SIMPLE SOLUTIONS FOR THE LONG-TERM BUDGET CHALLENGE

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The United States long-term fiscal outlook is considered by many experts to be unsustainable. If no policy changes are made, the projections beyond 2030 are not really plausible, because by then the financial position of the U.S. government will have become unstable. With government debt in excess of 100 percent of GDP and more than six times government revenues, the risk premium that investors charge the Treasury could become significant. If we attempt to follow current policy, and a crisis ensues, then by the time today's 40- and 50-year-olds reach age 65, the only will option will be to spend less on medical services in their old age, with the spending restrictions imposed by draconian government rationing.

RESEARCH FINDINGS

- Government fiscal positions tend to be highly opaque. This is as true of the United States today as it has been of other countries in the past. We have no standard measures of the potential liabilities of the U.S. government for losses on mortgages due to default, losses on mortgage securities due to interest-rate fluctuations, potential losses of the Pension Benefit Guarantee Corporation, and so on. If anything, the medium-term fiscal outlook is probably too optimistic.

- We could have a fiscal death spiral by 2030. By then, investors would be unlikely to view U.S. debt as risk-free. Instead, investors would be building a substantial default premium into their pricing of government securities. If the default premium were enough to raise interest rates by five percentage points, then the additional interest would raise the deficit by nearly another 6 percent of GDP, which would worsen the fiscal outlook even more, leading to a higher risk premium, and so on. This is a fiscal death spiral, or a "sudden stop," as it is known in the academic literature.

- The dire future fiscal position comes largely from promises being made to people who will be eligible for Social Security and Medicare in 2020 or later. Fixing the fiscal outlook is as simple as scaling back those promises to more realistic levels. Scaling back our promises does not necessarily harm anyone. If the promises are excessive (as they will prove to be if we undergo a fiscal death spiral), then those promises will be broken. In fact, it is likely to be better for today's young and middle-aged workers if they are given realistic promises of future benefits rather than to have them make plans based on unrealistic promises on which the government has to renege.

OPPORTUNITIES FOR CHANGE

- Increase the age of eligibility for Social Security. Restore the life expectancy of a Social Security recipient to 13 years, as it was around the time that the program was enacted. The goal would be to complete this restoration for those who will be 65 in 2032. This proposal assumes no additional revenue from payroll taxes, and this assumption could be "hard-coded" by exempting workers between age 67 and 73 from the payroll tax.

- There are two approaches for keeping Medicare within a fixed budget. One approach would set the budget and have medical procedures rationed by government officials. Another approach would be to convert Medicare to a voucher system, in which individuals would have to make their own decisions about which medical procedures to undertake and how to pay for them. The latter is the preferred approach.
  - The new Medicare would consist of a voucher supplemented by catastrophic health insurance. For individuals who experience ailments that require expensive treatment, the proposal provides government-provided catastrophic insurance.
  - Medicare's budget will be fixed by eliminating reimbursement for medical services. It is expected that individuals will pay for *some* of their health expenses and insurance premiums out of personal savings.

SUMMARY

The current U.S. fiscal trajectory will inevitably lead to debt exceeding the total size of the economy by 2030. At this point investors will begin to stop lending to the government and interest rates will spike. The historical record indicates growing the economy out of this problem is unlikely if not impossible. The solution requires modest reforms to entitlements so that dramatic breaks in the promises to young and middle-aged workers are not required.

RECENT RESEARCH BY ARNOLD KLING

"Simple Solutions for the Long-Term Budget Challenge," *Mercatus Center Working Paper*, No. 10-14, March, 2010.

ARNOLD KLING IN THE NEWS

"Why Our Current Budget Situation is a Crisis," *The American*, May 4, 2010.
"Is Central Planning the Answer to Health Care?," *AOL News*, February 23, 2010.
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ABOUT DR. KLING

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