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ECONOMIC VIEWPOINT
By Glenn Hubbard

# The Social Security And Medicare Morass

**Entitlement reform -- and encouraging more private saving -- are essential**

What the U.S. needs is a fiscal debate. The coming months will see heated election discussions about near-term deficits, interest rates, discretionary spending rules, or guidelines for tax cuts. But if we are serious, the policy conversation must turn quickly to entitlements. We can restrain the growth of government and improve the viability of our entitlement programs at the same time. But we must start now.

First we have to get beyond the current debate over whether or not deficits are raising interest rates enough to choke off the recovery. The deeper, long-term problem facing America is that pressures for higher government spending are no longer effectively countered by budget rules that cap that discretionary spending. The Bush Administration is proposing ways to put new rules in place and must nurture an agreement with Congress on fiscal policy objectives.

**BUT EVEN THIS IS NOT THE BIG PROBLEM.** The 2004 Social Security and Medicare Trustees reports offer a sobering calculation of the unfunded liabilities of the two big entitlement programs. The unfunded liabilities are the excess of promised benefits under current law minus revenues from dedicated payroll taxes -- or $72 trillion in off-balance-sheet obligations, the bulk of which stems from Medicare. Compare this to conventional government debt today of $4 trillion.

These numbers are so large that they may escape -- rather than seize -- the public's attention. And references to "fiscal imbalances" obscure the real discussion, which must be about choices over spending and taxes. A better way to frame the issue is the Congressional Budget Office's projection that spending is on track to rise from 20% of gross domestic product in 2010 to 33% of GDP 40 years later, dominated by Medicare and Social Security spending.

This shift and the higher debt-service costs it requires are the nation's real long-term fiscal problem. Indeed, the CBO projects a rise in federal revenue over the next 40 years as economic growth pushes taxpayers into higher brackets.

Senator John F. Kerry (D-Mass.) says the fiscal crisis is due to President George

W. Bush's tax cuts. This is disingenuous. Kerry would retain all of the tax cuts except those for very high-income taxpayers -- which, ironically, are the cuts with the biggest bang for the buck since top-rate taxpayers are often entrepreneurs and small-business people. Besides, even canceling all of the Bush tax cuts would contribute very little to the long-run annual gap identified by the CBO. Its long-term estimates are useful, but they can't come to pass. As the late economist Herb Stein famously said: "If something cannot go on forever, it will stop." Either taxes will have to rise or the growth of entitlement spending will have to be slowed.

There are two essential policy choices. The first is: How large do we want government's share of GDP to be? Closing the gap in the CBO estimates would require large tax hikes -- at least a 50% rise across the board -- to cover Social Security and Medicare alone. Such a large increase in taxes would discourage work effort, entrepreneurship, and investment -- precisely at a time when the country needs the dividends of economic growth to meet the needs of an aging society.

The second question is: How do we help younger workers prepare for this shift to lower benefits in retirement? Incentives to save, such as the Bush Administration's proposal for an expanded Retirement Saving Account, offer such an opportunity and would generate new savings and capital per dollar of revenue cost to the Treasury. Dedicating funds now to Social Security Personal Accounts also offers a way to accomplish this. Similar arguments can be made for Medicare. The new Health Savings Accounts give Americans the opportunity to save today for future medical expenses.

While discussions of entitlement reform are central to the long-run fiscal debate, more than the budget is at stake. Social Security and Medicare ensure support for all Americans in old age and redistribute resources from high-lifetime-income individuals to low-lifetime-income individuals. The changes I've outlined satisfy these objectives. Saving incentives, Social Security Personal Accounts, and Health Savings Accounts strengthen individuals' resources. Reductions in benefit growth can and should be concentrated among upper-income households with little change and, indeed, an improvement in the resources available to the less well-off. We have real choices to make. We should start making them.

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Glenn Hubbard will become dean of Columbia Business School on July 1. He chaired the Council of Economic Advisers under George W. Bush from February, 2001 to March, 2003.