

**Testimony by Kent Smetters for the Committee on the Budget of The U. S. House of Representatives. Submitted on February 14, 2005, for hearing on February 17, 2005,**

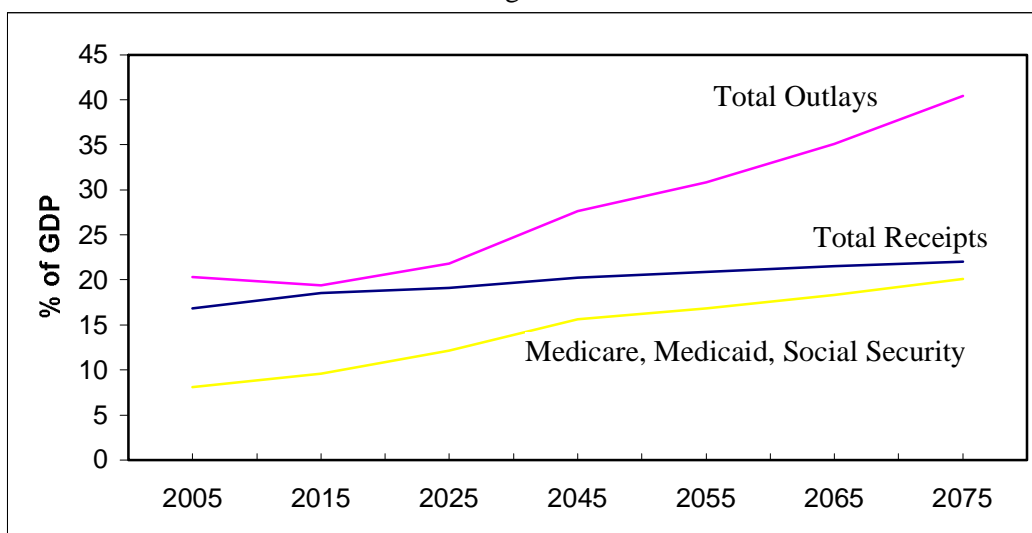
Thank you, Chairman Nussle, and members of the Committee for the opportunity to speak on the challenges in meeting the nation's future obligations in its domestic entitlement programs. While these programs provide vital resources to many American households, these programs also face enormous financial shortfalls during the next several decades.

The purpose of this testimony is three fold. First, it documents the looming financial problems in the nation's entitlement programs. Second, it demonstrates how the current federal budget framework encourages the U.S. Congress to promise more in the form of future entitlement spending than can actually be afforded; conversely, the federal budget makes it difficult to reduce these unfunded obligations. Third, this testimony shows how various budget frameworks and rules are ineffective at controlling entitlement spending. A new framework is then recommended.

*Entitlement Spending Dominates the Budget Landscape*

As you can see from Figure 1 (also see Table 1 in Appendix) that is based on the President's 2006 Budget, the nation's largest three entitlement programs – Medicare, Social Security, and Medicaid – will grow rapidly over time and absorb almost all projected federal revenue within the lifetime of young people alive today. Medicare represents the largest problem at the federal level, followed by Social Security and then Medicaid. However, unlike the other two, Medicaid is shared between the federal government and the states, and represents a growing problem at the state level.

Figure 1



Source: The Presidents 2006 Budget, Analytical Perspectives, p. 209; also see Table 1 in Appendix

Figure 1 is, in fact, fairly optimistic for several reasons. First, it assumes no fix of the Alternative Minimum Tax (AMT). The AMT will continue to tax an increasing number of households over time since the AMT's thresholds are not indexed to prices. Second, consistent with the Medicare Trustees' assumptions, these calculations assume that health care costs in the future grow at a much

slower rate than they have in the past. Third, these calculations don't show the shortfalls after 2075; these financial problems do not *subside* after the baby boomers generation passes on.

Table 2 in the Appendix presents an alternative perspective that shows the *present value* of all future cash flow deficits for the government as a whole as well as specifically for the Social Security and Medicare programs. Future cash flow deficits are discounted -- that is, reduced -- by the government's borrowing rate in order to demonstrate the amount of money needed *today* (if invested with interest) that would place government policy on a sustainable course. For 2005, the federal government currently faces a present value imbalance equal to about \$65 trillion, of which Medicare alone contributes \$63 trillion. The new prescription drug benefit alone costs about \$17 trillion.

This \$65 trillion imbalance is about \$20 trillion more than the value of all U.S. corporations, homes, and land in the United States. This imbalance could, in theory, be eliminated by increasing uncapped (HI) payroll taxes immediately and permanently by an additional 22.4 percentage points, thereby more than doubling the current employer and employee combined payroll tax of 15.4 percent. Of course, such a policy would first send the U.S. economy into a tailspin and collect little revenue. Instead, the growth of entitlement spending must be controlled in order to avoid economic collapse.

Delaying action will place an even larger burden on the economy. Table 2 shows that in 2010, or just 5 years from now, the nation's present value imbalance will increase to over \$79 trillion if no action is taken. Such an imbalance could, in theory, be eliminated by increasing *uncapped* (HI) payroll taxes *immediately* and *permanently* by an *additional 23.9 percentage points*. In other words, the required payroll tax increase would increase by 1.5 percent points in just 5 years if no action is taken. Clearly, quick action is needed to avoid a disintegration of the standard of living in the United States.

### *Budget Horizons*

Why do we face such a large shortfalls today? The answer is very straightforward: The current federal budget framework encourages policymakers to over-commit to future entitlement spending because the true long-term costs are not properly tracked in the budget.

The standard five-year or 10-year projection window, in particular, substantially underestimates the costs of entitlement programs. For example, before Medicare Part D (prescription drugs) was passed by Congress toward the end of 2003, it was scored as having a 10-year cost of \$400 billion between 2004 and 2013. Controversy erupted when it was learned, after the bill was signed into law, that the cost would be closer to \$535 over this same time period. Today, the cost of Part D is estimated to equal \$724 billion over the 10-year period between 2006 and 2015, assuming that the cost savings assumed in the score actually materializes. Virtually all of the increase in cost of Medicare Part D, from \$535B to \$724B, comes from simply shifting the 10-year window to include 2014 and 2015.

In their annual reports, the Social Security and Medicare Trustees have traditionally focused on the "actuarial deficit" that includes the present value of the program's shortfall over the subsequent 75 years. While 75 years might seem like a long projection window, it is also inadequate:

"Doing the calculations for a 75-year horizon understates the deficiencies, because the 75-year actuarial calculations omit the large deficits that continue to occur beyond the 75<sup>th</sup>

year. The understatement is significant, even though values in the distant future are discounted by a large amount.” (President’s 2006 Budget, *Analytical Perspectives*, p. 217)

For example, the 1983 Social Security reforms were designed to eliminate Social Security's shortfall over the subsequent 75 years, that is, until 2057. Today, only 22 years later, Social Security faces another multi-trillion dollar deficit calculated over 75 years, that is, until 2079. Over 60% of the Social Security shortfall we see today consists simply of moving the 75-year window to include the new cash flow deficits in the years between 2057 and 2079. The “moving-window problem” is even worse today. If a reform today balanced Social Security for just 75 years, then in just two decades, the new 75-year imbalance would equal the 75-year shortfall that we face today. In other words, attempting to balance Social Security for 75 years only provides about 20 years of actual progress.

In response to this problem, Social Security’s chief actuary, when scoring a proposed piece of legislation, will often determine whether it will allow the Social Security program to become “sustainably solvent.” In particular, he determines whether a proposed legislation eliminates the 75-year imbalance *and* produces time path of values for the Social Security trust fund that is increasing toward the end of the 75-year window. The critical assumption is that the trust fund will continue to increase in value after the 75<sup>th</sup> year. This joint criterion, though, has two problems. First, it cannot be used for programs like Medicare that are not self-financing. Second, the joint criterion is easy to “game” with a vast array of different policy reforms that produce additional revenue inside of the 75-year window but require larger outlays after the 75<sup>th</sup> year, e.g., increasing Social Security’s maximum taxable earnings. In other words, the assumption that the trust fund continues to increase after year 75 simply because it is increasing before year 75 is often incorrect.

### *Reforming the Budget Framework*

A new federal budget framework, therefore, is needed that includes the present value of all future federal sources of revenues and outlays, and not just over a limited time horizon. Table 2 provides a summary of a new federal budget framework that accurately includes the present value of all of the federal government’s sources of revenues and outlays into the indefinite future, thereby removing any incentive to over-commit.<sup>1</sup> Table 2 is decomposed into the major spending categories, including Medicare, Social Security, and the Rest of Government. Additional details could also be provided within this framework. For example, the present value of Medicaid’s shortfalls and defense spending could be listed under “Fiscal Imbalance in the Rest of Federal Government.”

For the major entitlement programs, Table 2 also decomposes the present value shortfalls in Medicare and Social Security into the present value of overspending on *past and living* generations (those age 15 and over as well as the deceased) and the present value of overspending on *current and future* generations (those age 14 and younger as well as the unborn). This generational decomposition is important because major entitlement programs are mostly financed on a pay-as-you-go basis where taxes on workers are distributed almost immediately as benefits to retirees. Currently, Medicare and Social Security face shortfalls because future tax revenue doesn’t equal outlays in present value.

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<sup>1</sup> See Jagadeesh Gokhale and Kent Smetters (2003), *Generational and Fiscal Imbalances*, AEI, 2003, updated in Gokhale and Smetters (2005), “Measuring Social Security’s Financial Problems,” NBER Working Paper #11060. These calculations are based on the President’s 2005 FY Budget assumptions and are currently being updating for the 2006 FY.

An entitlement program that is financed on a *strict* pay-as-you-go basis would not produce cash flow deficits and, hence, would not lead to present value imbalances. Nonetheless, it would transfer considerable wealth between generations. The reason is that retirees and near-retirees alive at the time that this policy is enacted are given resources for which they paid little or nothing during their working years. These resources are paid for by younger workers and future generations who must pay additional taxes instead of investing their money and earning investment income. The generational decomposition shown in Table 2 would indicate this transfer.<sup>2</sup>

These types of new measures have been recently included in their annual reports by the Social Security and Medicare Trustees for those specific programs. The Social Security Trustees began reporting Social Security's present value imbalance, along with its breakdown between generations, in its 2003 Report, and continued with its 2004 Report. A technical panel composed of leading economists and actuaries who were appointed by the independent, bipartisan Social Security Advisory Board "strongly endorsed" the inclusion of these newer measures.<sup>3</sup> The Medicare Trustees began including these measures in their 2004 Report.

Present value projections of the type shown in Table 2 have sometimes been criticized as being "sensitive" to the underlying demographic and economic assumptions. While it is true that the *dollar* value of these imbalances are sensitive to different assumptions, the values of the imbalances *relative* to the present value of tax receipts or outlays is generally not that sensitive, since both the numerator and denominator move in similar directions.<sup>4</sup> In other words, the size of the *policy reform* that is needed to balance entitlement programs is not very sensitive to the key underlying assumptions.

### *Current Reform Proposals*

The President's 2006 Budget proposes the reenactment of various pay-as-you-go rules on mandatory spending that were formerly in the Budget Enforcement Act, "except that it does not apply to tax legislation. It also does not permit mandatory spending increases to be offset by tax increases." (President's 2006 Budget, *Analytical Perspectives*, p. 238). It is unclear whether Congress will impose this set of asymmetric constraints on future budget authority. Without these asymmetric constraints, however, the pay-as-you-go requirement would still allow pay-as-you-go entitlement programs to transfer large sums of resources from workers and future generations toward retirees. The pay-as-you-go rule would also prevent positive reforms to entitlement programs that required an upfront investment but produced long-run reductions in unfunded obligations in present value.

The President's 2006 Budget also proposes "new measures to prevent enactment of legislation that worsens the long-term unfunded obligations of Federal entitlement programs." (President's 2006 Budget, *Analytical Perspectives*, p. 240). The Budget does not explicitly define these measures but its own analysis suggests something close to Table 2. However, the Budget's focus on just *entitlement*

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<sup>2</sup> Similarly, a tax cut in the short term that is financed by an equal present value tax increase in the long term would also change the generational decomposition.

<sup>3</sup> 2003 Technical Panel on Assumptions and Methods, Social Security Advisory Board [available at: <http://www.ssab.gov/NEW/documents/2003TechnicalPanelRept.pdf>, check on 2/13/05]

<sup>4</sup> See Gokhale and Smetters (2003), op cited. One exception is the assumed growth rate in health care spending relative to GDP. Following the Medicare Trustees, we used very optimistic projections over the first 75 years (1% over GDP); after year 75, we made the even more optimistic assumption of identical growth with GDP. Despite these optimistic assumptions, Medicare still faces a very large present value imbalance.

*programs* could allow for some “gaming” vis-à-vis general revenue transfers *unless* those transfers are explicitly excluded when calculating the entitlement program’s present value imbalance, as in Table 2. Senator Joe Lieberman introduced the Honest Government Accounting Act of 2003 (S. 1915) into the 108<sup>th</sup> Congress (1<sup>st</sup> Session) that would help ensure that the government fully accounts for its explicit debt and implicit unfunded obligations. It deserves careful study.

#### *Federal Programs with Contingent Liabilities*

Although my invitation letter asked me to testify before the Committee on my views “on our challenges in meeting the obligations of domestic entitlement programs,” let me close with a few words about the budgetary treatment of several federal programs with contingent liabilities that represent a non-trivial risk to the budget, including the Pension Benefit Guarantee Corporation (PBGC) and the Terrorism and Risk Insurance Act of 2002 (TRIA). Currently, the PBGC has about \$39 billion in assets and so it can meet its obligations for several years. But the PBGC also has about \$62 billion in liabilities and so it will face large funding shortfalls in the future.<sup>5</sup> The Administration has proposed a set of new reforms that will reduce the PBGC’s likely shortfall, but risks still remain. TRIA exposes the federal government to \$100 billion in possible losses after a terrorist act. The fair market values of neither of these contingent liabilities appear in the President’s budget.<sup>6</sup> Instead, these programs, along with other federal programs such as the FDIC, are treated on a cash flow basis. In fact, quite perversely, premium income collected by the PBGC and FDIC often appears to provide revenue.

Under The 1990 Credit Reform Act, the cost of direct loans and loan guarantees must be recorded in the Budget. This cost is calculated as the present value of all cash flows over the life of the loan, discounted using the interest rates on Treasury securities of the same maturity. This Act, for example, covers the federal government’s student loan program but does not cover the contingent liabilities noted above. While Credit Reform was a step in the right direction, it still falls short because the true economic costs of the loans and loan guarantees, as reflected in the values that the market would place on the underlying risks, are not incorporated.

Options pricing and other pricing techniques should be used to determine the market value for the contingent liabilities in the PBGC, TRIA, and FDIC program as well as for the programs covered under Credit Reform. A “zero” cost (or, in some cases, a *negative* cost) -- which is currently assumed in the Budget for many of these program – currently encourages policymakers to create seemingly “free” contingent liabilities.<sup>7</sup> Requiring that the market values of these programs be included in the budget would remove this bias.

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Mr. Chairman, thank you again for the opportunity to share my views with you and the Committee.

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<sup>5</sup> President’s 2006 Budget, Analytical Perspectives, p. 104.

<sup>6</sup> Currently, the CBO includes an estimate for TRIA in its baseline but OMB does not.

<sup>7</sup> See, for example, CBO, “Estimating the Value of Subsidies for Federal Loans and Loan Guarantees,” August 2004.

**Table 1: Long-Run Federal Budget Range Estimates (As a Percent of GDP)**

Fiscal Years		2005	2015	2025	2045	2055	2065	2075
<b>Receipts</b>		16.8	18.5	19.1	20.2	20.9	21.5	22.0
<b>Outlays</b>		20.3	19.4	21.8	27.6	30.8	35.1	40.4
<b>Discretionary</b>		7.9	5.9	5.9	5.9	5.9	5.9	5.9
<b>Mandatory</b>		10.9	11.6	13.8	16.9	18.0	19.5	21.2
Social Security		4.2	4.4	5.4	6.0	6.1	6.2	6.4
Medicare		2.4	3.3	4.6	7.0	7.9	9.1	10.4
Medicaid		1.5	1.9	2.1	2.6	2.8	3.0	3.3
Other		2.8	2.0	1.7	1.3	1.2	1.1	1.0
<b>Net Interest</b>		1.5	1.9	2.0	4.8	6.9	9.7	13.3
<b>Surplus or Deficit (-)</b>		-3.5	-0.9	-2.7	-7.4	-10.0	-13.6	-18.4

Source: The Presidents 2006 Budget, Analytical Perspectives, p. 209

**Table 2: Fiscal and Generational Imbalances at End of the Year Shown (billions of constant 2004 dollars)\***

<b>Fiscal Years</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>
<b>Total Fiscal Imbalance--U.S. Federal Government</b>	<b>63,220</b>	<b>65,861</b>	<b>68,564</b>	<b>71,245</b>	<b>73,893</b>	<b>76,570</b>	<b>79,337</b>
Social Security	8,006	8,352	8,710	9,067	9,423	9,784	10,158
Medicare	60,822	63,315	65,805	68,249	70,641	73,044	75,518
Rest of Federal Government	-5,608	-5,805	-5,951	-6,071	-6,171	-6,258	-6,339
<b>Fiscal Imbalance in Social Security</b>	<b>8,006</b>	<b>8,352</b>	<b>8,710</b>	<b>9,067</b>	<b>9,423</b>	<b>9,784</b>	<b>10,158</b>
<b>Future Benefits less Taxes, those age 15 and over (and deceased)</b>	<b>9,549</b>	<b>9,899</b>	<b>10,256</b>	<b>10,610</b>	<b>10,958</b>	<b>11,311</b>	<b>11,676</b>
Future Net Benefits of Living Generations	11,182	11,686	12,205	12,729	13,255	13,787	14,338
Trust Fund	-1,634	-1,787	-1,949	-2,120	-2,297	-2,476	-2,662
<b>Future Benefits less Taxes, those age 14 and below (and unborn)</b>	<b>-1,543</b>	<b>-1,547</b>	<b>-1,547</b>	<b>-1,543</b>	<b>-1,535</b>	<b>-1,527</b>	<b>-1,518</b>
<b>Fiscal Imbalance in Medicare</b>	<b>60,822</b>	<b>63,315</b>	<b>65,805</b>	<b>68,249</b>	<b>70,641</b>	<b>73,044</b>	<b>75,518</b>
<b>Future Benefits less Taxes and Premiums, age 15+ (+ deceased)</b>	<b>24,094</b>	<b>25,430</b>	<b>26,777</b>	<b>28,130</b>	<b>29,483</b>	<b>30,860</b>	<b>32,287</b>
Future Net Benefits of Living Generations	24,375	25,725	27,097	28,465	29,834	31,226	32,668
Trust Fund	-282	-295	-320	-335	-350	-366	-381
<b>Future Benefits less Taxes and Premiums, age 14- (+ unborn)</b>	<b>36,728</b>	<b>37,885</b>	<b>39,028</b>	<b>40,118</b>	<b>41,158</b>	<b>42,184</b>	<b>43,231</b>
<b>Fiscal Imbalance in the Rest of Federal Government</b>	<b>-5,608</b>	<b>-5,805</b>	<b>-5,951</b>	<b>-6,071</b>	<b>-6,171</b>	<b>-6,258</b>	<b>-6,339</b>
Future Outlays	81,323	83,402	85,537	87,576	89,492	91,375	93,304
Future Revenues	-93,266	-96,013	-98,675	-101,168	-103,500	-105,770	-108,055
Living Generations	-34,939	-36,156	-37,325	-38,417	-39,431	-40,405	-41,364
Future Generations	-58,327	-59,857	-61,350	-62,751	-64,069	-65,365	-66,691
<b>Excess Future Outlays Over Revenues</b>	<b>-11,943</b>	<b>-12,611</b>	<b>-13,138</b>	<b>-13,591</b>	<b>-14,008</b>	<b>-14,395</b>	<b>-14,751</b>
<b>Liabilities to Social Security and Medicare Trust Funds</b>	<b>1,915</b>	<b>2,082</b>	<b>2,269</b>	<b>2,454</b>	<b>2,648</b>	<b>2,842</b>	<b>3,043</b>
<b>Debt Held by the Public</b>	<b>4,421</b>	<b>4,724</b>	<b>4,918</b>	<b>5,066</b>	<b>5,190</b>	<b>5,294</b>	<b>5,368</b>

**MEMO Items:**

**Present value of GDP**

762,921 772,260 790,733 812,819 834,656 855,240 874,525

**Present Value of uncapped Payroll**

291,063 294,436 301,354 309,630 317,783 325,432 332,577

\* Positive numbers add to the imbalance and negative numbers reduce it.

Source: Gokhale and Smetters (2005), "Measuring Social Security's Financial Problems" NBER Working Paper #11060, 2005.

Based on FY2005 budget information obtained from the Office of Management and Budget and calculated under OMB economic assumptions.