AVERTING NATIONAL BANKRUPTCY

Congress should

- raise the age of eligibility for Medicare and Social Security;
- phase in higher deductibles and copayments for Medicare, Medicaid, and Obamacare; and
- freeze Social Security benefits per capita at the current (inflation-adjusted) value.

The United States' debt is on an unsustainable path; that is, the United States is in extreme fiscal imbalance. In particular, the four main entitlement programs (Medicare, Medicaid, Obamacare, and Social Security) are collectively growing far faster than any plausible path for gross domestic product (GDP). Congress should curtail these programs to avoid fiscal Armageddon.

Background

The United States faces a challenging fiscal future. According to the Congressional Budget Office (CBO), the debt-to-GDP ratio crossed 100 percent in 2020. Projections indicate it will hit 185 percent by 2052 and continue to climb unless the nation adjusts its tax and spending policies. If no policy changes occur and the debt ratio continues on its projected path for an extended period, the United States will eventually face rising interest rates on its debt, an even steeper debt path, and a fiscal crisis. This outcome is not inevitable; the United States likely has decades to adjust its policies. Few dispute, however, that unless the CBO's projections are substantially too pessimistic, the United States needs major adjustments in spending or tax policies to avoid a fiscal meltdown.

Despite widespread agreement that spending or tax policies must change, however, appropriate adjustments have so far not occurred. Indeed, many recent policy changes have worsened the U.S. fiscal situation. They include the creation of Medicare Part D ($91.7 billion in 2020); new subsidies under the Affordable Care Act, often called Obamacare ($65.0 billion in 2020); the

expansion of Medicaid under Obamacare (from $374.7 billion in 2009 to $671.2 billion in 2020); higher defense spending (from $304.7 billion in 2001 to $754.8 billion in 2021); increased spending on veterans' benefits and services (from $45.0 billion in 2001 to $234.3 billion in 2021); and greater spending on energy programs (average annual spending rose from $0.58 billion over 1997–2001 to $4.83 billion over 2017–2021). Politicians across the spectrum, moreover, propose additional spending all the time.

Since spring 2020, federal spending has boomed in response to the COVID-19 pandemic. Over two years, Congress enacted six major spendings bills to mitigate the economic and public health effects of COVID-19, which totaled $4.3 trillion in obligations as of July 2022. They include the Paycheck Protection Program (PPP) and Health Care Enhancement Act, the American Rescue Plan Act, and the CARES Act—the largest economic relief package in U.S. history. The most expensive programs included $844 billion in direct stimulus checks, $828 billion in PPP loans to businesses, and $666 billion in increased unemployment compensation. This drastic increase in spending and the concurrent recession caused the largest year-over-year increase in federal debt on record.

"Fiscal imbalance" is the excess of what we expect to spend, including repayment of our debt, over what government expects to receive in revenue. A plausible explanation for America's failure to address its fiscal imbalance is a belief that "this time is no different," since earlier alarms have not ended in a fiscal meltdown. In the 1980s, for example, the government experienced a large buildup of federal debt due to President Ronald Reagan's tax cuts and increases in military spending. Concern arose over the spiraling debt, causing congressional budget showdowns during President Bill Clinton's first term. But ultimately, no serious fiscal crisis ensued.

In 2011, fears of a U.S. government default arose during the debt-ceiling crisis. Disagreements between members of Congress resulted in a political stalemate, massive public apprehension, and a one-notch downgrade of the U.S. credit rating. Just before the deadline, however, the Budget Control Act was signed into law, raising the debt ceiling by more than $2.1 trillion and staving off the threat of immediate default. A similar crisis loomed in 2013 when Congress's inability to rein in the federal deficit almost triggered a "fiscal cliff"—a series of deep, automatic cuts to federal spending. Once again, with only hours to spare, lawmakers reached a compromise and averted larger economic consequences. Overall, the past 30 years reveal a clear trend: time and time again, alarm erupts over the rising federal debt level, but a full fiscal meltdown never materializes. Thus, many people dismiss claims that the U.S. fiscal balance is a calamity in waiting, believing "this time is no different."

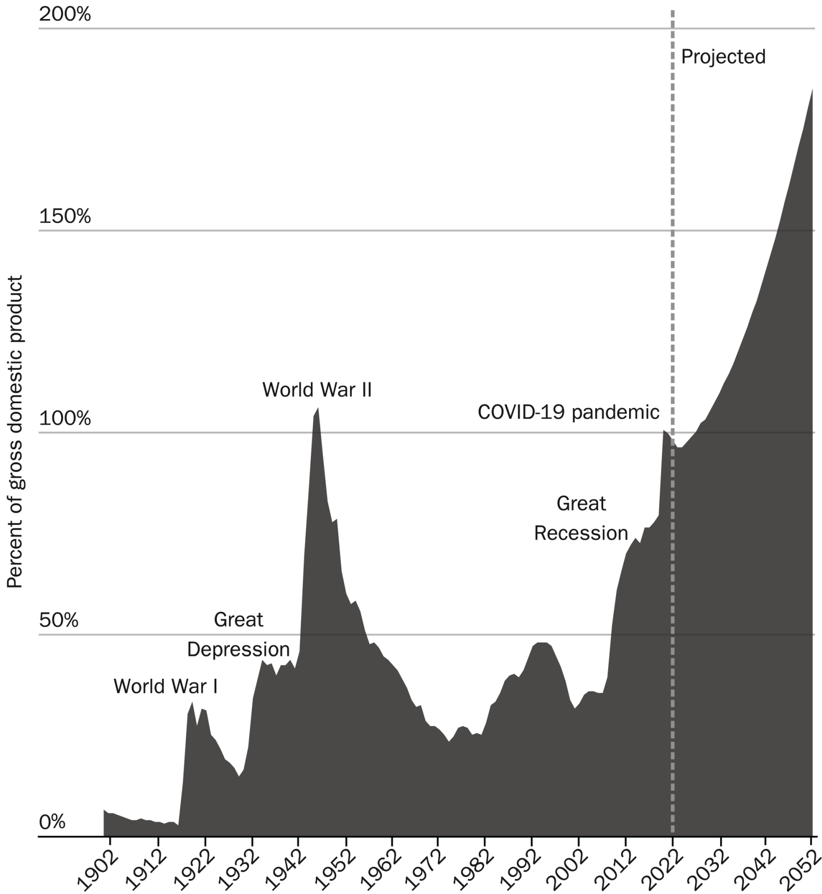
In truth, this time *is* different. Although a fiscal meltdown is not imminent, the nation's fiscal situation has been deteriorating since the mid-1960s, is far worse than ever before, and will worsen as time passes if no adjustments occur. This view follows from looking not just at current deficits and the current value of the debt; these are incomplete measures of the government's fiscal situation because they account only for past expenditure relative to tax revenue. The true impact of existing expenditure and tax policies also depends on the projected paths of future expenditure and tax revenues. The standard measure of the overall fiscal situation is known as fiscal imbalance, which adds up (in a way that adjusts for interest rates) all future expenditures, minus future tax revenues, plus the explicit debt. The projected path of the debt-to-GDP ratio—which divides total federal debt held by the public by the GDP—is a simple proxy for the degree of imbalance.

Figure 1 presents the historical and projected U.S. debt-to-GDP ratio for the period 1900–2052. The ratio has risen enormously since the Great Recession and is projected to rise dramatically going forward, reaching 185 percent in 2052. Moreover, outside studies and the CBO's own evaluation show that, at least in the past decade, the CBO's forecasts tend to underestimate the future debt-to-GDP ratio. Annual budget surpluses from 1998 to 2001 fueled a period of overestimation in the 1990s, but the United States has not seen an annual surplus since.

The reason for the persistent increase in fiscal imbalance is that the composition of federal expenditure has shifted markedly since 1965, especially from defense spending to mandatory health and retirement spending—that is, entitlements. Defense spending has declined relative to GDP over the post–World War II period; this spending could increase in the future but is unlikely to grow without bound. Entitlement spending, however, not only consumes a large fraction of the federal budget but also is likely to grow faster than GDP, indefinitely, under current law. This excess growth reflects the increasing share of the population collecting benefits relative to younger people paying taxes, as well as the impact of subsidized health insurance on health care cost inflation. Thus, the CBO forecasts that health and retirement spending will increase substantially faster than GDP going forward.

In principle, the United States has three options for restoring fiscal balance: faster economic growth, higher taxes, or slower expenditure growth. In practice, only slower growth of entitlement spending can make a significant difference. Even if economic growth achieved its highest historical levels, that would not reduce imbalance materially. Similarly, even if taxes were raised substantially above their postwar average—and had no adverse effect on growth—fiscal imbalance would still be large.

Figure 1
Federal debt held by the public, 1900–2052



Source: "The Budget and Economic Outlook: 2022 to 2032," Congressional Budget Office, May 25, 2022, https://www.cbo.gov/publication/57950.

That leaves expenditure cuts as the only viable way to significantly reduce fiscal imbalance. And the cuts must target entitlements, since those programs are large and are the ones growing relative to GDP. Even the drastic increase in COVID-19 spending is only expected to raise the *level* of the debt-to-GDP ratio, not its growth rate. A crucial difference between expenditure cuts and tax hikes is that the former could plausibly increase the level or growth of GDP, by reducing distortions in health and retirement decisions, whereas the latter would almost certainly reduce growth, making imbalance worse. Thus, cutting the growth of federal health and retirement expenditure is a win-win. Congress has three main options for cutting entitlements and averting bankruptcy.

Raise the Eligibility Age for Social Security and Medicare

The original justification for Social Security and Medicare was to help citizens who could no longer care for themselves. When Congress created Social Security in 1935, life expectancy was 63 and the age of eligibility was 65, so Social Security was insurance against "living too long." Similarly, when Congress adopted Medicare in 1965, life expectancy was about 70 and the age of eligibility was again 65, so most beneficiaries expected only a few years of subsidized health care. Today's average life expectancy, however, has reached 77. Social Security's age of "normal retirement" has increased by only two years since 1965, and Medicare's is still 65. Unsurprisingly, the total number of Social Security beneficiaries has skyrocketed; 25 million Americans received Social Security benefits in 1970, compared with 65 million in 2021.

Thus, as life expectancy has steadily increased, and health conditional on age has improved, Social Security and Medicare have evolved from helping only those in serious need to also providing income support and subsidized health insurance, over decades, for middle- and upper-income households. Simultaneously, the fraction of the population receiving benefits has grown relative to the fraction paying taxes, making these programs fiscally unsustainable. Thus, under current parameters, both programs have grown far beyond their original intent and have become unaffordable.

Congress should raise the age of eligibility in both programs, by at least enough to offset the increase in life expectancy since creating each program. The higher ages could be phased in gradually—for example, by six months every year for some number of years, with the higher age affecting only those below some cutoff, such as age 50. Thus, the higher eligibility ages would not affect those already receiving benefits or even those within 15 years of current eligibility. Congress should also index the eligibility age to future increases in life expectancy; doing so would help avoid future expansions of Social Security and Medicare relative to the size of the economy.

Increase Deductibles and Copayments for Medicare, Obamacare, and Medicaid

Standard economics explains that people demand health insurance to financially protect themselves in case of major illnesses or accidents, not to cover routine expenditures, such as for checkups, medications, and other moderate and predictable outlays. This insight implies that economically efficient health insurance should have substantial deductibles.

Standard economics also suggests that economically efficient health insurance should come with significant copays. Insurance can generate excessive

health expenditure because the insured do not pay the costs of their care (a phenomenon known as moral hazard). One remedy is deductibles; a second is copays, the portion of a health expenditure paid by the insured person after the deductible has been met. Copays do not fully balance the costs of care against the benefits, but they nudge health care decisions in the right direction while still reducing the risk of large outlays for the insured.

Thus, Congress should modify Medicare, Obamacare, and Medicaid to incorporate significantly higher deductibles and copays. The appropriate adjustments differ across programs, but increases of at least 50 to 100 percent, or more, make sense in many cases. For example, the yearly deductible for Medicare Part A is only $1,556 and for Part B only $233. Obamacare caps yearly out-of-pocket spending for deductibles and copays at $8,700 for self-only coverage and $17,400 for family coverage. Medicaid charges minimal copays for those below 150 percent of the federal poverty level.

Freeze (Real) Social Security Benefits

Under current policy, the level of Social Security benefits that an individual receives is a function of that individual's earnings history. In market economies, wages tend to rise with worker productivity (which in turn reflects technological progress), so that as an economy experiences productivity growth, real wages rise. Thus, the inflation-adjusted level of Social Security benefits grows along with the economy's increase in overall productivity. Indeed, over the past five decades, the average annual Social Security benefit for retired workers (in real terms) has more than doubled, from $8,654 per recipient in 1970 to $19,896 in 2022 (constant 2022 dollars).

Assuming Social Security exists to prevent poverty, the ongoing increase in benefit levels is excessive. Instead, society should determine a level of benefits that allows those without other income to attain some modest standard of living. Congress should keep that level in place over time.

Congress should therefore freeze the level of real benefits at its current value; this amounts to indexing the level of new benefits to price rather than wage inflation. Under this approach, Social Security expenditure would grow far more slowly than under the current system because it would only reflect increases in the population age 65 and older, rather than also increasing with productivity.

Suggested Readings

Gokhale, Jagadeesh. "Spending Beyond Our Means: How We Are Bankrupting Future Generations." White paper, Cato Institute, February 13, 2013.

Miron, Jeffrey. "COVID-19 and the U.S. Fiscal Imbalance." Cato Institute Policy Analysis no. 905, December 8, 2020.

———. "Curtailing Subsidies for Health Insurance." In *Reviving Economic Growth*, edited by Brink Lindsey. Washington: Cato Institute, 2015, pp. 197–201.
———. "Fiscal Imbalance: A Primer." White paper, Cato Institute, December 8, 2015.
———. "U.S. Fiscal Imbalance over Time: This Time *Is* Different." Cato Institute White Paper, January 26, 2016.

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