

# FACING FACTS QUARTERLY

## A Report about Entitlements & the Budget from The Concord Coalition

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### Kabuki Drama over the Budget

In traditional Japanese theater, actors erupt in ritual speeches and ceremonial passion over trivial provocations. In Washington, DC, the White House and Congress are engaging in a similar display as they grapple with the FY 2008 Budget. The GOP accuses the Democrats of “immense new government spending” and even “spending lust,” while the Democrats accuse the GOP of “heartlessness” toward domestic programs on their watch. The whole show is a diversion—intended, perhaps, to obscure the fact that even in a non-election year neither party wants to focus on the nation’s long-term fiscal challenges.

The joint FY 2008 Budget Resolution, passed by both houses of Congress on May 17, approved discretionary appropriations for next year that are exactly \$23.2 billion over the President’s proposal. On cue, the GOP expressed outrage over this “excessive” and “runaway” spending, and the White House is threatening to veto seven of the twelve appropriation bills. A major budget showdown looms this fall.

Some perspective is in order. \$23 billion is less than one percent of federal spending—and \$16 billion of this merely offsets the unusually deep real cuts proposed this year by the White House in domestic discretionary outlays other than Homeland Security. Having in prior years signed into law bigger increases than it now finds objectionable, the White House has no right to complain. Nor should the Democrats talk about “starvation.” Domestic discretionary outlays other than Homeland Security are the same share of GDP today (about 3.3 percent) as they were during most of the 1980s and 1990s.

So why are the two sides spoiling for a fight? Apparently, they feel that the 2008 campaign is already underway and that a good fight will help their party improve its image with the American voter. Politics first, posterity later.

Now let’s turn to two questions that will have much greater budget impact—and have received correspondingly less attention. The first is whether this Congress will honor its commitment to pay-go. There are positive signs. The Senate has now joined the House (in the budget resolution) in formally adopting a pay-go rule, and both houses are searching in good faith for offsets that would pay for this year’s highest price-tag items. The SCHIP expansion (\$35 to \$50 billion over 5 years) is to be funded with extra taxes on cigarettes; the AMT patch (\$50 billion over one year) with “tax gap” closure by the IRS; and the new farm bill (\$20 billion over 5 years) with higher taxes on foreign businesses.

But there are also troubling signs. As yet, the Democratic leadership has not decided to sign its pay-go rules and

discretionary caps into law, as the Blue Dogs have suggested, in order to bind Congress more firmly to an enforcement process. And some of the budget accounting is gimmicky—especially the assumption that SCHIP will downsize five years from now (after which, presumably, Congress will annually “patch” the program).

More seriously, neither party has a long-term vision for handling the rising fiscal burden of health-care and pension spending. Looking for ad-hoc sources of new revenue each time a new cost arises is not a long-term vision, especially now that the total tax burden (18.6 percent of GDP in FY 2007, thanks to unexpected revenue gains over the past three years) has climbed back over its pre-Bush postwar average (17.9 percent). At some point, leaders will need to

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### *FISCAL UPDATE by Neil Howe*

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respond to outlay rises with outlay cuts.

We come now to the second question: Can this Congress cut outlays? At best, with great difficulty. It is terminating no program of note. It is achieving virtually no benefit savings (except less than \$1 billion in the student loan program) through reconciliation. It is reauthorizing several bloated special-interest programs (notably, farm aid) with little restructuring. And it is doing almost nothing to control costs, while doing plenty to fuel spending, in several high-growth health-care programs—not just SCHIP, but also veterans health care, Tricare for military retirees, and Medicare itself (where House leaders want to delay scheduled physician payment reductions for two more years.)

Earlier this year, there was talk about establishing a bipartisan congressional commission that would report a major entitlement savings package back to Congress this fall. That proposal is on hold. The only hope now is a commission that would not report back until *after* the 2008 election. Early next year, the Medicare “trigger” will require Congress to focus on rising health benefit outlays to the elderly and disabled (see accompanying essay). It will, that is, unless Congress repeals it first, as House Democrats now urge.

So get ready this fall for great budgetary theater. You will see the President wield his veto pistol and Congress howl in protest. You may even see a government shutdown and giant “omnibus” bills drafted in the dead of night. All of this will be just a foretaste of 2008—when, during a full year of presidential campaigning, partisan posturing will likely trump truth-telling. All eyes will shift to 2009. Only then will our leaders snap out of their partisan personae and do real work on America’s fiscal future. At least, so we hope. ■

## Don't Kill the Medicare Trigger

In their annual report in April, Medicare's Trustees pulled the so-called Medicare trigger, a provision that requires the President to submit and Congress to consider a plan to reduce spending or raise new dedicated revenue if the program's general revenue subsidy threatens to exceed 45 percent of annual expenditures. Many Congressional Democrats, with broad support from the senior lobby, have been pushing for repeal of the trigger. The push came a step closer to realization last week when language repealing it was spliced into the House bill to reauthorize SCHIP.

Repealing the trigger would be a mistake. It serves the highly salutary function of shifting Congress' attention from the actuarial status of the Hospital Insurance trust fund, a partial and misleading measure of Medicare's fiscal sustainability, to the program's overall projected burden on the federal budget. It also represents a first tentative step toward a much needed global budget for federal health-care spending, the prerequisite for effective cost control.

The critics raise many concerns about the trigger, from the way it defines general revenue to its impact on progressivity. These concerns, however, are either minor quibbles or easily addressed. The real objection is that the trigger threatens to clamp down on Medicare's open pipeline to the Treasury, and so would necessitate cost-saving reform. According to Families USA, "It will undoubtedly lead to attempts to reduce benefits, increase premiums, or cap the amount Medicare will pay per beneficiary." Indeed, it would—and that's precisely why it's needed.

### A Staggering Burden

The place to start is with Medicare's long-term financial outlook. According to the latest Trustees' report, the cost of Medicare is due to soar from 3.2 percent of GDP in 2007 to 6.5 percent by 2030, 9.0 percent by 2050, and 11.3 percent by 2080, the Trustees' time horizon. Meanwhile, dedicated Medicare revenues, which consist mainly of payroll taxes and beneficiary premiums, will only grow from 1.9 to 3.1 percent of GDP. (See chart on the following page.) While Medicare's general revenue subsidy now pays for 40 percent of program expenditures, that share would have to rise to 72 percent by 2080 to cover the shortfall in dedicated revenue.

The future burden is staggering no matter how you measure it. In present value dollars, the Trustees calculate that the gap between dedicated Medicare revenues and expenditures comes to \$34.2 trillion over the next 75 years. As a share of GDP, the gap will steadily widen from 1.3 percent today to 8.1 percent by 2080. Medicare's general revenue subsidy now consumes 12 percent of total federal income taxes. But closing the program's financing gap would require 73 percent of total federal income taxes by 2080, assuming that revenues remains constant as a share of GDP.

Put another way, Congress would have to jack up income tax rates by 73 percent to keep the deficit from ballooning. Either that, or it would have to gut every other function of government. As a share of GDP, Medicare's 2080 financing gap is twice what the nation now spends on

national defense. Indeed, it is larger than the federal government's entire "discretionary" budget—not just defense, but everything from NASA to the national parks.

### The Trigger's Importance

The trigger attempts to limit the burden of Medicare on the rest of the budget by capping its general revenue subsidy. The Medicare Modernization Act of 2003, which created the trigger, requires Medicare's Trustees to issue a "funding warning" if they determine in two consecutive annual reports that the subsidy will exceed 45 percent of program expenditures within the next seven years. When they issue this warning, as they did for the first time in April 2007, the President is required to submit a plan to Congress that would reduce spending or raise new dedicated revenues sufficiently to prevent the threshold from being breached. The President's plan is due within 15 days of the submission of his FY 2009 budget in February 2008.

To understand the trigger's importance, it's worth recalling that Medicare spending is set on autopilot—and that this in turn means that Medicare's claim on general revenue is effectively set on autopilot as well.

To be sure, spending under the Hospital Insurance or HI component of Medicare is subject to some constraint, since annual benefits by law cannot exceed dedicated tax

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### *ISSUE IN FOCUS by Richard Jackson*

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revenue plus any accumulated trust-fund balance. But there is no constraint on spending under Supplementary Medical Insurance or SMI—the much faster growing component of Medicare that pays for physician services and the new drug benefit. Here dedicated revenues cover just one-quarter of costs. The balance is paid for by a general revenue subsidy that rises automatically along with expenditures, meaning that SMI is by definition perpetually "solvent." Even the constraint imposed by the HI trust fund, moreover, is more apparent than real, since there's nothing to prevent Congress from short-circuiting the trust fund by shifting spending from HI to SMI, as it did with home health benefits in the late 1990s.

The trigger, to be clear, does not actually require Congress to cut spending or raise new dedicated revenue. It merely requires the President to submit a reform plan and Congress to consider it on an expedited basis. In its FY 2008 budget, the administration proposed turning this "soft trigger" into a "hard trigger." Specifically, if Congress fails

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to take action, it would require an across-the-board 0.4 percent reduction in payments to providers in the year the threshold is breached—and an additional 0.4 percent reduction in each subsequent year that general revenues exceed the threshold. But far from considering ways to strengthen the trigger, Congress is now considering repealing it altogether.

### What the Critics Say

Critics have raised a wide range of objections to the Medicare trigger, some of which have some merit. The objections, however, fail to add up to a coherent argument—or a persuasive case for repeal.

- The critics say that many government programs are entirely financed with general revenues, and that the composition of Medicare financing is therefore unimportant. This was not the understanding of Medicare's founders, nor is it the understanding of today's public, who have always believed that Medicare is a program in which participants substantially pay for their own benefits through payroll taxes and premiums, not a program that can be indefinitely expanded through general revenues.
- The critics say that the 45 percent threshold is arbitrary. The critics are right that the particular number is arbitrary, but they are wrong if they believe that the threshold caps Medicare's general revenue subsidy at an historically low level. For most of Medicare's history, general revenues were a relatively small component of its finances. Indeed, as recently as 2000 they paid for just 21 percent of program expenditures.
- The critics say that the trigger overstates Medicare's general revenue subsidy because it fails to count HI trust-fund interest and assets, which represent prior year payroll taxes, as dedicated revenue. The critics may have a point, though it's worth pointing out that the trust fund can only be redeemed by taxing the public or borrowing from it—in other words, by raising general revenue. In any case, the sums involved are trivial. The HI trust fund now totals \$305 billion, enough to defray just 1.3 percent of total HI expenditures over the next 75 years. That's much less than the share that will be paid by Social Security benefit taxes credited to the HI trust fund, which *are* counted as dedicated revenue under the trigger, but (as income taxes) clearly shouldn't be. When everything is netted out, this line of argument is not to the critics' advantage.
- The critics say that the trigger would make Medicare financing more regressive by increasing its reliance on payroll taxes and beneficiary premiums. While this is a legitimate concern, it need not be a major problem. Premiums can easily be made progressive—and in fact, the President's FY 2008 budget proposes greatly expanding the means-testing of SMI premiums. In principle, even payroll taxes could be made progressive by imposing higher contribution rates on higher earners.

It's also important to realize that the trigger still allows for a very substantial increase in general revenue financing. Remember: 45 percent of Medicare expenditures will likely be a much larger share of GDP in 2080 than it is today, even if expenditures are reduced dramatically beneath current projections.

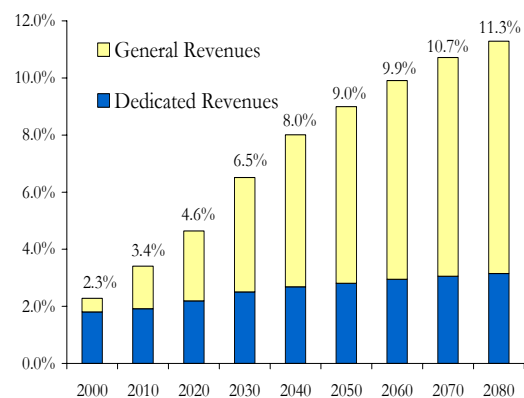
- The critics say that it would make more sense to base the trigger directly on some measure of total Medicare cost—for instance, total spending as a share of GDP or the rate of growth in per beneficiary spending. This approach may have merit as part of some future comprehensive cost control package. But the general revenue trigger offers a rule of thumb, grounded in the public's understanding of Medicare as contributory social insurance, that is already in place. Congress would do well to take it seriously and enforce it until it devises another. Exactly how the trigger is designed is less important than whether we have a trigger at all.

### The Interests of Posterity

Underlying the critics' opposition to the trigger is the presumption that any control over federal health-care spending must await broad reform of the entire health system. It's time to lay this canard to rest. The federal government now pays directly for one-third of national health-care spending; including state spending, government's share is nearly one-half. Federal policy, moreover, indirectly affects most of the rest through extensive regulation and the open-ended tax subsidy for employer-paid health care. The underlying cost drivers must indeed be addressed. But in fact, the federal government already has plenty of leverage to begin exercising control over national health-care spending.

It's time we stopped lavishing open-ended subsidies on ourselves while mortgaging our children's future. The interests of posterity will not be served until we draw a line. We must have some cap on Medicare—and ideally, total federal health-care spending—that is capable of compelling resource trade offs. The Medicare trigger we have may not be perfect, but it's much better than no trigger at all. ■

Medicare Revenues by Type, as a % of GDP



Note: Dedicated revenues include payroll taxes, premiums, benefit taxes credited to HI, and state transfers to Part D; general revenues are assumed to cover HI deficit after trust-fund bankruptcy.

<b>Federal Budget: Debt &amp; Deficits</b>	<b>Bil \$</b>	<b>% GDP</b>	<b>Fed Outlays: FY 2007<sup>‡</sup></b>	<b>Bil \$</b>	<b>% Budg</b>
Gross Federal Debt: End of June 2007	\$8,868	63.8%	Social Security	\$581	21.4%
Statutory Debt Limit	\$8,965	NA	Medicare	\$426	15.7%
Publicly Held Debt: End of June 2007	\$4,943	35.6%	Medicaid	\$193	7.1%
Debt Held by Foreigners: End May 2007	\$2,183	43.8%*	Other Entitlements	\$421	15.5%
Budget Balance in FY 2006	-\$248	-1.9%	Domestic Discretionary	\$494	18.2%
Budget Balance in FY 2007: CBO Estimate	-\$177	-1.3%	Defense	\$535	19.7%
Budget Balance in FY 2007: Concord Estimate <sup>†</sup>	-\$214	-1.6%	Net Interest	\$236	8.7%
10-yr Budget Balance: CBO Projection	\$586	NA	Offsetting Receipts	-\$166	-6.1%
10-yr Budget Balance: Concord Projection <sup>†</sup>	-\$5,113	NA	<b>TOTAL OUTLAYS</b>	<b>\$2,719</b>	<b>100%</b>
Budget Balance in FY 2017: CBO Projection	\$217	1.0%	<b>TOTAL REVENUES</b>	<b>\$2,542</b>	<b>NA</b>
Budget Balance in FY 2017: Concord Projection <sup>†</sup>	-\$808	-3.8%	<b>TOTAL DEFICIT</b>	<b>-\$177</b>	<b>NA</b>

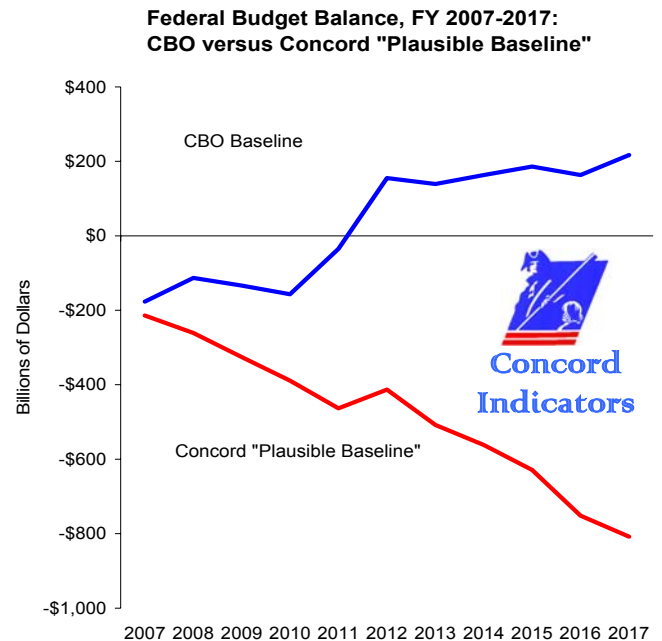
\*Percent of publicly held debt. †Concord's "plausible baseline" assumes discretionary spending grows with GDP, operations in Iraq and Afghanistan are gradually scaled back to about one-third of today's level, and all expiring tax provisions are extended with AMT relief. ‡Based on March 2007 CBO baseline; includes minor Concord imputations.

<b>GAO's Long-Term Budget Scenario* (% GDP)</b>	<b>1962</b>	<b>1980</b>	<b>2000</b>	<b>2020</b>	<b>2040</b>
Discretionary	12.7%	10.1%	6.3%	7.5%	7.5%
Entitlements*	4.9%	9.6%	9.8%	13.7%	20.0%
Net Interest	1.2%	1.9%	2.3%	2.9%	11.6%
Revenue	17.6%	19.0%	20.9%	18.4%	18.6%
Budget Balance	-1.3%	-2.7%	2.4%	-5.7%	-20.5%
Pub Held Debt	43.7%	26.1%	35.1%	62.7%	250.3%

\*GAO April 2007 update. Assumes discretionary spending grows with GDP and all expiring tax provisions are extended; entitlements are net of offsetting receipts.

<b>National Savings (% GDP)</b>	<b>2006</b>	<b>1st QTR 2007</b>
Personal Savings Rate*	-1.0%	-0.7%
Net Private Savings	3.1%	2.8%
State & Local Savings	0%	-0.3%
Federal Savings	-1.1%	-1.0%
Net National Savings	2.0%	1.5%
Current Account Balance	-6.1%	-5.6%
Intl Investment Position	-19.2%	NA

\*Percent of disposable income.



Note: Concord's "plausible baseline" assumes discretionary spending grows with GDP, operations in Iraq and Afghanistan are gradually scaled back to about one-third of today's level, and all expiring tax provisions are extended with AMT relief.

<b>Social Security &amp; Medicare*</b>	<b>Social Security</b>	<b>Medicare HI</b>	<b>Medicare SMI</b>	<b>Social Security &amp; Medicare</b>
Payroll Cost Rate in 2007	11.2%	3.1%	2.8% <sup>†</sup>	17.1% <sup>†</sup>
Payroll Cost Rate in 2040	17.3%	7.6%	7.1% <sup>†</sup>	32.0% <sup>†</sup>
75-Year Liability (PV \$)**	\$6.8 TRILLION	\$11.9 TRILLION	\$22.3 TRILLION	\$41.0 TRILLION
Infinite-Horizon Liability (PV \$)**	\$15.7 TRILLION	\$29.8 TRILLION	\$44.8 TRILLION	\$90.3 TRILLION
Date of First Cash Deficit	2017	2007	NA	NA
Date of Trust-Fund Insolvency	2041	2019	NA	NA
Cash Deficit in Year of Insolvency (2007 \$)	-\$368 BILLION	-\$71 BILLION	NA	NA

\*Data are from 2007 Trustees reports. \*\*Unfunded liabilities are not offset by trust-fund assets. †Figures for Medicare SMI are net of beneficiary premiums. Although SMI is not financed with payroll taxes, net expenditures are shown here as a percent of payroll to facilitate comparison.