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How to Balance a $43 Trillion Checkbook

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Current government accounting practices fail to grasp the future economic consequences of Social Security and Medicare. Necessary reforms of these entitlement programs will be thwarted unless policymakers take account of these long-term implications.

The Office of Management and Budget has released new federal budget projections showing deficits over the next five years that are much larger than we expected just a short while ago. Yet dire as they appear, the projections tell us very little about the real fiscal problems facing our country: Medicare and Social Security.

Medicare now faces an imbalance exceeding $36 trillion—yes, trillion. That is the amount of money in present value that Medicare is projected to pay out for future benefits in excess of the money in its trust fund, plus the money it is projected to collect in future taxes and premiums. Social Security's imbalance exceeds $7 trillion. Both of these imbalances dwarf the $3.5 trillion that the government officially reports as its current level of debt held by the public.

These calculations are based on the economic and demographic assumptions of the administration's budget for fiscal year 2004. The numbers are available for anyone to confirm these results. So why don't we see real entitlement reform? Why does Congress seem more interested in expanding these entitlements without also proposing real reforms that would put both systems on a sustainable course?

Bias against Real Reform

An important reason, we believe, is that Congressional Budget Office and OMB budget reports are not sufficiently forward looking. Instead of showing the large imbalances facing Medicare and Social Security, these reports direct attention to the level of government debt and annual deficits over the next few years, which very likely biases policymakers' choices against real reform.

To understand the current budget bias against reform, consider an alternative arrangement for financing retirement benefits: creating a Social Security system that includes personal accounts. Suppose that workers are given the option to invest some of their payroll contributions in such accounts, which they would own and control. In exchange, participants' future benefits under the existing Social Security system would be reduced—by one dollar in present value for each payroll dollar invested in personal accounts.

The retirement benefits of personal-account participants would now include reduced Social Security benefits plus income from personal-account assets. However, today's retirees must still be paid Social Security benefits as prescribed under current laws. Because the now-lower payroll tax revenues will be insufficient to cover those

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payments, federal debt will have to be increased. The federal government's overall fiscal imbalance will remain unchanged, however, because future Social Security obligations are reduced by the same amount as the increase in debt. Therefore, focusing only on debt and short-term deficits makes this reform appear undesirable.

In other words, debates about reforming Social Security to introduce personal accounts start from a bias against this financing arrangement: even a neutral transition to a system with personal accounts looks bad under current budgeting conventions.

Now suppose that future Social Security benefits are reduced by a little more than a dollar for each dollar of payroll taxes redirected into personal accounts. Many people may prefer this plan to assume control of their retirement assets. Now, the government's financial position improves because Social Security's obligations are reduced more than the increase in the debt. Again, however, this reform appears unfavorable under today's budgeting that focuses on only the debt and ignores future obligations.

Future Policy Implications

A more complete accounting that explicitly recognizes the government's future net obligations would remove this policy bias. This same bias may be at work today regarding the Medicare prescription drug plans currently under consideration by Congress: focusing on the $400 billion cost over ten years may be promoting passage of a more expensive plan than if the true total cost, including that beyond the ten-year window were to be widely disseminated.

Recognizing the inadequacy of projections over a limited period of time, the Social Security Trustees now also report that program's shortfall evaluated through perpetuity in their 2003 report. Extending this type of budgeting to Medicare and the rest of government appears to be a prerequisite for an entitlement reform debate wherein all options are properly evaluated.

Fortunately, a growing constituency within and outside the administration is taking notice. For example, in a November 14, 2002, speech in Columbus, Ohio, Treasury undersecretary Peter Fisher argued: "We need to bring this forward-looking understanding out of the shadows. We need to shine the same spotlight on it that the annual deficit and total debt receive in our government's budget rituals." Until the future implications of today's policies are fully documented and become the basis for policy analysis, reforms to preemptively address the enormous problems in the nation's entitlement programs could remain on hold.

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