



# MANHATTAN

## INSTITUTE



### MEMORANDUM

TO: The Administration and Congressional Leaders

FROM: Brian Riedl

DATE: June 11, 2019

SUBJECT: A Plausible Blueprint for Fiscal Sustainability

### INTRODUCTION

The greatest long-term threat to economic prosperity is a national debt that threatens to crowd out investment, raise interest rates, and ultimately bury the federal budget in unaffordable interest costs. And Social Security and Medicare's cash shortfalls—defined as the benefits and resulting interest costs that must be funded by outside general revenues—drive the entire coming debt avalanche.

Over the next decade, 91 percent of the projected increase in budget deficits—which are set to approach \$2 trillion—comes from the increased cost of filling these shortfalls. Over the next 30 years, Social Security and Medicare are projected to run a \$100 trillion cash shortfall (including resulting interest costs), while the rest of the budget is projected to run a \$16 trillion surplus.

The blueprint presented here would avert a debt crisis by stabilizing the debt around 90 percent of GDP. It would accomplish this primarily by reforming the Social Security and Medicare shortfalls driving the debt, rather than by eviscerating the safety net and social spending, or doubling taxes on existing workers.

### TOP THREE POLICY RECOMMENDATIONS

#### *Modernize Social Security*

Social Security is projected to run a cash deficit of \$18 trillion over the next 30 years, plus \$12 trillion in resulting interest from borrowing to cover this shortfall. Reducing this shortfall should begin with gradually raising the Social Security full-benefit retirement age from 67 to 69 by 2030, and by significantly limiting the growth of benefits for the highest-earning half of new retirees. Initial Social Security benefits would be set lower than under current schedules for those with higher lifetime earnings. Also, seniors whose current (postretirement) incomes exceeded \$85,000 (single) and \$170,000 (married) in the previous year would not receive a cost-of-living increase (but this threshold would rise with the inflation rate).

The bottom 40 percent of lifetime earners would be held harmless by these reforms (other than the higher eligibility age).

By also incorporating the 1-percentage-point payroll-tax increase in this blueprint—described later—the 30-year Social Security cash deficit would fall from \$18 trillion to \$5 trillion, and likely reach annual balance around 2050.

### **Revitalize Stale Health Entitlements**

Medicare is projected to run a cash deficit of \$41 trillion over the next years, plus \$29 trillion in additional interest costs. This is the result of adding 74 million baby boomers to a Medicare system that pays benefits three times as large as the typical senior's lifetime contributions.

The first place to seek savings is by making Medicare more efficient. Transitioning to a moderate premium support model—where seniors would receive a payment equal to the average bid of all local competing plans—would reduce premiums by 7 percent, and total Medicare spending by 5 percent, all without any reduction in guaranteed benefits. In short, premium support means more choices for seniors, no reduction in benefits, and substantial cost savings both for seniors and the federal government.

Next, Congress should gradually raise total senior premiums to cover 50 percent of Medicare Part B costs—which matches the original program design—and 40 percent of Medicare Part D costs. This can be done while exempting the bottom-earning 40 percent of retirees.

Combining these two policies, total Medicare premiums would rise by approximately 4 percent of aggregate senior income relative to the baseline.

These proposals eliminate more than half of Medicare's projected 3.0 percent of GDP cost growth over 30 years. A Medicare payroll-tax increase described below will also bring in 0.36 percent of GDP, and also extend the Medicare Part A Trust Fund.

Within Medicaid, Congress should cap Washington's per-capita payments to states beginning in 2023. This will end the irrational policy of rewarding big-spending states with extra federal dollars, and will encourage state innovation. The caps would grow by 3.5 percent annually for children and adults; and 4.0 percent annually for the elderly and disabled (a weighted average of 3.8 percent). This is not far below the estimated 4.6 percent annual growth in per-capita Medicaid spending assumed in CBO's long-term budget baseline. Innovative governors should be able to stay under these more generous caps without raising state taxes or deeply limiting eligibility.

### **Limit Painful Tax Increases**

Washington has promised senior citizens—the wealthiest age group—benefits far exceeding their contributions to Social Security and Medicare. In this situation, drowning working families in exorbitant taxes is no more moral than drowning them in debt. Instead, the benefit programs themselves should be made sustainable.

Over the next 30 years—even if all current tax cuts are extended—real bracket creep will add 2 percent of GDP in revenues. An additional 1.5 percent of GDP can be raised by phasing down the tax exclusion for employer-provided health care, raising the Social Security and Medicare payroll taxes by 1 percentage point apiece, and adding a 1 percent income surtax to cover incomes above the Social Security payroll tax phase-out.

These small, broad-based tax increases will affect nearly all workers while crippling very few, and also add resources to the Social Security and Medicare systems. By contrast, trying to close the gap solely by taxing the rich would require exorbitant and unrealistic tax rates that would severely harm the economy.

We need not wait for long-term reforms to address the budget deficit. The discretionary spending caps should be extended as part of legislation to raise the debt limit. The highway program (and gas tax) should be sent back to the states.

## **CONCLUSION**

Unless we address the Social Security and Medicare shortfalls driving the debt to unsustainable levels, we will continue to see taxes rise and other priority spending get squeezed out. Without reform, eventually interest rates will rise, investment spending will fall, and interest costs will overwhelm the budget. There is no plausible level of tax increases, defense cuts, or safety net savings that can close more than a fraction of Social Security and Medicare's \$100 trillion cash shortfall. If we act quickly, we can reform these programs without burdening low-income families or retirees.

  

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## A PLAUSIBLE BLUEPRINT FOR FISCAL SUSTAINABILITY

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### INTRODUCTION

Budget deficits are projected to soon surpass \$1 trillion, on their way to \$2 trillion within a decade—or closer to \$3 trillion if interest rates return to 1990s levels. Over the next 30 years, the national debt is projected to soar to between 150 percent and 230 percent of GDP, depending on interest rates and the fate of expiring policies.

Unless reforms are enacted, global markets will eventually stop lending to the U.S. at plausible interest rates. When that event occurs, or even approaches, interest rates will soar, and the federal government will not be able to pay its bills, with dire consequences for the economy.

There is no dispute that Social Security and Medicare's shortfalls drive these deficits. Because payroll taxes and senior premiums are insufficient, the annual general revenues (and resulting interest costs) needed to pay full Social Security and Medicare benefits will rise from \$396 billion in 2018, to \$1,681 billion in 2029. This accounts for 91 percent of the increase in projected budget deficits over that period.

The long-term picture is even more dire. Data from the Congressional Budget Office show that Social Security and Medicare face a \$100 trillion cash shortfall over the next 30 years—consisting of a \$41 trillion Medicare shortfall, \$18 trillion Social Security shortfall, and \$41 trillion in national debt interest payments directly resulting from these shortfalls. The rest of the budget is projected to run a \$16 trillion surplus over this period. In short, the long-term deficit is entirely driven by the Social Security and Medicare systems' shortfalls.

Social Security and Medicaid should continue to aid seniors. Yet it makes no sense to drive Washington towards a debt crisis so that the wealthiest seniors can receive Social Security and Medicare benefits far exceeding their lifetime contributions.

The blueprint presented here would stabilize the national debt around 90 percent of GDP, which requires gradually reducing the annual deficit to 2.5 percent of GDP. Yet rather than present an unrealistic

conservative or liberal fantasy scenario, the reforms here thread the needle of bipartisan plausibility and effectiveness in stabilizing the debt without damaging the economy. They achieve most savings from the programs that are driving the debt, and protect other priorities. Specifically, reforms are crafted in four tiers (ranked by priority):

- **Tier 1:** Squeeze out inefficiencies from the health programs driving spending upward.
- **Tier 2:** Trim Social Security and Medicare benefits for upper-income retirees.
- **Tier 3:** Trim other federal programs to the extent feasible on a bipartisan basis.
- **Tier 4:** Close the remaining gap with new taxes in the broadest and least-damaging manner possible.

The blueprint also provides that: the lowest-income 40 percent of seniors are protected from any Social Security or Medicare cuts (although the Social Security full-benefit retirement age would rise); spending cuts to antipoverty programs are avoided; parity between discretionary defense and nondefense spending is maintained; Washington's structural budget deficits are not passed on to the nation's governors; tax increases are kept within reasonable limits; and policy changes are phased in gradually, mostly beginning in 2023.

By focusing most reforms on improving health efficiencies and trimming expensive benefits for upper-income seniors, the blueprint avoids large, economy-damaging tax increases, and also protects the middle- and lower-income families from deep cuts in their benefits.

## SPENDING

### *Medicare, Medicaid, and Other Federal Health Programs*

**Medicare.** Medicare spending—projected to more than double, from 2.9 percent to 5.9 percent of GDP by 2049—is the single largest driver of long-term deficits.

The first place to seek savings is by making Medicare more efficient. The largest efficiencies would come from implementing a premium support system for Medicare Parts A and B. Instead of the traditional Medicare system's one-size-fits-all model (which is slightly improved by the Medicare Advantage option), premium support creates a health-care market where insurers must compete for retirees. This model has proved, in the case of Medicare Part D, to empower seniors, encourage innovation, reduce premium growth, and stabilize taxpayer costs. As applied to Medicare overall, this proposal's federal premium support payment would equal the average bid of all competing plans, all of which would be required to offer benefits at least actuarially equivalent to the current system. CBO estimates that premiums paid by retirees would fall by 7 percent, and the federal Medicare savings would total 5 percent of projected Medicare spending by the fifth year. In short, premium support means more choices for seniors, no reduction in benefits, and substantial cost savings both for seniors and the federal government.

Past premium support proposals were criticized for tying the payment level to a variable such as inflation or economic growth that may not keep up with the rising cost of health plans—or tying the payment level to one of the lowest-bid plans, thus making it likely that seniors would pay more out-of-pocket for a typical plan. By contrast, this premium support proposal is more generously set at the average local bid. No matter how much health-care costs rise, the premium support payment would remain tied to the cost of the average plan.

Medicare can achieve additional savings by modestly tweaking other payment policies and curtailing spending such as Graduate Medical Education subsidies. Overall, efficiency savings could rise to 9 percent of projected program costs by 2049. The combined annual growth rates of Medicare Parts A and B would fall from approximately 6.3 percent to 5.8 percent (and declining).

The next step is to rebalance the responsibility for funding Medicare Parts B and D. Currently, more than 95 percent of seniors are charged premiums that cover no more than 26 percent of the cost of their coverage. Taxpayers fund the rest. The federal subsidies for Medicare Parts B and D were not “earned” with earlier payroll taxes—which contribute only to Medicare Part A.

Congress should gradually raise total senior premiums to cover 50 percent of Medicare Part B costs—which matches the original program design—and 40 percent of Medicare Part D costs. The monthly premiums would rise on a sliding scale, based on current, postretirement income. Retirees whose income is at or below the 40th percentile would see no premium hikes. However, the monthly premium would increase between the 41st and 80th income percentile, until it reaches 100 percent of the cost of the insurance plan.

These higher premiums will be more affordable because they are partially offset by efficiency gains from the premium support mechanism that should lower total Medicare Part B costs. Once fully phased in, total Medicare premiums would rise by approximately 4 percent of aggregate senior income relative to the baseline.

The Medicare eligibility age would remain at 65, as the limited federal budget savings of raising the age are not worth the upheaval.

These proposals eliminate half of the projected 3.0 percent of GDP cost growth of Medicare by 2049. A Medicare payroll-tax increase described below will also bring in 0.36 percent of GDP. Medicare’s projected 30-year cash shortfall would fall from \$41 trillion to \$24 trillion through a combination of efficiencies (saving \$4.2 trillion), Part B premium income-relating (saving \$5.9 trillion), Part D premium income-relating (saving \$2.6 trillion), and a payroll-tax increase (raising \$4.0 trillion).

**Medicaid.** Recent eligibility expansions and natural caseload increases have raised federal Medicaid spending from 1.3 percent to 1.9 percent of GDP since 2007—and spending is projected to reach 2.8 percent of GDP within 30 years. Achievable reforms can instead limit that growth to 2.2 percent of GDP while improving the program.

Congress should first repeal the 90 percent long-term federal reimbursement rate for the newly-eligible population of nondisabled, working-age adults with higher incomes that was implemented in 2014. States should continue to be allowed to include these newly added adults in their Medicaid programs; but no rational explanation exists for Washington subsidizing nondisabled, working-age adults on Medicaid with a much higher reimbursement rate than children, the elderly, and the disabled.

Next, Congress should cap Washington’s per-capita Medicaid payments to states beginning in 2023. The current system irrationally reimburses a preset percentage of state Medicaid costs, which means that the more a state spends, the larger its federal subsidy. The current system also restricts state innovation in health care. Per-capita caps would provide an incentive and the added flexibility for states to devise innovative coverage for low-income residents. States developing successful approaches will certainly be copied by other states.

In keeping with the principle that deficit reduction should not simply dump the federal budget deficit onto states, the per-capita caps would be significantly looser than those proposed in Congress. The caps would grow by 3.5 percent annually for children and adults; and 4.0 percent annually for the elderly and disabled (a weighted average of 3.8 percent). This is not far below the estimated 4.6 percent annual growth in per-capita Medicaid spending assumed in CBO's long-term budget baseline. Innovative governors should be able to stay under these more generous caps without raising state taxes or deeply limiting eligibility.

### **Social Security**

The blueprint's Social Security reforms are based on a modified version of the Social Security Reform Act of 2016, authored by House Ways and Means Social Security Subcommittee chairman Sam Johnson (R., Texas).

The vast majority of the federal-budget savings would come from gradually raising the Social Security full-benefit retirement age from 67 to 69 by 2030, and by significantly limiting the growth of benefits for the highest-earning half of new retirees. Initial Social Security benefits would be set lower than under current schedules for those with higher lifetime earnings. Also, seniors whose current (postretirement) incomes exceeded \$85,000 (single) and \$170,000 (married) in the previous year would not receive a cost-of-living increase (but this threshold would rise with the inflation rate).

Additionally, in this modified proposal, the bottom 40 percent of lifetime earners would be held harmless (other than the higher eligibility age).

These benefit cuts are less drastic than they appear. The Social Security baseline assumes that future retirees will receive much higher benefits than current retirees, even adjusting for inflation. Instead, for all except the top 20 percent of retirees (by income), someone turning 65 in 2049 would receive an inflation-adjusted benefit roughly equal to (or even slightly above) the benefit level of someone turning 65 in 2019. And only the top 10 percent of future retirees would see a significant drop in inflation-adjusted benefits relative to 2019 levels.

By also incorporating the 1-percentage-point payroll-tax increase in this blueprint—described later—the 30-year Social Security cash deficit would fall from \$18 trillion to \$5 trillion, and likely reach annual balance around 2050.

**Senior impacts.** Well-off retirees will shoulder most of the costs of bringing Social Security and Medicare finances to a sustainable level. The wealthiest half of seniors often have incomes and net worths (even excluding illiquid home equity) that exceed those of young workers, while typically not having mortgage or child-raising expenses. They are also currently scheduled to receive benefits far exceeding what they paid into these programs.

The 2030 impact figures below apply to individuals reaching retirement age that year, and are adjusted for inflation:

- Seniors with post-retirement incomes below the 40th percentile would see no change in Social Security benefit formulas (just a higher eligibility age) and would benefit from lower Medicare premiums due to premium support efficiencies.
- Seniors with post-retirement incomes in the middle quintile—with an average household income of \$52,500 in 2030—would face approximately \$2,500 less in annual Social Security benefits and \$1,050 in higher Medicare premiums by 2030.

- Seniors in the fourth income quintile (\$91,300 average in 2030) would face approximately \$3,700 less in annual Social Security benefits and \$6,300 in Medicare changes by 2030.
- Seniors in the top income quintile (\$280,000 in 2030) would experience a decline in their Social Security benefits of \$8,600 and a rise in Medicare premiums of \$11,000 by 2030.

## **Defense**

The blueprint proposes that annual defense appropriations would grow by 2.5 percent through 2030, and 3.5 percent thereafter—a little faster than projected chained CPI inflation plus population growth (2.8 percent). Because this spending rate slightly trails projected economic growth rates, defense spending would fall from 3.1 percent to 2.4 percent of GDP over 30 years. This would represent the smallest defense spending level since the 1930s.

## **Non-Defense Discretionary**

This blueprint would maintain parity between defense and nondefense discretionary spending levels—as a bipartisan compromise and an acknowledgment that neither category can be reduced as deeply as partisans on either side wish. Thus, non-defense discretionary spending would match the defense levels above.

## **Other Mandatory**

This spending would grow at CBO’s baseline level through 2029, and then 3.3 percent annually thereafter—slightly faster than the 2.8 percent projected rate of chained CPI inflation plus population growth, but slower than the economy. Thus, this federal spending would dip by 0.3 percent of GDP over 30 years. There is no politically realistic path to achieving much larger savings from this slice of federal spending.

Specifically, non-health mandatory spending on “vulnerable populations” consists of 1.5 percent of GDP spent on programs like SNAP (aka food stamps), the Earned Income Tax Credit (EITC), Child Tax Credit, Supplemental Security Income (SSI), and unemployment benefits. Even the most aggressive reforms, such as SNAP work requirements, would save just 0.1 percent of GDP. It is not plausible to expect deep savings here.

Nor is it plausible to significantly cut veterans’ benefits (0.5 percent of GDP), military pensions (0.2 percent of GDP), and federal employee pensions (0.3 percent of GDP). Recent wars and the aging of the population will increase these costs, and the proposed growth is roughly in line with (or slightly faster than) inflation plus population.

There is room to phase-in modest federal employee pension reforms, eliminate wasteful farm subsidies, privatize lower-priority programs, and sell federal land and assets. These savings could finance stronger growth in veterans’ benefits or an expanded EITC.

## **REVENUES**

Even all plausible spending cuts listed above are not enough to stabilize the debt. Tax revenues must also gradually rise from 16.5 percent to 20.2 percent of GDP over the next 30 years. This blueprint first permanently extends the 2017 tax cuts and the current health care tax moratoriums in order to set up a current-policy baseline. Even with those extensions, real bracket creep and the deluge of baby boomer taxable retirement distributions will automatically push projected tax revenues up to 18.6 percent of GDP over 30 years. The final 1.6 percent of GDP in revenues would come from new tax reforms.



## **Individual Income Taxes**

The 2017 Tax Cuts and Job Act reforms would be made permanent. Step-up basis for capital gains taxes on inherited assets would be repealed as of 2023.

## **Corporate Income Taxes**

The 2017 Tax Cuts and Job Act reforms would be made permanent.

## **Tax Expenditures**

The current moratorium on Affordable Care Act taxes should be permanently extended. Then, in 2023, the employer health-care tax exclusion should be capped at the 75th percentile of health-insurance premiums paid by employers that year (replacing the Obamacare “Cadillac tax” that was never implemented). The cap level setting a maximum-deductible premium would grow annually at the rate of the CPI. Capping the exclusion will reduce business incentives to overspend on health benefits and to downplay cost containment, and thus contribute to broader efficiency savings in health care. It will also increase take-home pay for many workers because more of their compensation would go toward wages rather than health-insurance premiums.

## **Other Sources**

These reforms would raise the Medicare and Social Security payroll tax by 1 percentage point each, while adding a 1-percentage-point income-tax surcharge above the level where the Social Security tax on earnings maxes out (all beginning in 2023).

This approach is recommended for two reasons. First, as stated above, the Social Security and Medicare systems face a combined \$100 trillion cash deficit over 30 years, so it makes sense to concentrate budget savings in those two systems. Second, any tax increases should be widely dispersed to minimize economic disruptions. The alternative of imposing enormous tax hikes on one industry or group of people would significantly decrease incentives to work, save, and invest, and thus harm economic growth—which would also decrease the resulting new tax revenues. A simple 2-percentage-point payroll-tax increase, split between Social Security and Medicare, will affect nearly all workers while crippling very few. Because the Social Security payroll tax maxes out at a certain income level, the blueprint proposes adding a 1-percentage-point tax to income above that level so that the new tax remains proportional.

Those who would prefer that all new taxes come from upper-income taxpayers should note that these taxpayers would already bear nearly the entire cost of the Social Security and Medicare reforms—as well as most of the cost of scaling back the employer health exclusion. Replacing the 2-percentage-point increase on the Social Security and Medicare payroll tax with a 20-percentage-point income-tax hike on families earning above \$400,000 would raise a similar amount of revenue yet significantly damage the economy and raise equity concerns.

Similarly, eliminating the 12.4 percent Social Security earnings cap (raising 0.8 percent of GDP) would combine with the benefit changes described above to leave Social Security with a large surplus and Medicare with an enormous deficit, while also pushing combined federal and state marginal tax rates as high as 62 percent.

For most lower-income families, the modest payroll tax increase would be their only cost of this substantial fiscal consolidation, beyond a future higher Social Security full-benefit retirement age.

## CONCLUSION

This blueprint has something for everyone to oppose. At first glance, many conservatives will assert that raising any taxes rather than eviscerating antipoverty and nondefense discretionary spending represents a weak-kneed surrender to big government.

In reality, it accepts that voters are not going to balance the budget on the backs of low-income families or social programs. The savings described above—focused mostly on health efficiencies are upper-income seniors—represent the ceiling of plausible spending savings.

Many liberals will also dismiss even these modest versions of Medicare premium support and Medicaid per-capita caps, as well as income-relating of Social Security and Medicare benefits—especially when paired with just 1.6 percent of GDP in broad-based tax increases.

However, tax hikes on upper-income earners and defense cuts alone cannot produce the savings needed to stabilize the national debt. The numbers simply do not add up. So if spending must be trimmed, it makes sense to target upper-income retirees while protecting low-income and social spending. Besides, maximizing upper-income tax rates to pay for Social Security and Medicare would leave no room to raise their taxes down the road to finance new initiatives such as tuition-free public universities or universal pre-K.

The details of reform are negotiable. What matters most is a bipartisan commitment to address the dire long-term projections. The retirement of 74 million baby boomers into expensive Social Security and Medicare systems is not just a theoretical projection. It is an inescapable demographic reality. And every year of delay significantly raises the cost of reform. Without reform, runaway deficits will all but guarantee a debt crisis that will profoundly damage the country's economic and social order. There is still time to avoid that crisis, but it will require the nation's fractious political leaders to leave their respective comfort zones and compromise.

Percentage of GDP	2019	2029	2049
Revenues	16.5	18.3	20.2
Spending	20.9	22.2	22.4
Deficit	-4.4	-3.9	-2.2
Debt Held by the Public	78.3	91.7	82.9