Blueprint for America

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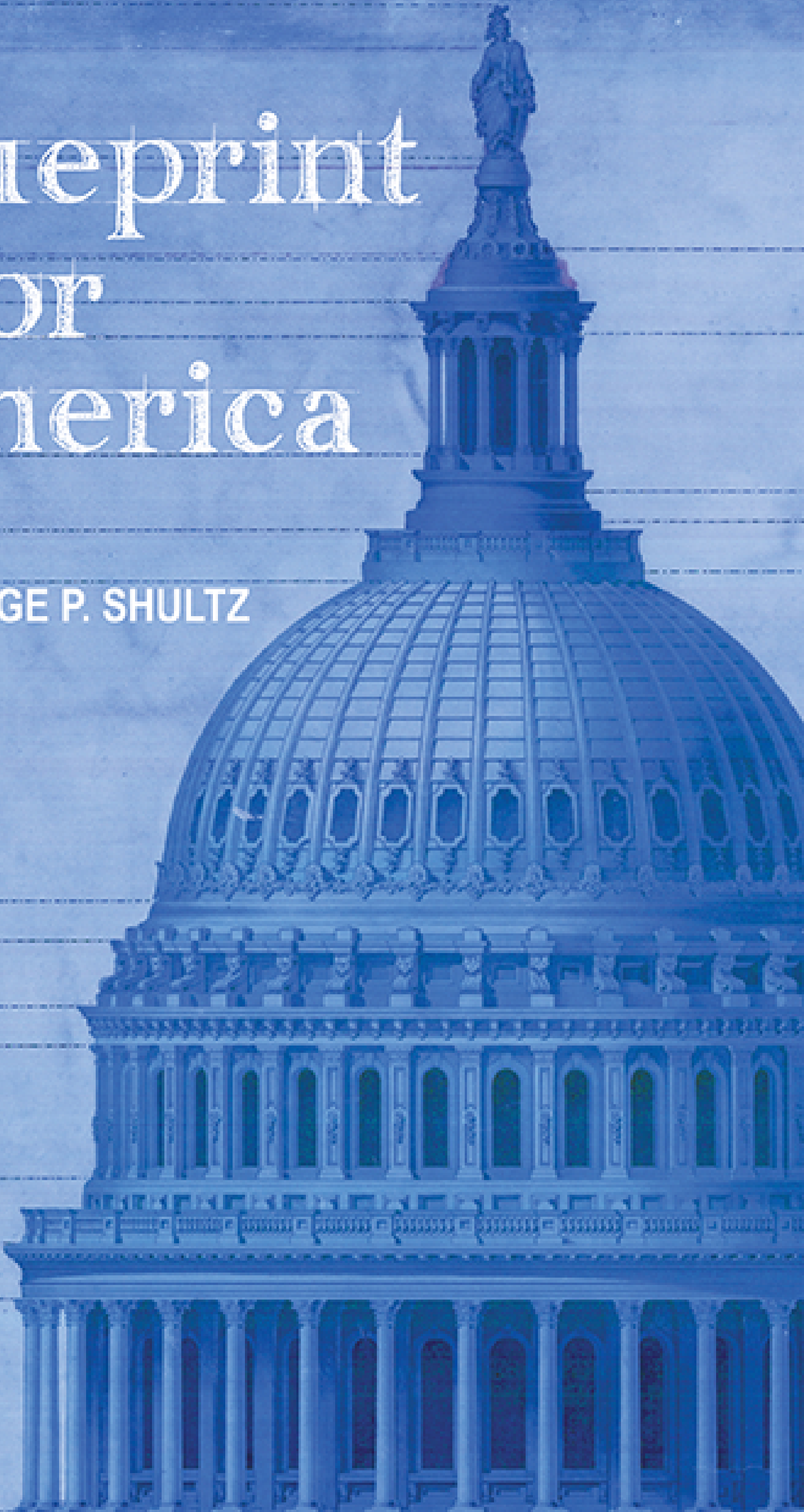

CHAPTER 2

ENTITLEMENTS AND THE BUDGET

John F. Cogan

The United States faces a fiscal challenge unlike any in its history. The annual federal budget deficit routinely exceeds $400 billion. Without any legislative change, it is expected to remain at this level for the next few years. As large as these deficits may seem, their true magnitude is masked by abnormally low current interest payments on the national debt. If the average interest rate on the debt were at the level of its prior sixty-year average, the current and near-term annual budget deficit would be $800 billion.

The future fiscal challenge is far more severe. Federal spending increases are projected to cause federal deficits to soar past the $1-trillion-per-year mark in ten years. At that point, the outstanding public debt would exceed the nation's output of goods and services. In twenty years, the expenditure growth is projected to push the publicly held federal debt to 150 percent of GDP. At that point, half of all federal income tax collections would be needed just to pay interest on the debt, and half of those taxes would be sent overseas to pay foreign holders of US debt.

Federal entitlement programs are the primary cause of the current and future fiscal situation. Throughout the post–World

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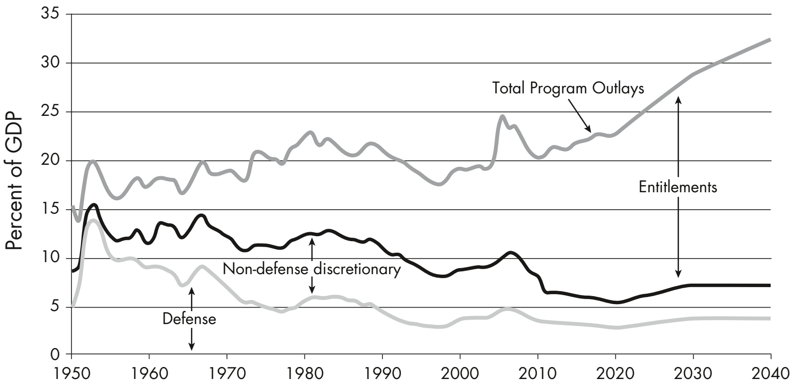
War II years, Congresses and presidents have created new entitlements and repeatedly expanded existing ones without regard to their fiscal consequences.

During these years, federal spending has risen from 15 percent to 21 percent of GDP (see figure 1). Entitlement spending alone accounts for all of this increase. Spending on national security, the federal workforce, and the vast complex of non-defense programs has actually declined as a share of the nation's output of goods and services. The growth in federal entitlement spending is about to accelerate, fueled by the 72-million-member baby boom generation's retirement. Unless action is taken soon, entitlement expenditures plus interest payments will consume all federal government tax revenues a dozen years from now.

Federal entitlement programs are often justified by the natural human impulse to help the poor, the elderly, and the disabled meet their health care, housing, nutrition, and other needs. But the complex network of entitlement programs has expanded far beyond this basic objective. The excesses are evident in a few num-

Figure 1. **Federal expenditures, 1950–2046**



SOURCE Author's chart and calculations from Congressional Budget Office, The Long-Term Budget Outlook, December 2015, https://www.cbo.gov/publication/50250#title0.

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bers. In 2013, the last year for which complete data are available, 56 percent of the US population lived in families that received assistance from at least one federal entitlement. Among the population living in families headed by persons under age sixty-five, the number is 46 percent. Similarly, the portion of the population receiving Social Security retirement benefits, Medicare, Medicaid, Social Security Disability Insurance, food stamps, Supplemental Security Income, and the earned income tax credit have all reached record highs. Entitlement benefits now flow mostly to middle-class Americans, paid for by middle-class Americans' taxes. Benefits provided to senior citizens have reached remarkably generous levels. The typical married couple that reaches Social Security's retirement age this year can expect to receive more than $1 million in Social Security and Medicare benefits, after adjusting for inflation, during their remaining lifetimes.

THE ESSENTIAL ELEMENTS OF ENTITLEMENT REFORM

The rapidly rising levels of federal spending and the national debt cannot be slowed without immediate legislative action to rein in entitlement spending. Major reductions in entitlement benefits or eligibility restrictions should come slowly and predictably. This is especially true for Social Security and Medicare changes to allow recipients sufficient time to make adjustments in planned retirement decisions. Policies to significantly alter either program's spending trajectory ten years from now must be put in place soon and be allowed to gradually take effect. History shows that a failure to act in advance of an entitlement-funding crisis inevitably results in higher taxes.

Three policies taken together would put Social Security on an affordable path. *First*, benefit increases paid to future cohorts of retirees should be limited to the rate of inflation. Under a mistaken "wage-indexing" policy put in place four decades ago, the inflation-adjusted value of Social Security benefits rises from one cohort of retirees to the next. This means the average worker who is age fifty today can expect to receive a monthly Social Security

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benefit that is about 15 percent higher than today's typical new retiree after adjusting for inflation. The average twenty-five-year-old worker today is promised an inflation-adjusted monthly benefit that is 36 percent higher. The United States can afford the current level of benefits, but not the promised increases. The proposed "price-indexing" policy would ensure that typical future retirees receive monthly Social Security benefits whose purchasing power is no less than that of today's typical retirees.

Second, Social Security's normal retirement age should be gradually increased and combined with a policy to encourage older workers to remain employed. The latter could be accomplished by eliminating payroll taxes on the earnings of workers once they have reached Social Security's retirement age. Eliminating the payroll tax would acknowledge that workers reaching Social Security's retirement age are "paid up" and, at the same time, it would provide a greater incentive for older workers who are capable of continued work to remain employed.

Third, younger workers should be allowed to invest a portion of their payroll taxes in safe, broadly diversified, stock and bond funds. Such a policy would create greater incentives for young persons to save and invest for retirement. It would allow younger workers to retire as millionaires through their own hard work and thrift, rather than from income taken from younger workers through taxation.

Slowing the growth in Medicare benefits is more difficult, but it can be achieved with a few simple policies. Moving away from Medicare's fee-for-service system and low copayments is essential. Under these policies, every time a senior citizen meets with his or her physician or other health care provider for a check-up, receives a lab test or undergoes surgery, or is admitted to a hospital, somebody other than the patient foots most of the bill. That such a program should produce runaway costs is hardly surprising. The federal government's main response to the program's soaring cost—price controls on physicians and hospitals—has only exacerbated the problem. Predictably, the price controls have already

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begun to make it harder for seniors to find doctors who are willing to treat them.

Medicare should be transformed gradually from its current form of an acute-care program into a true insurance program that offers greater financial protection against the high cost of catastrophic illness. Medicare recipients should be given vouchers to enable them to buy affordable private insurance plans from a menu of choices. Although this policy might seem radical, it is not. Currently, 25 percent of all Medicare recipients are enrolled in Medicare Advantage programs, which pay private health plans a fixed amount for each enrollee. A similar policy currently governs the entire Medicare prescription drug program. The voucher proposal would give patients the ability to choose among health plans—just as they now choose among Medicare prescription drug plans—and it would sweep away the need for any and all of Medicare's current 10,000 individual price controls. Competition among health care providers, not government-administered prices and government boards of experts making coverage decisions, is the best way to ensure high quality and reasonably priced health care.

Cost-consciousness among Medicare recipients could be greatly improved by modestly increasing Medicare premiums and copayments for routine services. Premiums paid by senior citizens once covered half of the cost of Medicare physician and related services. They now cover only one-fourth. Copayments that once covered nearly 40 percent of Medicare physician costs now cover less than 20 percent. The conversion of Medicare into a true insurance program should be completed by allowing Medicare health plans to cover catastrophic health care costs. Such a policy would afford Medicare recipients, a significant portion of whom have nontrivial financial assets, a more appropriate insurance protection. These reforms will not only save taxpayer money, they will ultimately give seniors greater access to cost-effective medical care than the existing program's combination of low copayments and increased rationing.

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Responsibility for welfare programs should be transferred back to the states with significantly less federal funding. The federal welfare role began in the 1930s when the federal government first provided limited financial assistance to state-run welfare programs for persons who were unable to work. This limited role has metastasized into a massive $700-billion complex of federal programs that now delivers entitlement benefits to households with incomes far in excess of the poverty line. Coupled with this aid are severe financial penalties that discourage work and human capital investments by recipients.

The highly successful 1996 reform of the controversial Aid to Families with Dependent Children program, at the time the main welfare program for single mothers with children (now named Temporary Assistance for Needy Families), provides the model for transferring authority for welfare to the states. The reform law eliminated the entitlement to AFDC, established a federal block grant to financially assist states, and gave states virtually complete authority to set eligibility rules and benefit levels. Since the reform law's enactment, states have moved millions of welfare mothers from a dead-end life of dependency on government assistance to one of self-sufficiency through work. Since 1996, the number of families dependent on AFDC has declined by 60 percent, two-thirds of AFDC mothers have left the welfare program to obtain productive employment, and poverty rates among single-female-headed households with children have declined. This same approach should be applied to food stamps, child nutrition programs, Supplemental Security Income, housing subsidies, Medicaid, and other welfare programs.

As with Social Security and Medicare, discussions about welfare are too often ideological. Reformers are incorrectly cast as heartless people who are unwilling to help the less fortunate. State governments are erroneously cast as uncaring entities that seek to offload the cost of assistance on neighboring states. An effective welfare reform, like the AFDC reform, improves the actual out-

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comes for the targeted citizens. Welfare reform should be judged on such results. By this standard alone, returning the welfare system to the states is long overdue.

THE IMPORTANCE OF ECONOMIC GROWTH

Entitlement reform, though necessary, can reduce the growth in spending by only so much. Policies to increase economic growth must also be a central part of any plan for entitlements. How important is economic growth? Recent history provides a powerful demonstration. Between 1982 and 2001, federal spending, adjusted for inflation, increased by 50 percent. Yet over the same period, the amount of national income that was required to finance this spending declined from 23 cents to 18 cents per dollar. This occurred because inflation-adjusted national income, bolstered by a 3.4 percent average annual real growth rate, nearly doubled during the period. The economic policy recipe that helped produce this growth consisted of sharply lower personal and business income tax rates, disciplined restraint on federal spending, reduced federal regulation of labor and commerce, lower international trade barriers, and a stable, rules-based, monetary policy. A return to these policies must be part of any effort to address the federal government's entitlement problem.

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