THE CASE FOR STRUCTURAL REFORM

<u>Key Points</u>

- Entitlement programs are driving the national debt.
- Structural reforms to these programs will help beneficiaries and save the most money.
- If we wait too long, interest rates will rise, and the debt will spiral out of control.
- But if we act now, we will pay down our debt and boost our standard of living.

Introduction

Entitlement programs are growing so large that they could go bankrupt and spark a debt crisis. At their core, they have structural problems. So to both strengthen these critical programs and get control of spending, we need to make structural reforms.

Not all budget cuts are created equal. Some will save money in the short term—say, in the next ten years. But ultimately, they won't be enough to get control of the debt.

Structural reforms, on the other hand, may not save much in the short run. But in the long run, they will save much more. Just as a prudent investment gets higher returns through compound interest, structural reforms produce greater savings over time. As a wise man once said, "The most powerful force in the universe is compound interest."

And it could turn against us. Today, the Federal Reserve is keeping interest rates unusually low. If we lock in structural reforms now, we will help keep interest rates low, which will boost our economy. But this opportunity won't last forever. Once interest rates rise, debt payments will eat up a bigger slice of the federal budget. In fact, those payments might grow so large that they bankrupt us. Structural reforms are crucial to economic growth, and we have to act now.

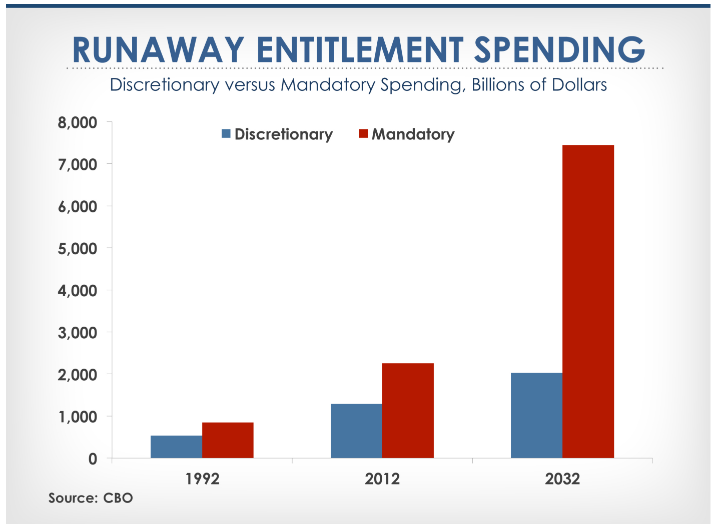
But these reforms won't just cut spending. They will improve our entitlement programs. Today, Social Security, Medicare, and Medicaid can't keep their promises to the poor or the elderly. If we make the right kinds of reforms, we can pay down the debt and help the most vulnerable.

The Problem: Autopilot Spending

There are two types of federal spending: discretionary and mandatory. Discretionary spending is subject to annual appropriations. It mostly consists of funding for government agencies, like the Defense Department. And it makes up roughly 40 percent of federal spending. The other 60 percent is mandatory spending. It mostly consists of funding for entitlement programs, which by law must serve all eligible beneficiaries—regardless of the nation's finances. The most notable are Social Security, Medicare, and Medicaid.

A key difference between these two is the rate of growth. Congress directly approves the amount of discretionary spending each year. But because mandatory spending is growing so quickly, discretionary spending is shrinking as a share of the federal budget. And since Republicans took control of the House in 2011, discretionary spending has declined dramatically.

Mandatory spending, on the other hand, is set on autopilot; it grows automatically. The chart below compares mandatory spending and discretionary spending 20 years ago, today, and 20 years from today.

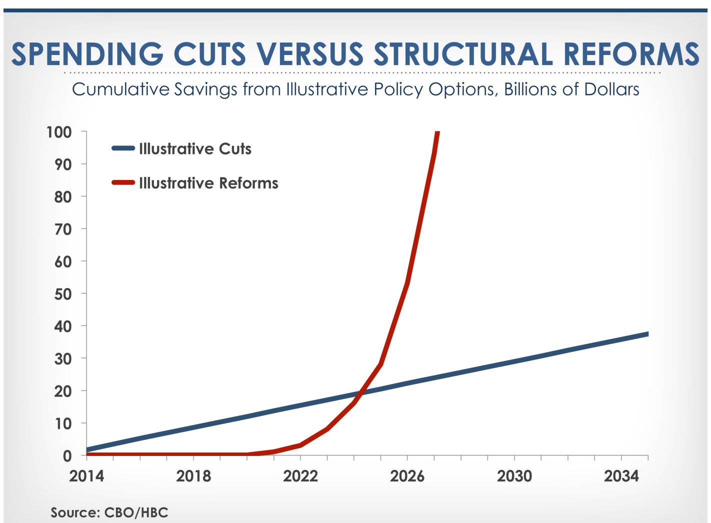


Most of the growth will be in Medicare, Medicaid, and Social Security. These programs are growing rapidly because the population is getting older and health-care costs continue to rise. About 10,000 baby boomers are retiring every day.[1] And in recent years, health-care costs have grown 50 percent faster than inflation.[2] To make things worse, the President's health-care law has dramatically expanded health-care obligations. So the programs are taking on more people, and these costs are compounding over time.

<u>The Solution: Structural Reforms</u>

To get control of the debt, we need to get control of entitlement programs. But we can't just cut these programs; we must reform them. In fact, cutting these programs without reforming them could hurt the very people they're meant to protect. The President's health-care law, for example, tries to save money by paying Medicare providers less. Such price controls have forced some doctors to stop seeing Medicare patients.

Structural reforms not only improve these programs, they also save more money. See the chart below.



The blue line measures the cumulative savings from straightforward cuts to mandatory spending. Such cuts could include eliminating the Social Services Block Grant or eliminating the categorical eligibility for the Supplemental Nutrition Assistance Program. These are good ideas, they would achieve immediate savings, and those savings would grow over time. But they wouldn't change the trajectory of the national debt.

The red line, on the other hand, measures the growing savings from structural reforms to mandatory spending. Such reforms could include combining Medicare's Part A and B deductible, raising the Medicare retirement age, giving states more flexibility with Medicaid, or creating real premium-support options for Medicare. If these reforms were phased in gradually to prevent disruptions for those in or near retirement, they wouldn't produce great savings within the first ten years—the

[1] Social Security Administration, *<u>Annual Performance Plan for Fiscal Year 2012</u>* (Washington: SSA, February 2011): 44.
[2] Congressional Budget Office, *<u>The 2013 Long-Term Budget Outlook</u>* (Washington: CBO, September 2013): 38.

standard measure for budgeting. But once these reforms were fully phased in, the savings would compound rapidly.

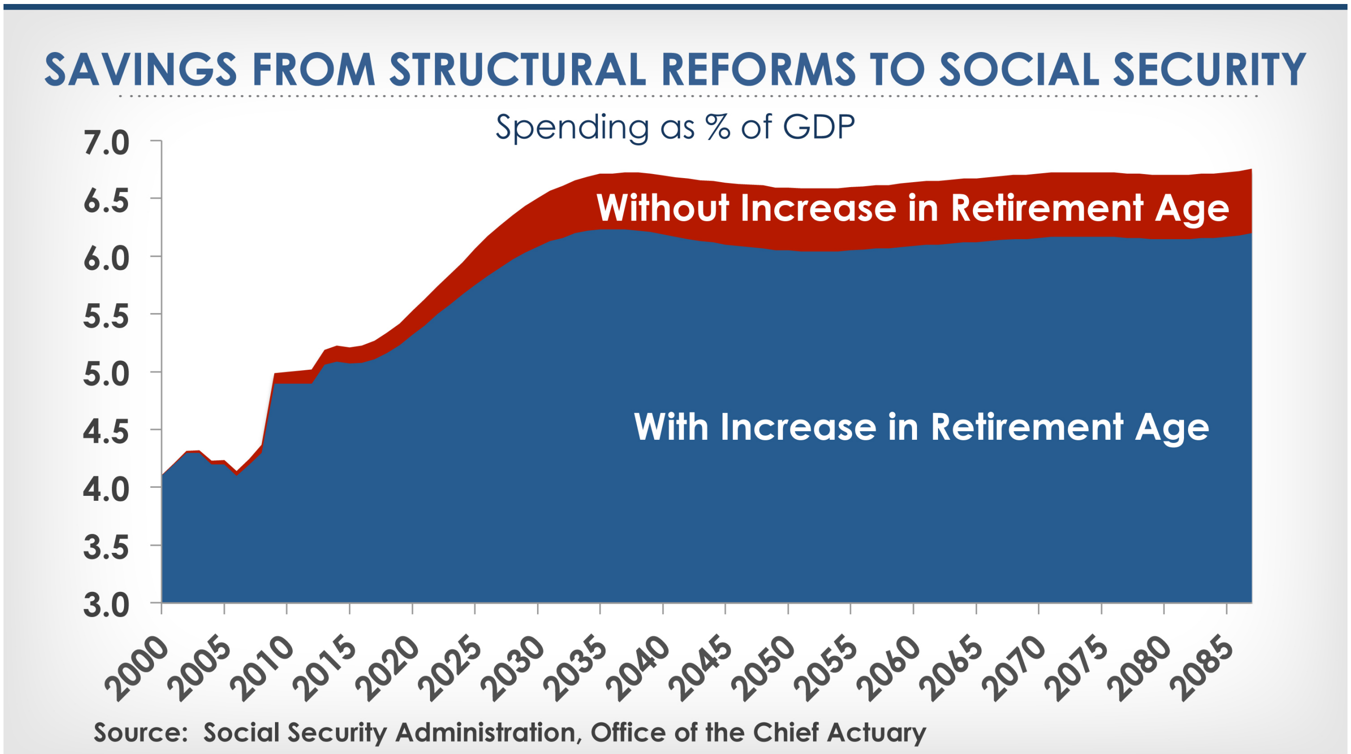
Example: The 1983 Social Security Commission

We've seen this dynamic before. In 1982, Social Security's trustees warned Congress that the program would go bankrupt by mid-1983.[3] If it had, beneficiaries would have suffered a reduction in their benefits. So members of both parties worked together to shore up the program.

The final deal was a mix of short- and long-term reforms that have helped to keep the program solvent well into the 21st century.[4] One major provision was an increase in the normal retirement age.

At the time, Social Security's Office of the Chief Actuary (OACT) estimated the savings from this reform. It made two sets of estimates—one short-term, the other long-term. OACT predicted that raising the normal retirement age would save no money between 1983 and 1989. But in the longer term, OACT found that it was the single largest improvement to the program.[5]

Today, this reform is still in place. OACT estimates that the change saved over $100 billion through 2012, and OACT estimates that it will save an additional $4.6 trillion over the next 75 years. All told, the savings from this provision alone will be $4.7 trillion—none of which occurred during the first five years.[6] For an illustration of these savings, see the chart below.



[3] The Board of Trustees, The 1982 Annual Report of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Fund (Washington: GPO, 1982).
[4] The latest Social Security Trustees' Report estimated that the program will remain solvent until 2033. The Board of Trustees, The 2013 Annual Report of the Board of Trustees of the Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds (Washington: GPO, 31 May 2013).
[5] Committee on Ways and Means, *Actuarial Cost Estimates of the Effects of Public Law 98-21 on the Old Age, Survivors, and Disability Insurance and Hospital Insurance Programs* (Washington: GPO, 8 September 1983).
[6] HBC staff analysis of data provided by the Social Security Administration, Office of the Chief Actuary.

The Economic Benefits of Structural Reforms

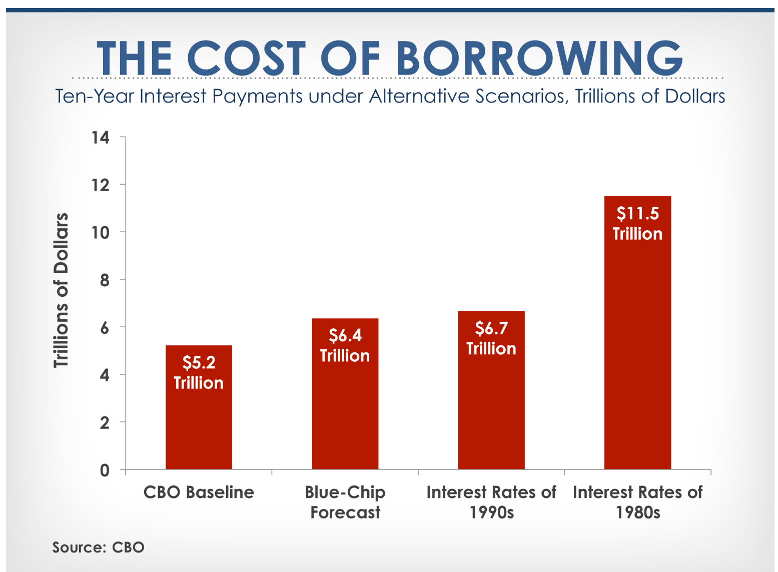
In its latest *Long-Term Budget Outlook*, the Congressional Budget Office (CBO) warns:

> The aging of the baby-boom generation, together with growth in health care spending per person and an expansion of federal subsidies for health insurance, is expected to steadily boost the government's spending for Social Security and major health care programs. Barring changes to current law, that additional spending would contribute to rising budget deficits starting in a few years, causing federal debt to swell from a level that is already very high relative to the size of the economy.

In the long run, structural reforms will not only help entitlement programs; they will also help the economy.

CBO says our national debt is ultimately unsustainable because it's growing faster than the economy. We haven't even felt the full impact yet. Right now, the Federal Reserve is keeping interest rates unusually low. If we started structural reforms now, there would be more certainty in the economy, which would spur more investment and job creation. But if we waste this opportunity, we will face even more difficult decisions down the road.

As interest rates rise, so will the cost of our debt. As a result, the federal government will have to borrow an increasing amount each year—both to fund its current obligations and to make good on its previous commitments—as the chart below illustrates. If interest rates follow CBO's predicted path, we'll pay over $5 trillion in interest alone over the next ten years. But if they rise to their 1990s average—or roughly where most blue-chip firms believe rates will end up—we'll pay over $6 trillion. And if they rise to their 1980s average, we'll pay over $11 trillion. CBO says this dynamic will decrease national saving and "crowd out" private investment, leading to a decline in economic output and a lower standard of living.



And things could get worse. If debt payments grew especially large, investors would worry whether we could meet all our obligations. CBO warns that, if left unchecked, "the risk of a fiscal crisis—in which investors demanded very high interest rates to finance the government's borrowing needs—would increase."

On the other hand, CBO finds that slowing the growth of the debt would be a significant boon to long-term economic growth. It notes:

> Stable or declining levels of federal debt relative to GDP would yield additional positive consequences beyond the effects on output. Relative to outcomes under the extended baseline, federal interest payments would be smaller, policymakers would have greater leeway in using tax and spending policies to respond to any economic downturns or financial crises, and the risk of a sudden fiscal crisis would be much smaller.[7]

[7] Congressional Budget Office, [The 2013 Long-Term Budget Outlook]() (Washington: CBO, September 2013): 3, 89.

Conclusion

In short, small changes can add up to big savings over time. That's the best way to pay down the debt—both for the budget and for the economy. But our goal isn't just to cut these programs; it's to reform them. It's to make them better—by infusing them with market principles and the character of our free society. If we wait too long, we will lose a big opportunity. And we will force even more painful decisions on the next generation. But if we take action now, we will strengthen these programs, pay down the debt, and build a stronger economy for our country.