A series of memos to President-elect Obama identifying policy areas where his words line up with our vision.

No. 18
January 13, 2009

How to Reform Entitlement Spending

A Memo to President-elect Obama

Brian M. Riedl and Alison Acosta Fraser

CHANGE *We* BELIEVE IN

ENTITLEMENTS
Entitlements are one of the greatest domestic challenges the nation faces.

*This product is part of the Entitlements Initiative, one of 10 transformational initiatives in our **Leadership for America** campaign.*

The Heritage Foundation
LEADERSHIP FOR AMERICA
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

We've got 78 million baby boomers who are going to be retiring over the next couple of decades. That means more retirees, fewer workers to support those retirees. It is common sense that we are going to have to do something about it. That is not a Republican talking point. And if we don't deal with it now, it will get harder to deal with later…. [W]e are still going to have an actuarial gap that has to be dealt with. It is not going to vanish and if we have a moral responsibility to the next generation to make sure that Social Security is there, the most successful program to lift seniors out of poverty that we've ever devised, then we need to start acting now and having a serious conversation about it.

—Barack Obama, Democratic presidential debate, October 30, 2007[1]

Well, Tom, we're going to have to take on entitlements, and I think we've got to do it quickly. We're going to have a lot of work to do, so I can't guarantee that we're going to do it in the next two years, but I'd like to do it in my first term as president.

—Barack Obama, Townhall Presidential Candidates Debate, October 7, 2008[2]

PRESIDENT-ELECT OBAMA, you based much of your presidential campaign on the promise of a better future for all Americans. A better future must be one in which Americans have the financial freedom to provide for themselves and their families. Yet this future is currently endangered by a Social Security, Medicare, and Medicaid system that is set to drown future generations in taxes and debt. Reforming these programs will be one of the greatest economic challenges of the 21st century.

In the coming decades, the cost of these three programs will leap from 8.4 percent to 18.6 percent of gross domestic product (GDP)—an increase of 10.2 percent. Without reform, this increased cost would require either raising taxes by the current equivalent of $12,072 per household or eliminating every other government program. Funding all of the promised benefits with income taxes would require raising the 35 percent income tax bracket to at least 77 percent and raising the 25 percent tax bracket to at least 55 percent.[3]

You know that the current system is unsustainable. With the cost of reform growing $1 trillion more expensive annually, there is no time for delay. Furthermore, many believe that Americans ages 55 and over should be exempt from any reforms. One-third of all baby boomers have already crossed that threshold, and at 4 million per year, all of them will have crossed it by 2019.

Entitlement reform is more than just an economic issue. Americans need to decide whether they want a future in which older Americans have an automatic claim on one-fifth of the future income of their grandchildren, who will be raising their own children and paying off their home mortgages. Under the current system, retirees will spend one-third of their adult lives in taxpayer-funded retirement while national security, education, health research, and antipoverty programs fight for the few remaining tax dollars and low taxes are threatened. Modernizing Social Security, Medicare, and Medicaid can provide a healthy retirement for those in need while also protecting future taxpayers.

The following guidelines can help you fulfill your pledge of entitlement reform.

- **Disclose the government's long-term obligations.** Though Social Security and Medicare currently comprise about one-third of the entire federal budget, Congress is not required to pass an annual budget for either program. Rather, both operate on autopilot under formulas contained in their governing laws. Moreover, the tendency of politicians to make promises to expand or enact new benefits is greatly enhanced by the lack of any measure of long-term costs of these programs in the budget. Two changes should be made in the budget process to ensure better stewardship for the nation's long-term solvency.[4]

  1. You should ensure that the long-term costs of entitlement programs are built into the budget process and considered along with other priorities during the annual budget process so that spending on Medicare would be considered in the same context as defense, education, or tax policy.
  2. Any changes in entitlement programs should also be measured over the long term.

  Bringing long-term costs into the legislative debate will mean that, unlike today, Congress must consider whether children and grandchildren can really afford to pay for new benefits for their parents and grandparents.

- **Put Social Security, Medicare, and Medicaid on long-term budgets.** Discretionary programs are forced to justify themselves annually though the budget process. By contrast, entitlement programs—including Social Security, Medicare, Medicaid, most antipoverty programs, farm subsidies, and refundable tax credits—are effectively on autopilot. Their budgets grow automatically each year without going through the regular budget process, being examined, or being forced to justify—or even constrain—their growth. Smaller entitlement programs are examined only once or twice per decade when they are reauthorized. Large entitlement programs are not required to be reauthorized

1. Transcript, "The Democratic Debate on MSNBC," October 30, 2007, at *http://www.nytimes.com/2007/10/30/us/politics/30debate-transcript.html?_r=1&pagewanted=print* (January 12, 2009).
2. Transcript, "MSNBC 'Townhall Presidential Candidates Debate,'" at *http://www.votesmart.org/speech_detail.php?sc_id=416929&keyword=&phrase=&contain=* (January 12, 2009).
3. Brian M. Riedl, "A Guide to Fixing Social Security, Medicare, and Medicaid," Heritage Foundation *Backgrounder* No. 2114, March 11, 2008, at *http://www.heritage.org/Research/Budget/bg2114.cfm*.
4. This section is largely excerpted from Robert E. Moffit and Alison Acosta Fraser, "Congress Must Pull the Trigger to Contain Medicare Spending," Heritage Foundation *WebMemo* No. 1796, February 4, 2008, at *http://www.heritage.org/Research/Budget/wm1796.cfm*.

or re-examined and are thus not subject to budgetary trade-offs. This is not a formula for sound budgeting.

You should call on Congress to create a framework for a budget that would be evaluated periodically to ensure that entitlement programs are sustainable over the long term. This could be done by creating a long-term budget window—for example, 30 years. All spending on entitlements would have to be reviewed and reauthorized every five years. This is similar to how other countries manage their long-term commitments. Congress should include "triggers" that would make automatic adjustments should spending grow above budgeted levels. One way to keep spending within budgeted levels would be to raise premiums, deductibles, and out-of-pocket expenses for Medicare Part B and Part D *automatically* for middle- and upper-income retirees.[5]

- **Create a commission to submit recommendations to Congress for a vote.** A promising bipartisan approach to entitlement reform already exists. The SAFE Commission Act, authored in the House by Representatives Frank Wolf (R–VA) and Jim Cooper (D–TN), would create a bipartisan commission intended to address the "unsustainable imbalance" between federal commitments and revenues while increasing national savings and making the budget process give greater emphasis to long-term fiscal issues. While the commission could consider a range of approaches, the bill places emphasis on two:

1. Reforms that would limit the growth of entitlements while strengthening the safety net and
2. Tax reforms that would make the tax system more economically efficient and improve economic growth.

The commission would hold public hearings around the country to discuss the long-term fiscal problem, and its recommendations would receive "fast-track" consideration by Congress.[6]

Senate Budget Committee Chairman Kent Conrad (D–ND) and ranking Republican Senator Judd Gregg (R–NH) have also introduced commission legislation. Such an approach can break the political logjam by requiring that Congress craft entitlement reform proposals and vote on them as well.

- **Create incentives for savings.** Social Security and Medicare were intended originally to supplement the savings that Americans build up over their lifetimes. However, too many retirees have not saved adequately and are wholly dependent on Social Security and Medicare to fund their entire retirement.

You have spoken positively of "automatic IRAs" for American employees not covered by employer-sponsored retirement plans. Such employees could direct payroll deposits to a low-cost, diversified individual retirement account that would continue automatically—an opportunity now limited mostly to 401(k)-eligible workers. To maximize participation, employers would be encouraged to use automatic enrollment, whereby employees automatically participate at a statutorily specified rate of contribution unless they opt out.[7]

Auto-IRAs are a terrific way to increase savings and thus empower Americans to build their own retirement savings. Lowering tax rates on savings would also help Americans to build wealth.

- **Do not increase taxes.** During the presidential campaign, you floated the idea of reforming Social Security by assessing a payroll tax of 2 to 4 percentage points on those who earn over $250,000 annually. President Bill Clinton rejected this idea in the 1990s, and you should as well. In addition to closing only a small percentage of the long-term Social Security shortfall, this policy would reduce economic growth by reducing incentives to work, save, and invest.

America cannot tax its way out of this entitlement challenge. The problem is caused by surging spending

5. This section is largely excerpted from Moffit and Fraser, "Congress Must Pull the Trigger to Contain Medicare Spending."

6. This section is excerpted from Stuart M. Butler, "The Wolf SAFE Commission Act: A Chance to Get the Budget Back on Track," Heritage Foundation *WebMemo* No. 1162, July 14, 2006, at *http://www.heritage.org/Research/Budget/wm1162.cfm*.

7. See J. Mark Iwry and David C. John, "Pursuing Universal Retirement Security Through Automatic IRAs," Heritage Foundation *White Paper* No. 02122006, February 12, 2008, at *http://www.heritage.org/Research/SocialSecurity/wp20060212.cfm*.

levels, not declining revenues—in fact, taxes as a percentage of the economy are already projected to rise to record levels over the next few decades.[8]

Furthermore, it is not clear why drowning future generations in higher taxes is any better than the status-quo approach of drowning them in debt. Any new tax revenues would go into the general pot of revenues, which Congress would likely allocate to business-as-usual government spending rather than shoring up entitlement programs. Better to focus on the real problem of skyrocketing entitlement costs.

- **Reform Social Security.** Social Security spending is projected to increase from its current 4.3 percent of GDP to 6.1 percent by 2050—an increase of 1.8 percent. Today, a spending increase of 1.8 percent of GDP would equal $246 billion, or $2,130 per household. Of this spending hike, 55 percent would result from demographic changes, and 45 percent would result from higher benefit levels.[9]

Your options for preserving Social Security's solvency are relatively straightforward. Rather than dumping large debt or tax increases on the next generation, several feasible options exist to restrain program costs. One option is to raise the retirement age (currently set to rise to 67 by 2030) by two months each year until it reaches 70, which would allow future seniors an average retirement of 17 years.

A second option would income-adjust benefits to target needy seniors more effectively. You can accomplish this through "progressive indexing," which would index initial benefit levels for middle-income and upper-income families partially to price inflation rather than wage growth, eliminating much of the increased Social Security costs driven by higher benefits. This would also allow for more benefit growth among lower-income retirees.

Finally, many economists believe that the most used consumer price index overstates inflation. Aligning Social Security's inflation adjustment with a more accurate price index would save money while still providing inflation protection.

In the long run, a more generationally equitable system would add a personal savings element to Social Security. While personal accounts by themselves do not reduce the taxpayer liabilities to current seniors, the long-term investment growth of a balanced portfolio would enable workers to do much better than they can under today's system. In addition, workers would be able to own their accounts, which could be passed on to their families in the event of their untimely death.

Millions of Americans with 401(k) plans and IRAs already understand how long-term investments can grow over several decades. Even with the recent market carnage, once investments return to their historical earnings level, workers will be able to recoup their losses in less than two years and again build their investments. Further, new savings instruments greatly reduce the risk that older savers will lose money close to their retirement.

- **Reform Medicare.** Medicare costs are projected to more than triple from today's 2.7 percent of GDP to 9.4 percent by 2050. In current terms, a cost increase of 6.7 percent of GDP would equal $916 billion, or $7,930 per household annually[10]

Medicare reform is very complex. While Social Security transfers income from one group to another and therefore can be fixed with formula changes, fixing Medicare is more difficult because it is a major part of the health care economy. Thus far, reforms have centered on reducing payment rates to doctors and hospitals, but payment rates are already well below market prices. This amounts to rationing health care, which may reduce costs but will not advance better care or encourage more rational decisions.

Some reforms, which could be made quickly, would significantly rein in Medicare costs. One new approach

8. Calculated using Congressional Budget Office, "The Long-Term Budget Outlook," December 2007, pp. 44–46, at *www.cbo.gov/ftpdocs/88xx/doc8877/12-13-LTBO.pdf* (January 12, 2009).

9. For additional information on Social Security, Medicare, and Medicaid reform, see Riedl, "A Guide to Fixing Social Security, Medicare, and Medicaid."

10. Even this projection assumes that per capita Medicare costs will grow only about 1 percentage point faster than GDP, even though Medicare costs have grown an annual average of 2.4 percentage points faster than GDP since the 1970s. If this trend continues, actual Medicare costs through 2050 could be double the current projection.

would be to reduce the massive Part B and Part D subsidies for upper-income families. These programs are not social insurance: Enrollees did not earn their benefits with payroll taxes. Rather, they are large subsidies from taxpayers. Part B recently began modest income-relating. President George W. Bush has proposed larger means-testing of Parts B and D.

Your long-term reforms should bring more choice and competition to health care, such as moving Medicare from a defined-benefit system to a defined-contribution system. The Federal Employees Health Benefits Program (FEHBP) has held down costs by creating a voucher-type system for federal employees to purchase coverage from competing health plans that offer differing coverage and costs.[11] By creating more choice and competition, the FEHBP has held down cost increases and may serve as a model for Medicare reform.

- **Reform Medicaid.** Federal Medicaid spending is projected to jump from 1.4 percent of GDP to 3.1 percent by 2050. Today, a 1.7 percent of GDP spending hike would equal $232 billion, or $2,012 per household. Most of this spending growth will come from senior citizens, whose long-term care costs are not covered by Medicare.

Two other factors will also drive up Medicaid costs: inflation of health care costs and the funding structure, which encourages states to overspend on Medicaid. Because Washington reimburses states for 57 percent of all costs, every dollar that a state spends on Medicaid guarantees an additional $1.33 grant from Washington. Consequently, states have a stronger incentive to allocate their budgets to expand Medicaid benefits and eligibility levels rather than to provide tax relief or education, regardless of the state's actual needs.

Converting Medicaid into a block grant to states would eliminate state incentives to overspend on Medicaid. Additionally, giving states more flexibility to craft different Medicaid packages for different individuals based on their unique personal circumstances could save money while improving service delivery.[12] State incentives to help individuals purchase long-term care insurance could also substantially reduce Medicaid's burden insofar as these expenses are concerned.

Conclusion

You have asserted a "moral responsibility" to reform entitlements. Unless Social Security, Medicare, and Medicaid are reformed, America faces a future of soaring taxes and government spending that will cause poor economic performance. Americans will pay onerous taxes, and future generations will have lower living standards than Americans enjoy today.

Delay only makes the necessary reforms more painful. It is vitally important to take up this challenge and make entitlement reform a top priority.

11. Robert E. Moffit, "Lessons of Success: What Congress Can Learn from the Federal Employees Program," Heritage Foundation *WebMemo* No. 565, September 14, 2004, at *www.heritage.org/Research/HealthCare/wm565.cfm*.

12. See John S. O'Shea, "More Medicaid Means Less Quality Health Care," Heritage Foundation *WebMemo* No. 1402, March 21, 2007, at *www.heritage.org/Research/HealthCare/wm1402.cfm*.

Brian M. Riedl is Grover M. Hermann Fellow in Federal Budgetary Affairs in, and **Alison Acosta Fraser** is Director of, the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.

This paper is also available online at:
www.heritage.org/Research/Budget/sr43.cfm