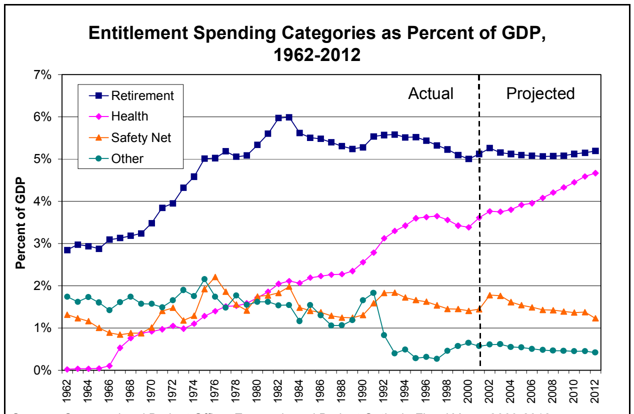
IN BRIEF: ENTITLEMENT SPENDING AND THE ECONOMY: PAST TRENDS AND FUTURE PROJECTIONS

In federal budget parlance, entitlements are spending programs that provide direct benefits automatically to persons or governments without annual appropriations when those persons meet certain requirements established in law. Numerous studies point to spending entitlements (particularly Social Security, Medicare, and Medicaid), along with the demographic aging of the population, as the chief sources of the nation's anticipated long-term fiscal problems when boomers retire.

This paper takes a fresh look at some common misconceptions about federal budget entitlements:

(1) It examines the size and growth of spending entitlements relative to the economy over the past 40 years and for the next 10 years;
(2) It compares the distribution of spending entitlements and tax entitlements by income groups;
(3) It considers the effect on the distribution of entitlement spending of viewing entitlements in the contexts of the life cycle and multiple layers of government;
(4) It discusses several factors influencing the long-term effect of entitlements on the economy; and
(5) It simulates the impacts of various economic and policy scenarios on the long-run projections of entitlement spending, deficits, and government debt.

Federal spending entitlements have increased no faster than gross domestic product (GDP) over the past quarter-century, and only two-thirds as fast as income tax revenue. Although total entitlement spending has remained steady as a percent of GDP in that period, health entitlements have tripled while other entitlements have decreased (see chart below). Despite criticisms that Social Security and Medicare disproportionately benefit the middle class, the majority of their dollars are received by people with incomes below $30,000, whereas tax entitlements, the tax benefits conferred under the Internal Revenue Code, are skewed toward the well-to-do. Nearly half of tax entitlement benefits go to those with incomes of more than $100,000, and nearly three-fourths go to those with incomes above $50,000.



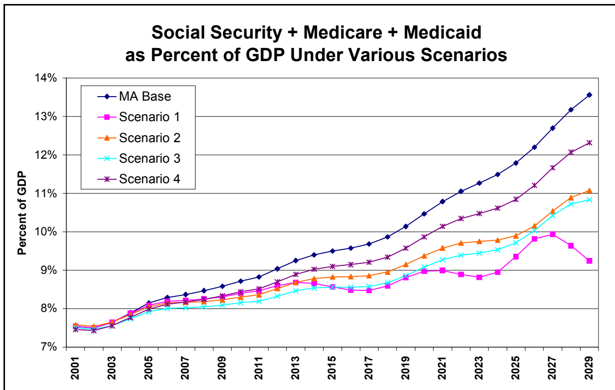
Source: Congressional Budget Office, Economic and Budget Outlook, Fiscal Years 2003-2012.

Long-term economic forecasts which project exploding government debt resulting from adverse demographics and entitlement spending growth, while sobering, are subject to large margins of error. Since the late 1980s, the Congressional Budget Office's 5-year deficit forecasts have been in error by an average of plus or minus three percent of

Source: John Gist and Satyendra Verma, *Entitlement Spending and the Economy: Past Trends and Future Projections.* A copy of the full 36-page paper can be found at http://www.aarp.org/ppi/. Or write for PPI Issue Paper #2002-13, Public Policy Institute, AARP, 601 E Street NW, Washington, DC, 20049.

GDP, well in excess of the long-term actuarial deficit in Social Security. Needless to say, forecasts of 30 or more years into the future are fraught with the potential for much larger error, and are highly sensitive to baseline assumptions, budget volatility, and extrapolation methods. Analysts who have done long-term projections of entitlement spending assume rising ratios of entitlement spending to GDP but flat ratios of revenue to GDP. However, the past 40 years have seen rising revenues as a percent of GDP and (since 1982) falling entitlement spending relative to GDP.

Four alternative economic and policy scenarios were modeled incorporating several factors that might mitigate the long-term consequences of demographic aging, including higher economic growth, greater labor force participation by the older population, slower growth in health care costs, and higher individual and national saving. The higher growth scenario had the greatest impact on entitlement outlays. With growth in GDP averaging 3.2 percent per year rather than 2.0 percent, Social Security, Medicare, and Medicaid would consume only 9.2 percent rather than 13.6 percent of GDP by 2029 (Scenario 1 in chart below). Moreover, rather than a deficit of 5.8 percent of GDP, we would have a surplus of 5.2 percent of GDP, and federal debt would be eliminated by 2029.



Source:
Simulations using Washington University Macro Model developed by Macroeconomic Advisers, LLC.

Although the demographic outlook represents a fiscal challenge to the nation, it is not a determinant of the future. Our future will be determined by choices made by individuals and by society. Boomers can adapt to their demographic situation as they have in the past by making different personal choices, particularly to save more (consume less) and to work longer. Government can support these individual efforts by promoting higher personal saving for retirement, improving work opportunities for older workers, extending and enhancing health insurance coverage, and controlling health and long-term care costs.