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MEETING THE LONG-TERM CHALLENGE OF OLD-AGE ENTITLEMENT SPENDING: What Can We Learn from the Greenspan Commission?

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EXECUTIVE SUMMARY

Is the United States going bankrupt? This question is asked with increasing frequency for two main reasons. First, deficits have soared in response to the financial crisis and the (recently ended?) recession. Second, spending on health and social security is projected to increase drastically over the next 60 years, engendering extraordinary fiscal pressure. *Some action will have to be taken.* The challenge is to take that action as quickly as possible, so that the fiscal future that we now face can be changed before it does significant and possibly irreparable harm.

Before deciding what to do, it is important to quantify exactly what the obligations of the federal government are. For better or worse, there are a number of measures of federal liabilities. Moreover, none of them is definitive for evaluating not only what obligations the government must meet, but which future costs it is most likely to honor. The most comprehensive picture of the assets and liabilities of the federal government is presented in the *Financial Report of the United States Government* (U. S. Treasury, 2010). In addition to the federal debt securities held by the public (plus accrued interest), the balance sheets recognize other liabilities that the government has committed to pay. What the *Financial Report* does not recognize as liabilities are any social-insurance benefits that are not yet due and payable. It does, however, include *Statements of Social Insurance* that provide the long-term projections for the social insurance funds prepared by the fund trustees.

There are two important reasons why the balance sheet of the United States government does not recognize future social-insurance benefits as liabilities. First, current law provides for full benefit payments only to the extent that there are sufficient balances in the social-insurance trust funds. If the trust funds run out, benefits must be delayed until the trust funds can be replenished. Second, the law states—and the Supreme Court has verified—that program participants have no accrued property right to benefits. This fact is emphasized by the Social Security Administration in the annual statements sent to all participants each year.

Only once has a major social insurance trust fund been threatened with insolvency and the specter that benefits would be delayed. The *1982 Annual Report of the Board of Trustees* stated: "Without corrective legislation in the very near future, the Old-Age and Survivors Insurance Trust Fund will be unable to make benefit payments on time beginning no later than July 1983." To avoid insolvency, President Reagan issued Executive Order 12355 on December 16, 1981 establishing the National Commission on Social Security Reform (commonly known as the Greenspan Commission, after its chairman). The Greenspan Commission had to act fast to avoid trust fund exhaustion, and it produced a set of recommendations that were in large measure adopted by Congress, avoiding insolvency in the short run and significantly improving the cash flow of the system into the foreseeable future.

A number of observers have argued that the Greenspan Commission was simply a rubber stamp for a political compromise between a Republican president and Democratic leadership in the House of Representatives. Even if we accept this criticism at face value, it is not clear that would make the Greenspan Commission a failure. If the political compromise is viable and the recommendations are sensible, the commission could facilitate their acceptance without compromising its integrity. The social security system was at a crossroads, and the fact that the government was able to stave off insolvency was an important achievement, even if the final outcome was to postpone, rather than solve, the problem.

From today's perspective, the important question is whether a Greenspan-type commission could address the looming crisis in entitlement spending. One might argue that recent appointment of the National Commission on Fiscal Responsibility and Reform could fit this mold. However, this commission lacks the leverage of either special treatment for its recommendations—for instance, a "vote without amendment" provision—in Congress or a forcing event, such as trust fund exhaustion. Could a commission focusing on entitlement spending use the special status of the trust funds to force action?

Two factors reduce the likelihood of real reform in the near future. First, unlike when the Greenspan Commission was appointed, trust fund exhaustion is still a number of years off. Second, the structure of the entitlement-spending problem has changed. The Greenspan Commission could achieve its objectives with a few, politically palatable recommendations. The same approach might work again for social security, but the current spending problem for Medicare is much less tractable. It is unlikely that the entitlement-spending crisis can be resolved without explicitly addressing (1) the redistributive goals of social insurance and (2) the appropriate role of the government in the financing and provision of health care.

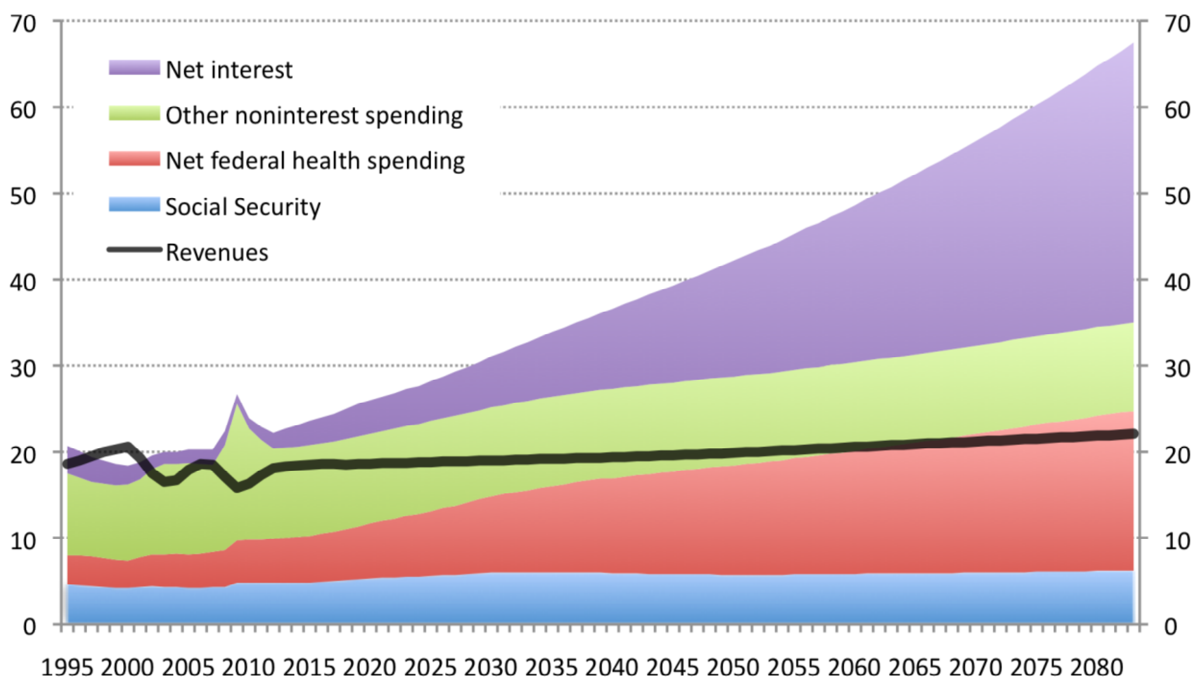
However, the key lesson from the Greenspan Commission is that government action *will be required* to address entitlement spending at some point to avoid the exhaustion of the social insurance trust funds. The political challenge is to use this fact to motivate action before trust fund exhaustion is imminent to (1) avoid last-minute "fixes" that might not address the problem in the most effective manner and (2) reduce the scope and smooth the timing of reforms to make them more palatable to the electorate.

MEETING THE LONG-TERM CHALLENGE OF OLD-AGE ENTITLEMENT SPENDING: WHAT CAN WE LEARN FROM THE GREENSPAN COMMISSION

I. IS THE UNITED STATES GOING BANKRUPT?

This question is asked with increasing frequency for two main reasons. First, deficits have soared in response to the the financial crisis and the (recently ended?) recession. Deficits are estimated by the Congressional Budget Office (CBO) to average over 5 percent of GDP through 2020, with a cumulative deficit of almost $6 trillion between 2011 and 2020. Second, spending on health and social security is projected to increase drastically over the next 60 years, engendering extraordinary fiscal pressure. The long-term budget outlook prepared by the Congressional Budget Office (CBO, 2009) quantifies both of these problems and projects that under current fiscal policies—and assuming no impact on the level of economic growth output—the budget deficit would grow to an astounding 44 percent of GDP by 2080 (figure 1), leading to an explosion in government debt held by the public to more than 750 percent of GDP (see appendix I for additional discussion of the long-term projections).

Figure 1. CBO Long-Term Budget Outlook
(current underlying fiscal policy as percent of GDP)



Source: CBO, *Long-term Budget Outlook*, 2009.

The International Monetary Fund (2010) has recently investigated the increased fiscal risk faced by advanced and emerging market economies as they recover from both the recession and the financial crisis. They calculate that the fiscal challenge facing the United States is potentially greater than that faced by any other advanced or emerging-market economy because (1) revenue will have to exceed noninterest spending by roughly 12 percent of GDP to bring the gross public debt below 60 percent of GDP and (2) this challenge will be made more difficult by the projected increase in old-age entitlement spending between now and 2030.

Of course, the scenario displayed in figure 1 could never play out exactly as projected, because the growth of government spending and huge deficits would in fact force the country into bankruptcy, as the national debt quickly grew to unprecedented and unsustainable levels. Even without allowing for any impact of the debt level on interest rates, interest paid on debt held by the public would grow to one-third of GDP by the end of the projection period. The growing debt would increase interest rates, reduce private capital, and retard growth. Investors would lose confidence in U.S. government securities. *Some action will have to be taken.* The challenge is to take that action as quickly as possible, so that the fiscal future that we now face can be changed before it does significant and possibly irreparable harm.

One of the benefits of figure 1 is that it demonstrates clearly that the primary source of future fiscal distress is the rapid growth in federal health care spending. Absent revenue increases, this, in turn, leads to an even greater growth in interest payments, to service the ballooning debt. Although social security spending grows by almost 30 percent as a share of GDP over the projection period (from 4.2 percent to 6.2 percent of GDP), this increase pales in comparison to the more than 270 percent increase in the share of GDP spent by the federal government on health care (from 4.9 percent to 18.5 percent of GDP). Within health care, Medicare spending as a share of GDP is projected to grow by more than 370 percent (from 3.1 to 14.8 percent of GDP), while federal Medicaid spending as a share of GDP is expected to double.[1] Other spending stabilizes at slightly over 10 percent of GDP. The core problem is obvious.

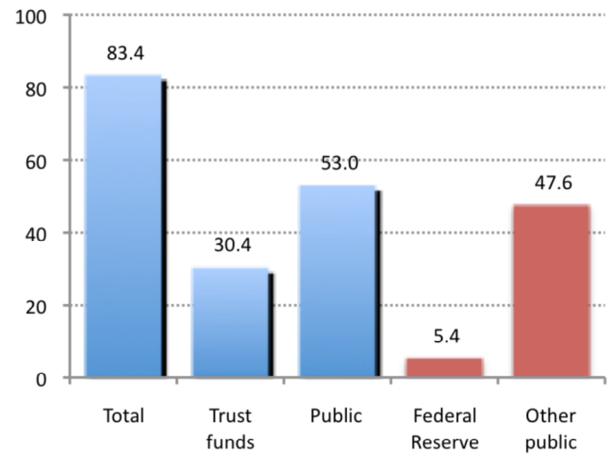
II. WHAT ARE OUR OBLIGATIONS?

Before deciding what to do, it is important to quantify exactly what the obligations of the federal government are for honoring the future spending shown in figure 1.

[1] The CBO projections predate the passage of the Patient Protection and Affordable Care Act, which has provisions designed to reduce Medicare and Medicaid spending. As discussed below, whether these provisions will be successful is problematic.

For better or worse, there are a number of measures of federal liabilities. Moreover, none of them is definitive for evaluating not only what obligations the government must meet, but which future costs it is most likely to honor.

Figure 2. Distribution of Federal Debt
(End-FY2009 in percent of GDP)



Source: CBO, *Long-term Budget Outlook*, 2009.

The budget classifies gross federal debt according to who holds it. The first distinction is between debt held by government agencies—including the social insurance trust funds—and debt held by the "public." The latter category is split between debt held by the Federal Reserve System and other debt held by the public (figure 2). These distinctions can be confusing and potentially misleading.

Most analysts focus on the debt held by the public. The CBO maintains that

> Gross federal debt comprises both debt held by the public and debt issued to various accounts of the federal government, including the major trust funds in the budget (such as those for Social Security). Because the debt issued to those accounts is intragovernmental, it has no direct, immediate impact on the economy. Instead, it simply represents credits to the various government accounts that can be redeemed as necessary to authorize payments for benefits or other expenses. Although the Treasury assigns earnings in the form of interest to the trust funds that hold the securities, such payments have no net effect on the budget (CBO (2009), p. 14).

This characterization is true as long as the amount of debt held by the trust funds has no impact on individual behavior. It is possible, however, that the assets of the social insurance trust funds lend credibility to at least some of the claims that individuals will want to make against these programs and, consequently, lead individuals to adjust their consumption and saving decisions accordingly. The distribution of the debt held by social insurance and other trust funds is displayed in figure 3).[2] The main social insurance trust funds are:

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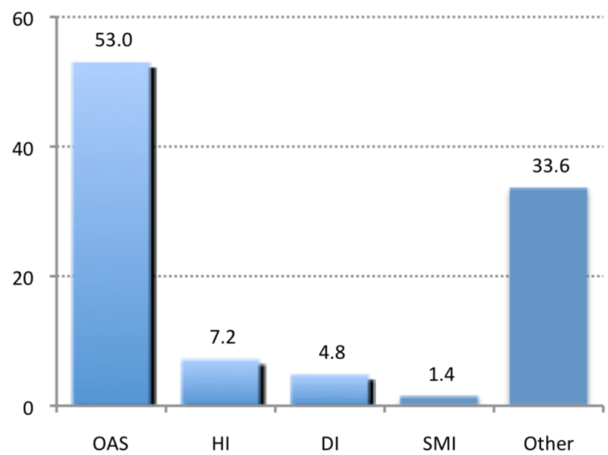
[2] The "other trust funds in figure 3 include two small social insurance fund—for black-lung and railroad-retirement benefits. Most of the remaining Treasury securities are held by trust funds administering federal employee and military benefit programs.

- The Old-Age and Survivors Insurance (OASI) Trust Fund, which covers these social security benefits and is funded by contributions of 10.6 percent of covered wages and self-employment income below a maximum.
- The Disability Insurance (DI) Trust Fund, which covers disability benefits paid prior to qualification for old-age benefits and is funded by contributions of 1.8 percent of covered wages and self-employment income below a maximum.

Figure 3. Distribution of Debt Held by Government Accounts
(in percent of total)



Source: CBO, *Long-term Budget Outlook*, 2009.

- The Hospital Insurance (HI) Trust Fund, which covers hospital costs paid under the Medicare program and is funded by contributions of 2.9 percent of covered wages and self-employment income.
- The Supplemental Medical Insurance (SMI) Trust Fund, which covers payments to nonhospital providers of medical goods and services (Part B) and prescription drugs (Part D) under the Medicare program and is funded by premiums collected from participants and budget transfers.

Moreover, given the huge cash flow deficits that these programs will run in the future under current law, their holdings of Treasury bonds will, in fact, be redeemed to pay benefits to the extent that current contributions are insufficient. Although it is not explicit, it is likely that the debt held by the social insurance trust funds is, in fact, assumed redeemed in the CBO long-term projections and transformed into debt held by the public. Consequently, ignoring these liabilities may be a bit too sanguine. On the other hand, the disposition of the debt held by the Federal Reserve System is arguably subject to more control than other debt held by the public. Interpreting the debt figures spun off by the budget is therefore not completely straightforward.

A more comprehensive picture of the assets and liabilities of the federal government is presented in the latest *Financial Report of the United States Government* (U. S. Treasury, 2010). In addition to the federal debt securities held by the public (plus accrued interest), the balance sheets recognize other liabilities that the government has committed to pay. Chief among these are accrued claims to federal employee and military benefits, because these are considered to have a contractual basis. In this sense, they are treated the same as the obligations of private companies to provide benefits to employees under pension and health care agreements.

What the *Financial Report* does not recognize as liabilities are any social-insurance benefits that are not yet due and payable.[3] It does, however, include *Statements of Social Insurance* that provide the long-term projections for the social insurance funds prepared by the fund trustees. The *Report* is not explicit on its reasons for reporting neither the present value of projected cash flows nor the debt held by the trust funds as liabilities. However, it does identify the uncertainty that a loss will occur and the inability to measure it accurately as criteria for not recognizing a liability on the balance sheet. In addition, the *Report* notes that "current Social Security and Medicare law provides for full benefit payments only to the extent that there are sufficient balances in the trust funds." For the OASI, DI, and HI trust funds, the only source of financing is payroll contributions. The SMI trust fund is financed by Part B beneficiary premiums and general revenue matching amounts, which by law are set each year at a level adequate to finance Part B expenditures. The *Report* also notes that, for the trust funds, "A change in law may change the future receipts and the terms under which the fund's resources are spent." These last two factors are crucial for evaluating "what we owe" to social insurance program participants.

A. Trust Fund Exhaustion

The first factor is given little prominence in the *Financial Report*, leading to some confusion. The section on "Where We Are Headed" in the introduction to the report misrepresents current law when it states that

> Spending under current law for Medicare, Medicaid, and Social Security is expected to grow much faster than GDP over the next 75 years as health care costs rise and the population ages. Revenues, on the other hand, are expected to grow only modestly faster than GDP. Together, these two trends imply that without policy changes, the difference between spending and revenues—the budget deficit—will grow larger as a share of GDP (U. S. Treasury (2010), p. x).

This presentation of the entitlement spending challenge implies that—absent government action—entitlement spending will explode. In fact, it will take

[3] Although the focus of this paper is social insurance, it is important to recognize that there are other, potentially very important, contingent liabilities that—for roughly the same reasons—are not recognized as liabilities. Important examples are environmental costs (including costs paid out of the trust funds for Superfund and Leaking Underground Storage Tanks) and bailout costs for private pension funds borne by the Pension Benefit Guaranty Corporation.

government action to *allow* entitlement spending to explode. To those who believe that the government will make every effort to honor current benefit provisions, the distinction may not seem important. However, when the unsustainable budgetary path depicted above is recognized, it becomes clear that these provisions cannot be honored without engendering unsustainable debt or draconian tax increases.

The CBO is similarly ambiguous in characterizing current law in their long-term budget projections. They refer to the social security benefit projections underlying their long-term budget outlays as "scheduled under current law," but note only in a footnote that "[o]nce the trust funds are depleted, the Social Security Administration no longer has legal authority to pay benefits." This does not reduce the value of the long-term projections. Rather, we believe it is important to stress the legal status of the projections because current law provides a "drop-dead date" for entitlement reform: the date of trust fund exhaustion.[4]

B. No "Accrued Property Right" to Benefits

The second factor is also crucial. Arguably the most important reason for not recognizing the future cash flow deficits of the entitlement programs as liabilities of the government is because program participants have no accrued property right to the benefits. The Supreme Court clarified this position in Flemming v. Nestor, 363 U.S. 603 (1960), where it noted that:

> [t]o engraft upon the Social Security system a concept of "accrued property rights" would deprive it of the flexibility and boldness in adjustment to ever-changing conditions which it demands. See Wollenberg, Vested Rights in Social-Security Benefits, 37 Ore. L. Rev. 299, 359. It was doubtless out of an awareness of the need for such flexibility that Congress included in the original Act, and [363 U.S. 603, 611] has since retained, a clause expressly reserving to it "[t]he right to alter, amend, or repeal any provision" of the Act. 1104, 49 Stat. 648, 42 U.S.C. 1304. That provision makes express what is implicit in the institutional needs of the program.

If the cash flow deficits of the social insurance programs were recognized as liabilities on the balance sheet, people could think they had a cause of action if actual or expected benefits were cut, creating a legal nightmare. To avoid this

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[4] The Federal Accounting Standards Advisory Board (2009) characterizes the current situation with respect to trust fund insolvency as a case where current law contains "inconsistent provisions." The Congressional Research Service (2008) concludes that the Antideficiency Act would take precedence in the event of insolvency, and although "the legal right of beneficiaries to receive full benefits would not be extinguished by an insufficient amount of funds in the Social Security Trust funds, it appears that beneficiaries would have to wait until the Trust Funds receive an amount sufficient to pay full benefits in the case of a shortfall, unless Congress amends applicable laws."

outcome, the Social Security Administration warns all participants in its annual statement of projected benefits that these benefits are subject to change. In particular, in its 2009 correspondence, it advised all participants that;

> Your estimated benefits are based on current law. Congress has made changes to the law in the past and can do so at any time. The law governing benefit amounts may change because, by 20141, the payroll taxes collected will be enough to pay only about 78 percent of scheduled benefits.

This statement is updated each year to reflect changes in the trust fund projections.

III. Was the Greenspan Commission a Successful Response to Insolvency?

A. Commission Recommendations

Only once has a major social insurance trust fund been threatened with insolvency. The *1982 Annual Report of the Board of Trustees* stated: "Without corrective legislation in the very near future, the Old-Age and Survivors Insurance Trust Fund will be unable to make benefit payments on time beginning no later than July 1983." The OAS trust fund itself would be exhausted earlier than that date, but the law would allow the trust fund to borrow from the DI trust fund for up to six months of benefits. To avoid insolvency, President Reagan issued Executive Order 12355 on December 16, 1981 establishing the National Commission on Social Security Reform (commonly known as the Greenspan Commission, after its chairman, see appendix II for a list of the members of the commission). The executive order directed that:

> The Commission shall review relevant analyses of the current and long-term financial condition of the Social Security trust funds; identify problems that may threaten the long-term solvency of such funds; analyze potential solutions to such problems that will both assure the financial integrity of the Social Security System and the provision of appropriate benefits; and provide appropriate recommendations to the Secretary of Health and Human Services, the President, and the Congress.

Between its inception and the transmission of its final report on January 20, 1983, the commission "reviewed the results of the many hearings, studies, and reports of other public bodies, . . . sought the advice of a number of experts and thoroughly examined a wide variety of alternative approaches." The commission's goal was to close the actuarial gap over the 75-year projection period of the Trustees Report, which, in the 1982 report, was 1.82 percent of wages subject to contribution. Twelve of the 15 members of the commission agreed on a "consensus" package that would reduce the gap by 1.22 percentage points. The key components of the consensus package are presented in table 1). Most important was the recommendation to tax the benefits of higher-income workers. The increase in coverage increased cash flow in the short run, and the delay of cost-of-living adjustments simply pushed the stream of benefit increases out six months. In a steady state, this is equivalent to losing six months of increases.

Table 1. Key Recommendations of the Greenspan Commission

Measure	Impact (% of payroll)
Taxation of benefits for higher-income persons	0.60
Cover nonprofit and new Federal employees	0.30
Shift COLAs to calendar-year basis (6-month delay)	0.27
Revise tax basis for self-employed	0.19
Increase delayed retirement credit	-0.10
Other	-0.04
Total	1.22

Source: Report of the Greenspan Commission (1983).

Separate recommendations for closing the remainder of the gap were made by subgroups of the committee. The key difference among the members of the committee was that eight members—Archer, Beck, Conable, Dole, Fuller, Greenspan, Heinz, and Trowbridge—proposed closing the remaining actuarial gap by increasing the retirement age, and five members—Ball, Keys, Kirkland, Moynihan and Pepper—proposed an increase in the contribution rate.

B. Impact

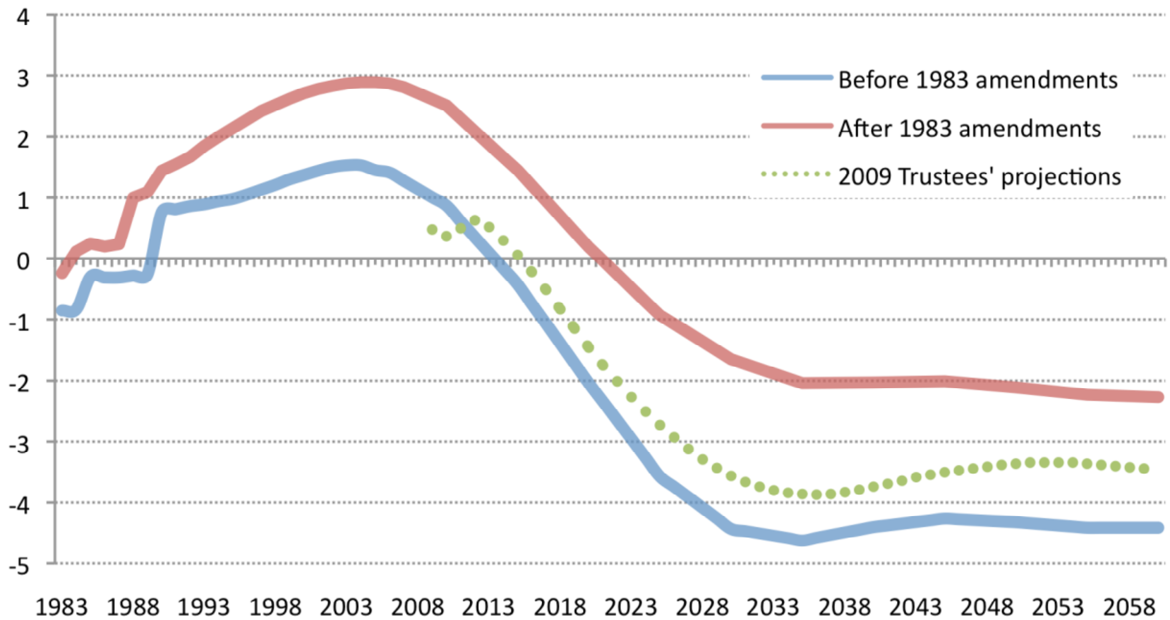
The *1983 Annual Report of the Board of Trustees* credited the Greenspan Commission for making recommendations that significantly improved the finances of the old-age and survivors component of social security, noting the "recommendations in the Commission's 'consensus package' formed the basis of the Social Security Amendments of 1983 (Public Law 98-21), although several of the proposals were modified somewhat." Congress opted for a delayed and gradual increase in the retirement age over an increase in the contribution rate in the 1983 amendments.

The 1983 amendments reduced the actuarial gap of the combined OASI and DI programs—hereafter OASDI—by an estimated 2.09 percent of wages subject to social security contributions—or roughly one percent of GDP.[5] Other changes, including in the demographic assumptions underlying the projections, reduced the total improvement to 1.84 percentage points. However, as Congressman Archer noted in his additional statement, the amendments failed "to address adequately the basic structural deficiencies which will continue to cause severe strains on the

[5] All of the summary statistics reported are based on Alternative II-B, which corresponds to the "intermediate" projection in earlier and later trustee reports.

system in the future." The Greenspan Commission shifted the cash flow curve up throughout the projection period, but it did not change its shape (figure 4).

Figure 4. The Impact of the 1983 Amendments
(Cash flow balance as a percentage of covered wages)



Source: 2009 Annual Report of the Boards of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

The measures taken provided some immediate help—in particular the acceleration of the already scheduled increases in contribution rates—but not enough to obviate the OASI trust fund borrowing funds from the DI trust fund. The full impact of the measures was felt only gradually because the coverage increase applied primarily to new employees and it took some time for the share of nonprofit and federal employees participating in social security increased and the share of benefits subject to taxation to increase.[6] The amendments pushed back the date at which the cash flow of the OASDI system turned negative by roughly 5 years, to 2020, and the date of combined trust fund insolvency by more than 30 years, past the end of the projection period. It is instructive, however, that since the 1983 report, the projected cash flow of the OASDI system has deteriorated significantly. For the overlap years

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[6] Then current federal workers were given the option of shifting into a new retirement system integrated with social security, and few switched. The threshold for determining what share of benefits would be subject to tax was not indexed to inflation, so there was a natural increase in that share over and above what would occur because real incomes of retirees were increasing.

of the two projections—2009 to 2060—the actuarial deficit has increased from 1.03 percent of covered wages to 2.61 percent (figure 4). In 2009, the OASDI trustees projected that the cash flow would turn negative in 2016, and the combined OASDI trust funds would run out in 2037. The 2011 budget projects that contributions will fall below benefits in the current fiscal year.

C. Was It a Success?

Whether one considers the Greenspan Commission a success depends on the criteria used. On the one hand, the commission played an important role in addressing and neutralizing an imminent payment crisis in social security. On the other hand, the measures it recommended were largely "low-hanging fruit" that did not achieve financial sustainability in the long run. The two key measures—increasing the normal retirement age and taxing benefits—were relatively benign, especially because their full impacts were significantly delayed. The first addressed a creeping increase in net benefits, as retirees received annuities that increased in value with their life expectancy, but at no additional cost in contributions. The second moved social security saving to a mode of taxation more consistent with private retirement saving. IRAs, for example, can be taxed either when the contributions are made or when the benefits are received. Either method implicitly exempts the returns on the saving from taxation and bestows "consumption-tax" treatment. Half of social security contributions have always been subject to tax. Exposing the other half to taxation when benefits are received makes social security saving equivalent to a combined regular and Roth IRA. The taxation of benefits was significantly curtailed at the outset by the threshold. However, since the threshold has been fixed in nominal terms since it was instituted, it has lost much of its value, dropping in real terms by more than 50 percent between 1983 and 2009.

A number of observers have argued that the Greenspan Commission was simply a rubber stamp for a political compromise between a Republican president and Democratic leadership in the House of Representatives. Henry Aaron (2010) quotes Robert Ball, one of the commissioners, as saying:

> "'[T]o suggest that the Greenspan Commission provides a model for resolving questions about Social Security's future would be laughable if it were not so dangerous... A commission is no substitute for principled commitment. Above all, we should not allow ourselves to fall into the trap of expecting miracles from another Greenspan commission—by deluding ourselves into believing, mistakenly, that the first one was a great success."

Even if we accept what Robert Ball had to say at face value, it is not clear that would make the Greenspan Commission a failure. If the political compromise is viable and the recommendations are sensible, the commission could facilitate their acceptance without compromising its integrity. Most of the members of the commission were in fact politicians rather than technicians, so it would be naïve to think that politics would not play a role in its deliberations. The social security system was at a crossroads, and the fact that the government was able to stave off insolvency was an important achievement, even if the final outcome was to postpone, rather than solve, the problem.

IV. Is the Greenspan Commission a Model for Today?

Whether or not one considers it a success, the recommendations of the Greenspan Commission and their impact on social security finances were certainly shaped by the timing and structure of the problems with which they dealt. The problem with commissions as a way to address fiscal problems is well known, particularly with respect to the recent appointment of the National Commission on Fiscal Responsibility and Reform. The prospects for this commission are being questioned on a number of grounds, including the need for near consensus, the fact that its recommendations would have no special treatment—for instance, a "vote without amendment" provision—in Congress, and the relatively modest goal of eliminating the primary deficit, which would stop, but not reverse, debt accumulation. Could a Greenspan-type commission make headway on reining in old-age entitlement spending?

A. Drop-dead date

Just as the requirement for a straight up or down vote can increase the effectiveness of legislative action, impending trust fund insolvency—a drop-dead date—can provide leverage for a Greenspan-type commission on social insurance. On this criterion, however, a new Greenspan Commission would be at a significant disadvantage relative to the original. The HI and DI trust funds are the weakest. Cash flow is already negative, and the trust funds are scheduled to dry up in 2018 and 2021, respectively.[7] Whether the demise of these trust funds is sufficiently imminent to engender fast action is problematic. The OASI trust fund was operating on borrowed money by the time the original Greenspan Commission presented its recommendations. The SMI trust fund, on the other hand, is a trust fund in name only, since premium and general revenue income for Parts B and D are reset each year to match expected costs. As noted above, the combined OASDI

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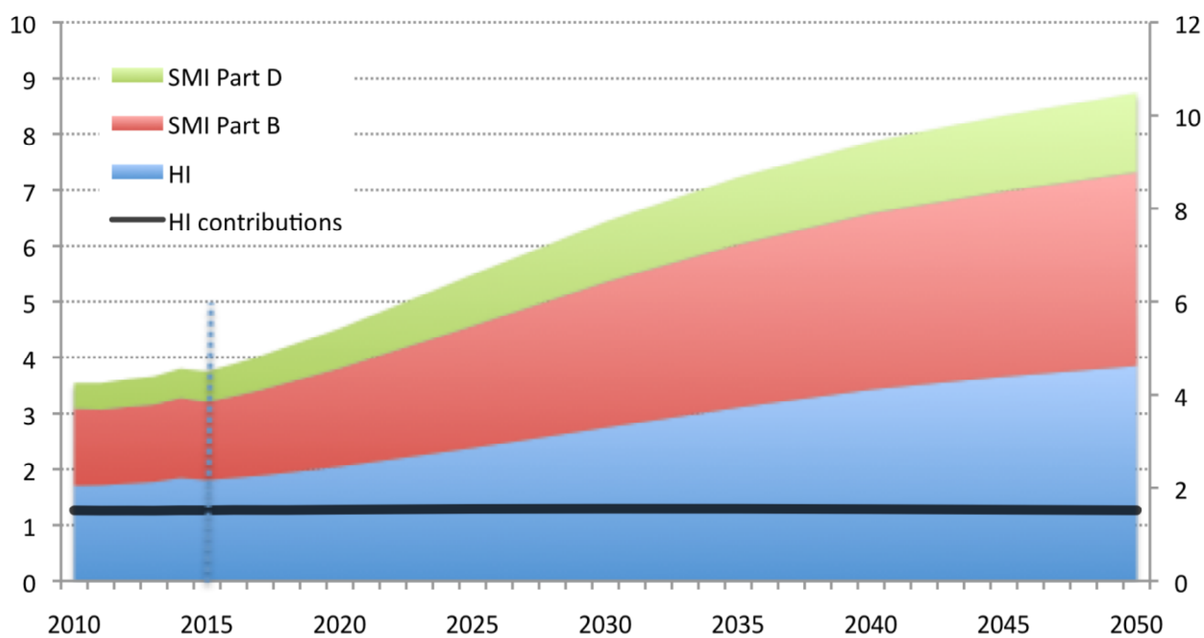
[7] The 2010 trustees' reports for social security and Medicare have been delayed to incorporate changes in projections engendered by the recently passed Patient Protection and Affordable Care Act.

trust funds are not projected to expire until 2037, and Congress can, as it has in the past, shift resources between the OASI and DI trust funds to temporarily address DI trust fund exhaustion.

Figure 5 presents Medicare spending and contribution projections from the 2009 Trustees Report. As the figure demonstrates, the fiscal pressure—although already substantial—grows relatively slowly through 2015, before accelerating. Outlays for Part B actually fall between 2010 and 2015, most likely reflecting the fact that "the projected future growth rate reflects unrealistic reductions in physician payments required by current law" (HI and SMI Trustees (2010), p. 21). Contributions to the HI plan, on the other hand, are essentially flat, at 1.5 percent of GDP, implying that wages subject to HI contributions—total wages, since there is no cap—will remain at slightly more than 50 percent of GDP. At least for a while, any call to action will have to be based on a financial crisis that is several years off.

Figure 5. Medicare Spending and Revenue Projections
(as a percent of GDP)



Source: 2009 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Supplementary Medical Insurance Trust Funds.

In summary, unlike for social security, only the hospital expenditures of Medicare are governed by a trust fund, and that trust fund is not projected to run out of funds for eight years. The remaining spending on other medical services and prescription drugs will require significant annual increases in premiums and budget spending, even though expenditures for providers are subject to unrealistic reimbursement provisions that are unlikely to remain in effect. As a result of changes instigated by the first Greenspan Commission, social security spending is a relatively small part of the problem that does not require immediate action, even if that action would make necessary long-term remedial steps both simpler and less painful.

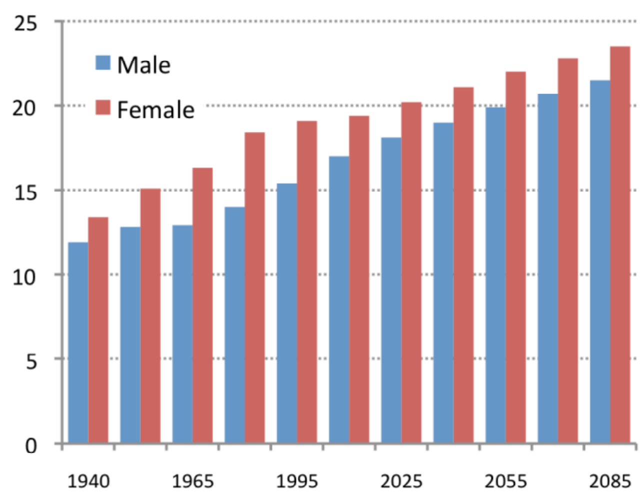
B. Structure of the problem

The structure of the entitlement-spending problem is also very different than it was in 1981. As demonstrated in figure 4, the immediate financial problem at that time was small and short-lived. The cash flow of the OASDI system would not go negative for good for another two decades. Moreover, there were obvious steps to take to delay the problem. In fact, the OASI program still is reasonably amenable to measures to cut future deficits, but the Medicare programs present a much more difficult structural problem.

Social Security

Just as in 1982, the most obvious measure to cut future cash flow deficits for social security is an increase in the normal retirement age. Life expectancy conditional on reaching age 65 for men and women combined increased by roughly five and one-half years between 1940, after the normal retirement age was set at 65, and 2010 (see figure 6 for the progression of life expectancy for men and women separately). Life expectancy at age 70 in 2010 is more than two years greater than life expectancy at age 65 in 1940. The increase in the normal retirement age to 66 was only recently completed, and the increase to 67 will not be completed for more than a decade. Life expectancy at 65 is projected to increase by more than four years between now and the end of the projection period. The chief argument against increasing the retirement age is that the decreases in mortality have not been accompanied by equivalent decreases in morbidity. People may live longer, but

Figure 6. Life Expectancy at Age 65



Source: 2009 Annual Report of the Boards of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

they may not be able or want to work that much longer.[8] For that reason, the early retirement age was not increased pari passu with the normal retirement age, and this approach can be continued, with appropriate offsets in benefits. In addition, an increase in disability retirement is also likely to accompany an increase in the normal retirement age, offsetting some of the financial improvement. In this context, the "losers" from an increase in the normal retirement age are workers who do not want to delay retirement, but are not disabled.

A number of options for reforming social security have been put forth in recent years. They cluster around two basic concepts—(1) "progressive" increases in contributions and reductions in benefits and (2) a partial shift to funded individual accounts with diversification to assets that have exhibited greater risk, but also greater expected returns. A few words of caution are in order:

- The regressivity of the payroll "tax" is often confused with the degree of progressivity in the social security system as a whole. There is a reason, however, why contributions were set by the Federal Insurance *Contributions* Act and the Self-Employment *Contributions* Act (italics added). Although the contributions apply to the first dollar of wages and are subject to a cap, their regressivity is more than offset by the progressivity of the benefit schedule and other aspects of the tax law.

  Benefits are set by multiplying a worker's "average indexed monthly earnings" (AIME) by a replacement rate. The replacement rate is 90 percent for workers with the lowest average earnings and the marginal replacement rate for high-wage workers is only 15 percent. In addition, the contributions are offset by the earned income tax credit (EITC) for low-income households, and both contributions and benefits are subject to income taxes for higher-wage workers.[9] The rate of return on contributions is much higher for low-wage workers than for high-wage workers, even before taking into account the taxation of

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[8] This is the basis for the recommendation by Diamond and Orszag (2005) that the increase in longevity be addressed in the level of annual benefits and the contribution rate, rather than an increase in the normal retirement age.

[9] According to Jonathan Barry Forman (1999), "As originally adopted in 1975, the earned income credit was intended to offset the Social Security taxes of low-income workers with children and to provide those taxpayers with an increased incentive to work." It has expanded well beyond this goal over the years. One change tied to the roll of FICA contributions was the implementation of a small EITC for individuals and families without children.

contributions and benefits or the EITC.[10] Attempts to increase the progressivity of the system beyond the current level run the risk of backlash and behavioral responses by high-income workers.[11] Progressivity is necessary to ensure that the system can finance adequate benefits for low-wage workers, but large increases in progressivity move the system away from social insurance toward a tax-and-transfer program.

- Funded, individual accounts are sometimes seen as a panacea for social security finances, shifting the responsibility for benefits from the social security system to the individual. Higher expected returns on retirement saving would certainly accompany diversification into risky assets. However, it is important to recognize that higher-return assets are, in fact, risky, and their returns will vary drastically across cohorts.

  To evaluate the impact of equity-market volatility on individual retirement saving, we simulate the performance of individual accounts invested in the S&P 500 over the past 47 years. To reflect an increasing wage profile, we assume the deposit grows smoothly from $667 in the first year to $1,333 in the last year. The only variable within these two profiles is the S&P rate of return, which is allowed to follow its historical path. We use a total return index, to allow for the reinvestment of dividends. The results of the simulation are displayed in figure 7, where the horizontal axis displays the year in which the worker retires.

  As figure 7 demonstrates, there is a huge amount of inter-cohort variation. The value of the accounts varies from $103 thousand to $347 thousand. The real internal rates of return (IRRs) earned on the deposits (the single rate that yields the same account total) show similar variation, ranging from 4.6 to 9.5 percent. It is interesting to note, however, that the minimum IRR is over 4.5 percent in both cases, significantly greater than the steady-state, pay-as-you-go

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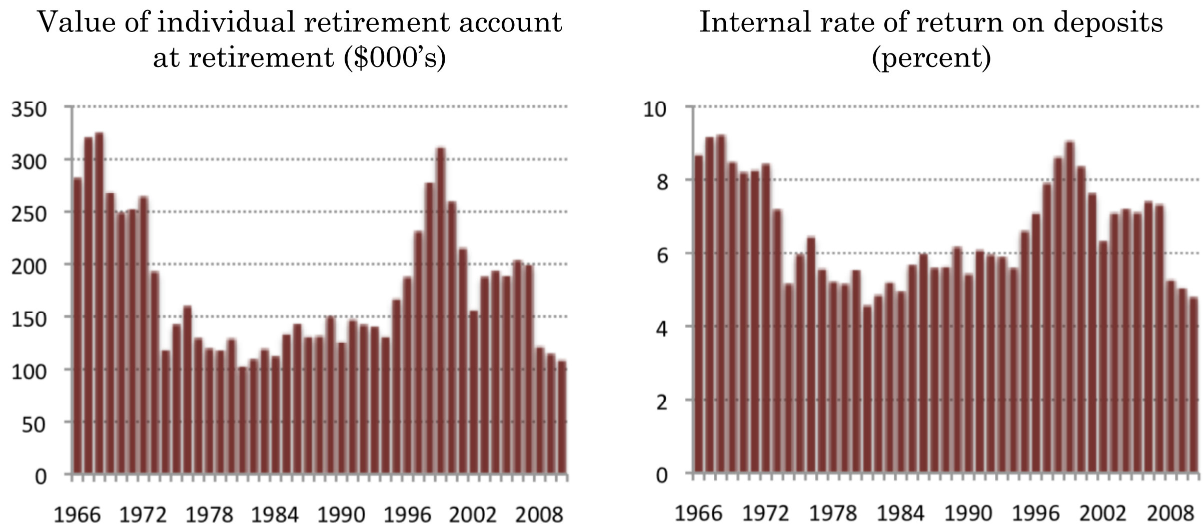
[10] Duggan, Gillingham, and Greenlees (1993, 1996) demonstrate the net progressivity of social security for early participants. The main change for later participants is to reduce the net benefits for all participants.

[11] For instance, Diamond and Orszag (2005) recommend greatly increasing the contributions of high-wage earners with little increase in benefits (a 15 percent marginal increase in benefits—10 percent under the Diamond-Orszag plan—as a worker's AIME increases because of faster increases in the cap on wages subject to contributions than under current law, and no additional benefit for "legacy taxes). The price indexation of the "bend points" in the benefit formula, which is often recommended, would also be progressive, but eventually cut benefits for (relatively) low-wage workers. In fact it would asymptotically cut the average replacement rate to 15 percent.

rate of return that could be sustained in the social security system. Moreover, despite the meltdown in the S&P 500 over the past 2½ years, workers retiring at the end of 2008 did not have the worst individual-account performance (although they are fast approaching the minimum and there is no guarantee that rates of return can be maintained in the future). In other words, even though the individual accounts produce "lucky" and "unlucky" cohorts, they still provide a reasonable rate of return even for unlucky cohorts.

Figure 7. Variation in Performance of Individual Retirement Accounts



Source: Haver Analytics.

Medicare

With the changes that have been made in the financing of Medicare over the past two decades, it is now arguably a tax-and-transfer, social-assistance program rather than a contributions-financed social insurance program. The HI program is financed by a 2.9 percent tax on wages. The cap on wages subject to contributions was repealed in 1993. As a result, the variation in contributions across income levels was significantly increased, although the objective of the program is to provide all participants with the same benefits. In this way, the HI contribution became a proportional, earmarked tax. As with social security, this makes the net benefits of the HI program highly progressive.

The SMI program is funded with a combination of budget transfers and premiums. Premiums are income-based and range from $96.40 per month (25 percent of total cost) for beneficiaries with individual (family) income less than $85,000 ($170,000) per year to $353.60 per month (80 percent of total cost) for beneficiaries with individual (family) income greater than $214,000 ($428,000) per year. In other words, the SMI subsidy from general revenues is means-tested, although the "income-related monthly adjustment amount" (IRMAA) currently applies to only a small share of beneficiaries.

It would be significantly more difficult to place Medicare on a financially sustainable path than it would be for social security. One obvious option is to increase the age at which people are eligible for benefits. Currently, you can delay signing up for Part B if you are actively employed and covered under an employer or union health plan, but there is no symmetric provision for early enrollment. A reform that increased the normal enrollment age, but allowed for early enrollment could reduce future cash deficits in a manner analogous to increasing the normal retirement age for social security, while still providing protection for workers who must or want to retire early.

Beyond adjustment of the eligibility age, possible reforms fall into four categories—(1) increases in budget transfers, financed either by higher contribution rates or general revenue, (2) increases in premiums, (3) reductions in benefits and (4) improvements in efficiency. All of these follow a tax-and-transfer model rather than a social-insurance model. For HI contributions to cover HI benefits, rates would have to increase more than three-fold by the end of the projection period. If rate increases were income-related, the rates for high-income individuals and families would have to increase by an even larger factor. Financing increases in transfers out of general revenues would face the same obstacle in terms of the size and distribution of the increase. Premiums are already highly progressive. They cannot increase for the highest-income beneficiaries by more than one-quarter without exceeding the cost of the benefits received. Benefit levels can be reduced, but Congress has shown little will to do so, recently increasing Part D benefits as part of the recently passed Patient Protection and Affordable Care Act (PPACA). Much hope has been held out for improvements in efficiency as it is the least painful of the options, but it is not clear whether correcting inefficiency would reduce the *rate of growth* as well as the *level* of spending.

This discussion begs the question of what would a Greenspan-type commission recommend to address the fiscal stress of Medicare? None of the measures recommended by the original Greenspan Commission were as fundamental and far-reaching as the steps that would be necessary to control Medicare spending. Moreover, some of the steps that might have been taken to reduce the Medicare deficit—including broadening of the base and increasing the rate for HI contributions by high-income taxpayers, reducing provider reimbursement rates and freezing the income thresholds for income-related premiums—were used to pay for the cost of PPACA.[12]

The effects of the PPACA are quite complicated. On the one hand, if its provisions are retained and the cost and revenue estimates for these provisions are accurate, it would not only provide resources to pay for health-care reform, but it would also have a significant impact on Medicare finances. The chief actuary for the Center for Medicare and Medicaid Services, Richard S. Foster, has estimated that—taken at face value—the provisions of the PPACA could delay exhaustion of the HI trust fund by 12 years (Foster 2010). However, as Foster points out, many of the cost savings could be illusory, based on assumed reductions in cost per beneficiary that may be unachievable. For comparison, he notes that

> [D]uring the last 25 years the average increase in the target growth rate [of cost per beneficiary] has been 0.33 percent per year below the average increase in nominal GDP per capita—which is approximately the target level for the physician sustainable growth rate (SGR) payment system. Congress has overridden the SGR-based payment reductions for each of the last 7 years (and, to date, for the first 5 months of 2010) (Foster (2010), p. 10).

C. What Can Be Done?

The logical conclusion of the above discussion is that—at least in the near future—a Greenspan-type commission would face a serious challenge in attempting to address old-age entitlement reform, because:

- The forcing event of trust fund insolvency is still several years off, even for the HI and DI trust funds. Moreover, there is no issue of trust fund exhaustion for Medicare SMI, which will be subject to a disproportionate share of increased spending going forward.
- The problem for Medicare is too large. Compared to the projected increase in Medicare spending, the financial pressure from social security is small indeed.
- There has been little discussion of the types and magnitudes of measures that would have to be implemented to address the fiscal problem. High-income taxpayers cannot be the only source of increased funding, either through tax rate or premium hikes. Moreover, some measures have already been used to finance health-care reform.

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[12] Estimating the yield from these measures is difficult because high-income taxpayers might respond more than expected to, or there might be a macroeconomic feedback from, the higher HI-type taxes, and it may be difficult to maintain the reduced reimbursement rates for providers.

One problem with a Greenspan-type commission for the current entitlement crisis is that it may not look at the issues in a sufficiently broad context. Social security and Medicare are highly progressive programs. As we project spending and revenue over the next 75 years, two questions will need to be addressed:

- First, what is the redistributive goal of the old-age entitlement programs? By 2085 compensation levels are projected to be roughly 3½ times as high as in 2010. This has implications for the role of the entitlement programs in protecting against *absolute* poverty or unaffordable health care in old-age, although it is not relevant for *relative* redistribution. Should an increase in absolute standards of living be accompanied by a greater role for individuals in saving for old age? Could a reduction in the relative size of the programs facilitate reform?

- Second, what role should government play in the health-care markets, both for the elderly and non-elderly? The role of the government in Medicare has always been preeminent. PPACA increased the role of the government in health care more generally. However, PPACA did not address some important, market-related factors. For instance, the tax deductibility of employer-provided health care is one of the most inefficient aspects of the current system. The internalization by consumers of the full cost of health care should make consumers more cost-conscious and, in turn, reduce consumption levels. Moreover, the elimination of this distortion would be incentive-compatible and could substitute for increases in more distortionary taxes to fund health care. Similarly, one of the most challenging characteristics of health insurance markets is the sensitivity of premiums to age. Would it be possible to design a system in which workers paid more than an actuarially fair premium when young in order to pay lower premiums as they get older (akin to premiums for whole life insurance and as is done in many employer-provided health-care schemes)? Should the government focus more on supporting private insurance markets for most consumers and focusing its activities on ensuring access for the poor and the very sick?

A Greenspan-type commission will not obviate considering and ultimately answering questions of this type in a manner that achieves social goals without losing the benefits of market forces. However, the key lesson from the Greenspan Commission is that government action *will be required* to address entitlement spending at some point to avoid the exhaustion of the social insurance trust funds. The political challenge is to use this fact to motivate action before trust fund exhaustion is imminent to (1) avoid last-minute “fixes” that might not address the problem in the most effective manner and (2) reduce the scope and smooth the timing of reforms to make them more palatable to the electorate.

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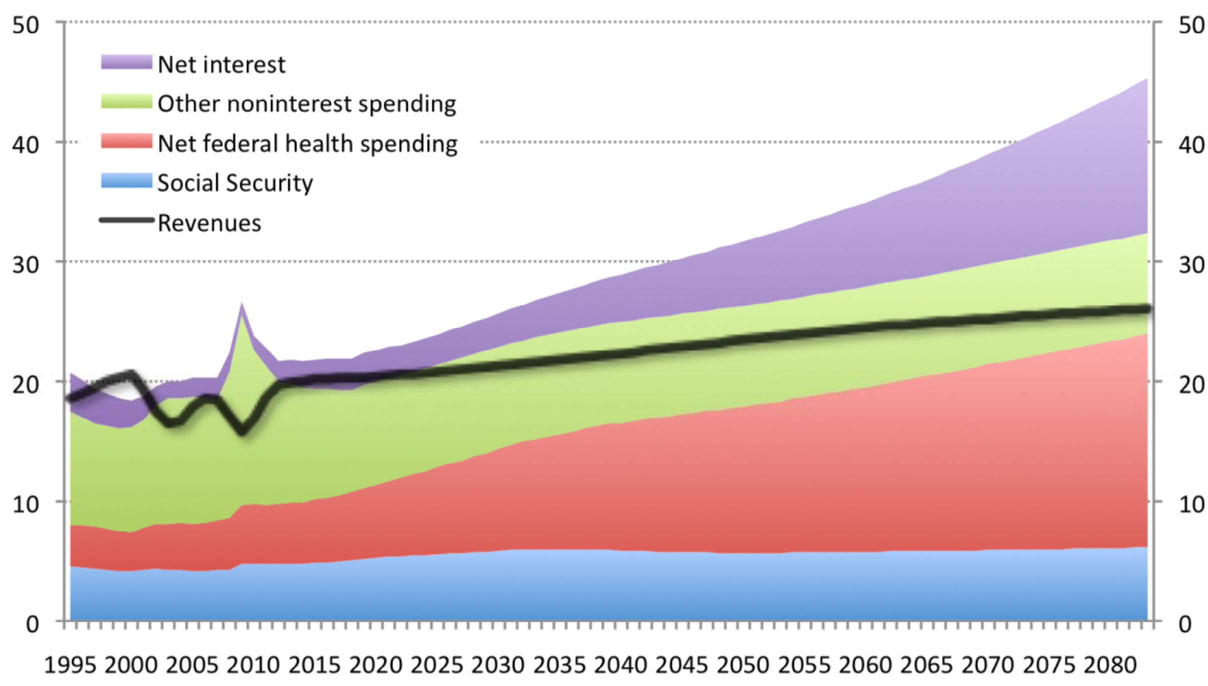
APPENDIX I. CBO'S LONG-TERM BUDGET PROJECTIONS

The CBO produces two sets of long-term budget projections. The first—the "extended-baseline scenario"—adheres as closely as possible to current law. The second, "alternative fiscal scenario," which is discussed above, represents one interpretation of what it would mean to continue today's underlying fiscal policy. The extended-baseline scenario differs from the alternative fiscal scenario in two important ways:

- The parameters of the AMT and not indexed to inflation, and several tax provisions that are likely to be extended are allow to expire.
- The cuts in Medicare provider reimbursements are not reversed by legislative action, as they have been in the past.

These two factors reduce outlays and increase taxes, presenting a more optimistic, though still dire, projection of future budgetary trends (figure 8).

Figure 8. CBO Extended Baseline Budget Scenario



Source: CBO, *Long-term Budget Outlook*, 2009.

The analysis above would be qualitatively similar using the extended-baseline scenario. The main difference is that due to the fact that the AMT is not indexed, revenues rise significantly. This slows the accumulation of the debt and the related interest payments.

APPENDIX II. MEMBERS OF THE GREENSPAN COMMISSION

Appointed by the president:

Alan Greenspan, Chairman — Chairman and President, Townsend-Greenspan and Company, New York, NY.

Robert A. Beck — Chairman of the Board and Chief Executive Officer, Prudential Insurance Company of America, Newark, NJ.

Mary Falvey Fuller — Management Consultant, San Francisco, CA (Member of 1979 Advisory Council on Social Security).

Alexander B. Trowbridge — President, National Association of Manufacturers, Washington, DC.

Joe D. Waggonner, Jr. — Consultant, Bossier Bank and Trust Company, Bossier City, LA (Member of Congress from Louisiana in 87th to 95th Congresses).

Appointed by the Majority Leader of the Senate, in consultation with Minority Leader:

William Armstrong — Senator from Colorado and Chairman of Subcommittee on Social Security, Committee on Finance.

Robert Dole — Senator from Kansas and Chairman of Committee on Finance.

John Heinz — Senator from Pennsylvania and Chairman of Special Committee on Aging.

Lane Kirkland — President, American Federation of Labor-Congress of Industrial Organizations.

Daniel Patrick Moynihan — Senator from New York and Ranking Minority Member of Subcommittee on Social Security, Committee on Finance.

Appointed by the Speaker of the House of Representatives, in consultation with the Minority Leader:

William Archer — Representative from Texas and Ranking Minority Member, Subcommittee on Social Security, Committee on Ways and Means.

Robert M. Ball — Visiting Scholar, Center for the Study of Social Policy, Washington, DC (Commissioner of Social Security, 1962-73).

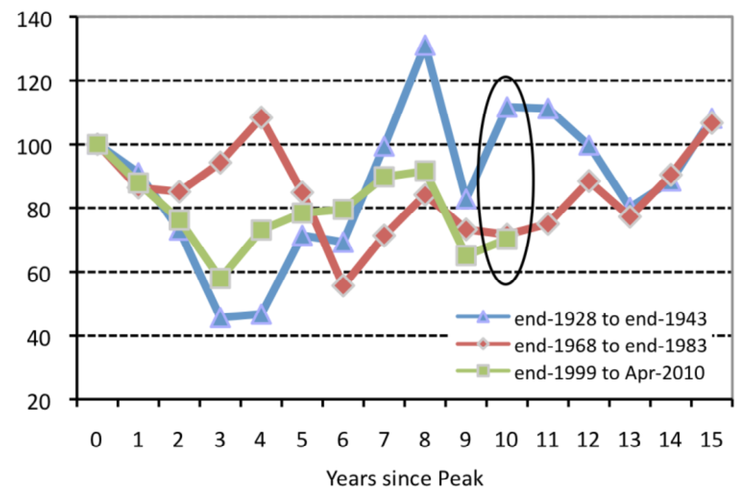
Barber Conable — Representative from New York and Ranking Minority Member, Committee on Ways and Means.

Martha E. Keys — Director of Educational Programs, The Association of Former Members of Congress, Washington, DC (Member of Congress from Kansas, in 94th and 95th Congresses. and Assistant Secretary of Health and Human Services, 1980- 81).

Claude D. Pepper — Representative from Florida and Chairman of Committee on Rules.

APPENDIX III. VARIATION IN THE PERFORMANCE OF INDIVIDUAL ACCOUNTS

Figure 9. Real S & P 500 Total Return Index for Three Market Slowdowns



Source: Haver Analytics.

The intercohort variation in the performance of individual retirement accounts is caused primarily by two stock market episodes. Figure 9 presents total return indexes for three periods during which equity markets were stagnant for relatively long periods. During the Great Depression, the value of an investment in the S & P 500 portfolio fell by almost 60 percent in three years. It recovered in year 8 only to fluctuate above and below its initial value until well into World War II. A similar investment at the end of 1968 never fell as low, but it remained below its original value for 13 of the next 14 years. More recently, an investment at the end of 1999 has yet to recover to its original value after almost 10 years. Moreover, its value at this point is below the value of the investments in the earlier periods after the same number of years. The Great Depression occurred early enough that it did not materially affect the individual accounts depicted in figure 7. However, the later two periods have had a profound effect on cohorts that retired in the middle and at the end of the period for which we simulated individual accounts.