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The Coming Entitlements Cliff

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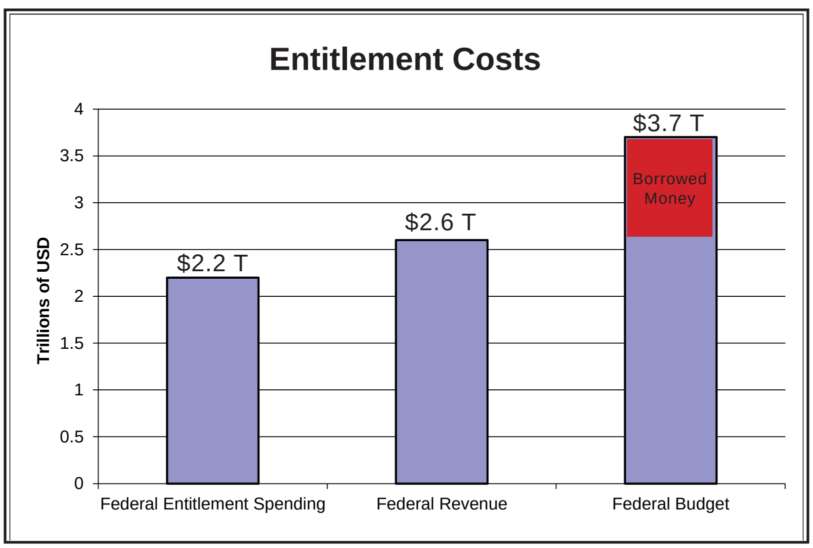
The "fiscal cliff" coming at the end of the year pales in comparison to the "entitlements cliff" being forced on us by a multitude of entitlement programs that we can no longer afford.

The Entitlement Population

Most people think of entitlement programs as Social Security and Medicare for seniors, Medicaid and perhaps some other means-tested welfare programs. But there are many more, including veteran benefits, unemployment, the children's health insurance program, disability income, the GI bill and Head Start.

The U.S. Census Bureau says 108 million Americans live in households where at least one person participates in a means-tested program. We estimate about 80 million are the primary recipients, though millions more share those benefits. That number has been growing rapidly under President Obama. Since the president took office:

- Medicaid has grown from 46.9 million to 56 million people;
- Disability beneficiaries have increased from 7.5 million to 8.8 million; and
- The food stamp program has grown from 32 million to 47 million Americans.



Add to that 80 million beneficiaries roughly 40 million Americans age 65 or older on Social Security and Medicare (about 9 million of the 49 million on Medicare, including some under the age of 65, also receive means-tested benefits).

That 120 million does not include the numerous smaller entitlement programs. Put them all together and a number approaching half of the country participates in an entitlement program.

The Coming Entitlements Explosion

Now add in the estimated 16 million new Medicaid beneficiaries as a result of the Patient Protection and Affordable Care Act (ACA), plus an estimated 18 million people who enter the health insurance exchanges beginning in 2014, where most will receive federal subsidies.

The Budget Challenge

The budget implications of these programs are enormous. For fiscal year 2012, the country spent roughly $2.2 trillion of its $3.7 trillion budget on entitlement programs—about $400 billion less than the $2.6 trillion in gross annual revenues. In addition, interest on the federal debt was $220 billion.

Thus, the cost of entitlement programs plus interest on the debt is nearly equal to total federal revenues today. Virtually everything else the government does is with borrowed, or printed, money.

Entitlement spending is also growing much faster than the economy. Since 1980, Social Security and the various income security programs have grown at an average annual rate of 6 percent, while Medicare and Medicaid have both grown at more than 9 percent annually, which includes population growth.

The States' Role

So far we have only focused on federal entitlement spending, but the states also play a big role, primarily with respect to means-tested programs.

Recently, the Congressional Research Service (CRS) released a white paper quantifying total federal welfare spending. The Senate Budget Committee (Republican staff) then added state spending.

CRS found that total federal means-tested spending for fiscal year 2011, excluding veterans' programs, was $746 billion—more than the $725 billion spent on Social Security. When state spending is included, total welfare spending rises from $746 billion to $1.029 trillion.

Who's Going to Pay?

Who is paying for all of those benefits? Not some 70 million children who do not work or have low-paying, part-time jobs. Nor are those 40 million seniors paying much in taxes.

Nor are low-income workers. According to the Tax Foundation, of the 143 million tax returns in 2010, 48 percent had incomes of less than $30,000. Those making $50,000 or more pay 46 percent of all income taxes.

The economic implications of these facts are brutal. Expenditures of $2.2 trillion for 120 million-plus entitlement beneficiaries equals nearly $18,000 per beneficiary.

According to the Tax Policy Center, 53.6 percent of households pay both income and payroll taxes, while 28.3 percent pay only the payroll tax. Thus some 76.6 million tax filers are bearing the full weight of our entitlement culture, while another 40 million are only paying the payroll tax.

And that number is beginning to decline. The estimated 77 million baby boomers (born between 1946-1964) are beginning to retire at an estimated 10,000 people every day, as they transition from being taxpayers to net benefit recipients.

The Negative Economic Impact

The federal government faces a serious economic challenge in trying to address this shortfall. Attempting to collect enough money to sustain this level of entitlement spending will only result in a reduction in work effort, reduced employment opportunities, and more people moving onto entitlements.

Solutions to Meet the Challenge

At least three changes must occur if we are to address the entitlement problem:

Entitlement Spending Must Be Cut—Roughly 60 percent of total federal spending is on entitlement programs. Just consider that 40 percent or more of all births are paid for by Medicaid; in some states that figure is over half.

That level of spending is unsustainable, especially since it nearly equals total federal revenue. And it is unnecessary for the richest country in the world. Means-tested benefits need to be reformed into real safety-net programs that help those most in need and do not create economic incentives to remain on welfare.

Policies That Encourage Economic Growth Must Be Implemented—We probably cannot get back to a sustainable financial path by only cutting benefits, nor should we. We also need to grow our way out of the entitlements cliff. But to do that Congress will have to do a complete 180-degree turn with respect to policies it has promoted, and in many cases passed, over the last four years.

Economic growth will increase federal revenue; by contrast, raising taxes may or may not have the same affect. That is because higher taxes in many cases will (1) encourage people to shelter more of their income to minimize the tax increases; (2) enter the entitlement system (retirement or welfare); or discourage work and investment, further exacerbating problems.

In order to spur economic growth Congress should lower personal and corporate income tax rates, while eliminating most or all of the current tax breaks. In short, income tax rates should be lower, flatter and simpler than they are now. In addition, keeping taxes low—or eliminating them completely—on investment income such as capital gains and dividends will also stimulate economic growth.

Several Programs Must Transition to Prefunded Personal Accounts—The private sector has shifted from defined-benefit retirement plans to defined-contribution plans. That is the best way to provide retirement benefits while eliminating long-term unfunded liabilities for the company.

And yet federal, state and local governments have been very reluctant to take that step for government employees. And so far the majority in Congress has adamantly opposed making that transition for Social Security and Medicare.

We will never solve Social Security and Medicare's long-term unfunded liability until we establish a system of prefunded personal accounts that belong to the worker. Any solution that maintains the current defined-benefit structure—unless it is for a small number of the poorest Americans—is only postponing the inevitable financial day of reckoning.

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