Jim Powell

What Would it Take to Cut Government Spending?

Runaway federal spending isn't likely to be brought under control as long as the major entitlements – Social Security, Medicare and Medicaid – remain out of control. The number of entitlement beneficiaries is growing faster than the number of taxpayers, entitlements account for more than half of federal spending, and unfunded liabilities (obligations not covered by payroll taxes) exceed $100 trillion.

To be sure, the Social Security and Medicare Boards of Trustees just released a report that tries to be upbeat, claiming Obamacare improves the long-term prospects of those entitlement programs. But readers who venture beyond the headlines find that the report is thoroughly hedged. For example, alleged benefits for Medicare are "premised on the assumption" that Obamacare would make the health care sector more efficient. Then the report concedes: "achieving this objective for long periods of time may prove difficult." If like so many government programs – including Social Security and Medicare – Obamacare doesn't work as advertised, "actual long-range costs would be larger than those projected." And of course, such speculation about Obamacare would end if it's struck down as unconstitutional.

There have been many thoughtful proposals about how to help the entitlements. Perhaps the most familiar is (1) enable younger workers to direct a significant portion of their payroll taxes into individually-owned retirement accounts that would be invested in a prudently-diversified portfolio to help provide for their retirement, and (2) have people who are or soon will be Social Security beneficiaries paid out of the government's general revenues. Another perennial recommendation: since people are living longer and often working longer, the age of eligibility for full Social Security benefits could be gradually pushed back a few years.

More controversial: indexing Social Security payments could be phased out, since it isn't fair or financially sustainable that working people — whose payroll taxes support Social Security — are exposed to inflation, while the rapidly-growing legions of beneficiaries are protected against inflation. Social Security and Medicare along with payroll tax revenue could be transferred to the states, so they could explore sustainable alternatives to the unsustainable current system. The federal government could give states Medicaid block grants rather than open-ended subsidies. Regardless of the merits, probably these and other proposals would encounter fierce resistance from beneficiaries screaming "Don't touch my Social Security!

Don’t touch my Medicare! Don’t touch my Medicaid!”

Because politicians seldom seem to care about much beyond the next election, they cater to interest groups that offer campaign contributions and/or votes. Politicians can’t say no to the well-heeled farm lobby that demands subsidies for only one third of one percent of the U.S. population, and they certainly can’t say no to the nearly 50 million Social Security beneficiaries, the nearly 50 million Medicare beneficiaries or the nearly 60 million Medicaid beneficiaries.

This means politicians are likely to continue resisting any proposed entitlement reform that might involve cutting payments, and they will continue to favor temporary fixes that involve raising payroll taxes to squeeze more money out of working people. But the higher tax rates go, the stronger the incentives people will have to modify their behavior in ways that reduce their tax liabilities. People will dump taxable corporate bonds and buy tax-free government bonds. More people will incorporate themselves to take advantage of tax breaks. More people – like doctors –will work fewer days each week or retire early. More business will be conducted off the books, on the black market and beyond easy reach of tax collectors. More funds will be transferred offshore for financial products structured to avoid IRS reporting requirements. Bottom line: ever higher tax rates will reach a point of diminishing returns when revenue declines. Taxes cannot save the entitlements.

Politicians will be under intense pressure to borrow more money for entitlements, but this will no longer be possible when investors lose confidence that they will be repaid. Then inflation will be the only way to keep the entitlements going. Government will expand the money supply. Rapidly-rising prices will become front-page news, and people will scramble for ways to keep up with inflation, since their pay will tend to lag behind. There will be a popular outcry for the government to “do something,” which invariably means price controls, wage controls, exchange controls, profit controls, rationing and other restrictions that throttle business, destroy private sector jobs and eventually bring on a depression. Indexing won’t protect entitlement beneficiaries from the ravages of inflation and depression, as Israeli experience during the 1980s made clear.

There will be escalating social conflicts. Probably the worst conflicts will involve entitlement beneficiaries battling taxpayers. Beneficiaries will view taxpayers as sullen servants. Taxpayers, forced to pay everybody else’s expenses as well as their own, will view beneficiaries as parasites. Beneficiaries are likely to use the force of numbers in an effort to intimidate taxpayers, and taxpayers might go on strike by reducing their tax liabilities, accelerating the financial collapse of entitlements. There will be potential for considerable violence. We could experience something like a civil war. If this seems far-fetched, just recall the violence that occurred in Greece during the past year when much less was at stake. Politicians announced they could no longer afford to give government employees 14 months' pay for 12 months' work. Instead government employees would have to live on 12 months' pay for 12 months' work, which provoked bloody riots.

Runaway spending crises ought to make clear that government really is broke. Not enough money can be squeezed out of taxpayers or coaxed out of lenders. Inflation wrecked the economy. Government's liabilities exceed its assets, and many of the assets (like money-losing government-run enterprises) cannot be easily sold to raise cash. In these circumstances, some entitlement beneficiaries might realize that reforms discussed for years – kept alive by market-oriented think tanks – are the least bad options for them. These options might provide something that would be better than nothing.

But reforms won't be easy to implement, because of the havoc brought about by runaway spending, taxing, borrowing and inflation. There are two main approaches to reform: go slow or go fast. The classic problem is that the pain (permanent spending cuts) comes before the gain (economic recovery). Companies that depended on constant infusions of more money will probably collapse if they can't adapt to new circumstances. Entitlement beneficiaries will be shocked by the reduction or suspension of their payments. Whether spending is cut slowly or quickly, most of the affected people will lobby aggressively against any cuts. A gradual reform plan will probably become bogged down by implacable resistance and little if anything will have been achieved. The best bet is generally "shock therapy" – cut spending, cut taxes and abolish price controls, wage controls and the other obstacles to enterprise, so that a recovery could begin as soon as possible, winning political support to sustain the reforms. The less an economy has been disrupted by misguided government policies, the better the prospects for reform.

So, it seems likely that few people will support fundamental entitlement reform until America is approaching a financial crisis or is actually going through a crisis. This doesn't make a crisis a good thing. A crisis is volatile. When other democracies have gone through such crises, sometimes a "strong man" has appeared, promising to restore order, and the result was authoritarian rule. In the U.S., the Great Depression spawned dangerous demagogues like Huey Long and Father Charles Coughlin.

A crisis is best-avoided, but it might become unavoidable because of the politicians who established financially-unsound entitlements and the beneficiaries who demanded entitlements-as-usual, regardless of the consequences.

Jim Powell's Biography
Jim Powell is a senior fellow at the Cato Institute in Washington DC.