

Policy Analysis

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Bankrupt Entitlements and the Federal Budget

by Michael Tanner

Executive Summary

The U.S. government is about to exceed its statutory debt limit of \$14.3 trillion. But that actually underestimates the size of the fiscal time bomb that this country is facing. If one considers the unfunded liabilities of programs such as Medicare and Social Security, the true national debt could run as high as \$119.5 trillion.

Moreover, to focus solely on debt is to treat a symptom rather than the underlying disease. We face a debt crisis not because taxes are too low but because government is too big. If there is no change to current policies, by 2050 federal government spending will exceed 42 percent of GDP. Adding in state and local spending, government at all levels will consume nearly 60 percent of everything produced in this country. Whether financed through debt or taxes, government that large

would be a crushing burden to our economy and our liberties.

Driving this massive increase in the size and cost of government are so-called “entitlement programs,” in particular Social Security, Medicare, and Medicaid. Indeed, by 2050, those three programs alone will consume 18.4 percent of GDP. If one assumes that revenues return to and stay at their traditional 18 percent of GDP, then those three programs alone will consume all federal revenues. Therefore any serious attempt to balance the federal budget and reduce our growing national debt must include a plan to reform entitlements.

It may well be politically convenient to continue ducking entitlement reform. But doing so will condemn our children and our grandchildren to a world of mounting debt and higher taxes.

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It is not as though there has been no warning about entitlement growth.

Introduction

No one should be shocked to learn that government spending is out of control. The Bush and Obama presidencies have been the two most profligate political eras of modern times. Federal government spending has nearly doubled over the last 10 years.¹ As a result, we now face budget deficits that are unprecedented in the post-World War II era.

In fact, Congress is about to vote on a resolution raising the nation's debt ceiling, allowing the US government to borrow more than the \$14.3 trillion currently authorized.

But our current budget problems are nothing compared to the explosion to come. The Congressional Budget Office predicts that the official debt alone (excluding the unfunded liabilities of entitlement programs) will exceed 100 percent of GDP by 2025 and could exceed 180 percent of GDP by 2035.² From there, it only gets worse.

No area of government spending has been immune from this explosion of spending. Since 2000, domestic discretionary spending has increased by 120 percent, and defense spending has risen by 135 percent.³ Both defense and domestic spending will have to be reduced if we are to begin putting our fiscal house in order.

The vast majority of future debt is driven neither by defense nor discretionary programs but by so-called entitlement programs, three in particular: Social Security, Medicare, and Medicaid.⁴ In fact, by 2050, those three programs alone are expected to consume every penny that the federal government raises in taxes. That means that everything else that the government does, from domestic programs to national defense, including paying interest on the federal debt, will have to be paid for through still more debt, or else government will have to raise taxes to astronomical levels.

As the full burden of entitlement programs kicks in, the federal government will consume more than 40 percent of GDP by the middle of the century.⁵ Again, half of that will be for Social Security, Medicare, and Medicaid.

It is not as though there has been no warning about entitlement growth. As far back as 1995, the Bipartisan Commission on Entitlement and Tax Reform was pointing out: "If we do not plan for the future, entitlement spending promises will exceed federal resources in the next century. The current trend is unsustainable." The commissioners went on to warn, "If we fail to act, we have made a choice that threatens the economic future of our children and the nation."⁶ Four years later, the National Bipartisan Commission on the Future of Medicare, while unable to reach a consensus on how to reform the program, concluded that it was unsustainable in its present form.⁷ Likewise, President Clinton's Social Security Advisory Council agreed that Social Security, as currently structured, could not meet its future obligations.⁸

For at least a decade, under both President Clinton and President Bush, as well as President Obama, experts inside and outside government have made it clear that entitlement reform was essential to the nation's long-term fiscal health. Most recently, in December 2010, the bipartisan Commission on Fiscal Responsibility and Reform warned that we have reached a "moment of truth" for budget reform.⁹

If anything, these warnings—over many years and across political and ideological differences—have understated the threat to future generations. But, so far, both political parties have sought partisan political advantage rather than dealing with the looming threat. Democrats demagogued President Bush's attempts to reform Social Security and continue to attack any Republican who raises the issue.¹⁰ Republicans criticized Democrats for daring to make cuts, however tentative, in Medicare as part of their health care reform effort.¹¹ That must change.

Unless the United States learns to live within its means, a true economic disaster beckons. That means Congress is going to have to cut spending at all levels. Both discretionary and defense spending will have to be scrutinized and pared back to affordable—not to mention constitutional—levels. Even

more important, Congress must finally enact entitlement reform. And that reform must go beyond mere tinkering; it must restructure the programs in fundamental ways.

Our looming fiscal train wreck has been amply abetted by both political parties. But the 2010 midterm elections demonstrated that voters see the debt as a major issue. In fact, polls show that the public puts a high priority on deficit reduction (although there is much disagreement on how to accomplish that goal).¹²

Congress now has an opportunity to change its ways. The coming months will show whether it will.

The Deficit

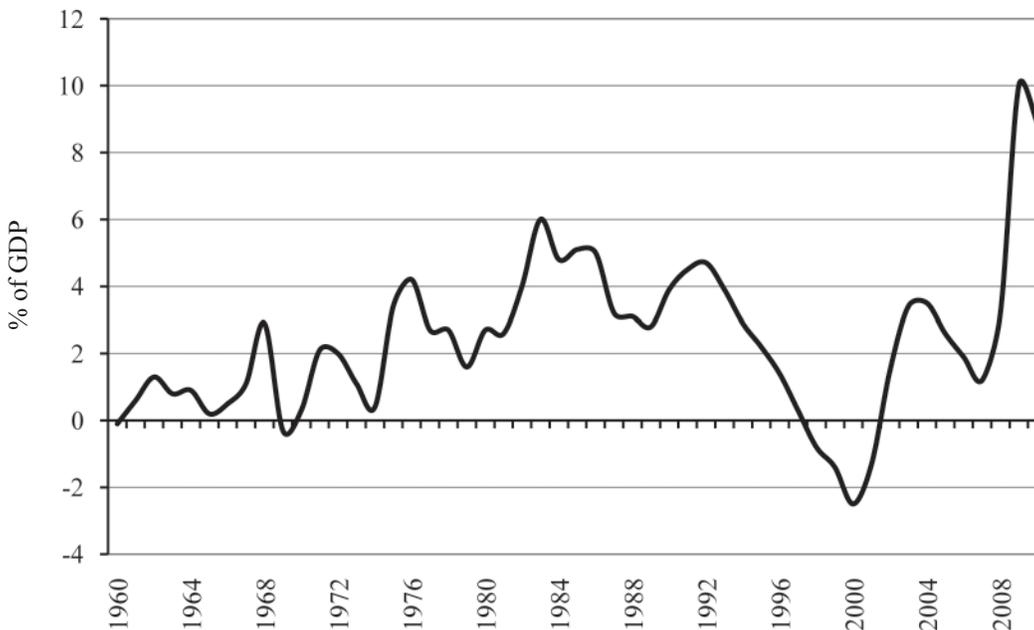
In Fiscal Year 2011 the federal government will spend \$1.65 trillion more than it took in.¹³ While a slight (\$119 billion) improvement over 2009, this still represents the second largest budget deficit in the last 65 years (see Figure 1). And the Obama administration projects that in 2012 the deficit will improve, but still top \$1.1 trillion.¹⁴

Some observers have claimed that recent deficits have been the result of the Bush tax cuts combined with the cost of the wars in Iraq and Afghanistan. Certainly fighting two wars has been expensive, costing more than \$1.1 trillion since 2001 by some estimates.¹⁵ However, as Figure 2 shows, with the possible exception of 2007, the cost of the wars represented only a small fraction of the deficits.

The impact of the Bush tax cuts is a bit more complicated, since one has to account for the dynamic impact of the tax cuts on economic growth. As the nonpartisan Tax Foundation points out, “No tax cut that has significant marginal rate cuts, as the Bush tax cuts did, will cost the Treasury its full ‘static’ score.”¹⁶ People and businesses change their behavior when faced with lower tax rates. They invest more, work more, take more risks, and earn more money, which in turn generates additional tax revenue. That is not to say, as some conservatives wrongly claim, that tax cuts always pay for themselves. But depending on the type and structure of the cuts, tax cuts may offset part of their cost through increased growth. Exactly how much lost revenue is off-

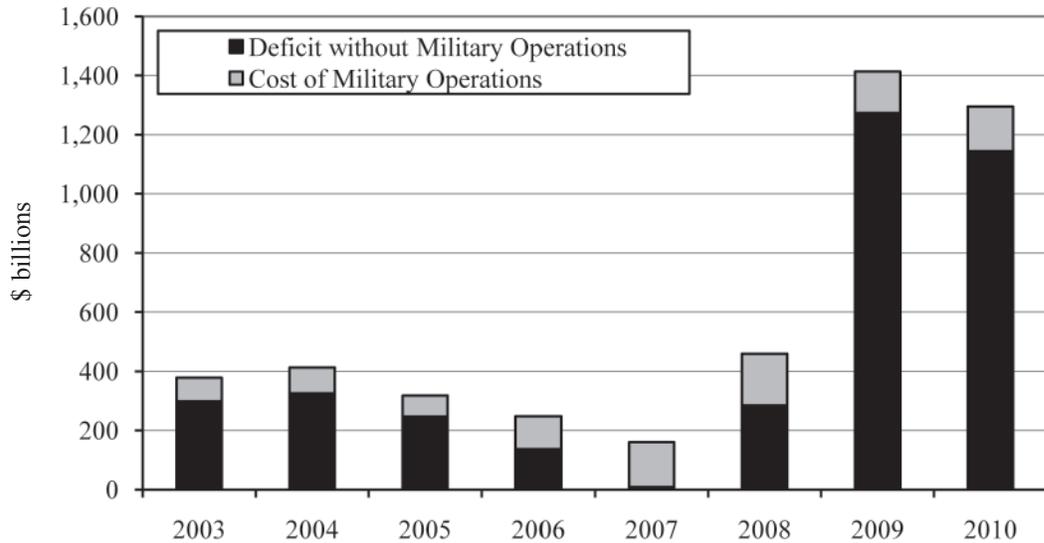
In Fiscal Year 2011 the federal government spent \$1.65 trillion more than it took in.

Figure 1
Historical Deficit



Source: Congressional Budget Office, “The Budget and Economic Outlook: An Update,” August 2010.

Figure 2
Deficit with and without Military Operations



Source: Author's calculations from data in Congressional Budget Office, "The Budget and Economic Outlook: An Update," August 2010.

set by increased growth is very difficult to determine, and, unfortunately, there have been no reliable estimates of how much increased economic activity—and therefore revenue—was generated by the Bush tax cuts.

Still, even if one accepts the most static interpretation of the tax cuts, assuming that they generated no increase in economic growth whatsoever, the tax cuts and the wars account for only a small portion of current deficits (see Figure 3). Moreover, this estimate includes all the Bush tax cuts, including the portion for low- and middle-income earners that is supported by the Obama administration. It also includes the cost of annual adjustments to the Alternative Minimum Tax (AMT), which are not technically part of the "Bush tax cuts."

One can also look at the gap between revenues and spending another way: for the last 40 years, federal spending has averaged approximately 21 percent of GDP, while revenues have averaged roughly 18 percent (see Figure 4).¹⁷ This has resulted in a structural shortfall equal to about 3 percent of GDP on average. Following the enactment of the Bush tax cuts, revenues did decline as a percentage of GDP—although measured in dollars,

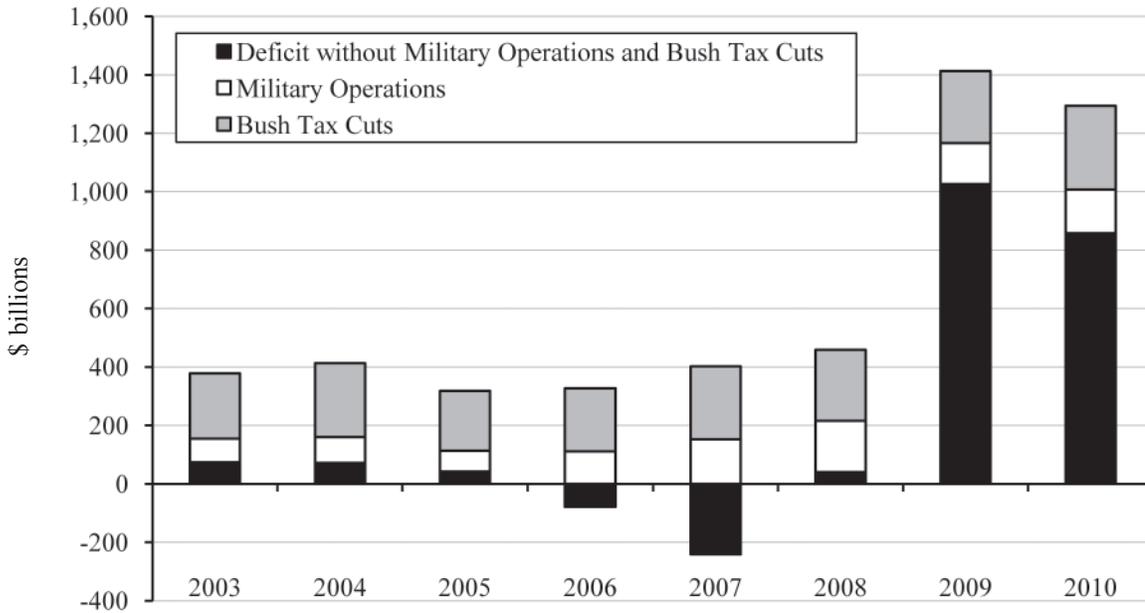
revenues actually increased by roughly \$740 billion between 2003 and the start of the recession in 2008.¹⁸ In 2009 and 2010, tax revenues were only about 14.9 percent of GDP, the lowest percentage since 1950.¹⁹ Of course, at least a portion of this decline is due not to the tax cuts, but to the recession and its attendant high unemployment. For example, Social Security and Medicare payroll tax revenues have declined significantly even though they were unaffected by the Bush tax cuts.²⁰

Extrapolating from a Congressional Budget Office report early last year, it can be estimated that even if the Bush tax cuts had been allowed to expire in their entirety, that would have added only about two percentage points of GDP to government revenues.²¹ Projecting that back on last year's deficit would mean that without the tax cuts, revenues would have been roughly 16.6 percent of GDP, leaving a deficit of more than 8 percent of GDP.

More important, all this ignores the other side of the equation. During the final years of the Bush administration and the first years of the Obama administration, spending skyrocketed.²² As a result, federal government spending in 2010 was roughly 24 percent of GDP, a

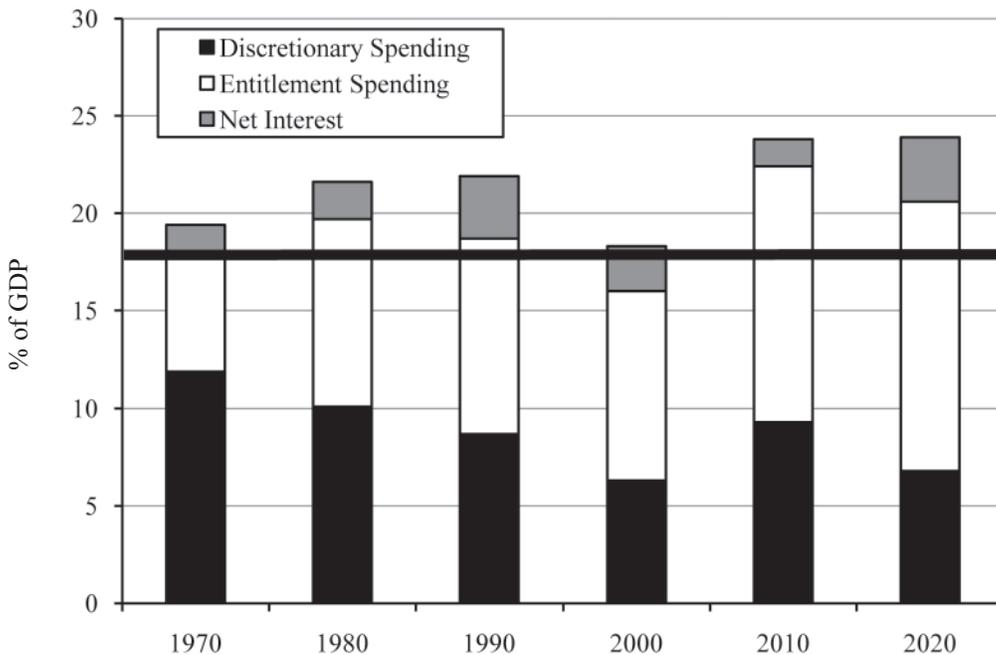
Even if revenues returned to the traditional 18 percent level, we would still face an enormous budget deficit equal to 6 percent of GDP.

Figure 3
Deficit with and without Military Operations and Bush Tax Cuts



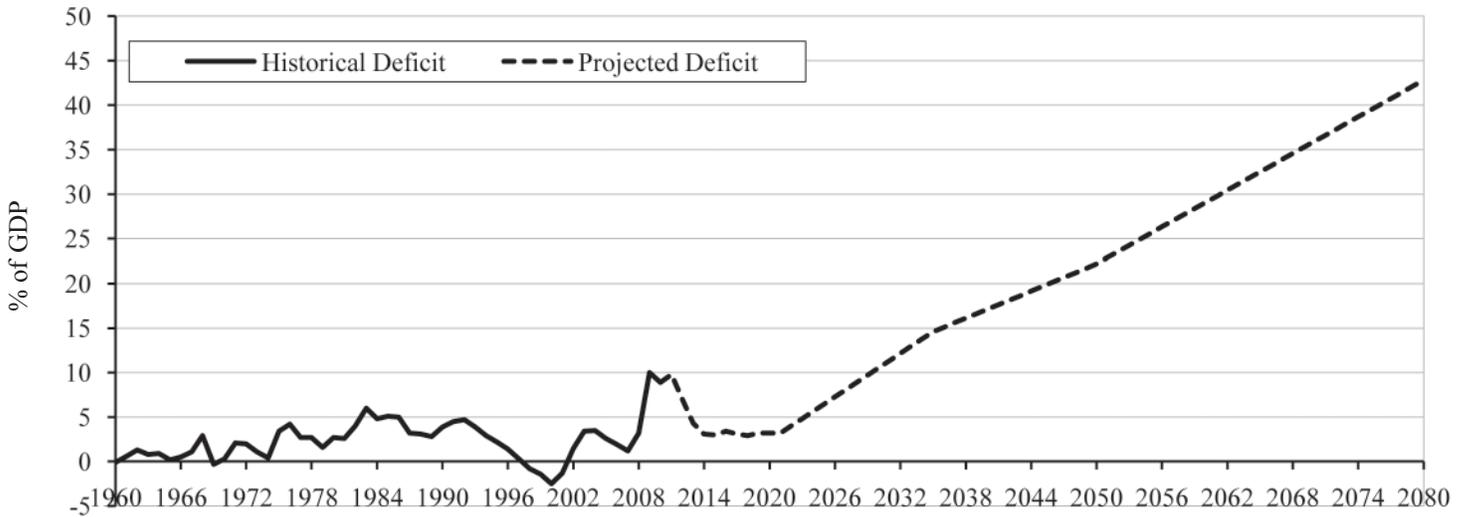
Source: Author's calculations using data from Congressional Budget Office, "The Budget and Economic Outlook: An Update," August 2010, and Citizens for Tax Justice, "Bush Tax Cuts Cost Twice as Much as Democrat's Health Care Proposal," September 8, 2009.

Figure 4
Historical Spending vs. Revenue



Source: Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2010 to 2020," January 2010.

Figure 5
Historical and Future Deficit Projections



Source: Congressional Budget Office, “The Budget and Economic Outlook: An Update,” August 2010.

Within a decade we will see annual budget deficits the likes of which this country has never before encountered.

slight decline from 25 percent in 2009, but still the second highest percentage since 1946.²³

Thus, even if revenues returned to the traditional 18 percent level, we would still face an enormous budget deficit equal to 6 percent of GDP, the highest level since Jimmy Carter was president. In fact, even if revenues were to rise to their highest post-war percentage of GDP, 20.6 percent in 2001, we would still have a \$500 billion deficit this year.

It is clear, therefore, that the current budget deficit is a result of overspending, not tax cuts.²⁴

The Congressional Budget Office estimates that revenues will return to 18.8 percent of GDP in 2013 and rise to 20.8 percent—the highest in post-war history—by 2021.²⁵ The CBO also projects that federal spending will decline somewhat as stimulus spending winds down and counter-recession spending, such as unemployment payments, is reduced. However, spending will bottom out at 23 percent of GDP in 2014 and then begin rising again, driven primarily by increases in entitlement spending.²⁶

As a result, budget deficits will decline slightly through the remainder of this decade, reaching a low of roughly 3 percent of GDP by 2018.

This may be better than what we face today, but it is still higher than the deficits we faced as recently as 2006. Worse, beginning in 2019, deficits will once more begin to rise. By 2050, the deficit will approach 20 percent of GDP and continue to rise thereafter (see Figure 5).

Thus, within a decade we will see peacetime budget deficits the likes of which this country has never before encountered. And, while no one believes that it is possible for deficits to remain on such a trajectory forever, only a change in budget policy can avert it.

The Debt

If rising annual budget deficits represent year-to-year fiscal irresponsibility, the cumulative total of that profligacy is the federal debt, which has now reached the \$14.3 trillion limit allowed under the current debt ceiling.²⁷ To put that in perspective: if you earned one dollar every second, it would take you 416,000 years to earn enough money to pay off that debt. Or to look at it another way, this amounts to a debt of \$44,516 for every man, woman, and child in America. Worse, these figures only

Table 1
Types of U.S. Government Debt

Type of Debt	Definition	Amount
Debt to Public	U.S. government securities owned by individuals, corporations, state or local governments, foreign governments and other entities outside the federal government itself.	\$9.46 trillion
Intergovernmental Debt	Debt the government owes itself; government securities that are held by government trust funds, revolving accounts, and other special accounts.	\$4.6 trillion
Implicit Debt	Unfunded obligations of government programs such as Social Security and Medicare, benefits promised under current law in excess of anticipated revenue.	\$45 – \$104 trillion or more

Source: Author’s calculations based on data from Congressional Budget Office, “The Budget and Economic Outlook: Fiscal Years 2011 to 2021,” January 2011; Treasury Direct, “Monthly Statement of the Public Debt”; Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds; and 2010 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds.

capture a portion of the actual debt we face.

There are several ways to calculate the federal debt (see Table 1). The U.S. government officially classifies its debt in two ways. The first is “debt held by the public,” which is primarily those U.S. government securities that are owned by individuals, corporations, state or local governments, foreign governments and other entities outside the federal government itself. As of January 31, 2011, debt held by the public exceeded \$9.46 trillion and represented more than 60 percent of GDP, the highest percentage of the economy since shortly after the end of World War II (see Figure 6).²⁸

The second classification for federal debt is “intragovernmental” debt, which consists of the debts that the federal government owes to itself, such as debt it owes to the so-called Social Security Trust Fund. As of January 31, 2011, the more than 100 government trust funds, revolving accounts, and special accounts held more than \$4.6 trillion in debt.²⁹ The largest portion of this was held in the Social Security (\$2.6 trillion) and Medicare (\$372 billion) Trust Funds.³⁰ If you combine debt held by the public and intergovernmental debt, you arrive at a total federal indebtedness

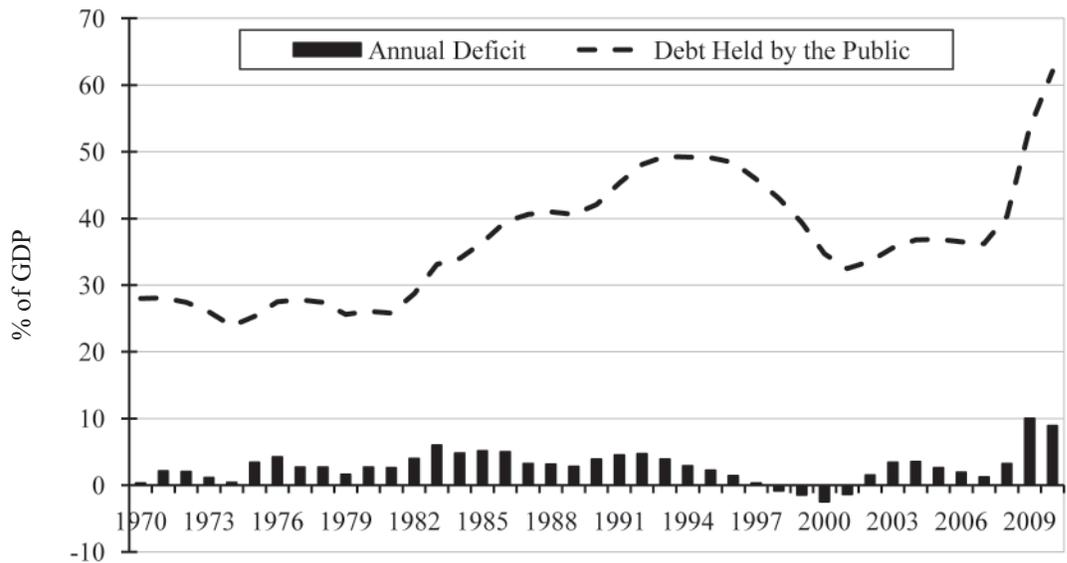
of \$14.1 trillion. (An additional \$200 billion in debt will accumulate in February and early March of 2011, reaching the statutory limit of \$14.3 trillion. That \$200 billion is not reflected in Table 1.)

Economists consider debt held by the public to be particularly noteworthy for several reasons. First, debt held by the public reflects government borrowing from private credit markets. The government borrowing competes with investment in the nongovernmental sector, leaving less money available for private investment in such things as factories and equipment, research and development, housing, and so on.³¹ And second, interest on debt held by the public is paid in cash and makes for a burden on current taxpayers.³² In contrast, intragovernmental debt holdings typically do not require cash payments from the current budget nor do they present a burden on the current economy.

Intragovernmental debt can also be considered somewhat “softer” than debt held by the public, since the government can control when and whether trust fund debt is repaid by, for example, altering the Social Security benefit formula. But the federal government

As of January 31, 2011, debt held by the public exceeded \$9.46 trillion.

Figure 6
Debt Held by the Public Since 1970



Source: Congressional Budget Office, “The Budget and Economic Outlook: Fiscal Years 2010 to 2020,” January 2010; and Congressional Budget Office, “The Budget and Economic Outlook: Fiscal Years 2011 to 2021,” January 2011.

cannot simply “write off” intragovernmental debt as inconsequential. As opponents of Social Security reform often argue, the securities held by the Social Security Trust Fund are backed “by the full faith and credit of the U.S. government.” Eventually the securities held by the various trust funds and other accounts will have to be redeemed, just as if intragovernmental debt was held by the public. Thus, no matter how you treat intragovernmental debt today, its repayment will ultimately have to be included in any projection of future government spending (see below).

There is a third category of government indebtedness that should be considered: “implicit debt.” Implicit debt represents the unfunded obligations of programs such as Social Security and Medicare—all the benefits promised under those programs in excess of anticipated revenues (including Trust Fund accumulations). Those obligations, of course, represent the “softest” form of debt, in that there is no legal requirement to pay all the promised benefits.

But “soft” does not mean debt that can be completely dismissed. Future promises to

pay benefits are generally categorized as debt according to Generally Accepted Accounting Principles (GAAP) and other accounting authorities.³³ Therefore, if the government was required to report its debt in the same way public companies do, those promises would show up as debt. Those benefit payments are called for under current law, and it would take congressional action to change them. Unless and until Congress does so, those obligations exist.

Social Security’s future unfunded obligations now run to more than \$16.1 trillion.³⁴ Medicare’s unfunded liabilities are more difficult to nail down, in part because of the uncertainty brought about by the new health care reform law. In 2009 Medicare’s trustees estimated that the program’s unfunded liabilities were \$89.3 trillion.³⁵ In the wake of the health care bill, though, those projections declined dramatically to just \$28.7 trillion.³⁶ But, there is reason to be skeptical of that revised figure. The Centers for Medicare and Medicaid Services (CMS), for example, believes that the spending reductions projected under health care reform are unrealistic.³⁷

Our debt could run as high as \$119.5 trillion, an inconceivable 900 percent of GDP.

Thus, the combined federal debt actually totals at least \$59.1 trillion, equal to more than 412 percent of GDP. And if the projected savings in Medicare do indeed prove unrealistic, our debt could run as high as \$119.5 trillion (including \$200 billion accumulated in February and March 2011), an inconceivable 900 percent of GDP.

Moreover, these projections assume that interest rates on government debt remain somewhere near current levels, about 2.2 percent. But over the past two decades the average rate of interest on government debt has actually been 5.7 percent. If interest rates were to return to anything close to traditional levels, it would add trillions to our future obligations. Lawrence Lindsey, for example, estimates that a return to historic interest rates would add \$557 billion to interest costs in 2015 alone.³⁸

It is also worth noting that the International Monetary Fund warns that U.S. budget projections show a strong tendency to be too optimistic. Using their own stochastic simulation, the IMF suggests that there is an 80 percent likelihood that the actual level of debt will be higher than the administration's current projections.³⁹

It's the Spending, Stupid

Yet, as frightening as the numbers discussed above may be, focusing on the deficit and debt is to confuse the symptom with the disease. As Milton Friedman often explained, the real issue is not how you pay for government spending—debt or taxes—but the spending itself. In other words: Don't just look at the deficit, look at why we have a deficit. And the reason we have a deficit is pretty simple: government spends too much.

Of course some government spending is necessary. Governments must provide certain basic services such as adjudicating disputes, maintaining police and defense functions, and, arguably, maintaining the infrastructure necessary for a functioning economy. Thus, under a scenario with zero government spending there would be little if any economic growth.

But beyond a certain level, nearly all economists would agree that the costs of government exceed the benefits it provides, leading to lower economic growth. For example, if government consumed 100 percent of GDP there would be little or no economic growth. In between is a curve, with rising initial growth accompanying increased government spending, followed by declining growth once government gets too large.

As economist James Gwartney and others argue:

As governments moves beyond these core functions [of protecting people and property], they will adversely affect economic growth because of a) the disincentive effects of higher taxes and crowding-out effect of public investment in relation to private investment, b) diminishing returns as governments undertake activities for which they are ill-suited, and c) an interference with the wealth creation process, because governments are not as good as markets in adjusting to changing circumstances and finding innovative new ways of increasing the value of resources.⁴⁰

Economists debate the slope of that curve, but few would argue that government can consume an unlimited proportion of the national economy without it having a significant impact on that economy. Estimates of the optimal size of government range from 17 to 40 percent of GDP, with the vast majority leaning toward the lower end of the estimates. Scholars at the Cato Institute might suggest an even lower percentage.⁴¹

But the damage from big government should not be seen in strictly economic terms. Much of what government does actually does more harm than good. Government social welfare programs, for instance, encourage dependency, discourage work-effort, and create disincentives for family formation. Government retirement programs crowd out private savings and can leave retirees with lower levels of retirement benefits than they might have

If interest rates were to return to anything close to traditional levels, it would add trillions to our future obligations.

Countries with high debt levels consistently grew their economies at slower rates than those with low debt levels.

received privately. Government health care programs can discourage innovation, decrease quality, and drive health care inflation.

And, of course, the more government undertakes, the less free it leaves us.

As mentioned above, the federal government is currently consuming roughly 24 percent of GDP. Since state and local governments typically spend another 10–15 percent of GDP, government at all levels in the United States is consuming between 34 and 39 percent of GDP, far higher than what could reasonably be considered a productive level. Worse, assuming there is no change in the current baseline, by 2050 federal government spending will exceed 46 percent of GDP. Adding in state and local spending, government at all levels would be consuming around 60 percent of everything produced in this country, double what could be considered a level consistent with economic growth. Beyond 2050, spending approaches levels that are, frankly, impossible (see Figure 7).⁴²

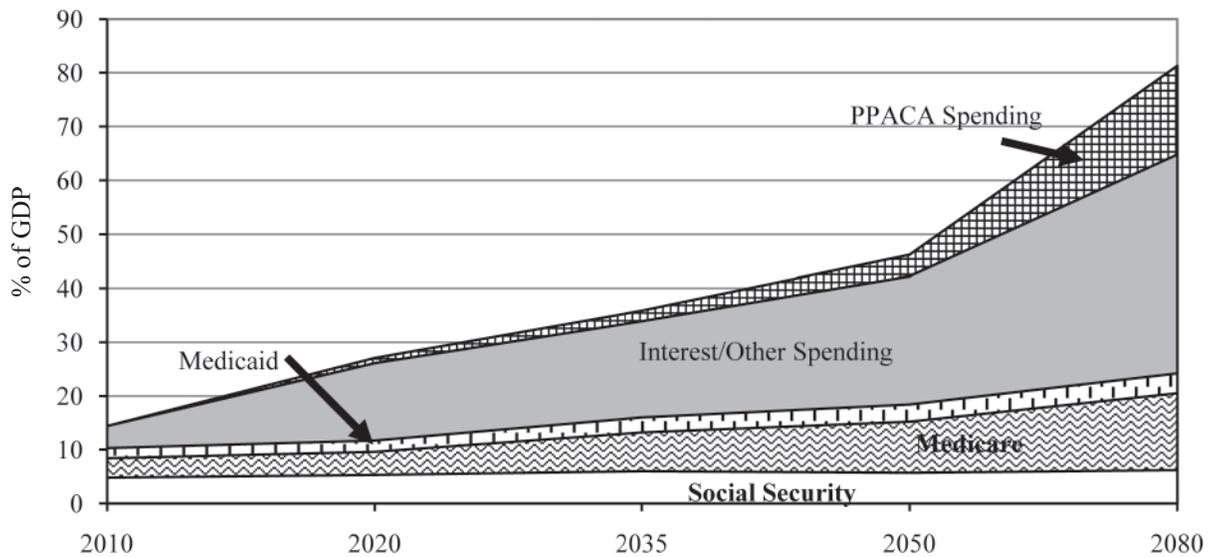
Regardless of the benefits or lack thereof from government programs, there lies the inescapable fact that, unless they are cut or

eliminated, all those future obligations must be financed in some way, either by a proportionate revenue increase (balanced budget) or deficit spending.⁴³ That is to say, either government will raise sufficient revenue to cover its expenditures, or it will not. Either would be devastating for the U.S. economy.

For example, the International Monetary Fund looked at the relationship between federal debt levels and economic growth, concluding that between 1885 and 2009, those countries with high debt levels consistently grew their economies at slower rates than those with low debt levels.⁴⁴

In perhaps the most comprehensive study of the impact of government debt on the economy, Douglas Elmendorf, then of the Federal Reserve Board, and Harvard economist Gregory Mankiw list five possible effects of increasing debt: (1) an adverse effect on monetary policy, often leading to inflation and increases in nominal interest rates, with little impact on the real interest rate, (2) the “deadweight loss of the taxes needed to service that debt,” (3) a reduction in the discipline of the budget process, (4) increased vulnerability to a crisis of in-

Figure 7
Long-Term Spending Projections



Source: Author’s calculations based on Congressional Budget Office, “The Budget and Economic Outlook: Fiscal Years 2011 to 2021,” January 2011; Congressional Budget Office, “The Long-Term Budget Outlook,” June 2009; and Letter from Douglas Elmendorf, director, Congressional Budget Office, to House speaker Nancy Pelosi, March 18, 2010.

ternational confidence,” and (5) “the danger of diminished political independence or international leadership.”⁴⁵ Elmendorf and Mankiw note that not each of these effects will be experienced, nor can the magnitude of each effect be perfectly predicted. However, empirical evidence has shown that some of these consequences can be quite serious and economically undesirable.

First, high debt levels cause inflated interest rates because potential investors demand greater returns for what they perceive as a riskier investment. As a result, central bankers may increase the money supply to counteract this effect, temporarily reducing interest rates but ultimately leading to heightened inflation (and no change to the real interest rate).⁴⁶

Second, all money borrowed today must be repaid eventually, with interest.⁴⁷ That means that taxes will eventually have to be raised, and the cost to society beyond the amount of revenue raised is known as “deadweight loss.” In cases of very high debt, that loss can be substantial, and policymakers would be wise to avoid fiscal policies that increase the potential for a massive burden of deadweight loss on future generations.

Third, economists since at least the 19th century have concluded that government borrowing reduces the discipline of the budget process. When lawmakers know that politically popular spending increases do not have to be offset by politically unpopular revenue increases, government spending tends to grow unrestrained, often for less-than-necessary purposes.

Fourth, the sheer size of the future debt could cause investors to lose confidence in the government’s intention and ability to fully honor its obligations. Of course, the United States can most likely issue more debt relative to GDP than other countries because it is viewed as a “safe haven” by investors.⁴⁸ Still, the risk tolerance of investors is not unlimited.

At some point, the government would have to hike interest rates in order to continue attracting investment. The question is whether the interest rate will increase gradually over time or abruptly. In 1979, for example, with

the U.S. economy weakened by stagflation, the Iranian oil embargo, and a weakening dollar, President Carter introduced a budget with deficits much deeper than predicted. International markets plunged into turmoil as the value of the dollar collapsed. Within a week, the Federal Reserve was forced to raise interest rates sharply, leading to a recession that stretched into 1982.⁴⁹

Given the much larger debt levels we currently face, the reaction could potentially be much larger and sharper than it was in 1979. CBO warns that such a spike in interest rates would lead to huge losses for bondholders, possibly precipitating a major economic crisis that “could cause some financial institutions to fail.”⁵⁰

Of course, as the Office of Management and Budget recently commented, “The problem is that there is no consensus on what level of debt might trigger a fiscal crisis.”⁵¹ Loss of investor confidence may never happen, but it also may happen tomorrow, and there is no guarantee that the tipping point for investors is not coming soon. That is to say, while our current debt to GDP ratio of 62 may seem safe to investors, no one can say with absolute certainty that 63, for example, is not the magical ratio when a sufficient number of investors bail, leaving the U.S. treasury borrowing at much higher rates.

The danger is undeniable. As one senior Chinese banking official noted: “But we should be clear in our minds that the fiscal situation in the United States is much worse than in Europe. In one or two years, when the European debt situation stabilizes, attention of financial markets will definitely shift to the United States. At that time, U.S. Treasury bonds and the dollar will experience considerable declines.”⁵²

Recently, George Mason economist Arnold Kling estimated the likelihood and timing of a debt crisis on the basis of Congressional Budget Office projections of growing U.S. debt and spending levels.⁵³ He calculates the likelihood of such a crisis on the basis of several key variables: (1) projected debt to GDP ratios and annual deficit levels, (2) pain thresholds,

All money borrowed today must be repaid eventually, with interest.

The fact that roughly half of the U.S. public debt is held by foreign creditors can diminish U.S. strategic and diplomatic options.

or the amount of spending cuts that any given country can tolerate, and (3) target debt levels necessary for investors to feel that their money is safe and continue to lend at current rates. He also includes the growth of real interest rates, which can have a considerable impact on projected debt levels. Kling concludes that “it would appear to be quite likely that the United States will experience a debt crisis within the next two decades, unless the path for fiscal policy changes” (see Table 2).⁵⁴

The point at which the U.S. faces a debt crisis comes when the margin of feasibility (the italicized data) become negative. The table illustrates that, given a pain threshold of 25 and target rate of 95 percent (for a total of 120), we could be facing a debt crisis by 2020.

Fifth, though the potential for this danger is low given the circumstances of the current U.S. economy, “the danger of diminished political independence or international leadership” resulting from a transition from a creditor nation to a debtor nation might implicate several of the aforementioned consequences, including a crisis of international confidence and loose monetary policy.

In addition, the fact that roughly half of

the U.S. public debt is held by foreign creditors can diminish U.S. strategic and diplomatic options. In fact, China is now the United States’ largest foreign creditor, holding 22 percent of our public debt.⁵⁵ The United States has itself used such financial leverage to influence the behavior of other nations, such as in the 1956 Suez crisis.⁵⁶ It is not inconceivable that China or other countries could act in a similar way in the event of a crisis.

Finally, as mentioned above, government borrowing tends to crowd out private investment, because a dollar borrowed by the government is a dollar no longer available for private use. This leads to a smaller capital stock and therefore lower economic output than would otherwise be the case. If future spending were financed through debt, it would crowd out increasing amounts of private capital available for investment. As Federal Reserve economists Charles Carlstrom and Jagadeesh Gokhale note: “This crowding out effect is much larger than the effect of the balanced-budget increase in government expenditure. . . . It reflects the greater distortionary effect of the higher tax rates under deficit financing that are imposed on young and future generations to pay for the redistribution

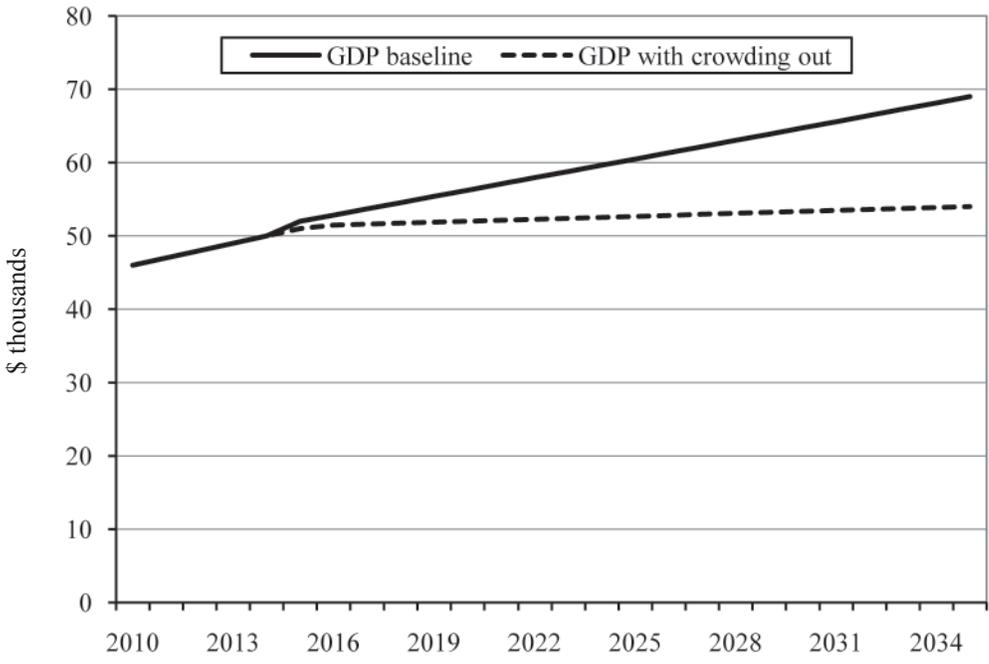
**Table 2
Feasibility of Default for 2015–2030**

Pain threshold + Target rate	2015	2020	2025	2030
100	<i>-1</i>	<i>-33</i>	<i>-76</i>	<i>-122</i>
120	<i>19</i>	<i>-13</i>	<i>-56</i>	<i>-102</i>
140	<i>39</i>	<i>7</i>	<i>-36</i>	<i>-82</i>
160	<i>59</i>	<i>27</i>	<i>-16</i>	<i>-62</i>
180	<i>79</i>	<i>47</i>	<i>4</i>	<i>-42</i>
200	<i>99</i>	<i>67</i>	<i>24</i>	<i>-22</i>
220	<i>119</i>	<i>87</i>	<i>44</i>	<i>-2</i>
240	<i>139</i>	<i>107</i>	<i>64</i>	<i>18</i>

Source: Author’s calculations based on Arnold Kling, “Guessing the Trigger Point for a U.S. Debt Crisis,” Mercatus Center Working Paper, no. 10-45, August 2010.

Note: Possibility of debt crisis is indicated by numbers in bold.

Figure 8
Drag on GDP Growth Per Capita Due to Crowding Out



Source: Congressional Budget Office, “The Long-Term Budget Outlook,” June 2010.

toward the initial older generations.”⁵⁷

Other studies are equally grim. For example, Carmen Reinhart of the University of Maryland and Kenneth Rogoff of Harvard conclude that countries with a debt ratio above 90 percent of GDP have median growth rates 1 percent lower than countries with a lower debt level and average growth rates nearly 4 percent lower.⁵⁸

Taking all this into account, the National Commission on Fiscal Responsibility and Reform estimates that if the federal debt rises to predicted levels it will reduce GDP by 6 percent by 2025 and by 15 percent by 2035 (see Figure 8).⁵⁹

Clearly, then, debt financing of future government spending would be extremely dangerous. However, financing projected levels of government spending through taxes would also carry severe economic costs. Indeed, the idea of taxing our way out of debt flies in the face of fiscal reality.

Many observers suggest that we can simply tax the rich. For example, the Center for American Progress has recommended, among

other things, imposing a 5–7 percent surtax on households with incomes above \$500,000 per year, eliminating the cap on Social Security payroll taxes, increasing the estate tax, and raising the top marginal tax rate on capital gains and dividends.⁶⁰ That would potentially raise the total marginal tax burden on some people to well above 50 percent.

Setting aside the simple immorality of government taking such an enormous portion of *anyone’s* income, there are many reasons to be skeptical of such an approach, starting with the fact that it may not actually generate any additional revenue. It is undeniably true that in recent years some Republicans have overstated the so-called “Laffer curve,” suggesting that all tax cuts “pay for themselves.”⁶¹ But the basic idea behind it is simple common sense:

Changes in tax rates have two effects on revenues: the arithmetic effect and the economic effect. The arithmetic effect is simply that if tax rates are lowered, tax revenues (per dollar of tax base) will be

Financing projected levels of government spending through taxes would also carry severe economic costs.

You could confiscate the entire wealth of every millionaire in the United States and still barely make a dent in the amount we will owe.

lowered by the amount of the decrease in the rate. The reverse is true for an increase in tax rates. The economic effect, however, recognizes the positive impact that lower tax rates have on work, output, and employment—and thereby the tax base—by providing incentives to increase these activities. Raising tax rates has the opposite economic effect by penalizing participation in the taxed activities. The arithmetic effect always works in the opposite direction from the economic effect. Therefore, when the economic and the arithmetic effects of tax-rate changes are combined, the consequences of the change in tax rates on total tax revenues are no longer quite so obvious.⁶²

In other words, incentives matter. At some point taxes become high enough to discourage economic activity and therefore produce less revenue than would be predicted under a more static analysis. Veronique de Rugy, senior research fellow at the Mercatus Center, for example, suggests that roughly 19 percent of GDP may be the upper limit of revenue that can actually be collected in taxes. She points out that revenue as a percentage of GDP has held relatively constant over the past 80 years regardless of the top marginal tax rate (see Figure 9).⁶³

But even if one assumes that taxes can be raised without having any impact on economic growth, taxing the rich still wouldn't get us out of our budget hole—because the hole is quite simply bigger than the amount of revenue we could raise from taxing the rich even if there were no disincentives. To put it in admittedly oversimplified perspective: our current obligations, including both implicit and explicit debt, total more than 900 percent of GDP. The combined wealth of everyone in the United States who earns at least \$1 million per year equals roughly 100 percent of GDP (see Figure 10).⁶⁴ Therefore, you could confiscate the entire wealth of every millionaire in the United States and still barely make a dent in the amount we will owe.

Clearly, therefore, any tax increases would have to extend well beyond “the rich.” In fact,

the Congressional Budget Office said in 2008 that in order to pay for all currently scheduled federal spending both the corporate tax rate and top income tax rate would have to be raised from their current 35 percent to 88 percent, the current 25 percent tax rate for middle-income workers to 63 percent, and the 10 percent tax bracket for low-income workers to 25 percent.⁶⁵ It is likely, given increased spending since then, that the required tax levels would be even higher today.

Regardless of how one feels about taxing the rich, taxes at those levels would be devastating to future economic growth.

Harvard economist Martin Feldstein points out that the actual loss from tax increases to the private sector is a combination of the confiscated revenue as well as a hidden cost of the actual increase, known as deadweight loss. This hidden cost can be very expensive. Feldstein calculates that “the total cost per incremental dollar of government spending, including the revenue and the deadweight loss, is . . . a very high \$2.65. Equivalently, it implies that the marginal excess burden per dollar of revenue is \$1.65.”⁶⁶ This means that for every 1 percent of GDP needed to be raised in revenue, the equivalent of 2.65 percent of GDP needs to be extracted from the private sector first. Clearly, tax increases required to finance an increase in spending of more than 40 percent of GDP would place an impossible burden on the private economy.

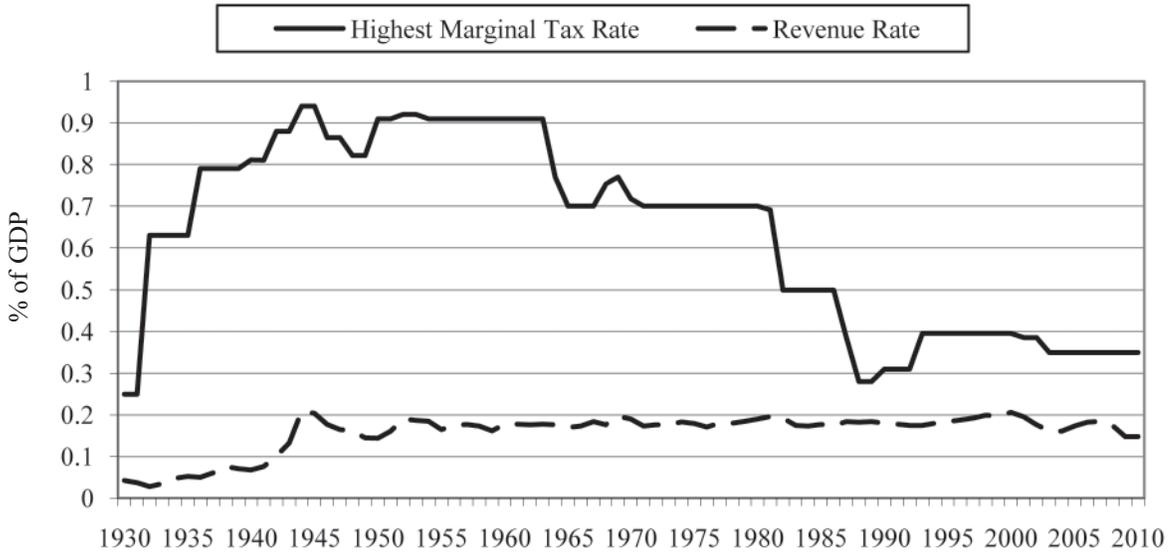
Thus, whether we pay for future government spending through debt or taxes, we simply cannot afford the anticipated levels of government spending.

Finally, we should recognize that a growing government poses a threat to more than just our economic future. An ever-growing government inevitably leaves us less free.

The Entitlement Crisis

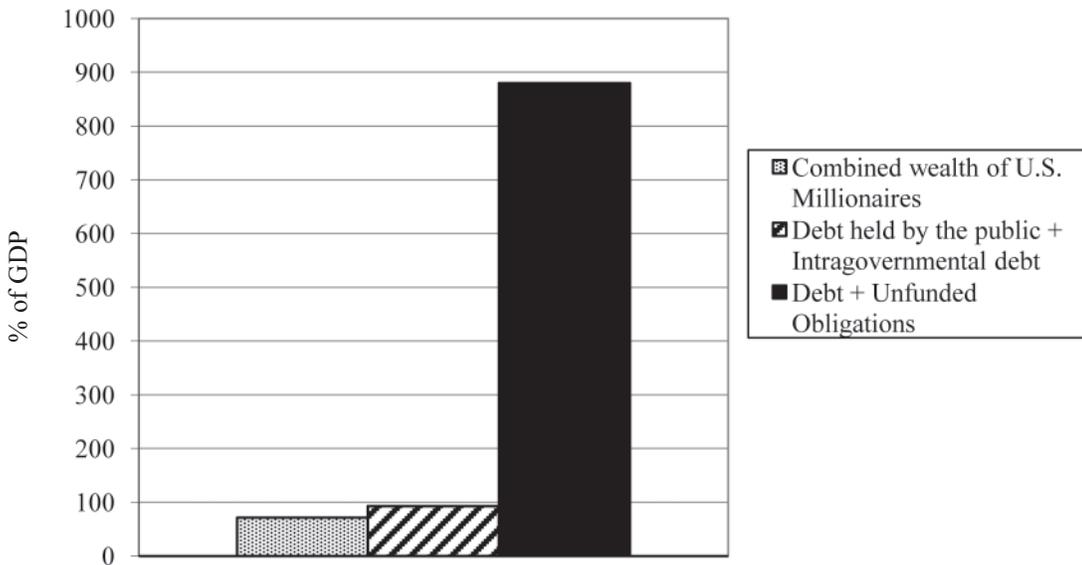
Politicians like to pretend that you can deal with the debt crisis by eliminating “fraud, waste and abuse” in the federal budget, and certainly there is plenty of that. This is, after all, a federal

Figure 9
Tax Receipts Stay Constant Regardless of Highest Marginal Tax Rate



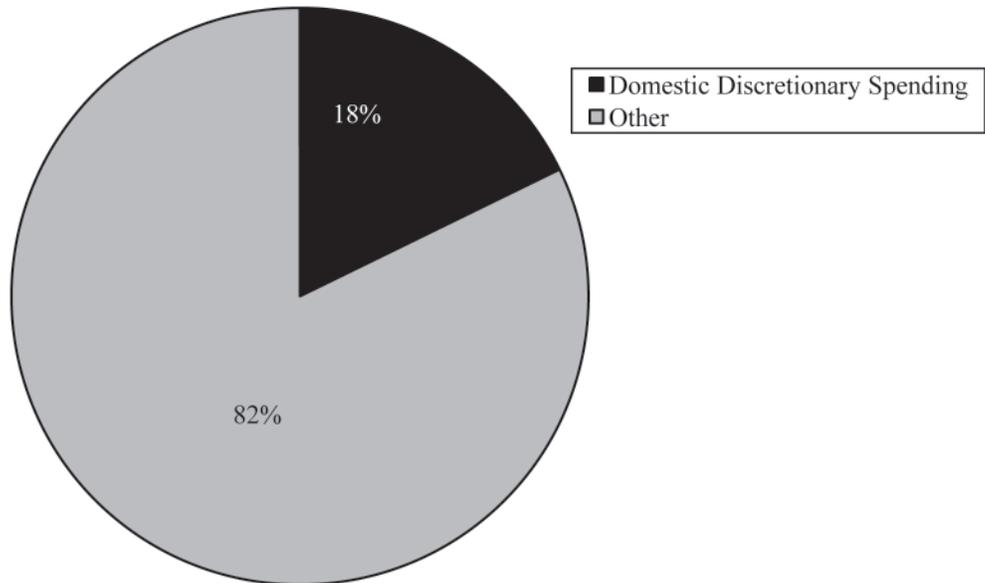
Source: Tax Policy Center, “Historical Top Tax Rate,” January 31, 2011; Office of Management and Budget, “Historical Tables,” Table 1.2; and Veronique de Rugy, “Reality Isn’t Negotiable: The Government Can’t Raise More Than 19% in Taxes for Long,” Mercatus Center, November 29, 2010.

Figure 10
Combined Wealth of U.S. Millionaires vs. U.S. Debt



Source: Author’s calculations based on data from Congressional Budget Office, “The Budget and Economic Outlook: Fiscal Years 2011 to 2021,” January 2011; Treasury Direct, “Monthly Statement of the Public Debt”; 2009 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, 2010; Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, and U.S. Internal Revenue Service, Statistics of Income Division, “SOI Data Tables,” published July 2008.

Figure 11
Domestic Discretionary Spending



Source: Congressional Budget Office, “The Budget and Economic Outlook: Fiscal Years 2011–2021,” January 2011, Table E-7.

government that is spending \$615,000 so the University of California at Santa Cruz can digitize Grateful Dead photographs, and \$1 million to help zoos put poetry on zoo plaques.⁶⁷ But the sad fact is that such outrages account for only a tiny fraction of federal spending.

As Figure 11 illustrates, all domestic discretionary spending—everything from the Department of Education to the FBI, from NASA to the Food and Drug Administration—accounts for just 18 percent of all federal spending.⁶⁸

Therefore, even if every penny of such spending were eliminated, we would still face a budget deficit this year of just under \$680 billion.

But, of course, no one is realistically calling for complete elimination of domestic discretionary spending. During the campaign, for example, Republicans spoke of rolling back domestic, discretionary spending (except for homeland security and veterans’ programs) to 2008 levels. Cuts of this size would save less than \$130 billion, 3.7 percent of federal spending. It would reduce government spending from 23.8

percent of GDP to 23.0 percent. That wouldn’t even begin to make a dent in our debt.

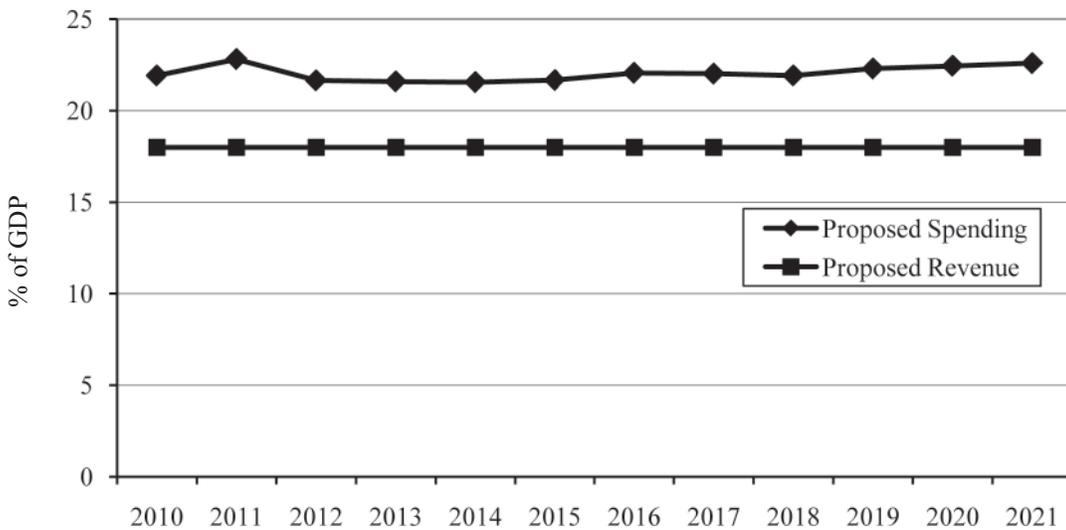
Defense constitutes another 20 percent of federal spending.⁶⁹ Clearly cuts can—and should—be made here as well. The bipartisan Commission on Fiscal Responsibility and Reform has recommended cuts in the range of \$1 trillion over 10 years.⁷⁰

As Figure 12 shows, if all the cuts proposed by Republicans plus the defense cuts recommended by the bipartisan debt commission were implemented, and if revenues returned to 18 percent of GDP, both total federal spending and deficits would continue to grow.

That is because the true heart of rising government spending is entitlement programs, in particular Medicare, Medicaid, and Social Security. Indeed, by 2050, those three programs alone will consume 18.4 percent of GDP. If one assumes that revenues return to and stay at their traditional 18 percent of GDP, then those three programs alone will consume all federal revenues. There would

The true heart of rising government spending is entitlement programs, in particular Medicare, Medicaid, and Social Security.

Figure 12
Proposed GOP and Fiscal Commission Cuts vs. Proposed Revenue



Source: Congressional Budget Office, “The Budget and Economic Outlook: Fiscal Years 2011 to 2021,” Table 3-1, January 2011.

not be a single dime available for any other program of government, from national defense to welfare. Adding in interest already owed would bring government spending to 31.9 percent of GDP, meaning that even a tax hike equal to nearly 14 percent of GDP would not be able to fund government beyond those three programs (see Figure 13).

Of course this is not an argument against cutting domestic discretionary spending. Congress should cut wherever possible. Any plan to successfully cut the budget will have to significantly roll back both defense and domestic spending. But, ultimately, any serious plan to balance the budget long term and to reduce the size and cost of government, must address Social Security, Medicare, and Medicaid.

Social Security

Because the recession and increased unemployment have reduced payroll tax revenue, Social Security began running a cash-flow def-

icit this year, paying out more in benefits than it takes in through taxes (see Figure 14).⁷¹

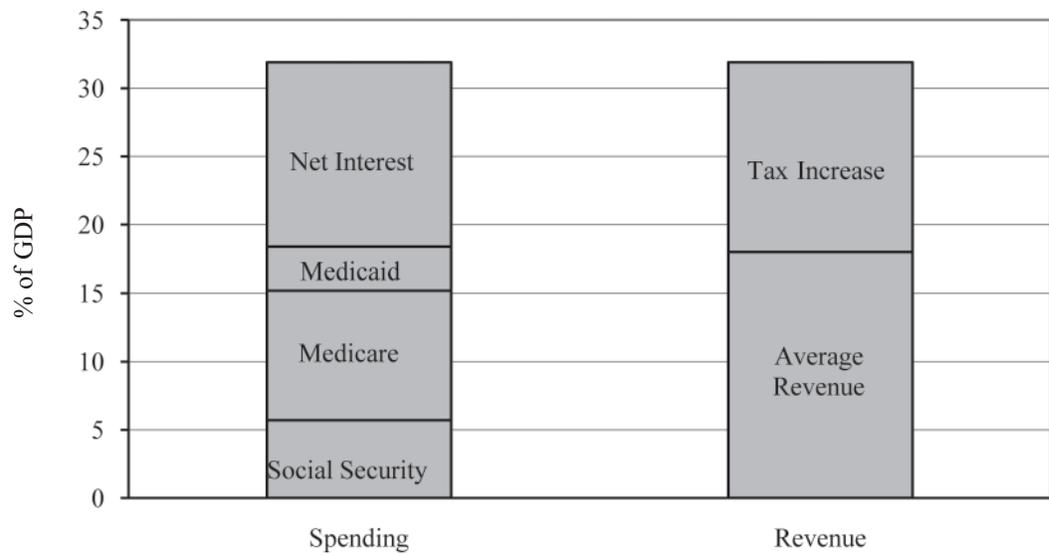
In theory, of course, Social Security is supposed to continue paying benefits by drawing on the Social Security Trust Fund. The Trust Fund is supposed to provide sufficient funds to continue paying full benefits until 2037, after which it will be exhausted.⁷² At that point, *by law*, Social Security benefits will have to be cut by approximately 22 percent.⁷³

However, in reality, the Social Security Trust Fund is not an asset that can be used to pay benefits. Any Social Security surpluses accumulated to date have been spent, leaving a Trust Fund that consists only of government bonds (IOUs) that will eventually have to be repaid by taxpayers. As the Clinton administration’s fiscal year 2000 budget explained:

These [Trust Fund] balances are available to finance future benefit payments and other Trust Fund expenditures—but only in a bookkeeping sense. . . . They do not consist of real economic assets that can be drawn down in the future to

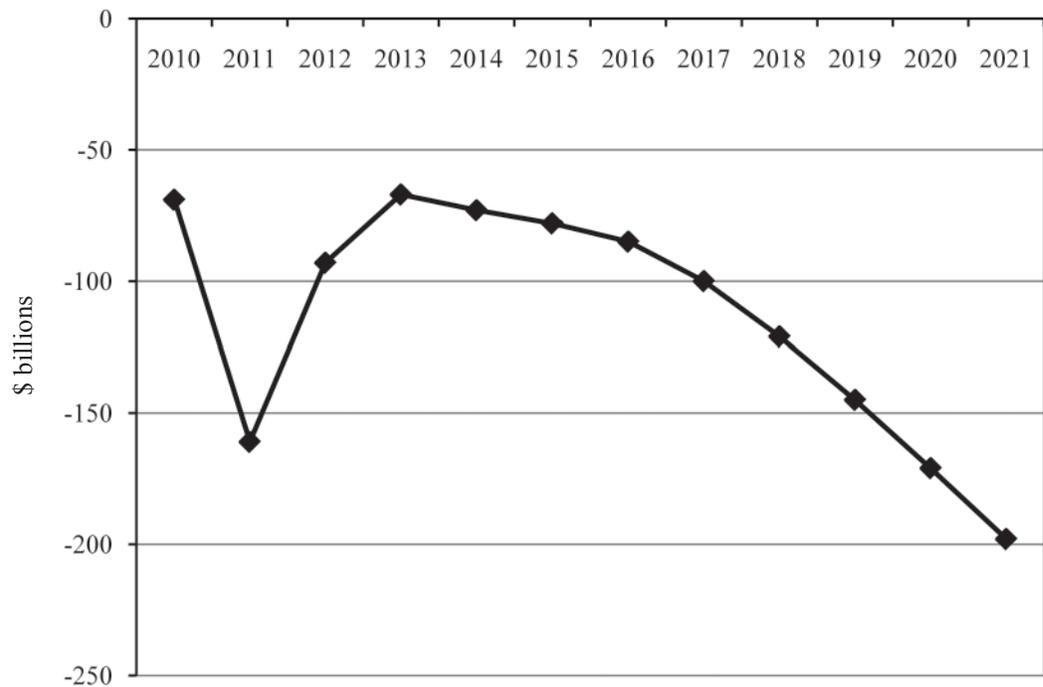
The Social Security Trust Fund is not an asset that can be used to pay benefits.

Figure 13
2050



Source: Congressional Budget Office, "The Long-Term Budget Outlook," Table 1-2, June 2009.

Figure 14
Social Security Cash-Flow Deficit



Source: Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2011–2021," January 2011, Table E-7.

Eliminating the cap would give the United States the highest marginal tax rates in the world.

fund benefits. Instead, they are claims on the Treasury that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures. The existence of large Trust Fund balances, therefore, does not, by itself, have any impact on the Government’s ability to pay benefits.⁷⁴

Even if Congress can find a way to redeem the bonds, the Trust Fund surplus will be completely exhausted by 2037.⁷⁵ At that point, Social Security will have to rely solely on revenue from the payroll tax—but that revenue will not be sufficient to pay all promised benefits. Overall, Social Security faces unfunded liabilities of nearly \$16.1 trillion (\$18.7 trillion if the cost of redeeming the Trust Fund is included).⁷⁶ Clearly, Social Security is not sustainable in its current form.

And, there are very few options for dealing with the problem. As former president Bill Clinton pointed out, the only ways to keep Social Security solvent are to (a) raise taxes, (b) cut benefits, or (c) get a higher rate of return through private capital investment.⁷⁷ Or as Henry Aaron of the Brookings Institution told Congress, “Increased funding to raise pension reserves is possible only with some combination of additional tax revenues, reduced benefits, or increased investment returns from investing in higher-yield assets.”⁷⁸

Supporters of the current Social Security system have long advocated the first of those options, bringing in additional tax revenue,

notably by removing the cap on income subject to the Social Security payroll tax. Currently, workers pay the 12.4 percent payroll tax on just the first \$106,800 of annual wage income. The bipartisan Commission on Fiscal Responsibility and Reform recommended that this be increased to \$190,000 by 2020.⁷⁹ The Center for American Progress would remove the cap entirely on the employer’s portion of the Social Security tax.⁸⁰ The National Committee for Preserving Social Security and Medicare has called for removing the cap for the entire payroll tax.⁸¹

Eliminating the cap would give the United States the highest marginal tax rates in the world, higher even than countries like Sweden. Studies suggest that it would cost the United States as much as \$136 billion in lost economic growth over the next 10 years, and as many as 1.1 million lost jobs.⁸² And, it is important to note that the Patient Protection and Affordable Care Act already raised payroll taxes on families earning more than \$250,000 per year by 0.9 percent.⁸³

Eliminating the cap could also lead to the perverse result of actually providing a huge increase in benefits to the wealthiest retirees. That is because the benefit formula is partially based on the level of wages taxed.⁸⁴ For example, Table 3 shows the benefit hike that retirees would receive if taxes were increased but the current benefit formula was retained.

Yet even this enormous tax increase would do relatively little to increase Social Security’s long-term cash-flow solvency. Although there have been no cash-flow simulations provided

**Table 3
Increased Social Security Benefits If Cap Were Eliminated**

Annual Income	Annual benefit
\$106,800 (current)	\$25,440
\$400,000	\$72,000
\$1,000,000	\$162,000

Source: Janemarie Mulvey, “Social Security: Raising or Eliminating the Taxable Earnings Base,” Congressional Research Service, September 24, 2010.

Combine any reduction in government-provided benefits with an option for younger workers to save and invest a portion of their Social Security taxes.

for recent proposals, earlier simulations suggest that even the most radical proposal—eliminating the cap completely while also changing the benefit formula so as not to provide any additional benefits—would add just seven years of cash-flow solvency to the system. Applied to the current solvency projections, that would extend to 2018 the date at which Social Security begins to run a cash-flow shortfall.⁸⁵

Eliminating the cap would, of course, extend the exhaustion date of the Social Security Trust Fund, but as we have seen above, that merely increases intergovernmental debt without actually improving the system's finances. If the additional revenue was used to pay for what would otherwise be deficit-financed spending, removing the cap would be indistinguishable from any other tax increase. Thus we could see a marginal improvement to the government's overall financial picture—not Social Security's—but at the costs associated with any other tax hike.

Cutting Social Security benefits, however, would have a positive impact on both the system's finances and the government's general balance sheet. Of course there are many different ways to reduce future Social Security payments with very different impacts on recipients. The bipartisan Commission on Fiscal Responsibility and Reform, for instance, has recommended a broad array of benefit changes, including raising the retirement age to 69 by 2075, with the early retirement age rising to 64 over the same period, reforming the formula for annual cost of living adjustments (COLA's), and trimming benefits for high-income recipients.⁸⁶

A better approach would be to change the formula used to calculate the accrual of benefits so that they are indexed to price inflation rather than national wage growth.⁸⁷ Since wages tend to grow at a rate roughly one percentage point faster than prices, such a change would hold future Social Security benefits constant in real terms, but eliminate the benefit escalation that is built into the current formula. Estimates suggest that making this change alone would result in a

35 percent reduction in Social Security's currently scheduled level of benefits, bringing the system into balance by 2050.⁸⁸ Variations on this approach would apply the formula change only to higher-income seniors, preserving the current wage-indexed formula for low-income seniors.⁸⁹

Other benefit reductions that have been discussed at one time or another include increasing the number of years included in income averaging as part of the benefit formula from 35 to 38 years, restructuring spousal benefits, and various means/asset-testing schemes.⁹⁰

The biggest downside of any benefit cuts is that it makes Social Security an even worse deal for younger workers than it already is. Indeed, for many young workers, Social Security taxes are already so high relative to benefits that they will receive a rate of return on their Social Security taxes well below the return that they could expect from private investment.

It makes sense, therefore, to combine any reduction in government-provided benefits with an option for younger workers to save and invest a portion of their Social Security taxes through individual accounts. A proposal by scholars from the Cato Institute that combines the wage-price indexing proposal described above with personal accounts equal to 6.2 percent of wages was scored by actuaries with the Social Security Administration in 2005 as reducing Social Security's unfunded liabilities by \$6.3 trillion, roughly half the system's predicted shortfall at that time. If the Cato plan had been adopted in 2005, the system would have begun running surpluses by 2046. Indeed, by the end of the 75-year actuarial window, the system would have been running surpluses in excess of \$1.8 trillion.⁹¹ At the same time, SSA actuaries concluded that average-wage workers who were age 45 or younger could expect higher benefits under the Cato proposal than Social Security would otherwise be able to pay.⁹² While there is no more current scoring available, there is no reason to presume that savings or benefits would be substantially different today.

Personal accounts would also solve some of the other problems with the current Social

Security system. Under the current system, workers have no ownership of their benefits; they are left totally dependent on the good will of 535 politicians to determine what they'll receive in retirement. Moreover, benefits are not inheritable, and the program is a barrier to wealth accumulation. Finally, the program unfairly penalizes African Americans, working women, and others. In short, it is a program crying out for reform. By giving workers ownership and control over a portion of their retirement funds, personal accounts are the *only* reform measure that deals with those issues.

Of course opponents of personal accounts have pointed to the recent struggles of the stock market to suggest that personal accounts are too risky to be relied on for retirement. The reality, however, is that despite recent volatility in the market, long-term investment represents a remarkably safe retirement strategy.

According to Andrew Biggs, former associate commissioner of Social Security for policy, someone who retired in, say, 2008, at the lowest point of the market's recent decline, and who started paying Social Security taxes when he was 22, would have begun investing in 1965. Since that time, the annual rate of return based on the S&P 500 Index, even adjusting for inflation, has been more than 7 percent, while Social Security investments expect an average annual return of just 2.2 percent. That means that despite the market's decline, he still would have seen substantial overall gains.⁹³

The failure of President Bush's disastrous campaign for personal accounts is widely believed to have taken the idea off the table for the foreseeable future. None of the recent deficit commissions included personal accounts in their recommendations. However, Rep. Paul Ryan (R-WI) has included a proposal for personal accounts in his Roadmap for America's Future. Ryan would allow workers under age 55 the option of privately investing slightly more than one third of their Social Security taxes through personal retirement accounts.⁹⁴ The Congressional Budget Office estimates that Ryan's proposal would gradually reduce Social Security's budget shortfall and, ultimately, restore the program to cash-flow solvency by 2083.⁹⁵

Several new representatives and senators elected in the 2010 mid-term elections appear sympathetic to personal accounts, meaning that a combination of benefit reductions and personal accounts remain not only the best policy option for Social Security reform, but also a viable political option.

Medicare

To some degree, of course, Medicare (and Medicaid, discussed below) is at the mercy of overall health care costs. But those problems are exacerbated by a fee-for-service system under which neither providers nor consumers have incentives to control costs. As a result, per enrollee costs in the program have been rising faster than per capita GDP, at an average of 1.7 percentage points annually since 1985. Since federal revenues grow at roughly the rate of increase in GDP, that is a recipe for fiscal disaster.

The 2009 Medicare Trustees' Report projected the program's unfunded liabilities at \$89.3 trillion.⁹⁶ Medicare Part B, which covers physician services and is funded through a combination of premiums paid by seniors and general tax revenues, accounted for the largest portion of this deficit, \$37 trillion. Medicare Part A, covering hospital services and funded through the Medicare payroll tax, was close behind, with a projected shortfall of \$36.7 trillion. And Medicare Part D, the prescription drug program, added another \$15.6 trillion in future unfunded obligations.

However, the 2010 Patient Protection and Affordable Care Act (PPACA) made a number of changes to the program designed to reduce its cost.⁹⁷ The health care bill anticipates a net reduction in Medicare spending of \$416.5 billion over 10 years.⁹⁸ Total cuts would actually amount to slightly more than \$459 billion, but since the bill would also increase spending under the Medicare Part D prescription drug program by \$42.6 billion, the actual savings would be somewhat less.⁹⁹

The health care law would bring in additional payroll tax revenue through a 0.9 percent increase in the Medicare payroll tax

Personal accounts remain not only the best policy option for Social Security reform, but also a viable political option.

Several of the proposed and projected Medicare cuts seem particularly unlikely to be achieved.

for individuals with incomes over \$200,000 for a single individual or \$250,000 for a couple, and the imposition of the tax to capital gains and interest and dividend income if an individual's total gross income exceeded \$200,000 or a couple's income exceeded \$250,000.¹⁰⁰

As a result, the trustees now project that the future unfunded shortfall under Part B will drop to just \$12.9 trillion.¹⁰¹ The projected shortfalls under Part A are projected to be eliminated completely.¹⁰² Part D's shortfall increases slightly to \$15.8 trillion, putting the overall future unfunded liabilities at \$28.7 trillion.¹⁰³

Of course, even if the new projections are accurate, \$28.7 trillion still represents a substantial burden for future generations. But there is ample reason to doubt that the projected Medicare savings will occur. The CBO itself cautions that "it is unclear whether such a reduction in the growth rate of spending could be achieved, and if so, whether it would be accomplished through greater efficiencies in the delivery of health care or through reductions in access to care or the quality of care."¹⁰⁴

Several of the proposed and projected Medicare cuts seem particularly unlikely to be achieved. For example, the projected savings anticipated a 23 percent reduction in Medicare fee-for-service reimbursement payments to providers, starting in 2010 and yielding \$259 billion in savings.¹⁰⁵ But Medicare has been slated to make reductions to those payments since 2003, yet, each year, Congress has voted to defer the cuts. There is no reason to believe that Congress is now more likely to follow through on such cuts. CMS believes that these cuts are extremely unlikely to occur, especially considering that the impending cut is "four times the size of most of those [cuts] previously avoided."¹⁰⁶

In fact, Congress has already agreed to postpone those reimbursement reductions until 2013. Theoretically, the change would be offset by requiring individuals who receive too large a subsidy to purchase insurance in 2014 to repay the excess.¹⁰⁷

In addition, a new "productivity adjust-

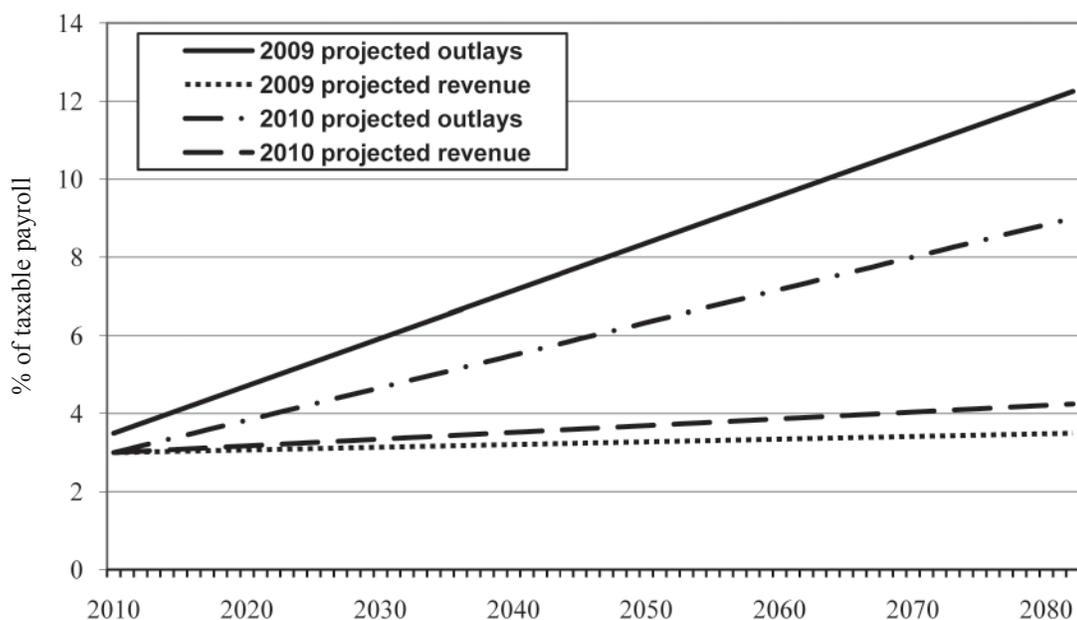
ment" would be applied to reimbursements to hospitals, ambulatory service centers, skilled nursing facilities, hospice centers, clinical laboratories, and other providers, resulting in an estimated savings of \$196 billion over 10 years.¹⁰⁸ There would also be \$3 billion in cutbacks in reimbursement for services that the government believes are over-used, such as diagnostic screening and imaging services. And, beginning next year, the "utilization assumption" used to determine Medicare reimbursement rates for high-cost imaging equipment will be increased from 50 to 75 percent, effectively reducing reimbursement for many services.¹⁰⁹ This change is expected to reduce total imaging expenditures by as much as \$2.3 billion over 10 years.¹¹⁰ Other Medicare cuts include freezing reimbursement rates for home health care and inpatient rehabilitative services and \$1 billion in cuts to physician-owned hospitals.¹¹¹

However, the actuaries at the Centers for Medicare and Medicaid Services claim that "neither of these update reductions is sustainable in the long range, and Congress is very likely to legislatively override or otherwise modify the reductions in the future."¹¹²

The Medicare cuts most likely to occur are \$136 billion in cuts to the Medicare Advantage program. Current Medicare Advantage programs receive payments that average 14 percent more than traditional fee-for-service Medicare.¹¹³ The Patient Protection and Affordable Care Act imposes a new competitive bidding model on the Medicare Advantage program that will effectively end the 14 percent overpayment, phased in over three years beginning in 2012.¹¹⁴ However, if the cutbacks cause insurers to stop offering Medicare Advantage plans, forcing millions of seniors back into traditional Medicare as has been predicted by CMS and others, this change too may prove unsustainable.¹¹⁵

CMS offers an alternative projection based on more realistic payment assumptions in the long range, and finds that the unfunded liability of the overall Medicare program is closer to the levels reported in 2009 than to those in the 2010 report.¹¹⁶

Figure 15
Medicare Part-A Financing



Source: Centers for Medicare and Medicaid Services, “Projected Medicare Expenditures under an Illustrative Scenario with Alternative Payment Updates to Medicare Providers,” August 5, 2010.

CMS does note that there is a marked improvement in Part A financing in the long term due to increases in revenue to the program.¹¹⁷ However, as Figure 15 illustrates, the increase in revenue is extremely modest in comparison to the much larger expansion of costs in the long term.

By 2080, rather than consuming nearly 5 percent of GDP as the 2009 Trustees’ Report projected, Medicare Part A expenditures under CMS’s post-PPACA alternative scenario will consume around 4 percent of GDP. While this is an improvement over the 2009 report, it is still double the roughly 2 percent of GDP that the 2010 Trustees’ Report projects.

The 2009 Trustees’ Report projected that Part B expenditures by 2080 will consume nearly 4.5 percent of GDP. The 2010 report claimed that PPACA reduced that figure to just 2.5 percent. However, CMS’s alternative projections not only claim that such an improvement is unlikely, it actually predicts that Part B expenditures will be even higher by 2080 than it would have been in

the absence of PPACA (see Figure 16). Under CMS’s alternative projection, over 5 percent of GDP will be consumed by just this one part of Medicare as the century nears its end.

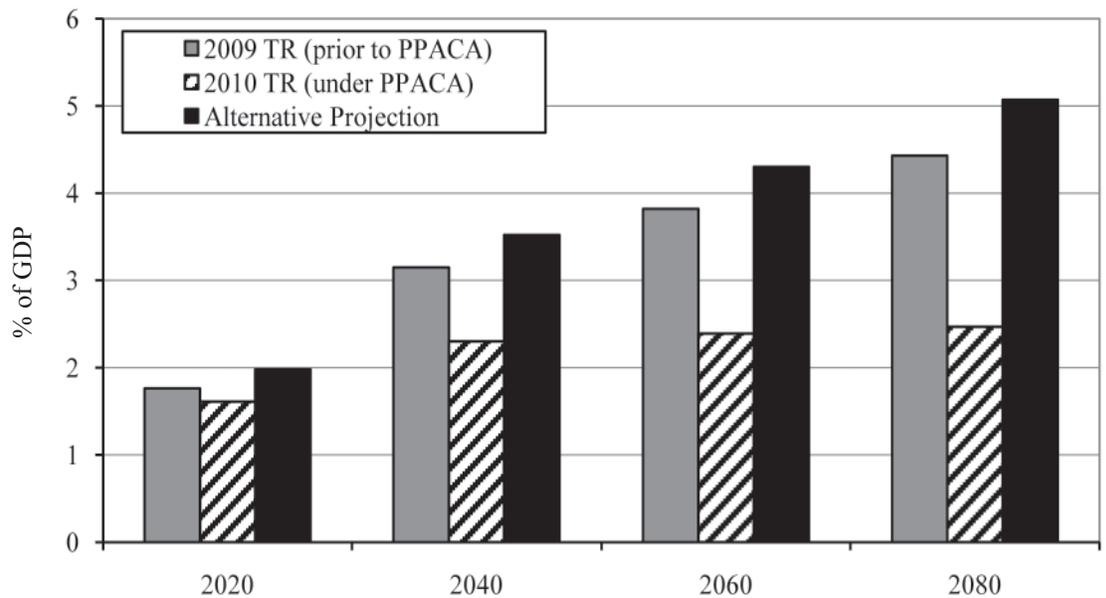
Overall, CMS suggests that Medicare expenditures for both Part A and Part B will have not actually changed significantly from the projections contained in the 2009 Trustees’ Report. Meanwhile, revenues will have increased from the 2009 projections but not by nearly enough to cover the gap in unfunded obligations.

Of course, even if all the projected savings under PPACA were to occur, the program remains nearly \$29 trillion in the red. PPACA demonstrates that it is simply not possible to bring Medicare back into solvency by trimming around the edges or attempting to squeeze more efficiency out of the system.

Therefore, any serious attempt to bring the system into long-term fiscal sustainability will require one of two approaches. Either the government will have to impose some form of rationing, denying services on the basis

Even if all the projected savings under PPACA were to occur, the program remains nearly \$29 trillion in the red.

Figure 16
Medicare Part-B Expenditure Projections



Source: Centers for Medicare and Medicaid Services, “Projected Medicare Expenditures under an Illustrative Scenario with Alternative Payment Updates to Medicare Providers,” August 5, 2010.

of cost-effectiveness, or the system will have to be restructured in such a way as to create incentives for providers and consumers to seek greater efficiency and lower costs.

To transition to a consumer-based system, Congress could give enrollees a voucher and let them choose any health plan available on the market. The voucher size could be adjusted to give a larger subsidy to poorer or sicker seniors. The amount of each individual’s voucher would be fixed. Enrollees who want to purchase comprehensive coverage could pay more for it, while those who chose a less expensive policy could save the balance of their voucher in an account dedicated to out-of-pocket medical expenses.¹¹⁸

Representative Ryan included a proposal along these lines in his Roadmap for America’s Future.¹¹⁹ The Congressional Budget Office estimated that this approach would reduce Medicare spending from a predicted 9 percent of GDP in 2050 and 15 percent of GDP in 2083 under the current baseline to just 4 percent of GDP in 2050 and roughly 3 percent in 2083.¹²⁰

Ryan and former CBO director Alice Rivlin have also proposed a variation on this approach in their recommendations for the Bipartisan Policy Center’s Debt Reduction Task Force (the Domenici-Rivlin Commission). Per beneficiary federal spending in the Medicare program would be limited to one percentage point above the moving five-year average of GDP growth. Medicare recipients could, if they chose, remain in the current Medicare program. However, if the cost of providing benefits under Medicare rose faster than the limit specified above, beneficiaries would be required to pay an additional premium to cover the difference. Alternatively, recipients could take their per capita subsidy and purchase a private insurance plan. The Bipartisan Policy Center’s Debt Reduction Task Force, chaired by Rivlin and former senator Pete Domenici estimated that restructuring Medicare in this way would reduce Medicare spending by \$7.1 trillion through 2040.¹²¹

Ultimately, as part of overall health care reform, as we move away from an employer-

Give enrollees a voucher and let them choose any health plan available on the market.

based health insurance system to one where individuals purchase personal and portable insurance policies, the federal government can transition out of providing a specialized health care system for the elderly all together. Individuals would be able to purchase long-term contracts for their health insurance coverage that begins when they are young but extends into their senior years. Such a system currently operates successfully, in Switzerland, for example.¹²²

Medicaid

The federal government currently spends approximately \$273 billion, or 1.9 percent of GDP, per year on Medicaid, according to the latest CBO figures,¹²³ up from just \$41.1 billion as recently as 1990.¹²⁴ The last two decades have seen consistent and rapid growth in the health-care program that was originally intended to aid only the most clinically and financially needy.

A recent article in *Health Affairs* by the director of health policy at the Urban Institute, John Holahan, suggests that most of the spending growth in Medicaid can be attributed to rapid growth in enrollment, not necessarily higher medical costs per enrollee. Between 2000 and 2007, he writes, “overall spending per enrollee for all Medicaid benefits increased 4.8 percent per year . . . well below overall spending growth.” Thus, the driver of a 7.8 percent growth rate in overall Medicaid spending during that time was an expansion of beneficiaries, some 4.7 times faster than the growth of the general population.¹²⁵

This means that the recently enacted PPACA, which adds an estimated 16 million Americans to the Medicaid rolls by the end of the decade, will cause the program’s cost to grow even more rapidly. According to the CBO, Medicaid spending is expected to nearly double, to \$543 billion, or 2.3 percent of GDP, by 2020.

Even before the enactment of PPACA, back in June 2009, CBO projected that Med-

icaid spending would grow to consume approximately 2.1 percent of GDP by 2020 and 3.7 percent of GDP by 2080.¹²⁶ Given that post-PPACA estimates have Medicaid spending more than last year’s estimates by 2020, it is plausible to assume that Medicaid alone may cost the federal government around 4 percent of GDP or more toward the end of the century.

The current structure of Medicaid, which involves a federal “matching payment” that covers on average about 55 percent of state Medicaid costs, also creates an incentive for states to design creative financing mechanisms that effectively increase the federal matching payment. Using these arrangements, states are able to increase benefits and eligibility while pushing much of the cost for their decisions off onto federal taxpayers.

The ability to control Medicaid costs by tinkering around the edges is extremely limited. Already, Medicaid reimbursement rates are so low that as many as a third of primary care physicians will not accept Medicaid patients, often driving those patients to emergency rooms for treatment.¹²⁷ As with Medicare, only a fundamental restructuring of the program can ultimately control costs.

Ultimately, Congress should treat Medicaid as it has other welfare programs, with block grants that give states the ability to innovate and the incentive to target their resources to the truly needy.

As part of the Personal Responsibility and Work Opportunity Act, signed by President Clinton in 1996, Congress eliminated the federal categorical entitlement to cash welfare (Aid to Families with Dependent Children, renamed Temporary Assistance to Needy Families). Federal funding for the program was frozen and then distributed to the states as a block grant with fewer federal restrictions. The results were generally positive. States cut welfare rolls nearly in half, while poverty rates, childhood poverty rates, and poverty rates for African Americans all declined dramatically. While some of the improvement was due to the robust economy of the late 1990s, much was brought about

The ability to control Medicaid costs by tinkering around the edges is extremely limited.

PPACA will add \$823 billion to the federal debt over that period.

by the states' ability to innovate and the elimination of an open-ended entitlement.

The federal government can take a similar route with Medicaid. Federal spending on Medicaid (and the state Children's Health Insurance Program) should be frozen at current levels, and then sent to states in the form of unrestricted block grants. The CBO has estimated that freezing Medicaid at current levels would save nearly \$1 trillion over the next 10 years.¹²⁸ This does not consider the possibility that state innovation could result in additional savings, as well as improved medical care for the poor. Moreover, the CBO estimate was issued before Congress passed the new health care reform law which vastly expanded Medicaid eligibility and spending (see below).

The Patient Protection and Affordable Care Act

Even as other entitlement programs were careening toward insolvency, Congress passed the Patient Protection and Affordable Care Act, dramatically expanding the federal government's health care commitments and effectively creating a new entitlement.

The CBO originally scored the Senate-passed PPACA as costing \$875 billion over 10 years.¹²⁹ The changes passed under reconciliation increased that cost to \$938 billion.¹³⁰ However, those numbers do not tell the whole story, nor do they reveal the bill's true cost.

The CBO does not provide formal budget analysis beyond the 10-year window, which points out that any calculation made beyond 2020, "reflects the even greater degree of uncertainty" regarding those years.¹³¹ However, since program costs will be on an upward trajectory through 2019, it expects the cost of the program to continue to grow rapidly after 2019.

Moreover, most of the spending under this bill doesn't take effect until 2014. So the "10-year" cost projection includes only 6 years of the bill. However, if we look at the bill more honestly over the first 10 years that the programs are actually in existence, say from

2014 to 2023, it would actually cost nearly \$2.7 trillion.

CBO officially scored the bill as reducing the budget deficit by \$143 billion over 10 years. In reality, however, that scoring is achieved through the use of yet another budget gimmick.

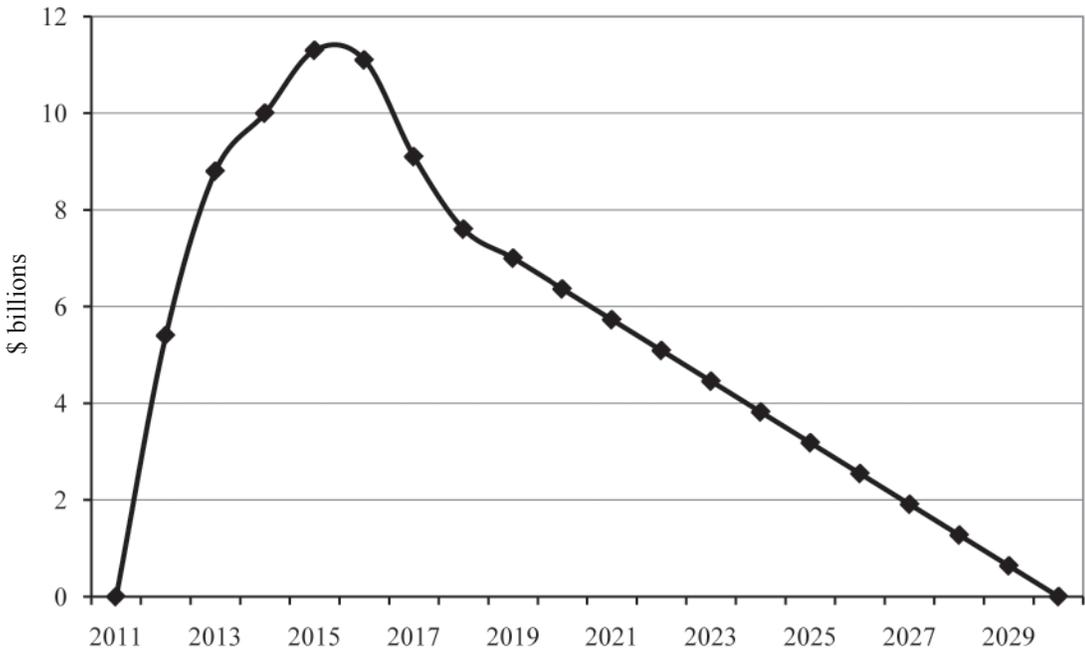
As mentioned above, the bill anticipates Medicare savings that are highly problematic. For example, in a letter to Representative Ryan, the Congressional Budget Office confirms that if the costs of repealing the 23 percent reduction in Medicare fee-for-service reimbursement payments to providers were to be included in the cost of health care reform, the bill would actually increase budget deficits by \$59 billion over 10 years.¹³²

Moreover, the initially projected cost failed to include discretionary costs associated with the program's implementation. The bill does not provide specific expenditures for these items, but simply authorizes "such sums as may be necessary." Therefore, because the costs are subject to annual appropriation and the actions of future Congresses are difficult to predict, it may be impossible to put a precise figure on the amount. However, CBO suggests that they could add as much as \$105 billion to the 10-year cost of the bill.¹³³

Adding the cost of the doc-fix and discretionary costs to the bill brings the total cost to over \$2.7 trillion by 2023. If all the costs associated with the health care law are fully accounted for, the PPACA will add \$823 billion to the federal debt over that period. And in the years beyond that both the cost of the health care law and the impact on the deficit become even greater.¹³⁴

Some aspects of the new law are of particular concern. For example, PPACA establishes a new national long-term care program, called the Community Living Assistance and Support Act (CLASS Act), designed to help seniors and the disabled pay for such services as an in-home caretaker or adult day services.¹³⁵ The CLASS Act is theoretically designed to be self-financed. Workers will be automatically enrolled in the program, but will have the right to opt out. Those who participate will pay a monthly premium that has not

Figure 17
Budgetary Impact of CLASS Act



Source: Letter from Douglas Elmendorf, director, Congressional Budget Office, to House speaker Nancy Pelosi, March 20, 2010; and Letter from Douglas Elmendorf, director, Congressional Budget Office, to Sen. Tom Harkin, November 25, 2009.

yet been determined.¹³⁶ Workers must contribute to the program for at least five years before they become eligible for benefits.¹³⁷ (Individuals age 55 or over at the time the program is fully implemented must not only contribute for five years, but must be employed for at least three years following the program’s implementation date.)¹³⁸ There is no health underwriting of participation or premiums.

The actual benefits to be provided under the program are among the many details that remain to be determined but will not be “less than an average of \$50 daily adjusted for inflation.”¹³⁹ Some estimates suggest that benefits will average roughly \$75 per day, or slightly more than \$27,000 per year.¹⁴⁰

Theoretically, the program will begin to collect premiums this year, although so many aspects of the program remain to be determined that many experts predict implementation could be delayed until as late as 2013.¹⁴¹ During the bill’s first five years, it will collect premiums, but not pay benefits.

As a result, over the first 10 years, the period conveniently included in the budget scoring window, the CLASS Act will run a surplus, collecting more in premiums than it pays out in benefits (see Figure 17).

Those premiums will accrue in a CLASS Act Trust Fund, similar to the Social Security and Medicare trust funds. Using trust fund accounting measures, the premium payments will reduce the federal deficit over that period by roughly \$70.2 billion.¹⁴² However, thereafter, the CLASS Act will begin to pay out benefits faster than it brings in revenue. Although this time period falls outside the formal 10-year scoring window, CBO warns, “In the decade following 2029, the CLASS program would begin to increase budget deficits . . . by amounts on the order of tens of billions of dollars for each 10-year period.” CBO goes on to warn, “We have grave concerns that the real effect of [the CLASS Act] would be to create a new federal entitlement program with large, long-term spending increases that far exceed revenues.”¹⁴³

In the decade following 2029, the CLASS program would begin to increase budget deficits.

Any effort to address the nation's long-term fiscal problems should include the repeal of PPACA.

Even Senate Budget Committee chairman Kent Conrad (D-ND), who eventually voted for the health care bill, called the CLASS Act “a Ponzi scheme of the first order, the kind of thing that Bernie Madoff would have been proud of.”¹⁴⁴

The bipartisan Commission on Fiscal Responsibility and Reform recognized that the CLASS Act program will “require large general revenue transfers or collapse of its own weight.”¹⁴⁵ The Commission recommended that the CLASS Act be reformed in some unspecified way so as to make it credibly sustainable over the long term or else repeal it.¹⁴⁶

Unfortunately the Commission was not able to tackle the underlying problem: the PPACA itself. In fact, the commission implicitly endorsed the continuation of this program. While that may have been a necessary compromise, given the commission's make up, it is ultimately the wrong answer. Any effort to address the nation's long-term fiscal problems should include the repeal of PPACA.

Conclusion

Our nation faces a massively growing debt that threatens our economic future. But as bad as that debt is, it is merely a symptom of a larger disease: a rapidly growing government that is consuming an ever larger share of our national economy. Unless decisive action is taken, government at all levels in the United States will consume roughly 60 percent of GDP by the middle of the century and rise to unimaginable levels thereafter. A government of that size is a threat not just to economic growth, but to our liberty and our way of life.

In the end, the debate over the deficit and the debt is not just a matter of finding enough revenue to pay for increased government spending without increasing the debt. It is, rather, a matter of reducing the size, cost, and scope of government.

That will involve some difficult choices. Too many politicians attempt to duck the hard choices by pretending that this can be done simply by trimming fraud, waste, and

abuse. But, there can be no meaningful effort to control the size and cost of the federal government without dealing with entitlement spending, and in particular by restraining and reforming Medicare, Medicaid, and Social Security.

It may well be “politically convenient” to continue ducking entitlement reform. But doing so will condemn our children and grand-children to a world of mounting debt and higher taxes.

Notes

1. Congressional Budget Office, “The Budget and Economic Outlook: An Update,” August 2010.
2. Congressional Budget Office, “The Long-Term Budget Outlook,” June 2009. CBO issued updates of its budgetary projections in 2010 and 2011. Congressional Budget Office, “The Budget and Economic Outlook: An Update.” Congressional Budget Office, “The Budget and Economic Outlook: Fiscal Years 2011–2021,” January 2011. The short-term budget numbers are comparable to the 2009 report. However, the updates do not include full projections for the years beyond 2011, and notably do not account for net accumulated interest in the out years. Therefore, the 2009 report remains the best source for long-term budget projections.
3. Congressional Budget Office, “The Budget and Economic Outlook: An Update.”
4. In the context of government spending, “entitlements” are those programs that do not require an annual appropriation by Congress. Funding levels are automatically set by the number of eligible recipients or other formulas and are not subject to congressional discretion. Each person eligible for benefits by law receives them unless Congress changes the eligibility criteria. The three largest entitlement programs are Social Security, Medicare, and Medicaid. But many other programs, including veterans' benefits and even agricultural subsidies are also entitlements. While the term “entitlement” may seem to grant these programs some special status aside from the way they are budgeted, they are no different, in reality, from any other form of government spending.
5. Congressional Budget Office, “The Long-Term Budget Outlook,” June 2009.
6. Bipartisan Commission on Entitlement and Tax Reform, 1995, *Final Report to the President*

(Washington: U.S. Government Printing Office/Diane Publishing, 1995).

7. National Bipartisan Commission on the Future of Medicare, "Building a Better Medicare for Today and Tomorrow," March 1999.

8. "Report of the 1994–1996 Advisory Council on Social Security," Washington, January 1997.

9. "The Moment of Truth," National Commission on Fiscal Responsibility and Reform, December 2010.

10. Ed Hornick, "Democrats to Use Social Security Against GOP This Fall," Cnn.com, August 13, 2010.

11. Angie Drobnic Holan, "Politifact: Republican Exaggerations about Cutting Medicare," St. Petersburg, http://articles.cnn.com/2010-08-13/politics/democrats.social.security_1_social-security-successful-government-program-democratic-party?s=PM:POLITICS Times, October 1, 2010.

12. <http://maristpoll.marist.edu/1213-cutting-the-deficit-should-be-next-sessions-main-concern/>.

13. Office of Management and Budget, "Fiscal Year 2012 Budget of the U.S. Government," February 14, 2011.

14. Ibid.

15. Congressional Budget Office, "The Budget and Economic Outlook: An Update."

16. "How Much Did Bush Tax Cuts Cost in Forgone Revenue?" Tax Foundation, May, 26 2010.

17. Author's calculations based on Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2010 to 2020," Table F-2, January 2010.

18. "The Budget and Economic Outlook: Fiscal Years 2010 to 2020," Congressional Budget Office, Table F-1, January 2010.

19. "Budget of the United States Government: Fiscal Year 2008," Office of Management and Budget, Historical Tables, Table 1.2, January 2008.

20. Congressional Budget Office, "The Budget and Economic Outlook: An Update," Table 1-2.

21. Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2010 to 2020," p. 10, January 2010.

22. "Budget of the United States Government: Fiscal Year 2011," Office of Management and Budget, Updated Summary Tables, Table S-34; "The Budget and Economic Outlook: An Update," Congressional Budget Office, Box 1-2, August 2010.

23. "Budget of the United States Government: Fiscal Year 2008," Office of Management and Budget, Historical Tables, Table 1.2, January 2008.

24. It has also been suggested that the current deficits are an unfortunate but necessary and temporary outgrowth of measures that are required to stimulate the economy in the face of a recession. This Keynesian approach holds that slow economic growth is caused by a decline in consumer demand and that government should therefore stimulate consumer spending as a way to increase growth. As Paul Krugman and Robin Wells argue, the key to economic recovery is for "the government to step in to spend when the private sector will not." Paul Krugman and Robin Wells, "The Way out of the Slump," *The New York Review of Books*, October 14, 2010. However, many economists question whether stimulating demand will actually boost economic growth. For example, University of Chicago economist Harald Uhlig calculates that stimulus spending similar to that of the American Recovery and Reinvestment Act (ARRA) results in \$5.80 of output lost for each dollar spent on stimulus. Harald Uhlig, "Some Fiscal Calculus," *American Economic Review: Papers & Proceedings* 100 (May 2010). Even CBO director Douglas Elmendorf, who supported increased deficit spending as a stimulus measure, expressed concern that "fiscal policies that aim to increase demand are likely to decrease output and income in the long run because such policies usually increase government borrowing and reduce the nation's saving and capital stock." Statement of Douglas Elmendorf, "The Economic Outlook and Fiscal Policy Choices," before the Committee on the Budget, United States Senate, September 28, 2010. Moreover, even if short-term deficit spending were beneficial, there is reason to be skeptical of Congress's ability to curtail such spending once the need has passed. As Elmendorf warned, "If policies that widened the deficit in the near term were enacted, observers might question whether, when, and how the difficult actions to narrow the deficit later would be carried out." Statement of Douglas Elmendorf, "The Economic Outlook and Fiscal Policy Choices."

25. Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2010 to 2020," p. 10, January 2010.

26. This likely underestimates future deficits. For example, at the time it made this estimate, CBO assumed that all of the Bush tax cuts would be allowed to expire this year. But in December, Congress permanently extended those tax cuts for low- and middle-income taxpayers, and extended tax cuts for wealthier Americans until 2012.

27. <http://www.usdebtclock.org/>.

28. Department of the Treasury, "Monthly State-

ment of the Public Debt of the United States,” Table 1, January 31, 2011.

29. Ibid.

30. Government Accountability Office, “A Citizen’s Guide to the Financial Report of the United States Government,” 2009.

31. Letter from Douglas Elmendorf, director, Congressional Budget Office, to Sen. Kent Conrad, August 3, 2010.

32. Government Accountability Office, “Financial Audit: Bureau of the Public Debt’s Fiscal Years 2009 and 2008 Schedules of Federal Debt,” November 2009, p. 2.

33. Executive Office of the President, Office of Management and Budget, “Accounting for Liabilities of the Federal Government,” Statement of Federal Financial Accounting Standards, para. 48, September 1995.

34. “2009 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Insurance Trust Funds.” This figure does not include the cost of redeeming bonds in the Social Security trust fund, which is properly classified as intergovernmental debt. Some estimates of Social Security’s total unfunded liabilities include that intergovernmental debt—since the repayment is unfunded—arriving at a total unfunded liability of more than \$18.7 trillion.

35. “2009 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Insurance Trust Funds.”

36. Ibid.

37. John Shatto and M. Kent Clemens, “Projected Medicare Expenditures under an Illustrative Scenario with Alternative Payment Updates to Medicare Providers,” Centers for Medicare and Medicaid Services, Office of the Actuary, August 5, 2010.

38. Lawrence Lindsey, “The Fiscal Trap,” *Weekly Standard*, December 6, 2010.

39. Oya Celasun and Geoffrey Keim, “The US Federal Debt Outlook: Reading the Tea Leaves,” International Monetary Fund Working Paper no. 10-62, March 2010.

40. James Gwartney, Robert Lawson, and Randall Holcombe, “The Size and Functions of Government and Economic Growth,” Joint Economic Committee, 1998.

41. See, for example, Robert Barro, “A Cross-Country Study of Growth, Saving, and Government,” Na-

tional Bureau of Economic Research Working Paper no. 2855, 1989; Georgios Karras, “On the Optimal Government Size in Europe: Theory and Empirical Evidence,” *Journal of the Manchester School of Economic and Social Studies* 65, no. 3: 280–94; Philip Grossman, “The Optimal Size of Government,” *Public Choice* 53: 131–147; Gerald Scully, “Optimal Taxation, Economic Growth, and Income Inequality in the United States,” National Center for Policy Analysis Policy Report no. 316, 2008; Richard Vedder and Lowell Galloway, “Government Size and Economic Growth,” Joint Economic Committee, 1998; Dimitar Chobanov and Adriana Mladenova, “What Is the Optimum Size of Government?” Institute for Market Economics, Sophia, Bulgaria, 2009; Daniel Mitchell, “The Impact of Economic Growth,” Heritage Foundation Backgrounder no. 1831, March 15, 2005.

42. Some might argue that the estimates of future GDP used to make the calculations in Figure 7 are too low, in part because the spending that the Obama administration is doing today is a form of “investment” that will lead to higher economic growth in the future. If GDP in the future is higher, then it follows that the ratio of spending to GDP will be lower than predicted. But, while the evidence is not unambiguous, most studies suggest that, with the possible exception of spending on education and infrastructure, government expenditures add little to private productivity. See Paul Evans and Georgios Karras, “Are Government Activities Productive? Evidence from a Panel of U.S. States,” *Review of Economics and Statistics* 76, no. 1 (February 1994): 1–11; Douglas Holtz-Eakin, “Public Sector Capital and the Productivity Puzzle,” *Review of Economics and Statistics* 76, no. 1 (February 1994): 12–21; and Kevin Lansing, “Is Public Capital Productive? A Review of the Evidence,” Federal Reserve Bank of Cleveland Economic Commentary, March 1, 1995. Moreover, as Figure 7 makes clear, the overwhelming majority of future spending increases comes from entitlement programs and interest on the debt, spending that is almost all consumption rather than investment. In addition, some might point out that a substantial portion of the projected future spending in Figure 7 is interest on the federal debt. Theoretically, if taxes were increased enough to cover spending, there would be no additional debt, and, therefore, far lower interest payments. But even if one assumed that the government accumulated no additional debt beyond the \$13.4 trillion it currently owes, federal government spending would still exceed 30 percent of GDP by 2050. Throw in spending by state and local governments, and government spending would still consume half of the U.S. economy.

43. Charles T. Carlstrom and Jagadeesh Gokhale, “Government Consumption, Taxation, and Economic Activity,” *Economic Review*, 1991, Q III, pp. 18–29.

44. S. Ali Abbas, et al., “An Historical Public Debt

- Database,” International Monetary Fund Working Paper no. 10-245, 2010.
45. Douglas Elmendorf and N. Gregory Mankiw, “Government Debt,” Harvard University and NBER, January 1998.
46. *Ibid.*
47. Theoretically debt could be rolled over in perpetuity rather than being paid off. But that has the same effect as paying it off in present value terms.
48. Elmendorf and Mankiw.
49. Roger Altman and Richard Haass, “American Profligacy and American Power,” *Foreign Affairs*, November–December 2010.
50. Jonathan Huntley, Federal Debt and the Risk of Financial Crisis,” Congressional Budget Office, July 27, 2010.
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52. Zhou Xin, Simon Rabinovich, and Kevin Yao, “US Fiscal Health Worse Than Europe: China Advisor,” Reuters, December 8, 2010.
53. Arnold Kling, “Guessing the Trigger Point for a U.S. Debt Crisis,” Mercatus Center Working Paper, no. 10-45, August 2010.
54. *Ibid.*
55. <http://www.treasury.gov/resource-center/data-chart-center/tic/Documents/mfh.txt>.
56. Altman and Haas.
57. Carlstrom and Gokhale, 18–29.
58. Carmen Reinhardt and Kenneth Rogoff, “Growth in a Time of Debt,” *American Economic Review Papers and Proceedings*, January 7, 2010.
59. “The Moment of Truth,” citing Congressional Budget Office, “The Long-Term Budget Outlook,” June 2010.
60. Michael Ettliger, Michael Linden, and Reece Rushing, “The First Step: A Progressive Plan for Meaningful Deficit Reduction by 2015,” Center for American Progress, December 2010.
61. Laffer himself warns: “The Laffer Curve itself does not say whether a tax cut will raise or lower revenues. Revenue responses to a tax rate change will depend upon the tax system in place, the time period being considered, the ease of movement into under-
ground activities, the level of tax rates already in place, the prevalence of legal and accounting-driven tax loopholes, and the proclivities of the productive factors.” Arthur Laffer, “The Laffer Curve: Past, Present, and Future,” Heritage Foundation Backgrounder no. 1765, June 1, 2004.
62. Arthur Laffer, “The Laffer Curve: Past, Present, and Future.”
63. Veronique de Rugy, “Hauser’s Law: This Reality Isn’t Negotiable,” National Review Online, November 29, 2010, <http://www.nationalreview.com/corner/254034/hausers-law-reality-isnt-negotiable-veronique-de-rugy>. However, Dan Mitchell warns that Hauser’s Law may not hold in event of a Value Added Tax (VAT). He notes that a VAT has enabled European countries to collect additional revenue, which they have used to expand the size, scope, and intrusiveness of government, <http://danieljmitchell.wordpress.com/2010/05/20/willhausers-law-protect-us-from-revenue-hungry-politicians/>. It may be more proper, therefore, to suggest that Hauser’s law applies better to income taxes.
64. Based on author’s calculations. Net worth of millionaires is calculated from 2004 Census data, “Table 703. Top Wealth Holders with Net Worth of \$1.5 Million or More,” divided by data taken from the Office of Management and Budget, “The Budget for Fiscal Year 2008,” Historical Tables, Table 10.1.
65. Letter from Douglas Elmendorf, director, Congressional Budget Office, to Rep. Paul Ryan, May 19, 2008.
66. Martin Feldstein, “How Big Should Government Be?” *National Tax Journal* 50 no. 2 (June 1997): 197–213.
67. Tina Korbe, “Updated—Worst of the Waste: The 100 Most Outrageous Government Spending Projects of 2010,” Heritage Foundation, December 10, 2010.
68. Congressional Budget Office, “The Budget and Economic Outlook: Fiscal Years 2011–2021,” January 2011, Table E-7.
69. Congressional Budget Office, “The Budget and Economic Outlook: Fiscal Years 2011–2021.
70. “The Moment of Truth.” The report never actually specifies how much will be cut from defense over the next 10 years. It only gives an illustrative cut of \$100 billion in 2015 or total discretionary cuts over 10 years, but projecting that over 10 years yields an approximate \$1 trillion reduction.
71. Congressional Budget Office, “The Budget and Economic Outlook: Fiscal Years 2011–2021.
72. *Ibid.* The Social Security trustees also project

- that the Trust fund will be exhausted in 2037. “2010 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds.” However, it is worth noting that because CBO assumes a slightly higher rate of return on government bonds, among other technical differences, it has in the past projected Trust Fund solvency to last roughly 10 years longer than do the trustees. The new CBO projection moves the Trust Fund exhaustion date forward by roughly 10 years. Therefore, it is likely that when it is issued later this year, the Trustee’s Report will show an exhaustion date even earlier than 2017.
73. “2010 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds,” p. 9.
74. Budget of the United States Government, Fiscal Year 2000: Analytical Perspectives, p. 337.
75. As noted, Figure 14 is based on CBO projections. The latest report of the Social Security Trustees, released last June, shows Social Security in deficit this year, then briefly returning to solvency, before plunging into permanent deficits after 2015. “2010 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds.” However, CBO’s projections are more recent and better reflect current developments such as the ongoing recession and the payroll tax cut enacted in December 2010.
76. “2010 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds,” p. 14.
77. William Jefferson Clinton, Speech at the Great Social Security Debate, Albuquerque, NM, July 27, 1998.
78. Henry Aaron, Testimony before Senate Committee on Finance, 106th Congress, 1st session, January 19, 1999.
79. “The Moment of Truth.” This is a somewhat smaller increase than it seems at first. Under current law the cap is scheduled to rise to \$168,000.
80. Ettliger, Linden, and Rushing.
81. National Committee for Preserving Social Security and Medicare, “Raising the Social Security Tax Cap,” August 2010.
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83. Patient Protection and Affordable Care Act, sec. 9015(a)(2).
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94. Paul Ryan, “A Roadmap for America’s Future,” House Budget Committee, 2010, <http://www.roadmap.republicans.budget.house.gov/>.
95. Letter from Douglas Elmendorf, director, Congressional Budget Office, to Rep. Paul Ryan, January 27, 2010.
96. “2009 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds.”
97. See Peter Orszag and Ezekiel Emanuel, “Health Care Reform and Cost Control,” *New England Journal of Medicine*, June 16, 2010.
98. Letter from Douglas Elmendorf, director, Congressional Budget Office, to House speaker Nancy Pelosi, March 20, 2010.
99. Congressional Research Service, “Medicare Provisions in PPACA (P.L. 111-148),” April 21, 2010.
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- conciliation Act, Title I, Subtitle E, sec. 1411, and Subtitle A, sec. 9015.
101. “2010 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds,” Table III.C15.
102. Ibid.
103. Ibid.
104. Letter from Douglas Elmendorf, director, Congressional Budget Office, to Senate leader Harry Reid, December 20, 2009.
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106. Shatto and Clemens.
107. Jennifer Haberkorn, “Senate Leaders Agree on ‘Doc-Fix,’” *Politico*, December 8, 2010.
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126. Congressional Budget Office, “The Long-Term Budget Outlook,” June 2009.
127. Ellyn R. Boukus, Alwyn Cassil, Ann S. O’Malley, “A Snapshot of U.S. Physicians: Key Findings from the 2008 Health Tracking Study Physician Survey,” Center for Studying Health System Change, Bulletin no. 35, September 2009.
128. Congressional Budget Office, “The Budget and Economic Outlook: Fiscal Years 2011 to 2021,” January 2011. Figure based on Table 3-3 reported 2010 spending on Medicaid, keeping spending at 2010 level constant, and calculating the savings

- each year in aggregate for the rest of the decade.
129. Letter from Douglas Elmendorf, director, Congressional Budget Office, to Senate Majority Leader Harry Reid, March 11, 2010.
130. Letter from Douglas Elmendorf, director, Congressional Budget Office, to House speaker Nancy Pelosi, March 18, 2010. Note that CBO calls this “a preliminary estimate” and it may be revised in the future.
131. Letter from Douglas Elmendorf, director, Congressional Budget Office, to House speaker Nancy Pelosi, March 18, 2010.
132. Letter from Douglas Elmendorf, director, Congressional Budget Office, to Rep. Paul Ryan, March 19, 2010.
133. Letter from Douglas Elmendorf, director, Congressional Budget Office, to Rep. Jerry Lewis, May 11, 2010.
134. See, Michael Tanner, “Bad Medicine: A Guide to the Real Costs and Consequences of the New Health Care Law,” Cato Institute White Paper, June 2010, updated, February 2011.
135. The Patient Protection and Affordable Care Act, sec. 8002(a)(1).
136. They will eventually be set by the secretary of HHS. However, the CBO estimates that will be roughly \$123 per month for the average worker. Letter from Douglas Elmendorf, director, Congressional Budget Office, to House speaker Nancy Pelosi, March 20, 2010.
137. Public Health Service Act , sec. 3202(6)(i), as amended by Patient Protection and Affordable Care Act, sec. 8002(a).
138. Public Health Service Act , sec. 3202(6)(ii), as amended by Patient Protection and Affordable Care Act, sec. 8002(a).
139. Public Health Service Act , sec. 3203(a)(1)(D)(i), as amended by Patient Protection and Affordable Care Act, sec. 8002(a).
140. Letter from Douglas Elmendorf, director, Congressional Budget Office, to Sen. Kay Hagan, July 6, 2009.
141. See <http://www.aaltci.org/long-term-care-insurance/learning-center/CLASS-Act.php/#cost>.
142. Letter from Douglas Elmendorf, director, Congressional Budget Office, to House speaker Nancy Pelosi, March 20, 2010.
143. Ibid. In short, the CLASS Act will create a situation analogous to Social Security. For Social Security, this means that once the cash-flow turns negative, beginning in 2016, the government will be faced with the choice to increase taxes, reduce benefits, or run additional debt.
144. Lori Montgomery, “Proposed Long-Term Insurance Program Raises Questions,” *Washington Post*, October 27, 2009.
145. “The Moment of Truth.”
146. “The Moment of Truth,” recommendation 3.2. The Commission pointed out that because the CLASS Act collects premiums now and pays benefits later, repealing it would incur a short-term cost of \$76 billion through 2020, but would save the government money in the long run.

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