

STABILIZING FUTURE FISCAL POLICY

It's Time to Pull the Trigger

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STABILIZING LONG-RUN FISCAL POLICY: IT'S TIME TO PULL THE TRIGGER

Fiscal policy is simply out of control. It's not the deficit per se, however—we have had deficits before. Usually, they could be easily contained in subsequent years simply by allowing revenues to grow as the economy expanded while enacting only small or no increases in appropriations for discretionary programs, most of which were newly funded every year. But discretionary programs now constitute less than 40 percent of spending, whereas they were almost 70 percent of spending in 1962. In fiscal year 2006, mandatory spending and interest made up 62 percent of spending.

Spending in these mandatory programs rests on contractual obligations to make payments and to pay benefits to eligible recipients, whose benefits and conditions for eligibility are defined by law. Consequently, spending is on automatic pilot unless Congress takes active steps to change the law.

Although mandatory spending may occupy a large portion of the current budget, it would represent less of a problem were it not for another issue. Existing law implies that this spending, particularly in some very large programs, will continually grow faster than tax revenues—and the economy. Much has been promised for far into the future. Because it is so difficult politically to take back past promises—even for benefit levels not yet attained by current recipients—policymakers find it almost impossible to control the future direction of policy. Past decisions have committed so many resources that legislators are limited in their ability to allocate resources to meet the current needs of society, and it has become extremely hard to satisfy the new wants of voters. New presidents with mandates for change, for instance, now come into power with much less discretionary power than their predecessors.

The time has come to change the direction of the automatic pilot that is now driving spending. To do so, policymakers can develop “triggers” that can be pulled at certain “trigger points” to automatically lower growth rates in programs expanding at unacceptably high rates.¹

We do *not* suggest that triggers are in any way superior to systemic reform. Far from it. We much prefer discretionary efforts that reform programs over time equitably and

efficiently. But there are few signs that our legislators are willing to take on this daunting task. Automatically triggered reductions in automatic spending growth, on the other hand, would reduce the needed number of painful votes. At the same time, triggered reductions would make more resources available both to improve old programs and to enact new ones. Triggers do this, in part, by leveling the playing field between programs that have large automatic growth and those where growth or even maintenance of effort cannot be obtained without new legislation. In effect, triggers would allow the budget to be more responsive to the democratic process.²

BUDGETING FOR GOOD NEWS

So how did the United States get to this point? For the most part, good things have been happening. Life expectancy is increasing and health care is improving. That is wonderful news.

While life expectancy has risen, birth rates have fallen—thus increasing the ratio of older to younger Americans. Because so many resources now available to most people in old and late middle age come from federal government transfers, the federal budget is at the heart of the debate over how to respond to these demographic pressures. As it is currently structured, federal spending largely reacts to demographic and economic changes automatically—determined more by the structure of pension and health programs invented in the distant past than by the votes of current elected officials.

Outside of spending on interest and defense, about half of federal outlays go directly to people age 65 and over. The biggest programs, especially benefiting seniors, are Social Security, Medicare, and Medicaid. These programs, which also cover some nonelderly adults and children, constituted just under 60 percent of noninterest civilian spending in fiscal year 2006.³ Yet it is not so much the current levels of benefits that threaten the budget: the danger comes from their continued spiral upwards. By 2030, the three programs are expected to absorb between 6 and 9 percent *more* of the gross domestic product (GDP) than they did in 2006, depending on the spending scenario that is chosen (Congressional Budget Office 2005; U.S. Government Accountability Office 2007).⁴ Meanwhile, the baby boomers start retiring in 2008, beginning a long period of projected decline in adult participation in the labor force. Over the next 30 years or so, these effects will compound, and programs will have to deal with the surge in retirements accompanying the complete retirement of the baby

boomers along with the steady growth in life expectancy that accompanies improvements in health. When demographics, combined with strong incentives to retire, create fewer workers per retiree, they simultaneously drive up the cost of Social Security relative to national income or product.

The Budget Squeeze

The rapid automatic growth of Social Security, Medicare, and Medicaid threatens to squeeze out other government activities. Programs for children, the poor, and infrastructure investment are particularly vulnerable.⁵ As only one example—and this for a period well before very many baby boomers retire—between 2006 and 2010, the cost of Social Security, Medicare, and Medicaid will grow by \$326 billion. The growth in revenues implied by current law is only expected to be \$494 billion over the same period. That is to say, the three programs will absorb two-thirds of all revenue growth, even though they still only constitute about 40 percent of total spending in 2006.

Spending is only half the story. The age cohorts retiring over the next few decades have too few children to easily support them and the previous generations moving into old age. Because birth rates fell rapidly in the 1960s and remained low, today's labor force—and, therefore, the number of taxpayers—is now growing slowly, and that growth is expected to decelerate in the future. So revenue growth is slowing just as spending growth is accelerating.

As an example, take a worker making \$50,000 a year (figure 1). Upon retirement, his Social Security and Medicare benefits will be approximately \$24,000 a year. His federal income and Social Security taxes, however, as well as state taxes, will fall by \$16,000. If no new worker replaces him, national income falls by \$50,000, but almost all the loss must be borne by someone other than the new retiree. That is, not only must someone must come up with the extra \$24,000 to fund his benefits, but existing programs (including Social Security and Medicare) must get by with \$16,000 less in revenues.

Figure 1. Example of Shift in Resources Upon Retirement

For a worker who earns \$50,000...	
Increases in Resources Transferred from Others	
Social Security benefits	\$18,500
Medicare benefits	\$5,000
Total 1	\$23,500
Decrease in Resources Transferred to Others	
Social Security taxes	-\$7,700
Federal income taxes	-\$6,600
Other taxes (Including state and local)	-\$4,000
Total 2	-\$18,300
Net Change in Transfers Received (Total 1 - Total 2)	\$41,800
Addendum: Additional decline in retiree's after-tax earnings otherwise available to meet current and future needs	\$31,700

Source: C. Eugene Steuerle and Adam Carasso, The Urban Institute, 2002.

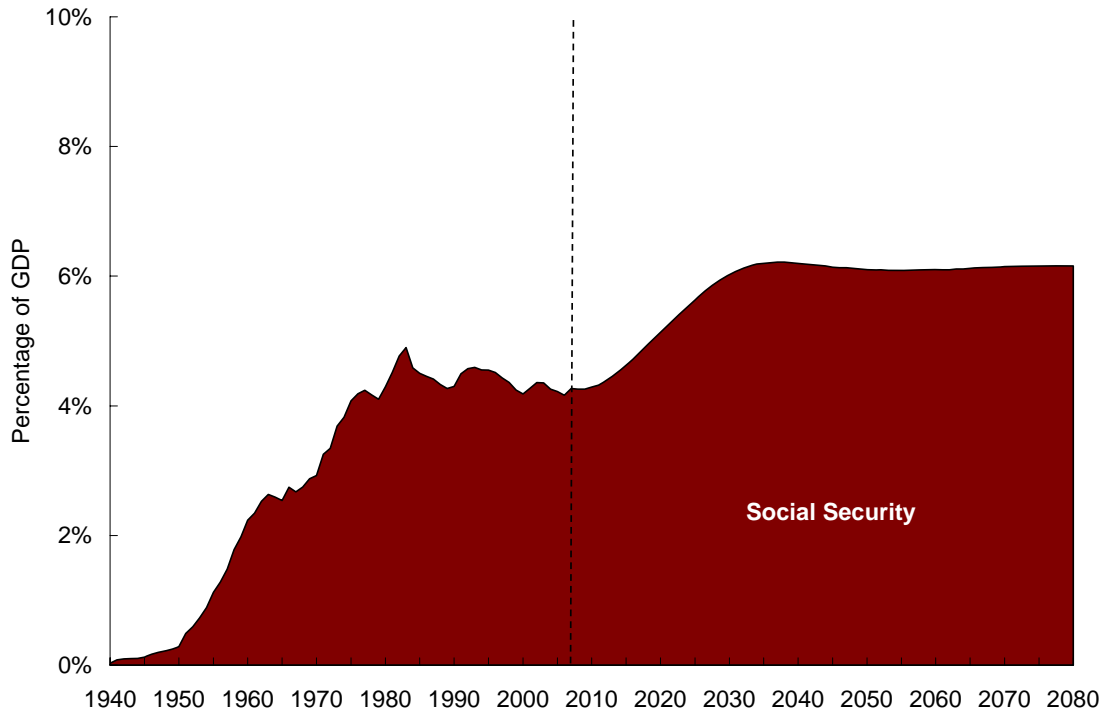
GROWTH ON AUTOMATIC PILOT

The analysis thus far may make it seem as though the aging of our population is at the root of the long-run fiscal problem facing the nation. But that is not quite true. The fundamental problem does not lie in demography. Instead, it lies in how we have designed our programs—seldom in line with demographic factors that reflect need, often in line with demographic factors that do *not* represent need, and often in line with factors for the most part unrelated to either demographics *or* need. Yet, as we shall see, the promises inherent in these program designs make it extraordinarily difficult for politicians to adjust to changing demographic trends and the evolving needs of the elderly and nonelderly alike.

Social Security's Built-In Growth

Let us now turn in more detail to the particular ways programs have been designed to grow so quickly on automatic pilot. Begin with Social Security. Several program features, when combined, cause the program to grow faster than the economy essentially forever (figure 2). The first design feature aims to keep the real benefits of the newly retired growing with the real wages of the working population. If our wages are 30 percent higher than the wages of our parents, then our annual benefits will be 30 percent higher as well. This goal is implemented by indexing the initial Social Security benefits of each generation of retirees to average wages in the economy.

Figure 2. Federal Social Security as a Percentage of GDP FY 1940–2080



Source: C. Eugene Steuerle, Adam Carasso, and Elizabeth Bell, The Urban Institute, 2006.

Note: Authors used January 2006 CBO data for Social Security, Medicare, and Medicaid through 2016, and grew Social Security and Medicare levels with 2006 Trustees data and Medicaid with 2005 CBO data.

After the initial benefit is awarded, a separate index (the Consumer Price Index) is applied to compensate for inflation. It is somewhat odd that legislators chose to keep initial benefits up with the living standards of the working population but decided to keep benefits up with inflation only after they had been awarded. Indeed, a long-lived retiree starting out close to the living standards of the average worker when first retired can fall far behind after 20 or 30 years in retirement. Price indexing existing benefits significantly slows the automatic growth of total Social Security costs compared with wage indexing. If the entire system were price-indexed, it would not cause a significant budget problem and we would not be discussing triggers to curb its growth.

Even without formal wage indexing, Congress likely would enact periodic improvements in benefits—as it did before the formal adoption of wage indexing in the 1970s. But in the very long run, wage indexing is not the most important reason that Social Security costs are growing faster than the economy. A significant cause of excess growth has been Social

Security's continual increase in the number of years of retirement support. In fact, if Social Security had merely promised individuals the same number of years of benefits over time—thus increasing the retirement ages as people lived longer—the system would be affordable at its current tax rate almost indefinitely.

To see just how much retirement ages have changes over time, contrast the situation today with the situation in 1940. At that time, the average retirement age was 68 and the earliest retirement age was 65. If people were to retire today for the same number of years as they did then, they would retire on average at age 74. In another 40 years they would retire at 78 (figure 3). Instead, people elect Social Security retirement benefits on average at age 63.8, and slightly less than half take early retirement at age 62.⁶ The earliest retirement age is scheduled to remain at 62 no matter how much longer people live.

Aging versus Living Longer

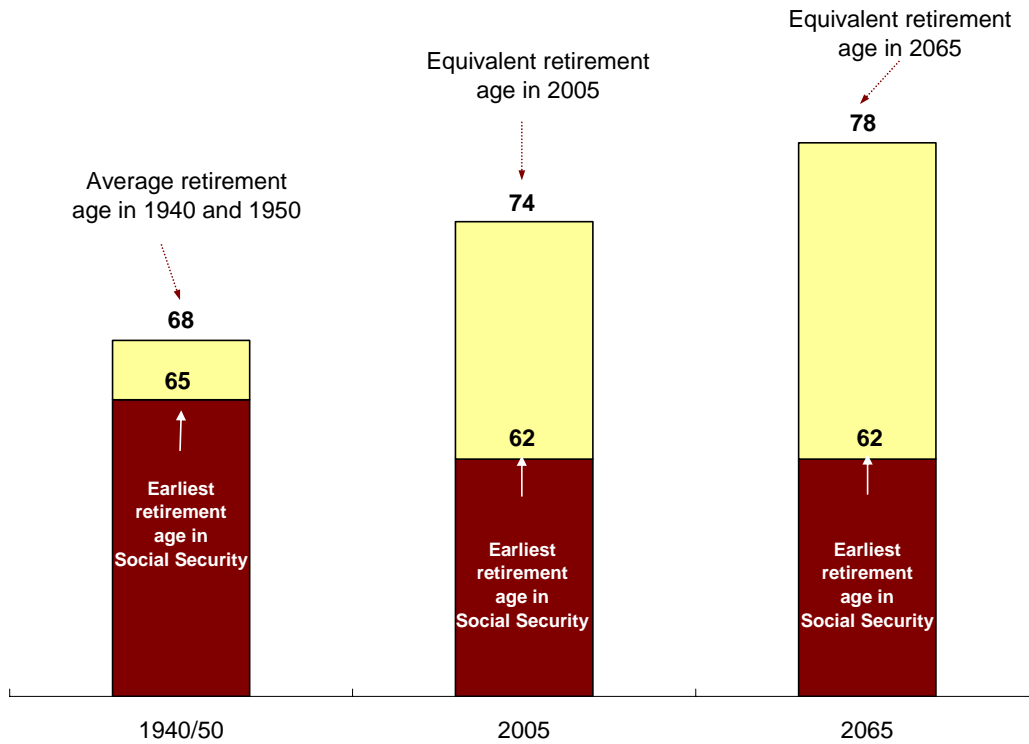
There is a distinction between people living longer and people aging. Because of improvements in health status and expected life, a person age 65 today has more well-being than a person age 65 in the 1960s. It might be said that the 65 year old today is the equivalent to the 60 year old of yesteryear. In other words, more people living longer does not “age” a population by itself. That is, there is no necessary increase in the proportion of the population closer to death or in worse health.⁷

A decline in the birth rate, by contrast, clearly increases the average age of the population and the share who are in their last years—that is, the percentage of the population within five years of death. Thus, needs relative to resources might indeed be greater for items like assisted living.

Medicare and Medicaid

The nation's health programs are more complicated. Like Social Security, Medicare has built significant demographic cost increases and revenue cuts into its structure. There is an automatic rise in the ratio of beneficiaries to workers because the system has maintained a constant age of eligibility while expected life has increased dramatically. At the same time, the decline in birth rates will soon slow the growth in tax revenues that support the program, as well as increase the share of the population in their last years of life.

Figure 3. Program Retirement Age—Indexed for Life Expectancy



Source: C. Eugene Steuerle and Adam Carasso, The Urban Institute, 2007. Based on data from the Social Security Administration, Birth Cohort Tables, 2007.

Note: These figures are based on male life expectancies as reported by the 2006 Trustee's Report.

In addition to these similarities with Social Security, however, Medicare defines entitlement to medical treatments in ways that seldom exclude any because of cost or ineffectiveness. Deductibles and cost sharing may reduce demand a bit, but, so far, they have been fairly modest relative to the total cost of the program. There are efforts to control costs by limiting what providers of health care can charge, and some premium payments charged to beneficiaries are rising, but these have little effect on gross costs, only on who pays.

For all practical purposes, these efforts have not deterred a very rapid rise in costs, and the budgets for the health programs remain almost totally open-ended. Medicare's automatic growth differs even from Social Security's, whose real benefit does not rise over a person's retirement years and whose per-beneficiary growth from generation to generation is not open-ended but fixed by a formula.

DISCRETIONARY VERSUS AUTOMATIC GROWTH IN BENEFITS

Entitlements with automatic growth differ radically from discretionary programs. Consider grants to support education or community development. Normally, these grants receive a limited appropriation each year and are not allowed to spend a penny more. Often they are cut in real terms from year to year, when appropriations are not increased enough to keep up with inflation. Needless to say, discretionary programs are at a distinct disadvantage in each year's battles for scarce budget dollars.

The goal of keeping the living standards of the elderly up with those of workers is laudable, and few think that it is a mistake to provide health insurance to the poor, disabled, and elderly. The program designs associated with these noble sentiments, however, imply that retirement and health programs' budgets should not be altered regardless of program costs and other societal demands. Increasing future retirement benefits, in a sense, is now automatically a budget priority over increasing educational spending or crime fighting (and the salaries of teachers and homeland security personnel). It is one thing to have certain social goals. It is quite another to imply that they should never be traded off, or traded off only with great difficulty, against other meritorious goals.

Legislators have the option, in theory, of cutting back on the promises inherent in program designs. But this option is excruciatingly difficult politically compared with simply avoiding appropriating enough for a discretionary program to maintain the quality of service offered the public. The first requires reneging on a "promise" and getting both houses of Congress and the president to tell the public they are doing so; the second merely requires inaction or actions to increase spending at less than the rate of inflation.

Social Security does not have to be designed to achieve its goals automatically. In fact, before 1972, the program was not indexed at all. Without legislation, benefits would erode because of inflation and would fall far behind wage levels. If Congress wished and thought it could afford it, it could periodically raise benefits to keep them up with the wages of the working population.

Oddly enough, indexing was first proposed as a means of saving money. For a time in the 1950s, 1960s, and early 1970s, Republicans and Democrats in Congress competed to see who could get credit for raising benefits or expanding coverage; often they raised individual benefits discretionally far in excess of the growth of wages. It was thought that both parties had lost the ability to restrain themselves and that benefit increases would be moderated if

they were put on automatic pilot. Yet Congress did at times make choices. For instance, real benefits were allowed to erode for long periods when Congress thought it less important to bump up everyone's benefit than to expand coverage, create a program for the disabled, or, as during World War II, meet other budget needs.

With the benefit of hindsight, it is also clear that the first three decades after World War II witnessed mass transfers of money from defense to domestic spending, a much lower (and, therefore, more politically palatable) Social Security tax rate than today, significant growth in revenues especially during the high-growth years of the 1960s, and interest rates that were almost zero when inflation was taken into account. These various sources of "financing" for domestic programs allowed Congress to be generous in many areas: tax cuts were frequent, and discretionary spending expanded into many new areas such as housing, education, and welfare (Steuerle 1996). Congress became much less generous in many areas once the nation was confronted by economic problems, such as slower growth in the late 1970s.

From a political viewpoint, the old, unindexed system made life much easier for legislators. They could appear generous from time to time. Even without all the extraordinary sources of money to finance domestic policy expansion just noted, economic growth continually gave Congress and the president great discretion to enact new programs or add to old ones. They could increase benefits without having to cut back on promises made in the distant past by legislators who are now long gone.

Medicare and Medicaid were designed from the beginning to have open-ended budgets. That was not necessary. In countries with universal coverage, like Canada and the United Kingdom, the health systems have fixed budgets. There is a bit of fudging around the edges when demand greatly exceeds what can be satisfied with limited resources, but, for the most part, the system makes do with whatever resources are provided each year by legislators. As a result, there is rationing, and that is unpleasant. There are also extreme political pressures on legislators to increase the fixed budgets rapidly from year to year, and health costs are rising rapidly despite the fixed budgets. But the important point is that the legislators have discretion over how much they accede to these demands each year.

THE TRIGGER ALTERNATIVE

It is not our intent here to recommend many of the ways that we might reform Social Security and Medicare (as well as other growing entitlements). Nor will we examine returning to a totally unindexed Social Security system or suggest that Congress needs to vote for every new treatment provided by Medicare and Medicaid as health technology expands. Nor will we examine the option of putting all programs on a discretionary basis, even if only periodically (e.g., every five years). Each of these ideas may be good, but our intent here is to examine and recommend minimal changes that will serve as a backdrop (or partial protection for other discretionary actions) when broader reform cannot be achieved for political or other reasons.

We keep an automatic pilot, but we redesign it so it adjusts when conditions are adverse. We also want adjustments that do not imply close to eternal growth, relative to GDP. That is, we want to restore more discretion to lawmakers and not leave the country flying into a mountain of debt.

Barring a first approach of broad reform, what should be done? A second approach to creating that more level playing field would simply be to adjust the automatic growth rates downward. In Social Security, for instance, one can index annual benefits to grow at less than the rate of wage growth or index lifetime benefits to grow at a slower rate through increases in retirement ages. In Medicare, the issue is again more complicated, but tightening methods can be developed—for instance, through fixed budgets for any government program, as in other countries, or through conversion toward a voucher-like program (with safeguards for insuring health insurance access for the less healthy). In both cases, increases in spending—either in a total budget or in size of credit—is and would be voted on by Congress each year.

A third method, related to but not the same as the second, is to resort to triggers—the main subject of this paper. A “trigger” actually has two major components: (1) a “triggering event”—that is, an event that forces the pulling of the trigger; and (2) a “triggering adjustment”—that is, some adaptation to the policy in place (a hard trigger) or a change in policymaking procedures (a soft trigger). Because pulling the trigger occurs automatically when the event occurs, one simple type of hard trigger adjustment is to convert an automatic growth path from one into two glide paths—that is, two sets of adjustments (both of which may still be automatic), depending upon which years or periods the trigger is pulled.

For instance, Social Security benefits might grow at one rate when the Social Security actuaries project long-term balance and at another rate when they project long-term imbalance. Here the imbalance is the triggering mechanism and the reduction of some rate of growth the triggering consequence. Obviously, there are many options as to how to measure imbalance and what the alternative rate of growth would be.

In effect, the design of both the triggering event and the triggering adjustment are important, if the policy is to be effective. The details of possible designs will be discussed below.

THE ADVANTAGES OF TRIGGERS

Triggers almost by definition are never better than “pure” reform, if such can be defined. Presumably the latter implies improving all the parameters of a policy according to principles such as fairness and efficiency (although these at times come into conflict), while adjusting over time to new needs and new knowledge. Depending upon both the triggering mechanism and the triggering consequence, triggers may also be inferior to adjusting automatic growth rates directly. For both economic and political reasons, however, sometimes triggers may be the only practical way of overriding automatic, eternal growth in programs irrespective of the needs of society or the wants of voters.

From an economic perspective, triggers should be designed to free up resources. They then create greater slack in the budget. Businesses or households rarely sign contracts for what they will buy 30 years or 100 years from now, much less contracts that would predestine how future growth in income would be spent. Triggers restore a democratic process whereby today’s voters, not dead legislators from the past, determine more of the parameters that guide today’s programs.

Freeing up resources opens up possibilities for improving health and retirement programs, not simply creating a more level playing field between those programs and others. For instance, government health subsidies per household (total health subsidies divided by total number of households) is scheduled to rise from an average of \$11,020 in 2006 to \$13,000 in 2010 without any vote from Congress on how that money should be spent.⁸ That money is allocated automatically so acute care in Medicare gets automatic precedence over preventive care, health insurance for children, and research, not to mention nonhealth areas such as education, justice, and community development. Similarly, when years of benefits in

retirement programs increase automatically, larger shares of Social Security benefits over time go to people who are healthier and further from their last years of life. These additional benefits could have been directed toward those who were older, in poorer health, or closer to poverty.

Politics argues even stronger than economics for triggers. As long as most future spending is directed by automatic growth in existing programs, doing anything new requires a whole series of adjustments. Before the current era when entitlement growth began to dominate future spending decisions, any new effort—whether an expenditure expansion, new program, or tax cut—required a majority of both houses of Congress and the president’s approval. The framers of our constitution wanted greater consensus for change than the simplest democratic majority. By inserting permanent automatic growth into programs, however, past policymakers not only preempted many choices today and tomorrow, but they also essentially required that to do anything new meant simultaneously retracting unfunded promises made in the past. If you believe we should spend more on children, for instance, you cannot simply fund the initiative out of normal revenue growth accompanying a growing economy. Normal revenue growth has been more than totally committed to old programs.

Practically speaking, this overcommitment makes modern policymaking extremely difficult. Losers typically have louder voices than winners. Politicians have great difficulty breaking out of the fiscal straightjacket that past legislators put around them. To make matters worse, by the early part of the 21st century, both political parties came to consider it political suicide to take anything away from anyone, with a few exceptions such as the very highest income taxpayers.

In this political climate, triggers have an appeal over simply paring the growth of programs to more sustainable rates. One major argument used against more broad-scale reform is that no one can predict the future that well. Some claim, for instance, that the economy may grow enough to lessen the budgetary squeeze. While sensitivity analysis usually shows this claim to be false—retirement and health programs, unlike discretionary programs, grow faster when the economy grows faster, hence providing little additional reprieve—it is still used powerfully against reform. “Let’s wait and see,” the story goes.

Triggers allow policymakers to respond that if the objection is right—that something happens in the future to make these various promises imminently affordable—then the

trigger won't be pulled or the adjustment will be less, even if pulled. For instance, suppose that the triggering mechanism is a projection by the Social Security actuaries that Social Security is out of long-term balance. If, because of improved economic or demographic circumstances later, the prediction turns out to be wrong, then the triggering adjustment will likely turn out to be negligible over time (and, indeed, depending upon design, might even be reversed).

A related advantage of triggers is that they can be based on objective and transparent criteria. Further, triggers can control spending and prevent the budget problem from getting worse while politicians are engaged in a protracted debate about more fundamental reforms.

Of course, it is entirely possible that the automatic adjustment to the former automatic growth path will be halted. Through legislation, Congress may step in and override the adjustment. Fine. To do so, it must then debate the program options. Now the budget dynamic is dramatically different. To restore the "old" automatic growth path requires a discretionary decision, and that decision will be "scored" as a choice of the current Congress, not a choice from the past for which current members can dodge responsibility.

For instance, suppose Medicare were to grow at 7 percent absent the pulling of the trigger, but only 4 percent if the trigger were pulled. Then for Congress to restore the 7-percent growth path, it would have to choose that additional growth over other spending, say, for community development. Any departure from using the trigger for Medicare would also have to be paid for with tax increases or other entitlement cuts under the pay-as-you-go rules adopted by Congress in 2007.

TRIGGERS IN OTHER COUNTRIES

Budget triggers are an important feature of the Social Security reforms implemented in several advanced democracies. The intent is to insure that reforms will remain actuarially viable without the immediate intervention of legislators.

Some countries believe that the actuarial assumptions underlying their reformed systems are conservative, and they do not believe that their trigger will be pulled except in extraordinary circumstances. In other countries, the trigger was introduced as part of the reform with the expectation that it would be used from time to time.

Sweden

The reformed Swedish system consists of a minimum guaranteed pension; a defined contribution, pay-as-you-go system; and mandatory individual investment accounts financed by contributions equaling 2.5 percent of wages (Kruse and Palmer 2007). The defined contribution, pay-as-you-go system is based on “notional accounts.” That is, individuals get credit for contributions and are paid an interest rate on the accumulated balances. The interest rate equals the rate of growth of average wages in the economy. There is, however, no real investment underlying these balances, and that is why it is referred to as a pay-as-you-go system. Upon retirement, the accumulated notional balance is converted into an annuity based on the life expectancy of a person’s cohort. The annuity is indexed for inflation, and its level assumes a real interest rate of 1.6 percent—the expected long-run growth rate of wages. If actual wage growth exceeds this amount, the annuity is enhanced. If wage growth falls short, the annuity is reduced.

As part of its reforms, Sweden adopted an automatic balancing mechanism (ABM) that applies to the system of notional accounts. The ABM is based on a comparison of the present value of the assets of the system and its liabilities. The present value of the assets is defined as the present value of future contributions plus the buffer fund, which is similar to the Social Security trust fund. The present value of the assets is divided by the present value of future benefit payments or liabilities; if this ratio is less than one, the interest rate paid on the accumulated balances is reduced, as is the indexing of the pensions of those already retired. For example, if the ratio is 90 percent, the interest rate paid on the accumulated balances would equal 90 percent of the rate of growth of average wages; the index applied to those already retired would also be reduced 10 percent.

As in the United States, the actuaries of the Swedish system estimate its financial health using three sets of assumptions—a base case and pessimistic and optimistic variants. When the reforms were first implemented, it appeared the ABM would be activated several times in the next 15 years in the base case. But the outlook has improved recently. It now seems unlikely that the ABM will be activated in the optimistic and base cases, and it will not be needed until 2013 in the pessimistic case.

It is interesting that some of the Swedish adjustment applies to those already retired. In the United States, a strong political consensus has emerged that no one over age 55 should

be affected by discretionary reforms to the system, even though this group is scheduled to get far more than future retirees (relative to what they have paid) out of elderly programs.

The Swedish Social Security reform, along with its automatic adjustment, has been copied, with minor variations, in several countries. Most notably, Italy is phasing in a Swedish-type system.

Canada

Canada reformed its Social Security system in 1997 (Bouchard 2007). It moved from a pure pay-as-you-go system to a partially funded one. This change required a significant increase in contributions, creating a surplus that has been deposited in a trust fund. To further enhance the financial health of the system, a portion of the growing trust fund is invested in private equities; those investments are managed by an independent board that is supposed to be insulated from political pressures.

The Canadian pension plan is administered jointly by the central government and the provinces. This joint responsibility could make decisionmaking somewhat cumbersome if the plan faced financial difficulties. Therefore, the plan added an automatic restraint that is triggered if the actuaries report that the system is not financially sustainable indefinitely and if federal and provincial finance ministers cannot agree on a remedy. All indexing of the system is frozen, and the contribution rate increases automatically until the financial health of the system is restored or the ministers agree on a solution. Canadian actuaries do not expect an automatic adjustment will be needed in the foreseeable future. Like the Swedish ABM, the automatic trigger affects both future benefits and the benefits of those already retired.

Japan

The Japanese have one of the most rapidly aging populations on earth. Their fertility rate has continually deteriorated beyond the expectations of their Social Security actuaries. Adverse demographics combined with the bursting of the Japanese financial bubble and slow subsequent economic growth devastated the financial health of the country's Social Security system, which had been made more generous during the economic boom of the 1970s.

The Japanese responded with a series of significant reforms, but they could not seem to keep up with deteriorating demographic conditions (Kabe 2007). To reduce the need for painful discretionary reforms, the government introduced "adjustment indexation" in 2004

to cap increases in premium levels. Benefits were to be adjusted so the premium would not have to be raised above 18.3 percent from 2017 onward. Actuarial estimates are made for a time horizon of 100 years.

The benefits of future Japanese retirees are indexed to disposable income, but it is expected that the index will have to be reduced 0.9 percentage points a year to achieve the goal set forth for the premium. Likewise, the price index used to adjust the benefits of the already retired will be reduced 0.9 percentage points a year. It is expected that this reduction will last until 2023.

The assumptions underlying assessments of the system's health will be reviewed every five years. Depending on estimates of the number paying into the system and the estimated life expectancy of beneficiaries, the adjustment factor may be raised or lowered. The adjustment will be suspended if it causes a reduction in nominal benefits or if disposable income or prices fall. It will also be limited if it causes the replacement rate for the average worker, which is now 59.3 percent, to fall below 50 percent. The adjustment mechanism is now at work, and so far, it has been accepted politically after a very painful debate.

Germany

The German Social Security system has recently faced problems similar to, but not as severe as, those of Japan, and the German government has responded in similar ways (Mersmann 2007). It made a number of significant reforms, with the latest occurring in 2001 and 2003/2004. The last was necessary because economic growth was disappointing and life expectancy grew faster than anticipated in 2001.

Like the Japanese, the Germans have set goals for contribution rates and replacement rates. Contribution rates are not to exceed 20 percent until 2020 and 22 percent until 2030. Replacement rates for the average worker are not to be lowered below 46 percent until 2020 or below 43 percent until 2030. It may take discretionary increases in the retirement age to achieve these goals.

The system is buttressed by automatic reductions in the indexing of benefits, which is now based on the change in gross earnings, for pre- and post-retirees. The automatic reduction is called a sustainability factor. It will be activated if the ratio of beneficiaries to taxpayers plus the unemployed increases. Howe (2007) points out that the system is "overengineered" in the sense that the sustainability factor could have been designed to

maintain the financial health of the system without requiring increases in the normal retirement age. Yet the sustainability factor is given a low weight in the benefit formula; with that low weight, it is unlikely to achieve the system's contribution rate goals without also adjusting the normal retirement age. But the low weight makes it more likely that the system's replacement rate goals will be achieved.

DESIGNING THE DETAILS OF THE TRIGGER

Triggers may be hard or soft (GAO 2006). A soft trigger initiates a procedure but does not directly change any program. For example, if some indicator suggests that a program faces financial difficulties, the president may be forced to offer a remedy that then must be considered by Congress on an expedited basis. A hard trigger automatically changes a program or a tax, perhaps by changing the indexing formula or by initiating some other structural change that either slows spending or enhances revenue. This paper, as noted, focuses on hard triggers because only they insure the restoration of some slack while the possibility of further reform is being considered or ignored.

Hard triggers must be designed with care. Their impact on spending must occur gradually and not be so painful as to be totally unacceptable politically. That is different from saying that politicians should never intervene to soften the cumulative effects of automatic adjustments. It is expected that politicians would intervene from time to time. Still, we must emphasize again: thwarting an automatic slowdown in spending growth allows policymakers to act generously as opposed to being forced to take back past, overly generous benefit promises.

The Spending Side

What spending should be affected? One view is that the sacrifice should be broadly based when the budget is in trouble and that almost all programs should be affected by automatic restraints. For example, the indices used for all indexed programs could all be reduced 1 or 2 percentage points while discretionary programs could suffer a comparable sequester.

We believe, however, that it is more reasonable to focus automatic restraint on the programs that are causing the problem. Those programs are Social Security, Medicare, and Medicaid. We would exempt Medicaid from trigger mechanisms because of its focus on the poor. There is, in our view, little merit at this point in using triggers to constrain programs,

such as food stamps and unemployment insurance, that are not inherently designed to grow faster than tax revenue; again, alternative reforms could be considered elsewhere, such as making those programs more discretionary by putting them through a periodic review.

The Revenue Side

Should taxes be included in the automatic adjustment, and if so, what taxes? The tax rate structure of the individual income tax is now indexed for inflation. That prevents inflation from pushing taxpayers into higher tax brackets even though their real income remains unchanged. This indexing could be suspended or reduced whenever the overall budget or certain programs get into trouble. A major problem with this approach, however, is that it would increase tax burdens toward the bottom of the income distribution proportionately more than at the top. Automatic rate changes could also be contemplated that could be designed more flexibly to have a desired distributional impact.

However, we do not believe that it is necessary to automatically adjust the personal income tax. We choose to focus new automatic restraints on Social Security and Medicare spending because the automatic portions of those programs cause the budget situation to worsen continually if Congress does nothing. In contrast, the personal income tax automatically makes the budget situation look better if Congress does nothing because real income growth continually pushes people into higher tax brackets. In effect, the individual income tax already moves toward the creation of budget slack by continually increasing average tax rates unless Congress enacts tax cuts. Under current law, the situation is even more extreme; the unindexed alternative minimum tax will automatically become more burdensome if Congress does nothing. Moreover, the most important Bush tax cuts will expire after 2010, thus increasing tax burdens further even if Congress extends many of the cuts. In other words, a “do nothing” Congress would greatly increase individual income tax burdens and reduce the budget deficit accordingly.

The payroll tax provides the bulk of the financing for Social Security and covers a large share of the cost of Medicare. The Social Security portion of the tax is applied to wages only up to a ceiling—\$97,500 in 2007. The ceiling is indexed to average wages. The Medicare portion is uncapped. The Social Security or OASDI tax rate is 12.4 percent. The Medicare or HI tax rate is 2.9 percent. Although the tax is shared between employers and employees, most economists believe that its true burden falls almost entirely on employees.

We do not advocate automatic increases in the payroll tax burden, though they are not crucial to our overall analysis of the merits of triggers. It was argued earlier that discretionary programs face a distinct disadvantage in the budget process versus entitlements that automatically grow faster than the GDP. Automatic increases in the payroll tax would maintain this disadvantage by increasing the financial resources devoted to Social Security, perhaps forever, while a more burdensome payroll tax makes it politically more difficult to raise income and other tax revenues that could be used to finance other programs. Because of the important effects of raising the payroll tax on the entire budget, payroll tax increases should result from discretionary acts of Congress and not from an automatic formula. Congress can always pass such tax increases either to limit the automatically triggered restraints on benefits that will be discussed below, or as part of a more fundamental Social Security reform.

Many will argue that if automatic adjustments are adopted, it is “fairer” to impose them on both the revenue and expenditure sides of Social Security and Medicare, thus rejecting our argument that it would increase the unfairness of the current competition for budget resources between these and other programs. As described above, different countries have resolved this issue differently; Japan and Canada apply automatic adjustments to both revenues and benefits, while Sweden and Germany apply them only to benefits. If, contrary to our recommendation, automatic payroll tax increases were adopted in the United States, two basic options could be used singly or in combination.

The first would automatically increase the ceiling on the wage base subject to payroll taxes. When Social Security was reformed through various amendments in the late 1970s, the wage ceiling on the tax was set so the payroll tax would cover 90 percent of wages, its peak, in the early 1980s. Because of growing wage inequality, the proportion of wages covered eroded to 84 percent in 2006. As part of an automatic adjustment to the Social Security system, the ceiling could be increased by something like 2 percentage points more than today’s wage index. The automatic adjustment could be turned off if coverage again reached 90 percent, but that would be very unlikely unless the distribution of wages equalizes. It would take an immediate increase in the tax base to \$177,600 to cover 90 percent of wages today. Therefore, a modest automatic adjustment would not reach 90 percent coverage in the foreseeable future. A disadvantage of base increases is that the largest percentage tax increases fall on those just above the current wage ceiling.

An alternative approach would raise the tax rate automatically, say, 0.1 percentage points a year. This option would affect all payroll taxpayers, including those with modest incomes. Considerations of economic efficiency argue for keeping marginal tax rates as low as possible, but it is unclear which option is preferable on this score. Modest automatic rate increases affect the marginal tax rate paid by all payroll taxpayers a little and is less progressive, whereas base increases affect a few taxpayers a lot.

Whatever is done with taxes, we do not believe that automatically triggered adjustments should leave a system in which balance is obtained by allowing both spending and taxes to increase without limit faster than GDP. The lack of sustainability is then simply transferred from that system to the larger budget, and little flexibility remains to expand other programs.

The Trigger

It is important to be careful in choosing the variable that triggers an automatic slowdown in spending growth or an increase in revenues. Tying the change closely to an erratic variable will lead to unpredictable, and ultimately politically unacceptable, results.

The Gramm-Rudman-Hollings law of 1985 (GRH) stipulated an automatic cut in spending linked to the amount by which the budget deficit exceeded a specific target. Because the budget deficit is highly erratic, it turned out to be a highly unsatisfactory trigger for spending reductions. GRH became untenable when the deficit took a jump upward, because it would have required spending cuts that increased when the economy tanked and unemployment rose, which became unthinkable politically. The law's deficit targets had to be increased; they were finally abandoned in 1990.

GRH might have worked better if the size of the automatic spending cut was not precisely linked to the amount by which the deficit exceeded its target. For example, the law might have stipulated that if the deficit exceeded a specified amount, then the indices used to index spending programs would all be reduced by 1 percentage point and discretionary spending would be decreased 1 percent. Although the trigger would still be erratic, the spending action triggered would be smoothed out and much more gradual.

Nevertheless, it is preferable to use a variable for a trigger that does not have such a large random component subject to the economic cycle. Spending slowdowns or revenue increases will then be easier to predict and will not be turned on and off erratically.

For Social Security, we suggest that a spending slowdown be triggered whenever the Trustees of the system state that the program faces an actuarial deficit for 25, 50, or 75 years—numbers which they already report. The purpose of the multiple triggers is to deter Congress from rejiggering the program to allow large deficits for the short run with a long-run trigger, or for the long run with a short-run trigger. Estimates of the actuarial deficit change slowly over time under constant law, and automatic changes would not be frequently turned on and off.

How Should Social Security Spending Be Slowed?

The design of the automatic slowdown in spending involves some crucial value judgments. One of the most important questions is whether the slowdown should affect those already retired. Some foreign triggers discussed earlier affect the already retired. In the recent debate regarding Social Security reform in the United States, however, almost all proposals, including that by President Bush, protected the benefits of anyone age 55 or older.

This constraint is very important. First, it implies that there can be no slowdown in benefit growth for at least seven years. The country loses not only the saving from benefit reduction, but also the compound interest on that amount. Second, the policy of protecting the retired and those near retirement protects those who have received the largest windfalls from Social Security—the ones who get the most lifetime benefits relative to lifetime taxes. Meanwhile, significantly more pain is imposed on those younger than age 55, already bigger losers, who now also face all the benefit cuts or tax increases to bring the system into balance.

We, therefore, believe that both current and future beneficiaries should bear some sacrifice, although it need not be equal for both groups. Nevertheless, the spending slowdown that is triggered should be gradual so beneficiaries are not unpleasantly shocked.

By exactly how much should benefit cost growth be slowed? Because the automatic pilots driving Social Security and Medicare cause them to grow faster than GDP, there will be enormous pressures to raise tax burdens considerably above historical levels by the end of the next decade, to cut other government activities to the bone, or to allow the deficit to soar to levels that threaten a financial crisis. That argues for immediately cutting benefit cost growth below GDP growth. Because reform has been delayed for so long, however, that option may not be practical for Social Security.

In their 2007 report, the trustees of the Social Security system estimate that total benefit costs in 2007 dollars will grow 4.0 percent a year under current law between 2010 and 2020. That is the result of a 2.6-percent-per-year increase in the number of beneficiaries and a real increase in the average benefit per beneficiary of 1.4 percent a year. The average real benefit increases because the wage-indexed initial benefits of the newly retired are significantly higher than those of longer-term retirees whose benefits have been price-indexed since retirement and those of the beneficiaries who die each year.

Over the same period, real GDP is assumed to grow 2.2 percent a year. With total cost growth equaling 4.0 percent a year, bringing total cost growth below GDP growth, therefore, requires a reduction in the former of more than 1.8 percent a year. That is a formidable task.

Any reasonable automatic change in the formula determining initial benefits takes a long time to significantly affect total costs for the obvious reason that in the first year of the automatic change only those retired less than one year would be affected. In the second year, two years of retirees would be affected, and in the third year, three years of retirees and so on, but it would take a long time for a very large portion of the retired population to be affected by the new regime. Modifying the indexing of the already retired would hasten the day that total costs grow less rapidly than the GDP, but doing it abruptly would be unacceptable. The process would be aided, however, by the fact that any reduction in the real growth of initial or existing benefits would probably induce some people to delay retirement. Consequently, the growth of the beneficiary population would be slowed along with the growth in the average real benefit; that, in turn, would raise revenues for the system from the additional work. The quantitative impact of reducing the growth of benefits on the time of retirement, however, is somewhat uncertain (Panis et al. 2002).

One option would be to increase the full retirement age (FRA) by two months a year beyond that stipulated in current law when the trigger is pulled and to increase the early retirement age (ERA) by the same amount. Abstracting from the effects of changing the ERA and assuming that retirement behavior is not altered in response to the FRA increase, benefit costs would be reduced 1.1 percent a year in the first year of the automatic adjustment for those retiring within 36 months of the FRA and 1.9 percent for those retiring even earlier, assuming that the same benefit reductions are applied for retirement before the FRA as in current law. Any postponement of retirement would add to the reduction in the

rate of growth of benefits, but again it must be emphasized that only one year of potential retirees would be affected in the first instance.

Delaying the ERA would have a significant impact in the first year on those who had previously planned to retire exactly at age 62. They would lose 100 percent of their benefits for two months. Their lifetime benefits would remain roughly the same (from this change only) because their annual benefits would be boosted upward and they would no longer suffer as large an actuarial penalty for being early retirees. Increasing the ERA would immediately delay the time of retirement and positively affect payroll tax revenues. Increasing the ERA and FRA has only minor effects on the benefits going to the disabled and their dependents, and one study finds that this change favors blacks and lower-income groups in part because they are disproportionately in the disabled population that does not face a benefit cut (Mermin and Steuerle 2006).

In the second year of operation, the automatic adjustment would double the percentage reduction in initial benefits for new retirees compared to current law; in the third year, the reduction would triple, and so on. (Note that these reductions are from benefits that are growing with the rate of growth of wages.) While total benefit costs would still grow faster than the GDP at first because so few retirees are affected and the demographic hump of baby boomers hits Social Security so strongly after 2007, cost growth would decelerate rapidly and eventually be below GDP growth unless Congress intervenes.

It was suggested earlier that the existing retired might also be asked to bear some of the sacrifice of making current policy sustainable. One way to do so would be to lower the cost-of-living adjustment applied to the benefits above some minimum by 0.5 percent a year. This reduction would induce more of a slowdown in cost growth in the very short run since a larger portion of the entire population of retirees would be affected. The living standards of the already retired would not necessarily fall absolutely, however, because economists generally agree that the current Consumer Price Index (CPI) overstates inflation. The CPI does not fully adjust for the effects of introducing new goods and services on living standards, or for the effects of quality improvements and the ability to rely more on goods and services whose relative price has fallen. These problems have been reduced significantly by improvements in the CPI over the years, but none have been solved completely. Limiting the impact to benefits above some minimum would protect the poor among the elderly.

Also, we believe that if this option is included, it should be limited in number of years of applicability.

As an alternative to increasing the FRA, the current benefit formula could be indexed less generously. To calculate a person's benefit, the Social Security Administration examines the highest 35 years of earnings during a lifetime. Past earnings are blown up, or indexed, by the increase in average wages in the overall economy since the earnings were received. Average indexed monthly earnings (AIME) are computed over the 35 years. In 2007 for people born in 1941, benefits equaled 90 percent of the first \$606 of the AIME, 32 percent of the next \$3,047, and 15 percent of the amount above \$3,653. The dividing lines between these brackets are known as "bend points," and they are indexed to average wages in the economy in order to prevent average replacement rates from falling as average real wages rise.

If the trigger is pulled, the bend points could be indexed to prices rather than wages. Average real benefits would still rise as real wages rise, but by less than they do under current law. In other words, the change in benefits from promised levels would be very gradual. A somewhat harsher approach would freeze real benefits even though average real wages were rising. Somewhat confusingly, both these approaches go under the name of price indexing, although the latter meaning has been used more frequently in recent years. A variant on the theme would make indexing less generous only for those with higher lifetime earnings (or AIMEs). This is often called "progressive price indexing." It should be noted, however, that this adjustment applies to an individual's earnings record. One might want to consider alternative designs for how combined family benefits would be indexed.

Increasing the FRA and changing the indexing of the benefit formula have very similar effects. Both cumulatively reduce benefits at any particular age of retirement. Both are likely to induce longer work. But an increase in the "full retirement age," especially when accompanied by an increase in the early retirement age, may have a greater psychological impact on work decisions, simply because Social Security sends people powerful signals about when they are old, eligible to receive "old age insurance," and attain "normal" retirement ages. The greater amount of work increases revenues and, therefore, reduces the amount of adjustment and amount of lifetime benefit reduction needed to bring the system back into balance.

The combination of automatic adjustments suggested above may seem harsh to some. Harsher automatic adjustments would have to be in force a shorter period of time if allowed to run their course. Yet harsher adjustments imply a greater likelihood that Congress would intervene.

A very large portion of the baby boom generation will be applying for benefits during the 2010s. Between 2020 and 2030, the growth of the retired population slows. The number of beneficiaries grows at 2.0 percent annually under current law compared with 2.6 percent in the previous decade. Total real costs grow at 3.1 percent annually compared with 4.0 percent earlier. The trustees also project that GDP growth will slow, but not nearly as much as cost growth. As a result, the automatic adjustments described above will lower the cost to GDP ratio at a faster rate as time goes on.

Reducing the Growth of Medicare Costs

The Medicare program already contains three triggers—two hard and one soft. One hard trigger adjusts provider payments so total Medicare costs follow a “Sustainable Rate of Growth” (SRG). Congress has always overridden this trigger, and in doing so, it has not been provoked into adopting other cost-saving measures. This trigger has failed miserably, partly because it is too harsh. Another hard trigger works much better. Premiums for physician and prescription drug insurance are automatically set to cover 25 percent of total costs, under a rule made permanent in 1997.

Medicare’s soft trigger was designed in the prescription drug bill passed in 2003. That bill specified that if the system’s trustees projected, in two successive years, that general revenue financing must cover more than 45 percent of total costs for any of the following seven years, the trustees have to issue a “funding warning.” The president then has to propose cost-saving measures in the following budget, and they have to be considered on an expedited basis by Congress. The trustees issued their funding warning in early 2007 (The Boards of Trustees 2007) and the president will have to make proposals in his budget for fiscal 2009 that will be issued in January or February 2008.

It is unclear how well this procedure will work. Cynics forecast that the president will not make meaningful proposals, or if he does, then Congress will not pass them.

In his 2007 submission of a budget for 2008, the president got tougher. He recommended converting the soft Medicare trigger into a hard trigger that would curb the

growth of provider payments automatically after a funding warning. Congress has not shown any interest in this proposal.

Before the president's proposal, we made an almost identical recommendation and wrote favorably about converting the soft trigger to a hard one. (Penner and Steuerle 2005). Now that a funding warning has been issued, however, the trigger mechanism has been criticized in various editorials and opinion pieces. (For a summary, see Thomas R. Saving, "Medicare Meltdown," *Wall Street Journal*, May 9 2007.) The main objection is that the trigger is biased against the general revenue financing of Medicare and that general revenue financing is desirable because it is likely to be more progressive than payroll tax financing or premium increases.

There are a lot of ways to make the federal tax-transfer system more progressive both within and outside Medicare—if that is deemed desirable—than to depend on more general revenue financing for Medicare. Indeed, Medicare itself has already been made more progressive in the prescription drug bill by significantly raising the premium for physician's services coverage for singles with more than \$80,000 in income and couples with more than \$160,000. In his 2008 budget, President Bush recommended another step toward more progressivity by suggesting that the premium for prescription drug insurance also be income-related. And of course, the personal income tax can be made more progressive directly or welfare programs can be enhanced.

Financing rapidly growing programs with earmarked sources of revenue has a major advantage. If financing falls short and earmarked taxes and premiums must be raised, the growing economic burden imposed by these programs will likely attract public attention.

In other respects, the Medicare trigger satisfies our criteria for being a good trigger. It is stable and relatively unaffected by random factors.

Although we disagree with the general revenue argument against the already proposed trigger, we are not wed to that trigger either. A trigger could be chosen that has no link to general revenue financing. For example, cost-saving measures might be triggered after any year that the cost of the program goes up more than 4 percent—that is, about 1 percentage point more than the long-run expected growth of GDP. Indeed, that may be a more clearly understood type of mechanism.

What sort of cost-saving adjustment should be triggered? In our earlier work, we suggested that if, in responding to the current soft trigger, Congress did not take sufficient

action to slow cost growth significantly, the growth of provider payments would be curbed automatically. This is not a very desirable solution for the longer run, but we hoped that such a measure would provoke Congress into more rational reforms. The failure of the SRG system to either curb provider costs or provoke more rational reforms does give one pause, but we would design our trigger to be somewhat less punitive. We also believe that overrides are less likely when other budgetary pressures, say, from demands for other programs, are much greater.

There are many other possible approaches to improving the financing of Medicare automatically. The payroll tax rate, premiums, and deductibles and co-payments could all be automatically increased over their current levels. Such measures would be opposed by those who favor more general revenue financing of Medicare. Measures that work only on the financing side of the program face another major difficulty. Because Medicare costs are rising faster than income, the financing burden would have to rise indefinitely, and that is not viable. As in the case of Social Security, we are not suggesting that taxes will not be part of the long-term solution. But we do not want a triggering mechanism that substitutes an unsustainable total budget for an unsustainable system, as measured narrowly by trust fund balances. Hence, in the long run, as long as spending is on an unsustainable path, there is no other choice but to curb its rate of growth.

The growth in spending could also be curbed by some selective measures. For instance, Congress could automatically increase the eligibility age, but that is probably inadequate by itself because younger eligibles are among the healthier Medicare beneficiaries. Because it is hard to come up with single options for spending curbs in Medicare that are sufficient by themselves, an appealing option would empower a commission (similar to the Medicare Payment Commission or the Base Closing Commission) to recommend options for reducing Medicare cost growth below GDP growth. The recommendations would be voted on by Congress as a package with no amendments allowed. If Congress voted down the package, or if the actuaries projected that the package was inadequate, automatic cuts in provider payments would follow. This is not a long-run solution, but the threat of imposing an irrational automatic adjustment would create an incentive for Congress to accept the Commission's hopefully more rational recommendations. Congress could, of course, respond by both rejecting the Commission's recommendations and obviating the automatic cut in provider payments, but it would then be hard-pressed to avoid a national debate on

Medicare's future. And, once again, we have put back on Congress the formal decision to choose this type of spending over other program spending, since the higher Medicare growth would be converted to a discretionary or legislative choice.

No one would deny that Medicare is an extremely inefficient program. Numerous options have been put forward for improving efficiency, and some may be adopted by the aforementioned Commission. But underlying cost growth is driven mainly by technological change that is constantly making available new and effective treatments that are highly desired by the public, especially if the public directly pays only a small share of the cost. Ultimately, the amount spent on treatments will have to be rationed by prices or quantity limits will have to be set by the marketplace, a bureaucracy, or the medical profession. That logical conclusion may not be pleasant, but inexorable growth in Medicare costs, if not curbed, will eventually force Congress to ration all other goods and services provided by government. That is not a pleasant thought either.

CONCLUSIONS

Today's tax burdens are not high enough to finance the future benefits promised by our Social Security, Medicare, and Medicaid programs. Our national debt could exceed our entire gross domestic product by the end of the next decade, if tax burdens are kept constant and noninterest spending outside Social Security, Medicare, and Medicaid grows with the economy. Unless the growth of the rest of government is held far below population growth and eventually made negative, it will take tax burdens significantly in excess of historical levels or cutbacks in benefit growth to avoid soaring budget deficits. Yet, our legislators are not inclined to consider fundamental policy reforms that would prevent a debt explosion and a possible financial crisis.

This paper considers an alternative approach to our fiscal dilemma. While we, like all policy analysts, would naturally prefer structural reforms, we suggest a second-best solution that would create a superior budget process in an interim, however long, until superior reforms are adopted. We recommend that politicians build automatic trigger mechanisms into the budget that would slow spending growth and raise taxes in order to slow our march toward a fiscal Armageddon.

Such automatic mechanisms provide three advantages to politicians. First, automatic restraint will not be imposed unless a trigger is pulled. If that trigger is properly designed, it

will be pulled only if there is an objective indication that a program is in financial trouble. Thus, it will be hard for anyone to argue that restraint is unnecessary. Second, politicians are not directly voting to cut program growth or raise taxes. They are only voting for a mechanism that insures fiscal responsibility. Actual restraint is imposed some time after the mechanism is designed. Third, legislators always have the option of suspending the mechanism, and they can look generous in the process without pushing spending above the levels that would have prevailed had the mechanism never been activated.

Critics may say that we are grasping at straws, and in a sense we are, but they are straws that have been grasped in other democracies with similar budget problems. True, other countries have used automatic mechanisms to bolster more fundamental reforms rather than to substitute for them, but their reforms could be less severe than they might have been without an automatic backup. And foreign experience suggests, at least, that automatic mechanisms have some political appeal in democracies.

The tragedy of our current fiscal situation is that few deny that dramatic reforms are necessary. Also, few deny that the necessary reforms become much more painful the longer we wait. Yet, few politicians are willing to move forward. The policies recommended in this paper are far from perfect. But at least they represent a start.

NOTES

¹ According to a recent report, the Government Accountability Office (2006) sees triggers being used in two contexts. In the first, a trigger would be pulled when a certain expenditure significantly exceeds forecast levels. In the second, triggers would counter a long-run tendency for expenditures to grow faster than revenues.

² Garrett suggests that budget triggers constitute a type of framework legislation (Garrett 2006).

³ While the bulk of Social Security spending is for pensions, the program also serves the disabled. Medicare serves both the elderly and disabled, while Medicaid provides health insurance for the poor. About 70 percent of Medicaid spending goes for long-term and acute care of the elderly and disabled (whether elderly or not).

⁴ This 6 to 9 percent range does not consider the lowest spending scenario used by CBO because that scenario assumes a dramatic decline in the growth of health care costs that we deem totally unrealistic.

⁵ Under current law, spending on children is scheduled to grow by only \$36 billion from 2006 to 2017, whereas other domestic federal spending would rise by \$609 billion. Children would receive less than 6 percent of the total increase (Carasso, Steuerle, and Reynolds 2007).

⁶ See *The Annual Statistical Supplement to the Social Security Bulletin, 2006*, table 6.B5.

⁷ Of course, depending upon the source of longer lives, the share of people suffering or less capable of work could either increase or decrease. For instance, more people having a particular disease may be able to survive; on the other hand, most survivors (new and old) may live a better quality of life. Also, our ability to detect impairments increases over time; hence, more people can get labeled as impaired even without an increase in its prevalence. This is one reason that researchers often turn to surveys, however qualitative, rather than prevalence of illness, to try to gauge well-being.

⁸ Authors' estimate based on data from the Centers on Medicare and Medicaid and the *Budget of the U.S. Government, FY 2007* (Steuerle 2003).

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