ECONOMIC POLICY

IN A MORE UNCERTAIN WORLD

EXECUTIVE SUMMARY

Will Population Aging Push Us over a Fiscal Cliff?

by John Sabelhaus

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KEY FACTS

- The share of the US population age 65 and older is rising dramatically. In the year 2000, 12 percent of the population was over age 65; by 2040 nearly one in five Americans will be. Much of this aging has already occurred; in 2022, just over 17 percent of Americans are retirement age.
- Population aging is applying upward pressure on government deficits as a result of increased public spending on entitlement programs, including Social Security and Medicare, that are designed to support older Americans.
- An aging population is generally associated with slower growth in real output and incomes, and therefore lower income tax revenues per capita. If spending per capita remains unchanged, the budget will be pushed further into deficit which—in addition to the possibility that debt crowds out investment and slows economic growth—imposes a burden on future generations.
- The aging-related government expenditures explain a relatively small portion of the US debt trajectory. Unfunded spending in other, non-aging parts of the budget, along with recent tax policy changes, has shifted the burden of paying for government programs disproportionately onto the less wealthy or been deferred onto future generations.

Author John Sabelhaus proposes that government spending programs be evaluated based not only on their efficiency but also their distributional impacts, characterized through the lens of fiscal winners and losers. The principle of fairness suggests that the subset of the population that benefits most from a social insurance program or from public investments should be responsible for the costs when the investment returns are realized. Sabelhaus also discusses how the distributional perspective on government deficits and debt should affect policy views about fiscal policy in response to the population aging. He argues that if the public debate ignores the other drivers of government deficits and debt—including a shrinking of the income tax base—and focuses only on changes to aging-related programs including Social Security and Medicare, then the country runs the policy risk of undoing or foregoing otherwise desirable government policies.

THE DISTRIBUTIONAL LENS

Sabelhaus distinguishes policy analysis through a distributional, rather than an affordability, lens, highlighting the need to consider whether the costs and benefits from government programs are matched across and within generations. Similarly, he argues that measuring redistribution—the process by which the government takes economic resources from one group and gives those resources to another—is key to understanding fiscal winners and losers in current and future economies.

Social Security and major government health programs such as Medicare have accounted for roughly half of all federal outlays in recent (non-pandemic) years and are expected to contribute to increased government spending in the coming decades. Because total spending over time must equal total revenues, fiscal imbalances today will be resolved by some combination of higher taxes or diminished benefits. The most important question facing policymakers is whose taxes to increase or whose benefits to cut.

Social Security and Medicare exist to improve economic welfare, requiring that their overall net benefits exceed their costs. Social Security redistributes from lifetime high-earners to lifetime low-earners within each generation, and both Social Security and Medicare generate redistribution across generations. For example, a generation of retirees may be receiving more in Social Security and Medicare benefits than they paid in taxes while they were working, and that redistribution is being paid for by current and future workers. The extent of this redistribution is largely determined by policy changes and by factors such as the pace of health cost growth.

POLICY IMPLICATIONS

To address increased fiscal pressure from an aging population, author John Sabelhaus emphasizes the importance of devising better distributional measures that can help elucidate how changes in taxes and benefits will impact individuals across and within birth cohorts.

Measuring Redistribution: Public discourse over health spending is distorted by a disconnect between the taxes people perceive they are contributing into government programs relative to the benefits they are receiving from them. Sabelhaus argues that CBO should be resourced to regularly measure the distributional impacts of other government programs, existing or proposed, beginning with healthcare programs. Analysts should also measure whether those groups benefiting from costly programs with high rates of return, such as infrastructure and technology investment, are paying a fair share of those programs' costs. These evaluations should be based on comprehensive measures of group incomes, and not on the biased income measures currently used in the personal, corporate, and estate tax systems.

Measuring the Net Benefit of Government Programs: Comparing a government program's costs and benefits is key to understanding whether that program should exist and at what scale. When an existing or proposed government program has a demonstrably high rate of return, that is generally indicative of some form of market failure—otherwise private industry would have already moved to take advantage of the potential investment opportunity. Social Security is a prime example of why policymakers ought to consider both net benefits and distributional impacts when making program decisions related to population aging. Population aging has shifted the balance between inflows and outflows, with Baby Boomers currently on track to receive more benefits than they put into the system, on average, and thus redistribute resources away from future generations. Rising life expectancies may justify reducing future benefits by delaying the retirement age, or alternatively, raising working-age taxes to keep benefits unchanged. A declining worker-to-beneficiary ratio will require some beneficiaries to be taxed more or receive less, on average, across and within generations.

“What We Can Afford” versus Matching Costs and Benefits: Many politicians argue that the government can’t afford to expand or even to continue some types of age-related social programs, and that further increasing government debt risks doing irreparable harm to long-term economic growth, diminishing our ability to afford even basic government programs in the future. Examining government programs through a redistributive lens provides an alternative to the macroeconomic affordability criteria by determining whether a program is sustainable based on if that program improves welfare by correcting a market failure (such as by providing insurance value in the case of Social Security or health programs) or has a high return on investment (such as in technology or infrastructure investments). Yet, even when an existing or proposed government program produces a positive net benefit as viewed through the lens of traditional public economics, Sabelhaus argues that an important follow-up question is whether the costs and benefits are matched across and within generations.

ABOUT THE AUTHOR

John Sabelhaus
Nonresident Senior Fellow, Brookings Institution

John Sabelhaus is a nonresident senior fellow at the Brookings Institution in Washington, D.C. and adjunct research professor at the University of Michigan. He also provides independent consulting to groups such as the U.S. Census Bureau (through the Mitre Corporation), AARP Public Policy Institute, Economic and Social Development Canada, and the U.S. Securities and Exchange Commission (through NORC). John was a visiting scholar at the Washington Center for Equitable Growth in 2019 and 2020. Prior to that, he was assistant director in the Division of Research and Statistics at the Board of Governors of the Federal Reserve System. John's roles at the Federal Reserve Board included oversight of the Microeconomic Surveys and Household and Business Spending sections, including primary responsibility for the Survey of Consumer Finances. Prior to joining the Federal Reserve Board staff, John was a senior economist at the Investment Company Institute and Chief of Long Term Modeling at the Congressional Budget Office, where he oversaw the development of an integrated micro/macro model of Social Security and Medicare. He also served as an adjunct in the Department of Economics at the University of Maryland between 1999 and 2018. John received his Ph.D., M.A., and B.A. in economics from the University of Maryland.

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