# CBO TESTIMONY

**Statement of**
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# Implications of Demographic Changes for the Budget and the Economy

**before the**
**Committee on Ways and Means**
**U.S. House of Representatives**

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Mr. Chairman and Members of the Committee, I am grateful for the opportunity to appear before you to discuss the challenges presented by projected changes in the makeup of the U.S. population. Those changes—together with, notably, rising health care costs—will produce a set of intertwined challenges for the budget and the economy. As a result, in the coming decades the United States will face economic shifts that will necessitate fundamental decisions about spending, taxation, and other economic policies that fall under the jurisdiction of this Committee.

## Demographic Changes

Over the next few decades, several demographic shifts are expected to occur. First, members of the large baby-boom generation will reach retirement age. Second, life spans are projected to continue to increase. Third, fertility rates are anticipated to remain well below the levels of the 1950s and 1960s. Taken together, those developments imply a significant and lasting increase in the number of elderly people in the population (see Figure 1 on page 7). Those same demographic factors are projected to lead to a sharp slowdown in the rate of growth of the labor force. In addition, families will be smaller than in the years of the baby boom, leaving fewer children to help care for elderly parents. And with fertility rates expected to remain at or below replacement rates for the native-born population, immigration is projected to account for most of the population growth in the long run.

## Economic and Budgetary Challenges

The choices made by the growing share of older households will play a large role across the economy: the goods and services they demand will affect what the economy produces; the rate at which they choose to exit—in whole or in part—from the labor force will affect labor markets; and the decisions they make about savings will be a key determinant of the national accumulation of productive assets. By preserving flexible markets for goods, labor, and capital, the United States will probably adjust smoothly in response to market incentives. But significant challenges remain.

Some of the future economic challenges posed by demographic changes stem directly from the structure of federal programs. In and of itself, an increase in the share of the elderly in the population need not present a problem. If each individual or household adequately prepared for retirement through its own saving, a greater share of elderly in the population would place no burden on younger people or the economy in general. However, a substantial share of the elderly's consumption is currently provided by government programs such as Social Security, Medicare, and Medicaid. Those programs have made important contributions to economic well-being in the United States. However, they are largely financed not by past savings in the economy as a whole, but by contemporaneous taxes. As the share of the elderly rises, current levels of taxation will be insufficient to finance those programs as they now operate.

For example, Social Security outlays are projected to rise from 4.3 percent of gross domestic product (GDP) to 6.3 percent in the next few decades, largely as a result of

the aging of the baby-boom generation (see Figure 2 on page 8). Thereafter, outlays will continue to rise slowly from continued increases in people's life spans, reaching about 6.6 percent of GDP by 2080. In addition, state and local pension programs that have not been adequately funded will face pressures similar to those faced by Social Security.

The aging of the population also will lead to growth in the number of Medicare beneficiaries. That growth, along with continued increases in the cost of health care, is projected to generate a potentially dramatic rise in Medicare spending. Furthermore, the steady increase in the number of the oldest seniors (those age 85 and older)—from 1.5 percent of the population in 2000 to 5.0 percent in 2040—is projected to lead to a rise in the demand for long-term care services, including those paid for by Medicaid and Medicare (see Figure 3 on page 9). That increase in demand will probably be heightened because in the future, the elderly will have fewer family members available to care for them than do the current elderly: declines in fertility imply fewer children per parent, and a greater share of women in younger cohorts work outside the home. Those trends will reduce the availability of informal care provided by family members and friends—currently the largest source of long-term care (see Figure 4 on page 10).[1] Furthermore, such trends could, in turn, raise the reliance on out-of-pocket payments, necessitating greater saving unless those costs are to fall on the young.

Given those increases in demand, if costs per beneficiary continued to rise as fast as they have in the past, overall federal outlays for Medicare and Medicaid could climb from about 4 percent of GDP to more than 20 percent by 2050 (see Figure 5 on page 11). Aging and increases in health care costs may also raise the demand for spending by other federal programs, including military retirement programs and the veterans' health care system.[2]

Aside from its impact on federal mandatory spending, the aging of the population presents economic challenges because retirement consumption is not always adequately prefunded by saving in the private sector. For example, many private-sector defined-benefit pension plans have not been properly funded, and an aging population can create some of the same pressures on those underfunded plans as it does on Social Security. Those pressures are projected to lead to higher net outlays for the government's Pension Benefit Guaranty Corporation as rising numbers of plans are unable to provide full benefits (see Figure 6 on page 12).

Moreover, whether through bad luck or poor planning, many people reach retirement age without enough resources to maintain their preretirement standard of living. Studies of savings levels suggest that as many as one-quarter of the baby-boom gener-

1. See Congressional Budget Office, *Financing Long-Term Care for the Elderly* (April 2004).

2. See Congressional Budget Office, *The Potential Cost of Meeting Demand for Veterans' Health Care* (March 2005).

ation have failed to accumulate significant savings.[3] Those people may experience significant declines in their standard of living upon retirement unless they receive some sort of assistance, whether from family members or government programs.

Alternatively, those individuals may choose to work longer; indeed, even those without pressing financial needs may consider that option. A relevant consideration is the degree to which private and government retirement plans are neutral with respect to the retirement age, providing neither an incentive to depart the labor force nor a requirement to extend working years.

Health care is a key part of consumption for both the young and the old. Rising health care costs threaten the current health insurance system for workers and retirees covered by private plans. Rapidly rising health insurance premiums are likely to reduce both the percentage of people who have health insurance and the comprehensiveness of the insurance held by those who are covered. As premiums rise, workers may be less willing to accept lower wage increases in exchange for keeping their health insurance. And employers may not wish to maintain increasingly costly benefits for retirees, especially since health spending for retirees does not contribute directly to a productive workforce, as might health insurance for current employees. Moreover, as noted above, given that a large portion of long-term care is now donated, an aging population may put a burden on younger generations even aside from the taxes required to finance government-funded care.

Despite those challenges, growth in productivity is currently projected to continue to raise people's living standards over time. However, it is very unlikely that productivity growth could by itself "solve" the projected budgetary shortfalls. Growth in productivity stems from two factors: growth in the amount of productive capital per worker, and technological advances that increase the amount of goods and services that can be produced by a given level of capital and labor—so-called total factor productivity (TFP). The rate of growth of TFP would have to shift upward in a very unlikely way to close just the budgetary gap in Social Security—and that gap is only a small part of the rise in consumption demands for the economy as a whole. For example, if the future growth of TFP was a full percentage point faster than its postwar average, over three-quarters of Social Security's projected 75-year actuarial balance would be erased. However, historical data on TFP growth suggest that such a sustained high rate of growth is quite implausible, with the probability of such a shift well under 1 percent. Moreover, even under such a scenario, Social Security would eventually begin to run cash flow deficits and exhaust its trust funds.

As for the amount of capital per worker, that will depend largely on national saving and wealth accumulation. In general, however, the impact of an aging population on the budget will tend to reduce national saving. By 2050, government spending is projected to climb to well above its historic share of GDP and considerably higher than

3. See Congressional Budget Office, *Baby Boomers' Retirement Prospects: An Overview* (November 2003).

the historical average share of revenues, which is about 18 percent (see Figure 7 on page 13). The levels of borrowing implied by that outlook could have a corrosive or, eventually, contractionary effect on productivity.

Moreover, the United States is unlikely to be able to borrow such sums on a sustained basis, even from international markets (especially given that aging populations in the rest of the developed world are likely to put similar pressures on budgets in other countries). Therefore, at some point, it is almost certain that spending will have to be cut or that taxes will have to rise. To the extent that increased taxes involved higher marginal rates on labor and capital income, they would tend to discourage work and saving, and therefore reduce economic output. For example, the Congressional Budget Office (CBO) has estimated that if all projected spending was financed by higher taxes, GDP could be 6 percent lower by 2050 than if spending was cut instead. (Although those estimated effects are significant, they are small relative to the projected growth of GDP over the next 50 years.)

More generally, choices about the degree to which budgetary adjustments should be addressed by changes in taxes or spending, and about when those changes should occur, involve fundamental issues concerning the distribution of burdens within and across generations. At some point, policymakers need to make choices about who will bear the cost of bringing commitments into line with projected resources. The longer those decisions are deferred, the greater the share of the cost that will tend to be borne by future generations. In addition, exempting certain groups—such as current beneficiaries and those near retirement—from the changes increases the burden that other groups must bear. In evaluating how to distribute the impact of policy changes, however, it is useful to note that because productivity is expected to continue to rise, future generations are projected to have a higher standard of living than current ones.

## Ways to Encourage Economic Efficiency

A paramount consideration is to ensure the continued accumulation of physical capital, technologies, and workers' skills to sustain economic growth. Policies that increased overall economic efficiency could lessen the impact of bringing commitments into line with available resources. For example, tax policies that involve lower marginal rates can reduce distortions that currently tend to discourage work and saving. Of course, the goal of reducing distortions must be balanced against consideration of the fairness of the distribution of taxes.

In addition to addressing the great pressure to increase federal spending, revisiting the structure of financing those outlays may be useful as well. For example, the income tax as currently configured operates somewhat like a high-end surtax. A large fraction of lower-income taxpayers now receive a net subsidy from the income tax, while a much smaller number of high-income taxpayers pay most of the taxes (see Table 1 on page 14). To the extent that that structure is embraced or extended, it may be useful to minimize the distortions imposed in raising revenue by explicitly designing the tax

to reflect the economic lives of the key taxpayers. Alternatively, it may be desirable to return the tax to a broader base in the population.

By contrast, payroll taxes take a larger share of the income of lower earners because they are levied only on labor income and are capped. A large part of payroll taxes do not represent a pure tax on the margin, because with higher earnings, workers not only pay higher taxes but also eventually qualify for higher Social Security benefits. Therefore, the payroll tax in principle should not discourage work as much as the legislated rates would seem to imply. However, workers might not fully realize the connection between current earnings and future benefits. In that case, the payroll tax would distort work decisions more strongly. If so, it may be desirable to moderate the extent of the payroll tax, or increase economic efficiency by clarifying the link between contributions and eventual benefits.

In general, a broader issue is whether a system that replaced the various types of taxes that are currently employed with a more integrated whole could be more efficient and fair.

Given the large scale of health care consumption, increased efficiency in that sector could yield significant benefits. From an economic perspective, a key problem with the current system is the lack of connection between those who are well-informed, those empowered to make decisions, and those who bear the cost of care. The result is that current health care spending is inefficient. For example, some regions of the country use many more medical services than others, on average, with no evident benefit in terms of health outcomes. Health insurance, depending on how it is provided, can also lead to excess spending: although insurance against uncertain health care costs has great value, to the extent that people are insured they do not face the direct cost of care and have little incentive to constrain costs. Furthermore, the tax preference given to employment-based insurance, a principal source of insurance in the U.S. population, may tend to bias the health care system toward higher spending.

At present, there is little consensus regarding clear-cut steps to improve the efficiency of the health care system. However, several incremental changes have received attention. Proponents of limiting medical malpractice awards argue that implementing such changes would reduce medical liability premiums, health insurance premiums, and the practice of defensive medicine. CBO has found that tort reforms would ultimately reduce medical liability premiums by an average of 25 percent to 30 percent from the levels that would otherwise occur, but total health care costs would fall by only about 0.5 percent. The more difficult question is whether there might be harder-to-detect, long-term shifts in practice patterns.

Another policy already being implemented to some extent for chronically ill patients is disease management. Disease management may entail various combinations of enhanced screening, monitoring, and education; the coordination of care among providers and settings; and the use of best medical practices to try to identify chronic

conditions more quickly, treat them more effectively, and thereby slow their progression. Unfortunately, although a few studies indicate that disease management programs could be designed to reduce overall health costs for selected groups of patients, to date little research directly addresses the issues that would arise in applying disease management to the broader population (including Medicare patients, who tend to be older and sicker).[4]

The fact that a relatively small number of patients account for a large share of medical expenditures suggests another possible cost-reduction strategy: identify potentially high-cost patients in advance and find effective intervention strategies to reduce their spending. A CBO analysis of Medicare patients suggested some promising strategies to identify patients who are disproportionately likely to incur high costs.[5] However, such identification does not by itself restrain costs. The extent to which targeted beneficiaries reduced their spending would ultimately rest on the costs of identification and the ability to devise and implement effective strategies to change beneficiaries' use of medical services.

In short, none of the approaches discussed above alone appears to provide a silver bullet to stem rising health care costs (or increase benefits for the same cost). However, taken together, in conjunction with other changes that more closely link the quality of care with its cost, such policies could move the system toward greater efficiency.

In closing, the demographic shifts facing the United States will place a premium on the accumulation of economic resources required to provide for the needs and wants of an older population. The structures of government programs will have important influences on the ability of the economy to sustain high levels of growth.

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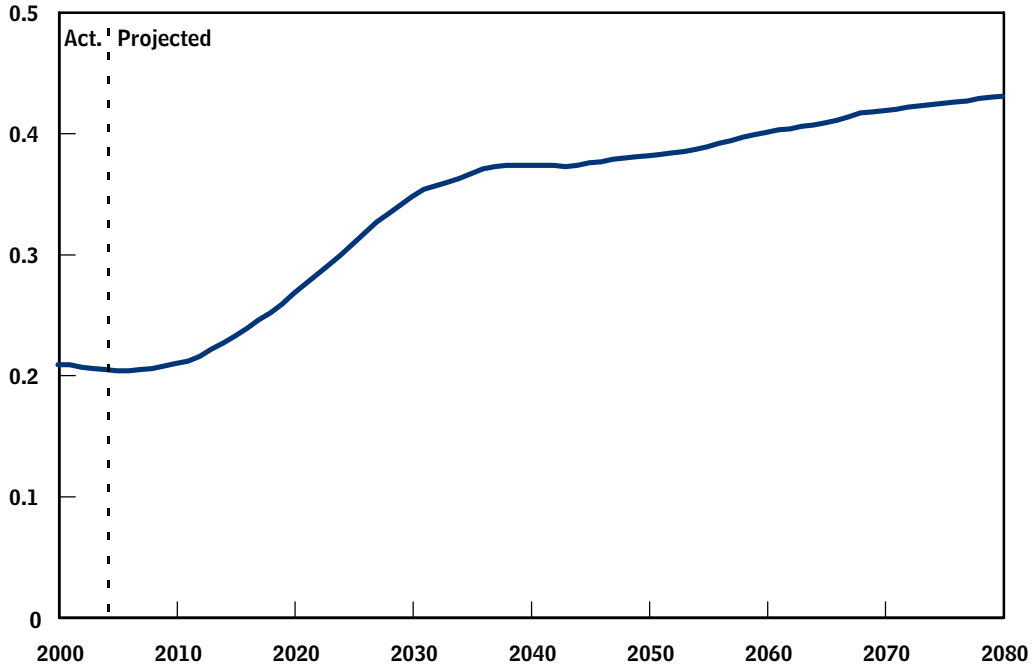
4. See Congressional Budget Office, *An Analysis of the Literature on Disease Management Programs* (October 2004).

5. See Congressional Budget Office, *High-Cost Medicare Beneficiaries* (May 2005).

**Figure 1.**

## Size of the Population Age 65 and Older Compared with the Population Ages 20 to 64

(Ratio)

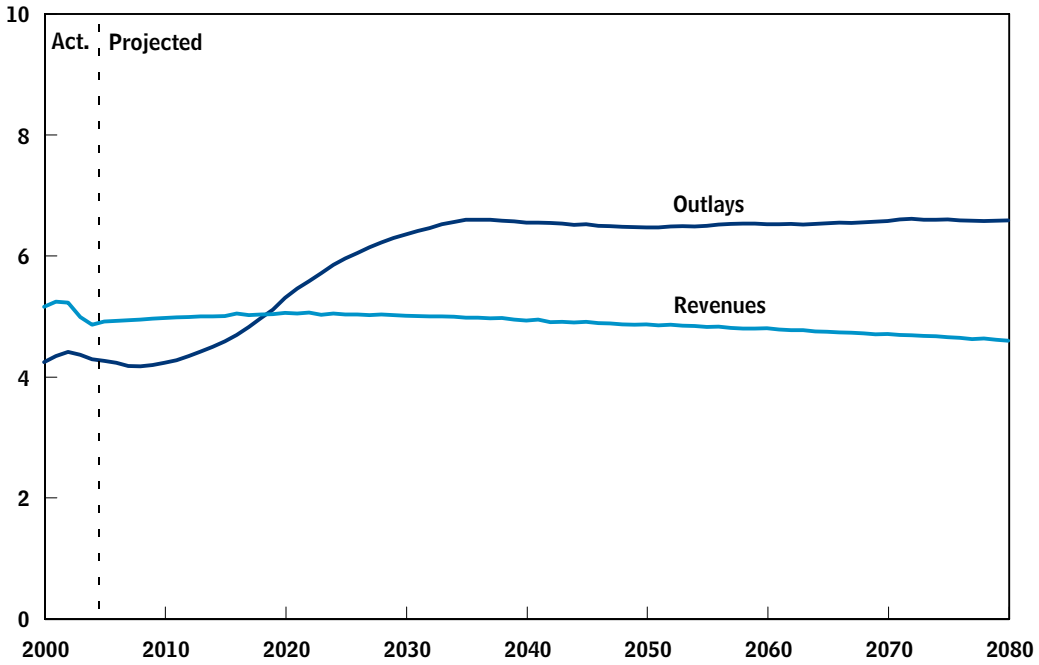



Source: Congressional Budget Office based on Social Security Administration, *The 2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (March 23, 2005), Table V.A2 (intermediate assumptions).

**Figure 2.**

## Social Security Outlays and Revenues Under the Scheduled-Benefits Scenario

(Percentage of GDP)




Source: Congressional Budget Office.

Notes: Based on the Social Security trustees' 2005 intermediate demographic and long-run economic assumptions and CBO's January 2005 short-run economic assumptions.

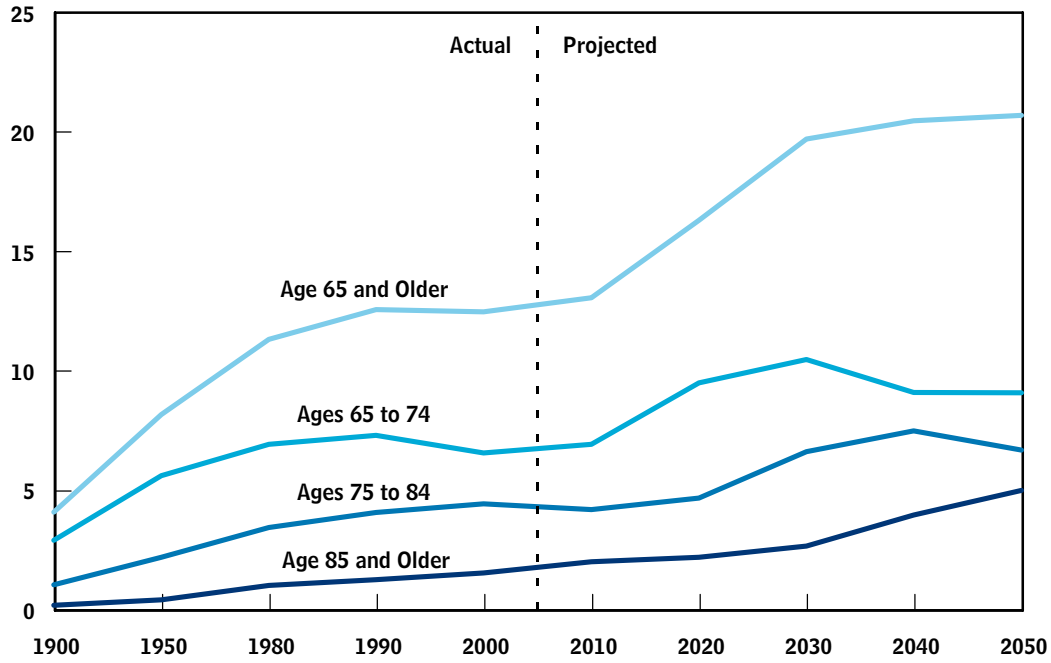
Revenues include payroll taxes and income taxes on benefits but exclude interest credited to the Social Security trust funds; outlays include scheduled Social Security benefits and administrative costs.

Under current law, outlays begin to exceed revenues starting in 2019; beginning in 2044, scheduled benefits cannot be paid.

**Figure 3.**

## People Age 65 and Older as a Share of the U.S. Population

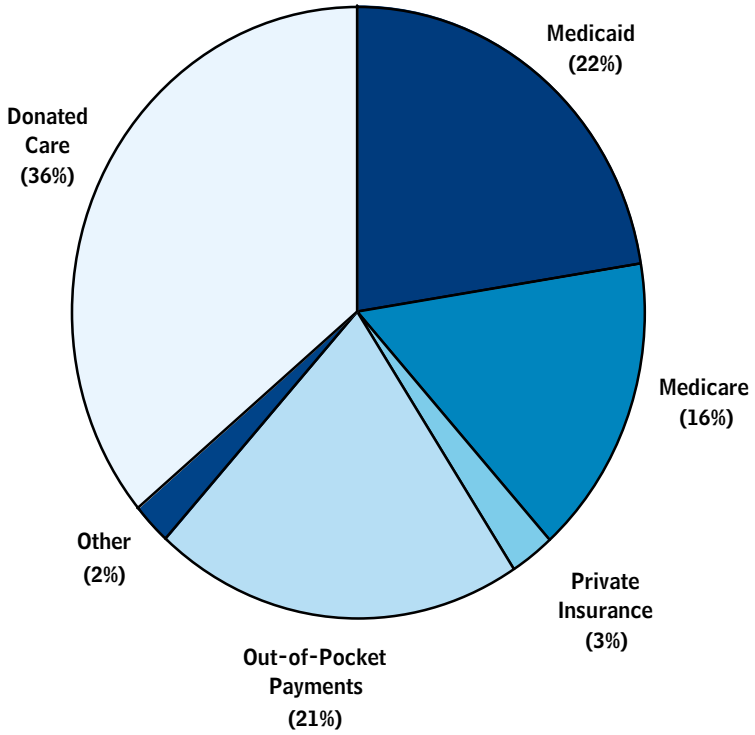
(Percent)




Source: Congressional Budget Office based on Bureau of the Census, *U.S. Interim Projections by Age, Sex, Race, and Hispanic Origin,* Table 2a, "Projected Population of the United States, by Age and Sex: 2000 to 2050" (March 18, 2004), available at www.census.gov/ipc/www/usinterimproj/natprojtab02a.pdf.

**Figure 4.**

## Estimated Percentage Shares of Spending on Long-Term Care for the Elderly, 2004

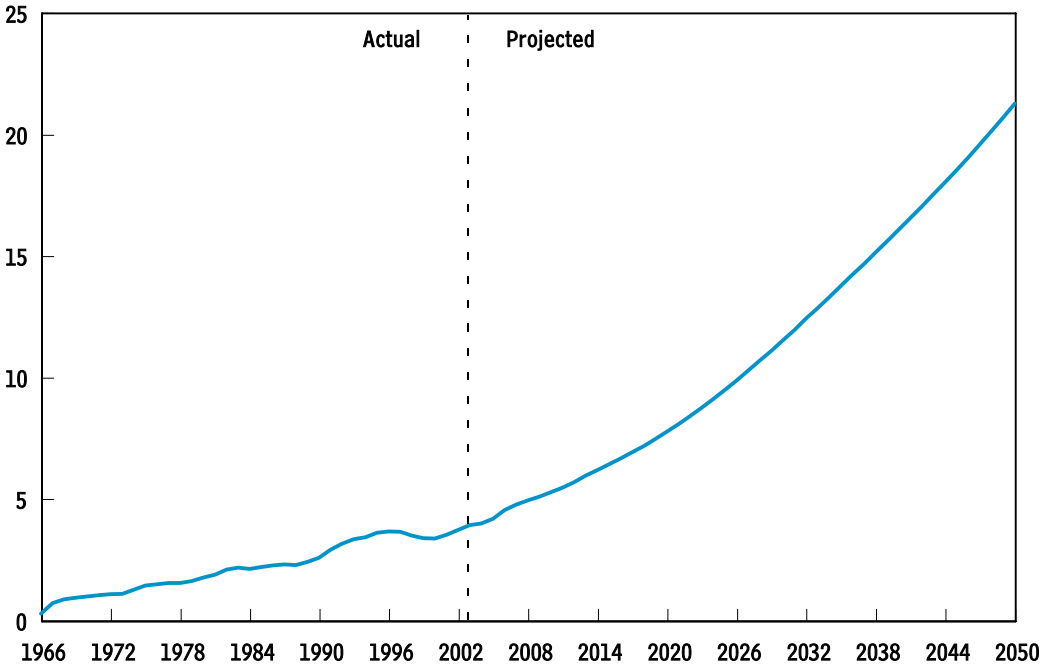



Source: Congressional Budget Office.

**Figure 5.**

## Total Federal Spending for Medicare and Medicaid

(Percentage of GDP)

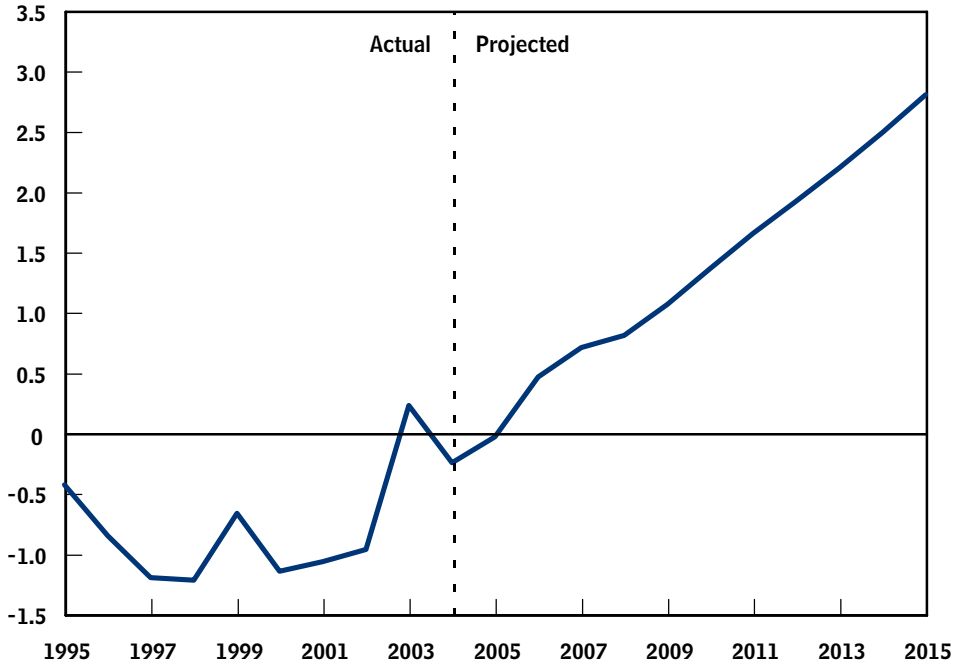



Source: Congressional Budget Office. See *The Long-Term Budget Outlook* (December 2003).

**Figure 6.**

## Net Outlays for the Pension Benefit Guaranty Corporation

(Billions of dollars)

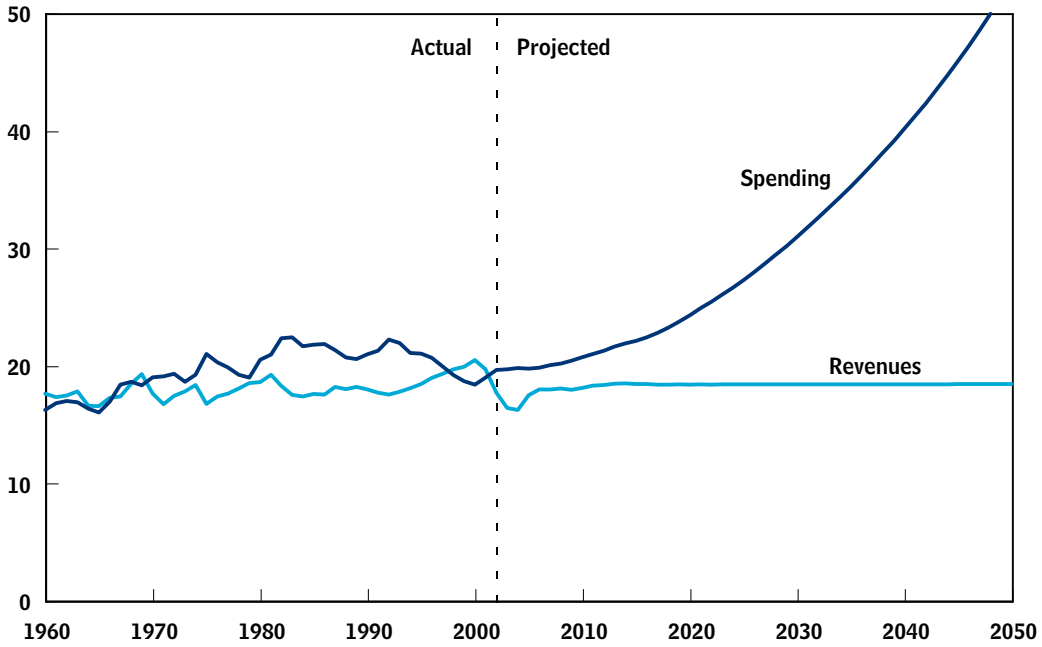



Source: Congressional Budget Office.

**Figure 7.**

## A Scenario for Total Federal Spending and Revenues

(Percentage of GDP)




Source: Congressional Budget Office.

Note: CBO categorized this scenario as one of high spending and lower revenues. The scenario is explained in detail in CBO, *The Long-Term Budget Outlook* (December 2003), pp. 6-12.

**Table 1.**

# Effective Federal Tax Rates and Shares of Federal Tax Liabilities, 2002

| Income Category | Millions of Households | Pretax Average Income (2002 dollars) | Effective Tax Rate for the Individual Income Tax | Pretax Share of Income | Share of Tax Liabilities Under the Individual Income Tax |
|---|---|---|---|---|---|
| Lowest Quintile | 22.6 | 14,400 | -6.0 | 4.2 | -2.6 |
| Second Quintile | 21.5 | 33,600 | -0.2 | 9.3 | -0.2 |
| Middle Quintile | 22.3 | 51,100 | 3.5 | 14.7 | 5.3 |
| Fourth Quintile | 21.7 | 75,900 | 6.8 | 21.2 | 14.8 |
| Highest Quintile | 22.8 | 175,900 | 15.6 | 51.5 | 82.8 |
| All Quintiles | 111.4 | 69,800 | 9.7 | 100.0 | 100.0 |
| Top 10% | 11.6 | 244,500 | 18.0 | 36.4 | 67.4 |
| Top 5% | 5.8 | 350,700 | 20.1 | 26.2 | 54.5 |
| Top 1% | 1.1 | 938,100 | 23.8 | 13.4 | 33.0 |

Source: Congressional Budget Office.

Notes: A household consists of the people who share a housing unit, regardless of their relationships.

Income categories are defined by ranking all people by their comprehensive household income adjusted for household size—that is, divided by the square root of the household's size. Quintiles, or fifths, contain equal numbers of people.

Comprehensive household income equals pretax cash income plus income from other sources. Pretax cash income is the sum of wages, salaries, self-employment income, rents, taxable and nontaxable interest, dividends, realized capital gains, cash transfer payments, retirement benefits plus taxes paid by businesses (corporate income taxes and the employer's share of Social Security, Medicare, and federal unemployment insurance payroll taxes), and employee contributions to 401(k) retirement plans. Other sources of income include all in-kind benefits (Medicare, Medicaid, employer-paid health insurance premiums, food stamps, school lunches and breakfasts, housing assistance, and energy assistance). Households with negative income are excluded from the lowest income category but are included in totals.