THE CHANGING NATURE OF THE LONG-RUN BUDGET PROBLEM

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Although recent performance and the short-term outlook for the federal budget deficit have been favorable, the good news is not expected to continue. Low interest rates and slowly growing health costs have helped ease the burden of the debt, but they are not expected to continue for very long. A likely combination of growing spending on Social Security, Medicare, Medicaid and other health programs will cause the deficit and debt to again grow faster than the economy. This paper analyzes which expenditures do and do not cause a significant increase in the federal debt and describes how a remedy implies difficult choices that require leaders of both political parties “to join hands and jump off the cliff together.”


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There has recently been some very good news on the fiscal front. The federal budget deficit has plummeted from almost 10 percent of the

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GDP in fiscal 2009 -- near the depth of the recession and the height of the stimulus program – to less than 3 percent in 2014. Unfortunately, the good news is not expected to continue. In the January 2015 Congressional Budget Office (CBO) baseline, the deficit stabilizes between 2.5 and 3.0 percent of GDP through 2019 and then begins an inexorable march upward reaching 4.0 percent of GDP by 2025. Even while the deficit is relatively low, it is not low enough to lower the debt-GDP ratio significantly. That ratio was 74.1 percent at the end of 2014, the highest level since 1950 when we were rapidly bringing down the debt ratio, which had soared during World War II.

The ratio has been less than half that level as recently as 2007, before the huge deficits caused by the Great Recession and the stimulus program. As a result of the enormous increase in the public debt, our fiscal future is much more vulnerable to an increase in interest rates than it has been in the past.

With the recent downward trend in interest rates, deficits have been almost costless, and that partly explains why politicians have not
been very worried about them. The average interest rate on publicly held debt was only 1.8 percent in 2014, and, despite huge deficits, the total interest bill of $229 billion in 2014 was lower than the bill in 2007.

At the same time as interest has become a much bigger threat to the budget, there has been some very good news regarding health costs. Total national health spending had been on an upward trend relative to GDP for a very long time. That had a direct impact on government health programs, which faced especially strong upward pressure as more and more baby boomers became eligible for Medicare, the largest government health insurance program. The aging population also added to the cost of the Medicaid, the second largest program.

Recently, the upward trend in the share of the GDP dedicated to health costs has come to a halt. Net Medicare costs\(^2\) did not rise as a share of GDP between 2009 and 2014.

\(^2\) Gross Medicare costs less premiums paid for Parts B and D.
There is considerable uncertainty whether the recent slowdown will continue and that topic will be considered later. But first I shall look in more detail at the threat posed by interest rates.

1. The Interest Bill

No one is very good at forecasting interest rates. But CBO has to decide on some sort of interest rate path in order to fulfill its obligation to project budget aggregates for 10 years. In compiling their January 2015 baseline, CBO assumes that the three-month Treasury bill rate will gradually rise from essentially 0 in 2014 to 3.5 percent in calendar 2028 and remain at 3.4 percent from 2019 through 2025. The 10-year Treasury note rate is projected to rise from 2.5 percent in 2014 to 4.6 percent by 2020 and then be constant through 2025.

As CBO explains, the assumed increase is relatively modest. The implied 10-year real interest rate of 2.2 percent from 2020 to 2025 is 75 basis points below the average real rate between 1990 and 2007, a period of relatively stable inflationary expectations. Nevertheless, interest becomes the government’s most rapidly growing expenditure, rising at
12.4 percent per year. If interest rates turn out to be 1 percentage point higher, the annual rate of increase would rise to 15.4 percent a year. But as this is written in April of 2015, interest rates seem to be running somewhat below CBO expectations, so it may be some time before the interest bill really begins to soar.

Would a rapidly rising interest bill make voters more concerned about the deficit? It is difficult to explain how deficits harm long-run living standards by drawing down national savings and wealth, but interest is something that most people have to deal with in their ordinary lives. They know that it is not a good thing if their interest bill is absorbing a higher and higher portion of their income, and they know that it is not a good thing if the government’s interest bill is equivalent to a higher and higher portion of tax revenues. Consequently, rising rates might very well raise public concern about the deficit.

Because interest rates are so hard to forecast, a considerable element of uncertainty has been added to the nation’s long-run fiscal outlook. If interest rates remain near today’s unusually low levels for
several years and all else remains equal, it is difficult to argue that the
country faces a very serious long-run budget problem, because the debt-
GDP ratio would be put on a declining path. If interest rates should soar
above CBO’s assumed path for a significant time in the next ten years
the fiscal outlook would be downright frightening. Debt would be
significantly higher, and GDP would very likely be lower. Even the
modest interest rate increase projected by CBO is cause for grave
concern.

The fiscal risks created by interest rates can only be reduced by
reducing the debt-GDP ratio. Options for doing that will be considered
later in this article.

2. Health Costs

The rapid deceleration in the rate of growth of health costs is not
well understood. If the rate of growth of costs stays subdued for a very
long time, it is very good news indeed. But we may just be seeing a one-
time improvement in the efficiency of providing care, and growth may
soon again exceed expected GDP growth. Or, worst of all, there may not
have been any real improvement at all in efficiency and the pause in
growth may be result of temporary factors related to the Great
Recession.

However, it does appear as though there are some real structural
improvements in the health care industry. The problem comes in
estimating their quantitative importance and in knowing whether they
will continue.

There seems to be some progress in escaping our highly inefficient
fee-for-service system. More health care is provided by large
organizations, such as Kaiser, and in hospitals. The compensation of
doctors in such systems does not depend on them persuading patients to
visit often or on how many tests they prescribe. Doctors are instead
salaried and, in theory, are rewarded for keeping patients well. New
medical graduates find these organizations attractive because their hours
are predictable and the organizations provide administrators who can
more efficiently relieve doctors of the problems created by the piles of
paper work required by insurance companies.
The Affordable Care Act (ACA) is contentious for all sorts of reasons, but it appears to have had some success in improving efficiency in at least one area. It created penalties against hospitals experiencing readmissions and readmissions are down. It is less clear whether the improvement has a long way to go or has run its course.

New kinds of insurance that have high deductibles and copayment are saving employers much money by making patients and doctors more cost conscious. Such policies are generally coupled with health savings accounts, which allow patients to pay deductibles and copayments in a tax-favored manner. Currently these policies cover a relatively small portion of the labor force, but they can be expected to spread much more widely, thus providing additional savings for a good long time.

There are some changes whose effects are clearly transitory. In 2012, an unusually large number of patents expired for widely used drugs. The so-called patent cliff enabled the substitution of generic drugs for much more expensive brand name drugs. This saved Medicare’s prescription drug program (Part D) a lot of money and has probably had
good effects throughout the health care system. There are, however, some indications that prescription drug costs have again begun to escalate.

The ACA reduced Medicare reimbursements and the subsidies for Medicare Part C. This is clearly a one-time saving. The Medicare actuary does not believe that it is sustainable because it may cause a growing number of doctors to refuse Medicare patients.

As implied above, there is a school of thought that believes that the slowdown in health costs is almost entirely due to a reduction in demand caused by the Great Recession. If that is true, rapid growth will be resuming very soon. Although the Great Recession may have had a significant impact, I find it hard to believe that it explains almost all the health cost slowdown. There are too many other changes that move in the same direction.

At the same time, there are factors that could increase long-run costs. Technological progress continues, and new treatments are often very expensive. Even when they are not, there is often a very high
demand for new treatments, and this increases total expenditures. Among the things on the horizon are personalized medicine, which designs very specific treatments whose effectiveness depends on an individual’s DNA; gene splicing; and nanotechnology. There is also a huge wave of mergers among hospital and other health care facilities. This has the potential to reduce competition and increase costs.

Amid all the uncertainty regarding health costs, the Congressional Budget Office faces the challenging task of projecting the health costs covered by the federal budget for a very long time when it periodically produces its long-run budget projections. Fairly detailed projections are provided for 35 years, and more tentative projections are provided for several decades after that.

In its most recent report, issued in July 2014, they assumed that government health costs will grow more slowly than they assumed a few years ago, but still faster than the GDP. Government health programs whose costs amounted to 4.8 percent of the GDP in 2014 are projected to equal 8.0 percent by 2039.
Demography is a major factor increasing costs. More and more baby boomers are becoming eligible for Medicare and are also imposing larger long-term and acute care costs on Medicaid. Medicaid costs are also going up because of the expansion financed by the ACA, and a new set of costs will be related to subsidies provided for insurance purchased through the ACA’s exchanges.

3. Policy Options

CBO’s budget baseline shows the Federal debt-GDP ratio rising from 74 percent of GDP in 2014 to 79 percent in 2025. Its longer-run projections, which will be released in July 2015, will very probably show the ratio rising at an increasing rate after that. But it appears as though the country has at least 10 years of debt-GDP ratios that are lower – sometimes considerably lower – than ratios that are common in Japan, many developed European economies, and in emerging markets. If CBO is only slightly too pessimistic with regard to its interest rate and health cost assumptions the nation could well see a stable or even a slightly declining debt ratio.
But a debt ratio of over 70 percent is nothing to brag about even if it is not among the highest in the world. A significant recession combined with a stimulus program could send the ratio above 100 percent in the blink of an eye. Moreover, even if bad things do not happen, there were good reasons that the old fashioned, normative goal of fiscal policy was to have a balanced budget absent a recession or a war.

In calendar 2014, net private saving was $1,220.4 billion and federal government dissaving was $582.3 billion. I do not mean to imply that if we suddenly balanced the budget, as defined by NIPA, the economy would have almost $600 billion in additional saving available. Balancing the budget would have macroeconomic effects that would probably reduce the amount of private saving. However, as we approach full employment, it is clear that deficits as large as today’s will significantly diminish additions to national wealth. They will leave less saving available to finance physical investment and so leave the country

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3 There are major differences between NIPA’s definition of government dissaving and the unified deficit as defined by budget accounting rules.
less productive in the future. Although that effect is diminished to the extent that we borrow from abroad, foreign borrowing means that we shall have to devote a higher portion of future income to paying interest and dividends to nonresidents. Either way future living standards will be lowered. That is reason enough to aim for lower deficits.

Today’s deficit is roughly consistent with maintaining a stable debt-GDP ratio of about 70 percent. Therefore, any lowering of the deficit will put the debt ratio on a declining path and make us less vulnerable to an increase in interest rates.

How do we do it? On the spending side we have to examine the largest programs. Small changes in large programs can have a significant effect on future debt-GDP ratios. Only three programs -- Social Security, Medicare, and Medicaid – constitute 51 percent of total spending. It is extremely difficult to put Federal spending on a significantly lower path without touching these programs. It is also difficult to imagine bringing down the debt-GDP ratio without some increase in the tax burden.
Without revenue increases, cuts in highly popular programs would have to be too draconian to be feasible politically.

*Social Security* – Social Security is the single biggest federal program, spending $845 billion in 2014. Reforming the program is simple analytically and excruciating politically. It must be the most politically popular program ever invented by government. Reform is analytically simple in that numerous options for changing benefits or increasing the payroll tax have been studied intensively. Analysts have a very good idea of how much different options would improve the financial health of the program and who would be affected. In what follows I shall examine only a small portion of the many options that have been put forward.

Policy options fall mostly into three main categories:

1. Proposals for changing the indexing of the benefit formula and existing benefits.
2. Changes to the full and early retirement ages.
3. Changes in the payroll tax base or tax rate.
One criterion used to judge options is to assess the extent to which they would move the program toward financial sustainability. In their 2014 report, the trustees of the program estimated that under current policy the present value of payroll tax receipts over the next 75 years will fall short of the present value of benefits by an amount equal to 2.88 percent of payroll.

The brackets in the benefit formula are now indexed to average wage growth in the economy. The goal is to keep initial benefits up with the standard of living of the rest of the population. Once retired, however, benefits are indexed to the CPI in order to maintain their purchasing power. Those on the program for a long time can see benefits erode substantially relative to the standard of living of the working population.

A commonly proposed reform would index the benefit formula to the CPI, which would presumably grow less in the long run than wages. If applied to those newly eligible in 2021, it would close the financing gap by 2.56 percent of payroll. In other words it would come close to
solving social security’s entire financial problem. However, it is a mistake to think that such a reform would last indefinitely. The Congress would probably raise benefits periodically to slow the erosion of benefits relative to the standard of living. Then, of course, the option would solve less of Social Security’s financial problem.

The Bureau of Labor Statistics has been experimenting with a relatively new measure called the chained CPI. It is thought to provide a more accurate measure of inflation and tends to grow 0.3 percent less per year than the official CPI. Using it to index existing benefits would solve 0.41 percentage points of the Social Security financing problem.

There are many other proposals to change the indexing of the system. Often they exempt people with low lifetime incomes from benefit reductions.

Given increased life expectancy, improved health at every age, and the fact that a much smaller portion of jobs is physically demanding than in the past, it seems reasonable to continue increasing the age at which a person receives full benefits beyond the 67, as scheduled in current law.
If the full retirement age is increased by 2 months each year after it reaches 67 for those aged 62 in 2022 until it reaches 69 and then 1 month per year every 2 years, the actuarial deficit would be reduced by 1.0 percent of wages.

Some advocate removing the cap on the OASDI payroll tax. The rate in 2014 was 12.4 percent on wage income up to $117,000. If tax payments in excess of the cap earn no additional benefits, this option reduces the Social Security deficit by 2.35 percent of payroll – almost enough to make the system financially sustainable. However, the top income plus payroll tax rate on wages would be pushed above 50 percent even before counting state and local income taxes.

*Medicare and Medicaid* – The United States operates its main health programs very differently from countries like Canada and the United Kingdom, which have nationalized systems. In those countries health costs are subjected to a strict budget, and for the most part, providers

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4 The total OASDI and Hospital Insurance (Medicare) tax rate is 15.3 percent. There is no cap on the Medicare tax of 2.9 percent. As of 2013 an additional 0.9 percent Medicare tax applies to couples earning more than $250,000.
live within the budget constraint. That frequently involves rationing and often the rationing is not transparent.

In contrast, the U. S. Medicare program is an entitlement. The law specifies who is eligible, and laws and regulations specify the treatments that will be provided. Then we pay for everyone who comes in the door. It is often said that the program is “uncontrollable”. We try to control costs with a price control system that would make the old Soviet Union proud, but it has never been very successful.

It is hard to imagine imposing strict budget controls in the United States, but the country can move in that direction by adopting a goal for Medicare spending and specifying actions to be taken when spending exceeds the goal. Both President Obama and Paul Ryan, the ex-chairman of the House Budget Committee, have done this. Most ironically, they chose the same goal for spending growth as recently as 2013 – GDP growth plus 0.5 percentage points. When they specified this goal, it seemed harsh, but recently it would have been more generous than current policy because of the health cost slowdown.
Whatever the goal, the president and Chairman Ryan would achieve it very differently. Ryan would turn Medicare into a premium support system. Enrollees would receive an income related subsidy to enable them to buy private insurance policies. The program would work in the same way as the exchanges provided by the ACA. If spending exceeded the goal, the subsidies could be cut back.

The president would rely on an Independent Payment Advisory Board (IPAB) created by the ACA. If the goal for spending growth, set by the ACA, is exceeded the IPAB would recommend policies to restrain costs and the policies would be implemented unless voted down by the Congress. The IPAB is now limited in what it can recommend, so the president has proposed that its powers be expanded beyond those granted by the ACA. So far, no members have been appointed to the IPAB and it appears likely that none will be unless the growth in health costs again accelerates significantly.

Chairman Ryan and his successor Chairman Price have proposed imposing budget controls on Medicaid by converting it into a block
grant program while giving states much more freedom in designing its characteristics. The budgets proposed for the block grant are significantly below the cost of current policy, and, although there are undoubtedly ways that the program could be made more efficient, the proposed cuts do not appear to be feasible without very large cuts in program benefits.

Even if we were not concerned about the debt-GDP ratio, there would be a strong argument for health reform, simply because our system is now so inefficient. It should be able to obtain the same quality of health care at a significantly lower cost. An added argument is that health reform will provide an insurance policy just in case underlying health cost growth again accelerates beyond current expectations.

*Discretionary Spending* – Discretionary spending, most of which is appropriated every year, has contributed little to the nation’s budget problem. Yet, it has borne the brunt of the few important efforts to reduce future deficits. The Budget Control Act of 2011 imposed caps on defense and nondefense spending through 2021 that were further
reduced by a sequester when a so-called super committee could not agree to more rational reductions in spending growth.

The caps are very severe. They apply to budget authority (not outlays) and were relaxed slightly for 2014 and 2015 by a bipartisan budget deal negotiated by Paul Ryan and Patty Murray, then Chairmen of the House and Senate Budget Committees. However, the original caps for 2016 have been retained.

There is a fudge factor that loosens the cap on defense budget authority. A special account, called Overseas Contingency Operations, was created to finance the wars in Iraq and Afghanistan and is now also used to finance the air war against ISIS. The Congress and the military will undoubtedly find ways to crowd spending into this account that is only tangentially related to wars. But even with this fudge, the original caps imply that defense spending will grow very slowly. In CBO’s January 2015 baseline, defense budget authority grows only 1.7 percent per year between 2014 and 2025 – less than the assumed rate of inflation. In 2025, defense outlays would amount to only 2.6 percent of
GDP, the lowest percentage since 1940. This does not seem credible given the many conflicts in the world and with China increasing its defense spending at a double digit rate in most years.

The caps on nondefense spending appear to be equally implausible. Budget authority also grows more slowly than the price level and makes no allowance for population growth. It seems probable that the caps will soon be relaxed by a deal similar to that earlier negotiated by Ryan and Murray.

The caps may not be realistic, but they were easy to pass, because the Congress as a whole could pass aggregate caps without specifying which programs would be affected. That painful task is left to the Appropriations Committees. In contrast, if Congress had reformed aspects of Social Security and Medicare, it would be very clear who would have lost benefits compared to what is now promised.

With the passage of the caps it became painfully apparent that budget hawks have been correct in arguing that Social Security and the health programs are crowding out all other functions of government.
Certainly, infrastructure spending has suffered and it is difficult for a president to push new initiatives in education, scientific research or anything else. It is for that reason that President Obama pressed for relaxing the caps in his 2016 budget with the increased spending to be financed with tax increases. Even so, his initiatives had to be modest given that he did not press for major reforms in Social Security and health.

Tax Policy – There is no doubt that our tax system is inefficient, inequitable, and horribly complicated. A fundamental tax reform is badly needed. But even a revenue neutral tax reform is extremely difficult to pass because there are so many losers and you are likely to hear more and louder screams from losers than congratulations from winners. Using tax reform to raise revenues is even more difficult because it raises the ratio of losers to winners. Nevertheless, there will be strong efforts to pass a fundamental business tax reform in coming months. But these efforts may not bear fruit for several years. It took a
very long time from the initial discussions of tax reform in the early 1980s to the eventual passage of a significant reform in 1986.

In the best of circumstances it is as hard to raise taxes as it is to reform Social Security and Medicare. It is particularly difficult to raise tax rates within the current system given its inefficiencies. But as noted previously, it is hard to imagine a grand bargain over fiscal policy that does not involve both some reduction of spending growth and some increase in revenues.

*The Congressional Budget Resolution* – For the first time since fiscal 2009 the houses of Congress have produced a conference agreement that produces a single budget resolution. It promises to balance the budget by 2024. At first sight, this accomplishment appears to have reduced the dysfunction that has so paralyzed the Congress in recent years.

But one should not cheer too loudly. The Congress finally has a budget, but it does not appear as though it will abide by it. Recently, the Congress prevented a very large, automatic cut in Medicare reimbursements from occurring. They did not pay for the entire amount
of increased spending with tax increases or other spending reductions. The budget resolution assumed that they would. They might still, but it is very, very unlikely.

The House has recently eliminated the estate tax. That also was not provided for in the budget resolution.

The budget resolution significantly reduces the nondefense spending caps after 2016. It was argued above that the current caps are unrealistically severe. Certainly, the new caps are unworkable. The budget resolution also implies very significant money saving reforms in Medicaid and in other welfare programs. Would the Congress want to take that on for a fiscal year just before the election?

If the budget resolution was serious about entitlement reform, it would have issued reconciliation instructions that ordered the committees responsible for various entitlements to save certain amounts of money.\(^5\) The legislation resulting from reconciliation instructions cannot be filibustered and debate is time limited. In the absence of the

\(^5\) Reconciliation instructions related to the elimination of Obamacare were issued.
reconciliation process, radical welfare reforms will require 60 votes in the Senate and that is extremely unlikely.

4. Summary and Conclusions

The recent rapid decline in the budget deficit and a much less alarming outlook for health-care cost growth make future fiscal challenges less daunting than they once seemed. Yet, CBO baseline projections and their longer-run outlook still show the deficit rising again late in the decade and the debt-GDP ratio on a relentless upward path. In other words, the long-run fiscal outlook is still unsustainable.

A large part of the problem is that the debt-GDP ratio more than doubled from about 35 percent to more than 70 percent as a result of the Great Recession and the stimulus program designed to fight it. If interest rates rise, as most expect, the interest cost of the public debt will rise rapidly and supplant health costs as the most menacing spending problem.

Even if all this is too pessimistic and the debt-GDP ratio stays where it is for a considerable time, it would not be a reason to remain
complacent. A future recession combined with a stimulus program could send the debt ratio soaring above 100 percent. Moreover, the deficits consistent with maintaining the debt-GDP ratio at around 70 percent represent a major reduction in national saving and a consequent slowing of improvements in living standards.

But there is no denying that it will be extremely difficult politically to put the debt-GDP ratio on a persistent downward path. It is almost impossible to do that without reforming the very large and very politically popular entitlements for the elderly – Social Security and Medicare. And to reduce the pain of such reforms, some unpopular increases in tax burdens will also be necessary. Defense and nondefense discretionary spending has already contributed more than their fair share to deficit reduction, and future increases in such spending relative to current caps seem more likely than decreases.

Despite the extreme difficulty of resolving our fiscal problems, the next president would be well advised to make a full court press in pursuit of fiscal responsibility. If he or she does not do it, the prospects
dim for any other needed initiatives, whether in infrastructure spending, in education, or anything else. As hard as it is to reduce the deficit, there will be no sympathy for increasing it either with the debt-GDP ratio above 70 percent and perhaps rising.

It is difficult to imagine any agreement that is not bipartisan, and it is difficult to imagine any bipartisan agreement that does not involve some slowdown in spending growth for elderly entitlements and some increase in taxes. It is a cliché to say that the two parties have to join hands and jump off the cliff together, but that is exactly what is required.

In the absence of policy changes, the nation is inexorably headed for a sovereign debt crisis. It may not happen for a very long time, but one would think that both the political right and left would want to eliminate this risk. As sovereign debt crises have evolved in Europe, we have seen the left forced to accept large cuts in social programs, including cuts in public pensions without providing much notice. At the same time the right has faced large and often arbitrary increases in taxes. Unemployment has soared, especially youth unemployment, and
economic growth has come to a halt for very long periods. It is not something that anyone should want for the United States.