Restructuring the US Economy to Prevent a Debt Crisis

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Abstract

Restructuring the US economy – and economic policymaking – is a topic of debate during the current US presidential election campaign. US fiscal policy has been contentious for the past few years, with threats of government shutdowns and repeated approaches to the debt limit. The Budget Control Act of 2011 and The Bipartisan Budget Act of 2015 illustrate the inability of the various factions in Congress to settle differences and set a fiscal path to promote long-term growth and stability. The result is that the ten-year outlook for federal budget deficits is that they will grow steadily, from 2.5% of GDP in 2015 to 4.9% of GDP in 2026. This string of continuing deficits would bring the public debt to 86.1% of GDP. These figures are based on current law with no allowance for contingencies. There are growing concerns that the emerging debt burden could lead to another financial crisis. The solution can come only from reform of federal outlays or revenues. The reason a solution is needed is well stated in the seminal study of financial crises over the last 800 years by Reinhart and Rogoff: "When countries become too deeply indebted, they are headed for trouble".

1. The Fiscal Imbalance

One effective way to view the fiscal situation of the US government is to compare the present value of future expenses and revenues by program and in total. Jeffrey Miron has constructed such annual data for 1965-2014. He found that in 2014 the fiscal imbalance reached a record high of $117.9 trillion. The primary cause for the growth in the fiscal imbalance is growth of mandatory spending – those spending programs not subject to the annual budgeting process. It is unlikely that tax revenue increases can close this gap; so spending controls must be adopted. Most (88%) of the mandatory spending category consists of Social Security and the major healthcare and nutrition programs. (Miron, 2016).

The composition of federal spending has changed since 1970. Discretionary spending (subject to Congressional appropriations) has declined from about 13% of GDP to 7% today. Over the same time, mandatory spending (not subject to Congressional appropriations) has increased from 4% of GDP to 12% today. Much of this paper is based on projections of federal government spending and revenues over a ten-year planning horizon (2016-2026) produced by the Congressional Budget Office (CBO). The CBO assumes no change in law but allows for the expected effects of demographic trends and external costs. These CBO projections show that the public debt will increase to 86% of GDP in 2026 and 250% in 2055. (CBO, 2015a).

2. Outlays

Federal government spending has averaged 21.1% of GDP for the past 50 years. Federal outlays fall into three broad categories: mandatory spending, discretionary spending, and net interest spending. Federal outlays were $3.7 trillion in 2015, and they are projected to rise to $6.4 trillion in 2026. That spending trend would lift outlays from 20.7% of GDP in 2015 to 23.1% of GDP in 2016. Of this increase, 51% is due to Social Security and Medicare. These programs are adversely affected by the demographic reality that the number of Americans age 65 or more will increase by 37% between 2016 and 2026.

Mandatory spending is that spending not subject to the annual budget appropriation process. These programs include Social Security, Medicare, Medicaid, subsidies under the Affordable Care Act (Exchanges), federal civilian and military retirement benefits, Supplemental Nutrition Assistance Program (SNAP or food stamps), Supplemental Security Income, student loans, certain payments to agriculture, and unemployment compensation. In some cases, there are revenues that partially offset these expenditures (such as Medicare premiums paid). Mandatory spending is projected to increase from $2.3 trillion in 2015 to $4.1 trillion in 2026, an increase of 80%. These spending projections by CBO are based on current law and assume no major changes in benefits.

Discretionary spending is subject to the annual appropriation process in Congress. This category of spending includes government administration, defense, and law enforcement. Discretionary spending is projected to increase from $1.2 trillion in 2015 to $2.4 trillion in 2026, a nominal increase of 23%. Although the need for these government activities will likely increase, the CBO projected discretionary spending will actually fall as a percentage of GDP, from 6.5% in 2015 to 5.2% in 2026. These spending projections by CBO are based on current law and assume no new programs or contingencies. (Congressional Budget Office, 2016).

Net interest spending is determined by the debt and interest rates on various federal government debt issues. Net interest spending was $223 billion in 2015, and is projected to reach $830 billion in 2026, an increase of 272%. This large percentage increase is due to the assumption of increasing interest rates and a growing debt.

3. Revenues

In 2015, most of federal revenues came from individual income taxes (47%) and payroll taxes (33%). Federal revenues were $3.2 trillion in 2015, and they are projected to increase to $5.0 trillion in 2026, an increase of 55%. Federal revenues were 18.2% of GDP in 2015, and they are projected to be 18.2% of GDP in 2026, based on the assumption of current law and no significant changes in tax policy.

There are those in Congress who advocate dealing with the deficit problem by raising taxes on upper income people, unpopular industries, and corporations that earn profits overseas. Others argue for tax reform to lower marginal rates, exempt business investment spending, or adopt a flat tax. Given the strong feelings on both sides, meaningful tax reform does not seem to be possible in the near term. If so, the projections of flat revenues may be quite likely.

4. Deficits and the National Debt

Federal revenues have averaged 17.4% of GDP for the past 50 years. Outlays have averaged 20.1% over the same period, leading to annual deficits in 46 of those 50 years that add to the national debt. During 2017-2026, the cumulative projected deficits will be $9.4 trillion, bringing the public debt to $23.8 trillion. These deficits would increase the debt by 82% from the level of 2015.

Note that these projections assume current law remains unchanged, and they leave no room for new programs or contingencies. In these projections the deficits get progressively larger. This is because most entitlements grow as the population ages, while tax revenues are assumed to be approximately flat. (Congressional Budget Office, 2016). If these debt trends continue to 2046, public debt would reach 155% of GDP, much higher than its record high during World War II. (Steele, 2011).

There is more to the national debt. The figures here are based on the debt held by the public. This amount does not include various categories of federal government debt held by government agencies, such as the Social Security System, Federal Home Loan Banks, and the Federal Reserve. This category of federal debt is called "intragovernmental holdings", and early in 2016 was $5.3 trillion. That means the total federal debt in early 2016 is actually $19 trillion rather than the publicly held debt of $13.7 trillion used in CBO projections.

Such large deficits and debt will take the US into uncharted territory. Reinhart and Rogoff have warned of a fiscal crisis. If the federal government continues to borrow funds to finance deficits, loanable funds will be less available to private investors. This "crowding out" of private investment would reduce productivity. Large-scale government borrowing also tends to bid up interest rates, which add to the cost of carrying the public debt and private debt. (Reinhart and Rogoff, 2009). This effect is currently being hidden by the historically low interest rates caused by current monetary policy.

Market interest rates are currently extremely low, and they are expected to rise as economic growth strengthens. The federal budget will need more funds to pay interest on the growing debt, requiring either tax increases or spending cuts elsewhere. In the event of a crisis, federal authorities will have fewer options to effect solutions. The most important risk may be that eventually investors around the world could question the ability of the US to service its debt. Such concerns would drive up the interest rates on US debt, and they could jeopardize the US dollar as the world standard of safety and liquidity. (Reinhart and Rogoff, 2009).

5. Spending Reform

Spending reform must come primarily from the mandatory spending known as entitlements: Social Security, Medicare, Medicaid, and some assistance programs. In 1962 entitlements made up 33% of federal government outlays, and by 2013 reached 60% of outlays. Many people depend on these programs, which explains why it is so difficult for politicians to reform them. In recent years there have been many reform proposals, making them politically tenuous. Nevertheless, we can outline here some options that help solve the problem.

Social Security started as a modest program in 1935, financed by a 2% tax on payrolls. Many workers were not covered and only worker retirement benefits were provided. Over the years, other benefits were added, and more workers were covered. Today 60 million people receive monthly benefits, which reached almost 25% of federal outlays in 2015. During the high inflation years of the 1970s cost of living increases were added twice per year. Payroll taxes have been increased, but are insufficient to pay for the benefits promised. Life expectancy, which was 65 years in 1935, had now increased to 88 years, adding many years of benefits for many retirees. There has been some reform, such as increasing the full retirement age from 65 to 67 for younger workers. Nevertheless, the Trustees of the Social Security and Medicare Trust Funds still estimate the present value of unfunded liabilities at $60 trillion.

The trust funds steadily increased from their founding until 2010 when trust fund outlays exceeded receipts for the first time. The CBO estimates that under current law the trust funds will be exhausted in 2029. If the trust funds are exhausted and Congress takes no action, then benefits must be cut the following year to keep trust fund disbursements in line with receipts. The current estimate of the cut needed in 2029 is 29%. (Congressional Budget Office, 2015b).

The Congressional Budget Office has evaluated 36 specific policy options for Social Security. These options include raising taxes on workers and employers, increasing the retirement age, changing the benefit formula, changing the cost-of-living calculations, and changing benefits for survivors. Each of these policy options has some effect on the overall viability of the trust funds, and some combination of options will be needed to significantly extend the insolvency date of the trust funds. (CBO, 2015b). One of the most effective policy options studied by CBO would apply the payroll tax to all income, but not increase benefits for higher income workers paying that additional tax. The expected political opposition to such a reform illustrates the difficulty of solving the problem.

Medicare is much more difficult to manage than Social Security, with an unfunded liability of $48 trillion. Medicare spending is now 15% of federal outlays, and is projected to grow due to the aging of the population and the development of new treatments and devices. The Affordable Care Act (ACA) budgeted $416 billion cost savings for Medicare over ten years (through reduced reimbursements to providers), and those costs have been taken out of the Trustees cost estimates. If these ACA savings do not materialize, those costs will further increase the deficit. According to the US Census Bureau, the number of Americans over age 70 will double by 2040, and the population over age 85 is now the fastest growing segment. Average healthcare consumption per capita has increased from $1,000 in 1960 to $9,000 in 2013. (Centers for Medicare and Medicaid Services, "National Health Expenditure Data for 1960-2013").

Medicare consists of several different programs, and each with its own challenges. Part A provides hospital care for everyone age 65 or more, and there is no premium paid. This benefit is financed by a 2.9% payroll tax paid by workers, there are deductibles and co-pays, and hospital stays are limited to 150 days per year. The Part A program has an unfunded liability of $1.9 trillion. Part B pays for physician services, there is a premium paid based on income, and the unfunded liability is $31.5 trillion. General tax revenues fund about three-quarters of the cost. Premiums cover about one-quarter of the cost. Part C is Medicare Advantage, in which private insurers contract to provide needed care and charge a premium. There is no unfunded liability. Part D is the newest addition to the program, and it covers prescription drugs with some deductions and co-pays. The unfunded liability is $14.2 trillion. (Tanner, 2015).

Numerous Medicare policy changes have been discussed to deal with the unfunded liabilities, none of which would be an easy fix. Reduced reimbursements to doctors and hospitals continue to be proposed. Such cuts already have reduced payments to about 80% of the reimbursements paid by insurance companies. As a result, many doctors have withdrawn from the Medicare program, and many no longer accept new Medicare patients. It seems that further cuts would make access to care a larger problem. (Tanner, 2015, page 98).

A new agency created by the ACA is the Independent Payment Advisory Board (IPAB). The IPAB, made up of 15 members appointed by the President, is charged with reviewing Medicare spending each year and limiting its growth to no more than 1 percentage point more than the growth rate of GDP. If the total spending exceeds this standard, the IPAB would submit a plan to control spending to Congress, which would go into effect in 75 days unless Congress voted it down. This procedure is similar to that used for the Base Closure and Realignment Commissions. (Tanner, 2015).

There are many reforms that could be considered. Medicaid could be split into two programs: one for able-bodied adults and their children, and one for the disabled and elderly. States could manage the program as is currently done, with a risk-based payment from the federal government. Medicare could be restructured for new retirees by providing a fixed level of funding, and then allowing participants to purchase the coverage they prefer. Current retirees could choose to remain in the current system. (Chen, 2016).

The Medicaid program is a means tested program financed by the federal and state governments. States administer the program and set the coverage standards. The program covers four broad categories of recipients: children, adults, elderly, and disabled. At the state level, Medicaid spending amounts to 26% of state budgets (in fiscal year 2014). The ACA allowed more people (with incomes up to 138% of the poverty level) to join the Medicaid rolls, but several states declined to add these recipients due to the strain on state budgets. The US Supreme Court has ruled that Congress cannot require this Medicaid expansion, making it optional for the states.

The Medicaid program is well known for fraudulent payments claimed by a few providers, and poor health outcomes for recipients. Recipients do not pay premiums or co-pays, so there is a tendency to overuse care. Because providers receive limited reimbursements, care may be lower quality and many providers will not participate in the program, limiting access to care. (See Tanner, 2015, page 126). The federal government pays approximately half of Medicaid cost, but the program is administered by states. As a result, the states have a reduced incentive to eliminate fraud. Any state cost savings would be shared with the federal government, while the states would bear the full cost of policing the providers.

Reform of Medicaid has been proposed using vouchers or block grants to the states. These efforts would put more power in the hands of the patients or the state authorities to manage care and costs. However, there is no indication that the major political parties can reach a compromise in this issue. (Tanner, 2015).

There has been much debate about the ACA and the US tradition of employer-based health insurance. Both of these are criticized as not market based, and many reform proposals have been made. In the current Presidential election campaign, each candidate seems has a different set of proposals. (Chen, 2016).

One feature of the current income tax system is that employer paid health insurance is not treated as taxable income. This “tax preference” for benefits rather than cash income distorts incentives. This feature reduces the incentive for employers and employees to seek lower cost policies. The ACA soon will impose a 40% “Cadillac tax” on the highest cost policies, while a better market-based strategy would be an upper limit on the tax preference for employer-paid premiums. This reform adds to the incentives for employers and employees to control costs.

The ACA provides subsidies to families earning up to $90,000 per year to help them pay for non-employer-based health insurance. A better plan would provide age-adjusted tax credits to help people buy insurance, without the current mandated coverage. This reform would extend access to health insurance. The ACA requires all people to have insurance. A market based plan would encourage voluntary coverage by protecting those with continuous coverage from premium increases or benefit restrictions.

A major goal of the ACA was to expand health insurance to more people. It encourages employers to provide health insurance by imposing a tax of $2,000 per full-time employee (not counting the first 20 employees) if health insurance is not provided. This requirement applies to firms with 50 or more employees. The strong incentive here is for small firms to hold their employment below 50 full time workers, or to convert some full-time workers to part-time (less than 30 hours per week). In the US the majority of new jobs created are in small firms, and the long-term impact of this perverse incentive is not known. (Hall, 2014).

6. Conclusions

Reforms to limit debt and promote economic growth must include some combination of changes to taxes and spending. Tax rates are higher in the US than other industrial nations, but some call for even higher tax rates to address the debt problem. Others call for tax rate reduction, a flat tax, or a “fair” consumption tax to grow the tax base and limit the size of government. Given the projected size of the debt based on current policy and demographic trends, it appears that tax increases alone cannot come close to resolving the debt problem. That means that spending control must be a major part of a solution, and most of the scheduled growth on spending is in entitlements. These expenditures are very difficult to control because they are driven by demographics and past political promises – both being very slow to change.

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