# Deficits, Debt, and Entitlements: Is the U.S. Becoming Greece

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It doesn't take more than a glance at the headlines to see that European countries are in trouble. From Greece to Britain, from France to Portugal, it is becoming clear that the modern welfare state is unsustainable, facing fiscal catastrophe, stagnant economic growth, punishing taxes, and prolonged joblessness. European countries are being forced, kicking and screaming, to rethink their approach to social welfare.

But how much better off is the United States?

While there are political reasons for both Democrats and Republicans to pretend that we've entered a new age of austerity, it's not even close to true. According to figures released last week by the Treasury Department, federal spending this year is *up* by roughly 5 percent over the same period last year. That's a $120 billion increase in just the first nine months of this year. That's right: Despite a near shutdown of the government and "holding the debt ceiling hostage," government spending is still increasing. And not surprisingly, we are borrowing more money in order to fund it. The deficit is already $23.5 billion higher this year — with three months still to go[1].

That deficit will be roughly $1.3 trillion this year. And, according to the Obama administration it will run roughly the same amount next year as well. A deficit of this size would be roughly 10.9 percent of GDP. Thus, measured as a proportion of the national economy, the U.S. has a larger budget deficit than, say, Greece, or many of the other troubled welfare states of Europe.

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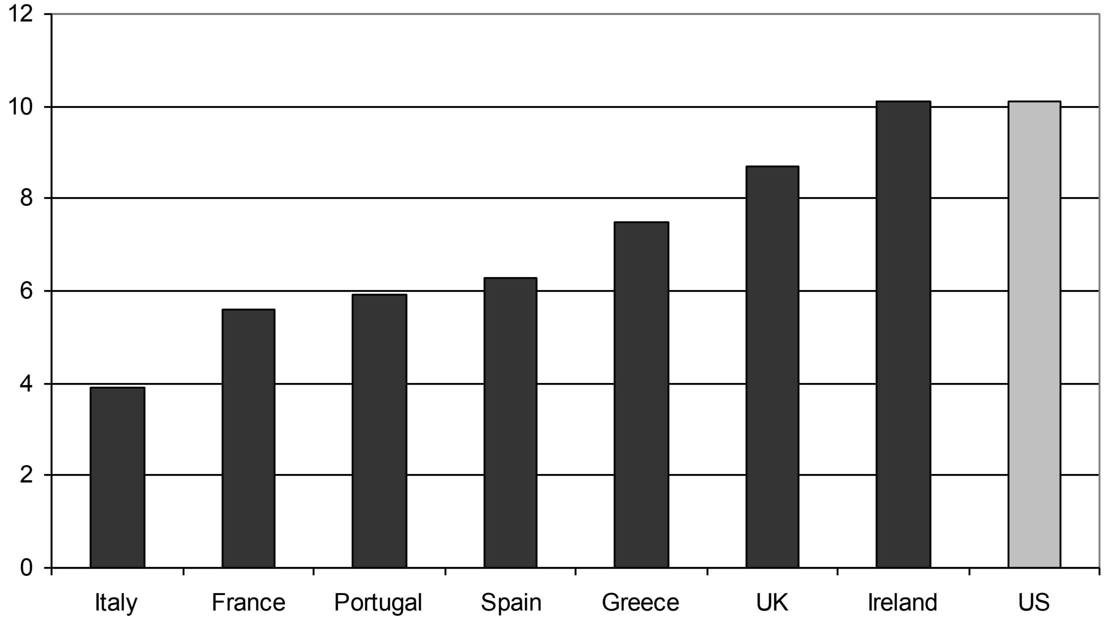
[1] "Monthly Receipts, Outlays, and Deficit or Surplus, Fiscal Years 1981-2010" US Department of the Treasury, http://www.fms.treas.gov/mts/mts.pdf

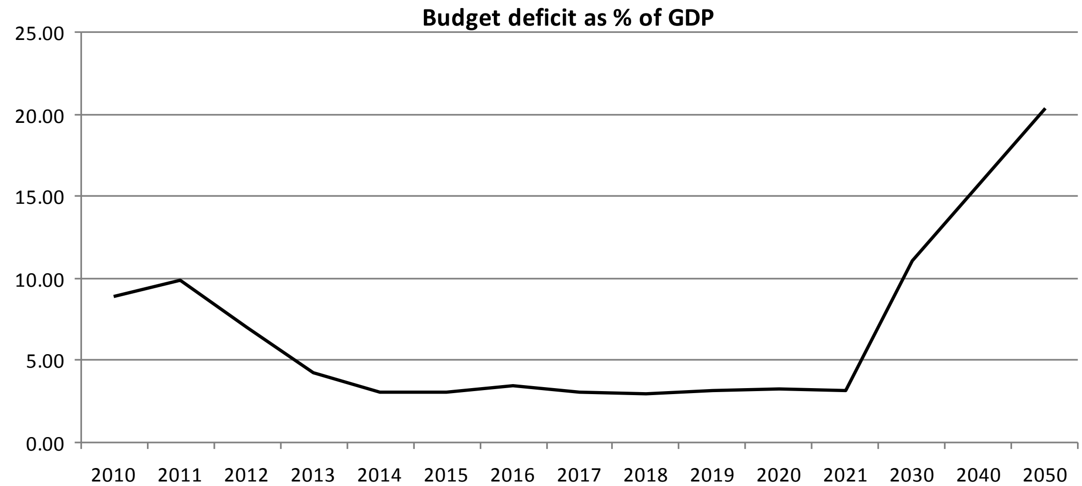
**Deficit as % of GDP in selected OECD economies in 2011**




Source OECD Economic Outlook 2011, Table 27

In part these deficits are due to tax revenues which are low today by historic standardsboth because of the recession and the Bush tax cuts. But this is a temporary phenomenon. According to the Congressional Budget Office, even if the entirety of the Bush tax cuts was made permanent and the Alternative Minimum Tax (AMT) repealed, tax revenue will rise to more than 20 percent of GDP by 2020. That's roughly two percentage points of GDP higher than the historic average.

If taxes will bring in more revenue than usual, how is it that we are still projecting huge future deficits? Simple, spending is expected to rise even faster. In 2020, it is estimated to be roughly 25 percent of GDP, roughly four percentage points higher than historic averages, and seven points higher than it was under President Clinton.

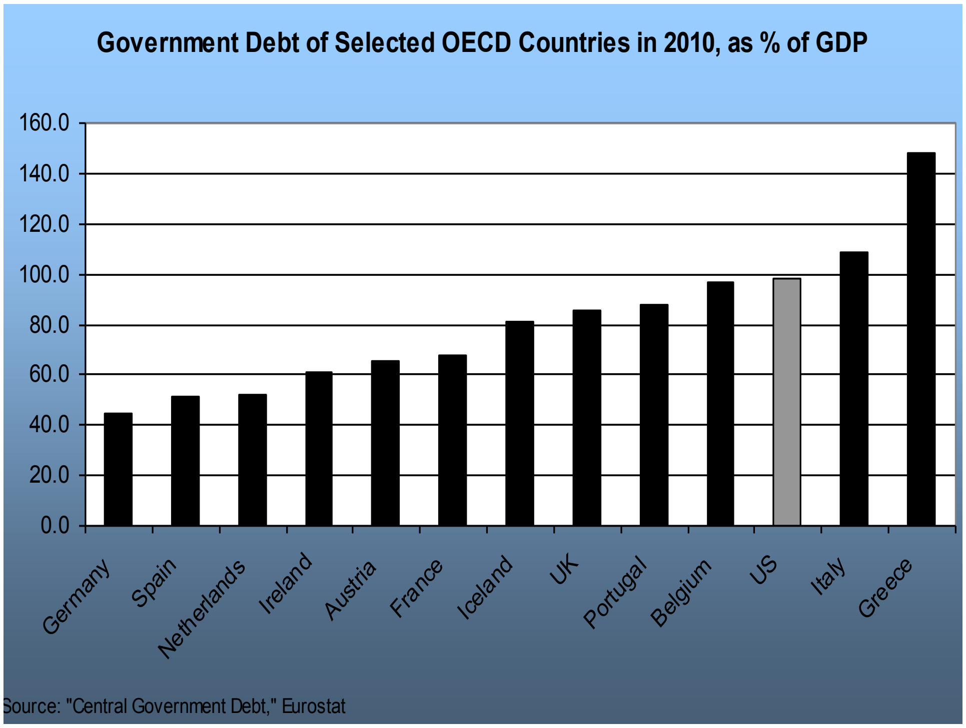



Source: FY 2011 Economic Outlook, Table 1-4 http://www.cbo.gov/ftpdocs/120xx/doc12039/01-26_FY2011Outlook.pdf

Thus, within a decade we will see annual budget deficits the likes of which this country has never before encountered. And, while no one believes that it is possible for deficits to remain on such a trajectory forever, only a change in budget policy can avert it.

If rising annual budget deficits represent year to year fiscal irresponsibility, the cumulative total of that profligacy is the federal debt. As of October 2011, our national debt totaled $15 trillion. To put that in perspective: if you earned one dollar every second, it would take you more than 507,000 years to earn enough money to pay off that debt. Or to look at it another way, this amounts to a debt of roughly $53,000 for every man, woman, and child in America.

This puts the U.S. as third worst among OECD countries, with a debt exceeded only by Greece and Italy.




But that doesn't tell the whole story. There are actually three different types of governmental debt. there are actually several ways to calculate government debt.

The first is "debt held by the public," government securities which are owned by individuals, corporations, state or local governments, foreign governments and other entities outside the federal government itself. Currently, debt held by the public exceeds $10.2 trillion and represents more than 72 percent of GDP, the highest percentage of the economy since shortly after the end of World War II.[2]

But the U.S. also has a second classification for federal debt, known as "intragovernmental" debt. This form of debt, which generally does not exist in European systems, consists of the debts that the federal government owes to itself, such as debt it owes to the so-called Social Security Trust Fund. Currently the more than 100 government trust funds, revolving accounts, and special accounts hold more than $4.74 trillion in debt.[3] The largest portion of this is held in the Social Security ($2.9 trillion) and Medicare ($372 billion) Trust Funds.[4]

Intragovernmental debt can be considered somewhat "softer" than debt held by the public, since the government can control when and whether trust fund debt is repaid by, for example, altering the Social Security benefit formula. But the federal government cannot simply "write off" intragovernmental debt as inconsequential. As opponents of

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[2] "Daily Treasury Statement Thursday October 20, 2011," US Department of the Treasury, October 20, 2011, Table III C, https://www.fms.treas.gov/fmsweb/viewDTSFiles?dir=w&fname=11102000.pdf

[3] "Daily Treasury Statement Thursday October 20, 2011," US Department of the Treasury, October 20, 2011, Table III C, https://www.fms.treas.gov/fmsweb/viewDTSFiles?dir=w&fname=11102000.pdf

[4] "Old Age, Survivors and Disability Insurance Trust Fund Data," Social Security Administration, October 25, 2011, http://www.ssa.gov/cgi-bin/ops_series.cgi

Social Security reform often argue, the securities held by the Social Security Trust Fund are backed "by the full faith and credit of the US government." Eventually the securities held by the various trust funds and other accounts will have to be redeemed, just as if intragovernmental debt was debt held by the public. Thus, no matter how you treat intragovernmental debt today, its repayment will ultimately have to be included in any projection of future government spending.

If you combine debt held by the public and intergovernmental debt, you get our current national debt, roughly $15 trillion.

But there is also a third category of government indebtedness that should also be considered: "implicit debt." For the United States, the implicit debt represents the unfunded obligations of programs such as Social Security and Medicare, all the benefits promised under those programs in excess of anticipated revenues (including Trust Fund accumulations). Those obligations, of course, represent the "softest" form of debt, in that there is no legal requirement to pay all the promised benefits.

Social Security's future unfunded obligations now run to more than $17.9 trillion.[5] Medicare's unfunded liabilities are more difficult to nail down, in part because of the uncertainty brought about by the new health care reform law. In 2009, Medicare's trustees estimated that the program's unfunded liabilities were $89.3 trillion.[6] In the wake of the health care bill, though, those projections declined dramatically to just $24.6 trillion.[7] But, there is reason to be skeptical of that revised figure. Few in Washington, including the CBO, and the Centers for Medicare and Medicaid Services (CMS) believe that all those savings will actually occur.[8]

Thus, the combined federal debt actually totals at least $58.2 trillion, equal to more than 412 percent of GDP. And if the projected savings in Medicare do indeed prove unrealistic, our debt could run as high as $127.5 trillion, an inconceivable 897 percent of GDP.[9]

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[5] "The 2011 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds," Social Security Board of Trustees, 2011, p. 63, http://www.ssa.gov/oact/TR/2011/tr2011.pdf This figure does not include the cost of redeeming bonds in the social security trust fund, which is properly classified as intergovernmental debt. Some estimates of Social Security's total unfunded liabilities include that intergovernmental debt – since the repayment is unfunded – arriving at a total unfunded liability of more than $20.8 trillion.

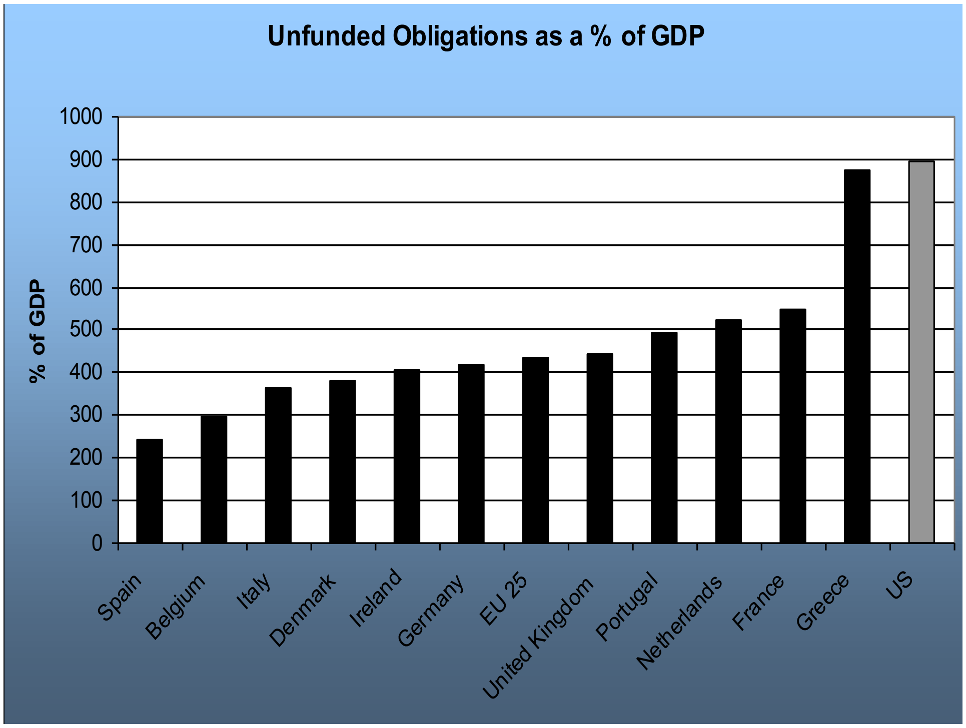
[6] "2009 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Insurance Trust Funds."

[7] "2010 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Insurance Trust Funds."

[8] John Shatto and M. Kent Clemens, "Projected Medicare Expenditures under an Illustrative Scenario with Alternative Payment Updates to Medicare Providers," Centers for Medicare & Medicaid Services, Office of the Actuary, August 5, 2010.

[9] Moreover, these projections assume that interest rates on government debt remain somewhere near current levels, about 2.2 percent. However, over the past two decades the average rate of interest on government debt has actually been 5.7 percent. If interest rates were to return to anything close to traditional levels, it would add trillions to our future obligations. Lawrence Lindsey, for example, estimates that a return to historic interest rates would add $557 billion to interest costs in 2015 alone. Lawrence Lindsey, "The Fiscal Trap," *Weekly Standard*, December 6, 2010. It is also worth noting that the International Monetary

If one matches our total indebtedness with the total indebtedness of European, including their unfunded pension and health care obligations, our total debt again tops the world.




As frightening as the numbers discussed above may be, focusing on the deficit and debt is to confuse the symptom with the disease. Milton Friedman pointed out that the real cost of government is the level of spending, not whether you pay for it through debt or taxes.[10]

Assuming there is no change in the current baseline, by 2050 federal government spending will exceed 42 percent of GDP. Adding in state and local spending, government at all levels would be consuming close to 60 percent of everything produced in this country, double what could be considered a level consistent with economic growth. Beyond 2050, spending approaches levels that are, frankly, impossible.[11]

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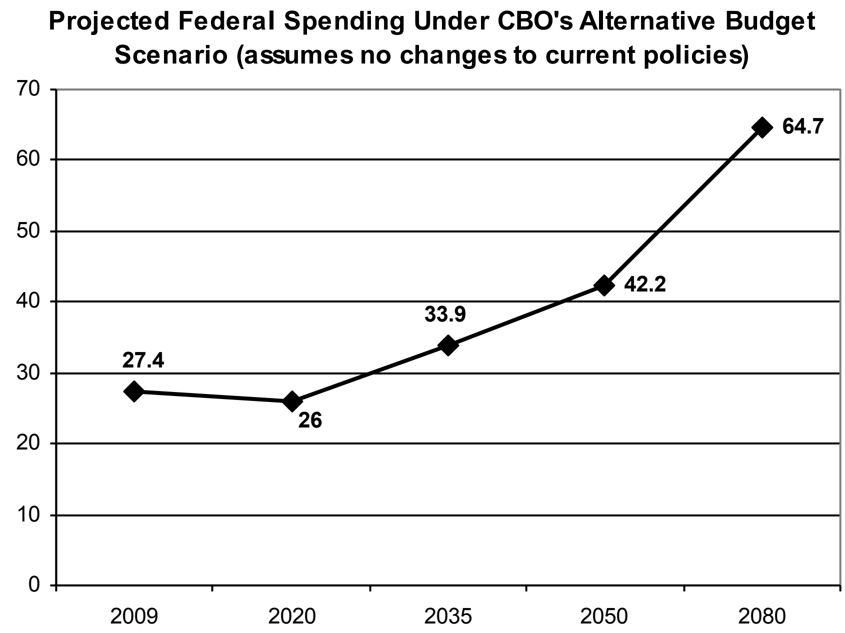
Fund warns that US budget projections show a strong tendency to be too optimistic. Using their own stochastic simulation, the IMF suggests that there is an 80 percent likelihood that the actual level of debt will be higher than the administration's current projections. Oya Celasun and Geoffrey Keim, "The US Federal Debt Outlook: Reading the Tea Leaves," International Monetary Fund Working Paper no. 10-62, March 2010.

[10] Milton Friedman interview with John Hawkins, Right Wing News, http://www.rightwingnews.com/interviews/friedman.php

[11] "Budget of the United States Government: Fiscal Year 2008," Office of Management and Budget, Historical Tables, Table 1.2, January 2008. Some might argue that the estimates of future GDP used to make these calculations are too low, in part because the spending that the Obama administration is doing today is a form of "investment" that will lead to higher economic growth in the future. If GDP in the future is higher, then it follows that the ratio of spending to GDP will be lower than predicted. But, while the evidence is not unambiguous, most studies suggest that, with the possible exception of spending on




Source: "The Federal Budget Outlook over the Long Run," CBO,

Of course, some might point out that a substantial portion of the projected future spending is interest on the federal debt. Theoretically, if taxes were immediately increased enough to cover spending, there would be no additional debt, and therefore far lower interest payments. But even if one assumed that the government accumulated no additional debt beyond the $15 trillion it currently owes, federal government spending would still exceed 30 percent of GDP by 2050. Throw in spending by state and local governments, and government spending would still consume half of the US economy.[12]

If the US government were, in fact, to grow to the levels predicted, this country's total government spending as a percentage of GDP would be higher than the current level of government spending in *every* EU country, except possibly Denmark.

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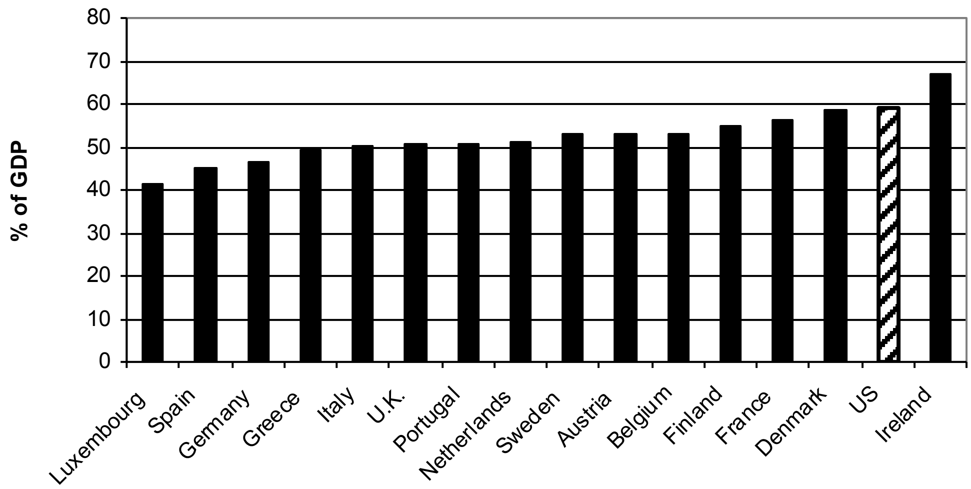
education and infrastructure, government expenditures add little to private productivity. See Paul Evans and Georgios Karras, "Are Government Activities Productive? Evidence from a Panel of U.S. States," *Review of Economics and Statistics* 76, no. 1 (February 1994): 1-11; Douglas Holtz-Eakin,"Public Sector Capital and the Productivity Puzzle," *Review of Economics and Statistics* 76, no. 1 (February 1994): 12-21; and Kevin Lansing, "Is Public Capital Productive? A Review of the Evidence," Federal Reserve Bank of Cleveland Economic Commentary, March 1, 1995. Moreover, as Figure 7 makes clear, the overwhelming majority of future spending increases comes from entitlement programs and interest on the debt, spending that is almost all consumption, rather than investment.

[12] Author's calculations based on Congressional Budget Office, "The Budget and Economic Outlook: An Update," Table 1-2, August 2010.

**US Projected Spending vs. Current EU spending in 2050 (% of GDP)**




Source: Author's calculations using Eurostat data, "Government revenue and expenditure"

Government of that size is destructive to economic growth regardless of how it is financed. On the one hand, continued debt financing of future government spending is unsustainable. On the other hand, financing projected levels of government through taxes would also carry severe economic costs. Indeed, the idea of taxing our way out of debt flies in the face of fiscal reality. That means that we will not be able to improve economic growth unless we reduce the size of government.

As Alan Greenspan recently warned in his typically understated way, "The very severity of the pending crisis and growing analogies to Greece set the stage for a serious response….Our economy cannot afford a major mistake in underestimating the corrosive momentum of this fiscal crisis. Our policy focus must therefore err significantly on the side of restraint."

In the face of this looming threat, our political leaders remain largely oblivious. Throughout much of 2011, for example, the political process was transfixed by a series of confrontations over a potential government shutdown and the debate on whether or how to raise the U.S. debt ceiling. In both cases, the showdown ended with last minute agreements that supposedly restrained spending. In reality, the compromises reached in both cases did little to change the fundamentals of governmental growth. Indeed, as noted above, federal spending will actually *increase* this year.

Even more troubling, however, is the fact that even these limited debates over spending reduction have focused almost exclusively on reductions in domestic discretionary spending. Of course, there is plenty that can be cut here. Discretionary spending has increased dramatically in recent years, up 21.4 percent over President Obama's first two years in office. And, it is important to remember that Obama's increases came on top of huge increases during the Bush administration. For example, federal spending on education has increased by more than 100 percent since 2001. The Department of Energy's budget is up 134 percent. Even the Department of Agriculture will spend 112 percent more in 2011 than it did before George W. Bush became president.

But simply cutting domestic discretionary spending will not come close to solving our long-term budget problems. Domestic discretionary spending amounts to barely 17 percent of federal spending. Total domestic discretionary spending – everything from the Department of Education to the Department of Commerce, from the FBI to the FDA – amounted to roughly $650 billion this year. If we simply abolished all of those programs, the muscle and bone as well as the fat, we would still have a $650 billion budget deficit.

Defense constitutes another 19 percent of federal spending. The defense budget, including homeland security, has increased by 161 percent since 2000. Clearly cuts can—and should—be made here as well.

In the end though, there is no way to deal with our growing level of debt without tackling the heart of the American welfare state – middle-class entitlements, notably Social Security, Medicare, and Medicaid. Entitlements, such as these, make up fully 58 percent of all federal spending. And as the population ages, that proportion will grow. By the middle of the Century, Medicare, Medicaid, and Social Security alone will consume 18.4 percent of GDP. If one assumes that revenues return to and stay at their traditional 18 percent of GDP, then those three programs alone will consume every penny of federal taxes. There would not be a single dime available for any other program of government, from national defense to welfare, from maintaining highways to education. Adding in interest already owed would bring government spending to 31.9 percent of GDP, meaning that even a tax hike equal to nearly 14 percent of GDP would not be able to fund government beyond those three programs.

The growth in entitlement programs is being inexorably driven by a combination of demographics, benefit formulas that exceed inflation, and rising health care costs. Yet, not only didn't President's Bush and Obama fail to act on this crisis, both actually added new entitlement programs that will add significantly to the future cost of government. President Bush created a new prescription drug benefit within the Medicare program that is expected to add as much as $17 trillion to that program's unfunded liabilities. And President Obama's new health care reform law creates a number of new entitlements and subsidies at an expected cost of $2.7 trillion over the program's first 10 years of full operation.

Start with Social Security. Like all PAYGO pension programs, the U.S. Social Security system is crumbling under the weight of demographic changes. In 1950, for example, there were 16 workers paying taxes into the system for every retiree receiving benefits from the program. However, Americans, like Europeans, have been living longer and having fewer babies. As a result, there are now just 3.3 workers per beneficiary, and by 2020, there will be only two.[13]

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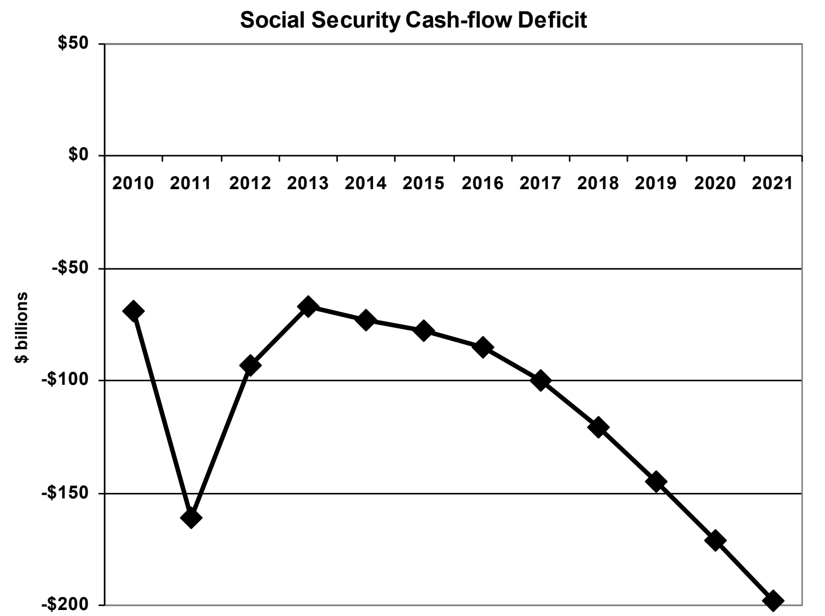
[13] "The 2011 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and the Federal Disability Insurance Trust Funds," Social Security Administration, May 13, 2011, p.53

Social Security began running a cash-flow deficit this year, paying out more in benefits than it takes in through taxes.[14] In theory, of course, Social Security is supposed to continue paying benefits by drawing on the Social Security Trust Fund. The Trust Fund is supposed to provide sufficient funds to continue paying full benefits until 2036, after which it will be exhausted. At that point, *by law,* Social Security benefits will have to be cut by approximately 22 percent.[15]




Source: Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2011-2021," January 201

However, in reality, the Social Security Trust Fund is not an asset that can be used to pay benefits. Any Social Security surpluses accumulated to date have been spent, leaving a Trust Fund that consists only of government bonds (IOUs) that will eventually have to be repaid by taxpayers. As the Clinton administration's fiscal year 2000 budget explained it:

> These [Trust Fund] balances are available to finance future benefit payments and other Trust Fund expenditures—but only in a bookkeeping sense. …They do not consist of real economic assets that can be drawn down in the future to fund benefits. Instead, they are claims on the Treasury that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures. The existence of large Trust Fund

[14] Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2011-2021, January 2011.

[15] "The 2011 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds," Social Security Board of Trustees, 2011, p. 9

> balances, therefore, does not, by itself, have any impact on the Government's ability to pay benefits.[16]

Even if Congress can find a way to redeem the bonds, the Trust Fund surplus will be completely exhausted by 2036. Overall, Social Security faces unfunded liabilities of nearly $17.9 trillion ($20.8 trillion if the cost of redeeming the Trust fund is included).

Clearly, Social Security is not sustainable in its current form. That means that Congress will again be forced to resort to raising taxes and/or cutting benefits in order to enable the program to stumble along.

And either the tax increases or benefit reductions would need to be significant. For example, to restore Social security to solvency would require raising the current 12.4 percent Social Security payroll tax to at least 17.6 percent, a 42 percent increase, or the equivalent amount of revenue from other taxes. (Eliminating the cap on taxable income for the payroll taxes, one frequent suggestion, would actually do little for the program's long-term solvency.)

On the other side of the ledger, as pointed out above, restoring the program to solvency would require at least a 24 percent reduction in benefits. Suggested changes include further raising the retirement age, trimming cost-of-living adjustments (COLAs), means-testing, or changing the wage-price indexing formula.

Obviously, there are better and worse ways to make these changes. But the larger point is that continued tax increases and benefit cuts will be necessary until the basic structure of social security is changed from the PAYGO model to a system where at least part of an individual's Social Security taxes are saved for that person's retirement and invested in real assets.

A proposal by scholars from the Cato Institute, that combines the wage-price indexing proposal described above with personal accounts equal to 6.2 percent of wages, was scored by actuaries with the Social Security Administration in 2005 as reducing Social Security's unfunded liabilities by $6.3 trillion, roughly half the system's predicted shortfall at that time. If the Cato plan had been adopted in 2005, the system would have begun running surpluses by 2046. Indeed, by the end of the 75-year actuarial window, the system would have been running surpluses in excess of $1.8 trillion.[17]

America's government run health care programs are an even bigger drain on U.S. finances. To some degree, of course, Medicare and Medicaid are at the mercy of overall health care costs. But those problems are exacerbated by a fee-for-service system under which neither providers nor consumers have incentives to control costs. As a result, per-enrollee costs in the programs have been rising faster than per-capita GDP by an average of 1.7 percentage points since 1985. Since federal revenues grow at roughly the rate of increase in GDP, that is a recipe for fiscal disaster.

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[16] Budget of the United States Government, Fiscal Year 2000: Analytical Perspectives, p. 337.
[17] Michael Tanner, "A Better Deal at Half the Cost: SSA Scoring of the Cato Plan for Social Security Reform," Cato Institute Briefing Paper no. 92, April 25, 2005.

The bottom line is that no health care system anywhere can provide unlimited care to everyone who wants it. Rather than attempting to rely on top-down, command and control style rationing and universal budgets, we need a more consumer oriented system, one that allows consumers to make more of their health care decisions within a competitive marketplace, but also makes those consumers bear more of the costs of those decisions. Of course this lesson should be applied throughout the U.S. health care system, but it should be immediately applied to our government run systems.

Start with Medicare: Congress could give enrollees a voucher and let them choose any health plan available on the market. The voucher size could be adjusted to give a larger subsidy to poorer or sicker seniors. The amount of each individual's voucher would be fixed. Enrollees who want to purchase comprehensive coverage could pay more for it, while those who chose a less expensive policy could save the balance of his or her voucher in an account dedicated to out-of-pocket medical expenses.[18]

Rep Paul Ryan included a proposal along these lines in his 2012 budget[19] The Congressional Budget Office estimated that this approach would reduce Medicare spending from a predicted nine percent of GDP in 2050 and 15 percent of GDP in 2083 under the current baseline to just four percent of GDP in 2050 and roughly three percent in 2083.[20]

At the same time, Congress should treat Medicaid as it has other welfare programs, with block grants that give states the ability to innovate and the incentive to target their resources to the truly needy. Federal spending on Medicaid (and the state Children's Health Insurance Program) should be frozen at current levels, and then sent to states in the form of unrestricted block grants. Freezing Medicaid at current levels would save nearly $1 trillion over the next 10 years.[21] This does not consider the possibility that state innovation could result in additional savings, as well as improved medical care for the poor.

And finally, of course, the Patient Protection and Affordable Care Act should be repealed.

European countries are beginning to discover that the modern welfare state is unsustainable. As we have seen, from Greece to Britain, from France to Portugal, European countries are taking the first tentative steps to cut social welfare benefits, raise the retirement age, reform their government-run health care systems, liberalize labor laws, and dismantle government bureaucracies. Yet, even as Europe is learning that you

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[18] Michael Cannon, "Yes, Mr. President, A Free Market Can Fix Health Care," Cato institute Policy Analysis no. 650, October 21, 2009.
[19] Paul Ryan, "A Roadmap For America's Future Version 2.0," p. 50, http://www.roadmap.republicans.budget.house.gov/UploadedFiles/Roadmap2Final2.pdf
[20] Letter from Douglas Elmendorf, director, Congressional Budget Office, to Rep. Paul Ryan, January 27, 2010.
[21] Author's calculation, based on Congressional Budget Office, "The budget and Economic Outlook: Fiscal Years 2011 to 2021," January 2011. Figure based on 2010 spending on Medicaid as reported in Figure 3-3, and keeping spending at constant 20210 levels, and calculating the savings each year in aggregate for the rest of the decade.

can't forever rob Peter in order to pay Paul, the U.S. is racing to transform itself into a copy of the failing European model.

In doing so, we are also recreating Europe's problems. The United States faces a massively growing debt that threatens our economic future. But as bad as that debt is, it is merely a symptom of a larger disease: a rapidly growing government that is consuming an ever larger share of our national economy. Unless decisive action is taken, government at all levels in the United States will consume roughly 60 percent of GDP by the middle of the century, and rise to unimaginable levels thereafter. A government of that size is a threat not just to economic growth, but to our liberty and our way of life.

Driving the growth of government is a massive and growing U.S. welfare state – not just programs for the poor, but social insurance entitlements that primarily benefit the middle class. The American welfare state has grown steadily since its inception, but that growth accelerated under President Bush and has taken off exponentially under President Obama. While we haven't yet reached European levels, we are clearly headed down that road.