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MEETING THE LONG-TERM CHALLENGE OF OLD AGE ENTITLEMENT SPENDING

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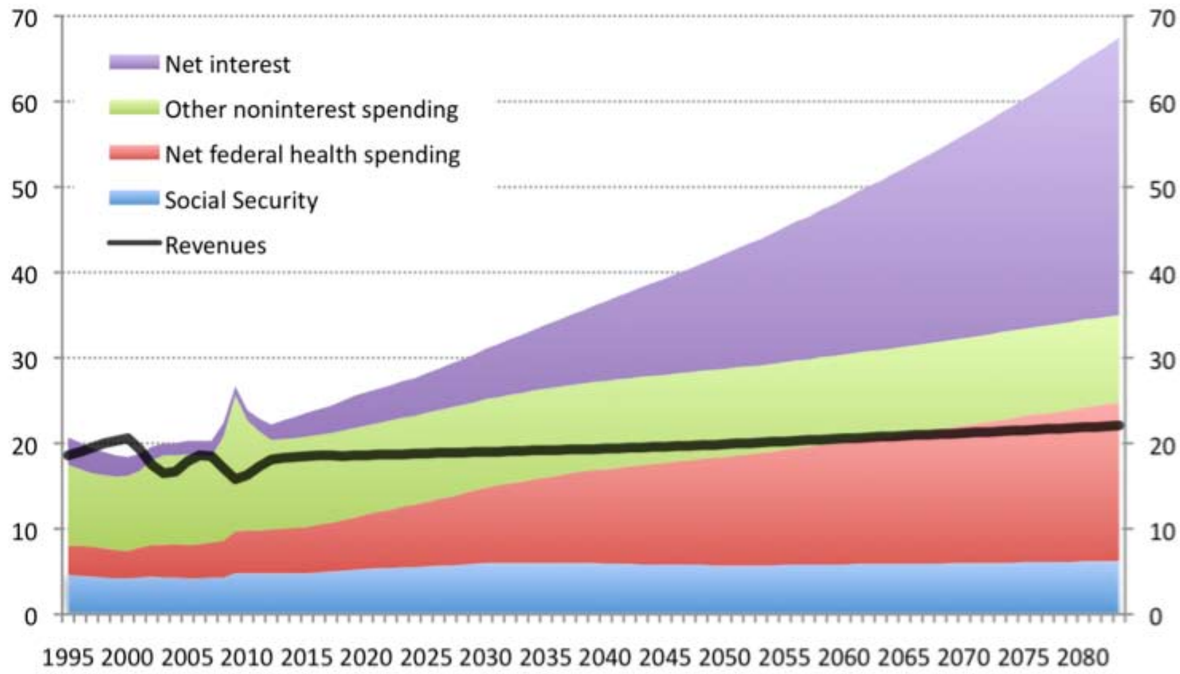
Is the United States going bankrupt? This question is asked with increasing frequency for two main reasons. First, deficits have soared in response to the financial crisis and the recession.[1] Second, spending on Medicare, Medicaid, and, to a lesser extent, social security is projected to increase drastically over the next 60 years, engendering extraordinary fiscal pressure (see figure 1).[2] Some action will have to be taken. The challenge is to take that action as quickly as possible, so that the fiscal future that we now face can be changed before it does significant and possibly irreparable harm.

FIGURE 1: CBO LONG-TERM BUDGET OUTLOOK



Source: CBO, Long-term Budget Outlook, 2009, alternative baseline.
Note: CBO recently released the Long-term Budget Outlook for 2010. It differs relatively little from the outlook in 2009 although no measures of net interest are provided because the outlook is deemed unsustainable.

FEDERAL OBLIGATIONS

Before deciding what to do, it is important to quantify exactly what the obligations of the federal government are. For better or worse, there are a number of measures of federal liabilities—none of which is definitive for evaluating the different kinds of obligations that the government must meet or which future costs it is most likely to pay. The most comprehensive picture of the assets and liabilities of the federal government is presented in the *Financial Report of the United States Government*.[3] In addition to the federal debt securities held by the public (plus accrued interest), the balance sheets recognize other liabilities that the government has committed to pay. They do not, however, recognize the social-insurance benefits that are not yet due and payable. Instead, the *Financial Report* includes *Statements of Social Insurance* that provide the long-term projections for the social insurance funds prepared by the fund trustees.

There are two important reasons why the U.S. government's balance sheet does not recognize future social-insurance benefits as liabilities. First, current law provides for full benefit payments only to the extent that there are sufficient balances in the social-insurance trust funds.[4] If the trust funds run out, benefits must be delayed until the trust funds can be replenished. Second, the law states—and the Supreme Court has verified—that program participants have no accrued property right to benefits.[5]

From today's perspective, the important question is whether a Greenspan-type commission could address the looming crisis in entitlement spending.

THE GREENSPAN COMMISSION AS A PARADIGM

Only once has a major social insurance trust fund been threatened with insolvency and the specter that benefits would be delayed. The *1982 Annual Report of the Board of Trustees* stated: "Without corrective legislation in the very near future, the Old-Age and Survivors Insurance Trust Fund will be unable to make benefit payments on time beginning no later than July 1983."[6] To avoid insolvency, President Reagan issued Executive Order 12335 on December 16, 1981 establishing the National Commission on Social Security Reform (commonly known as the Greenspan Commission, after its chairman). The Greenspan Commission had to act fast to avoid trust fund exhaustion, and it produced a set of recommendations that were in large measure adopted by Congress, avoiding insolvency in the short run and significantly improving the cash flow of the system into the foreseeable future (although subsequent changes in the economy and demographic projections have resulted in a deterioration in system finances relative to that projected at the time the recommendations were adopted).[7]

From today's perspective, the important question is whether a Greenspan-type commission could address the looming crisis in entitlement spending. One might argue that the recent appointment of the National Commission on Fiscal Responsibility and Reform could fit this mold. Its mandate includes proposing "recommendations that meaningfully improve the long-run fiscal outlook, including changes to address the growth of entitlement spending and the gap between the projected revenues and expenditures of the Federal Government."[8] However, this commission lacks the leverage of either special treatment for its recommendations—for instance, a "vote without amendment" provision where Congress does not have the option of amending the commission's recommendation prior to voting, or a forcing event, such as trust fund exhaustion. The best outcome would be if the commission could, in fact, spur comprehensive entitlement reform. Absent this outcome, the question is whether a new commission focused on entitlement spending using the special status of the trust funds could help force action.

WHY IS THE SITUATION TODAY DIFFERENT?

The structure of the entitlement-spending problem has changed. The Greenspan Commission could achieve its objectives with a few, politically palatable recommendations. The same approach might work again for social security, but the current spending problem for Medicare is much less tractable.

One obvious option for Medicare is to increase the age at which people are eligible for benefits. Beyond adjustment of the eligibility age, possible reforms fall into four categories: (1) increases in budget transfers, financed either by higher contribution rates or general revenue, (2) increases in premiums, (3) reductions in benefits, and (4) improvements in efficiency. The first three of these follow a tax-and-transfer model rather than a social insurance model. For health insurance (HI) contributions to cover HI benefits, rates would have to increase more than three-fold by the end of the projection period.[9] If rate increases are income-related, the rates for high-income individuals and families would have to increase by an even larger factor. Financing increases in transfers out of general revenues would face the same obstacle in terms of the size and distribution of the increase. Premiums are already highly progressive, with high-income beneficiaries paying roughly three-quarters of the cost of the benefits received.[10] Benefit levels can be reduced, but Congress has shown little will to do so. Much hope has been held out for improvements in efficiency, but it is not clear that reducing inefficiency would constrain the *rate of growth* as well as the *level* of spending.

KEY LESSONS

The following lessons can be drawn from the Greenspan Commission:

When government action is required to avoid trust fund insolvency, it is possible for the Congress and president to take action.

We will know soon enough whether that lesson can be applied in today's highly polarized political environment. Although not "imminent," action will be required in the relatively near future to address entitlement spending to avoid the exhaustion of the social insurance trust funds. The question is whether the more severe and broad-based nature of the current social security and Medicare crises will render a "Greenspan Commission" approach unworkable.

Unrealistic assumptions about the future evolution of costs will make it more difficult to take timely action.

For instance, the recently passed Patient Protection and Affordable Care Act (PPACA) includes provisions to control the level of reimbursements to providers.[11] The chief actuary for the Center for Medicare and Medicaid Services, Richard S. Foster, has estimated that—taken at face value—the provisions of the PPACA could delay exhaustion of the HI trust fund by 12 years.[12] However, Foster points out that the cost savings could be illusory, based on assumed reductions in cost per beneficiary that may be unachievable.

The political challenge is to motivate action before trust fund exhaustion is imminent to 1) avoid last-minute "fixes" that might not address the problem in the most effective manner and 2) reduce the scope and smooth the timing of reforms to make them more palatable to the electorate.

One problem with a Greenspan-type commission for the current entitlement crisis is that it may not look at the issues in a sufficiently broad context. Social security and Medicare are highly progressive programs. As we project spending and revenue over the next 75 years, two questions will need to be addressed:

- First, what is the redistributive goal of the old-age entitlement programs? By 2085, compensation levels are projected to be roughly 3.5 times as high as in 2010.[13] This has implications for the role of the entitlement programs in protecting against *absolute* poverty or unaffordable health care in old age, although it is not relevant for *relative* redistribution. Should an increase in absolute standards of living be accompanied by a greater role for individuals in saving for old age? Could a reduction in the relative size of the program—for instance, by constraining the growth of the cap on wages subject to contribution—facilitate reform?

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- Second, what role should government play in the health care markets, both for the elderly and non-elderly? Despite increasing the role of the government in health care, the PPACA did not address some important, market-related factors. For instance, the tax deductibility of employer-provided health care is one of the most inefficient aspects of the current system. If the deductibility were rescinded (or out-of-pocket co-pays were increased), consumers would become more conscious about the cost implications of their health care choices, leading to a reduction in consumption levels. Moreover, the elimination of the tax distortion would be incentive-compatible and could substitute for increases in more distortionary taxes to fund health care. Similarly, one of the most challenging characteristics of health insurance markets is the sensitivity of premiums to age. Would it be possible to design a system in which workers paid more than an actuarially fair premium when young in order to pay lower premiums as they get older? Should the government focus more on supporting private insurance markets for most consumers and focusing its activities on ensuring access for the poor and the very sick?

A Greenspan-type commission will not obviate the need to consider and ultimately answer questions of this type in a manner that achieves social goals without losing the benefits of market forces.

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ENDNOTES

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