

# ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

## Health Care Reform from a Generational Perspective

by David Altig and Jagadeesh Gokhale

**E**very so often in the course of public affairs, we reach a defining moment, beyond which our final decisions have the potential to shape legislative and cultural reality for decades to come. In federal health care reform, that moment may be at hand.

The eventual scope of these decisions is, as yet, unclear. Congressional acquiescence to certain elements of President Clinton's reform blueprint, such as mandatory participation in regional health alliances, seems very much in doubt. Other major components remain in the mix, however, including required basic benefit packages, universal coverage, the enshrinement of employer-based insurance arrangements, portability of coverage, and financing schemes that rely heavily on an expanded payroll tax.

The rationales for contemplating so profound a change in American life are many, but there can be little doubt that mounting expenditures for government health care have commanded the attention of the electorate and its designated representatives. As figure 1 illustrates, health-care-related outlays represent the only major federal spending category projected to rise as a share of total output through the beginning of the next century. In fact, by fiscal year 2004, the Congressional Budget Office projects that Medicare and Medicaid expenditures together will make up a larger share of GDP than all of discretionary spending combined.<sup>1</sup>

This outlook underlies the widespread political acceptance of the President's call for action. Whether driven by a belief that health care delivery systems are fundamentally broken and in need of a major overhaul or by the sentiment that the medical environment is inherently sound but in need of fine-tuning, legislators have acknowledged the prospect of persistent and increasing fiscal pressure associated with federal health care programs, and the necessity of doing something about it.

Popular discussion of government health care spending trends typically focuses on the implied path of federal deficits. However, even if fully financed by pay-as-you-go legal restrictions—which are void of deficit implications—the outlay patterns shown in figure 1 will have substantial redistributive and allocative consequences, the effects of which are the true measure of any public policy.

Of particular consequence is the fact that current policies imply significant redistributions of wealth across different generations, redistributions to which Medicare and Medicaid trends contribute a large share. This is the focus of our concern in this *Economic Commentary*—scoring the effects of health care reform with respect to intergenerational tax burdens.

**Through the beginning of the next century, the only major federal spending category projected to rise as a share of output is health care expenditures. As Congress debates the merits of different reform proposals, the potential redistributive effects of any policy change should be kept at the forefront of discussion. Generational accounts, which emphasize the explicit path of revenues and transfers that certain age groups can expect to pay and receive, provide a much clearer view of policy-induced intergenerational redistributions than is evident from the usual focus on the size of deficits. Here, the authors examine the tax burdens that are likely to arise under the President's reform proposal as well as under two alternatives, one more restrictive and one less restrictive than the Clinton plan.**

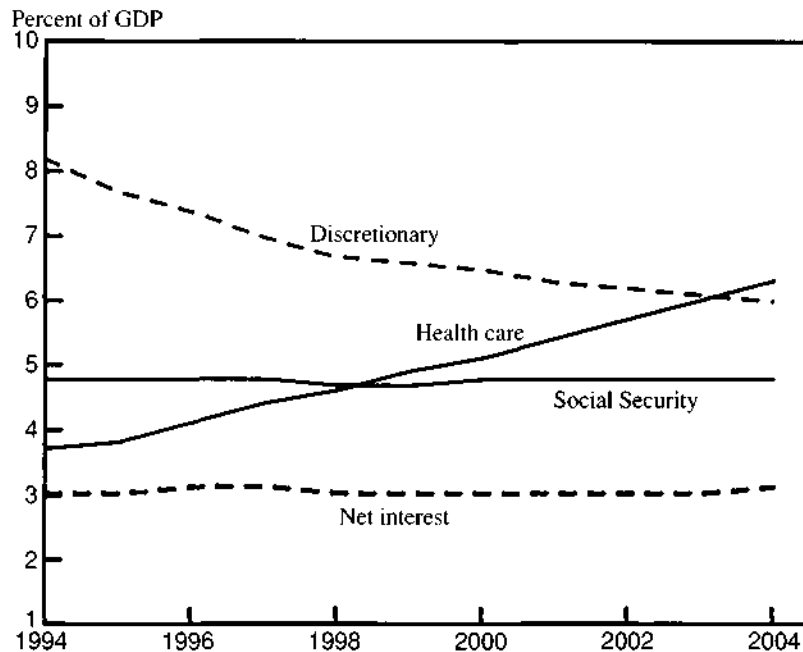
## ■ Redistribution across Generations via Fiscal Policy

A cursory look at federal budgetary aggregates confirms that, today, the redistributive activity of the federal government overshadows its role as a provider of public goods and services: More than half of all federal outlays in fiscal year 1995 are likely to be disbursed as direct benefits to individuals.<sup>2</sup> For the purposes of this article, the important dimension of these activities involves the redistribution of resources across different generations. Measuring the extent of such redistribution is the focus of generational accounting.<sup>3</sup>

A generational account is an estimate of the present value of taxes net of transfers that members of a given generation are projected to pay, on average, over the remainder of their lifetimes—their *net tax payment*. Under the assumption that current tax and transfer policies remain in effect for living generations throughout their lifetimes, and that the current policy for government spending on goods and services is maintained, generational accounting also provides an estimate of the net tax burden that must be imposed on future generations in order to balance the government's books over time.<sup>4</sup>

This framework allows us to ask, among other questions, whether a proposed set of policy changes will make the distribution of net tax burdens among living and future generations more balanced. Many different interpretations of "balance" are possible in fiscal policy. Most intuitively appealing is that of imposing equal lifetime net tax burdens on living and future generations after adjusting for economic growth.<sup>5</sup>

FIGURE 1 PROJECTED OUTLAYS AS A SHARE OF GDP, 1994-2004



SOURCE: Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1995-1999*, January 1994.

Concern with intergenerational equity, however, is not the sole motive for seeking a balanced policy. A severely imbalanced distribution of net tax burdens—say, one favoring current over future generations—is likely to encourage greater consumption, reduce capital formation, and dampen future generations' incentives to work and save, thereby reducing prospective standards of living.

By emphasizing the explicit path of revenues and transfers that certain age groups can expect to pay and receive (given specific policy assumptions), generational accounts provide a much clearer view of policy-induced intergenerational redistributions than is evident from the more common focus on the size of deficits.<sup>6</sup> Because the benefits from government spending are not included in these estimates, they are best suited to analyses of fiscal policies that affect revenues or transfer outlays only—which is exactly the case with respect to proposed health care reforms.

Using this device of generational accounting, we can examine the change in lifetime net tax payments associated with federal health care outlays as projected under the Clinton plan relative to current policy. Although we do not have sufficient information to provide the same detailed examination of other specific reform proposals, we do calculate, as points of reference, changes in intergenerational tax burdens for two hypothetical alternatives. The first stabilizes health care expenditures at an assumed rate of per capita productivity growth of 0.75 percent—which is more restrictive than the Clinton plan—and the second increases the growth of total Medicare and Medicaid outlays at a rate 2 percent faster than the administration's proposal during the first two decades of the next century. Before turning to these alternative paths, we consider a set of baseline accounts in order to establish perspective.

**TABLE 1 BASELINE GENERATIONAL ACCOUNTS**  
(Thousands of 1992 dollars)

Generation's Age in 1992	Net Tax Payments	
	Male	Female
0	78.4	44.1
10	124.8	67.3
20	187.7	96.9
30	201.6	69.1
40	170.9	2.4
50	81.0	-86.3
60	-43.9	-124.6
70	-98.6	-100.5
80	-79.4	-11.3
Future generations	177.1	99.6
Imbalance	126.0%	126.0%

NOTE: Numbers represent the present value of net taxes under post-OBRA 1993 policy. Percent changes may not be exact due to rounding.

SOURCES: Office of Management and Budget (see footnote 2); and authors' calculations.

#### ■ Generational Accounts under Current Policy

Our baseline accounts are derived under the assumption that current policies, including the changes enacted under the Omnibus Budget Reconciliation Act (OBRA) of 1993, are maintained into the future. Table 1 shows per capita net tax payments of selected generations *over the balance of their expected lives*.<sup>7</sup> The entry for "future generations" refers to the net tax payments of Americans born in 1993, assuming that the government's long-run budget is balanced (in a present-value sense) and that, after adjusting for productivity growth, all future generations share equally in the burden imposed by this constraint.

Under current policy, future generations are slated, on average, to bear a 126 percent larger tax bite relative to current newborns.<sup>8</sup> Underlying this number is a reality already understood by most observers and policymakers:

**TABLE 2 NET TAX BURDENS OF FUTURE GENERATIONS**  
(Thousands of 1992 dollars)

Policy Option	Net Tax Payments		Change Relative to Baseline		Generational Imbalance <sup>a</sup>
	Male	Female	Male	Female	
Current policy baseline	177.1	99.6	—	—	126.0
Clinton health care proposal	144.7	79.7	-32.4	-19.9	73.9
Stable health care expenditure growth after 1994	97.6	57.2	-79.5	-42.4	13.6
Health care expenditure growth 2 percent higher than Clinton plan	165.5	88.2	-11.6	-11.4	108.8

a. Percentage difference in net tax payments of future generations relative to generation born in 1992.

SOURCES: Office of Management and Budget (see footnote 2); and the Federal Reserve Bank of Cleveland.

Expected growth in entitlement spending, especially for Medicare and Medicaid, and in the relative size of elderly generations over the next few decades is at the root of the huge generational imbalance facing the nation's fiscal affairs.

#### ■ The Clinton Plan

Here, we consider the generational impact of the President's health reform proposal, using the administration's projections of changes in revenues and expenditures as if the plan will be implemented as proposed.<sup>9</sup> We consider only the *public* taxing and spending component, and do not pass judgment on either the feasibility of the proposal's elements or their desirability.<sup>10</sup>

As shown in figures 2 and 3, the Clinton plan would increase the net tax burdens on living generations. As may be expected, generations close to retirement bear most of the burden from reduced benefits. For 60-year-old males, the implied restrictions on government health care outlays raise net tax burdens by \$8,800. Because females have a longer life expectancy, the spending constraints exact an even greater toll: The average 60-year-old woman would see a \$12,000 increase in her net tax payment.

As a result of the reduction in public benefits accruing to living generations, the Clinton proposal would substantially reduce the per capita net-payment burden on future generations. While the generational imbalance—the percentage difference in net tax payments of future generations relative to the generation born in 1992—is still almost 74 percent, this compares favorably to 126 percent under current policy (see table 2). Thus, taking the administration's projections at face value, these experiments suggest that, from the perspective of addressing the generational imbalance in existing policy, the Clinton plan moves in the right direction.

#### ■ A More Restrictive Alternative

In figures 2 and 3 and table 2, we also report the estimated generational impact of a policy (more restrictive than the Clinton reform proposal) that would, beginning in 1994, stabilize the growth of Medicare and Medicaid spending at a rate that would accommodate growth in the eligible population and allow per capita benefits to expand at the average rate of productivity growth, assumed to be 0.75 percent per year.<sup>11</sup>

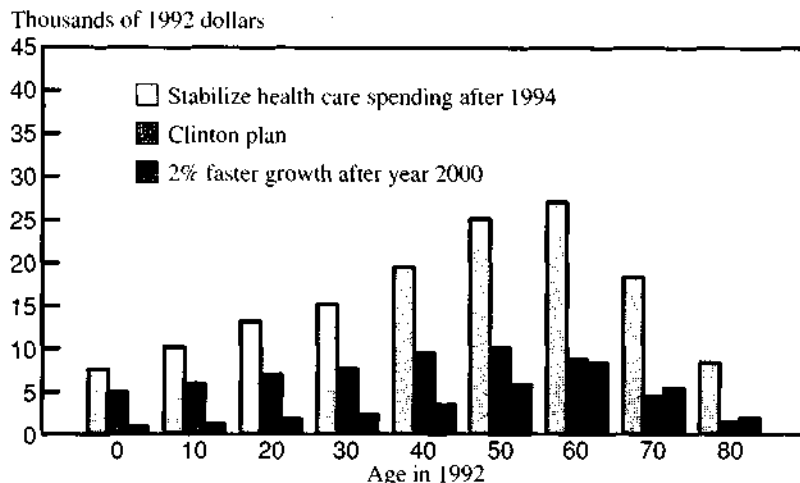
For most of the population, the effects of such a policy are more than twice as large as those implied by the Clinton plan. For instance, the increase in the present-value burden on 60-year-old males is a sizable \$27,000; 60-year-old females would lose approximately \$36,000 in the present value of reduced benefits. As a consequence, the generational imbalance in fiscal policy would be substantially mitigated: The lifetime net payments of future generations would be a mere 14 percent larger than those of the generation born in 1992.

**■ A Less Restrictive Alternative**

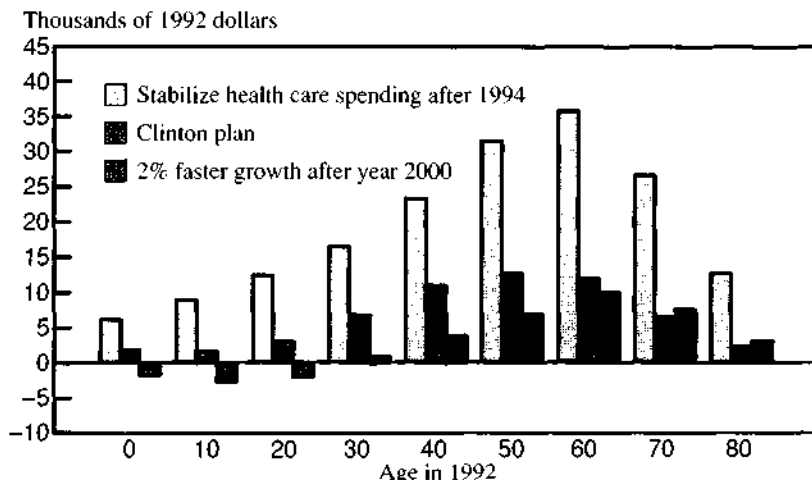
The growth of health care expenditures under the new system is subject to a large degree of uncertainty. Accordingly, we also report the generational implications of a somewhat higher rate of outlay growth than found in the administration's proposal. Assuming a 2 percent faster growth pattern in health care expenditures for two decades beginning in the year 2000 (relative to the post-reform spending estimates) reduces the additional burden considerably on all except today's oldest generations. In fact, the net payment burdens of younger living generations would actually decline under such a policy.<sup>12</sup>

It follows, of course, that the advantage of reforms in terms of lessening future generations' per capita burden is less than in the Clinton plan. If Medicare and Medicaid spending were, by design or bad luck, to exceed the administration's guesses by just 2 percent per year, the generational imbalance of fiscal policy would rise to 108 percent.

**FIGURE 2 CHANGES IN NET TAX BURDENS FOR MALES UNDER ALTERNATIVE HEALTH CARE SPENDING PATHS**



**FIGURE 3 CHANGES IN NET TAX BURDENS FOR FEMALES UNDER ALTERNATIVE HEALTH CARE SPENDING PATHS**



SOURCES: Office of Management and Budget (see footnote 2); and authors' calculations.

## ■ Conclusion

Continuing on our current policy path for public health care spending is likely to prove economically hazardous. The projected explosion in expenditures is a major contributor to the imbalance in lifetime fiscal burdens between living and future generations. The direct wealth redistribution toward older generations implicit under the current framework may be reinforced over time as the induced greater consumption may slow the pace of capital formation and lower future productivity.

If implemented as projected, the public spending restrictions in the Clinton plan would reduce the net payments of future generations between 18 and 20 percent, while increasing those of all living generations. The effects are more dramatic for a policy that would stabilize the ratio of health spending to GDP, but quite a lot less if they exceed the administration's projections by 2 percent per year from the years 2000 to 2020.

These estimates obviously abstract from other important aspects of the reform proposals wending their way through Congress, such as the impact of the proposed interventions on private insurance and delivery systems. We believe, however, that some reform of federal health care programs is almost inevitable, and that the perspective afforded by our generational accounting exercise is critical in evaluating policies that will fundamentally affect a huge share of our nation's resources.

## ■ Footnotes

1. Discretionary spending includes all outlay categories subject to the annual appropriations process.
2. See Office of Management and Budget, *Budget of the United States Government, Analytical Perspectives, Fiscal Year 1995*, Washington, D.C.: U.S. Government Printing Office, 1994, p. 12.
3. For a background on the generational accounting method and related topics, see the following issues of the Federal Reserve Bank of Cleveland's *Economic Commentary* series: Alan J. Auerbach, Jagadeesh Gokhale, and Laurence J. Kotlikoff, "Generational Accounts: A New Approach to Fiscal Policy Evaluation," November 15, 1991; David Altig and Jagadeesh Gokhale, "An Overview of the Clinton Budget Plan," March 1, 1993; and David Altig and Jagadeesh Gokhale, "The Budget Reconciliation Act of 1993: A Summary Report," October 15, 1993.
4. The estimate of the net tax burden on future generations incorporates an adjustment for expected economic growth.
5. For a more thorough discussion of this issue, see Laurence J. Kotlikoff and Jagadeesh Gokhale, "Passing the Generational Buck," *The Public Interest*, no. 114 (Winter 1994), pp. 73-81.
6. Laurence J. Kotlikoff presents a detailed critique of the deficit as a measure of the government's fiscal policy performance in "Deficit Delusion," *The Public Interest*, no. 84 (Summer 1986), pp. 53-65.
7. These baseline estimates are the same as those published in *Budget of the United States Government, Analytical Perspectives, Fiscal Year 1995*, chapter 3. They differ from those published a year ago (see footnote 3) because they employ actual revenue and spending aggregates for 1992, new projections of these aggregates for future years, and technical improvements in the estimating procedure. In particular, the current estimates employ more realistic assumptions regarding the growth rate of state and local Medicaid expenditures for future years. An additional difference is that current fiscal treatment is extended to one more generation—that born in 1992. The net tax payment attributed to this generation is reduced relative to a year ago, thus increasing the per capita burden on future generations.

8. It is not valid to compare future generations' net tax burden with that of any generation other than current newborns: Because these calculations are prospective, we do not account for taxes paid in the past by other living generations.

9. The effects of health care reform are estimated using the administration's projections of revenues and expenditures until the year 2000 and rough projections thereafter. Health care expenditures are subjected to a level increase in 2001 to account for a scheduled expansion in the standard benefit package. Thereafter, these outlays are assumed to grow at the rate of overall productivity increase per capita, plus growth due to changes in the age and sex composition of the population.

10. The health care reform proposals contain provisions that are likely to change private incentives substantially, the effects of which are not included in our calculations. For example, this experiment does not account for the proposals' consequent effects on employment and retirement behavior.

11. We do not implicitly support or advocate the policies in these experiments: We perform the calculations only to estimate the size of the generational imbalance that would be eliminated by these alternatives. Obviously, reductions in spending on other items would also reduce the imbalance.

12. The 2 percent faster growth is assumed for two decades after the year 2000. This, in effect, reduces the benefits to the current elderly but increases the benefits received by today's younger Americans in their retirement years. The burden on future generations is lower because current generations as a whole contribute more in net taxes.

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The views stated herein are those of the authors and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System

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