Fiscal Policy and the Major Entitlements: An Introduction

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The Sources of Fiscal Distress

Sound fiscal policy is essential for sound governance. History shows that while there are many complex reasons that countries and empires dissipate their power, reckless borrowing is one of them. It would be disastrous on a global scale if the United States were to cede its role as leader of the democratic West because of economic decline caused by the slow boil of fiscal excess.

Unfortunately, that's no longer a remote possibility. Indeed, unless elected leaders in the U.S. move decisively to narrow long-term budget shortfalls, the federal government will accumulate debt over the next thirty years on a scale that will be difficult to ever reverse.

There are a number of reasons for the U.S.'s deteriorating fiscal outlook, but two are most salient: unabated spending growth on the largest entitlement programs over many years, and two damaging and costly economic emergencies in rapid succession.

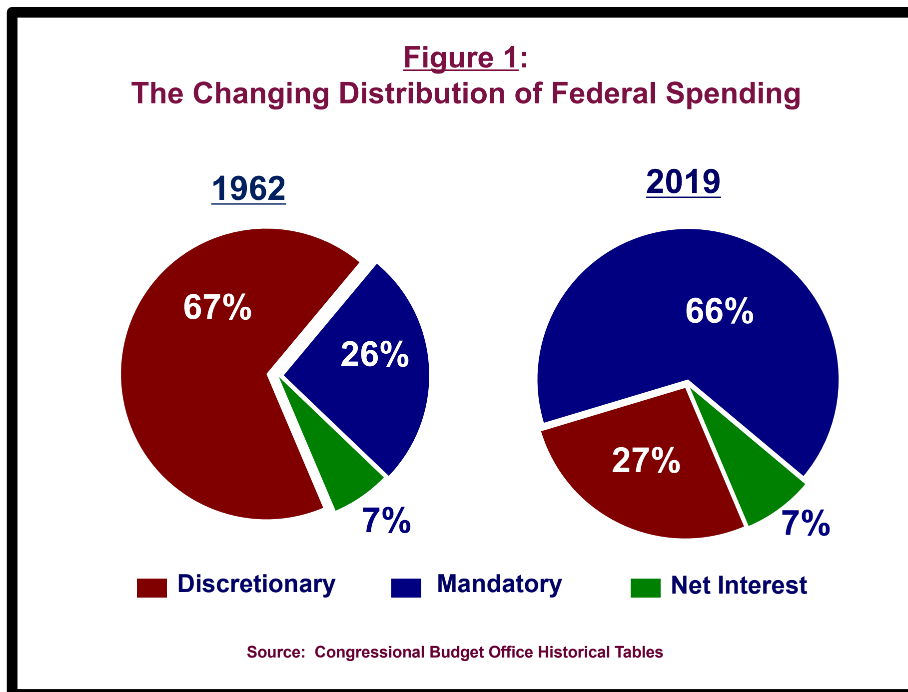


Figure 1 depicts the effects of entitlement spending growth on the nation's budget priorities. In 1962, two-thirds of the federal budget passed through the annual appropriations process, and less than one-third was spent on entitlement programs. By

2019, the shares had flipped, with entitlement spending now comprising two-thirds of all federal spending. Net interest spending on accumulated debt was the same ~~as a~~ share of the total budget in 1962 and 2019.

The growth of entitlement spending is partially a function of legislative intent. Presidents of both parties have worked with Congress since World War II to expand the reach and generosity of the main benefit programs. Entitlement spending has a privileged status in the federal budget; Congress has provided them with permanent spending authority, which means benefits are paid automatically without the need for a new congressional appropriation each year.

Entitlement spending is tied primary to federal benefit programs; participants are "entitled" to a certain amount of financial assistance, and Congress satisfies these obligations by ensuring funding is available without further congressional action. The largest entitlement programs are Social Security, Medicare, and Medicaid. Together, they now make up nearly half of all federal spending. Their combined growth over the past half century is the source of tremendous financial pressure.

By itself, escalating spending on entitlements would be enough of a problem to set off budgetary alarms. The recent economic crises, occurring barely more than a decade apart, have made matters far worse.

In 2007, just as the retirement of the baby boom generation was about to ramp up federal spending, the financial crisis hit and the economy went into a deep recession that lasted until mid-2009. In response, Congress enacted a series of expensive financial rescue measures, including a $0.8 trillion stimulus bill in 2009. After a long and slow recovery, the pace of economic growth finally began to pick up around 2016. Then, in early 2020, the COVID-19 pandemic precipitated the most severe contraction of the U.S. economy since the Great Depression. The full cost of this crisis is not yet known but is likely to far exceed what was incurred during the financial crisis that preceded it.

CBO's Projections

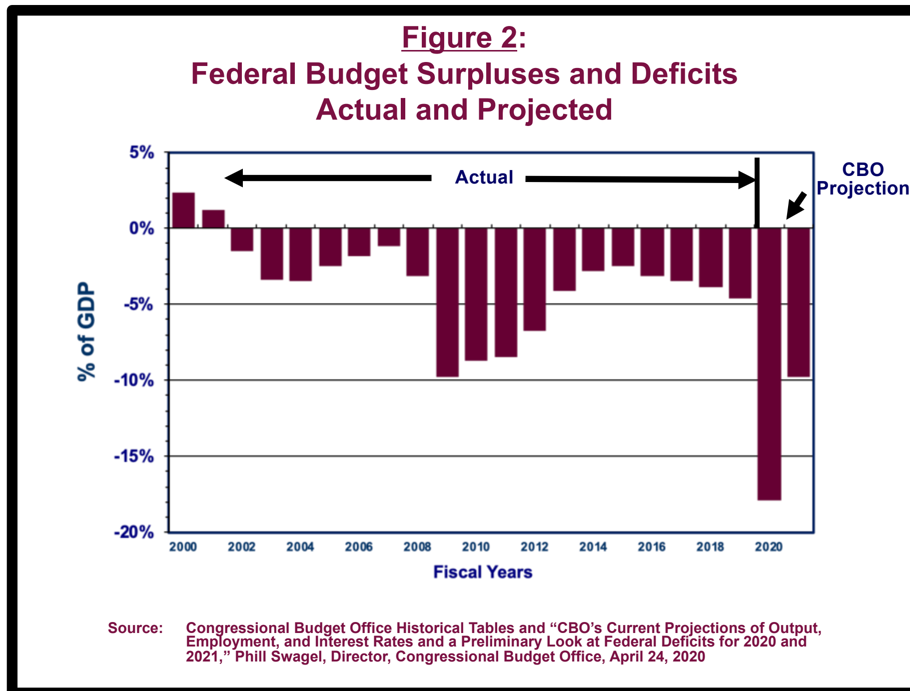
Congress relies heavily on the nonpartisan Congressional Budget Office (CBO) to provide it with factual assessments of the current state of fiscal policy, and to forecast what will occur in the future under current laws and policies.

Typically, CBO will issue a ten-year projection three times each year, as well as an annual long-term forecast covering thirty years. That normal process has been upended in 2020 by the COVID-19 pandemic.

While the crisis is still unfolding, and its full damage remains unknown, it is already clear that the toll will be significant and perhaps unprecedented. As of mid-May 2020, 32 million Americans had filed claims for unemployment insurance over a two-month

period.[1] Congress has responded by passing four separate pieces of emergency legislation that CBO expects will push the government's annual deficit in 2020 to 17.9 percent of GDP -- the highest annual deficit on record going back to World War II.[2] In 2021, the deficit is expected to decline as economic activity picks up, but it would still be very large at 9.8 percent of GDP. It may be years before the economy returns to the path of growth it was on before the crisis began.

Figure 2 shows the projected annual budget deficits for 2020 and 2021 alongside the actual deficits going back to 2000.



Even before the pandemic, CBO's latest long-term forecast, from January 2020, showed rapidly growing annual deficits and rising federal debt (see Figure 3). As of 2008, federal debt stood at just under 40 percent of GDP. The financial crisis, and the ensuing deep recession, widened the annual deficit substantially, and pushed up accumulated federal debt as well. By 2019, federal debt reached 80 percent of GDP, which is far above the levels that have been the norm during the post-war era. CBO's long-term forecast showed debt escalating rapidly over the next three decades with entitlement spending growth far outpacing increases in federal revenue. By 2050, federal debt was projected to reach 180 percent of GDP, which would be well above anything in the nation's historical experience.

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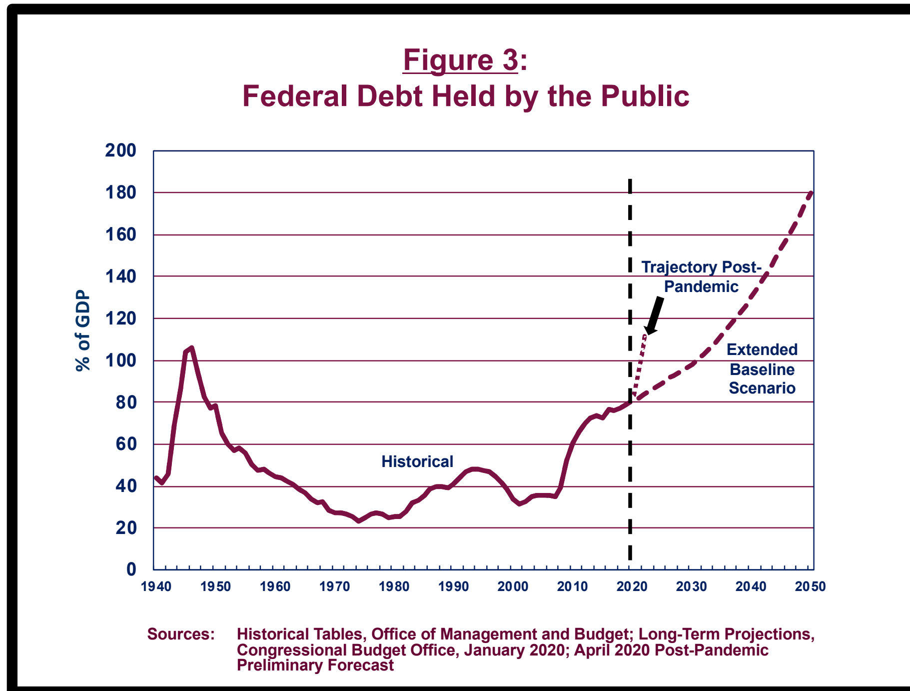
[1] "Unemployment Insurance Weekly Claims," Department of Labor News Release, May 14, 2020 (https://oui.doleta.gov/press/2020/051420.pdf).

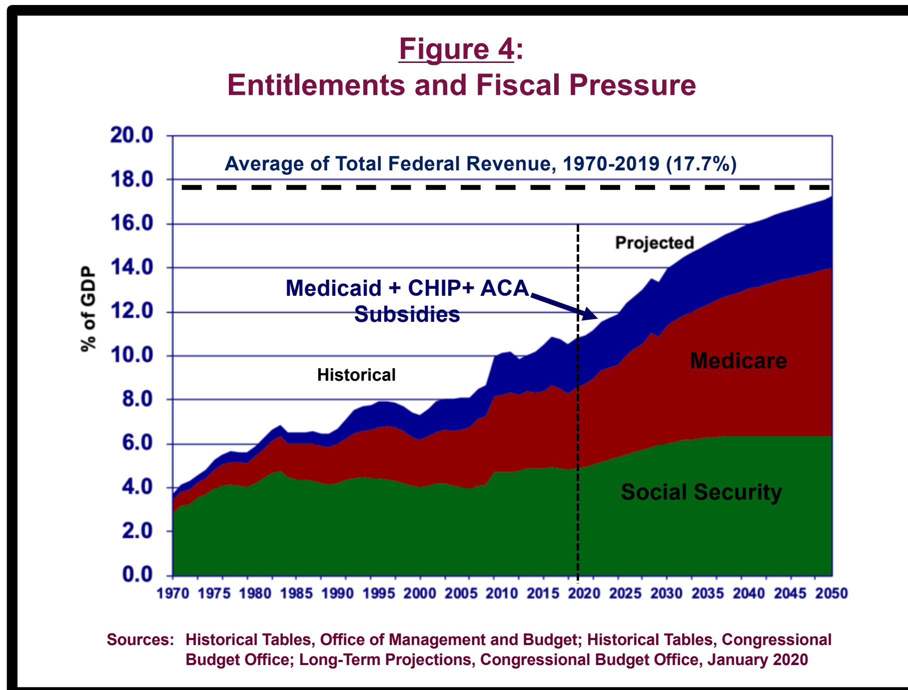
[2] "CBO's Current Projections of Output, Employment, and Interest Rates and a Preliminary Look at Federal Deficits for 2020 and 2021," Phill Swagel, Congressional Budget Office Blog, April 24, 2020 (https://www.cbo.gov/publication/56335). See also Historical Tables, Fiscal Year 2021 Budget of the United States Government, Office of Management and Budget, February 2020, https://www.whitehouse.gov/omb/historical-tables/.

The pandemic has made even this dire projection look optimistic. CBO now expects federal debt to reach 101 percent of GDP in 2020 and then 108 percent of GDP in 2021, which is higher than it was at any time during and after World War II. This recent surge in debt puts the country on a path that is well above what CBO forecast in January.



Underlying CBO's long-term forecast is an expectation that spending on Social Security, Medicare, Medicaid, and health insurance subsidies for lower-income households will continue to grow as rapidly in the future has it has in the past. Figure 4 presents both the historical record and CBO's estimates for these programs to 2050.

These largest entitlement programs have transformed the federal budget. In 2019, combined federal spending on them was 9.8 percent of GDP, up from 3.7 percent in 1970. CBO expects them to cost 17.2 percent of GDP in 2050, which is almost equal to the average annual revenue collected by the federal government over the period 1970 to 2019. The implication is that, absent a dramatic increase in revenue, or a substantial reduction in entitlement costs, Social Security and the major health entitlements are on track to consume almost all federal revenue in 2050. All other spending commitments will necessitate additional federal borrowing.



High Debt Creates Economic Risks

High governmental debt poses serious risks for the U.S. economy. Treasury securities are in high demand because they are the gold standard for risk-free investments. For this reason, it is easy for the federal government to borrow money in public markets, which is why interest rates remains low despite the massive amount of debt now being sold. But just because it is easy to borrow funds now does not mean rapidly rising debt carries no risk.

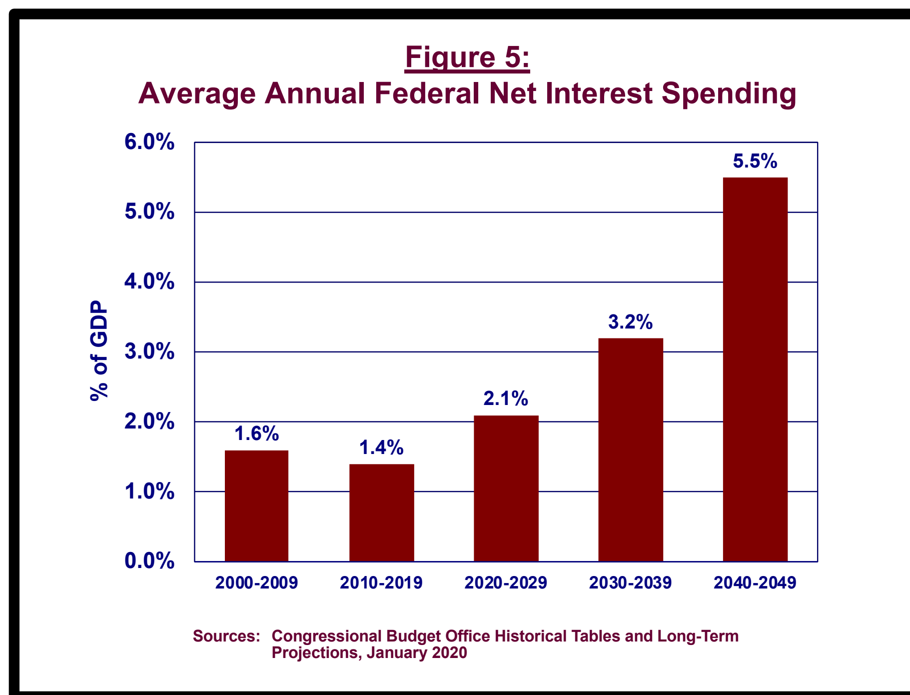
CBO has identified four concerns with persistent, excessive borrowing by the federal government[3]:

- *Lower Savings Means Slower Income Growth*. Federal deficits reduce total savings and investment, especially in the private sector, and thus lead to slower rates of income growth. Diverting resources to federal activity through added borrowing means less capital investment in the private economy. In the short-run, deficits can help counter a recession or exceptionally slow growth. But over the medium and long run, persistent large deficits make it more difficult to sustain strong income gains because productivity suffers.

- *Rising Interest Costs Squeeze Out Other Spending Priorities*. Even with low interest rates, large amounts of debt force the government to devote ever-increasing portions of federal revenue to paying interest to bondholders. As

[3] "Federal Debt and the Risk of a Fiscal Crisis," Issue Brief, Congressional Budget Office, July 2010, https://www.cbo.gov/sites/default/files/111th-congress-2009-2010/reports/07-27_debt_fiscalcrisis_brief.pdf.

shown in Figure 5, current projections show a rapid rise in the government's cost for servicing the national debt, even with today's historically low interest rates. Over the period 2000 to 2009, annual net interest spending averaged 1.6 percent of GDP. CBO projects this portion of the budget to increase to an average of 5.5 percent of GDP over the decade starting in 2030. Net interest spending leaves less room to pay for other priorities. In effect, current and future taxpayers are forced to pay for consumption enjoyed by previous generations, at the expense of public investments that could boost economic prospects for the future. For instance, with high debt and high net interest payments, it is more difficult for the federal government to pursue infrastructure projects or support educational opportunities. Further, many bondholders are outside of the U.S., so net interest payments represent a transfer of income from U.S. taxpayers to foreign institutions and individuals.



- *There Is Less Fiscal Flexibility in a Crisis*. If the federal government runs large deficits even during times of benign economic conditions, then there will be less ability to make policy adjustments in response to a crisis, such as an economic downturn or a war. The result could be a reluctance by policymakers to take decisive action even if that is called for by the circumstances. Congress responded quickly to the crisis posed by the COVID-19 pandemic, but the large increase in debt that has occurred since March 2020 may make it difficult to respond if another crisis emerges over the coming year. For instance, Congress may be less willing to provide new funding for the military to confront national security threats because of the resources devoted to the pandemic.

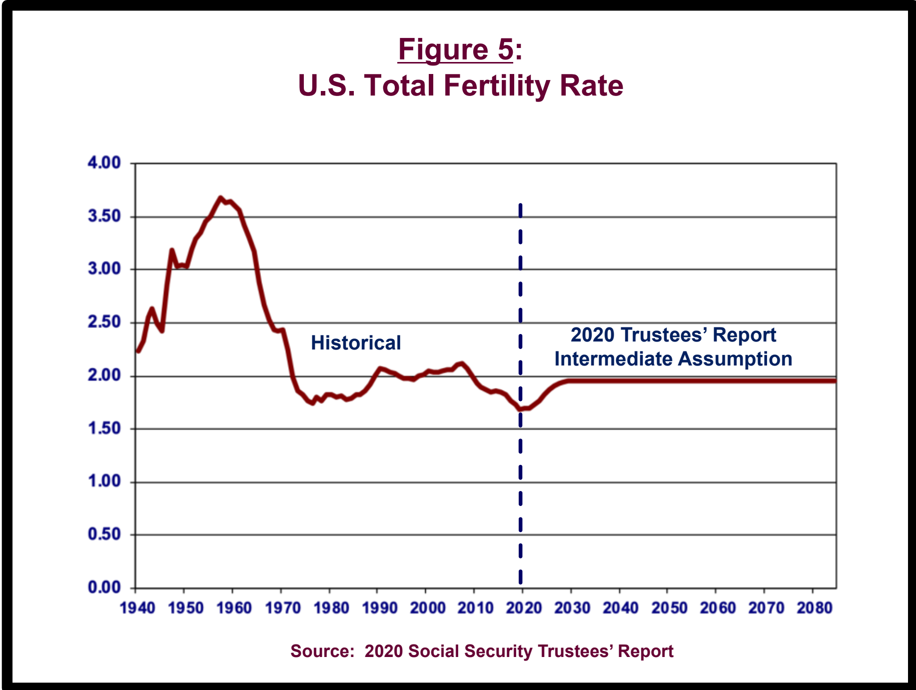
- *There Is a Higher Risk of a Debt-Induced Economic Crisis*. It cannot be ruled out that, at some point, excessive debt will create a sudden and disruptive re-evaluation of the safety of investing in Treasury debt. If that were to occur, interest rates could spike, and it may become harder for the U.S. to secure the funds it needs to meet its obligation. This is what has happened most often to precipitate debt crises in other countries.

Demographic Shifts

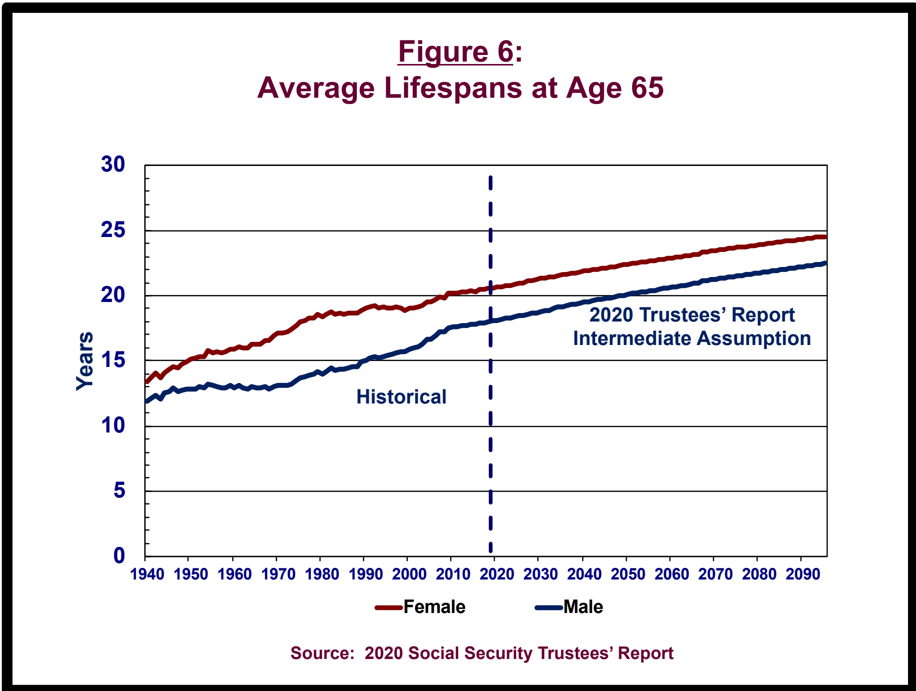
The rise is entitlement spending that has occurred over the past half century, and which is expected to accelerate over the next thirty years, is driven in part by demographic changes. In particular, the U.S. population is aging, with a larger and large portion qualifying for old-age entitlement benefits, even as the number of Americans of working age grows more slowly than it has in the past. The U.S. is not alone among high-income countries in this regard; all advanced economies are aging. That fact does not make it any easier for the U.S. to cope with this unprecedented demographic transformation and the challenges it poses for economic growth and fiscal sustainability.

Population aging is a function of lower birth rates and longer lifespans.

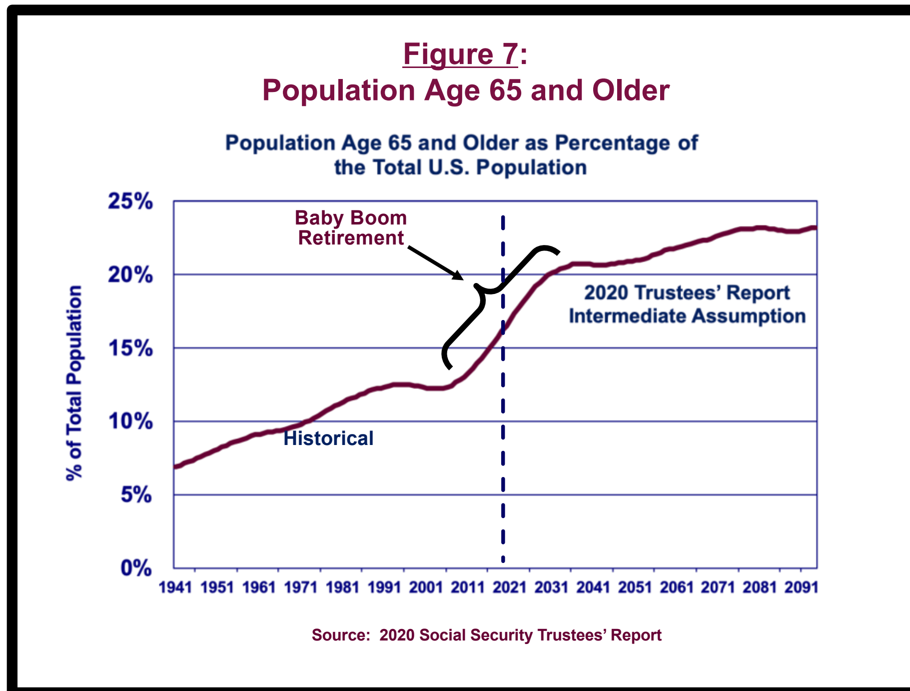
As shown in Figure 5, the U.S. experienced a dramatic decline in birth rates, as measured by the total fertility rate (TFR), after the baby boom of the immediate post-war years (TFR is the average number of children born to women during their child-bearing years). The baby boom generation is now reaching retirement age in large numbers, but the cohorts that follow it were modest in size, which means the workforce paying taxes has not kept up with the surge in new retirees. The latest projections -- from the trustees overseeing the finances of the Social Security program -- show TFR rising slightly in the coming years but staying below 2.0. A TFR of 2.1 is needed just to maintain a population at its current size. At the height of the baby boom, in 1957, the TFR reached 3.68.



At the end other end of the life cycle is longevity. Americans are living much longer when they reach age 65 than they did during the first part of the last century, as shown in Figure 6. The average man who reached age 65 in 2019 is expected to live 18.1 years, which is 6.2 years longer his predecessors in 1940. Women have experienced an even more pronounced improvement, with average life expectancy for those who reach age 65 rising to 85.6, up from 78.4 in 1940.



The combination of fewer births and longer lifespans shifts the center of gravity of a population toward older cohorts. The U.S. has experienced a steady increase in the share of the population age 65 and older over the past half century, and now, with the baby boom generation crossing into its retirement years, that share is rising even more rapidly than it did previously. As shown in Figure 7, in 2019, the population age 65 and older accounted for 16.1 percent of all Americans, up from 9.7 percent in 1970. The Social Security trustees project the 65-plus cohort will grow still further in the decades ahead, to nearly 21 percent of the population in 2050 and even higher later in the century.



An Aging Workforce Depresses Growth

Population aging affects the economy as well as the federal budget. Growth is determined by two factors: the increase in the size of the labor force, and the added productivity of the average worker. In the past, the U.S. experienced rapid annual economic growth because both the labor force and productivity grew rapidly. In recent years economic growth has slowed because both factors are now depressed relative to our historical experience. As shown in Figure 8, from 2009 to 2018, the labor force had a potential average annual growth rate of just 0.5 percent, down from 1.6 percent over the period 1983 to 1991. At the same time, potential productivity growth was down as well, at an average of 1.0 percent annually from 2009 to 2018. Productivity growth averaged 2.0 percent annually from 1992 to 2002. With both the labor force and productivity growing more slowly, wage gains were minimal.

Modest growth is a problem for the federal budget. Revenue rises more slowly, and there are more applicants for federal benefit programs, such as Medicaid and food assistance.

CBO's long-term forecast indicates that the aging of the population will continue to suppress economic growth in the coming decades. Over the next thirty years, the labor force increase is expected to be very modest, averaging around 0.4 percent annually. It is very unlikely that productivity gains will be sufficient to push overall growth to the levels that were the norm during the second half of the last century.

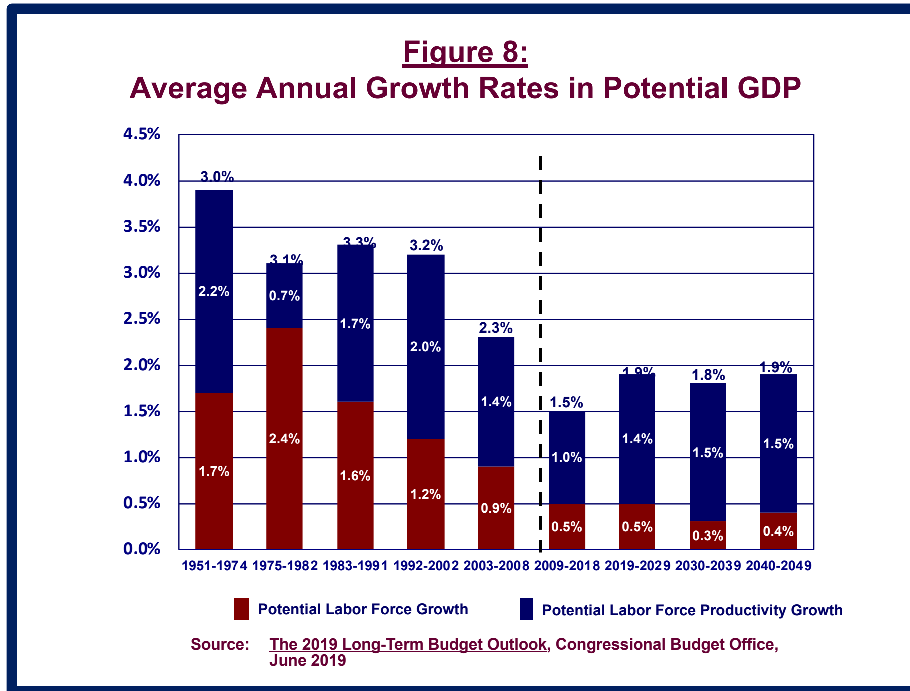


Figure 8:
Average Annual Growth Rates in Potential GDP

Source: The 2019 Long-Term Budget Outlook, Congressional Budget Office, June 2019

Social Security

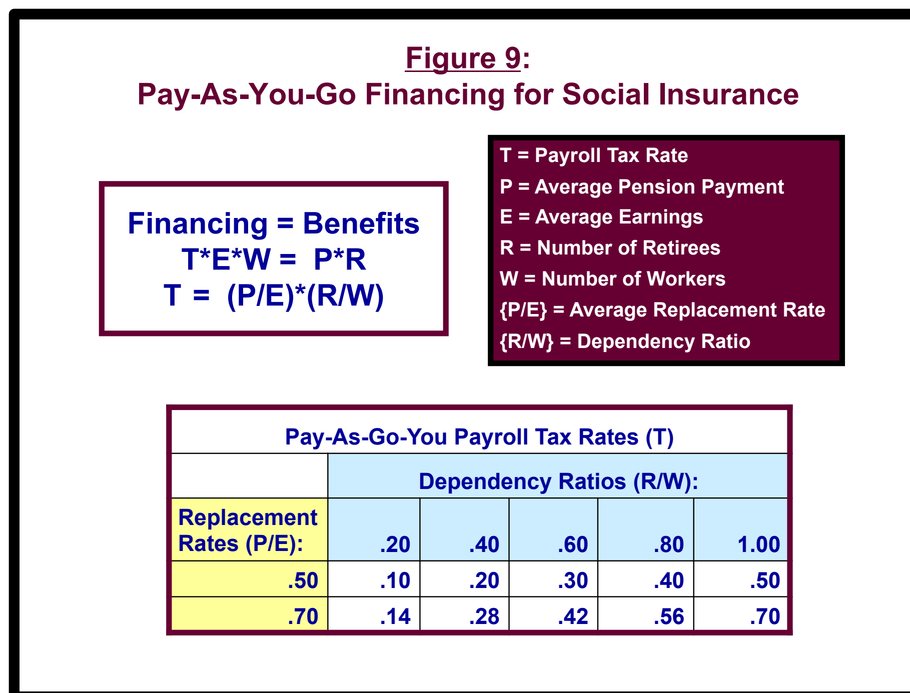
Social Security is a conventional "pay-as-you-go" state-run pension system, in which taxes collected from today's workers are used to pay benefits for today's retirees. The benefits provided to retirees are based on their earnings records during the course of their working careers.

Social Security's pay-as-you-go structure is reinforced by the use of trust funds to keep track of program revenue and spending. (There are actually two separate trust funds -- one for retirement benefits, the other for disability payments.) Each year, the program's trustees issue a report on the projected balances of these funds over a period of 75 years. Forecasts of depleted reserves are supposed to signal to Congress that adjustments are needed to keep the program solvent.

The financial constraints embedded in a pay-as-you-go program like Social Security can be summarized in a simple mathematical formula, shown in Figure 9. The critical assumption in this equation is that, over time, a pay-as-you-go pension system must collect revenue ("financing") that keeps pace with annual benefit payments. Pension financing can be calculated by multiplying the payroll-tax rate (T) by the average earnings of workers on which the tax applies (E) and by the total number of workers

paying into the system (W). Pension benefits are determined by multiplying the average pension paid (P) by the number of retirees (R).

With these parameters established, it is possible to reconfigure the equation to more easily see why demographic factors are critical to the program's financial outlook. The ratio of what a program participant gets in retirement to what he or she earned while working is called the "replacement rate," and is depicted by "P/E." The ratio of retirees to workers is called the "dependency ratio," and is represented by "R/W." And the multiplication of these two ratios can be used to calculate the required tax rate necessary to keep the program solvent.



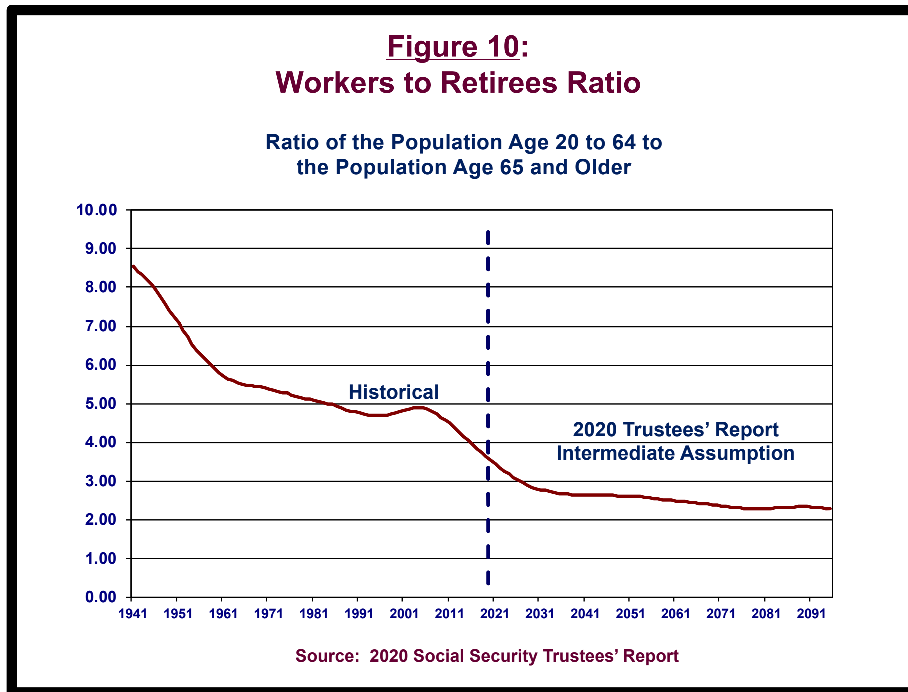
Pay-As-Go-You Payroll Tax Rates (T)					
	Dependency Ratios (R/W):				
Replacement Rates (P/E):	.20	.40	.60	.80	1.00
.50	.10	.20	.30	.40	.50
.70	.14	.28	.42	.56	.70

The old-age dependency ratio is affected by shifts in fertility and longevity. As fertility falls and longevity rises, the old-age dependency ratio increases. And as the old-age dependency ratio increases -- R/W in Figure 9 -- either payroll-tax rates must rise to maintain balance between spending and revenue, or the replacement rates used to calculate benefits must be reduced. Currently, the Social Security payroll tax rate is 12.4 percent -- split evenly between workers and their employers – and is applied to wages below $137,700 annually.[4]

As the U.S. population has aged in recent decades, Social Security's dependency ratio has risen. Another way of considering this shift is to look at the inverse equation -- that is, of the ratio of number of persons of working age relative to those who are age 65 and older. As shown in Figure 10, this ratio has fallen dramatically and will continue to decline in the coming decades. In 2019, there were just 3.6 workers for every person age 65 and

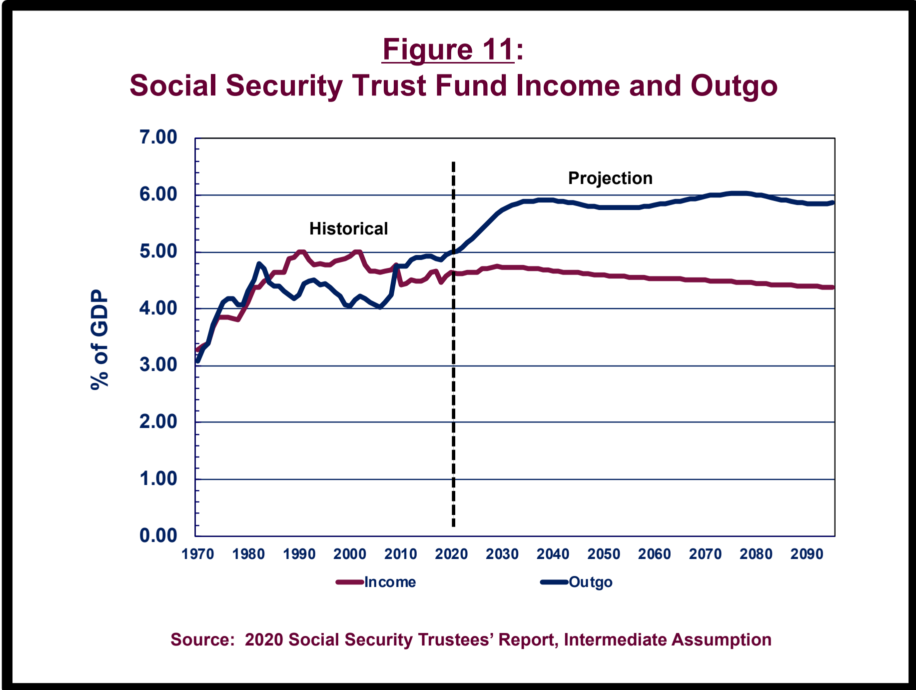
[4] "Contribution and Benefit Base," Social Security Administration, https://www.ssa.gov/OACT/COLA/cbb.html.

older, down from 5.45 in 1970. By 2050, the ratio will have fallen even further, to just 2.6 workers for every person 65 and older.

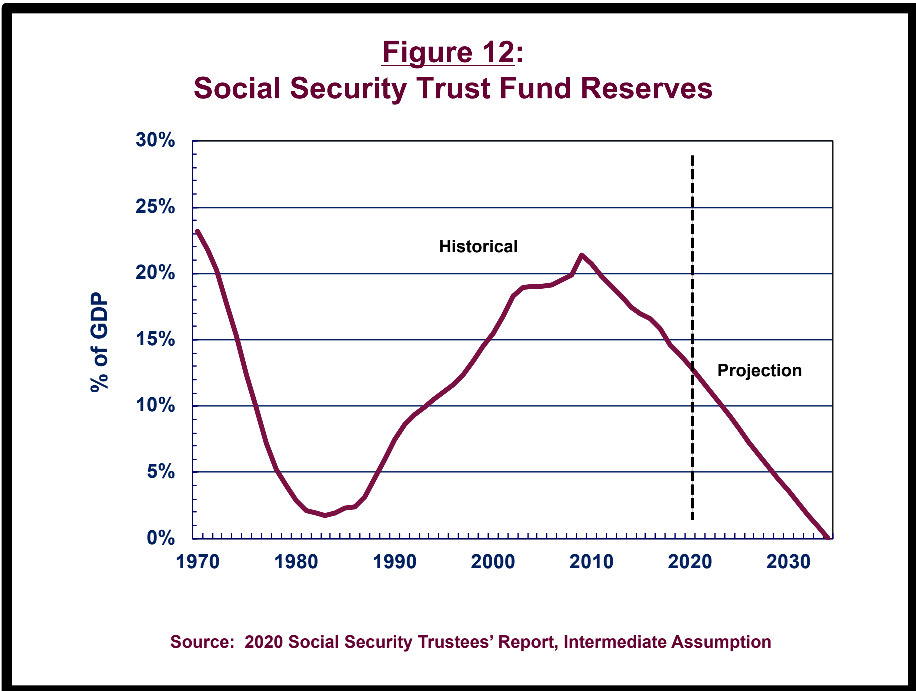


The changing demographic profile of the U.S. population is the primary reason for Social Security's financing challenges. With the number of retirees growing rapidly, and the workforce growing more slowly, payroll tax collections have not kept pace with benefit payments.

As shown in Figure 11, Social Security income has been less than outgo since 2010, and the gap between them is widening. By 2050, annual outgo will exceed income by 1.2 percent of GDP.



Without reform, these deficits will quickly drain the Social Security trust funds of their remaining reserves, as shown in Figure 12. In 2020, the trust funds will have reserves of $2.9 trillion, or about 13 percent of GDP. By 2035, the trust funds will be depleted of back-up funding and unable to pay full benefits to program participants. When the trust funds are depleted, benefits will be paid only with revenue that comes into the program from payroll taxes. It is expected that payroll tax revenue will accommodate benefit payments at about 80 percent of their full value.



The trustees overseeing Social Security's finances estimate the program's financing shortfall over 75 is substantial. To pay full benefits over that period, the payroll tax would need to be increased immediately by 3.21 percentage points, which is equivalent to a 26 percent increase in the current 12.4 percent tax rate.[5]

Medicare and Medicaid

Medicare and Medicaid are the nation's primary public insurance programs. Medicare provides coverage for the nation's elderly and persons with disabilities who are receiving Social Security payments. It is administered by the federal government, and paid from trust funds modeled on Social Security. Medicaid provides health insurance to the nation's lower-income households and is administered by state governments with substantial financial assistance from the federal government. The federal share of Medicaid is 62.5 percent of total costs.[6]

Like Social Security, Medicare and Medicaid are affected by population aging. As the number of Americans age 65 and older surges, spending in Medicare rises because of increasing numbers of program enrollees. Medicaid is the nation's largest source of support for nursing home and community services for the frail elderly. With longer lifespans, there are more people needing assistance with activities of daily living than in prior years, and demand for these services is expected to increase even more rapidly in the coming decades with the aging of the baby boom generation.

Beyond the aging population and surging enrollment, Medicare and Medicaid costs also are escalating because of systemwide cost pressures. The U.S. provides more expensive health care than any other high-income country; Medicare and Medicaid spending is heavily influenced by the same forces driving systemwide cost escalation.

CBO has produced a summary measure of rising per-person spending on health care, called "excess cost growth." Excess cost growth is health spending growth on a per capita basis in excess of GDP growth per person. As shown in Figure 13, Medicare spending from 1985 to 2017 grew 1.1 percentage points faster than per capita GDP, and Medicaid grew 0.7 percentage points faster. The agency expects this trend to continue over the coming three decades, with Medicaid's cost growth accelerating dramatically. The compounding effect of annual growth exceeding growth in the economy is dramatic and explains why the health programs are considered the most pressing fiscal challenge for the federal government.

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[5] The 2020 Annual Report of the Board of trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, The Board Of Trustees, Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, April 2020, https://www.ssa.gov/OACT/TR/2020/tr2020.pdf.

[6] "Federal and State Share of Medicaid Spending," Kaiser Family Foundation, https://www.kff.org/medicaid/state-indicator/federalstate-share-of-spending/?currentTimeframe=0&sortModel=%7B%22colId%22:%22Location%22,%22sort%22:%22asc%22%7D.

Figure 13:
Historical Per Capita Health Spending

"Excess Cost Growth"*

	Actual 1985-2017	Projected 2019-2049
Medicare	1.1%	1.1%
Medicaid	0.7%	1.6%

*Excess Cost Growth is the average annual per capita spending growth rate in excess of average annual per capita GDP growth.

Source: The 2019 Long-Term Budget Outlook, Congressional Budget Office, June 2019

Medicare's financing is both similar to and different from Social Security because Medicare has two parts with distinct sources of revenue. Medicare makes payments for inpatient hospital services from the Hospital Insurance (HI), or part A, trust fund; Supplementary Medical Insurance (SMI), or part B, pays for physician services and other ambulatory care. Income and outgo for the prescription drug benefit (part D) are included in the SMI trust fund.

The HI trust fund is vulnerable to insolvency because, like Social Security, it is financed mainly by payroll taxes collected from current workers. When the population ages, spending surges and payroll tax revenue does not keep up.

Under current law, employers and employees each pay a 1.45 percent Medicare payroll tax on wages, with no upper limit. The Affordable Care Act (ACA) increased the applicable tax for workers by an additional 0.9 percentage point for earnings above $200,000 annually for individuals and $250,000 for couples.[7]

The SMI trust fund is different from HI because it is impossible under current law for it to become insolvent. Beneficiary premiums are set by law to cover just 25 percent of annual outlays; the general fund of the Treasury -- i.e. taxpayers -- automatically pays for the other 75 percent. Consequently, the trust fund always has sufficient reserves to pay for its obligations.

[7] "Medicare Financial Status: In Brief," Congressional Research Service, July 2019, https://fas.org/sgp/crs/misc/R43122.pdf.

In April 2020, Medicare's trustees projected the HI trust fund would be depleted of reserves in 2026. At the end of 2019, the trust fund had a balance of $194 billion, which was 60 percent of expenditures in that year. The trustees recommend keeping reserves above at least 100 percent of expected annual outgo -- a test which has not been met since 2003.[8]

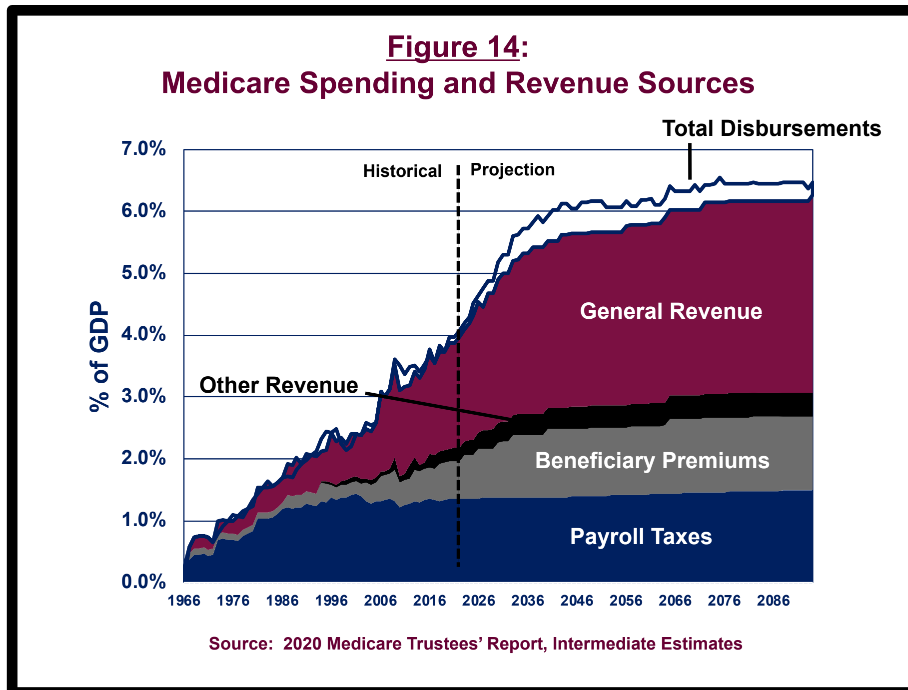
HI's long-run outlook also is adverse. According to the 2020 projections, the HI trust fund will run a 75-year actuarial deficit of 0.76 percent of taxable payroll, which means that eliminating the deficit with revenues alone would require an immediate and permanent payroll tax rate increase of 0.76 percentage point, which is 26 percent of today's combined employer-employee rate 2.9 percent.[9]

The SMI trust fund is automatically funded with large payments from the general fund of the Treasury, so there is no possibility of it becoming insolvent or unable to pay claims. However, as shown in the trustees' projections, the general fund's payments to SMI are quite substantial, and growing rapidly. In 2019, the combined contribution to the part B and part D sub-accounts of the SMI trust fund totaled $321 billion, up from $205 billion in 2010. In the coming years, with Medicare's SMI costs rising rapidly, the general fund payments will soar, reaching a total of $5.3 trillion over the period 2020 to 2029.[10]

These large general fund contributions obscure the extent of the Medicare's financial burden on current and future taxpayers. While they ensure the SMI trust fund is always solvent, they have a real cost, measured in the amount of federal resources diverted to covering Medicare's expenses and in the amount of borrowing required to cover the government's large and rapidly growing annual deficits. In 2000, the general fund transfers to SMI equaled 5.4 percent of total individual and corporate income tax collections. By 2019, they had grown to 16.4 percent of this revenue, and the trustees expect them to rise still further to more than 26 percent by 2040.[11]

Figure 14 provides a comprehensive view of Medicare's financing sources. Medicare's total disbursements rise rapidly over the coming decades as excess cost growth on an annual basis compounds and pushes up obligations. Payroll tax revenue and premiums paid by the beneficiaries stay constant with GDP growth. The widening gap between Medicare's obligations and its revenue sources is covered by the general fund of the Treasury, i.e. taxpayers.

[8] 2020 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, The Boards of Trustees, Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, April 2020, https://www.cms.gov/files/document/2020-medicare-trustees-report.pdf.
[9] Ibid.
[10] Ibid.
[11] Ibid.



Medicaid's costs are influenced by its shared federal-state design. Because both levels of government are responsible for financing the program, there is split political control and thus less accountability for controlling escalating costs.

Medicaid spending is assigned to the federal and state governments by a state-specific federal match rate. For every dollar spent by the states on the program, the federal government provides "matching" funds covering a portion of the cost. As noted previously, the federal government pays for about 63 percent of total Medicaid costs.

The use of matching funds to pay for Medicaid complicates spending discipline. States that would like to restrain program spending must consider that more than half of whatever is saved will go the federal treasury instead of state coffers. Further, because there is no upper limit on how much federal support can be sent to the states for Medicaid, state officials may have stronger incentives to maximize federal financial support than rein in state costs.

Potential Reforms

Reforming the nation's entitlement programs is an immense political challenge because so many Americans rely on them for income support and health coverage. Federal officials are reluctant to raise the subject out of fear that voters will punish then politically at the next election.

Even so, there has been substantial work by independent agencies and academic researchers on reforms that would make entitlement spending more sustainable financially over the long-run. In all likelihood, reforms will have to be phased-in slowly, to protect current retirees from disruptions to their benefits and to give those still working

some time to adjust their retirement plans in anticipation of changes in their federal support.

Reforms to Social Security are the most straightforward. As noted, the program's financing challenge is driven by demographic transformation. The number of beneficiaries is surging while the workforce is growing slowly. Closing the program's financing gap will require a combination of higher taxes to pay for current benefit obligations and slower growth in earned benefits for future retirees.

It is likely that any reform of Social Security will need to protect lower-income households from additional financial burdens. Consequently, frequently-cited adjustments include raising taxes on higher-income households to pay for future Social Security benefits, and lowering benefits in the future mainly for high-wage workers.

CBO has provided estimates of various versions of such reforms in recent years, as shown in Figure 15.

On the benefit side, the starting point could be an adjustment to the program's normal retirement age (NRA). In 1983, when Social Security was near insolvency, Congress and the Reagan administration agreed to a bipartisan rescue plan that raised the retirement age from 65 to 67 over a long phase-in period. With lifespans continuing to go up, it would make sense to make another adjustment over the coming decades, to reflect demographic reality. CBO estimates that a gradual increase to age 70 would lower spending in 2050 by 0.51 percent of GDP.[12] Raising the retirement age would have the added benefit of sending a signal to workers and the labor market that expectations about when to retire should adjust to reflect the longer lifespans of Americans.

In addition to an increase in the retirement age, the formula for calculating pensions for new retirees could be adjusted to lower the return for the highest wage earners. Low-wage workers would be protected from any benefit reduction. This reform would apply prospectively to future retirees. CBO estimates it could reduce costs by about 0.13 percent of GDP.

In addition to spending restraint, some analysts are advocating tax hikes to pay for the program. One option would be to impose a new 4.0 percent tax on wages above $250,000 annually, with the receipts deposited into the Social Security trust funds. Unlike current payroll taxes, high-wage workers would not get additional benefits from paying this new tax. Breaking the link between tax payments and earned benefits would be a departure from the program's original design and history, and would therefore be controversial. CBO estimated that this tax would increase taxes by about 0.2 percent of GDP in 2050.

Originally, Medicare's age of eligibility was tied to Social Security's normal retirement age. That link was broken with the 1983 reform. As the population ages, Medicare eligibility could be adjusted to reflect longer lifespans in a manner similar to what is

[12] These estimates are based on previous CBO analyses from prior years; the numbers have been updated to 2050 by the author.

proposed for Social Security. On a prospective basis, the normal age of eligibility could be increased on a gradual basis from age 65 to 67. CBO estimates this provision would reduce costs by only 0.05 percent of GDP in 2050 because much of the savings would be offset by subsidies paid through other programs. In particular, persons age 65 and 66 who are not eligible for Medicare may choose to enroll in coverage offered through the Affordable Care Act's exchanges. If their incomes are low enough (as they would be for many early retirees), then the federal government would subsidize their premiums with tax credits. The cost of these subsidies would offset some of the savings from delayed Medicare eligibility.

Beyond an increase in the eligibility age, bringing discipline to Medicare and Medicaid is a complex proposition. A discussion of costs for these large programs necessarily involves looking at the broader health system. In general terms, there are two views on what should be done to rein health spending growth across-the-board. One view is that the U.S. should adopt stricter regulatory controls, on prices and capital expenditures, as is the practice in most high-income countries. The other perspective is that the U.S. needs more cost discipline imposed by competition and market forces.

CBO has provided an estimate of one reform that is advanced by proponents of market discipline. It would convert how Medicare operates into a "premium support" system. Beneficiaries would get fixed levels of support from the federal government for enrollment into competing health insurance plans. Because the government's contribution toward coverage would not increase with the expense of the plan chosen, beneficiaries would have an incentive to enroll in low-premium, high-value options. CBO has estimated that one version of this reform would cut Medicare's costs by about 8 percent, which translates into savings of 0.49 percent of GDP in 2050. Beneficiaries costs would fall 7 percent as well.

Proponents of more regulatory control of costs favor reforms which both increase and decrease federal expenditures. Regulatory controls would lower per person health expenses, but the government would become responsible for covering more people through public insurance. For instance, proposals to create a new "public option" would pull enrollment out of commercial insurance, and thus lower the government's tax subsidy for job-based plans. Tax revenue would increase accordingly. However, subsidies for coverage in the public option are likely to more than offset the added revenue. The government's net fiscal position would worsen in the absence of other tax hikes or spending cuts.

Figure 15:
Major Reforms

	Estimated Improvement in Fiscal Position % of GDP 2050
Raise the Social Security Retirement Age to 70	-0.51
Make the SS Benefit More Progressive	-0.13
Apply a New 4% Tax On High Earners for SS	-0.20
Raise the Medicare Eligibility Age to 67	-0.05
Implement Premium Support in Medicare	-0.49

Sources: Congressional Budget Office (Options for Reducing the Deficit: 2019 to 2028, January 2018; Social Security Policy Options, 2015, December 2015; A Premium Support System for Medicare: Updated Analysis of Illustrative Options, October 2017)

Conclusion

The federal government's deteriorating fiscal position is not a new problem. Policymakers have known for many years that the aging of the population would create financial pressure for the federal budget. A presidential commission from the mid-1990's was tasked with coming up with a solution.[13] It was followed by multiple public and private efforts, including another presidential commission in 2010.[14]

And yet despite widespread acknowledgement of the problem, very little has been done over the past three decades to address it.

Now, with the COVID-19 pandemic, the U.S. may be entering a different era in fiscal policy. Debt is soaring well beyond what even pessimistic scenarios predicted a few years ago, and the country is close to the point beyond which it will be difficult to produce sufficient revenue to pay for current obligations and debt retirement.

Indeed, the problem is so large that it is beyond the ability of either major party to address on its own. Progress will require bipartisan cooperation, which has become less common with intense political polarization. One must hope that these obstacles can be overcome before another economic crisis forces a precipitous response.

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[13] See "Final Report to the President," Bipartisan Commission on Entitlement and Tax Reform, December 1994, https://www.ssa.gov/history/reports/KerreyDanforth/KerreyDanforth.htm.

[14] See "President Obama Establishes Bipartisan National Commission on Fiscal Responsibility and Reform," The White House, February 18, 2010, https://obamawhitehouse.archives.gov/the-press-office/president-obama-establishes-bipartisan-national-commission-fiscal-responsibility-an.