

# **IMPROVING WITH AGE: FINANCING GOVERNMENT IN THE 21<sup>ST</sup> CENTURY**

By

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Former ADA National Board Member

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*President Jim McDermott \* National Director Amy F. Isaacs*

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August 2007

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# IMPROVING WITH AGE: FINANCING GOVERNMENT IN THE 21<sup>ST</sup> CENTURY

By Max B. Sawicky

## Executive Summary

The late John Kenneth Galbraith is credited with the phrase “the conventional wisdom,” and he spent much of his life demonstrating that it is often wrong. That’s still true. The current Washington consensus on the U.S. Federal budget foresees disaster in the growth of entitlement spending. Public spending is invoked as a threat to economic growth. This paper provides an alternative view.

Our main themes are:

- Assumptions upon which pessimistic budget projections are based are highly uncertain and biased towards the expectation of low growth.
- Underlying the projected long-term fiscal imbalances, the discretionary spending portion of the budget is of negligible importance, Social Security is a secondary concern, and health care is the principal challenge.
- The budget problem should not be seen as a deficit problem. Rather, it signifies a political struggle over the size of government.
- In light of the likely trend of wages for the vast majority of Americans, Social Security will continue to be a progressive program between generations and within generations. In retirement, workers in the future would still be better off than the present generation, even if their taxes are raised to cover projected Social Security deficits and to provide benefits promised by law.
- The health care spending outlook is not a matter of facing rising costs for a fixed level of service in the face of reduced economic capacity. Rather, the question is how great an increase in health care services is desirable. In other words, how should we steer the fruits of economic growth for maximum health benefits per dollar spent. A new book by the conservative author Arnold Kling more aptly characterizes the problem as a “crisis of abundance.”
- Under most likely scenarios, Federal revenue will need to grow to historically unprecedented levels; this will be economically feasible, though the subject of intense political debate.
- Social Security and Medicare are the unique sources of economic security for most Americans. The future solvency of both programs will hinge on the

politics of financing, as well as success in health care reform for the entire population, not just for the elderly, disabled, and poor who currently benefit from Medicare and Medicaid.

The first part of this paper provides background on the demographic assumptions underlying long-run budget projections. These projections rest on debatable assumptions regarding fertility rates, immigration, and participation in the workforce by persons over 65 years of age.

The media panicked when the Social Security Trustees published their report that compared the ratio of workers to elderly today with the ratio in 2035 as the Baby boomers retire. In 2006 there were 165,593,000 workers covered by Social Security paying for the benefits of 48,879,000 beneficiaries/retirees, 30.2% of the covered workers. By 2035, there will be 185,004,000 covered workers and 88,576,000 beneficiaries/retirees, 47.8% of covered workers. Put differently, in 2006 there were 3.3 workers for each beneficiary, and in 2035 there will be 2.2 covered workers to each beneficiary. These figures lead to the media panic. What the media failed to note was that from 2035 to 2080 the shrinking relationship between workers and beneficiaries slows down and levels off. In 2080, there will be 2.0 workers for every retiree, a change from 2035 that is not dramatic at all. These percentage relationships are graphed as “dependency ratios” in Figure 1 on page. 5.

As to immigration, the Trustees assume continued current law, whereas immigration policy can be adapted to changing labor force needs. And improved health of the elderly – and the entire population – can lead to lower health care costs and greater participation in the labor force of older people.

Part two addresses questionably pessimistic economic assumptions about unemployment, productivity, and Gross Domestic Product, although with more optimistic assumptions, concerns remain. To give one example, the Social Security Trustees assume an unemployment rate (currently 4.7) of 5.5, while the CBO and OMB assume 5.0. Such big differences in assumptions have enormous budget implications.

Parts 3 and 4 outline trends in the principal spending categories of the Federal budget. The purpose is to provide perspective on the roles of interest, defense, Social Security, Medicare, and domestic discretionary spending. Federal budget projections become alarming primarily due to the rising cost of interest on the debt, which arise from the Bush administration’s borrowing to pay for increased spending, especially for the military. If we increase debt no more than we increase GDP, paying for increased spending with taxes, interest on the debt is no longer burdensome. (See Figure 2 on page 12.)

Part 5 considers revenues in light of spending trends and provides alternative ways to accomplish the inevitable expansion of revenues necessary to maintain current benefits. Taxes in the U.S. are 18.8% of GDP, whereas in OECD countries, the

average is 36.3, and the EU is 40.6. Yet GDP growth of many of these countries with high tax burdens is as great as ours. (See Figure 5 on page 21.) As the U.S. has decreased the share raised by corporate income and excise taxes, we have increased the share raised by payroll taxes. OECD countries rely far more heavily on consumption taxes. (See Figure 6 on page 11.) We should reverse most of the Bush administration's tax cuts, including the lower tax rate on capital gains, dividends, and estate and gift taxes, eliminate corporate tax breaks, improve enforcement, and consider consumption taxes, but not as a substitute for progressive income taxes.

Part 6 is a more general discussion of Social Security and social insurance. It demonstrates the economic feasibility of maintaining scheduled benefits and explains the significance of pay-as-you-go social insurance for working families as the counterpart to the wealth of the rich. To maintain benefits, the cap on wages subject to the payroll tax can be removed or we can rely on general revenue to fulfill social insurance obligations.

The paper concludes with a summary of the policy priorities and options that follow from the analysis:

- Increase non-defense public investment, which can increase GDP, while Maintaining environmental sustainability;
- Reduce contracting out government services, a source of corruption;
- Enact serious health care reform, reducing waste and subsidies, and making for a healthier workforce; health care should be viewed as a public good;
- Recognize the importance of social insurance for retirement, disability, health care, and unemployment – the principal assets of working people.

## Introduction

Assessments of the U.S. economic future seem oddly mixed. On the one hand, the nation has enjoyed decades free of the 1970s bugaboo of inflation, while the unemployment rate has reached lows previously thought to be impossible or infeasible. Although plagued by sluggish employment growth at the outset, the past two recessions were relatively mild in terms of lost output. Signs recur that the severe slow-down in productivity growth that began in the '70s may have ended.

On the other hand, the shadow of America's Baby Boom hovers over the future. Imbalances in both the Federal budget and the nation's trade deficit are almost universally held to be dangerous and unsustainable.

In the face of these storm clouds, what hope is there for the public sector, particularly for the major components of our social insurance system: Social Security, Medicare, and Medicaid? This paper lays out the demographic and economic background for future fiscal policy decisions. It criticizes the common nostrum that profligate Federal government commitments to the retirement security and health care of working families must eventually trigger a fiscal crisis. We show that financing retirement benefits is a relatively minor problem, while health care is the neglected sector.

Parts 1 and 2 provide demographic and economic background for considering long-range budget trends. Assumptions on trends in population and economic growth are assessed. The focus here is on the choices underlying the Social Security trustees' "intermediate" projections of the financial status of Old Age, Survivors, and Disability Insurance. These assumptions are the usual props for dire economic predictions. We demonstrate the bias underlying these assumptions, their uncertainty, and therefore the flimsiness of justifications for radical changes in vital Federal programs.

Parts 3, 4, and 5 outline the principal components of the Federal budget: discretionary spending, entitlements, and revenue. This discussion provides context for considering the long-range prospects of Social Security, Medicare, and Medicaid. It enables us to explain why we do not face a problem of deficits or general entitlement spending. Potential growth in spending can be financed with tax increases. We do face a political conflict over the size of government, especially over its commitment to guaranteeing universal access to medical care. Possible tax reforms are weighed.

Part 6 reviews the specific case of Social Security. The program is of particular interest because its purported condition has been the basis for alarmist statements about the Federal budget. Social Security is strongly supported by the American public. Sustaining it requires a future commitment of public resources. Social Security is at the core of the generational interdependence that is the foundation of economic security in a modern economy. From philosophical, political, and economic standpoints, this foundation is the logical, ultimate target of conservative criticism of social insurance.

The concluding part proposes the policy priorities and options that follow from our analysis.

## **I. Demography**

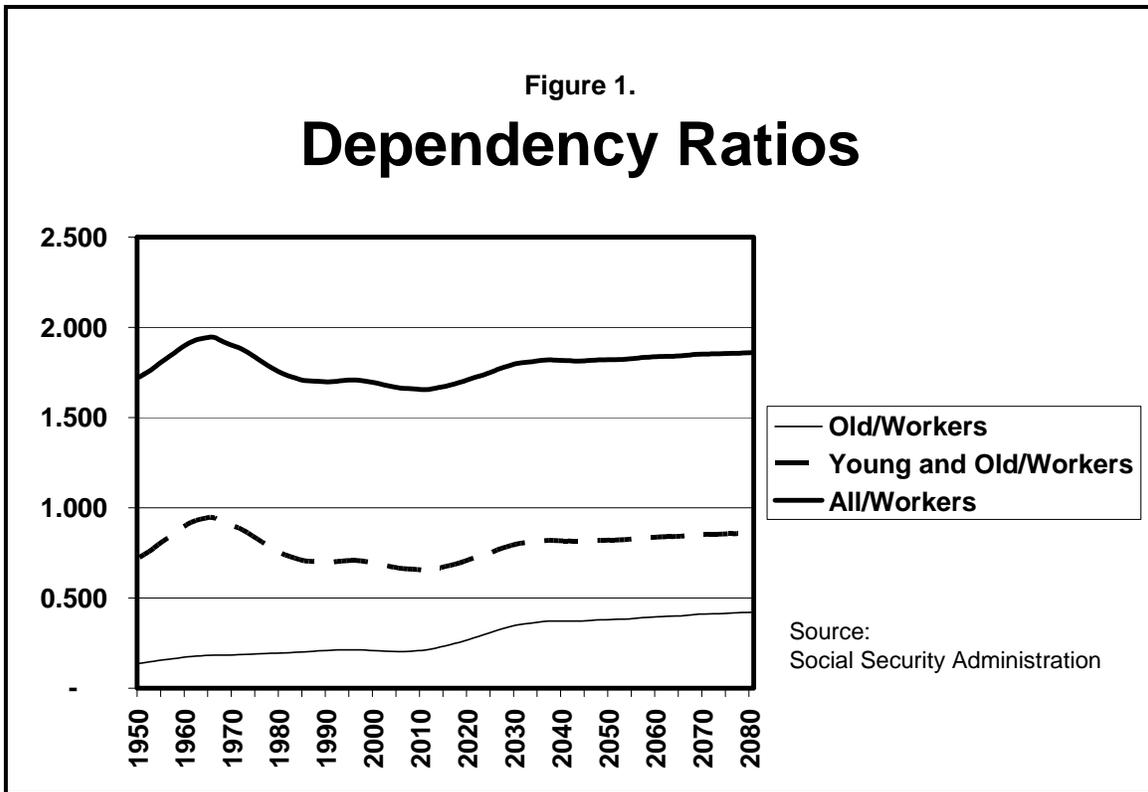
Commentary on budget prospects dwells on expected changes in the ratio of workers to Social Security beneficiaries. Recently the Social Security trustees reported that in 1945 the ratio was 41.9 covered workers for every single beneficiary. Today's rate is 3.3, and the Trustees' projected ratio in 2080 is just 2.0 (Trustees, 2006). In this vein, the Trustees create a mountain of what is more like a molehill.

Presenting the change from 1945 to 2080 creates a cataclysmic illusion. Superficially, the change from 41.9 to 3.3 – a change we are living with at present with no noticeable trauma, while the Social Security program runs large surpluses – is not much less dramatic than a fall from 41.9 to 2.0. More to the point, the change in the ratio after 1945 for the most part does not reflect changes in population. It reflects the gestation period of a program, before the bulk of the workforce became old enough for retirement benefits and before Congress expanded the categories eligible for coverage (including self-employed, domestic workers, etc.).

Projected changes from the present time forward assume no change in eligibility, so it is reasonable to look at the limited number of basic assumptions driving projected changes over the next 75 years.

We will return to the Social Security program data in Part 6, below. Here we confine ourselves to broader demographic and economic trends. Underlying the projections are assumptions about population growth and employment. The implication is that a sea of dependent elderly will overwhelm a shrinking cohort of workers.

Figure 1 shows so-called “Dependency Ratios” based on historic and projected population trends (Trustees, 2006). ‘Young’ means the number of persons under 20 years of age, ‘old’ is 65 and over, and ‘workers’ are those in between. The categories of “old” and “workers,” respectively, correspond roughly to beneficiaries of Old Age Insurance (OAI) and covered workers (those paying into the program).



The bottom line in the chart is the basis for the frightening figures found in the news media. It is the ratio of old people to workers. In 2013 it takes off, and by 2035 it begins to slow down. This leveling trend is of course the retirement and passing of the Baby Boom (those born between 1946 and 1964). By 2035, the youngest surviving Boomer is 71.

The trend after 2035 is much different than that in the preceding two decades: growth in the ratios is visibly slower, as the rise is followed by a plateau.

Panicked media coverage often compares the ratio in 2035 to today – a ratio of ratios. This magnifies the change but adds no information. The arbitrary selection of 2035 as the cutoff of the comparison reflects a bias intended to cause alarm.

Often ignored is that the elderly are not the only “dependent” portion of the population. Workers do not provide only for the elderly. The middle line shows the ratio of children *and* old people to workers. The upturn, followed by a plateau, is much the same. Over the entire projection period to 2080, the ratio fails to reach its previous peak level. In other words, dependency in this broad sense becomes less onerous in the future, with a much larger economy, than it has been in the more recent past. As a matter of simple arithmetic, the “ratio of ratios” for, say, 2035 to 2015, is much lower than for elderly to workers, simply because the respective levels are higher.

Here is an example. Suppose Baby Susie weighs 20 lbs, and her toddler sister Amy weighs 40. The ratio of their weights is 2.0. Now fast forward thirty years, where Amy weighs 140 and Susie weighs 120. The difference is the same – twenty pounds – but the ratio is now 140/120, or 1.17, which is much less than 2.0. Or take their uncle and father, one of whom weighs 280, the other 260. The difference is still 20 pounds, but the ratio is 280/260, or 1.08, even smaller than 1.17.

Finally we have the top line in the chart. This is actually the most relevant trend: workers provide for their own consumption needs, as well as for that of all dependents. This pattern resembles that of the middle line. However, instead of the ratio of workers to elderly rising precipitously from .20 to .37, or 85 percent, the change is from 1.67 to 1.82, or just nine percent.

Nine percent implies less change in the burden of dependents on workers. Exacerbating the burden to some extent, however, is the changing composition of dependents from children to elderly adults. In 2005, more than 31 percent of dependents are over 65; by 2080, the elderly are projected to be 49 percent of dependents. Under some circumstances, adding one or two children to a household implies less expense than maintaining living standards for one or two elderly persons. For children there is the expense of child care, but for the elderly, there is the potentially astronomical cost of nursing home care or its home-based counterpart.

It is often noted that on top of the relatively benign trend in the ratio of total population to workers, labor productivity is expected to increase indefinitely. Offsetting this development, however, is the built-in expansion of benefits in the biggest entitlement programs. We expect contributory social insurance programs to support the rising living standards of the future, not those of today. Social Security benefits are evaluated in terms of replacement rates of ever-rising wages. Workers rightfully expect some positive rate of return on their payroll tax contributions, analogous in that respect to private sector savings.

Similarly, health programs will be expected to provide medical care of the future, not of the past. Strictly speaking, productivity growth does not necessarily speak to the financing problem. In fact, the projected gaps in Social Security financing assume some productivity growth. Just as population could safely outgrow the number of farmers in the U.S., the likelihood of productivity growth should assuage general concerns about dependents growing faster in number than workers. We return to this subject below.

While demographic projections have proven reasonably accurate, they are not immune to change. Ongoing research and new data fuel continuous recalibration of basic assumptions. The principal variables in question are fertility rates (children per woman), death rates by age-gender group, and net immigration.

The 2006 Trustees' report revised its 2005 prediction of the long-run fertility rate of 1.95 in the 2005 report to 2.0 for the 2006 and 2007 reports, thereby increasing the projected number of workers relative to retirees. In 2006, this improved the 75-year actuarial

balance by .03 percentage points. In the 2005 report, a similar change had resulted in another improvement of .03 points. Higher fertility rate assumptions improve the long-run projected condition of Social Security and Medicare by stemming the slow-down in labor force growth. In the 2005 report, fertility estimates ranged from 1.7 to 2.3 children per woman. The most recent estimate for the current level is 2.04 (Trustees, 2007).

Back in 1975, the fertility rate was 1.77, while women were surging into the labor force. Fertility nonetheless grew thereafter, although the rate is now projected to decline slightly in the future, to the detriment of Social Security's financial health.

In addition to fertility, population estimates depend on projections of net immigration. Although not strictly comparable, estimates of immigration relative to workers must be built into the projections of total population. The Trustees estimate 1,075,000 immigrants of assorted ages in 2006 (legal and 'other'). They foresee a decrease to one million by 2010, then to less than a million in 2020 and thereafter. By contrast, the working age (20-65) group increases from 183 to 233 million over the next 75 years.

One or even two million additional workers in a single year may not seem like much compared to 183 million, but over an extended period the additions accumulate. An extra million per year over the next 30 years to cover the biggest part of the sag in workforce growth would be a significant expansion. A strategic immigration program focused on meeting the need for new workers as the growth in native-born workers slumps would go some ways toward alleviating retirement and health care financing problems.

The Social Security Advisory Board (Technical Panel, 2003) criticized the Trustees' immigration assumption for basing predictions of the future on current law. The Board urged the Trustees to base projections instead on historical trends and to express the numbers in terms of a rate, rather than an absolute number, as is the current practice. One might question the consistency of the Trustees' assumptions of declining labor force growth, suggesting increased demand for labor, with the assumption that policymakers will hold down immigration.

In addition, if the health of the elderly continues to improve, some elderly people might choose to delay retirement, which would lessen the assumed decline in the number of workers. Elderly participation in volunteer programs could add to national well-being, lightening the implied load on workers, since measured GDP is not the only source of consumption. Volunteer services provide benefits that are not counted as part of GDP. More elderly in paid employment, subject to payroll taxes, would bolster the program directly. In the same vein, improved health of the elderly could reduce health care costs.

## **II. Economic Growth**

Notwithstanding problems with population projections, they are the most certain factors in predictions of labor force levels. Also critical to estimating economic growth are assumptions about unemployment, hours of work, and productivity growth. The

determinants of these factors and their expected future values are controversial and uncertain.

*Unemployment.* A decade ago, conventional wisdom among economists held that if the unemployment rate fell below 5.5 or six percent, ruinous inflation would ensue. In the latter part of the '90s, the unemployment rate often fell below five and, at times four percent, with no such inflationary result. The Congressional Budget Office (CBO, 2006) and the Office of Management and Budget (OMB Mid-Session Review, 2006) assume a long-run unemployment rate of 5.0 percent.

By contrast, the Social Security Trustees hold that the 2005 unemployment rate of 5.1 is unsustainable. They assume a long-run rate of 5.5 percent. (In the most recent Trustees' report, the current rate is 4.7 percent.) Substitution of the CBO or OMB numbers would lead to a more optimistic long-run budget outlook.

*Productivity Growth.* Growth in productivity, defined as output per hour, reflects all the factors that give rise to economic growth. Nobody believes that the number of hours worked is the sole determinant of Gross Domestic Product (GDP). Growth arises from investment in a larger capital stock – in both the private and public sectors –and in advances in organizing production. Other less tangible but hugely important factors include educational attainment, skill acquisition, and scientific discovery. Finally, even if one had a definitive list of the “supply-side” factors, exactly how they fit together would remain to be discovered.

The demand side of the economy also comes into play. Demand for goods and services induces their production – increased demand calls forth increased supply. Expectation of sales encourages businesses to invest. Investment makes possible research and development, and capital formation, even though not all ventures succeed.

Preparing economic projections requires reducing much of this enormous complexity of future economic development to a single number – the rate of productivity growth. The current assumption of the Social Security Trustees yields a long-run value of 1.7 percent annually (the current level is 2.0 percent). The period between 1967 and 1997 saw an average of 1.5. Experience before and after has been better than 1.7. For 2001-2006 inclusive, the average was 2.4 percent.

An assumption that productivity growth will slow down as the workforce shrinks and the capital stock grows is counter-intuitive. Usually, economists expect higher productivity in the sense of higher output per worker as the ratio of capital to workers increases.

Here again, the Office of Management and Budget offers a dissenting view to the SSA Trustees. The OMB estimates a 2.3 rate of growth in the long run. If productivity grows an extra half a percentage point faster and it is passed through to in wages (not a sure thing), the 75-year gap in Social Security would be reduced from 1.95 to 1.40 percent of taxable payroll (Trustees, 2007).

Although highly debatable, an influential school of thought contends that inflation is typically overstated by as much as a percentage point a year. If one were to adjust real wage growth upward to that degree in response, it would knock pessimistic Social Security projections into a cocked hat (Baker and Weisbrot, 1999).

Critics of Social Security propose private investment in personal retirement accounts as a solution to the projected long-run deficits in the program. Evaluation of privatization schemes is beyond the scope of this paper. Yet it should be clear that the returns to private investment depend on economic growth. Dividend and interest payments are financed by business profits, and capital gains stem from expectations of future profits. Profit growth depends on productivity growth. The Trustees' pessimistic expectations on productivity imply correspondingly dim returns to private investment (Baker and Weisbrot, 1999; Baker, DeLong, and Krugman, 2005). Thus, it defies logic to assume increased return on private investments while at the same time assuming low productivity growth.

### *GDP Projections*

As noted above, pessimistic predictions of productivity growth necessarily give rise to assumptions of lower GDP growth. The Social Security Trustees foresee decreasing real GDP growth (adjusted for expected changes in the Consumer Price Index) from an annual rate of 2.6 percent this year to about 2.0 percent after 2020. By 2050 the Trustees foresee a GDP of \$29 trillion (in 2007 dollars). The slower growth rate is attenuated to some extent by reduced population growth. They assume real annual per capita GDP growth falling from annual growth of 1.9 percent in 2007 to 0.9 percent as soon as 2013, but remaining level and eventually increasing by 1.2 percent a year.

The upshot, according to the Trustees' projections, is that the nation will have to accustom itself relatively soon – sooner than any major reform of entitlements is likely – to slower real per capita GDP growth, but eventually the situation will ease to some extent.

Over long periods, even low growth rates give rise to dollar levels that are hard to imagine. The Trustees' assumptions lead to a GDP projection of \$29 trillion in 2050, and \$49 trillion in 2085 (in 2007 dollars). Per capita GDP, which is now \$43,000, would grow to an inflation-adjusted level of \$103,000 by 2085. The current real average wage of \$40,461 becomes \$95,145 in 75 years.

As elsewhere, the picture foreseen by the Congressional Budget Office (2005) is more positive. The CBO anticipates real GDP growth in the range of 1.8 to 2.1 percent by 2050. Even a small difference compounded annually translates into a large difference in future dollar values. Real GDP in 2050 is projected by CBO at \$33 trillion in 2005 dollars, contrasted to the Trustees' projection of \$29 trillion.

### **III. The Long-Run Federal Budget Outlook**

This Part describes trends in the Federal budget and the implied challenges for future fiscal policy. For this purpose we use pessimistic assumptions about the future economy. Economic assumptions of some kind are necessary because projections of spending and taxes depend on anticipated economic growth. Changes in GDP and the price level can affect spending and tax revenue receipts, aside from discretionary legislative action. From an evaluation standpoint, taking for granted some of the prevailing pessimism underlines the relative feasibility of more likely outcomes. Things are not as bad as they look, even with pessimistic assumptions.

Often discussions of the future begin with the unified budget deficit, which is simply the difference between all outlays and receipts, usually assuming no change in current law. A shortcoming of this approach is that it glosses over the distinction between program spending and obligatory interest payments on Federal debt held by the public.

Under current law, unsustainable unified budget deficits persist indefinitely. Because of this, Federal debt accumulates continuously, and interest obligations and debt both grow faster than the economy. Consequently, the further in the future the budget is projected, the more untenable the picture becomes.

The deficits implied by decades of inaction are often offered as proof of required changes in taxes and/or spending in the present. This radically overstates the dimensions of the problem. The buildup of interest obligations is a major component of the ballooning deficit, but the cause of higher interest payments is faster growth of debt, and debt grows faster or slower depending on the extent to which current spending is paid for with borrowed funds or taxes, respectively. So of course, if you run excessively high deficits, debt and interest blow up. This could happen if Federal programs were half the current size. Conversely, if the Federal government were twice its current size and paid for all spending with taxes, interest and debt would be lower than projected.

Some would close the deficit with spending cuts, others with tax increases, depending on whether they preferred that the Federal government shrink or grow. For this reason, the long-run budget gap should not be seen as a deficit problem. There is instead an argument about the size of government. Within limits, higher public spending can be financed with higher taxes. The more pertinent question is whether expansion of public programs is desirable, not whether it is feasible. Exploding deficits are commonly assumed to be unavoidable and intolerable, but if program spending is paid for with tax revenue, there will be no such explosion.

Table 1, Long-Run budget Projections, below is taken directly from the President's 2007 budget documents (OMB, 2006).

## Long-Run Budget Projections

| Table 1.<br>(Percentage of GDP)  | 2007      | 2010 | 2020 | 2030  | 2040  | 2060  | 2080  | Change,<br>'07-'80 |        |       |                    |         |          |
|--|-----------|------|------|-------|-------|-------|-------|--------------------|--------|-------|--------------------|---------|----------|
| Receipts   | 18.5      | 17.9 | 18.9 | 19.4  | 20.0  | 21.3  | 22.4  | 3.9                |        |       |                    |         |          |
| Outlays  |           |      |      |       |       |       |       |                    |        |       |                    |         |          |
| Discretionary  | 7.8       | 6.1  | 5.6  | 5.6   | 5.6   | 5.6   | 5.6   | (2.2)              | (2.20) |       |                    |         |          |
| National Defense   | 4.1       |      |      |       |       |       |       |                    |        |       |                    |         |          |
| Other Discretionary  | 3.7       |      |      |       |       |       |       |                    |        |       |                    |         |          |
| Mandatory  |           |      |      |       |       |       |       |                    |        |       |                    |         |          |
| Social Security  | 4.2       | 4.2  | 4.9  | 5.8   | 5.9   | 6.1   | 6.4   | 2.2                | 2.20   | 2.20  | Social Security    |         |          |
| Medicare   | 2.7       | 2.8  | 3.7  | 5.0   | 6.1   | 7.9   | 10.4  | 7.7                | 7.73   | 7.73  | Medicare           |         |          |
| Medicaid/SCHIP   | 1.4       | 1.5  | 1.9  | 2.1   | 2.3   | 2.8   | 3.3   | 1.9                | 1.91   | 1.91  | Medicaid/SC<br>HIP |         |          |
| Other  | 2.3       | 2.3  | 1.9  | 1.6   | 1.4   | 1.1   | 0.9   | (1.4)              | (1.43) | 7.70  | Net Interest       |         |          |
| Subtotal,=Mandatory  | 10.6      | 10.8 | 12.4 | 14.5  | 15.7  | 17.9  | 21.0  | 10.4               |        | 19.53 |                    |         |          |
| Net Interest   | 1.7       | 1.9  | 1.4  | 1.5   | 2.3   | 4.7   | 9.4   | 7.7                | 7.70   |       |                    |         |          |
| Total Outlays  | 20.1      | 18.8 | 19.4 | 21.6  | 23.6  | 28.2  | 36.0  | 15.9               | 8.20   | 1962  | 19.5               | 567.6   |          |
|  |           |      |      |       |       |       |       |                    |        | 2005  | 474.9              | 12290.4 | 1.077075 |
| Primary Surplus or<br>Deficit (-)  | 0.1       | 1.0  | 0.9  | (0.7) | (1.3) | (2.2) | (4.2) | (4.3)              |        |       |                    |         |          |
| Federal Debt held by the<br>Public   | 38.3      | 37.5 | 26.2 | 28.8  | 43.3  | 88.6  | 177.4 | 139.1              |        |       |                    |         | 474.9    |
| Source: Analytical<br>Perspectives, Budget of<br>the U.S. Government,<br>Fiscal Years 2007 and<br>2008 |           |      |      |       |       |       |       |                    |        |       |                    |         |          |
|  | 13,761.20 |      |      |       |       |       |       |                    |        |       |                    |         |          |

The table is based on the unlikely assumption that all the Administration's policies are enacted into law. Nevertheless, it serves our purposes as a summary of the budget picture. We note some of its biases below.

For 2080, the projected unified budget deficit under the President's proposed policies is 13.6 percent of GDP (in today's terms, \$1.8 trillion), and debt is 177 percent of GDP. Of this 13.6 percent, 9.4 percent consists of net interest payments (compared to well under two percent today). But since the interest component is the child of absurd deficit policy, the unified deficit is the wrong place to look to understand future financing requirements.

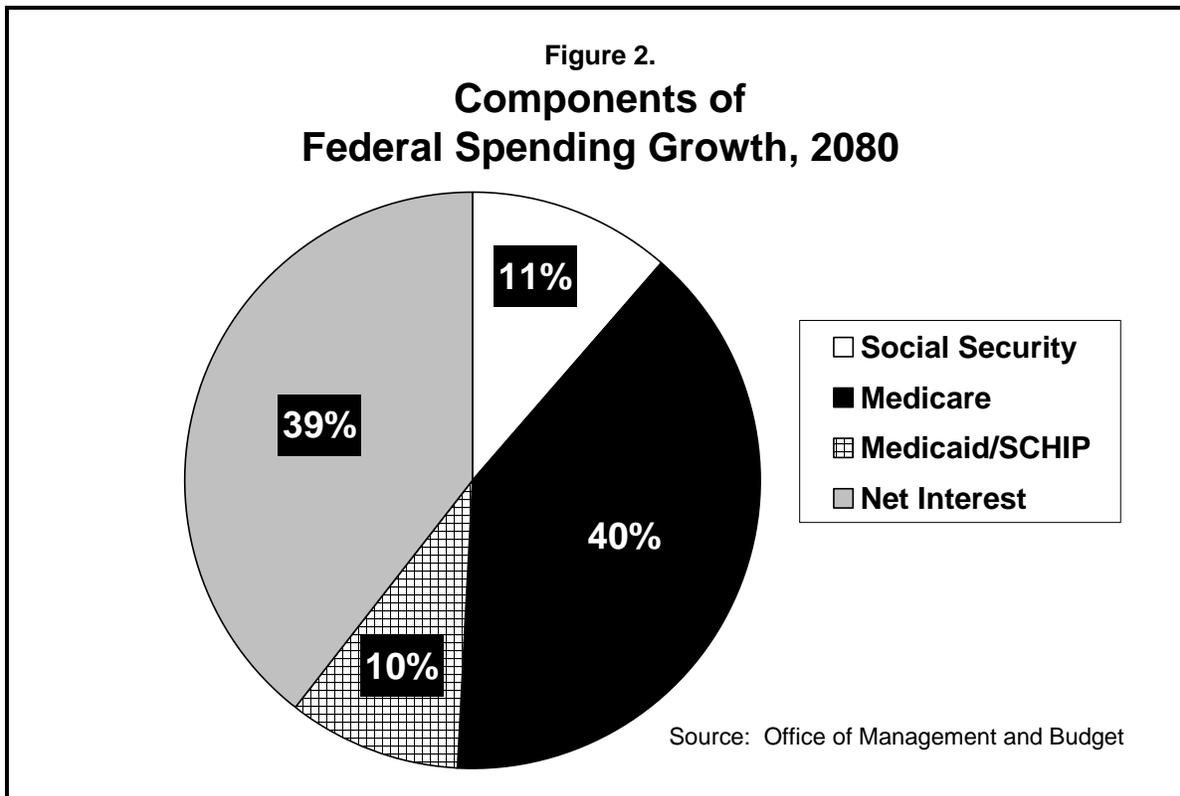
The "primary deficit" in 2080, which is program expenditures less receipts, is much less than the unified deficit – 4.2 percent of GDP. Deficits low enough to restrain debt from growing more rapidly than GDP – deficits of somewhat less than two percent of GDP – would prevent interest from growing as a share of GDP as well. By the same token, closing the current deficit by 13.6 percent of GDP – running a surplus, in light of the current deficit of 1.3 percent of GDP – is a much larger adjustment than would be necessary to maintain the current, sustainable proportion of Federal debt relative to GDP.

To repeat, to a great extent projections of unified budget deficits are artifacts of deficit policy in the interim, not of program costs or the size of government. Closing the primary deficit by whatever means has a significant ripple effect on the projected unified budget deficit. Eliminating the primary deficit would restrain interest and debt from growing more rapidly than GDP and stabilize the unified deficit at a tolerable level.

This suggests a two-stage approach to considering future budget trends. Stage one: determine what level of borrowing would be sufficient to limit the growth of debt to that of the economy. For purposes of economic stimulus during recessions, it could prove desirable to increase this amount to some extent. Otherwise, in Stage Two, determine total desired expenditures aside from interest payments on pre-existing debt. The difference between total expenditures (desired and obliged due to debt) and feasible borrowing is the amount of necessary tax revenue. Under current circumstances, aside from periodic considerations of stimulating employment, deficits of nearly two percent of GDP can be sustained indefinitely.

#### IV. Spending

What are the implications of the policy presented in Table 1? The Office of Management and Budget projects outlays to grow from today's 19.9 percent of GDP to 36 percent of GDP by 2080. Figure 2 below illustrates the components of the increase. Interest payments and Medicare clearly lead the list. As explained above, the surge in projected interest payments is a function of the projected failure to close the primary budget deficit.



In terms of program spending, the culprits clearly are the two big health care programs: Medicare and Medicaid (hereafter, "M&M"). In the future, Social Security is much less burdensome a factor. The level presented in the chart reflects benefits scheduled under

current law for Medicare, Medicaid, and Social Security. The discretionary spending share depends on assumptions to which we now turn.

*Discretionary Spending.* Standard practice in budget projections is to assume “current services” for outlays. This is defined, more or less arbitrarily, as constant-dollar spending for existing discretionary programs. In other words, the dollar amount is adjusted for inflation, but nothing more. For longer-term analysis, it is commonly recognized that discretionary outlays usually track GDP growth. Since 1962, nominal GDP has grown at an average annual rate of 7.4 percent, and discretionary outlays by 7.7 percent.

In Table 1 the Administration assumes discretionary spending at a fixed level of 5.6 percent of GDP in the long run, down from the present level of 7.3. Part of this decrease could be justified as a logical wind-down from the current bulge in defense spending due to the occupations of Iraq and Afghanistan. In its own long-range projections, CBO limits defense spending by 2050 to a range of 1.4 to 2.0 percent of GDP. The higher end of the range is CBO’s estimate of the effect of enacting the Bush Administration’s defense plans (CBO, 2007).

These relatively low estimates (to be sure, a small share but of a growing GDP) stem from the nature of national defense underlying the estimate. Defense needs depend on national security threats, not the size of the economy. There is no particular relationship between GDP and the cost of a defense establishment, except in the sense that a higher GDP makes defense at any level more affordable. By contrast, we could expect the demand for non-defense benefits and services to keep pace with the growth in population and the economy.

A counter-argument is that if the U.S. finds it desirable to maintain relative military dominance over Russia or the Peoples Republic of China, and if those economies continue to grow strongly, then it is possible that some constant share of GDP would be reserved for defense in the U.S. We could hope that all such adversaries would find it mutually advantageous to dial down their defense expenditures in concert.

Even with a defense drawdown, the Administration’s projection of 5.6 percent of GDP is unlikely and unrealistic as a projection of total discretionary spending. But in general, discretionary spending is not considered an unstable element of the budget. As noted above, its growth has been close to that of GDP. An increase of one or two percentage points would affect the long-run primary deficit by that same amount, well under the impacts of health care spending discussed below.

Funds for discretionary programs must be approved annually, and for this reason the programs are more vulnerable to cuts, or more amenable to reductions, depending on one’s point of view. Changes in spending have been common. There is no inexorable political force demanding their substantial increase.

Since 1962, non-defense discretionary spending has never exceeded 5.6 percent of GDP. Since 1984, it has been less than four percent. A permanent increase in its share of GDP

of a percentage point or two would be large compared to existing levels but relatively small compared to overall long-run budget imbalances.

Federal investment spending is a sub-category of discretionary spending. In 2005 it reached \$232 billion, out of \$475 billion in non-defense spending, or two percent of GDP. Of the \$232 billion, about half is given in grants to state and local governments. Unlike for private business firms, in Federal budget accounting an investment outlay is treated the same as spending for current consumption. This practice embodies a bias against investment, since by ordinary accounting principles spending for things like durable capital facilities should not be counted as a current cost; rather, cost should be amortized over the useful life of the asset.

As shown in Table 1 and Figure 2 above, a one percentage point of GDP increment to discretionary outlays would be small, compared to the factors underlying projected long-run growth in all program spending as a share of GDP. Social Security, Medicare, Medicaid, and Net Interest between them are projected to increase by nearly 20 percentage points of GDP. An increase in non-defense discretionary spending of one or two percent of GDP from current levels would return us to spending in the mid 1970s. If this was financed by transfers from defense, it would not adversely affect the primary deficit at all.

*Mandatory Spending: Social Security and 'Other'.* The Administration projection foresees the cost of Social Security growing to 6.3 percent of GDP by 2080, close to the Social Security Trustees' most recent 'intermediate' projection. Over this period, the increase as a share of GDP is 2.1 percentage points. CBO projects the cost of the program growing to a total of 6.85 percent of GDP in 2080, and to 7.09 percent by the year 2100. (CBO also projects higher dedicated Social Security tax receipts than the Trustees do. We turn in more detail to Social Security financing below.)

Aside from health care, the remainder of mandatory spending is projected to decrease in the future by more than one percent of GDP (roughly half the extent of the increase in Social Security, or about what we might look forward to in the growth in non-defense discretionary spending). The bulk of this decrease is due to the pension benefits of Federal employees, expenses that fade after the impending mass retirement of Federal workers of the Baby Boom generation.

*Health Care.* Assuming continuation of its own proposed policies, the Bush Administration projected total spending on Medicare and Medicaid at 4.2 percent of GDP in 2006, reaching 9.7 percent of GDP by 2080. CBO (2005) published three alternative scenarios in which total spending ranged from 7.0 to 21.9 percent of GDP by 2050, from a base of 4.5 in 2006. As most estimates go, the Administration's figure is relatively low. As such, we could say it assumes the success of money-saving measures and is therefore a liberal estimate of savings attained.

Growth in health care spending has not been limited to the public sector, a fact that points to a problem beyond government budgeting. National health expenditures grew from 5.1

percent of GDP in 1960 to 16.0 percent in 2004 (CMMS 2006). In most years since 1999, private health insurance spending grew faster than total spending. In 2004, private health insurance was 35 percent of national health spending. The average annual growth rate of total spending was 2.6 percentage points greater than GDP, though this gap has narrowed somewhat in the past decade.

Health care spending in the private sector and by state and local government is heavily subsidized by the Federal government. A more limited Federal role with reduced Federal spending, would not necessarily promise a lower rate of growth in spending.

Nor does a reduction in Federal spending imply a reduction in cost. Costs not picked up by government or insurance companies may be borne out-of-pocket by individuals. Alternatively, the individual “pays” by foregoing care. The overarching question is what sort of system would provide a desirable level of care at an acceptable cost.

U.S. health care spending per capita and as a proportion of GDP are high compared to other industrialized countries, while health outcomes are not superior and by some indicators are markedly inferior. The causes of the spending disparity are subject to dispute.

One dimension is the *level* of cost, compared to other countries. A second is the *rate* at which spending grows. It is the anticipated rate of growth that gives rise to projections of untenable budget outcomes in the long run. In contrast, the burden of a high level of cost could ease over time if growth of health care spending is less rapid than the growth of the economy.

Possible factors in the rate costs are growing include: proliferation of new technology and pharmaceuticals, increasing medical specialization, and innovation in treatments; increasing availability of health insurance, including through the major public programs; increasing barriers to market entry for medical professionals; and the “cost disease” of public services that results from the need for government to compete with rising private sector pay for skilled workers in the health care field.

The idea of the ‘cost disease’ is that some services that tend to be provided by government are inherently less susceptible to productivity improvements than others, while the skills required of government workers are comparable to other sectors. Hence the growth of productivity and pay in the private sector tend to push up the cost of government services, since the government must compete with the private sector to attract sufficiently skilled workers.

The role of our aging population in the growth rate is commonly exaggerated. Current Federal spending on Medicare and Medicaid is 4.5 percent of GDP. (As noted above, total national spending, including Medicare and Medicaid and private spending, exceeds 16 percent of GDP.) By 2050, the impact of aging and GDP growth alone would take total M&M outlays up to 7.0 percent of GDP (CBO, 2005). In other words, if Medicare and Medicaid spending per program beneficiary grew no faster than GDP per capita, total

spending would increase by 2.5 percentage points of GDP over the next four decades. The bulk of high spending growth projections is not due to aging of the population.

The usual suspects for the high *level* of spending in the U.S., compared to other countries, include the administrative burden of a complex, decentralized public-private system and high U.S. prices for specific services otherwise similar in quality. The price differences could be due to monopolistic market characteristics, such as the efforts of the medical profession to control licensing of health care professionals, to the marketing costs of health insurance and pharmaceuticals, or to the costs of pharmaceuticals enjoying patent protection. Whether these factors continue to grow disproportionately over time goes to whether or not they are an important part of the high rate of growth in health care spending.

The high U.S. disadvantage in health care prices, not supported by any comparable benefit in health care outcomes, suggests a lot of inefficiencies that ought to be wrung out of the system. Possible efficiencies include the centralization and technological modernization of administration, recapture of more of the public subsidies to research and development, especially for pharmaceutical products, and reducing barriers to entry into medical and other health care professions.

Without doubt, an aging population will consume more health services regardless of how provision and financing of health care are organized. General growth in income could be expected to stimulate consumer demand for health care, as for many other goods and services.

Both the increased supply of and demand for health care services are signs of economic progress, a basic point that is typically obscured in doomsday budget rhetoric. Income growth, increased longevity, advances in medicine, and the demand for real growth in health care spending are mutually reinforcing. In principle, a prediction of high health care spending implies an expectation of economic prosperity.

The failure of health insurance markets and our consequent reliance on the public sector for health care certainly presents a formidable task in managing and restructuring health insurance coverage, one buffeted by strong political winds. But any problem should not be seen as stemming from a future dearth of economic capacity. Unlike challenges facing a family with more dependents and less means to care for them, the health care problem is more like our descendants deciding how to divide the bounty of a rich estate – how much *additional* health care to buy, and how much of the bequest to reserve for other purposes.

A basic tool for estimating projected Medicare and Medicaid spending is the concept of “excess cost growth,” defined as the difference in the growth rates of the cost of Medicaid and Medicare per program beneficiary and the level of GDP per capita. The purpose of this measure is to highlight the increased use of resources for health care, stripped of changes in program participation (particularly due to aging of the population) and expansion of the economy as a whole. Basically, it is conceded that health care

consumption will rise at least as fast as all other consumption, and that consumption will be higher for beneficiaries of Medicare and Medicaid than for others, so what is of central interest is the *excess* of growth in health care program spending, relative to these expectations. For example, if M&M per beneficiary grow at seven percent, and GDP per capita grows at five percent, the excess cost rate is 2.0.

From 1967 to 2007, excess cost growth was 2.5 percentage points (CBO 2007). In other words, spending per beneficiary grew 2.5 percentage points faster than GDP per capita. During this period, as well as over the past three years, we have seen legislative expansion of program benefits. To some extent, historic growth reflects discretionary legislative actions as well as intrinsic, ‘automatic’ growth. Expansion of eligibility would not necessarily affect the excess cost growth calculation, since it is spending per beneficiary that is in question. Future restraint in expansion of benefits would more likely restrain aggregate spending growth.

The overall rates of growth since the early 1970s obscure some important shifts over that time period. Table 2 below distinguishes between Medicare and selected categories of Medicaid beneficiaries. The growth rates have fallen over time. 1965-75 saw the launch and maturation of both programs. Naturally compared to a zero level of spending, growth rates over that period would appear to be high.

**Table 2.**

**Medicaid & Medicare Payments per Beneficiary**  
*Real Average Annual Rates of Growth*

|                  | Medicaid/Beneficiary |      |          | Medicare/<br>Beneficiary | GDP/<br>capita |
|------------------|----------------------|------|----------|--------------------------|----------------|
|                  | All                  | Aged | Disabled | All                      |                |
| <b>1975-1980</b> | 4.1%                 | 5.8% | 5.3%     | 7.1%                     | 2.6%           |
| <b>1980-1990</b> | 1.4%                 | 2.5% | 1.9%     | 5.4%                     | 2.3%           |
| <b>1990-2000</b> | 0.6%                 | 2.1% | 1.1%     | 3.5%                     | 2.0%           |
| <b>1975-2002</b> | 1.6%                 | 2.9% | 2.5%     | 5.1%                     | 2.1%           |

*Source: Center for Medicare and Medicaid Services, Department of Health and Human Services.*

The first three columns show the rates for Medicaid. The overall Medicaid rate in the first column is actually below GDP per capita in the right-most column. From this standpoint, it is as much an error to lump Medicaid and Medicare as it is to lump both together with Social Security, much less other components of the Federal budget. Nor would it do to use an excess cost rate affected by Medicare spending to the slower-growing Medicaid program.

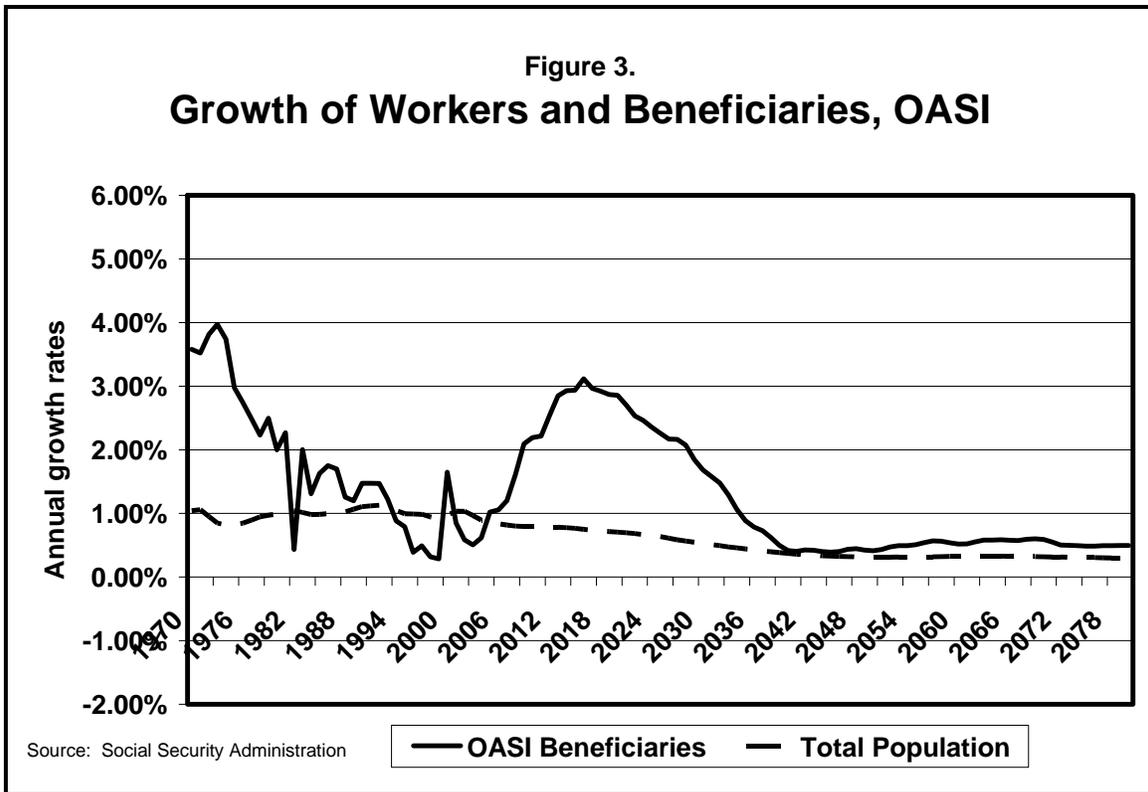
It is true that some elements of the Medicaid clientele are growing as a share of the population, but that would take us back to the framework discussed above, where it is the ratio of workers to the population as a whole that is most relevant.

In the Medicare column, the implied excess cost rate of 1.5 for 1990 to 2000 is still high and would present major budgetary challenges if it persisted. The Administration's projections in Table 1 assume an excess cost growth rate of just one percentage point (OMB, 2006). With the same assumption, the CBO projects that combined outlays for Medicare and Medicaid add up to 12.6 percent of GDP by 2050.

An assumption of an excess cost rate of 2.5 percent in alternative CBO projections gives rise to combined Medicare and Medicaid spending of almost 22 percent of GDP. (Recall that the current level is 4.5 percent.) Assuming this as a worst-case scenario, the estimates in Table 1 for other spending add up to a grand total Federal program outlays of about 35 percent of GDP in 2080.

State and local spending is about 12 percent of GDP. Combined with a Federal share of 35 percent of GDP, this economic 'doomsday' would put total U.S. public sector spending as a share of GNP on a par with European social-democratic systems. This would of course amount to a revolution in U.S. public policy. It also underlines the question of whether this focus of resources on health care is the most beneficial choice for society.

The annual growth rates in the number of persons over 65, compared to the total population, are shown in Figure 3.



Clearly, the over-65 rate takes some large swings, compared to total population growth. By contrast, the steady growth in health care consumption per elderly person (not shown) is much less volatile. Both trends contribute to the same result: Medicare costs grow faster than GDP, but the timing difference is huge. In an important sense, the Baby Boom is a transitional phenomenon – to be sure a great one, but still a change whose end is foreseeable.

Extended discussion of how the growth of health care spending might be slowed is beyond the scope of this paper. Greater reliance on the market would give rise to denial of care for the medically uninsurable and for the poor, for whom premiums and health care prices would be prohibitively expensive. In this way spending could be reduced, though not necessarily without cost to life and limb. Expansion of public sector coverage would present a politically difficult task of reorganization and rationing, if the pace of spending growth is to be restrained.

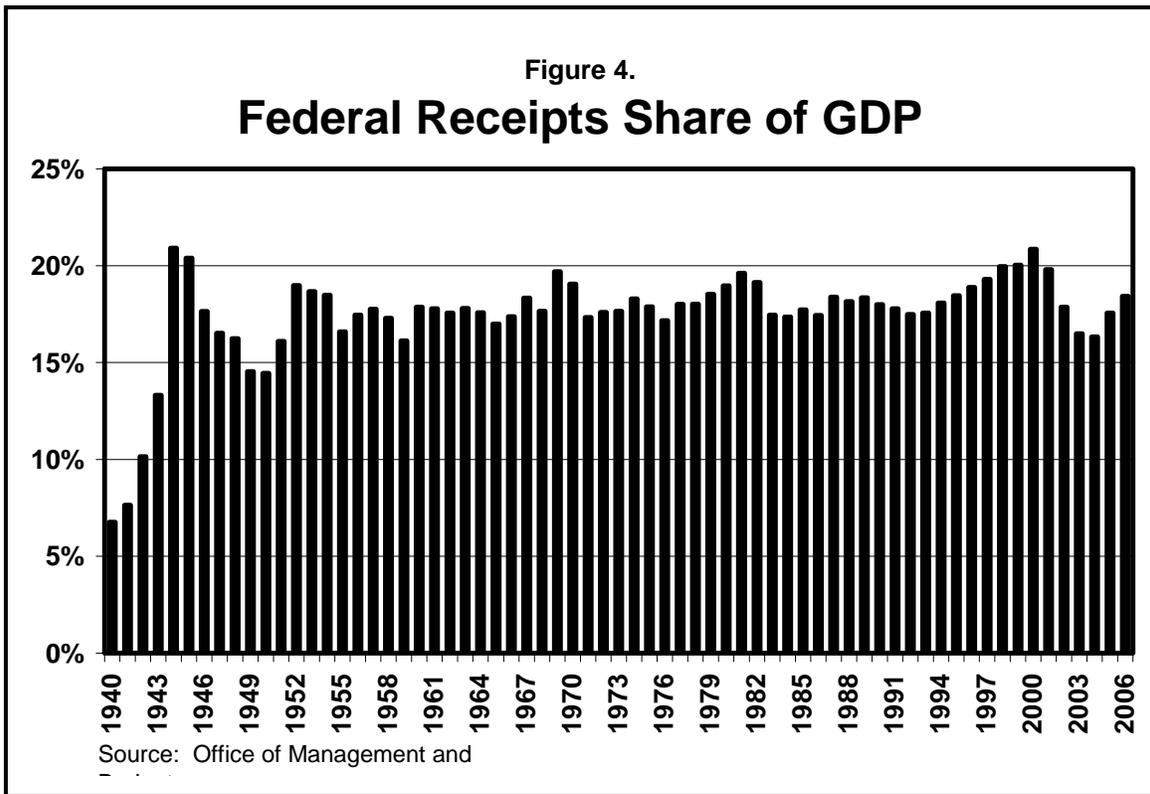
## V. Revenue

Table 1 shows government revenues – mainly taxes – increasing as a share of GDP, assuming indefinite continuation of the Bush tax cuts, as well as proposed cuts yet to be enacted (OMB, 2006). Even so, this implies significant growth in revenues relative to GDP over the next 75 years – about five percentage points. The explanation for this rather surprising outcome is that as income grows, individual income tax revenues grow faster. Higher income obliges some taxpayers to pay the Alternative Minimum Tax

(AMT), which is not indexed to inflation. The AMT raises their average tax rate. Further income growth causes better-off taxpayers to face still higher statutory marginal income tax rates. In any case, notwithstanding many anomalies, the individual income tax remains progressive at all income levels.

In its most recent budget documents (OMB, 2007), the Bush Administration departed from standard reporting practice and projects a receipts share of GDP of 18.3 through 2080. No explanation is provided, other than that 18.3 reflects the average for the past 40 years. This ought to cast doubt on other calculations provided this year by OMB.

Figure 4 shows Federal receipts as a share of GDP for every year since 1940.



The rate breaks through 20 percent just four times, with the only recent points in 1999-2000. Naturally, the average depends on the time period employed. Including years prior to World War II would reflect a very different American society and public sector. The average after 1950 is 18 percent of GDP.

After the 2000 peak, tax cuts enacted starting in 2001 brought revenue as a share of GDP to 16.3 percent of GDP in 2004, lower than any time since 1959. The most recent level for FY2007 is 18.8 percent (OMB, 2007). From Table 1, it should be clear that

eliminating the recent tax cuts and taking receipts back up to 20 percent of GDP would not be nearly sufficient to address the anticipated long-term growth in Federal outlays.

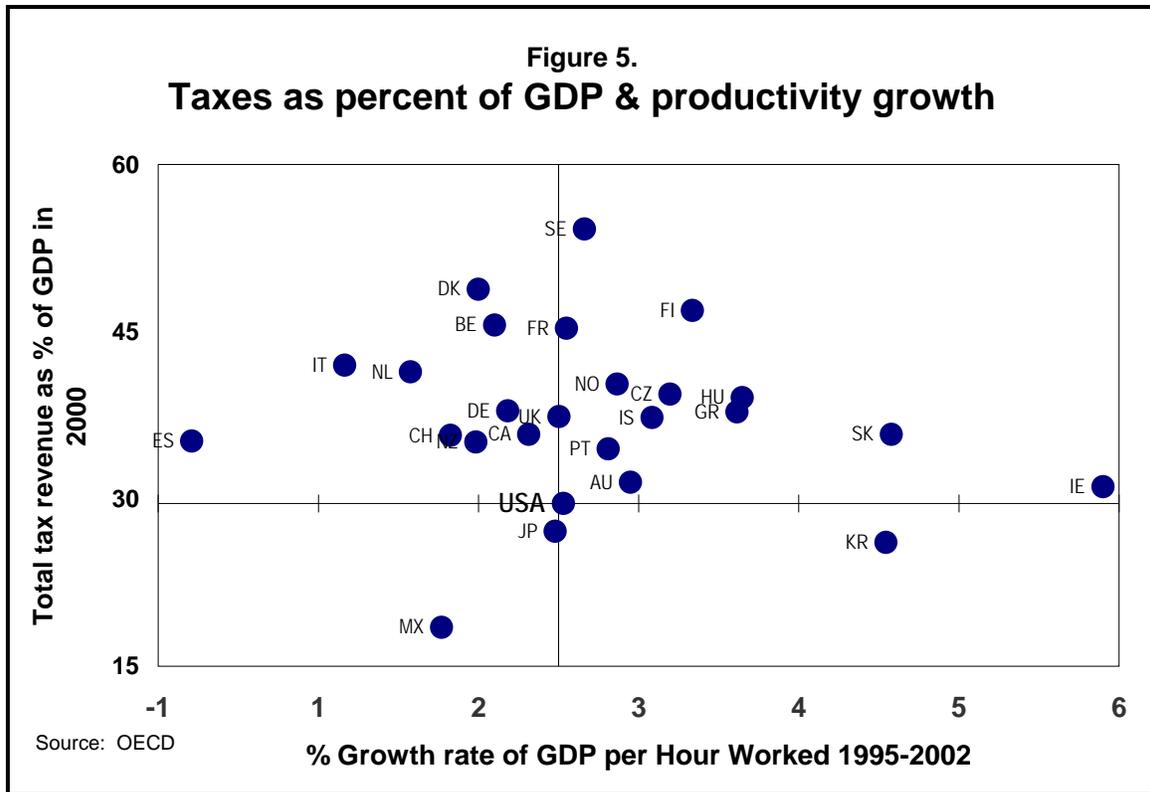
Recall that if the primary deficits (program expenditures less receipts, disregarding interest payments) are eliminated, the program budget still requires the financing of additional spending somewhere between ten and twenty percent of GDP over the remainder of the 21<sup>st</sup> century. Short of miraculous economizing in health care spending, historically unprecedented tax levels will be required.

In the past, financing needs for Social Security and Medicare have always been met, even with large changes in the dependency ratios. Moreover, benefits have increased and eligibility has been broadened. However, as Figure 4 shows, for most of the post-war period the overall level of taxation has remained stable. In effect, government resources have been transferred among uses rather than augmented overall.

We could be exaggerating the inherent political constraints on revenue growth. While the overall Federal tax share of GDP seems to have had an upper limit of 20 percent, the composition of revenues has changed significantly. The shares derived from excise and corporate income taxes have fallen, while payroll taxes have increased. Restoration of the former sources need not preclude preservation of the latter. Meanwhile, the individual income tax – the focus of most political agitation – has changed the least.

The U.S. ranks among the lowest of OECD countries in its ratio of taxes to GDP. In 2002 this ratio of taxes to GDP was 26.4 (including federal, state, and local governments). The 2002 OECD average percent of GDP was 36.3, and the EU average percent was 40.6 percent. The higher estimates of health care spending growth would put the U.S. above these averages.

Other modern industrial economies have shown they are able to carry much bigger tax burdens. Figure 5 below (Price and Sawicky, 2004)

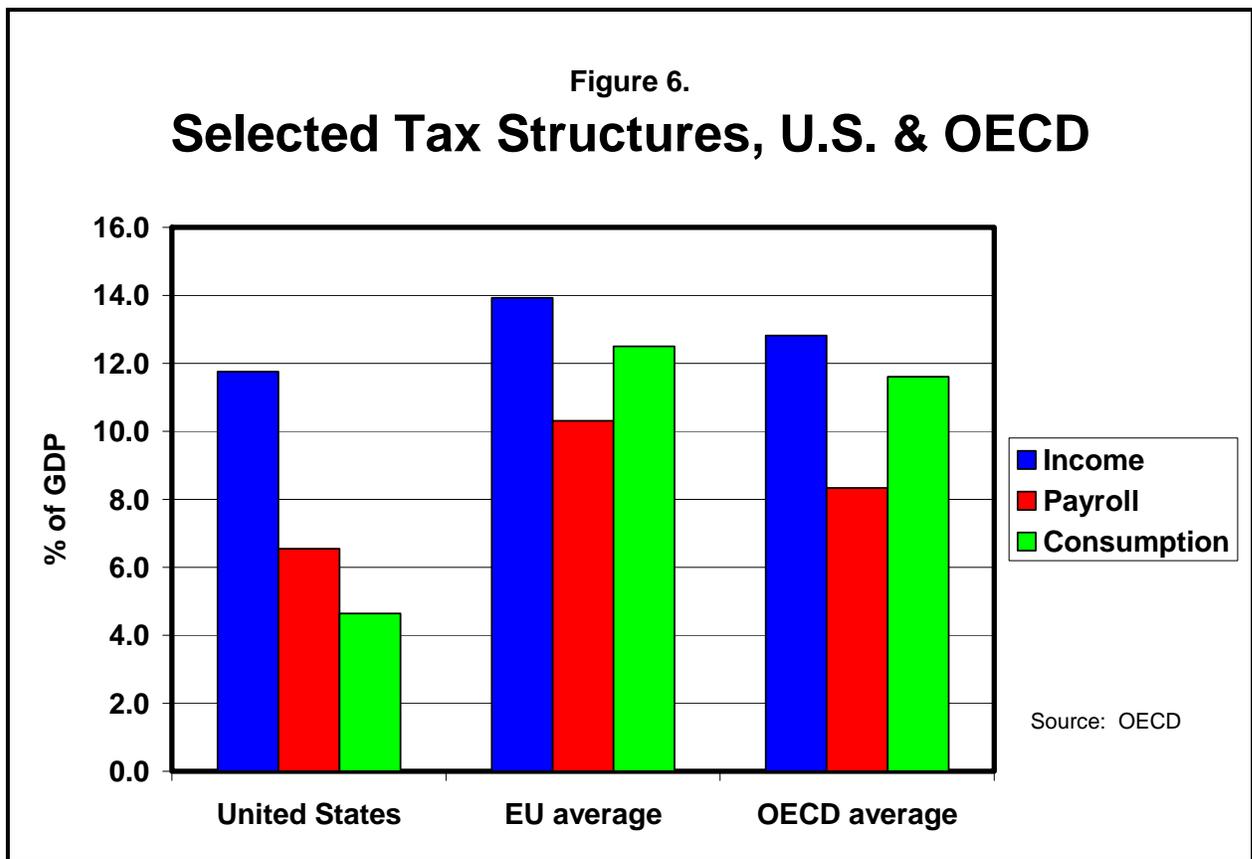


shows the association of productivity growth and the size of tax systems.\* There is no lack of examples of countries with productivity growth that compares favorably to the U.S. combined with much larger revenue systems. But it is impossible to imagine the U.S. moving into the high-tax camp without significant changes in our politics, if not our economics.

The principal missing ingredient in the U.S. revenue system, compared to European tax structures, is mass consumption taxation – in particular, the value-added tax. Figure 6 suggests that the size of revenue systems is limited by the extent to which taxation is focused on individual and corporate income. Uses of corporate and individual income taxes in the U.S. are comparable to the EU and OECD averages, while the U.S. relies markedly less on payroll and especially consumption taxes.

Transition to a fully consumption-based system would require radical tax reform. Such a project would hold some possibility of maintaining the progressive character of the tax system, though not of increasing it. As Figure 6 below shows, adoption of a value-added tax would cause the U.S. to more closely resemble European tax structures.

\* Abbreviations as follows: AU, Australia; AT, Austria; BE, Belgium; CA, Canada; CZ, Czech Republic; DK, Denmark; FI, Finland; FR, France; DE, Germany; GR, Greece; HU, Hungary; IS, Iceland; IE, Ireland; IT, Italy; JP, Japan; KR, Korea; LU, Luxembourg; MX, Mexico; NL, Netherlands; NZ, New Zealand; NO, Norway; PL, Poland; PT, Portugal; SK, Slovakia; ES, Spain; SE, Sweden; CH, Switzerland; TR, Turkey; UK, United Kingdom; USA, United States.



We have been citing figures for expansion of the public sector over the next 75 years. In the short term, much smaller adjustments are sufficient. Recovery of the bulk of the tax cuts enacted since 1997 (a year which saw a capital gains tax cut) would more than adequately restrain the deficit over the next decade. Presently, elimination of the tax cuts would put the current budget into surplus (Horney, 2006). Program costs for Social Security and Medicare do not really take off until the Baby Boom retirements go into full swing, around 2020, as shown in Table 1.

Expanding the existing revenue system would rest on the following basic devices:

- Returning capital income more fully to the tax base. Long-standing breaks for capital gains, and more recently for dividends, as well as increasing leaks in the Corporate Income Tax and Estate and Gift Tax, have pushed the tax system in a less progressive direction;
- Restoring the tax rates to those maintained throughout the 1990s;
- Comparing the effectiveness and fairness of existing tax expenditures (tax credits, deductions, depreciation allowances, etc.) to explicit spending programs in the Federal budget. Capping or eliminating a tax preference

releases revenues for alternative purposes. For instance, if our objective is to support home ownership, the design and costs of existing tax concessions to home ownership should be compared to possible expansions of spending programs with such an objective. In the same vein, government health care spending is a potential substitute for tax deductions for health insurance.

- Addressing the crisis in tax enforcement (Sawicky, 2006). The IRS claims that legislation to require more third-party reporting and withholding would be worthwhile and more effective than increasing labor-intensive audits (*Tax Notes*, 2006). There is evidence that a variety of measures would yield net positive returns.

There is ample room for expansion of a progressive, income-based tax system.

## **VI. The Case of Social Security**

Thus far we have treated Federal revenues as fungible, considering them only *in toto*. Two of the largest Federal programs have dedicated revenues. Social Security (Old Age, Survivors, and Disability Insurance, or OASDI) – with outlays of \$545 billion in 2006, out of a total Federal budget of \$2.6 trillion – is such a program.

OASDI is distinct in other ways. For one, it is *social insurance*. That is, as *insurance* it provides benefits against certain contingencies, where the benefits provided to individuals and their dependents have some relationship to the taxes paid. Second, as *social* insurance, the determination of these benefits is founded not on a strict actuarial model where expected benefits equal contributions, but on an interest in meeting additional program objectives pertaining to equity. Third, it employs a pay-as-you-go financing scheme, unlike private sector pension plans that rely entirely on a pre-funded reserve. This pay-as-you-go feature implies inter-generational transfers: today's workers finance benefits for retirement, disability, and premature death of yesterday's workers.

Social insurance for retirement, disability, or survivors should be understood as the worker's most likely and reliable form of wealth. In the case of both Social Security and private wealth accumulation, present consumption is sacrificed for the sake of future economic security. For holders of wealth, insuring against low earnings is not at issue, nor is there a pressing need for inflation-proof annuities, but otherwise the two institutions serve similar functions, and each enjoys measures of protection under law, albeit differing ones.

In the political arena, the financial condition of Social Security is a common point of departure for criticism of a wide range of programs in the Federal budget, as well as for the welfare state as a whole. OASDI heads the list of programs we are told are unaffordable in an aging society. The extent to which Social Security and other programs make explicit commitments of one sort or another to future generations is linked to a critical lack of national saving and capital formation that will supposedly cripple economic growth.

As noted above, the practice of pre-committing future income on a contractual basis is not unique to Social Security. It is inherent in any entitlement program, as well as to private investment and property ownership. Governments make rules that condition the distribution of wealth, also understood as claims on future income. For instance, sellers of stocks and bonds are subject to government regulation, and banks are subject to disclosure and other rules. Social insurance benefits are one form of wealth.

We seldom hear that it might not be possible in the future to honor debts to holders of corporate bonds. In fact, failures in the realm of private investment are often treated to government rescue by the Federal Government. One example was the savings-and-loan bailout; another was the extraordinary, infamous measures taken by the Federal Reserve to protect the now-defunct Long Term Capital Management fund.

In the case of both the returns to private capital and social insurance benefits, protection of the funding source is a fundamental issue of political economy. The obsession with Social Security financing stems as much, if not more, from anxiety about possible sources of financing as it does from a conservative aversion to the growth of a Federal program. Privatization is motivated by fears that the individual income tax will be expanded to meet gaps in Social Security financing.

Any fragility of claims to Social Security benefits relative to private sector financial assets is founded in politics, law, and morality, not economic necessity. Policies affecting returns to capital (for example, a tax on dividend income) can affect the incentives to save and invest. Policies affecting OASDI benefits – the returns to payroll tax payments – affect the incentive to work. The law promises to protect returns on investments, and the law has promised recompense for payroll taxes paid under the auspices of Social Security.

Several different measures are used to summarize the condition of Social Security. The most common is called the actuarial deficit, expressed as a percentage of taxable payroll. The most recent Trustees' report (2007) estimates the deficit to be 1.95 percent of taxable payroll, given the payroll tax cap allowed for under current law. It is the difference in present value terms of program costs and receipts over the next 75 years of operation. By this point of reference, an immediate increase of 1.95 percent in the payroll tax for Social Security, currently at 6.2 percent each for employee and employer, would eliminate the shortfall. So too would a reduction in program benefits of this amount, or a smaller reduction in some combination with a tax increase.

The 1.95 estimate reflected a reduction (an improvement in financial condition) from the previous year's estimate of 2.02, due to revised assumptions about the cost of the Disability Insurance component of Social Security.

Taxable payroll is a misleading indicator of the program's financial health. Under current law, taxable payroll is defined as wages that fall beneath the tax cap, now \$97,500. Although the cap is adjusted upward annually, growing wage inequality pushes

an increasing share of wages above the cap – more wages are exempt (Bivens, 2005). Taxable payroll becomes a smaller share of GDP. Today taxable payroll is 38 percent of GDP. By 2080 it is projected to be less than 34 percent. At the same time, on a more mundane level, program needs relative to the limited taxable payroll are far higher than a comparison of needs to either *total* payroll (including wages above the cap), or to GDP. Confining a comparison to taxable payroll tends to obscure the possibility of financing part of the program from a broader tax base, either by eliminating the cap on wages subject to the tax or by drawing funds from some other revenue source.

More reasonable would be an expression of the 75-year shortfall in terms of GDP. This turns out to be .7 percent. In comparison to the Bush tax cuts, which approach two percent of GDP, the shortfall seems manageable. One could also note the extent of short-run changes in receipts relative to GDP over the past forty years, shown in Figure 4. Repealing just half of the Bush cuts and putting that revenue into the Social Security Trust Fund would easily wipe out the 75-year actuarial deficit.

These present value figures are premised on immediate collection of revenues that are then put in reserve to accumulate interest, like the existing trust fund. Without benefit of such a reserve, larger changes, arguably feasible ones, would be necessary in the future.

At present Social Security is running a cash surplus. This is projected to dwindle in size, starting in 2008. In this sense, next year the pressure on the Federal budget as a whole begins. Less cash surplus and no let-up in spending growth means higher deficits than would otherwise be the case. That's a budget problem, albeit a limited one, not a Social Security problem.

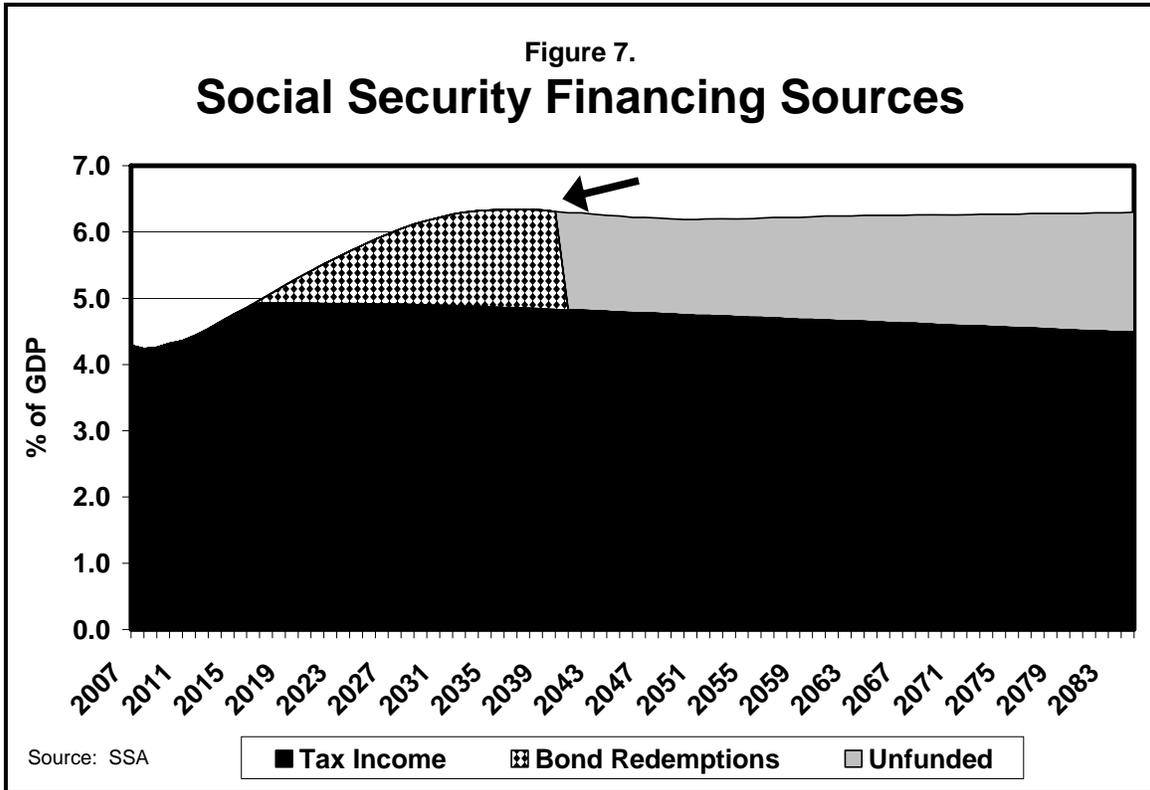
Assuming no action is taken to increase the payroll tax, the Trust Fund's cash surpluses end in 2017. At that point, the program is funded mostly by tax income (the payroll tax, and limited taxation of Social Security benefits on higher-income recipients), and partly by conversion of some interest on Trust Fund assets to cash. In other words, the Federal government begins to draw on general revenue to redeem its obligations to the Trust Fund (as it does to redeem other Treasury bills and bonds), mostly with taxes on individual and corporate income. Again, this is a budget issue, not a matter of Social Security solvency.

By 2027 the Trust Fund must begin liquidating its bonds, requiring more cash from Federal general revenue. This required cash reaches 4.25 percent of taxable payroll in 2041, or 1.55 percent of GDP. Transfer from general revenue to Social Security to redeem Trust Fund bonds for payment of scheduled benefits is mandated by law.

With the exhaustion of Trust Fund assets in 2041, a gap opens between scheduled benefits and payable benefits. "Payable" in this context means based on available tax income under current tax law. From an economic standpoint, however, what was payable in 2040 remains payable in 2042. There is no economic adjustment, much less any shock, implied by a switch from redemption of Trust Fund assets to simple, unrequited transfers from general revenue. Nor is there any affordability issue. If the taxes required

by law to repay debts to the Trust Fund are affordable in 2040, so too would be the same taxes used to fill financing gaps after 2040. The size of the needed transfer, under the Trustees' intermediate assumptions, rises to 1.83 percent of GDP by 2080.

Figure 7 below shows Social Security's funding sources as a percent of GDP.



The black region reflects benefits financed by the program's dedicated tax revenues, primarily the payroll tax. The checkered region is the extent of benefits that by law are financed out of Trust Fund interest income and then reserves, accomplished by transfers from general revenue – mainly the individual income tax. In other words, repaying the debts incurred by the Federal Government to the Social Security Trust Fund. The gray region after 2040, marked by the arrow, reflects the extent of scheduled benefits with no set funding at this time.

The bulk of the adjustment, mandated by law, is clearly between 2017 and 2030, in the form of general revenues up to 1.5 percent of GDP (less than the Bush tax cuts) being used to repay obligations to the Trust Fund. Under current 'intermediate' projections, the Trust Fund's reserves (but not its income) would be exhausted in 2041. At that point, the adjustment in question is not economic, but political. Will those same general revenues be used to continue paying scheduled benefits? No "tax increase" is at issue. The same taxes used to redeem debts to the Trust Fund could continue to top up the program's dedicated tax income.

After 2041 the possible required adjustment is much more gradual. The required general revenue to maintain scheduled benefits rises by .34 percent of GDP over the ensuing 45 years. In today's terms, that would be roughly \$47 billion. In other words, the "longevity" bugaboo implies a tax adjustment over 45 years analogous to \$47 billion in terms of this year's GDP. This again speaks to the transitional nature of the Baby Boom problem, qualitatively and quantitatively distinct from longer run issues arising from improving longevity.

As discussed in Part I, the extent of the gap hinges on arguably pessimistic assumptions about such factors as unemployment, productivity growth, and net immigration. The Trustees also estimate a "low-cost" scenario under which the Social Security Trust Fund is solvent throughout the next 75 years, as well as for some time thereafter. The projections are only as good as the assumptions underlying them; the commonly projected shortfall is not inevitable.

In 2045, without the benefit of any additional pre-funding, the Social Security cash shortfall is estimated at 4.25 percent of taxable payroll. The real average wage (an index number based on taxable payroll and earnings from self-employment, relative to total hours of work) for 2045 is projected to be \$60,183. Splitting the entire burden of the projected gap on top of the current payroll tax rates of 6.2 percent for OASDI for both employee and employer would reduce the average after-tax wage to \$56,452. If the entire burden of the shortfall was loaded on an employee-side payroll tax hike, after tax earnings would be \$53,894. The annual growth in real after-tax wages from 2005 to 2045 would be 1.02 percent rather than 1.14 percent. The real average after-tax wage would have increased over those years by 50 percent instead of 57 percent.

Insofar as tax increases were phased in before 2041 and deposited into the Trust Fund, the magnitude of total required tax increases would be reduced. In other words, with no additional pre-funding, 4.25 percent of taxable payroll would be needed in 2041. With pre-funding, an immediate increase of 1.95 percent in FY2007 would be sufficient. The greater the delay increasing the payroll tax rate, the greater the needed transfer from general revenue. A greater delay moves the number from 1.95 towards 4.25.

It should be emphasized that no amount of pre-funding or lack of it changes the amount of resources the program requires. The use of pre-funding only changes the auspices under which financing is provided. Suppose the payroll tax was increased today and then reduced to the current level in 2041. The same amount of general revenue would be required to top-up payroll tax revenues. The difference is that they would be redeeming Trust Fund assets, rather than simply transferred to shore up the program.

It is possible that if the resources from additional pre-funding (tax increases or benefit cuts) were put into a "lockbox" – in other words not available for other purposes – that national savings and investment would increase and cause the economy to grow more than otherwise. But the same could be said if those resources were devoted to public investment. The determinants of economic growth are not well-understood or agreed upon by economists.

Growth would certainly aid the program. A modest uptick in productivity growth that translated into wage growth would easily offset the burden of a payroll tax hike (Baker and Weisbrot, 1999). By the previous example, an increase of .12 percent in the annual real rate of growth of the real average wage would leave workers of 2045 no worse off, if faced with a payroll tax hike in lieu of transfers from general revenue to pay benefits.

Under current law, eventually, higher real wages would result in higher scheduled benefits. Because the cost of higher benefits is delayed, however, productivity growth improves the condition of the program.

If one thinks of Social Security, or in general terms a retirement scheme financed in pay-as-you-go fashion with taxes on labor compensation, from an inter-generational standpoint, the policy is progressive. Better off workers will sacrifice part of their wages to support less well-off workers in retirement, and remain better-off in after-tax terms (CBO, 2007).

The use of income tax revenue would be less burdensome to workers than a payroll tax hike. But workers of course would not be exempt from bearing some of the burden, since wages are part of the income tax base, but relying on the income tax would have less adverse effects on labor markets. A dirty little secret of the Social Security debate is that the animus towards the transfer of “general revenue” into the Trust Fund is cover for reluctance to tap the more progressive individual and corporate income tax. Social class interests are at stake.

Alternatively, if the program gap went unfilled, median annual payable benefits would still increase from \$14,800 to \$19,300 for those born between 1940 and 2005 (Trustees, 2006). This is well below scheduled benefits, but it does not quite square with the alarmist portrait of a program that George W. Bush described as “flat, busted, broke.”

Pre-commitment of future resources through programs such as Social Security and Medicare must be made mindful of the sustainability of such commitments. The advantages are that locking in an entitlement program furnishes political protection and avoids the need for immediate tax increases. The bet is that once established, the political interest in providing benefits will overcome resistance to the necessary taxation.

A downside is that such pre-commitment can constrain alternative spending initiatives, particularly in the politically vulnerable areas of public investment and anti-poverty programs. Deficit worries and fear of future entitlement obligations have put a damper on interest in public investment.

In light of the time periods in question, pre-commitment of any sort is to some degree an illusion. From an analytical standpoint, decisions affecting present day policy outcomes are not easily justified by uncertain long-run calculations. And as Dean Baker has pointed out (Baker and Weisbrot, 1999), nothing absolutely binds future voters and elected officials to fiscal policy decisions of the past.

## Conclusion and Policy Options

Under every likely budget scenario, health program spending is the dominant potential source of future fiscal imbalances. Accordingly, any concern about excessive Federal spending growth ought to begin with Medicare and Medicaid, keeping in mind that health care costs are an economy-wide problem, not a problem unique to the Federal government. Blocking *any* growth in health care consumption in the face of a growing elderly population would be perverse. The goal should be to arrive at a feasible rate of real growth, over and above population and income growth. One possible baseline from which to consider policy changes would be to plan for per-beneficiary spending to grow at the same rate as per capita GDP.

Likely revenue adjustments to fund Social Security are in the low single-digits, in terms of percent of GDP. They range from the use of progressive general revenue sources – taxes on individual and corporate income, and perhaps wealth – to packages of incremental payroll tax hikes and benefit cuts. The latter could be either progressive or not. Any of these devices might be aimed at satisfying long-run measures of solvency that are vulnerable to criticism in their own right.

“Infinite horizon” measures, however, are wholly creatures of assumptions on unknowable economic developments of the distant future (Baker and Weisbrot, 1999). As such, these measures are of mostly academic interest. The 75-year actuarial measures for Social Security have some political currency, but the need to take radical steps now for the sake of addressing relatively small imbalances decades away is debatable.

A modest interim compromise noted above is to reverse a significant portion of the Bush tax cuts. At best, serious health care reform, such as reining in wasteful spending and subsidies in the private non-elderly sector, will take time. Meanwhile the costs of Medicare and Medicaid will continue to grow. Declining Social Security cash surpluses will need to be replaced.

In the field of discretionary spending, there should be little doubt that eliminating “waste, fraud, and abuse” – albeit desirable -- would be irrelevant to meeting the basic challenge. Two factors may have worsened the problem. Constraints on visionary thinking about Federal spending, fortified by Republican control of Congress, may be to blame for the proliferation of earmarked spending in recent years. Second, the drive to replace Federal employees with contractors, especially – but not entirely -- in the case of crisis-like conditions underlying military missions, may induce greater corruption and waste in procurement. In either case, this category of spending – while important in its own right - - is a minor player in the long-run budget outlook.

Significant augmentation of the nation’s non-defense public investment would be perhaps the easiest change, since the current commitment is so limited. The impact of faster economic growth on the Federal budget is ambiguous, however. In general, greater

sustainable economic growth provides more resources for many purposes, but the effects on Social Security and health care are mixed.

Faster economic growth has the offsetting effects on Social Security of higher benefits discussed above. On net the effects are positive. Faster growth will increase the demand for health care, given greater affordability, a healthier workforce, enhanced life expectancy, and likely, increased innovation.

Health care presents economic problems of allocation, rather than a dearth of resources or a need to reduce consumption. Investment in cost-savings would be beneficial. The incentives for cost-savings depend on the overall organization of the health care system.

That faster economic growth, assuming it satisfies needs for environmental sustainability (which itself depends on public investment efforts), gives rise to health care demand is a good problem, reflecting a promising future. The unique character of health care as an inherently public good, one that the market provides especially poorly, ensures the growing importance of the public sector in the economy of tomorrow.

Social insurance for retirement, disability, health care, and unemployment is the foundational capital asset of working people. It is both practical and right that public policy should focus on protecting and augmenting this asset for generations to come.

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*ADA National President Jim McDermott started his political career in the Washington State Legislature in 1970 and served in the state House and Senate before being elected to the 101<sup>st</sup> Congress. He is now serving his 7<sup>th</sup> term and has been especially active on health care issues. While serving in the Washington state legislature, he developed the first program providing low cost health insurance for the unemployed and the working poor.*

*In the House of Representatives, Congressman McDermott serves on the Ways and Means Committee and its Subcommittees on Human Resources and Trade. Jim McDermott became President of Americans for Democratic Action in June 2002.*

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