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before

Committee on the Budget
United States House of Representatives
February 15, 2006

Chairman Nussle, Ranking Member Spratt and members of the Committee, I am pleased to have the opportunity to discuss the topic of mandatory spending in the federal budget. In my remarks, I wish to make the following four points:

- Mandatory spending is currently two-thirds of federal spending, and will grow rapidly as the United States undergoes it demographic transition – especially outlays for Social Security, Medicare and Medicaid. These programs merit review and reform because:
    - The demographic shift is a permanent change in the landscape in which these programs operate;
    - Economic growth alone will not alleviate the burden of rising spending for these programs; and
    - The demographic shift has arrived, so efforts to control their growth should begin soon.

- The amount of spending is the best measure of the size of government. Having made the commitment to spend funds, this commitment must ultimately be paid for in higher taxes in either the present or the future.

- The size and growth of the U.S. economy is the central source of the international standing of the United States, its ability to project power and influence international affairs, and to provide for domestic priorities. A central question in the decades to come will be the size of the federal government and the degree to which its budgetary activities diminish the potential for private sector economic growth.

- There are several alternative strategies to controlling the growth of future outlays.
    - Fundamental reform on a program-by-program basis, such as reforms of Social Security or Medicare on a stand-alone basis;
    - Cross-cutting reforms of programs that have a common basis in demographic shifts; or
    - Incremental reform on a continual basis, such as would be accomplished by reconciliation instructions on an annual schedule.

Let me brief discuss each point in turn.

The Future Growth of Mandatory Spending

It is useful to begin with the spending outlook.[1] Left unaltered, over the next fifty years spending for Social Security will rise dramatically, increasing about 50 percent from its current level of just over four cents out of each national dollar. In the process, Social Security will be transformed from a cash cow that provides excess funds to the remainder of the Federal budget to a cash drain that will require annual infusions totaling over $300 billion (in today's dollars). The rise in Social Security spending is predictable – most of these recipients are already in the labor force – and results from the permanent shift to an older population that will accompany the retirement of the baby boom generation. After this shift is completed, scheduled Social Security benefits will be roughly 7 percent of GDP, and rise slowly as longevity increases in the future.

In contrast, spending on federal health programs, Medicare and Medicaid, will be driven not only by sure, steady annual aging, but also by health care spending that will outpace income growth. How fast will spending grow? Nobody can know for sure, but if the history of the past four decades repeats itself between now and 2050, Medicare and Medicaid spending will rise from a level comparable to Social Security (four cents out of each national dollar) to over 20 percent of national income. To put it another way, health programs alone will be as large as the entire current federal government. (Many believe this "just can't happen," but that raises the question of how spending growth will moderate.)

In any scenario, the demand for mandatory spending in Social Security and health programs swamps all projections of the future of the federal government. Fine-tuning the outlook for defense spending, international aid, education, worker-adjustment assistance and the myriad of other policy initiatives does not change the basics.

Measuring the Size of Government

The projected growth of spending is important. A good (if not perfect) measure of the "size of government" – the economic burden of a government's programs – is spending. Spending on government programs diverts resources from the private sector – from consumption or investment –to the use of government. If the transfer replaces private consumption with government consumption, then the costs are felt immediately as lower private consumption. If the impact is to "crowd out" private investment, then the cost is slower growth in productive capacity. This loss persists into the future, ultimately lowering consumption at some future time.

The means by which the federal government finances that spending – either via taxes or borrowing – is the mechanism by which the resources are taken from the private sector. But the key is not the particular mechanism that is used, but rather the fact that the decision to spend itself imposes the burden. Because the use of dollars for one purpose precludes their use for another, government spending always has a burden. When

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[1] This testimony draws heavily on the projections by the Congressional Budget Office contained in *The Long-Term Budget Outlook*, December 2005. All interpretation, however, is strictly my own.

Members are deciding whether to spend $1 billion for a federal program, they are choosing such a burden – even without a discussion about taxes. Unless other expenditures are reduced, current or future taxpayers will be required to pay more and give up their income to cover the costs.

The Importance of Supporting Economic Growth

The United States must meet enormous challenges to its security, strategic influence and international competitiveness. Over the past 100 years, annual growth of Gross Domestic Product has averaged 3.4 percent, a pace that has permitted the U.S. to become the dominant global economic power. The American economy serves as the well of resources to meet defense needs, international assistance, and other policy goals. Similarly, the ultimate purpose of U.S. economic competitiveness is to provide sustained increases in our citizens' standard of living.

How has the United States achieved this record? U.S. economic success is largely due to the strength of the private sector. The mirror image of reliance on private markets is commitment to a government sector that is relatively small (granted, "small" is in the eye of the beholder) and contained. Growth in spending of the magnitude promised by current laws guarantees a <u>much</u> larger government.

Second, the small U.S. government has been financed by taxes that are relatively low by international standards and interfere relatively little with economic performance (the same caveat applies to "low" and "little"). Spending increases of the type currently promised guarantee higher taxes and impaired economic growth.

Finally, a hallmark of the U.S. economy has been its ability to flexibly respond to new demands and disruptive shocks. In an environment where old-age programs consume nearly every budget dollar, to address other policy goals politicians may resort to mandates, regulations, and the type of economic handcuffs that guarantee lost flexibility. Why should the government book the costs of homeland security, or worker training, or new initiatives when it can demand that the private sector do it "free"?

Doing nothing is not an option. The United States is highly unlikely to "grow its way out" of the burden of the projected spending growth. To see this, consider the mix of budgetary and economic events necessary for "business as usual" to be sustainable (to maintain a steady ratio of federal debt to GDP) over the long term. First, assume that long-term productivity growth remains at the trend experienced in the past decade – a period of rapid productivity increase. Next, assume that the federal government collects roughly 18 cents on the national dollar in taxes – close to the postwar average. Third, permit Social Security outlays to grow as currently scheduled, but couple this with extreme discipline on discretionary spending and small mandatory programs – essentially frozen in real terms for the next five decades. Certainly, this sounds like a recipe for government of the same size as in the past. Will it work?

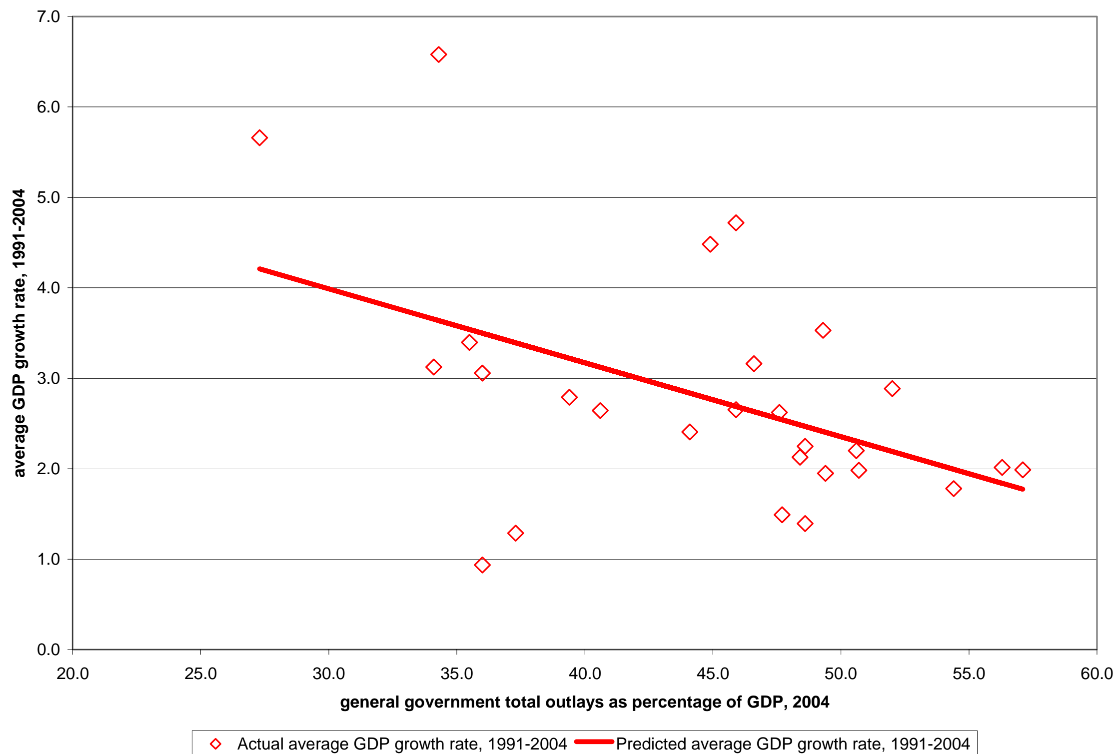
The key is the growth of health care outlays. If, but only if, health care spending per beneficiary grows no faster than income per capita, then outlays and taxes will balance sufficiently that sustained growth will keep the debt-to-GDP ratio stable. The bad news is that over the past four decades, spending per beneficiary has annually grown 2.5 percent faster than income per capita. Even a radical drop to spending that grows only 1 percent faster (or, equally miraculous, GDP growth that was 1.5 percent faster every year) leads to explosive debt growth.

In short, the key is not to count on economic growth to eliminate pressures from spending. Instead, the challenge is to control spending sufficiently to permit adequate long-term growth. The central economic impact of rapid spending growth is to further tilt the nation away from saving for the future. Retirement income and health programs are intended to ensure that beneficiaries can consume goods, services, and health care. Taxes (or their moral equivalent, federal borrowing) that finance federal spending do not undo the damage by offsetting the increased consumption. The net loss of savings, in turn, slows the accumulation of funds needed to finance the foundations of sustained growth: the innovation and deployment of new technologies, the acquisition of skills education and skills, and the purchase of new equipment, software, and structures. While the U.S. builds from a position of economic strength – its sustained productivity growth is the envy of other advanced economies – the imminent growth of spending is potentially a self-inflicted threat to this foundation.

An illustration of the potential impacts may be drawn from the experiences of the OECD countries. The figure below displays the relationship between the size of government and the average rate of growth in real GDP.[2] Not only is the relationship negative, the long-run impacts are quite significant. For example, raising the size of government by 10 percentage points – less than would be likely in the absence of changes in mandatory programs, would result in growth that is slower by 0.8 percentage points annually. Even such seemingly small changes accumulate over long periods of time. If growth was slower by 0.8 percentage points annually, standards of living in the United States would rise by 30 percent less than otherwise.

It is desirable to change course immediately. The sooner the 21st century old-age programs are finalized, the sooner workers can make sensible retirement plans, and the sooner the economy as a whole will begin to benefit. Perhaps most importantly, immediate reform recognizes the demographic foundations of the problem: spending will rise with the retirement of the baby boomers; reform must beat the boomers to the retirement finish line.

[2] I thank Michael Boskin at the Hoover Institution for these data and analyses.



Strategies for Controlling Mandatory Spending

Broadly speaking, there are three broad strategies – not mutually exclusive – for controlling the growth of mandatory spending. The first is to undertake fundament reform on a program-by-program basis. That is, one could undertake separate reforms of Social Security, Medicare, Medicaid, and other mandatory spending programs. If so, there is a strong argument to begin with Social Security.

The underpinnings of growth in Social Security outlays are well-understood. Moreover, there exist a wide variety of modifications to the basic program – increases in the normal and early retirement age, changes in the indexation of initial benefit awards, changes to the cost-of-living indexation during retirement, altering benefits to reflect longevity, and others – that would slow the growth of outlays. If undertaken quickly, such changes would resolve uncertainty about the future of the program, thereby benefiting workers in planning their retirement. Moreover, such changes would also likely raise household saving, especially if coupled with explicit pre-funding of future benefits, and provide a direct benefit to the accumulation of capital in the United States.

In contrast, the growth in Medicare and Medicaid is largely driven by underlying trends in health spending, and these are less well understood. The key requires not only slowing the growth of outlays, but making sure that we get quality for each dollar of spending. Given the scale of the challenge, it is likely that there is no single reform needed, but

rather a long series of adjustments to ensure that the United States does not overspend on health care.

A second strategy would recognize that the problems of retirement income (Social Security), old-age health care (Medicare) and long-term care services (Medicaid) share a common demographic basis. Moreover, there is little to distinguish between home-based care services and either some outpatient health therapies, or the spending of retirement income to maintain a desired lifestyle. In short, there may be merit to rethinking these programs from the perspective of ensuring an adequate accumulation and foundation for old-age requirements in all three areas.

Finally, it may be the case that mandatory spending in these areas requires continual adjustments. One way to undertake such controls is through proactive, regular implementation of the reconciliation process. However, it may be desirable to augment such procedures by augmenting the budget process with indicators of the need for such efforts. For example, in the current Medicare program, physician payments are governed by the Sustainable Growth Rate (SGR) mechanism, which limits cumulative payments. In the absence of changes by the Congress, the SGR automatically reduces payments and lowers the growth of spending.

A broader set of SGR-like mechanisms could be used to set a "baseline" level of mandatory spending growth – say at the rate of GDP growth. To permit faster-than-GDP growth, the budget resolution could specify allocations for authorizing committees that open the possibility of greater program expansion. In their absence, however, spending would have to be controlled to stay at the sustainable rate.

An alternative approach is the use of triggering mechanisms to specify cuts – perhaps unpalatable cuts – automatically and thereby induce action to change mandatory programs. An example is the Administration's recent proposal for automatic reductions in Medicare if the program requires greater than 45 percent in general revenue.

Conclusion

To summarize, controlling the future growth of mandatory spending – especially that in old-age programs – is central to controlling the size of the federal government, fostering future economic growth, and maintaining a sustainable fiscal policy. Thank you for the opportunity to appear today, and I look forward to your questions.