

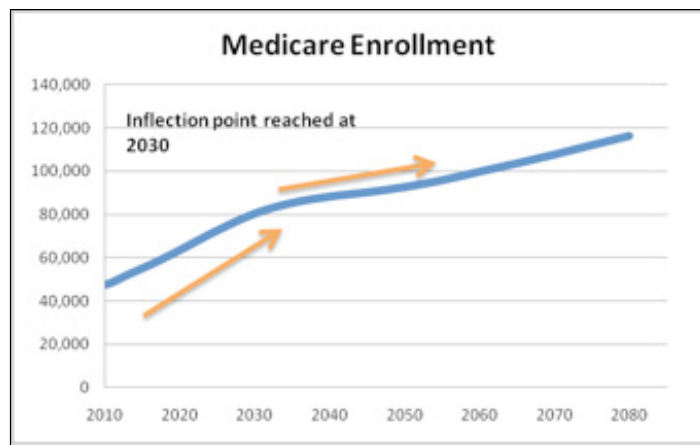
Rates of Deterioration Key to Understanding Budget Projections

e21 Staff Editorial | August 6, 2010

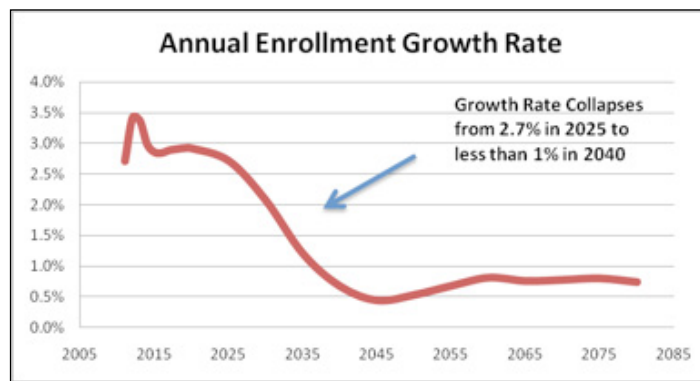
Yesterday, the Medicare and Social Security Trustees released their annual reports on the status of these programs' finances. The Administration cynically used the occasion to tout the benefits of the health care reform bill. Treasury Secretary Geithner released a statement proclaiming that the health care bill "dramatically improved projected Medicare finances." He praised the bill for extending "the solvency of the Medicare Part A Trust Fund by 12 years longer than was projected last year, which is a record increase from one report to the next." Of course, the same funds that supposedly bolster Medicare's financing – a new payroll tax on capital income and cuts to Medicare payments – were also counted as offsetting the cost of the new health care entitlement, which is projected to cost \$200 billion in 2018 and rise by 7% per year thereafter. The Administration can choose: either the health care entitlement was not paid for and therefore dramatically worsened the near-term budget outlook, or there's no change to the financing status of Medicare. They cannot have it both ways.

This debate about how to interpret Trustees' reports that only a handful of people ever actually read helps to explain why U.S. public finances are about to enter a period of acute shock. Issues like "Trust fund solvency," "cost rates," and "dates of exhaustion" obscure what should be very clear: the growth of entitlement spending will overwhelm the U.S. budget over the next decade. The numbers cited in the press – insolvency dates (2029 for Medicare Part A; 2037 for Social Security) – mask the immediacy of the problem. The retirement of the baby boom

generation is the driver of the cost increase. And it is already well underway.

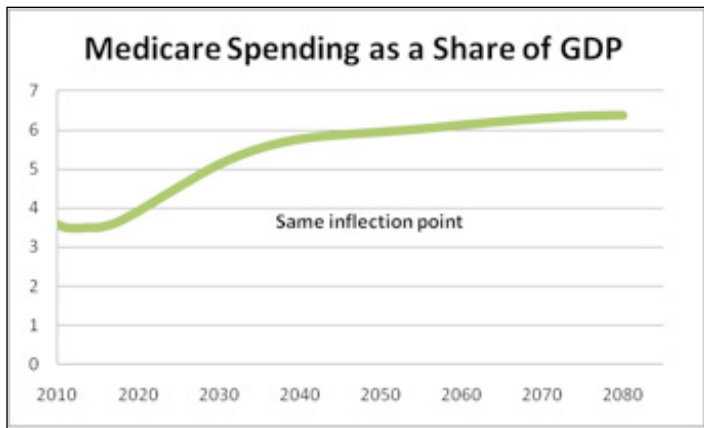
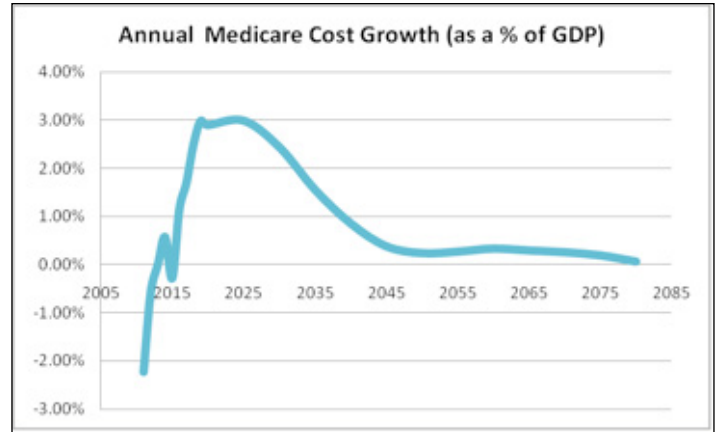


Medicare Enrollment Growth Slows Dramatically After 2030 – Let's start by taking a look at total Medicare enrollment. In 2030, an inflection point is reached, where growth slows rather dramatically. From today and 2030, enrollment growth has a sharp upward slope; thereafter, enrollment basically flattens before turning up again slightly sometime after 2060.



The graph above looks at the annualized growth

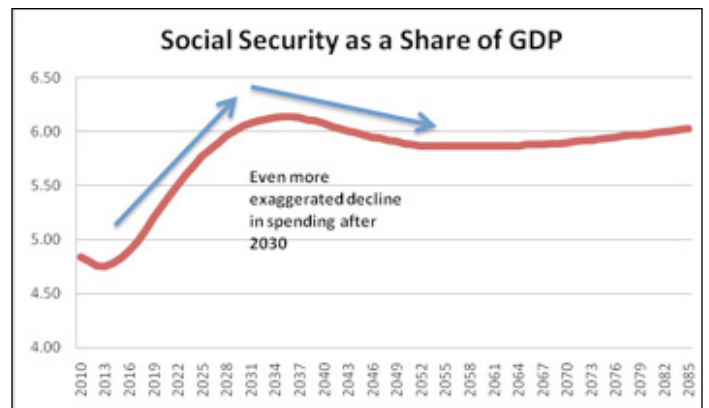
rate in Medicare enrollment. The fastest enrollment growth occurs in the middle of this decade (about 3.5% per year). Thereafter, it stabilizes until 2025, at which point enrollment grows much more slowly. By 2040, enrollment growth is down to less than 1% per year. By 2050, total enrollment is growing by half of a percent annually. From 2010 to 2030, total enrollment will have grown by 70% on a cumulative basis. Over the next 20 years (2031-2050), enrollment will grow by just 15%.



The Trustees generally do not have to impose this constraint on growth until after 2030 to achieve a smooth transition to the long-run assumption that health spending grows at the GDP growth rate. The decline in the growth rate partly reflects this assumption, but also underscores that after 2030 the main driver of near-term cost growth – aging – slows dramatically.

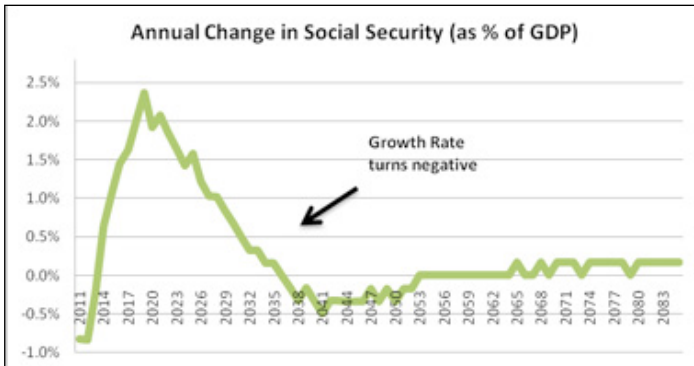
Medicare Cost Growth Follows the Same Pattern

– A key argument made by the Obama Administration and outgoing OMB chief Peter Orszag was that the driver of long-run entitlement spending was health care costs – not an aging population. However, Medicare spending as a share of GDP largely follows the same pattern as enrollment. The share of the economy devoted to Medicare grows by 42% from 2010 to 2030, but by only 16% in the following 20 years (2031-2050). Part of this is just asymptotic properties of equations – health care spending cannot persistently grow faster than GDP because it would eventually consume the entire economy. Unless you believe the 2065 U.S. economy will be nothing but hospitals, clinics, pharmaceutical companies, and medical device manufacturers, with no Arby’s, BestBuys, or airplanes anywhere in sight, you implicitly agree with this assumption.



Social Security’s Problems are Now – Social Security’s enrollment growth will be roughly the same as Medicare’s. Total beneficiaries will go from 53 million (including disabled) in 2010 to 85 million in 2030 – an increase of 60%. Over the subsequent 20 years, enrollment will grow by 14% to 96 million. Since initial Social Security benefits are set at wage growth, the program’s share of the economy will be driven almost entirely by changes in enrollment. As a consequence, 2030 is not an inflection point,

but rather a maximum. From 2010 to 2030, Social Security outlays will grow by 25% as a share of the economy; by 2050, Social Security outlays will be 3% less as a share of GDP than they were in 2030.



Today, Social Security and Medicare consume 8.43% of the U.S. economy. By 2030, their combined share will be 11.16% – a 32% increase. Over the next 20 years (2031-2050), the share of the economy consumed by these two programs will increase by just 6%. This means that the entitlement outlays will grow 5-times faster over the next 20 years than they will over the subsequent 20 years (as a share of the economy). The problem arrives suddenly and painfully, but then stops getting worse: if the government can make it through the next 15 years of entitlement spending growth – including the introduction of the new health care entitlement – it can make it through the next 65 years. Of course, absorbing these costs would require a sudden transition to a high-tax economy, which would likely include the imposition of a value-added tax and additional taxes on income, including capital income, which would result in a smaller (overall) capital stock and almost surely lower standards of living.

The “spin” surrounding the Trustees Reports will largely involve what the new health care bill did and did not do to “solvency” and other metrics. Unfortunately, the real “news” in the reports is that the window for reform to slow the growth of these

programs and to keep taxes at historical levels has nearly closed. Program beneficiaries need to be told of changes before they retire so they can adjust their life plans accordingly. If someone knows in advance that Social Security benefits will be lower or Medicare Part B premiums higher, they can delay retirement and make other changes. When people are informed of these changes in retirement, that flexibility has been taken away, leaving them worse off. Yet, if reforms are passed in say 2013 (a soon but reasonable timeframe) and they exempt future beneficiaries within 10 years of retirement, the reforms will (or can only) address less than 40% of the entitlement cost growth. In short, the painful process of adjusting to a much larger government will have already been baked into the cake.