CBO TESTIMONY

Statement of
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Congressional Budget Office

on
Entitlement and Tax Reform

before the
Bipartisan Commission on Entitlement
and Tax Reform

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NOTICE

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Chairman Kerrey, Vice Chairman Danforth, and Members of the Commission, I appreciate the opportunity to appear here today to discuss the nature of the entitlement problem facing our nation and the context for reform. I want to commend the Commission for keeping the public's attention focused, in a responsible way, on the important issue of entitlements. With recent declines in the federal budget deficit, it would be tempting to turn away from the politically divisive discussion of benefit reductions and tax increases in the false hope that the deficit will just go away by itself.

My statement today discusses three topics:

- The relationship between federal budget deficits, entitlements, and future living standards;

- The nature of entitlements and the reasons they will contribute to rapidly growing deficits in the future; and

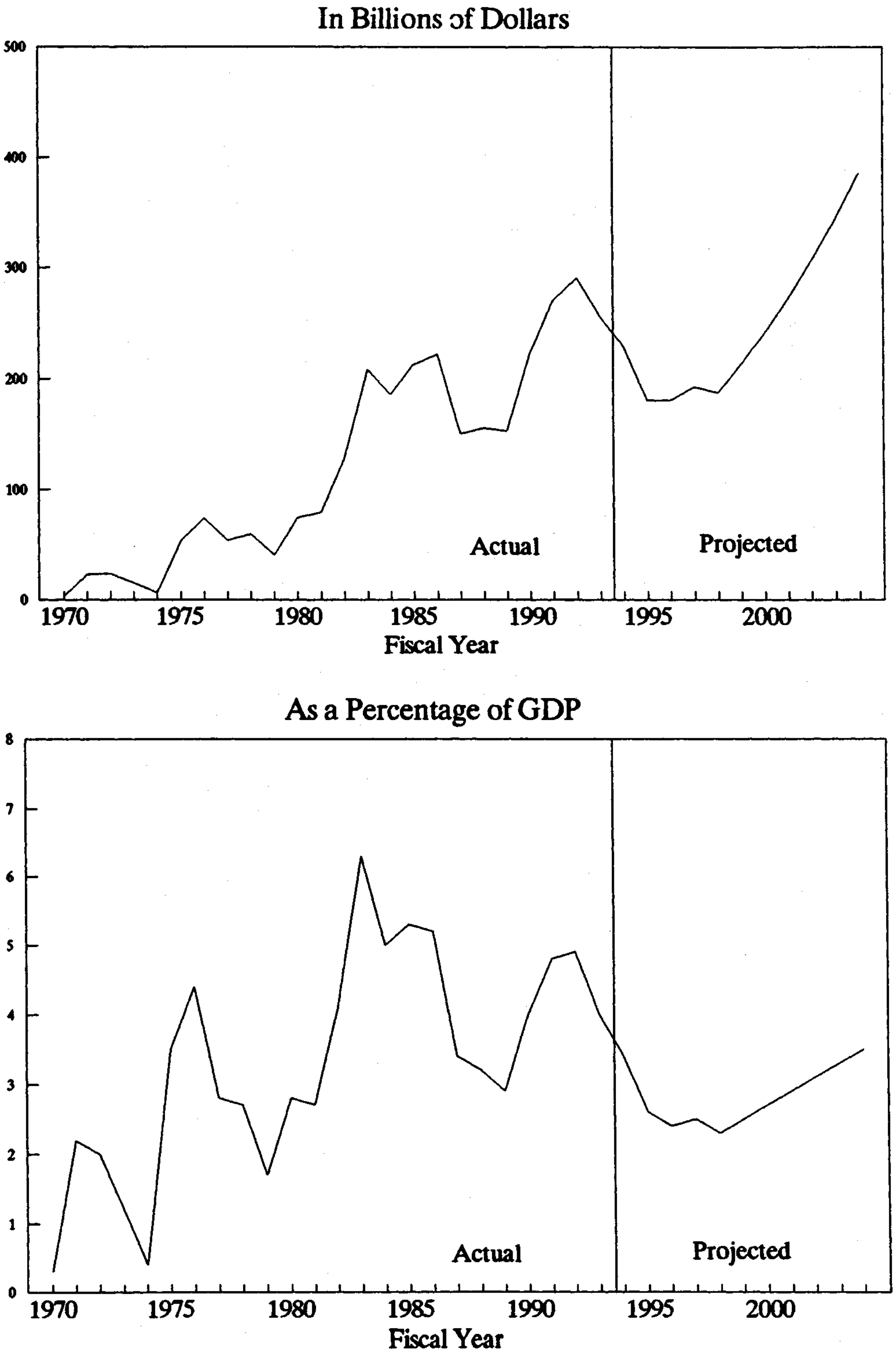
- The importance of acting soon to address the entitlement problem.

PROJECTED DEFICITS AND THEIR IMPLICATIONS FOR FUTURE LIVING STANDARDS

Although actions taken by the Congress and recent Administrations in 1990 and 1993 have brought down the deficit, a considerable long-run imbalance remains between the revenues that will be generated by the existing tax system and the expenditures that will be required to maintain existing federal programs. The budget deficit has fallen from a peak of $290 billion in fiscal year 1992 to about $200 billion in the current fiscal year, and it is expected to fall below that in 1995 and 1996 (see Figure 1 and the Appendix Table). But this respite will be only temporary. Near the end of this decade, the deficit will begin to rise faster than the economy under current policies, with the annual budget shortfall reaching $385 billion--or 3.5 percent of gross domestic product (GDP)--in 2004. The situation will become considerably worse around 2010, when the baby-boom generation begins to retire.

Large budget deficits are debilitating because they absorb national saving that otherwise could be used for investments that would improve the living standards of future generations. National saving--that is, saving by individuals, businesses, and various levels of government--finances investments that add to the stock of factories, machinery, and other types of capital in the economy. This additional capital, in turn, generates employment, increased productivity, and growing real incomes for more and more workers. From time

Figure 1.
Federal Budget Deficits, 1970–2004



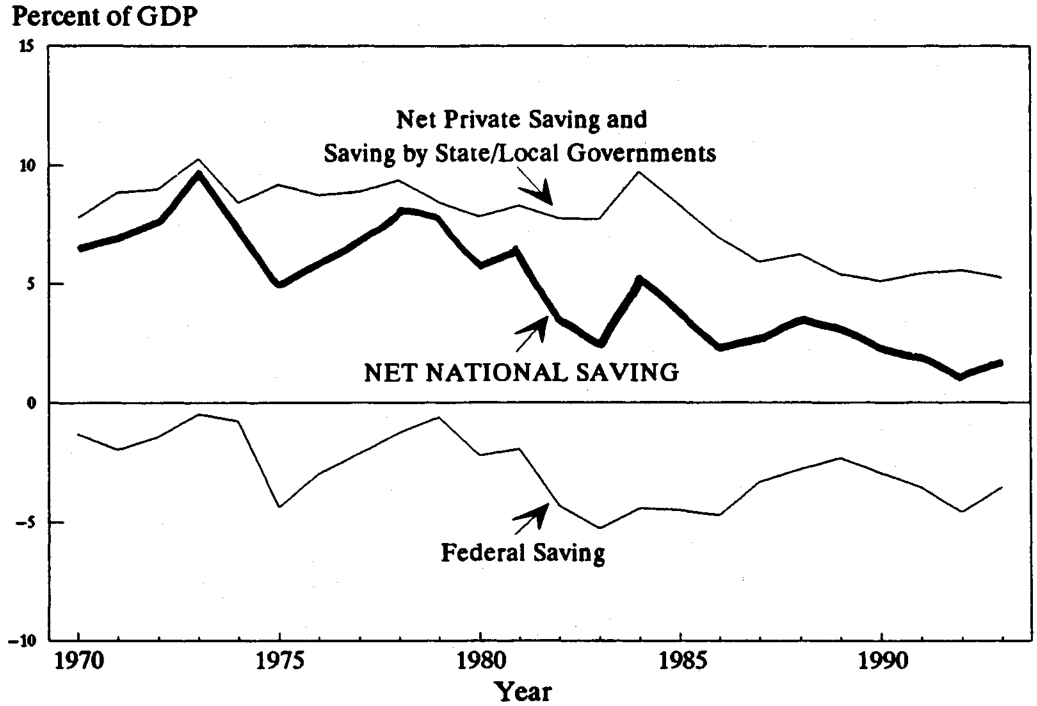
SOURCE: Congressional Budget Office.
NOTE: GDP = gross domestic product.

to time, national saving can fall short of investment because inflows of saving from abroad can fill the gap temporarily. However, history has shown repeatedly that sustained growth in living standards is achieved most reliably through national saving.

Primarily because of the large budget deficits since about 1980, the net national saving rate has fallen precipitously. After averaging 7.7 percent of GDP in the 35-year period ending in 1980, the net national saving rate fell to only 3 percent between 1981 and 1993, and to only 1.7 percent in 1993 (see Figure 2). High federal deficits have been particularly worrisome in recent years because of the decline in net private saving that has also occurred during that period. If low rates of saving continue, the United States can expect lower growth of productive potential and lower real income in the future than would otherwise occur. The surest way to remove this cumulative threat to the growth of living standards is to reduce the federal budget deficit.

Spending on entitlement programs is the major factor underlying the overall deterioration of the deficit situation projected during the next several decades. Entitlement and other mandatory spending is expected to grow at an average annual rate of 6.7 percent between now and 2004--considerably faster than the average growth rates of federal revenues, total outlays, and the overall economy, each of which is expected to be about 5.1 percent a year. As a result,

Figure 2.
Net National Saving as a Percentage of GDP, 1970–1993



SOURCE: Congressional Budget Office.

entitlement spending as a share of all federal spending is projected to rise from about 54 percent now to 63 percent by 2004. More than half of the growth in entitlement spending over this period will occur in two programs that finance health care--Medicare and Medicaid.

The hemorrhaging in the deficit that will occur after about 2010 under current policies is also clearly related to the anticipated increase in spending on entitlements. Retirement of the baby-boom generation will accelerate the growth of Social Security spending and further push up Medicare costs.

By contrast, total discretionary spending is projected to grow at less than 2 percent a year between now and 2004. This spending on programs ranging from national defense to aid for schools, transportation, and the environment now represents about 8 percent of GDP, down from over 10 percent in the 1970s and 1980s. During the next decade, discretionary spending is projected to fall to 6 percent of GDP, assuming that appropriations rise with inflation after 1998 when the budgetary caps have expired. That share is not large when compared with the projected size of future budgetary shortfalls.

The term entitlement encompasses many programs that account for slightly over half of all federal spending. These programs make payments to recipients who are eligible and apply for funds. Usually these recipients are people, but occasionally they are businesses or state and local governments. Payments are governed by formulas set in law and are not constrained by the annual appropriation process.

Because the government is legally required to provide the specified benefits to all eligible applicants, the only way to reduce costs is to change the underlying legislation. Beyond that, indirect factors--demographic shifts in the population, economic conditions such as rates of inflation, and program participation rates--drive spending on entitlements. Although many people regard entitlement spending as out of control, not all entitlement programs have grown rapidly, nor are all expected to do so in future years.

The Composition of Entitlements

Only about one-fourth of entitlement spending is means-tested--that is, paid to people who must document their need based on income, assets, or related

criteria. Among means-tested programs, however, is Medicaid, the fastest growing of all major entitlements. Spending for this program, which provides medical care to some of the poor, has skyrocketed in recent years and is expected to reach $151 billion by 1999 (see Table 1).

Many factors are responsible for increased Medicaid spending, including rapidly rising costs of medical care, court decisions requiring that states set reimbursement rates at higher levels, the phase-in of expanded eligibility for children, and efforts by state and local governments to maximize the funds obtained from the federal government. Roughly two-thirds of Medicaid spending is for elderly and disabled recipients.

Aside from Medicaid, only two large means-tested entitlements are projected to grow faster than the overall economy during the next few years. Spending for the refundable portion of the earned income tax credit is expected to double in the next five years to $22 billion as a result of increases legislated in 1993, with larger benefits going to a greater number of people. Similarly, spending on Supplemental Security Income for the aged, blind, and disabled is expected to increase by 40 percent to $35 billion, primarily as the result of an increase in the number of disabled participants. But federal spending for other programs ranging from child nutrition to student loans to veterans' pensions is expected to expand slowly, if at all, over that period.

Table 1.
CBO Baseline Projections for Mandatory Spending, Excluding Deposit Insurance
(By fiscal year, in billions of dollars)

	Actual 1993	1994	1995	1996	1997	1998	1999
Means-Tested Programs							
Medicaid	76	86	96	108	121	135	151
Food Stamps[a]	25	25	26	27	28	29	30
Supplemental Security Income	21	25	24	24	29	32	35
Family Support	16	17	18	18	19	20	20
Veterans' Pensions	4	3	3	3	3	3	3
Child Nutrition	7	7	7	8	8	9	9
Earned Income Tax Credit	9	11	15	18	20	21	22
Student Loans	2	2	2	2	2	2	2
Other	3	3	3	4	4	4	5
Total, Means-Tested Programs	162	180	196	212	234	254	277
Non-Means-Tested Programs							
Social Security	302	318	335	352	370	388	408
Medicare	143	160	177	195	216	238	263
Subtotal	445	478	512	547	585	626	671
Other Retirement and Disability							
Federal civilian[b]	39	40	42	44	46	49	51
Military	26	26	27	29	30	32	35
Other	4	5	5	5	5	5	4
Subtotal	69	71	74	78	81	86	90
Unemployment Compensation	35	27	24	25	25	26	27
Other Programs							
Veterans' benefits[c]	17	18	17	16	18	18	19
Farm price supports	16	11	7	8	8	8	9
Social services	5	6	6	6	6	6	5
Credit reform liquidating accounts	2	-1	-1	-4	-5	-5	-6
Other	11	13	11	10	10	10	8
Subtotal	51	46	41	35	37	37	36
Total, Non-Means-Tested Programs	600	622	651	685	729	774	824
Total							
All Mandatory Spending, Excluding Deposit Insurance	762	802	847	897	963	1,028	1,100

SOURCE: Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 1995* (April 1994).

NOTE: Outlays for most of the benefit programs shown above do not include administrative costs, which are classified as domestic discretionary spending. Outlays for Medicare do not include premium collections, which are classified as offsetting receipts.

a. Includes nutrition assistance to Puerto Rico.

b. Includes Civil Service, Foreign Service, Coast Guard, and other retirement programs, and annuitants' health benefits.

c. Includes veterans' compensation, readjustment benefits, life insurance, and housing programs.

Among the roughly three-quarters of entitlement spending that is not means-tested, Medicare is the only major program that is expected to grow faster than the economy over the next five years, reaching $263 billion in 1999. In spite of repeated efforts to rein in its costs, Medicare spending has grown by about 10 percent a year during the last decade and is expected to continue that trend over the next few years. Program growth is mainly attributable to higher expenditures per enrollee rather than a larger number of enrollees. These expenditures in turn are fueled by rapidly rising costs of medical care, related in part to technological advances, and by greater use of covered services.

Growth in spending for Social Security and other retirement and disability programs is expected roughly to match the growth of the economy over the next few years, while spending for several other categories of non-means-tested entitlements is projected to remain constant or fall. Social Security, the single largest program, has grown by about 6 percent annually over the last decade, and similar growth is projected for the next few years. But even so, Social Security is projected to cost $408 billion by 1999. Other categories such as unemployment insurance, farm price supports, and social services are projected to remain constant or decline slightly in the next few years.

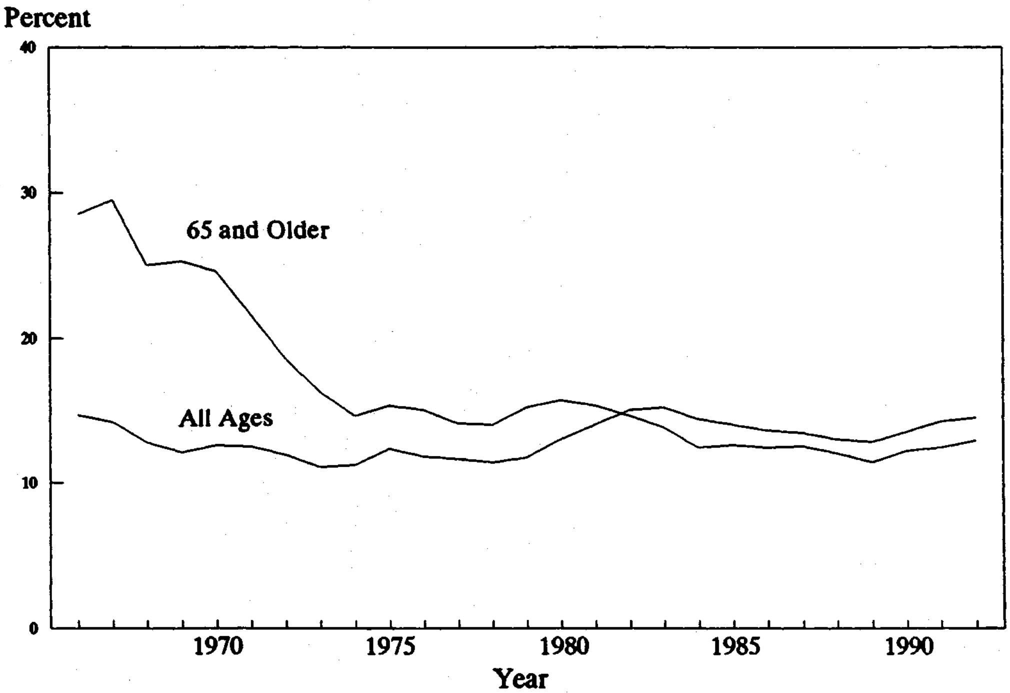
The Benefits of Entitlement Spending

Although the huge amount of entitlement spending and the incessant growth of some programs has made the term entitlement almost a pejorative one, it is important to note the major accomplishments that this spending has achieved. The principal beneficiaries of federal entitlements are, and have been, the elderly and disabled, but other groups such as low-income families with children have also gained a great deal.

Aid to the Elderly and Disabled. In 1990, federal entitlement spending for elderly and disabled people totaled more than $400 billion--over 70 percent of all entitlement spending, and nearly one-third of all federal spending. Current and past federal spending on these groups has enhanced their economic security and living conditions in several ways. First, the poverty rate of the elderly has been cut roughly in half over the last quarter century (see Figure 3). Between 1966 and 1992, the poverty rate of people ages 65 and older fell from over 25 percent to about 13 percent. This decline occurred during a period in which the overall poverty rate hovered in the range of 11 percent to 15 percent.

The availability of medical care through Medicare and Medicaid has also improved the circumstances of many elderly and disabled people. It has

Figure 3.
Poverty Rates by Age Group, 1966–1992



SOURCE: Congressional Budget Office based on data from the Bureau of the Census.

reduced their fears that they will not be able to afford the care they need or that they will bankrupt their families to receive it.

Finally, a by-product of their increased income security has been the ability of more elderly people to live independently. In 1992, fully three out of four elderly people either lived alone or lived only with their spouse; this figure compares with only about 55 percent in 1960. Separate living arrangements not only have provided the elderly with a greater degree of independence, but also have given their children and grandchildren more freedom and flexibility in their life styles.

Aid to Low-Income Families with Children. The availability of entitlement benefits has also helped many low-income families with children, though not to the extent that they have benefited the elderly. The economic and nutritional needs of many low-income families with children have been helped through Aid to Families with Dependent Children and other family support programs, the earned income tax credit, child nutrition assistance, and food stamps. In addition, the Medicaid program has enhanced access to health care. Although the high poverty rate of children--nearly 22 percent in 1992--continues to be a major concern, many children in low-income families receive considerable financial and in-kind support through several entitlement programs.

Aid to Other Groups. Benefits from other entitlement programs also enhance the lives of many other groups of people. For example, many unemployed workers have a portion of their wages replaced temporarily each year through the unemployment insurance program, and large numbers of students attend postsecondary educational institutions with the help of federally backed student loans. Similarly, farm price supports provide many farmers with more even income streams over time.

The Entitlement Problem

As a result of the creation and expansion of several massive entitlement programs and growth in the costs of health care that vastly exceeded general inflation, the country now has a more generous set of entitlement commitments than it seems willing to pay for. Over the intermediate term, increases in the federal deficit will be largely driven by health care entitlements, with federal spending on Medicare and Medicaid each expected to nearly triple by 2004. Spending for other entitlements is projected to be much more stable during the next 10 years, however, with outlays for Social Security and other retirement and disability programs remaining roughly constant as a share of GDP.

The long-run entitlement problem is also one of programs directed at the elderly and disabled. Future spending on retirement and disability benefits will mirror the large increases in those populations resulting from the aging of the baby-boom generation. Moreover, without major changes in the health care sector, federal spending on health programs will continue its meteoric rise, reflecting both higher costs per beneficiary and more beneficiaries.

A variety of factors have led to the current dilemma. Health costs have risen extremely rapidly as the capabilities of the medical care sector have expanded. Cash entitlement programs have become more generous over time. The size of the elderly population is growing because of increases in life expectancies and the aging of the baby-boom generation. But the nation has been unwilling to raise taxes to match the growth in the costs of entitlement programs.

That imbalance could be resolved in several ways: by cutting back on entitlement commitments, increasing revenues, reducing spending on discretionary programs, or doing some of each. As long as any increased revenues came largely from consumption and any reduced discretionary spending did not cut into public-sector investment activities, the exact mix of responses would not affect the increases in economic growth that would result from deficit reduction. But it is important to remember that benefit reductions

and tax increases would reduce the living standards of some groups, both now and in the future. In particular, we need to be aware of how the living standards of the active population would be affected compared with those of people receiving entitlements.

THE IMPORTANCE OF ACTING SOON

The next few years represent a window of opportunity during which we can deal with the entitlement problem in a deliberate and reasoned fashion. The economy seems well positioned to absorb any short-term adjustments that would come with actions to reduce the deficit, and projected deficits under prevailing policies are relatively stable over the next few years. Entitlement spending is not expected to surge before the retirement of the baby-boom generation some 15 years from now, so a precipitous policy response is not required now.

This time span is fortunate because entitlement programs are generally viewed as long-term commitments between the government and the citizenry, and people have structured their behavior based on current provisions. Moreover, entitlement benefits largely go to the elderly, the disabled, poor single-parent families, and the unemployed--groups that have little ability to

respond to abrupt changes in policies. Gradual changes in spending and tax policies would give people adequate time to plan and adjust their behavior.

If we take advantage of this opportunity and act soon, we could reap enormous benefits in the future by taking only modest, prudent steps to modify current spending and taxing policies. Such changes made now would produce increasing gains in deficit reduction and national saving in the decades ahead. Moreover, the adverse impacts could be spread over a larger number of cohorts, and because the changes could be phased in over a number of years, they need not cause major disruptions in life styles or standards of living.

If we fail to act soon, however, this opportunity will pass and the required actions will have to be more drastic. Previously available options for reducing benefits will become less viable, for example, because members of the baby-boom generation will no longer have time to adjust their work and saving behavior in response to cuts in their benefits. Yet the budgetary shortfalls will mount, and the need to respond will grow commensurately. As difficult as the policy choices are now, they will only get worse the longer that action is postponed.

Appendix Table.
The Budget Outlook Through 2004 (By fiscal year)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
					In Billions of Dollars						
Revenues	1,251	1,338	1,411	1,479	1,556	1,630	1,706	1,783	1,868	1,958	2,054
Outlays											
Discretionary	547	546	551	549	549	566	584	602	621	640	660
Mandatory											
Social Security	318	335	352	370	388	408	429	450	473	497	523
Medicare	160	177	195	216	238	263	290	320	354	391	434
Medicaid	86	96	108	121	135	151	168	186	206	227	250
Civil Service and Military Retirement	62	65	68	71	74	79	82	86	90	94	99
Other	176	174	174	185	192	199	206	212	219	226	233
Subtotal	802	847	897	963	1,028	1,100	1,175	1,255	1,342	1,436	1,538
Deposit insurance	-3	-12	-14	-6	-5	-4	-2	-2	-1	-1	-1
Net interest	201	214	230	241	252	264	276	291	307	325	345
Offsetting receipts	-68	-77	-72	-76	-82	-85	-88	-92	-95	-99	-104
Total	1,478	1,518	1,591	1,670	1,743	1,843	1,945	2,054	2,173	2,300	2,439
Deficit	228	180	180	192	187	213	240	271	305	343	385
Deficit Excluding Deposit Insurance	231	192	194	198	192	216	242	273	306	344	386
Debt Held by the Public	3,465	3,653	3,846	4,055	4,260	4,492	4,751	5,041	5,366	5,728	6,132
					As a Percentage of GDP						
Revenues	18.8	19.1	19.1	19.0	19.0	19.0	18.9	18.9	18.8	18.8	18.8
Outlays											
Discretionary	8.2	7.8	7.5	7.1	6.7	6.6	6.5	6.4	6.3	6.1	6.0
Mandatory											
Social Security	4.8	4.8	4.8	4.8	4.7	4.7	4.8	4.8	4.8	4.8	4.8
Medicare	2.4	2.5	2.6	2.8	2.9	3.1	3.2	3.4	3.6	3.8	4.0
Medicaid	1.3	1.4	1.5	1.6	1.7	1.8	1.9	2.0	2.1	2.2	2.3
Civil Service and Military Retirement	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Other	2.6	2.5	2.4	2.4	2.4	2.3	2.3	2.2	2.2	2.2	2.1
Subtotal	12.1	12.1	12.1	12.4	12.6	12.8	13.0	13.3	13.5	13.8	14.1
Deposit insurance	-0.1	-0.2	-0.2	-0.1	-0.1	a	a	a	a	a	a
Net interest	3.0	3.0	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.2
Offsetting receipts	-1.0	-1.1	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-0.9
Total	22.3	21.7	21.5	21.5	21.3	21.4	21.6	21.7	21.9	22.1	22.3
Deficit	3.4	2.6	2.4	2.5	2.3	2.5	2.7	2.9	3.1	3.3	3.5
Deficit Excluding Deposit Insurance	3.5	2.7	2.6	2.5	2.3	2.5	2.7	2.9	3.1	3.3	3.5
Debt Held by the Public	52.2	52.1	52.1	52.1	52.1	52.3	52.7	53.3	54.1	55.0	56.1

SOURCE: Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 1995* (April 1994).

a. Less than 0.05 percent of GDP.