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PAY-AS-YOU-GO ENTITLEMENTS, THE BABY-BOOM, AND THE FEDERAL BUDGET — FACING UP TO REALITY

The United States is in a deepening fiscal crisis that the much hyped budget agreements of 1990 and 1993 have done little to avert. In order to secure the vital vote of Sen. Robert Kerrey (D-Neb.) for the 1993 budget, the administration and congressional leadership had to agree to the creation of a bipartisan commission to study the problem of entitlements growth.

That commission has been collecting the facts (which are discussed below), but so far has failed to recognize the clear implications of the coming retirement of the baby-boom generation. Demographically, it will simply be impossible to pay for that population's health care and retirement with a pay-as-you-go system. Instead, the commission seems to be trying to preserve pay-as-you-go through tax increases and benefit cuts in a futile effort to chase demographically driven cost increases. In fact, the baby-boom generation cannot be retired under Social Security without ruinous economic consequences unless the Social Security System is converted to a true saving system.

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The most serious consequence of pay-as-you-go financing has been its effect in driving down private saving and increasing consumption. Net private saving has been falling for more than a decade, and last year was only 2.7% of gross domestic product (GDP). This is down from 8% only 30 years ago. The decline in private saving has closely paralleled the sharp increases in payroll taxes necessary to continue pay-as-you-go financing of Social Security.

Institute for Research on the Economics of Taxation

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Lower saving and investment mean less capital at the disposal of the American worker, which means lower worker productivity, and therefore lower real wages. As a result of the saving decline, net domestic investment has fallen to 3.8% of GDP, or about half the levels of the 1960s. Real wages, which were growing at 3% in the 1960s, grew at only 0.7% last year.

The counterpart of this poor saving record is record consumption, driven by enormous transfers from the working young to the elderly through pay-as-you-go Medicare and Social Security benefits. These transfers have outstripped public willingness to pay for them through taxes, and we are left with rising government deficits. (Chart 1) Since 1960, the population has increased by 41%, GDP has nearly tripled, but total government social spending has increased five times.

Mandatory and entitlement spending, which consumed about 30% of the federal budget in 1963, today accounts for over 60%. By 2003, it is projected to reach 72%. (Chart 2) We are reaching the point where by the year 2030, entitlements alone will be more than revenues, with nothing left over to pay for net interest or discretionary government (defense, general government, etc.). (Chart 3)

This situation is brought about primarily by demographics. The increase in longevity, coupled with the population bulge of the baby-boom, means that there simply will not be enough people working in the early part of the next century to pay for the health care and retirement of the elderly population under a pay-as-you-go system. In 1950, there were 7.3 working age people for each person over 64; in 1990 there were only 4.8, and by 2030, there will be 2.8.

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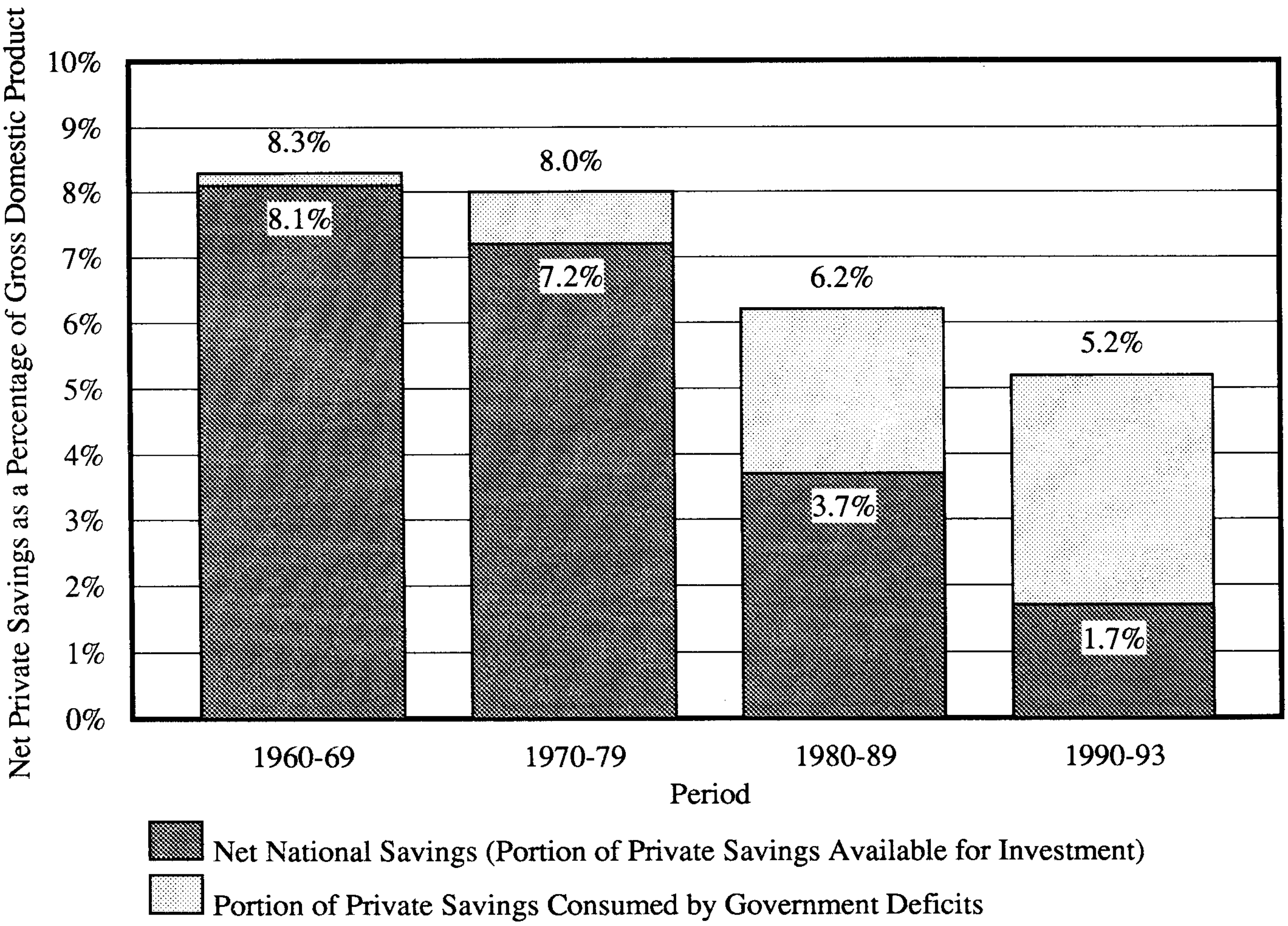
The current surplus in the Social Security Trust Fund will quickly be exhausted as the baby-boom retires. Every year the long range projections for solvency have been getting worse. In 1985 the Social Security Trustees projected exhaustion in 2049. This year, exhaustion is estimated in 2029. (Chart 4) In reality, the crisis is much closer because the Trustees estimate that Social Security will begin running an operating deficit in 2013. (Chart 5)

To put the matter another way, the huge gap between outlays and revenues that will result from attempts to continue pay-as-you-go (Chart 6) imply a doubling of current tax burdens. Anyone contemplating such a result should realize that the baby-boom generation cannot be retired on pay-as-you-go. We will have to turn to the obvious, as some other countries have done. When you are faced with the need for extraordinary future outlays that cannot be financed with expected levels of

Chart 1
Falling Private Savings And Rising Government Deficits Mean Less Private Savings Available For Investment

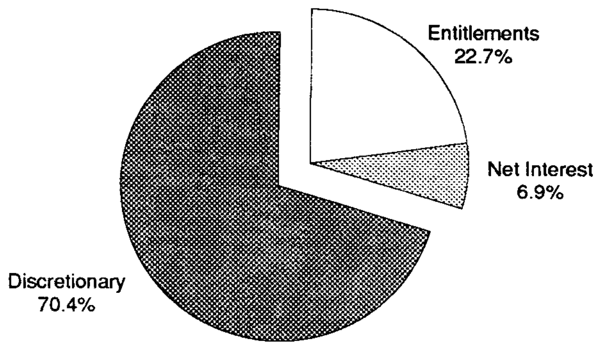


Over the past three decades, net private savings (household savings plus undistributed corporate profits) have declined from more than 8% of GDP to about 5% of GDP today. At the same time, government budget deficits (Federal deficits less state and local budget surpluses) have consumed an increasing portion of our remaining private savings. As a result, net national savings (private savings that are available for private investment) have dropped from more than 8% of GDP to less than 2% of GDP today.

Source: Bipartisan Commission On Entitlement And Tax Reform

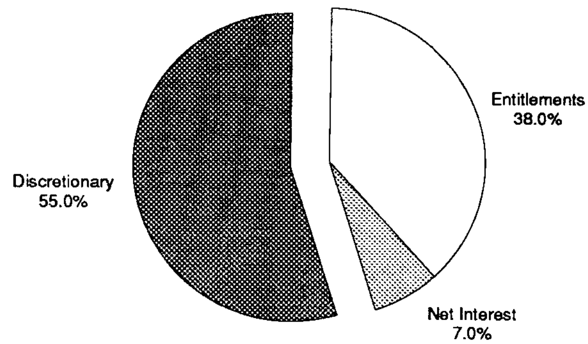
Chart 2
Growth Of Mandatory Spending In The Federal Budget
1963-2003

FY 1963



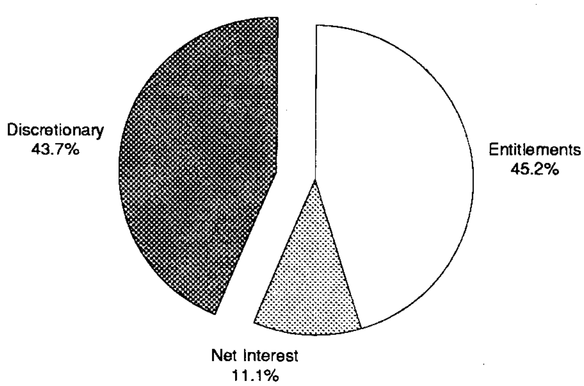
Mandatory Spending 29.6%

FY 1973



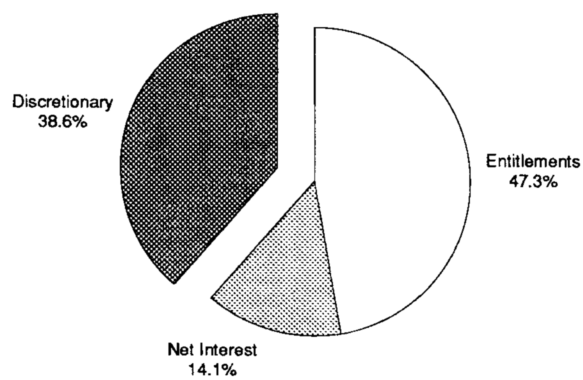
Mandatory Spending 45.0%

FY 1983



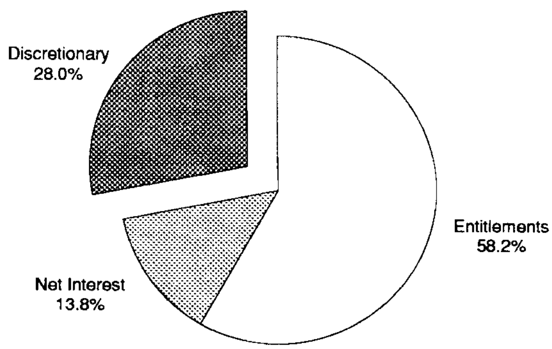
Mandatory Spending 56.3%

FY 1993



Mandatory Spending 61.4%

FY 2003 (Projected)

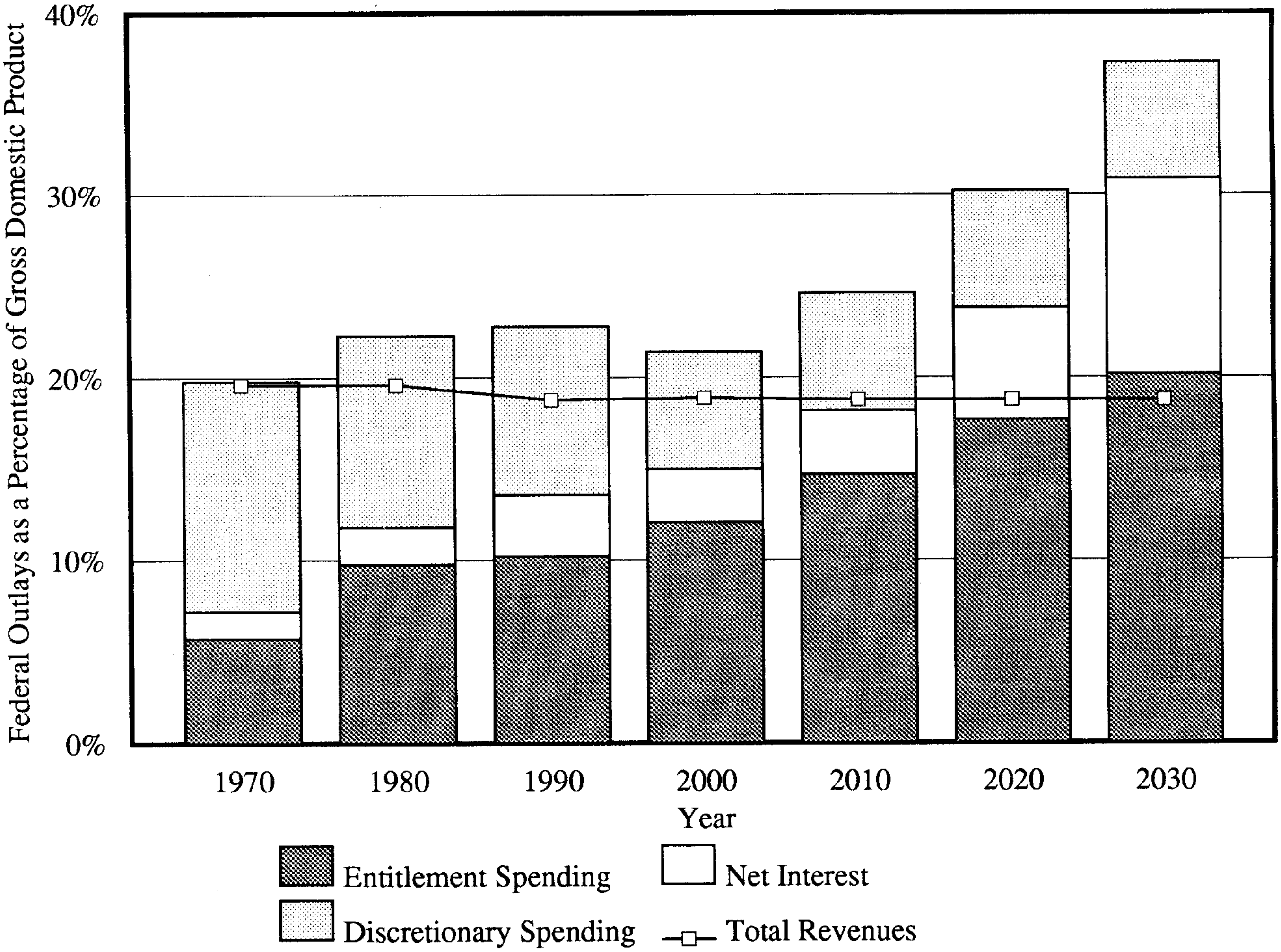


Mandatory Spending 72.0%

In 1963, mandatory spending (the sum of entitlement and net interest outlays) was less than 30% of the Federal budget and discretionary spending was more than 70%. According to the Congressional Budget Office, those percentages will be reversed by 2003.

Source: Bipartisan Commission On Entitlement And Tax Reform

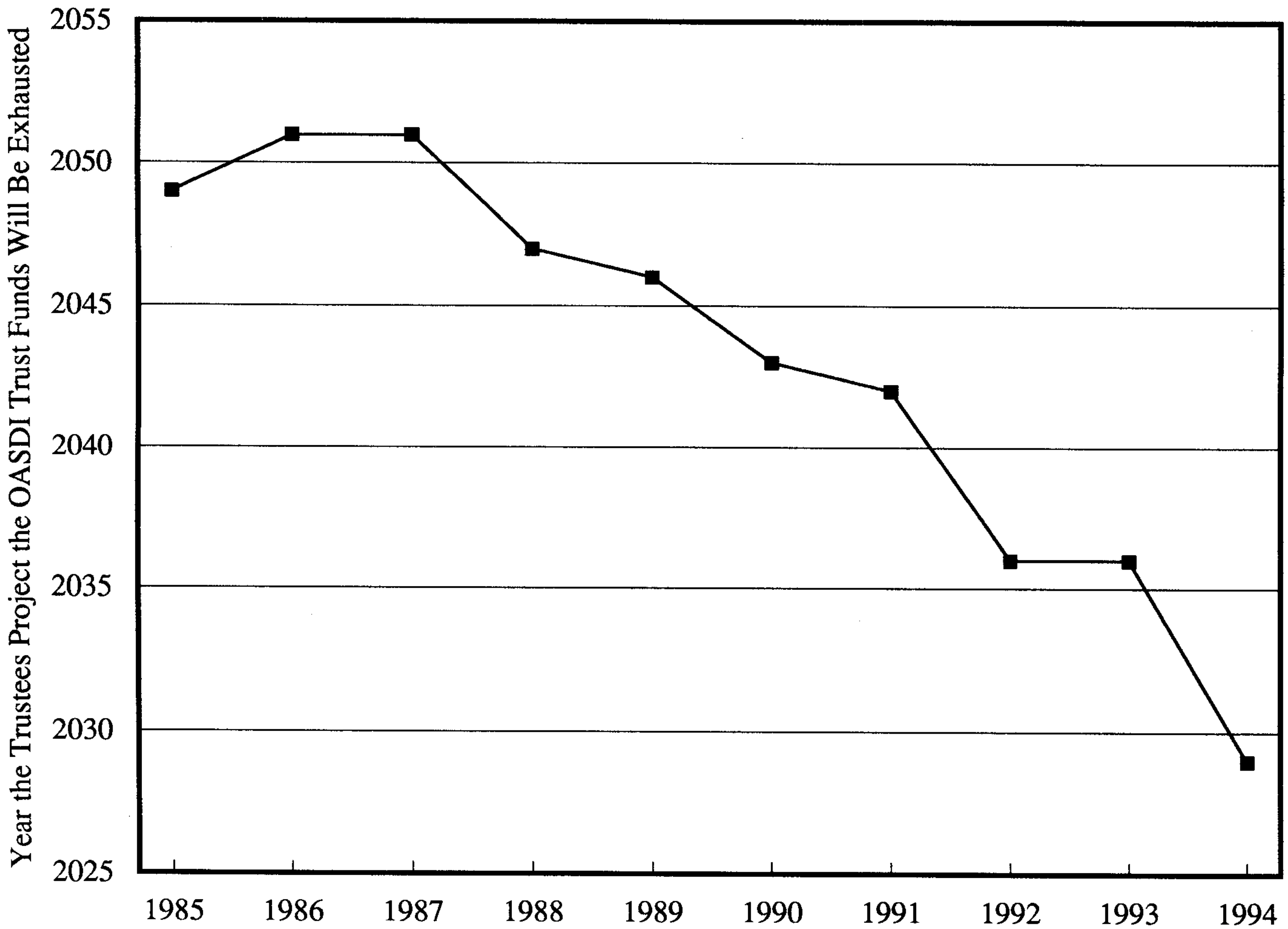
Chart 3
The Present Trend Is Not Sustainable



The gap between Federal revenues and spending is growing rapidly. Absent policy changes, entitlement spending and interest on the national debt will consume almost all Federal revenues in 2010. In 2030, Federal revenues will not even cover entitlement spending.

Source: Bipartisan Commission On Entitlement And Tax Reform

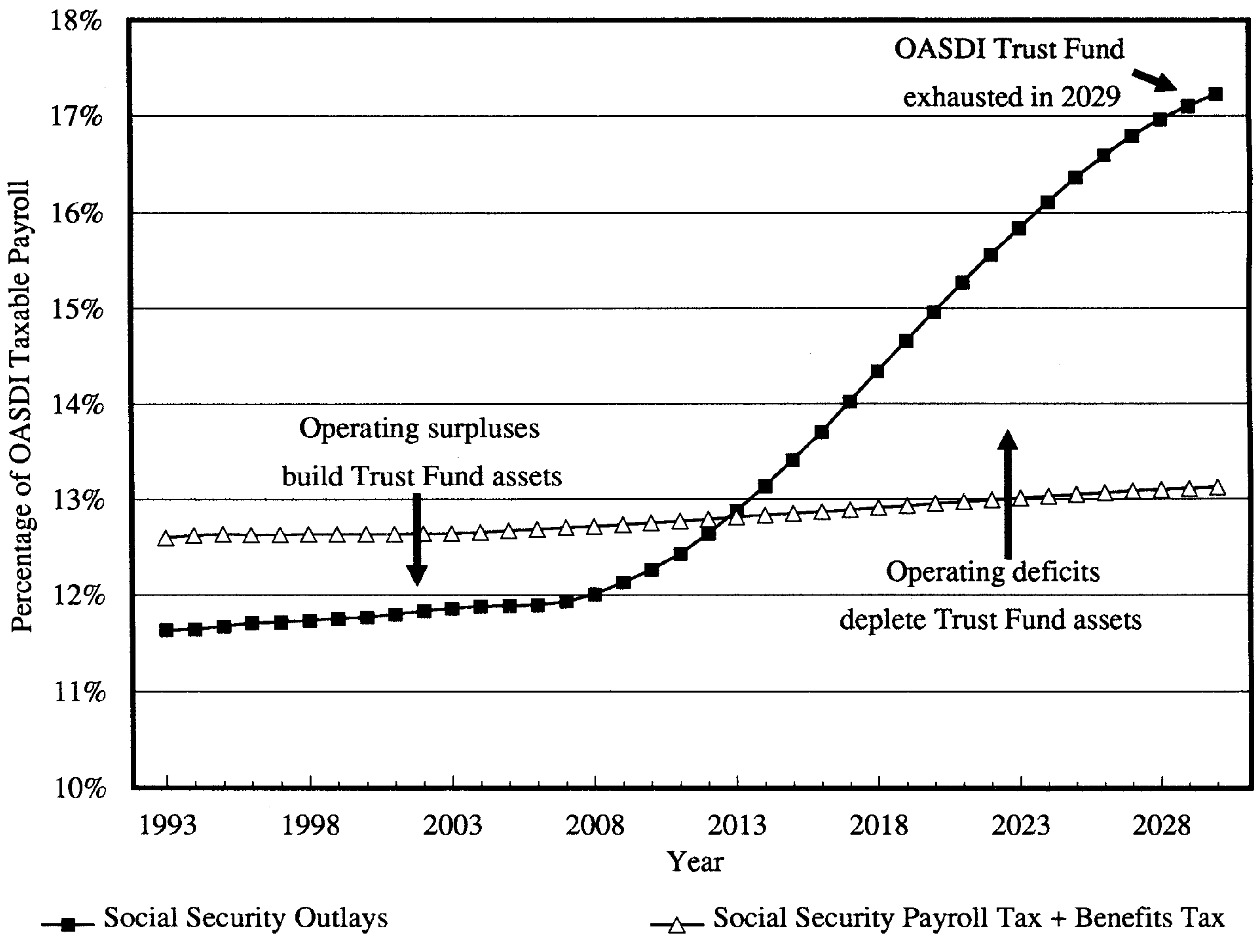
Chart 4
Long-Range Projections About The Solvency Of Social Security Have Been Getting Worse



Each year, the Social Security Trustees report on the long-run (75 year) sustainability of the OASDI program. Since 1985, the Trustees have concluded that in the long run, Social Security taxes will not support the benefits that have been promised. The date the Trustees project that the Social Security Trust Fund will be exhausted has been approaching rapidly. In 1985, they estimated exhaustion in 2049. In 1994, the Trustees estimated exhaustion in 2029.

Source: Bipartisan Commission On Entitlement And Tax Reform

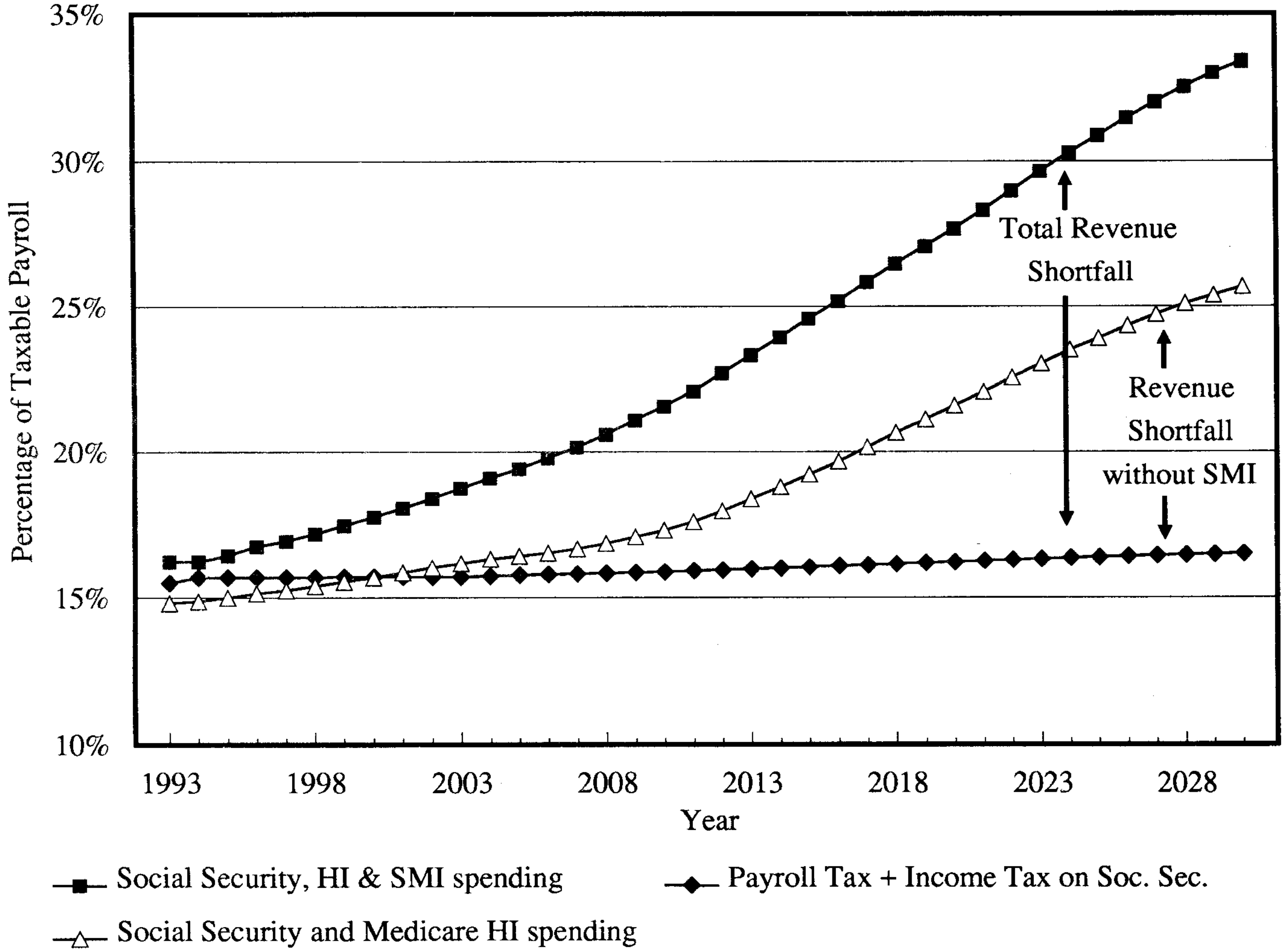
Chart 5
Social Security Tax Collections Exceed Current Benefits, But Aren't Enough To Fund Future Promises



Using the Trustees' best estimates, the Social Security program will run cash surpluses through 2012, and will start running cash deficits in 2013. Those deficits will rise to more than 4% of payroll by 2030. To cover Social Security outlays, payroll taxes would have to increase from 12.4% today to more than 16.5% in 2030.

Source: Bipartisan Commission On Entitlement And Tax Reform

Chart 6
Pay-As-You-Go Financing Of Social Security And Medicare Would Double The Current Payroll Tax Rate



Using the Social Security and Medicare Trustees' best estimates, the gap between tax receipts and outlays for Social Security and Medicare widens from less than 1% of payroll today to over 16% of payroll by 2030. Payroll taxes would need to more than double – from less than 16% to almost 33% – to close this gap. Even without SMI (which is not financed by payroll taxes), payroll taxes would need to increase to over 25%.

Source: Bipartisan Commission On Entitlement And Tax Reform

future income, you must save. More specifically, the current pay-as-you-go government programs need to be converted to actual saving programs, such as are employed in some other countries.

Beginning with the "reforms" of the 1983 Social Security Commission, and culminating with the 1990 and 1993 budget deals, public policy makers have steadfastly avoided this conclusion. Instead, we have had a process of repeatedly increasing taxes and promising reductions in future spending that have fallen far short of offering any solution. That process is breaking down. In 1983, it may have been possible to impose large tax increases to fund Social Security. That was a time when everyone retired or near retirement could expect to receive benefits far in excess of his contributions. In effect, participants were only being asked to accept a slight reduction in excess benefits.

Today the situation is very different. The average taxpayer paying into Social Security will get little or no return on his "investment," but will be burdened with taxes that if invested with any insurance company, would produce a retirement package worth many times as much as Social Security, due to investment buildup. Further, the public has seen the Social Security surpluses resulting from the 1983 tax increases used entirely to finance other federal spending, with large deficits to boot. The original intention had been that these taxes would increase national saving — and economic growth —- by creating federal budgetary surpluses or at least reducing federal budget deficits.

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It is not surprising that it is not politically feasible to cut Social Security benefits. With much of the working public now facing the prospect of paying far more in taxes under a pay-as-you-go system than it would take to purchase a really handsome retirement package in the private market, calls to cut benefits are not acceptable.

Of course, health care is a substantial part of the problem. But even if health care cost growth were brought down to the rate of growth of population plus inflation, the problem would still exist. Demographic growth alone will take Social Security, Medicare, and Medicaid from 8% of GDP today to 14% by 2030. If it were 14% today, federal budget outlays would be $400 billion higher.

There will have to be substantial changes in health care to avert huge increases in the Medicare and Medicaid drain on the federal budget. Continuation of current trends are unsustainable, and regrettably, the major health care reform proposals under consideration would only make the situation worse. Indeed, a major concern is that poorly designed reform would lock in an unsustainably high base line of growth.

It has become clear that pay-as-you-go cannot very much longer work, reflected by public refusal to countenance the tax increases and benefit cuts that would be required. The alternative, a move to convert social programs to actual saving, however, has yet to receive much consideration. What are the outlines of such a transformation?

As a first step, benefits for all retirees and near term retirees would be kept as is, eliminating the political obstacle of taking away benefits from those currently receiving them. Our laws, no matter how misguided, have created a sort of property right in these citizens as against their fellow citizens, never mind unfairness. (It is unfair because most of the redistribution is up the income scale, which is the ugly secret of our welfare state).

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Next, the existing Social Security surpluses would be used to start to fund actual individual IRA-like Social Security accounts. Unlike the proposed accounts to be published soon by the Social Security Administration, these accounts would show everything paid in. Social Security would become in effect a defined contribution account. The taxpayer could direct investment of his account among qualified investment consortiums, to include mutual funds, banks, etc. The taxpayer could voluntarily supplement his account on a tax deductible basis.

As mortality reduced the existing cohort of retired people, an increased portion of the tax revenues would be available to fund the accounts. Some redistribution could be accommodated through the vehicle of account funding, if necessary. However, the substantial investment buildup should greatly reduce the need for redistribution as compared with the current system.

The use of the Social Security surplus in the general budget would be ended. These revenues might be replaced by spending cuts, or in part with new revenues from a reformed, saving- exempt tax system.

Several plans (Nunn-Domenici, Danforth-Boren, etc.) have been put forth to reform taxation so as to remove the heavy anti-saving bias inherent in the current income tax system. Unfortunately, public trust is at a very low level. This situation is understandable, given recent history. The idea of "tax reform" no longer has credibility, given the repeated instances of abuse.

Even if major tax reform somehow could be carried through, it would not in itself suffice to resolve the saving problem. Clearly, tax reform to remove excessive burdens on saving is an essential element of a comprehensive approach. Given public attitudes, it is probably only in the context of a comprehensive reform of entitlements that addresses the real issue that taxes can in fact be reformed. The real issue, of course, is that pay-as-you-go simply cannot continue, given demographic realities.

The simultaneous conversion of the entitlements system to a saving-based approach should be managed to consume all funds generated as part of the tax reform process, preventing tax reform from foundering on interest group politics. Because it would be clear that the creation of individual funded accounts would forever place the national retirement system beyond political tinkering, it would create an atmosphere of credibility for the whole reform process. It could even be that in such circumstances, the public would be willing to countenance an increase in mandatory retirement saving, provided it all went into such individual accounts.

While there are many difficult issues to be resolved in any move toward conversion of...Social Security...into [a] genuine saving program, the sooner the process is started, the better.

Attempts to reform taxation in any smaller context would be subject to demagogic attack and could break down into the kind of interest group gaming seen in 1990 and 1993. Any attempt to improve the treatment of saving is vulnerable to being portrayed as "favoring the rich," even though it is primarily working class people who have been hurt by the low national saving rate. That is why the tax reform would have to be coupled to creation of the individual accounts — to create a broad based public stake in pro-saving reform. Such reforms should also ease the task of means-testing or otherwise limiting other programs.

While there are many difficult issues to be resolved in any move toward conversion of the present consumption-driving, saving-depleting Social Security (and possibly Medicare) into genuine saving programs, the sooner the process is started, the better. Such reforms are the key to the restoration of an acceptable national saving rate, an essential precondition for renewed economic growth. Absent such growth, we will likely see a rise of redistributionist zero-sum politics, as interest groups fight over the shrinking pie.

The ability to finance economic growth from domestic saving would end the need for capital imports, thereby resolving the trade deficit. The trade deficit has been driving protectionist politics which fly in the face of our need for competitiveness in the global economy.

What is astonishing is that with all the facts staring us in the face for the last twenty years, we have not faced up to the simple reality of the demographics: pay-as-you-go, with its sorry history of intergenerational abuse, is doomed. We can either start to fix things now, or wait until we are in terrible trouble, which is probably not much farther ahead of us than the purported reforms of 1983 are behind us.

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Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.