



**BRIEF ANALYSIS**

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## Piling Up Future Debts

by Jagadeesh Gokhale and Kent Smetters

Recent federal budget projections show much larger deficits over the next five years than were expected just a short while ago. However, these short-term projections convey almost no information about the true magnitude of our nation's financial problems. We need to adopt a comprehensive fiscal accounting system that communicates the size of unfunded future federal spending commitments under current policies. Because Medicare and Social Security account for most of the unfunded spending, we also need to be informed about whether it arises on account of past, living or future generations. Without such an accounting system, policymakers and the public will remain unable to evaluate available policy options fairly, leading to poor decisions. For example, using traditional accounting that focuses on short-term deficits, Congress seems poised to enact a costly Medicare prescription drug benefit without any provision for funding it.

**How Much Is the Total Future Debt?** The Fiscal Imbalance (FI) is a measure of the federal government's total unfunded obligations. It consists of the current publicly-held debt plus the present value of the difference between all projected

federal noninterest spending and all projected federal revenue under existing fiscal policies. "Present value" means that revenue and spending projections are discounted by the government's long-term borrowing rate.

The United States' federal fiscal imbalance has been calculated by taking present values as of the end of Fiscal Year (FY) 2002 and interpreting the Bush administration's proposed FY 2004 federal budget as "current policies." Those policies imply a Fiscal Imbalance of \$44.2 trillion. However, the FY 2004 budget includes the President's prescription drug proposal, which is now unlikely to be adopted. Excluding that proposal, current FI equals \$38.1 trillion. This is the amount that the federal government must have available today to invest with interest to make current policies sustainable—that is, never requiring policy changes because of accruing revenue shortfalls.

Given that the federal government does not possess an extra \$38.1 trillion in interest earning assets, how-

ever, it must raise an equivalent amount by increasing future revenues and/or cutting future outlays. Of course, to equal \$38.1 trillion in *present value*, the cumulative value over future years of these policy changes will have to be substantially *larger* than \$38.1 trillion.

Medicare and Social Security account for almost all of this projected shortfall. As the figure shows:

- Social Security's unfunded liabilities are about \$7 trillion in present value.
- Medicare's projected shortfall is \$30.5 trillion—of which Part A (the Hospital Insurance program) contributes \$14.4 trillion and Part B (the Supplemental Medical Insurance program) contributes \$16.1 trillion.

- By contrast, the rest of the federal government's fiscal imbalance is only \$0.5 trillion, comprised of \$4.6 trillion in excess future outlays over revenues in present value, publicly held debt of \$3.5 trillion, and liabilities to Social Security and Medicare trust funds of \$1.6 trillion.

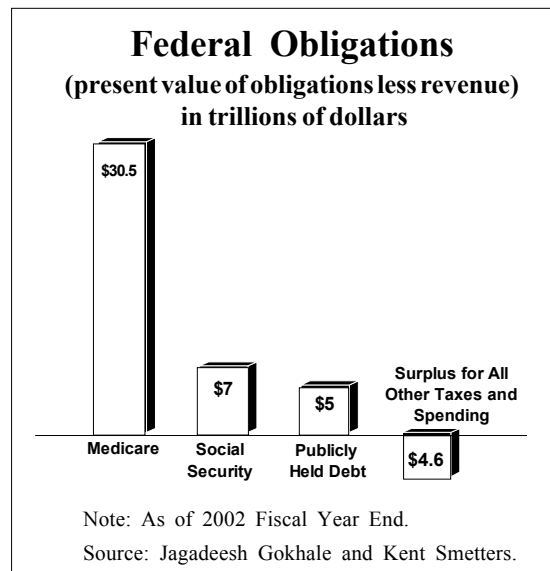
**What Would It Cost to Eliminate the Fiscal Imbalance?** The current payroll tax rate includes a capped Social Security tax of 12.4 percent, applied to the first \$87,000 of a worker's wages (in 2002), and a 2.9 percent Medicare tax applied to all of a worker's wages (uncapped). Assuming that

surplus tax revenues can be saved for future use, we estimate that to achieve fiscal sustainability:

- An additional 14.4 percentage points of total annual (capped) payrolls would have to be taxed away *forever* beginning today and invested in securities paying a real return of about three percent per year.
- Alternatively, income tax revenues would have to be hiked immediately and permanently by 59.1 percent—increasing their share of gross domestic product (GDP) from 9.5 percent to 15.1 percent.
- Another (equally drastic) alternative would be to cut Social Security and Medicare benefits by 41.6 percent immediately and forever.

Alternatively, we could permanently eliminate all future federal discretionary spending—for such services as national defense, highway construction, administration of justice and so forth.

The FI will grow by about \$1.4 trillion for each year that passes without fiscal reforms to achieve fiscal



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sustainability. With no policy changes, it will climb to about \$47 trillion by 2008, and the magnitude of the necessary corrective policies will grow larger the longer their adoption is postponed.

**How Much Would Medicare Drug Benefits Cost?** Adding an unfunded Medicare prescription drug benefit would substantially increase the Fiscal Imbalance. The Bush administration's FY 2004 budget proposal included strong incentives for competition that would yield future savings. As already indicated, it would add \$6.1 trillion to the fiscal imbalance.

If instead of the President's prescription drug plan we adopt the bipartisan prescription drug proposals now being debated in a congressional conference committee, and if drug costs continue to increase at current rates for the next few decades, it will add as much as \$12 trillion to the fiscal imbalance. The federal government's FI would rise from \$38.1 trillion to over \$50 trillion. As a result,

- The hike in payroll taxes required to close the fiscal gap would rise from 14.4 percentage points to 18.9 percentage points.
- Alternatively, income tax revenues would have to rise to 16.8 percent of GDP.

### **Shifting the Burden to Future Generations.**

Almost the entire fiscal imbalance arises in the Medicare and Social Security programs. These programs' benefits are targeted to a specific population group — retirees. Current retirees paid in payroll taxes in the past and are now receiving benefits. Today's workers are paying payroll taxes with the expectation of receiving future benefits. These programs are expected to continue indefinitely and future workers may expect to pay payroll taxes when working and receive support when they retire. Both of these programs are, therefore, entirely redistributive in nature. Increasing retiree benefits and/or payroll taxes redistributes resources from workers and future generations to retirees. Because these programs' outlays are large and expected to grow rapidly, it is important to capture their fiscal (essentially redistributive) effect clearly.

A second measure, the Generational Imbalance (GI), tells us how much of the Fiscal Imbalance arises from older generations shifting tax burdens to younger (including yet-unborn) generations. The GI is the excess of benefits received by past and current older generations over taxes paid by them, in present value. Under current Medicare and Social Security policies, those aged 14 or younger (as of 2002) and future generations will pay more in taxes than they will receive in present value of benefits. The current GI of Social Security (\$8.7 trillion) is larger than its Fiscal

Imbalance (\$7 trillion). This means future generations are expected to pay \$1.7 trillion more in taxes than the benefits they will receive.

Medicare's GI (\$12.8 trillion) is smaller than its FI (\$30.6 trillion). Under current policies (those of the FY 2004 budget, excluding the President's prescription drug plan) past generations and those alive today (aged 15 and older) are projected to receive \$12.8 trillion more in present value of benefits than they will pay in Medicare taxes. Under those same policies, future generations are also scheduled to receive \$17.8 trillion more in Medicare benefits than they are projected to pay in taxes. However, since revenues must ultimately be brought in line with outlays, it is future generations who will pay: If today's and past generations expected surplus of benefits over taxes (\$12.8 trillion in present value) is realized, future generations will not only be forced to give up their projected surplus of \$17.8 trillion, but also will have to pay an additional \$12.8 trillion in extra taxes to cover the excess benefits of their forebears.

### **Current Budget Measures Are Biased Against Reform.**

The fiscal measures used by the Congressional Budget Office and Office of Management and Budget do not look far enough into the future. Their reports direct attention to the public debt and annual deficits over the next few years. Such accounting, apart from hiding a large chunk of the long-term costs of new programs, is inherently biased against reforms that improve the long-range financial picture. This same bias may be at work today regarding the Medicare prescription drug plans under consideration by Congress: Focusing on the \$400 billion cost over 10 years may be promoting passage of a more expensive plan than if the true total cost of \$12 trillion, which includes expenditures beyond the 10-year window, were widely known.

Until the future implications of today's policies — as reflected in the FI and GI estimates mentioned above — are fully documented and reported by the nation's budget score-keepers *and* unless they become the basis for making policy decisions, it will take longer to implement reforms to address the enormous problems in our entitlement programs, imposing permanently higher tax burdens on future Americans.

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