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Adam H. Putnam, Chairman

Entitlement Spending and the Budget

In 2006, the most recent projection is that the deficit will come in at $260 billion, an improvement of $58 billion compared to 2005 and an improvement of $153 billion compared to 2004. For the ten-year budget outlook, the budget situation remains relatively stable, but with entitlement spending projected to increase as a percentage of the federal budget.

The longer-term budget math provides no room for making changes to the federal budget to cover increased liabilities from entitlement programs that does not involve either unrealistic cuts for all non-entitlement federal spending, tax increases without precedent in U.S. history, or a crushing debt burden. The fourth option is to reform entitlements, with the changes required to ensure solvency small in comparison to the costs of doing nothing.

The Federal Budget in 2006

The Congressional Budget Office (CBO) projects the federal deficit in 2006 to come in at $260 billion or 2 percent of GDP. This is the second year in a row that the deficit has declined and the primary reason is growth in federal revenues. The deficit, as a percentage of GDP, is below the average of the last forty years, which is 2.3 percent of GDP.

For 2006, federal revenues will equal 18.3 percent of GDP, slightly higher than the average of the last forty years, which equals 18.2 percent of GDP. This marks the second consecutive year that revenues have experienced rapid growth. In 2005 revenues increased by 14.5 percent and for 2006 the latest CBO estimate has revenues increasing by 11.6 percent.

In 2006, spending is lower, revenues are higher, and the deficit is below the historic average of the last forty years. Furthermore, CBO's projections in the ten-year budget outlook through 2016 show a relatively stable budget picture, with spending declining slightly as a percentage of GDP, revenues remaining at or above the historic average as a percentage of GDP, and the deficit remaining below average as a percentage of GDP.

However, changes in the composition of federal spending will have important consequences for the federal budget beyond 2016. Specifically, entitlement spending, and in particular spending on Medicare, Medicaid, and Social Security, will overwhelm the federal budget unless reformed.

Ten Year Outlook for Entitlement Spending

From 2006 to 2016, spending is projected to hold steady measured as a percentage of GDP, declining slightly from 20.3 percent of GDP to 20.2 percent of GDP. Discretionary spending, which under CBO's baseline projection grows at a rate just above inflation, is projected to decline from 7.8 to 6.4 percent of GDP. Mandatory spending, on the other hand, is projected to increase from 10.8 percent to 12.2 percent of GDP.

Figure 1: Growth in Federal Spending 2006 to 2016
(percent)

	Annual Growth Rate	Cumulative Increase
Nominal GDP	4.8	59
Inflation	2.3	28
All Entitlement Spending	6	79
Social Security	5.8	77
Medicare	9.3	144
Medicaid	8	117
Discretionary Spending	2.7	30

Data based on CBO's *The Budget and Economic Outlook: An Update*, August 2006

As seen from the table, entitlement spending over this period is projected to grow 1.2 percentage points faster than nominal GDP and 3.7 percentage points faster than the rate of inflation. The overall budget is projected to remain stable only because CBO baseline projections have discretionary spending, both for defense and non-defense, growing at about half the rate of GDP growth.

The federal government's long-term spending problem results from the fact that mandatory spending is projected to increase by a substantial margin beyond 2016, while discretionary spending will have less room to decrease after 2016 to make room for the additional mandatory spending.

The Long-Term Outlook for Entitlement Spending

Entitlement spending was 54 percent of all federal spending in 2005. By 2015, mandatory spending is projected to be 59 percent of the federal budget with discretionary spending declining to only 33 percent. Beyond 2015, entitlement spending is projected to continue to increase faster than discretionary spending. More ominously, under current spending projections, CBO projects a significant increase in the portion of the federal budget that will have to be dedicated to paying interest on the public debt.

Figure 2: Composition of the Federal Budget Over Time
(percentage of federal budget)

	2005	2015	2030	2050
Discretionary	39	33	21	14
Interest	7	8	17	33
Mandatory	54	59	62	54

For 2005 and 2015, data is based on CBO's most recent baseline projections for the ten-year budget outlook. For 2030 and 2050, calculations are based on the Intermediate Spending/ Lower Revenues projections in CBO's long-term budget outlook released December 2005.

In addition to mandatory spending becoming a larger portion of the federal budget, under the assumptions used in this table, the federal budget becomes a larger percentage of GDP. In 2050, spending would be 37.7 percent of GDP compared to 20.3 percent of GDP this year. Just spending for interest payments on the public debt would be 12.4 percent of GDP.

Changing Composition of Entitlement Spending over Time

The three largest components of entitlement spending are Medicare, Medicaid, and Social Security.

Social Security is currently the largest entitlement program in the federal budget and will remain so for a couple of decades. But Medicare and Medicaid are growing faster than Social Security and they represent a substantially larger share of the projected growth in entitlement programs.

Figure 3: Composition of Mandatory Spending Programs as Percentage of GDP

(percent)

	2005	2015	2030	2050
Social Security	4.2	4.5	6.0	6.4
Medicare	2.7	4.0	6.4	8.6
Medicaid	1.5	1.9	2.8	4
Other Mandatory Spending	2.4	1.4	1.7	1.3
Total	10.7	11.8	16.9	20.3

Data based on Intermediate Spending Projection in CBO's, December 2005, *The Long-Term Budget Outlook*

Compared to today, Social Security will add 2.2 percent of GDP to the federal budget by 2050. On the other hand, Medicare will add 5.9 percent of GDP to the federal budget and Medicaid will add 2.5 percent of GDP to the federal budget.

Other mandatory spending is projected to decline by 1.1 percent of GDP in part because, as Medicare spending increases, Medicare premiums are projected to also increase as a percentage of the federal budget. In CBO's long-term budget outlook, Medicare premiums are counted as offsetting receipts and subtracted from the "other mandatory spending" portion of the federal budget.

Figure 4: Projected Milestones for Entitlement Spending

2008	First baby boomers become eligible for Social Security benefits.
2012	Medicare Board of Trustees projects a Medicare funding warning for this year as Medicare spending exceeds dedicated revenue sources by 45 percent.
2017	The Social Security system runs a deficit. From this date forward the Social Security system runs a deficit every year.
2018	The Medicare Hospital Insurance trust fund is exhausted.
2026	Though Social Security will have been growing faster than the rate of GDP growth for nearly two decades, Medicare is projected to grow by a much larger rate. In this year Medicare is projected to surpass Social Security as the largest program in the federal budget.
2040	The Social Security trust fund, after 23 years of deficits, is exhausted.

What Causes Growth of Entitlement Spending?
Two factors cause entitlement spending to increase as a percentage of GDP – demographics and rising health costs.

1) Demographics. Social Security and Medicare were established when life expectancy was shorter than today. In 1900, life expectancy at birth was 49.2 years. By 1940 the figure reached 63.6 years, with Social Security's retirement age set at 65. In 2003 life expectancy at birth reached 77.5 years with Social Security's full retirement age set at 67 for those born after 1959 (and 65 for Medicare).

In 1945 there were 42 workers for every retiree. In 2005, there were 3 workers for every retiree. In 2030, there will be two workers for every retiree. The declining worker to retiree ratio is caused by an increasing life expectancy, but also by changes in the birth rate since World War II. 77 million baby boomers will be retiring in the coming years.

Demographics explain why Social Security is projected to increase as a percentage of GDP. Demographics are a contributing factor, though not the most important factor, in the projected increase for Medicare and Medicaid spending.

2) Rising Health Costs. The other factor that causes entitlement spending to grow faster than the economy is rising health care costs. Since Medicare and Medicaid were created, both programs have historically had "excess cost growth." Excess growth is the difference between general growth in the economy and growth in spending on Medicare and Medicaid that is not explained by demographic factors.

Excess growth was 5.5 percent between 1975 and 1983. Since 1970 the average excess cost growth has been 2.9 percentage points faster than per capita GDP. Since 1990 that has slowed to 1.9 percent. Differences in cost growth for Medicare produce radically different results over time in Medicare spending.

What future excess cost growth in health spending will be is far from certain, but it is the single most important variable in projecting the long-term budget forecast. Middle range projections assume that there will continue to be excess cost growth in Medicare and Medicaid spending but that it will be substantially less than the average from 1970 to 2004. CBO's intermediate spending projection, for example, allows for 1 percent excess cost growth in Medicare and Medicaid.

Figure 5: Federal Medicare/ Medicaid Spending Under Different Assumptions for Excess Cost Growth

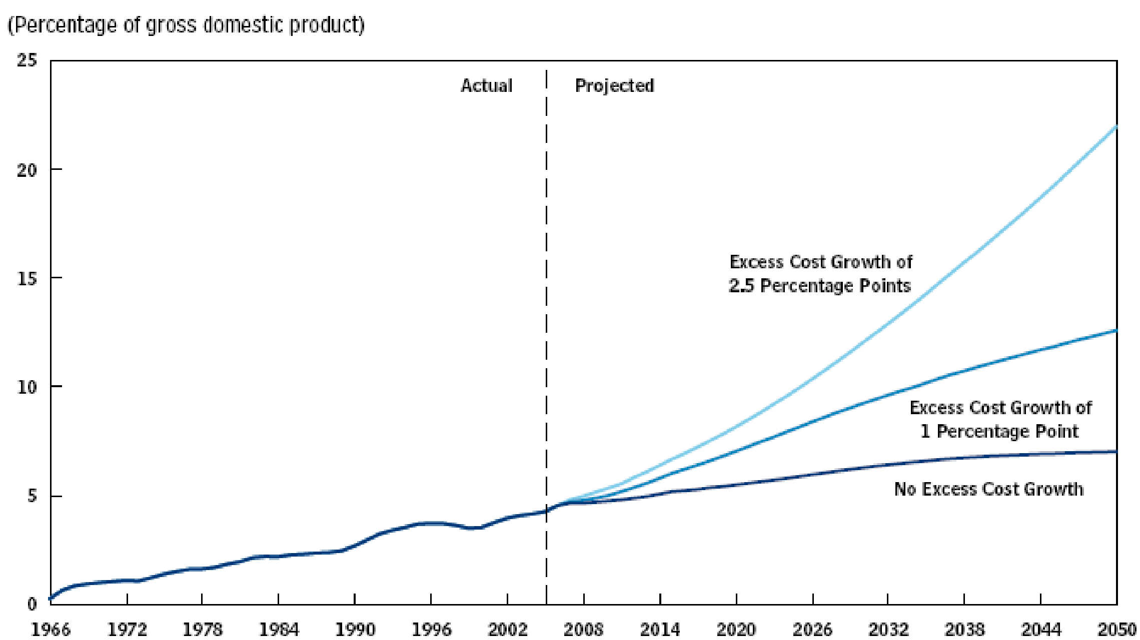

Chart from CBO, December 2005, *The Long-Term Budget Outlook*

As seen from the chart, even with no excess cost growth in Medicare and Medicaid, the two programs increase as a share of GDP because of demographic factors. If excess cost growth comes in at the higher projection of 2.5 percentage points, by 2050 spending on Medicare and Medicaid alone would take up a larger share of GDP than the entire federal budget today.

Options for Dealing with Long-Term Fiscal Imbalance

In general, there are four options for coming to terms with these projections: curtail all other federal spending, significantly raise taxes, let the federal debt climb to unprecedented levels, or reform entitlements.

Option 1: The Discretionary Spending Option. As previously mentioned, CBO projects spending to remain stable as a percentage of GDP over the next decade. This is due to a projected decrease in discretionary spending as a percentage of GDP. But beyond the ten year budget outlook, just limiting discretionary spending will not be enough to cover entitlement spending.

Figure 6: What Has to Happen to Discretionary Spending to Keep Budget Same Share of GDP as in 2006? (percent of GDP)

	2006	**2015**	**2030**	**2050**
Entitlements	10.8	11.8	16.9	20.3
Interest	1.7	1.6	1.8	1.8
Discretionary	7.8	6.9	1.6	***-1.8***
Total	20.3	20.3	20.3	20.3

As seen from the table, without entitlement reform, in order to limit the federal budget to the same share of the economy as today, discretionary spending has to more than disappear entirely by 2050. In fact, even before 2030, discretionary spending would have to represent an amount far below what is realistic. It is also worth noting that, for purposes of this exercise, it is presumed that interest spending does not increase as a share of GDP. If the public debt were to increase in proportion to the US economy or if interest rates were to increase, increased spending for interest on the debt would put even more pressure on discretionary spending.

It would be possible to allow for more discretionary spending without reforming entitlements, but only with a federal budget that consumes more of the Gross Domestic Product. And that would require either an increase in taxes or an increase in debt.

Option 2: The Tax Increase Option. In the long run, presuming tax cuts currently scheduled to expire are extended or made permanent, several components of the tax code will lead to a tax burden unprecedented in U.S. history, during peace time or in war. On the other hand, the impracticality of such a high tax burden suggests that something close to the current level of revenue is a better bet for revenue forecasts.

Assuming tax cuts enacted in 2001 and 2003 are not allowed to expire, CBO examines three features of the tax code under present law that cause the government's take in taxes to grow as a share of the economy.

Real Bracket Creep. Under current law one reason tax revenue would be expected to rise faster than the rate of growth in GDP is because of the progressive nature of our tax system.

The level at which income is subject to each tax rate is adjusted for inflation. But wages grow faster than inflation over time. The difference between wage growth and inflation causes revenues from the income tax to grow faster than economic growth.

In addition, under current law, some components of the tax code that limit tax liability are not indexed for inflation either. An example of this is the child tax credit.

The Alternative Minimum Tax (AMT). Since the AMT is not adjusted for inflation it will impact more and more taxpayers in future years. Two percent of taxpayers are affected by the AMT today. According to CBO, without adjustments for inflation, sixty-five percent of taxpayers would be subject to the AMT by 2050.

Deferred Tax Payments. Contributions to 401(k) and individual retirement accounts are not tax-exempt. However withdrawals from these accounts are taxable. As the baby boomers retire this will be a growing source of federal revenue.

The Congressional Budget Office provides two illustrative paths for future revenues. In one path, taxes are kept at the same level as the historical average of the last 30 years - 18.3 percent of GDP.

In the higher tax path, taxes are allowed to increase as a percentage of GDP as provided for by current law. Under this scenario, taxes would reach 23.7 percent of GDP. This scenario presumes the tax cuts are allowed to expire, but this actually explains a small portion of the increase. Making the 2001 and 2003 tax cuts permanent, and otherwise following current laws, would still cause federal revenues to reach unprecedented levels, almost 23 percent of GDP.

Figure 7: Taxes Under Present Law Compared to Historical Average

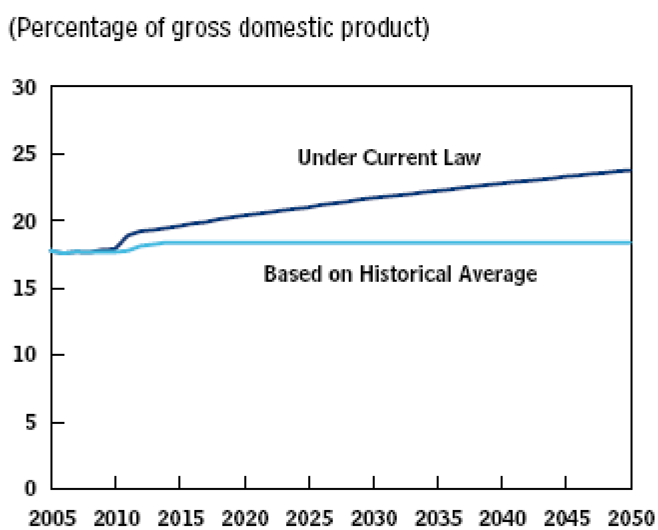

Chart from CBO, December 2005, *The Long-Term Budget Outlook*

There is good reason to believe that the lower-tax path will prove more accurate than the higher-tax path. As former CBO Director Douglas Holtz-Eakin has noted:

> Government forecasts predict that budget deficits will narrow as revenues rise from the current level, which is below the post-World War II average of 18 cents on the dollar, to a level near the postwar peak of 20 cents. Is that realistic? Historically, when taxes reach that level, U.S. politics drive them back down.
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> - *Washington Post* column, February 5, 2006

If taxes were to follow the CBO higher-tax path, when state and local taxes are included, the tax burden in America would approximate Europe's.

But CBO's higher-tax projection would still produce a substantial increase in the federal debt if spending is left on automatic pilot. By 2050, under this scenario, interest payments would consume 4.7 percent of GDP. To prevent that, further tax increases would be required.

In order to cover the federal government's projected long-term fiscal imbalance with tax increases alone, it would be necessary to do all of the following:

1) Allow all of the tax cuts Congress has enacted since 2001 to expire.
2) Do nothing to fix the AMT, allowing it to affect more and more taxpayers until it impacts 65 percent of taxpayers.
3) Allow real bracket creep to cause more and more middle class taxpayers to fall into tax rates designed for wealthier taxpayers.
4) Raise taxes still further, until more than a quarter of the nation's economic output is taken by the federal government in the form of taxes, a level of taxation without precedent in American history whether in peace or war time.

Option 3: The Debt Option. If instead taxes remain at historic levels, and spending follows current projections, the remaining option is to allow the debt to increase. Under this scenario, the public debt climbs from 37 percent of GDP in 2006 to almost 100 percent of GDP by 2030. By 2050, the debt would be equal to 256 percent of GDP, and since by this time the federal deficit would be 19 percent of GDP, the debt would continue to grow rapidly.

A debt of this magnitude, at multiple levels of GDP, is not sustainable. The public debt has exceeded 100 percent of GDP only once in American history, for a very brief period during World War II. At more than twice that level, the impact of such a large public debt means federal spending for interest payments would be equal to 12.4 percent of GDP (compared to 1.7 percent of GDP in 2006) in 2050. CBO notes why borrowing cannot cover our liabilities from entitlement programs forever:

> In each of those scenarios, the growth of debt would accelerate as the government attempted to finance its interest payments by issuing more debt—leading to a vicious circle in which ever-larger amounts of debt were issued to pay ever-higher interest charges. Eventually, the costs of servicing the debt would outstrip the government's ability to pay them, thus becoming unsustainable.
>
> - CBO, December 2005, *The Long-Term Budget Outlook*

Option 4: The Reform Option. Without eliminating spending for all discretionary programs, raising taxes or the public debt to unprecedented levels, or doing some combination thereof, the final option is to reform entitlement programs.

The advantage of this option is it eliminates the need for large tax increases, while also preventing a massive increase in the national debt. In addition, entitlement reform will allow the federal budget to retain the flexibility to meet new challenges that will inevitably arise.

Conclusion

It is worth noting that in the past three decades there has been some success in reforming entitlements from impending fiscal problems. The Social Security Amendments of 1977 and the Greenspan Commission of 1983 did not succeed in making Social Security permanent forever, but they did manage to substantially reduce the program's liabilities compared to what would otherwise have been the case. With Medicare, an important reason excess cost growth has decreased from 5.5 percent to 1.9 percent over the period since 1990 is changes in Medicare payment policies.

These reforms were bipartisan and without them, the federal budget would be in far worse shape today. Unfortunately, during the 109th Congress, Democrats have opposed even the most modest of reform efforts. The Deficit Reduction Act, for example, did not receive the support of a single Democratic Member of the House. Instead they would either allow the debt to spiral out of control or raise taxes to levels with no tradition in U.S. history.

There are a number of reasons why it is important to begin to address the problem now instead of waiting. First, the longer we wait, the larger the changes need to be. Today, we have the option of solving the problem by making relatively modest changes to entitlement programs and implementing these changes on a slow, gradual basis. Aside from being the easiest route toward solving the problem, solving the problem now instead of waiting will give future retirees more time to take into account the changes for planning purposes.

Second, the longer we wait, the harder the problem becomes to solve because of interest payments. If we wait, the debt will increase causing interest payments to take a larger share of the federal budget. That would necessitate larger, more painful changes than if the portion of the federal budget dedicated to interest payments remains stable.

Republicans are committed to reform. We will fight waste, fraud, and abuse in mandatory spending. We will work to reform the federal budget process to protect the taxpayer, curtailing the pro-spending bias of the current budget process. And we will work to modestly restrain the amount by which entitlement spending is projected to increase on an annual basis, which will have the cumulative effect of providing long-term solvency for these programs.