CATO INSTITUTE
Tax & Budget BULLETIN

No. 15 • June 2003

The Federal Government in 2040

by Chris Edwards, Director of Fiscal Policy, Cato Institute

In just five years, a demographic tidal wave will begin that will forever alter the federal budget. The large baby boom generation will begin retiring and cause the costs of Social Security and Medicare to rapidly escalate. Longer life spans and rising costs per federal health care enrollee will exacerbate the huge burden that will be placed on future generations unless entitlement programs are reformed. Social Security, Medicare, and Medicaid costs are set to rise so quickly that major budget cuts will be needed across the entire government to avert a massive tax hike on tomorrow's workers.

No Reform Means Huge Tax Increase

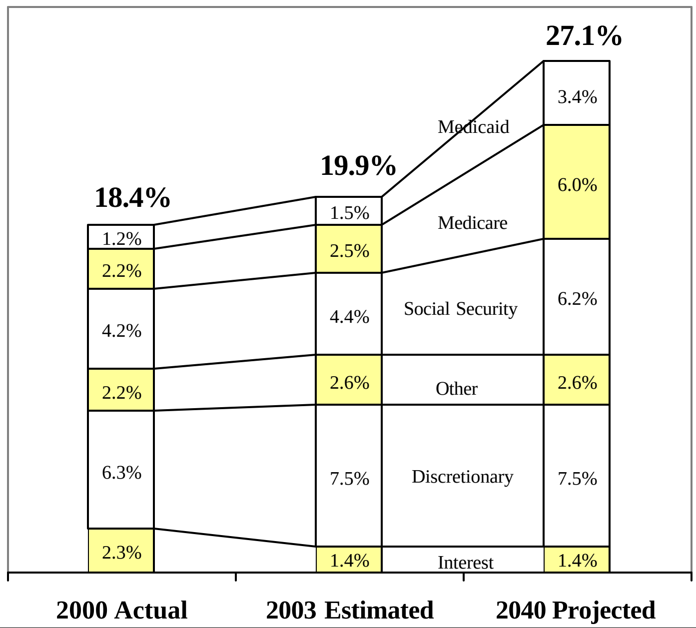
Without reforms, combined spending on Social Security, Medicare, and Medicaid will rise from 8.4 percent of gross domestic product this year to 15.6 percent by 2040, according to Congressional Budget Office projections.[1] Figure 1 shows that if all other government programs stay at the same size relative to the economy, the budget will grow from 19.9 percent of GDP in 2003 to 27.1 percent by 2040—a 36 percent expansion in the government's command over the U.S. economy.

If such spending increases were thrust onto taxpayers today, the result would be a huge $778 billion annual tax increase (an increase of 7.2 percent of GDP on today's $10.8 trillion GDP).[2] By comparison, President Bush's income tax rate cuts will save taxpayers roughly $100 billion per year.[3] Thus, without reforms, families in 2040 will face a tax increase more than seven times larger than the size of Bush's tax rate cuts.

Figure 1's projection understates the future spending problem if Congress continues to expand the budget as rapidly as it has recently. For example, Figure 1 assumes that discretionary spending grows at the same rate as nominal GDP through 2040, or about 4.8 percent annually. Yet nondefense discretionary spending grew at an annual average rate of 8.2 percent between fiscal 1998 and 2003.[4] Also, CBO's projected growth in Medicare spending per enrollee, as reflected in Figure 1, is much lower than growth in recent decades, and thus may be optimistic.[5]

1. Federal Spending in 2040 Without Reform

(Percent of GDP)



Sources: Author's assumptions and CBO entitlement projections.

Long-Range Forecast Assumptions

A July 2002 CBO projection showed that federal spending would grow to 23.8 percent of GDP by 2040.[6] The projection assumed that discretionary spending grows initially at the inflation rate, then speeds up to the GDP growth rate. As a result, the government initially shrinks as a share of GDP, then starts expanding.

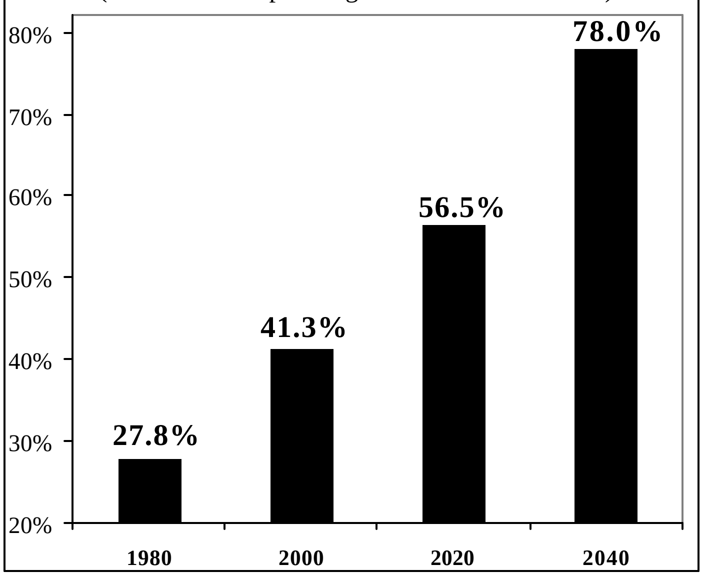
However, the future spending crisis is more serious than that if Congress does not change its usual spending patterns. Baseline projections show spending growth for programs under current law, but Congress frequently adds new programs and expands existing ones. For example, seemingly unaware that Medicare faces a huge financial crisis, lawmakers plan to add a prescription drug benefit that will cost taxpayers $400 billion over the first 10 years.[7] A drug plan will cost much more in the second 10 years as millions of baby boomers enter retirement.

What if Spending is Limited to 20 Percent of GDP?

Suppose that the three main entitlement programs are not reformed, but that the overall size of the federal government is limited to today's 20 percent of GDP. Figure 2 shows that nearly all other federal programs would be squeezed out as Social Security, Medicare, and Medicaid exploded to nearly 80 percent of the budget by 2040. Note that the share of benefits received by the elderly is 76 percent for Social Security, 87 percent for Medicare, and 29 percent for Medicaid.[8] Thus, under this scenario the elderly would elbow aside all other citizens as they seized the bulk of the federal budget.

2. Social Security, Medicare, and Medicaid as a Share of Total Federal Spending

(Future Total Spending Fixed at 20% of GDP)



Note: Total federal outlays are 19.9 percent of GDP in FY2003.
Sources: Author's assumptions and CBO entitlement projections.

Entitlement and Discretionary Spending Cuts Needed

If Americans want to limit the government to its current size—let alone shrink it—then entitlement programs must be overhauled and Congress must shed all nonessential programs. Social Security should be moved to an individual savings-based system. That would help solve the economic challenge of getting today's workers to build a large pool of capital to use for their retirement, rather than relying on tomorrow's taxpayers.

Reforms for Medicare and Medicaid should include greater emphasis on paying expenses out-of-pocket, introducing more individual choice and health provider competition, moving from defined benefit to defined contribution structures, and increasing individual savings to reduce dependence on government. CBO's "Budget Options" includes numerous ideas to cut taxpayer costs, such as increasing the share of Medicare Part B benefits that are covered by premiums from the current 25 percent.[9]

Regarding discretionary spending, the *Cato Handbook for the 108th Congress* lists over $300 billion in programs that could be terminated, privatized, or transferred to the states. That list of cuts would save about 3 percent of GDP—somewhat less than half the savings needed to offset entitlement spending increases expected by 2040.

Conclusions

Unreformed entitlement programs will impose a desperate fiscal crunch on future generations as the number of elderly soars. The elderly already receive a majority of their income from government transfers, on average, yet Congress plans to channel even more taxpayer money to the elderly with a prescription drug plan. Prescription drugs should only be added to Medicare if Congress cuts the program elsewhere on a one-for-one basis. Unless entitlements are reformed and discretionary spending cut, the uniqueness of the United States will disappear as it embraces European-sized government.

---

[1] CBO, "A 125-Year Picture of the Federal Government's Share of the Economy, 1950 to 2075," July 3, 2002. See also, CBO, "An Analysis of the President's Budgetary Proposals for FY2004," March 2003. Fiscal year data.
[2] This somewhat overstates the taxpayer costs because the Medicare figure is gross of Medicare premiums.
[3] See Joint Committee on Taxation, JCX-51-01, May 26, 2001. Under the 2001 law, the annual revenue loss for all the rate cuts when fully phased-in for 2007 was scored at $103 billion.
[4] Assumes the president's budget for 2003, per CBO.
[5] CBO, "Budget Options," March 2003, p. 262.
[6] CBO, "A 125-Year Picture," July 3, 2002.
[7] The president's FY2004 budget and the FY2004 congressional budget resolution included $400 billion for a drug plan.
[8] Author's calculation based on CBO, "Federal Spending on the Elderly and Children," July 2000.
[9] CBO, "Budget Options," March 2003, p. 154.