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United States House of Representatives
"Domestic Entitlements and the Federal Budget"
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Mr. Chairman, Mr. Spratt, and Members of the Committee:

I am Isabel Sawhill, Senior Fellow and Director of Economic Studies at the Brookings Institution. I am pleased to have this opportunity to testify but want to emphasize that my testimony represents my personal views and not those of the Brookings Institution or any of its other scholars, trustees, advisers, or funders. Let me begin by summarizing my testimony.

Overview

In efforts to restore fiscal balance, it's important to focus on entitlements for a number of reasons:

- Entitlements are where the big dollars are.
- They are growing rapidly.
- Given the unsustainable deficits that this growth implies, there are only three possible options: restructure entitlements, eliminate most of the rest of government, or raise taxes to unprecedented levels.
- Sooner or later, entitlements will have to be addressed—and sooner is much better than later.
- As long as entitlements are left off the table, all of the pressure will fall on discretionary programs.
- That pressure is likely to lead to underinvestment in the next generation and to cuts in programs for low-income families.

What might be done?

- In the long-run, new but politically contentious ideas should be considered and debated, such as:
    - Moving toward income-relating benefits but in ways that protect the vulnerable
    - Increasing the normal retirement age
    - Moving from defined benefits to defined contributions in retirement and health programs
    - Making the contributions mandatory
    - Using public health programs to introduce greater efficiency and effectiveness into the entire health care system
    - Raising existing taxes by broadening the tax base for both payroll and income taxes and adding a value-added tax to the mix

- In the short-run, Congress should consider a temporary suspension (or partial suspension) of indexing of both benefits and taxes that would remain in effect until a preset deficit reduction goal is achieved. I estimate that this would save $150 billion over three years (2007-2009).

Why Focus on Entitlements?

At present, 84 percent of the federal budget is for entitlements, defense, homeland security, or interest on the debt. Any effort to achieve a reduction in spending by focusing on the remaining 16 percent is unlikely to be very effective. For example, a 1 percent cut in nominal non-security discretionary spending for one year reduces total spending by only 0.17 percent. Over five years, it reduces total spending by 0.89 percent.

Entitlements, on the other hand, represented 53 percent of total federal spending in 2005 with Social Security, Medicare, and Medicaid representing 41 percent of the total.[1] These three programs are growing rapidly, and along with interest on the debt, will absorb all projected federal revenues by the early 2030s (Figure 1).

The reasons for this rapid growth include the aging of the population (greater longevity, in particular—not just the retirement of the large baby boom generation) and rapidly increasing spending on health care. Health care spending per capita has been growing at a rate that is 2.5 percentage points greater than GDP per capita for about 40 years and given continuing improvements in medical technologies (better diagnosis, new treatments, and new drugs), no one expects this rate of increase to slow any time soon. For this reason, spending on Medicare is projected to grow 5 times faster than spending on Social Security between now and 2030 and is thus the major challenge to controlling the growth of entitlements.[2] A variety of health care reforms—from greater use of electronic records to curtailing malpractice awards—could reduce the level of spending somewhat, but are not likely to constrain spending growth very much, except perhaps temporarily.

Last year I and my colleagues at Brookings published a volume entitled *Restoring Fiscal Sanity, 2005: Meeting the Long-Run Challenge.* The book concluded that projected deficits over the next 25 years are unsustainable and that, as a result, there are only three possible options: restructure entitlements, eliminate most of the rest of government, or raise taxes by one third or more.[3] We and many others have emphasized that addressing the growth of entitlements sooner rather than later will be far less painful than if we wait until the day of reckoning has arrived. Not only will delay require sharp increases in taxes or major benefit cuts, but the intervening accumulation of debt will necessitate that a rising proportion of available revenues be used to pay interest on that debt. Under realistic assumptions, interest on the debt is currently slated to grow to around $466

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[1] Office of Management and Budget, *Fiscal Year 2007 Budget of the United States Government*, February 2006, Tables 8.1, 8.3.

[2] Congressional Budget Office, "The Long Term Budget Outlook," December 2005, Scenario 1.

[3] Alice M. Rivlin and Isabel Sawhill, editors, *Restoring Fiscal Sanity, 2005: Meeting the Long-Run Challenge* (Washington, D.C.: Brookings Institution Press, 2005).

billion in 2016. Thus, over one out of every four income tax dollars will buy nothing except the right of the federal government to continue to borrow.[4]

Restoring Fiscal Sanity 2005 outlines and estimates the budgetary savings or revenue enhancements associated with a number of specific options such as increasing the retirement age for both Social Security and Medicare, changing benefit formulas in Social Security, imposing higher Medicare premiums on the affluent, introducing more market discipline or more rationing into the health care system, raising payroll or income taxes, and introducing a VAT.

Because such fundamental reforms do not appear to be feasible at the current time, most of the downward pressure on spending resulting from efforts to restore fiscal balance are aimed at domestic discretionary programs. I recognize that Congress has made some efforts as part of the Deficit Reduction Act of 2005 to reduce spending on entitlements, but that restraint represents only three-tenths of one percent of total spending over the five years, 2006-2010.[5] In the meantime, non-security domestic discretionary programs as a proportion of GDP are at 3.5 percent and slated to shrink to their lowest level since we first began collecting the data.[6] Moreover, this is only the beginning of a continuing squeeze on this part of the government.

This squeeze will have two unfortunate effects in my view. First, it will threaten economic growth. Second, it will require too much sacrifice on the part of low- and moderate-income working families. In particular, programs serving the young will lose out relative to programs serving the old. As shown in Figure 2, per capita federal spending on the elderly is about 4.5 times as great as per capita spending on children.[7] These figures on per capita spending at the federal level were much closer together back in 1970 but are slated to widen further by 2015, at which point spending on the elderly will be about five times as great as per capita spending on children (Figure 3). To the extent that discretionary programs are frozen or cut in nominal terms, the resulting impact on children versus the elderly will be even greater.

Not all federal programs targeted on children are effective. Nonetheless, well-chosen investments in children are not only a sensible use of scarce federal resources but can also have feedback effects on economic growth and revenues, similar to what is often discussed in the context of tax cuts. Retirement benefits and nursing home care for the elderly, by contrast, have no such benefits. As an example of such feedback effects, I and my colleagues William Dickens and Jeffrey Tebbs have recently completed a detailed analysis which shows that an investment in universal preschool for all three- and four-year-olds would initially worsen the deficit, but over the longer run would produce increased economic growth and additional revenues sufficient to

[4] Alan J. Auerbach, William G. Gale, and Peter R. Orszag, "New Estimates of the Budget Outlook: Plus Ça Change, Plus Ç'est la Même Chose," January 31, 2006. Available at: http://www.brookings.edu/views/papers/20060131galeorszag.pdf.
[5] Congressional Budget Office, "The Budget Outlook: 2006-2017," January 2006, Summary Table 1; Congressional Budget Office, "Cost Estimate, S.1932, Deficit Reduction Act of 2005," January 27, 2006.
[6] Office of Management and Budget, Tables 1.2, 4.1, and 8.1
[7] When state and local spending is included, per capita spending on the elderly is still almost twice what it is on children.

more than pay for the program under a wide variety of assumptions about the various uncertainties involved.[8]

I read that the Administration is planning to spend $513,000 to set up an office of dynamic analysis within the Treasury Department to determine how tax proposals affect economic growth.[9] This type of analysis is fraught with uncertainty. Well-respected economists outside of government disagree about how to do it and whether the results are meaningful. According to CBO, a 10 percent reduction in tax rates would recoup between 1 percent and 22 percent of the lost revenue through economic growth effects in the first five years, and add as much as 5 percent to that loss or offset as much as 32 percent of it over the second five years.[10] However, it would be inappropriate to claim that such effects exist only on the tax as opposed to the expenditure side of the budget.

A second reason for concern about the squeeze on discretionary programs is the likely impact on low- and moderate-income working families. Although many of the elderly, especially older women living alone, have low incomes, the rate of poverty among the elderly is far lower than it is among families with children.[11] Thus, if we must cut spending, some of the burden should fall on older Americans and not just on younger families. These issues of fairness are especially salient in light of the fact that income inequality in the United States is at an all-time high and has been exacerbated by recent tax cuts.

What Might Be Done?[12]

This section of my testimony first outlines the kind of principles that might guide entitlement reform. But since real reform is unlikely any time soon, I later suggest a stopgap measure that would help to reduce the deficit very significantly over the next few years.

Principles of Reform. The President has called for a bipartisan commission on entitlements, a step that I think makes good sense given the current impasse on Social Security, the lack of clear solutions in the case of Medicare or Medicaid, and the need for fundamental reform. Such a Commission—if it had the trust of both sides in the debate and a degree of independence from the Administration—could perform a real service. It's challenge, as I see it, would be to establish certain principles to guide the process and then to suggest how those principles might be translated into specific policy proposals. What might such principles look like? Let me suggest a few, without in any way claiming that these are not controversial and thus in need of far more debate.

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[8] William Dickens, Isabel Sawhill, and Jeffrey Tebbs, "The Effects of Investing in Early Education on Economic Growth," Working Paper, January 2006. Available at: http://www.brookings.edu/views/papers/200601dickenssawhill.htm.
[9] Robert Guy Matthews, "White House Calls for New Tax-Cut Analysis Unit," *Wall Street Journal*, Feb. 11-12, 2006, p. A4.
[10] Congressional Budget Office, "Analyzing the Economic and Budgetary Effects of a 10 Percent Cut in Income Tax Rates," Economic and Budget Issue Brief, December 1, 2005.
[11] The proportion of children under 18 living below 150% of the poverty line is twice as high (28%) as the proportion of those 65 or older (14%).
[12] This section of my testimony reflects my own view only and should not be attributed to other scholars at Brookings, our trustees, advisers, or funders.

First, I believe that health care and retirement benefits should be more related to income than they are at present. The President's proposal to raise Medicare premiums for those with incomes above $80,000 a year, and to leave the eligibility threshold unindexed, moves in the right direction. Progressive indexing of Social Security benefits would accomplish a similar goal. Tightening up on the transfer of assets to children in order to qualify for Medicaid funding of nursing home care is still another example.

Second, the retirement age at which people qualify for full benefits under both Social Security and Medicare needs to be increased and indexed for longevity. Such an increase was accomplished in the Social Security system back in 1983 suggesting that it is possible for the political system to change these rules if adequate advance warning is given.

Third, we need to move away from a system that guarantees health care and retirement benefits toward one that guarantees instead, what the government is willing to contribute—in short, from a defined benefit to a defined contribution system. This does not mean that the political system couldn't decide to increase the level of those contributions over time, but it would not leave its liabilities, as now, on automatic pilot. Nor does it mean that the level of contribution shouldn't be higher for those with lower lifetime incomes. However, individuals would be expected to contribute more to their own health care and retirement, consistent with their ability to do so. One model for such a system is the Federal Employees Health Benefits Program.

Fourth, these contributions should be mandated by the government. If they were voluntary, too many individuals would fail to save for their own retirement or health care and thus become dependent on charity or the government as a last resort. There is abundant evidence that most people do not save enough for their retirement. For the first time since the Depression, household savings are now negative.[13] And unless national savings is increased, we are unlikely to continue to enjoy the kind of economic growth we have had in the past.

Fifth, virtually all experts agree that our current health system is inefficient and too often provides care that is not worth its cost. A greater emphasis on evidence-based medicine, on payment for performance, and on a more efficient delivery system in the big public programs (Medicare and Medicaid) could be used to leverage change in the entire health care system. This could help to constrain the health care spending increases that bedevil not only federal and state budgets, but also private employers and their employees.[14]

Sixth, taxes must be on the table. No commission on entitlements will get very far unless this is part of the deal. Just as it took Nixon to go to China, it will take more than token involvement by Democrats to revise the social contract with the elderly. And as the 2005 debate on Social Security demonstrated, public sentiment on these issues is with the Democrats. Many Republicans, for their part, fear that any increase in taxes will slow economic growth or lead to a new burst of government activism. But these supply-side effects have been much exaggerated, in

[13] Bureau of Economic Analysis, National Income and Product Accounts, "Table 2.1: Personal Income and Its Disposition," 2006.

[14] A more specific set of options for accomplishing these goals will be included in a Brookings volume being edited by Alice Rivlin and Joseph Antos to be published in early 2007.

my view—especially in light of the fact that recent tax cuts were financed by borrowing, almost entirely from abroad, and are not on balance good for the country's future domestic prosperity. In addition, not all tax increases have negative effects on growth. Indeed, some would accomplish just the opposite. Consider, for example, the President's Tax Reform Commission's proposal to rein in the deductibility of health insurance premiums paid by employers. This would lead to a more efficient, pro-growth tax system and simultaneously slow health care spending, and reduce one of the largest hidden (tax) expenditures in the federal budget. Or to take another example, it would be possible to raise the income cap on Social Security payroll taxes while simultaneously lowering the rate. And a new Value Added Tax might reduce reliance on income taxes while reducing the deficit in ways that would increase long-term growth.

An Action-Forcing Proposal. Because I am not optimistic that these issues will be resolved any time soon, I would like to share with the Committee an idea that was originally suggested to me by Robert Reischauer and which I believe has enough merit to bring to your attention.[15]

The proposal involves a temporary suspension of indexing of both benefit programs and the tax system. Many benefit programs, the largest of which is Social Security, are indexed for inflation using the Consumer Price Index, and since 1981, we have also indexed individual income tax brackets, personal exemptions, and the standard deduction.

The suspension would be put into effect immediately (FY2007) and would thus begin to stem the flow of red ink with savings in the neighborhood of $150 billion over three years (2007-2009). Its primary justification would be the need for broad-based sacrifice on the part of the American public to pay for the war in Iraq and the reconstruction costs associated with Katrina. Programs targeted on low-income families might be exempted. But otherwise almost everyone would be affected. Both spending and taxes would be part of the solution, making bipartisan compromise on enacting the proposal a possibility.

The suspension would be linked to the achievement of a deficit reduction goal. For example, Congress could enact a law calling for policy actions that would halve the deficit as a percent of GDP over the next five years with interim goals specified for each intervening year. In any year that the goal was not achieved (according to the CBO), indexing would be once again suspended for the following year (with a concomitant increase in the budgetary savings). In this fashion, the public would be brought into the process since their tax bills and Social Security checks would be affected if Congress failed to make serious progress.

A related proposal would be to simply make a technical change in the CPI to better reflect some of its existing flaws. This is a problem that is well-known among experts and has been cited as badly in need of correction by Alan Greenspan among others.

Conclusion. Short-term pressures to produce a budget resolution each year and to enact authorizing and appropriations bills may mitigate against finding long-term solutions to a budget deficit that is literally headed towards infinity, driven primarily by the growth of entitlements,

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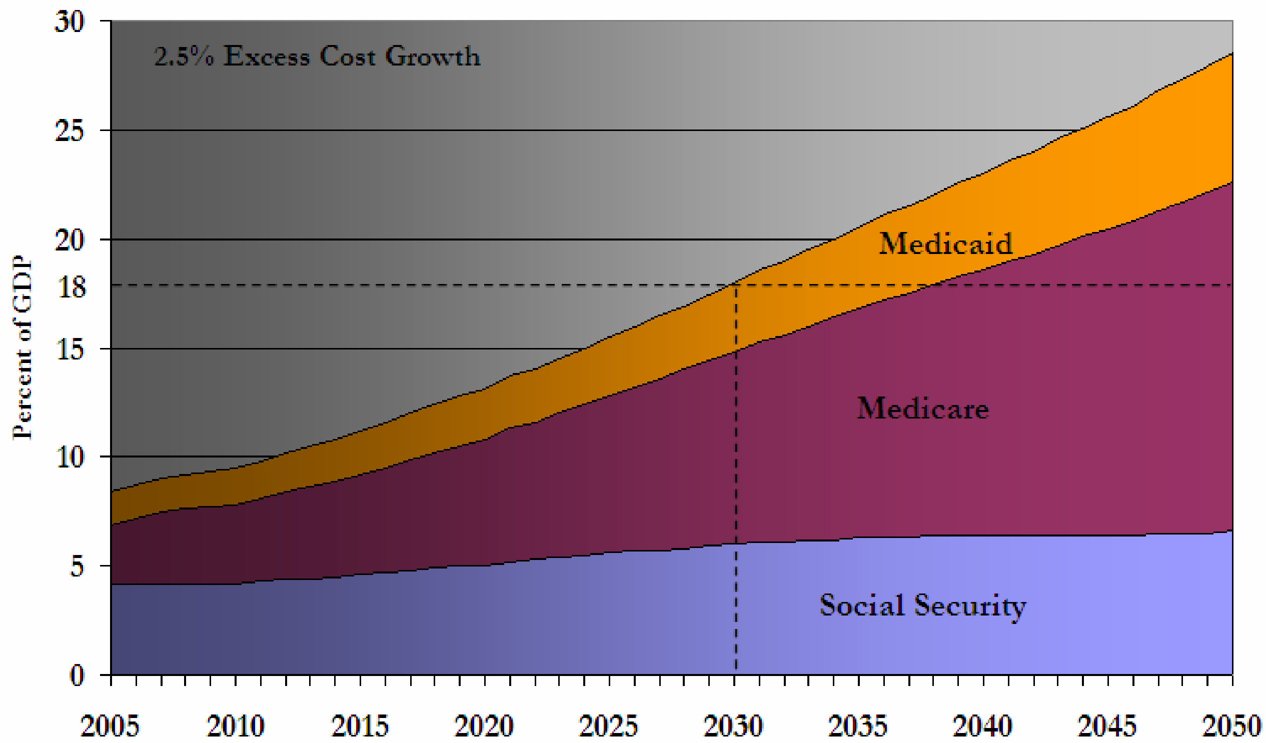
[15] A description of my proposal will be found in an op-ed published by the *Baltimore Sun* on January 27, 2006. Although I want to give credit to Bob Reischauer for surfacing this idea at a general level, I do not want to implicate him in the details of the current proposal, some aspects of which he may not like.

especially health care spending. Thus, I want to commend this Committee for taking up the challenge and urge you to begin the process of discussing the kinds of principles that need to guide fundamental reform.

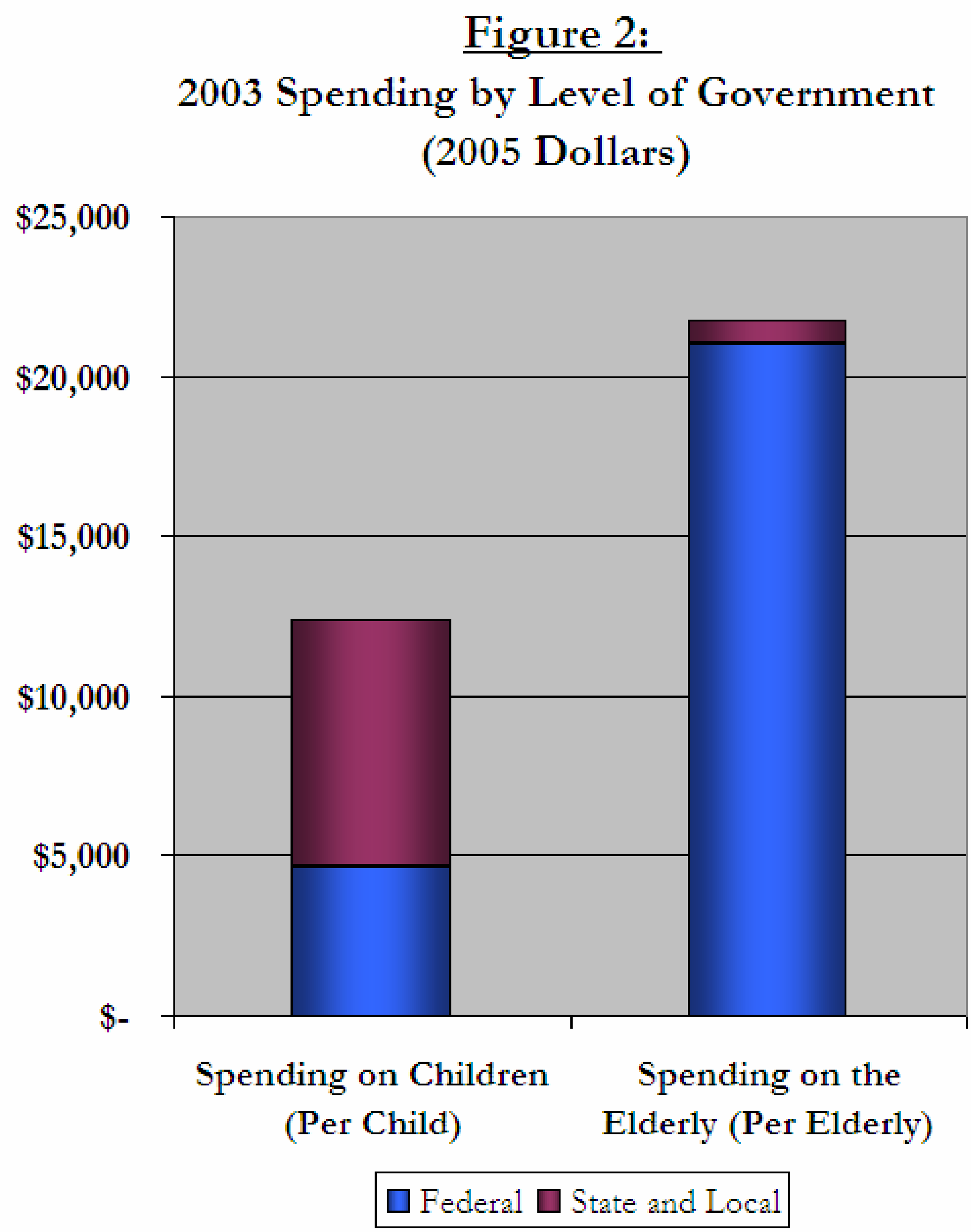
Like many others, I worry that currently projected deficits are a grave threat to our economy and that further tinkering around the edges can only postpone the day of reckoning. Even if we escape a hard landing for the economy, large deficits are likely to undermine our national strength by reducing national savings and necessitate that an increasing proportion of our future incomes be earmarked to pay back foreigners for current borrowing.

Figure 1:

Congressional Budget Office Projection of Social Security, Medicare, and Medicaid

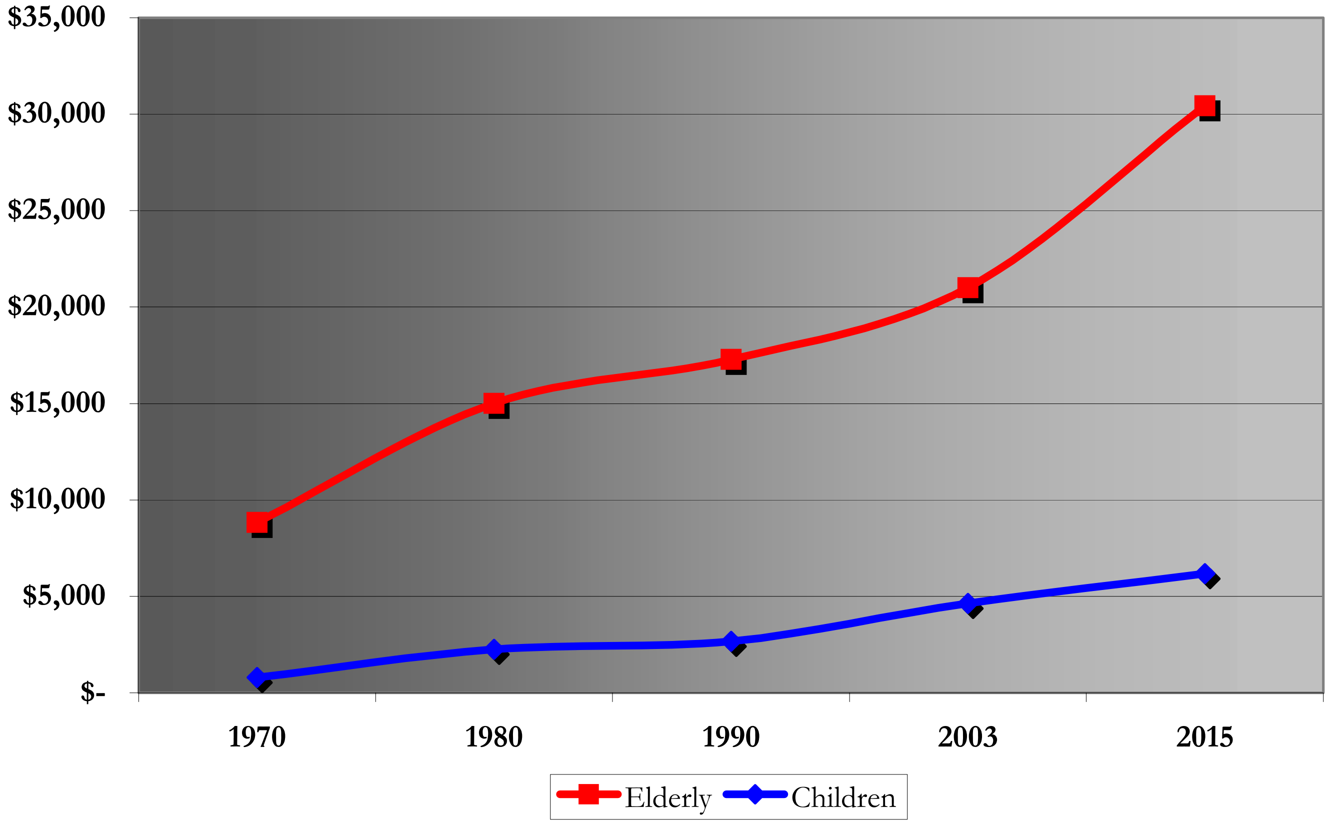


Source: Congressional Budget Office, The Long-Term Budget Outlook, December 2005, Scenario 1



Source: Brookings Institution, based on data from Congressional Budget Office, Office of Management and Budget, Social Security Administration, and various other government agencies.

Figure 3:
Federal Spending Per Child and Per Elderly
(2005 Dollars)



Source: Brookings Institution, based on data from Congressional Budget Office, Office of Management and Budget, Social Security Administration, and various other government agencies.