

AMERICA'S RELATED FISCAL PROBLEMS

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Does America have a major fiscal problem? I don't think anyone would say that the answer is "No." The complication is that the United States, like many OECD countries, has five "fiscal" problems, all intertwined:

1. **Short-term or countercyclical policy.** Fiscal policy needs to operate countercyclically, as it did during the recent recession. But now it is scheduled to turn pro-cyclical during an upturn, diminishing flexibility for dealing with the next recession.
2. **Long-term sustainability.** The nation's projected long-term deficits—that is, deficits that will mount if today's policies don't change—are not sustainable and threaten our economic viability.
3. **Fiscal democracy.** The law now commands such extraordinary commitments of limited revenues to mandated programs—those that by design operate eternally under rules written by yesterday's legislators and without any vote by newly elected legislatures—that fiscal democracy is at risk.
4. **Fiscal sclerosis.** Our budget is for a declining nation—one tilted toward spending more on consumption and less on investment, particularly in our children.
5. **An aged age policy.** Total cost aside, our policies toward the elderly can be much more fair and efficient.

These knotted fiscal issues have hit our economy simultaneously and interact multiplicatively. Short-term countercyclical policy, which generally requires rises in the debt-to-GDP ratio to counter recession, can't work unless that ratio is reduced during good economic times. But, for the first time in U.S. history, large long-term deficits are being predetermined even if future Congresses do nothing, thus constraining short-term policy options. Meanwhile, our down-the-road deficits derive largely from putting into the law unbalanced commitments for low revenues and rising benefits, thus robbing future voters of their say over how to meet new budgetary demands or emergencies. Sclerosis occurs because these commitments increasingly direct revenues toward consumption, less work, and less saving. Finally, our policies toward the elderly increasingly favor those with fewer needs and are programmed to discriminate forever against single heads of household, among other regrettable design features.

SOME EVIDENCE

Figure 1 demonstrates the first two fiscal problems. The debt path it shows is based on historical data and Congressional Budget Office projections, although Government Accountability Office projections are similar. Of course, the long-run trajectory is dominated by interest costs that compound with rising debt, but those costs rise quickly even in the near term. For instance, the Obama Administration's early

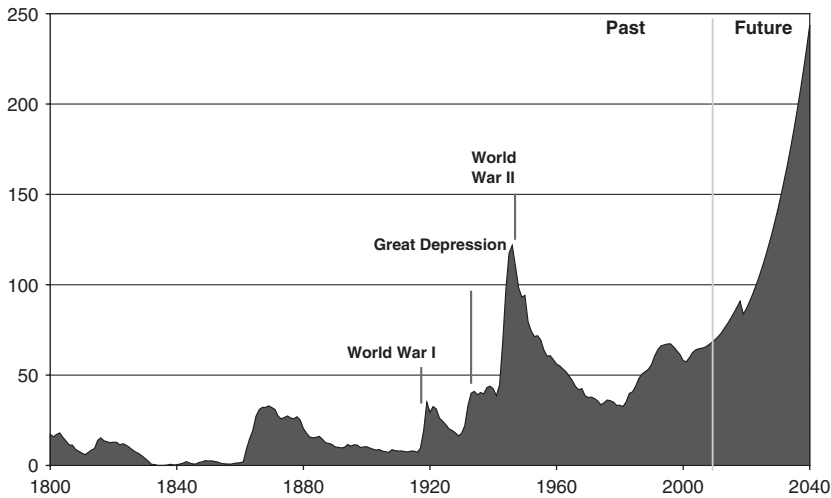


Figure 1. U.S. Federal Debt as a percentage of GDP, 1800–present.

2010 budget proposal projected that annual real interest costs would rise by approximately \$350 billion from fiscal year 2009 to 2015. No other change in spending under the economic recovery bills or health reform can compete in order of magnitude with that increase. And debt levels are slated to keep rising even if economic growth continues—they don't decline countercyclically in good years.

Figure 2 helps demonstrate the decline in fiscal democracy that I first mapped out with Tim Roeper. This index shows that in 2009, for the first time in U.S. history, mandated programs plus interest on the debt absorbed all government revenues. After a brief and small respite during a recovery period, the index is scheduled to go negative again more or less permanently. The U.S. government is operating like a firm that projects increasing revenues and then commits all future growth in those revenues through long-term contracts that suit only today's and yesterday's voters. But in a democracy, that accumulation of past commitments means that any new action—or even paying for welfare, defense, justice, most public education, or a civil service—requires cutting back on some past promises. This is, of course, an extraordinarily difficult task politically. Essentially, Democrats and Republicans have both attempted to remove the give or slack from future budgets by mandating spending increases *and* a revenue system inadequate to meet those expenditures. Treated like unreliable adolescents, future voters aren't trusted to make choices about what government should do and what size it should thus be.

Fiscal sclerosis derives from devoting ever smaller shares of the budget to children, investment, and opportunity and mobility—programs most associated with a growth agenda. The aggregate evidence is compelling (Carasso, Reynolds, & Steuerle, 2008; Carasso et al., 2008; Steuerle, Reynolds, & Carasso, 2007), but a simple touchstone is the skyrocketing growth in the share of the budget going to underwrite basic consumption rather than promoting opportunity. By contrast, for instance, spending on education and work supports is scheduled to decline both absolutely and as a share of GDP.

Most expenditures aimed at making sure Americans get the basics—food, clothing, or shelter—were designed for a different age. For example, 40 years ago, less than half of Social Security expenditures on men went to those who had more than ten years of life expectancy. It was predominantly a program for old age. Today,

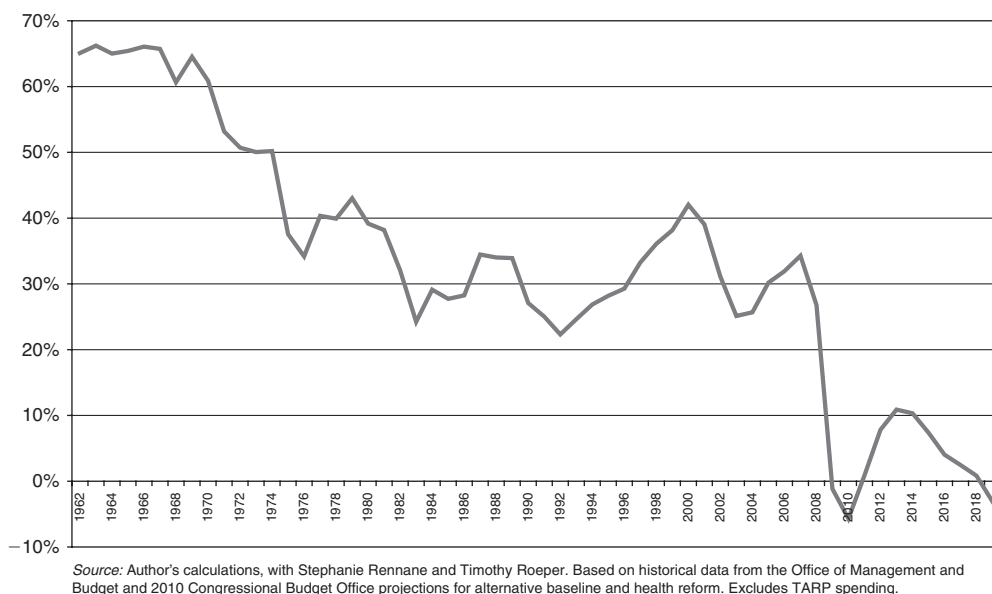


Figure 2. Steuerle-Roeper Fiscal Democracy Index: Percent of revenues available after expenditures on mandatory programs.

almost two-thirds of expenditures go to that group, and Social Security has morphed into a middle-age retirement system. Meanwhile, features like spousal and survivor benefits, unlike private pension benefits, cost the worker's family members nothing extra. As a consequence, many single heads of household work more, pay more tax, and raise more children, yet receive hundreds of thousands of dollars less in lifetime Social Security benefits than many married persons. Put another way, Social Security provides a pile of money that is available at no additional cost *only* to those who are married more than ten years. In health care, the biases toward acute over preventive care, specialization over primary care, and payments to drug companies for chronic care over cures are well known.

CONFLUENCE

Several factors made these five fiscal problems coalesce right now. First, the Baby Boomers began retiring around 2008 after swelling the workforce since the mid-1960s. The Baby Boomer phenomenon alone creates a demographic boom–bust cycle: increases in employment and revenues with moderate spending on the elderly followed by decreases in employment and revenues and rises in spending on the elderly. Macroeconomically, the Baby Boom retirement that started in 2008 will lead to the equivalent of an unemployment rate increase of about 1/3 of 1 percentage point each year for 20 years running if retirement patterns don't change. Soon, close to one-third of the adult population is scheduled to receive Social Security.

Second, exceptional female workforce growth has ended. Like Baby Boomer employment, it drove up and helped maintain the adult employment rate throughout most of the post–World War II era—even while making it relatively easy to let older workers, mainly men, retire earlier relative to their life expectancies.

Third, the rate of health cost growth is significantly outstripping the economic growth rate, and that growth is building on an ever-larger base. Because many of these costs are paid for automatically in the budget, the share of the budget pie for other programs is scheduled to dwindle at an ever-increasing pace.

Fourth, unprecedented levels of deficit even apart from expenditures on war have left a substantial debt burden that must be reduced (relative to the size of the economy).

Finally, tax cutters during the past 30 or more years have effectively ignored the corresponding deficit increases they created rather than treating them as what they really are—taxes that future generations must pay.

In sum, Baby Boomers' retirement, the leveling out of female-to-male employment rates, a high rate of health cost growth building on an ever-larger base, unprecedented debt levels, especially following a large recession, and a revenue system that can barely support yesterday's commitments have combined to make addressing the five nested fiscal problems urgent.

LABELS AND THEIR LIMITATIONS

Each of these problems could remain on its own even if some of or all the others were solved. For that reason, combining them under one label could invite incomplete policy adjustments. Consider three common labels in political discourse that are basically misleading half-truths:

- **The “deficit” label.** Our fiscal problems extend far beyond the residual left after subtracting spending from revenues. A higher deficit in a recession is usually a good thing if it is balanced on the other side of the economic cycle by lower deficits and surpluses. But even eliminating long-term deficits does not necessarily prevent fiscal sclerosis, a weakening of fiscal democracy, or an outdated and poorly targeted age policy.

The deficit label (and the public's current understanding of the “deficit issue”) also confuses short-term countercyclical policy with longer-term fiscal policy. The former is largely an issue of profligacy in a current year or during an economic cycle. The latter stems mainly from the amount of built-in growth in spending or tax cuts—*independent of economic cycles*—that is set in the law today and will continue indefinitely, restraining future budgets.

Sound countercyclical policy can abide large deficits during recessions if it also provides for significant surpluses or at least small deficits at other times. Early in World War II, huge spending increases were backed up by anticipated cuts in spending and higher taxes that would continue after the war. Had 10-year budget estimates been calculated in 1942, they would have shown huge surpluses in the very late 1940s thanks to the law in place during the war years that planned for these developments.

- **The “Social Security” label.** Considered in isolation, additional Social Security spending is significant, but it pales in comparison to growth in health and interest costs. As a share of GDP, Social Security costs would rise by about one half (from about 4 percent of GDP to 6 percent of GDP) from 2008 to 2030, while taxes would decline a bit, from about 5 percent toward 4.5 percent of GDP. In contrast, current and projected deficits in the broader federal budget will run several times that amount. To be sure, then, Social Security solvency is an issue and we need to balance revenues and costs of that system. But it is only a piece of the larger demographic issue of how to adjust government policy in view of falling birth rates and rising life expectancies. A decline in the worker-to-adult ratio hugely affects income tax revenues, GDP, and worker incomes, not just Social Security actuarial deficits.

Social Security has other effects besides its price tag. Social Security law defines when one is “old” partly by setting eligibility for “old-age-insurance” at age 62.

(Legislators lowered the early retirement age even as the average American's life-span increased.) Besides its impact on national output and the rest of the budget, this official start date creates expectations about when to retire. That powerful signal, in turn, prompts many to reduce their lifetime productivity and income, pay less in lifetime taxes, start drawing down their private retirement plans instead of adding to them for a few more years, and start relying on the government for health care.

- **The “health care only” label.** Viewed in isolation, health cost growth projections dominate the growth in Social Security costs. But changing demographics have other, less discussed effects too. Measures of Social Security imbalances don't capture what the projected decline in employment rates will do to revenues other than Social Security taxes. And dependency ratios in programs like Medicare and Medicaid (increasingly dominated by long-term care issues) will shift.

If, hypothetically, birth rates decline toward zero and eventually only a few workers are under Social Security and Medicare eligibility ages, is that a demographic effect? A Social Security effect? A Medicare effect? Far less hypothetically, our worker-to-retiree ratio has gone from 4 to 1 in 1963 to a little above 3 to 1 as the Baby Boomers begin retiring; in 2040, it will be closer to 2 to 1 (Board of Trustees, 2009). Even if health costs weren't outpacing economic growth, this shift must be accommodated in systems that are essentially pay as you go. For instance, going from 3-to-1 to 2-to-1 essentially means that tax rates must increase by 50 percent, benefit rates must be lowered by 33 percent, or something in between. (Some of that accommodation within Social Security, but less in the rest of the budget, was already achieved through earlier legislation.)

HEALTH AND RETIREMENT

Common to all five fiscal problems are rising rates of cost growth in health-care and retirement programs. It's no small wonder that health reform and social security reform continually come up when any of the five fiscal issues are discussed. Let's examine this growth in a bit more detail.

Health Costs

Today, health costs are about \$21,000 per household—17 percent of GDP and between 25 and 30 percent of households' total monetary income. With health costs rising much faster than our national income, that \$21,000 cost could double in as little as 15 years, absorbing ever-larger shares of total income. Counting tax subsidies, government now covers about 57 percent of these costs, a number that will rise above 60 percent under health care reform.

Lifetime Value of Social Security and Medicare

One quick way to summarize the rising costs of retirement and health programs (independent of demographics) is to calculate the present value of Social Security and Medicare for those newly retiring. This sum represents the approximate assets needed in an account of a person at age 65 to cover the remaining lifetime benefits (here assuming a real 2 percent interest rate, with the interest largely nontaxable). For a couple, that amount has risen by several hundred thousand dollars since 1965 and is now approaching \$1 million. Indeed, typical couples are scheduled to get close to \$1.5 million (in constant, inflation-adjusted dollars) by about 2030. By my calculations, this lifetime benefit exceeds the private net worth (counting everything

from pensions to homes) of more than three-quarters of new retirees (Steuerle, 2005).

Source of Automatic Growth

What causes these increases in costs, independent of the demographics shifts to which we must adjust in any case? Essentially, they grow on automatic pilot. In health care, when we go to the doctor, we often bargain over what everyone else will pay for our care. Correspondingly, fee-for-service medicine essentially allows providers to add on services and goods with only modest limits on quantity or price.

In the case of Social Security, with only one modest exception, the system is wage indexed so a generation earning 30 percent higher average wages than its parents automatically receives a 30 percent higher annual benefit. And more years of support are provided to every generation as it lives longer.

Years of Government Support

Lifetime benefits soon reach these million-dollar-plus levels largely because benefits last for so many years. The average male at age 62—Social Security's early retirement threshold—can expect to live another 18 years, the average female another 21 years, and the longer living of the two, 27 years. Skipping through some of the math on discounting and health-care cost escalation, a benefit package worth on average \$40,000 a year yields \$1 million in benefits over 25 years.

When Social Security first began in 1940, the average male worker retired at age 68, even though work was much more physically difficult then, and the earliest retirement age was 65 (Johnson, Mermin, & Steuerle, 2006; Steuerle, 2005). Given today's longer life spans, workers retiring for the same number of years today would work until age 75. Projecting forward to 2070, that worker would retire at age 80 (Figure 3). Instead, workers have retired earlier and earlier until recently.

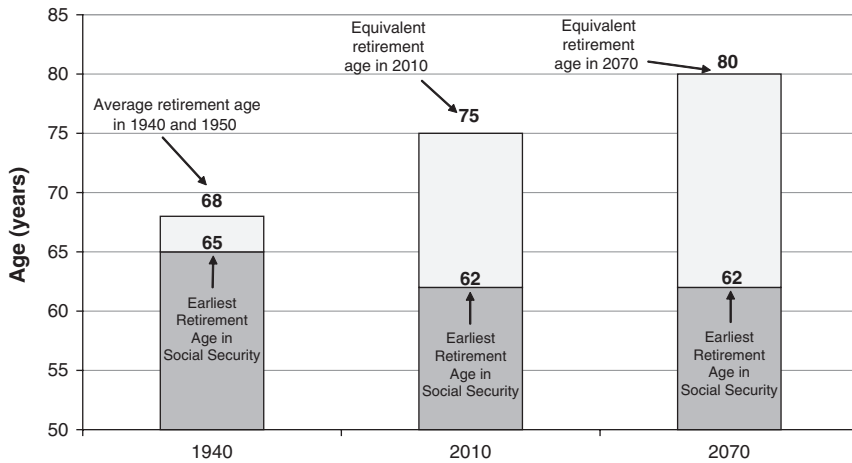
REVENUES

Revenues, of course, have not increased commensurately with government's obligations and challenges. In fact, as long-term commitments have continued to grow, revenues have been reduced through tax cuts. Current policies in place yield federal revenues of about 17 percent of GDP, below the average of the past few decades of about 18.5 percent. While no revenue increase can cover the cost of programs that continually rise faster than GDP, our current pattern of revenue collection and our failure to save for demographic and other changes have only added to the burdens placed on younger populations to pay for decisions their generation didn't make.

REFORM

What reforms would help most now? On the revenue side, policymakers should push hard to pare or eliminate many special deductions, exclusions, and other income tax breaks. Let's also consider adopting a value-added tax—though to justify the administrative costs, such a tax needs to be assessed at a rate higher than a few percent, and should thus displace some other taxes.

Equally important, substantial give or slack must be restored to the budget. On the demographic front, let's do all we can to increase work efforts among the near elderly. That probably means increasing the retirement ages—preferably by eliminating the confusing way that retirement benefits are adjusted for delaying receipt and moving toward an earliest retirement age of 65, indexed right away to keep constant the number of years of support. Through more simply offered and explained



Source: The Urban Institute, 2010. Based on data from the Social Security Administration, Birth Cohort Tables.

Figure 3. Indexing Social Security for life expectancy.

actuarial adjustments, we could at the same time encourage people to buy larger annuities with income from further work or other saving. But encouraging work and favoring the neediest among the elderly also means making other adjustments, including structuring Social Security benefits so larger shares go to the truly old and those more likely to need long-term care or other extra help.

Health-care policies would serve us better if we moved closer to a voucher-like system or at least bundled payments to limit how much cost growth can be driven by a fee-for-service system that continually adds new services. And any new health-care system must have a budget. For instance, if Medicare is going to operate largely as structured now, it has to be empowered to stay within a budget, primarily by ratcheting down relative prices in a manner more consistent with what we expect from other growth sectors. Congress can always override those decisions, but at least education and other options could compete on a more level playing field. At the same time, Medicare should shift relative payments toward preventive and primary care. Because government soon will control more than three-fifths of the health care market (including tax subsidies), it must lead the way.

Recent health reform correctly attempted to improve our knowledge base in health care, with the goal of improving its efficiency. Unless health care operates within a budget, however, I believe there will be little incentive to adopt cost-reducing improvements.

By the same token, we should attempt to limit automatic, eternal, built-in growth in any program, including many tax breaks. Many expenditures and programs should be increased over time, but which ones and by how much should largely be left to future voters. Caps, enforceable budgets, triggering mechanisms that come into play when growth rates are unsustainable, and other devices should displace automatic growth as the default when Congress and the president can't or won't make decisions directly.

Unfortunately, this Point/Counterpoint addresses dealing with problems rather than opportunities. My goal in tackling these problems is not just creating a sustainable budget but, more broadly, reorienting government to spend relatively more future revenues on education, investment, and opportunity and relatively less on covering consumption. I'd rather put more into teachers and primary care health providers and less into surgeons, more into children and work subsidies than

financing retirement for one-third of our adult lives. Along the way, I would increase the progressivity and equity of programs such as Social Security by such actions as shifting larger shares of its spending to the truly old, creating minimum benefits, and removing the discrimination against single heads of household—issues that go well beyond this brief.

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