professional estimators. The real, as opposed to estimated, savings could be much higher. With incentives properly aligned, the Medicare and health insurance marketplaces could begin to look like other marketplaces – with continual productivity improvements and efficiency gains that drive down costs and deliver higher value to beneficiaries. So even if the professional estimators remain cautious about the potential for market-based reforms to slow health care cost escalation, pursuing them is still worth the effort. According to CBO, if Medicare and Medicaid spending growth is 1.0 percent above annual per capital GDP growth instead of 2.5 percent, federal spending will be lower in 2030 by 3 percent of GDP and in 2050 by 10 percent of GDP.[45]

Moreover, for supporters of a market-based system driven by consumer choice, there is no other option but to pursue more rigorous price competition. If these reforms – or similar versions -- are not adopted over the next several years, there is the possibility that frustrations with the current health system – rapidly increasing costs and greater numbers of full year or temporary uninsured -- could lead public sentiment to favor more intrusive governmental intervention and regulation of health care.

Both the proposal to limit the tax exclusion for employer-paid health insurance and the proposal to shift a portion of the Medicaid program into SCHIP-like allotments are unlikely to produce significant budgetary savings separate from their critical contribution to changing the incentives in health care toward more efficient delivery. Both proposals would, in fact, produce real budgetary savings, but the savings is likely to be needed to help subsidize expanded insurance coverage for low and moderate income families. CBO estimated that an option to limit tax exclusion for employer-paid insurance to average-price plan in 2006 (and indexed to inflation thereafter) would generate over $700 billion in additional revenue over ten years.[46] But, as proposed here, any revenue generated from this proposal should be used to enact a generous and widespread health insurance tax credit in order to expand insurance coverage and reduce the number of uninsured.

Other Available Cost Information

Several of the other proposals suggested in this paper have been estimated by either CBO or the Social Security actuaries in recent years, and those estimates are cited below. Other proposals have not been estimated yet, but information is available which provides some perspective on the likely magnitude of the budgetary change. Further modeling work would be necessary to provide cost estimates associated with explicitly tying RSAs and other tax-favored retirement accounts to a requirement to pay higher Medicare beneficiary premiums.

Estimating entitlement policy changes as suggested in this paper is complex, and there is frequently substantial interactions between proposals that may alter cost estimates. Those interactions are not reflected in the information provided here.

Voluntary Personal Accounts. The proposal for voluntary personal accounts is intended to be essentially neutral to Social Security over the long run, but its budgetary impact depends on the time frame examined. In the early decades, the revenue lost from diverting payroll taxes to personal accounts exceeds the lower Social Security spending from the benefit offset. Past a certain crossover point, the benefit offset overtakes the lost revenue. As stated previously, the Social Security actuaries estimated that the crossover year would be 2041 for a proposal such as that included in Commission model 2. CBO's cost estimate for this proposal is similar to the actuaries' estimate. According to CBO, in 2025, the personal accounts add about 0.67 percent of GDP to the federal budget deficit. By 2065, the accounts would reduce the federal budget deficit by about .11 percent of GDP.[47]

Early Retirement Adjustment and Increase in the Normal Retirement Age. Adjusting the Social Security early retirement benefit reduction and increasing the delayed retirement credit, as proposed in model 3 of the President's Commission, would decrease Social Security spending by 0.28 percent of taxable payroll over 75 years. Taxable payroll is projected to fall slightly from about 38 percent of GDP to 34 percent in the decades ahead.[48] Consequently, this proposal could be expected to save about 0.1 percent of GDP when fully implemented. Increasing the normal retirement age to 68 would reduce Social Security spending by approximately 5 percent when fully implemented, or about 0.3 percent of GDP in 2050.[49]

Raising the retirement age for Medicare would also significantly reduce the government's long-term liabilities. According to estimates provided by CBO, raising the retirement age to 68 would reduce spending on Medicare by about 8.8 percent when fully implemented.[50] In 2030, when such a retirement age might be feasible, 8.8 percent of Medicare spending is projected to be about 0.6 percent of GDP.[51]

Payroll Tax Exemption. There were nearly 6.5 million workers over the age of 65 in the labor force in 2002, or about 4.2 percent of the workforce. Assuming these workers earned the average wage, eliminating Social Security and Medicare payroll taxes for them would reduce total payroll tax revenue by about 0.25 percent of GDP in 2030. These workers earn well below the median wage, however, and so this estimate likely represents the upper range of the potential revenue loss from this proposal. The estimate also does not include the potential income tax revenue increase from greater work effort among the elderly.[52]

Other Social Security Benefit Adjustments. CBO estimates that the increase in spousal benefits would increase costs modestly, adding 0.02 percent of GDP in spending in 2025.[53] The reduction in the highest wage replacement rate from 15 to 10 percent would reduce Social Security spending by 0.16 percent of taxable payroll, according to estimates provided by the Social Security actuaries.[54] Consequently, reducing the replacement rate for high earners could be expected to reduce Social Security spending by about 0.05 percent of GDP when fully implemented.

Supplemental Security Income Benefit Increase. There were about 450,000 SSI beneficiaries over the age of 80 in December 2003. A 50 percent increase in benefits for these beneficiaries would have cost about $1 billion in 2004, or less than 0.01 percent of GDP.[55] The real cost of this proposal would be somewhat higher than this estimate as more beneficiaries above the current income threshold would become eligible for a portion of a higher benefit. Even so, this proposal is not likely to cost much as a percentage of GDP in 2030.

Political Considerations

Reforming the major entitlement programs will be difficult politically under the best of circumstances, as there is very little to gain politically from proposals to scale back entitlements. As reforms are considered in Congress, it will be necessary for

policymakers to couple reforms that scale back government spending with reforms that may have some political appeal.

For instance, the President has advanced voluntary personal accounts in the context of an effort to put Social Security on a more sound financial footing. In effect, voluntary personal accounts – which offer personal ownership and higher rates of return – can provide some political attraction in legislative packages that will necessarily include difficult reductions in future benefit promises. Similarly, raising the normal retirement age for Social Security and Medicare could be coupled with the proposal to ease payroll taxes for those who continue working beyond age 65, as well as additional protection for the very old through Supplemental Security Income. And market-based health care reforms will need to be tied to new subsidy provisions which will reduce the number of uninsured.

Conclusion

The size of the currently projected, long-term fiscal imbalance is staggering and can lead one to assume that no combination of politically feasible options exists to close the entire gap. Certainly, one would not expect the proposals offered here, based on conventional scoring assumptions, to bring the fiscal gap, however measured, to zero.

But, given the political difficulty of making far-reaching entitlement changes, closing the entire fiscal gap in one or two legislative steps is not a realistic possibility anyway. Policymakers should focus on moving ahead with an agenda that is realistic, set in motion reforms that can begin to change behavior and expectations, gather more information as reforms are put in place, and come back to address the situation again at the next opportunity for legislation. The policies suggested in this paper for Social Security, Medicare, Medicaid, Supplemental Security Income and the tax law would put in place many levers that could be altered later to achieve additional savings as necessary.

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