Building A Better Future

The Graying of America Project:
Part 1

The Committee for a Responsible Federal Budget
February 1997
The Committee for a Responsible Federal Budget

is a bipartisan private nonprofit organization created to educate the public about the Federal budget, the budget process, and other important economic issues. For more than a decade, we have worked to promote public understanding of the fact that Federal fiscal policy is unsustainable and encourage candid discussion of real choices to solve the problem. No single year's deficit is a serious danger, but the pattern of persistent, growing deficits and debt poses a serious threat to our future economy and standards of living.

Current public debate focuses on short term problems, diverting energy and attention away from more serious challenges we face over the longer term. Political leaders continue to discuss individual programs and policies as if each existed in a vacuum. But various aspects of spending and tax policy must fit together like a jigsaw puzzle. Policymakers must take into account trade-offs among individual programs and consider the impact of spending decisions and tax policies on one another. Otherwise, choices they make in one area may foreclose desirable options in others.

Changing demographics make the problems we face much more urgent than they otherwise would be. Medicare, Social Security, and the tax system generally are viewed as causes of the problem, but they must contribute to the solution. Ignoring the inter-relationships among these issues and their collective impact on the Federal budget and the overall economy is folly.

The Graying of America is a project we initiated in 1995 to examine the impact of America's changing demographics on major public policy issues. This is a two-part initiative. This pamphlet summarizes findings from the project's first phase in which we collected information on the issues.

We present here too much and too little information. We repeat much that we and others take to be common knowledge because we believe the facts bear repetition. We do not propose specific solutions. We do hope to spur a new kind of debate - about public and private responsibilities, the role of government and what we are willing to support with tax dollars - and about the kind of government we need — to meet our entire population's needs and continue to lead the world into the twenty-first century.
PUBLIC POLICY
PRINCIPLES FOR A PROSPEROUS FUTURE

Make Economic Growth the Over-arching Goal of Public Policy

Steady growth produced our current high standard of living. Absent continued growth, individual opportunity will be limited and societal goals frustrated. To sustain healthy growth will require more effort in the future than in the past. Growth requires saving, but U.S. net saving has declined since the post-World War II era.

Federal budget deficits divert saving from productive private investment. Balancing the budget is one thing government can do that we know would free up huge amounts of incremental savings to help grow the economy. Under current laws and policies, however, Federal deficits would skyrocket in the twenty-first century.

Net National Savings and Investment (Percentage of GDP)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Net Savings</strong></td>
<td>8.1</td>
<td>7.0</td>
<td>3.8</td>
<td>1.9</td>
</tr>
<tr>
<td>Total Gov't Savings</td>
<td>-0.1</td>
<td>-1.0</td>
<td>-2.6</td>
<td>-3.3</td>
</tr>
<tr>
<td>Federal Gov't. Savings</td>
<td>-0.2</td>
<td>-1.7</td>
<td>-3.5</td>
<td>-3.6</td>
</tr>
<tr>
<td>State/Local Gov't. Savings</td>
<td>0.0</td>
<td>0.7</td>
<td>0.9</td>
<td>0.3</td>
</tr>
<tr>
<td>Total Private Savings</td>
<td>8.3</td>
<td>8.0</td>
<td>6.5</td>
<td>5.2</td>
</tr>
<tr>
<td>Business Savings</td>
<td>3.2</td>
<td>2.4</td>
<td>1.5</td>
<td>1.5</td>
</tr>
<tr>
<td>Personal Savings</td>
<td>5.1</td>
<td>5.6</td>
<td>4.9</td>
<td>3.6</td>
</tr>
<tr>
<td><strong>Total Net Investment</strong></td>
<td><strong>7.9</strong></td>
<td><strong>7.8</strong></td>
<td><strong>4.1</strong></td>
<td><strong>2.4</strong></td>
</tr>
<tr>
<td>Net Private Investment</td>
<td>0.6</td>
<td>0.2</td>
<td>-1.0</td>
<td>-1.1</td>
</tr>
<tr>
<td>Net Foreign Investment</td>
<td>0.6</td>
<td>0.2</td>
<td>-1.0</td>
<td>-1.1</td>
</tr>
<tr>
<td>Statistical Discrepancy</td>
<td>-0.3</td>
<td>0.6</td>
<td>0.2</td>
<td>0.5</td>
</tr>
</tbody>
</table>

Source: Bureau of Economic Affairs

What should be public solutions, and what should be private responsibilities? What should be individual and family responsibilities? How best to raise the revenue necessary to support the responsibilities we agree to assume collectively through government?

We must ask the right questions to get the right answers. Current Federal fiscal policies are unsustainable. They are designed to meet needs we identified in the past, not the challenges we face in the future.

The question we should ask now is: how to continue to meet the needs of those who depend on Social Security and Medicare – as well as the legitimate needs of millions of Americans of all ages who will look to government in the future for income support, health care assistance, and much more? That is different from asking how to save Social Security, Medicare, or any other program, and it could yield very different answers.

We cannot focus on Federal programs and solutions alone. The private sector, individuals and other levels of government also must play a role. We should ask: have we divided responsibilities to achieve the best, most efficient, most effective outcomes possible?
However we approach the issue, individual responsibility must be a cornerstone of public policy for the future.

If we expect people to accept more personal responsibility, we must eliminate barriers and disincentives to work, save, and invest that exist in current laws and policies.

If government is to provide future retirees less generous income support and health care benefits, workers should know now so they can plan ahead.

Every new policy, every program change, will affect other areas of the budget and the broader economy.

We should make short-term decisions consistent with longer-term goals. We must make changes that facilitate rather than foreclose desirable options in other areas of public policy.
Where we start will determine who appears to win and lose, whenever public policy changes. We should consider the impacts of our decisions on lifetime incomes, tax burdens and government benefits for all population groups.

Longer life expectancy and the changing composition of the labor force argue for incentives for people to work longer and for strategies to ensure that everybody in our slower growing future workforce is as productive as possible.

Racial and Ethnic Composition by Age

<table>
<thead>
<tr>
<th>Year</th>
<th>Under 65</th>
<th>65 and older</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>28%</td>
<td>13% 15%</td>
</tr>
<tr>
<td>2030</td>
<td>43%</td>
<td>20% 25%</td>
</tr>
<tr>
<td>2050</td>
<td>51%</td>
<td>20% 34%</td>
</tr>
</tbody>
</table>

- **White, Non-Hispanic**
- **Non-White and Hispanic**
The new century is only four years off. The United States and the world have changed dramatically since 1900. The next hundred years surely will bring changes just as great. We hope for prosperity and peace. We want the world to be a better place when we retire, and after we are gone, for our children and grandchildren.

We cannot know exactly what lies ahead. We do know that steady growth produced our current standard of living. We know U.S. demographics are changing. We know those changes make growth, if anything, more important for our future. We know slow growth would inhibit individual opportunity and frustrate societal goals. We know growth requires investment, investment requires saving, and we do not save nearly enough to make our hopes real.

The post-World War II era cannot be repeated. The rest of the developed world was in ruins. The U.S. was the sole source for goods and services needed to rebuild. Accumulated savings and pent-up demand for everything from hairpins to housing drove domestic production. Living standards doubled within a generation. In 1950 television was a new technology and personal computers were nonexistent. Today the average American household owns 2.2 television sets and 80 percent of us have VCRs. Twenty-three percent own personal computers. The United States economy almost certainly will not grow 4-5 percent per year, over any sustained period of time, again in our lifetimes. But increasing growth by 1 percent— even a fraction of 1 percent— can improve substantially the outlook for our future.

It is hard to shape up when you have gotten lazy and gained weight. It is easier to maintain good habits in the first place. Similarly, economic progress will require more effort today than it did in the past. Government must change, and so must we. Like dieting, the change will require us to exercise willpower. Current private behavior is incompatible with current workers’ expectations for retirement. Current fiscal policy is irresponsible.

The United States is a rich nation. We produce nearly one-quarter of global economic output with only about 5 percent of the world’s population. The choices we face may be politically difficult, but we can solve our problems without asking anyone truly to sacrifice. Economically, we are well-prepared to meet any challenge. We need leadership and political will.

### Current Policy Deficit Projections
As a Percent of GDP

<table>
<thead>
<tr>
<th>Fiscal Years</th>
<th>CBO, with economic feedback</th>
<th>CBO, without economic feedback</th>
<th>GAO, with economic feedback</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>2%</td>
<td>9%</td>
<td>18%</td>
</tr>
<tr>
<td>2000</td>
<td>5%</td>
<td>12%</td>
<td>28%</td>
</tr>
<tr>
<td>2005</td>
<td>9%</td>
<td>16%</td>
<td>32%</td>
</tr>
<tr>
<td>2010</td>
<td>13%</td>
<td>20%</td>
<td>36%</td>
</tr>
<tr>
<td>2015</td>
<td>16%</td>
<td>23%</td>
<td>40%</td>
</tr>
<tr>
<td>2020</td>
<td>19%</td>
<td>26%</td>
<td>44%</td>
</tr>
<tr>
<td>2025</td>
<td>22%</td>
<td>29%</td>
<td>48%</td>
</tr>
<tr>
<td>2030</td>
<td>25%</td>
<td>32%</td>
<td>52%</td>
</tr>
<tr>
<td>2035</td>
<td>28%</td>
<td>35%</td>
<td>56%</td>
</tr>
<tr>
<td>2040</td>
<td>31%</td>
<td>38%</td>
<td>60%</td>
</tr>
<tr>
<td>2045</td>
<td>34%</td>
<td>41%</td>
<td>64%</td>
</tr>
<tr>
<td>2050</td>
<td>37%</td>
<td>44%</td>
<td>68%</td>
</tr>
</tbody>
</table>

### Slowdown in Economic Growth
Average Annual Change in Real GDP from Preceding Year (in Percent)

<table>
<thead>
<tr>
<th>Period</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1950-73</td>
<td>5.2%</td>
</tr>
<tr>
<td>1974-94</td>
<td>2.6%</td>
</tr>
</tbody>
</table>
How We Got to Where We Are

New Role for Government

Throughout much of our history, the Federal budget was in balance most of the time. Spending increased and we ran deficits to fight wars. Government got smaller and paid off its debts in peace time.

Astronomical unemployment in the 1930's changed that, inspiring a spate of new policies including unemployment insurance, the Social Security program, farm price supports, the Civilian Conservation Corps and other job creation initiatives. Those programs reflected fundamental values of the times: men should work, women should stay home and take care of children, poor children should not go hungry, and somebody should take care of widows and parents of deceased workers.

Initially, Social Security covered only about 60 percent of the work force those in industry and commerce and provided only retirement benefits. Today, it covers 98 percent of civilian workers. Disability coverage was added in the 1950's. Today, payments to disabled workers and their dependents comprise nearly 30 percent of benefits. Policymakers in the 1930's could not have anticipated how large and popular Social Security would become. Nor could they have imagined the impact that taxes dedicated to pay for Social Security (and later for Medicare) would have on government's ability to raise revenues for other purposes.

In the 1940's, ways in which employers compensate workers changed. Those changes were affected by public policies. They produced a complex set of relationships between social policies and employment, on the one hand, and workers and employers on the other.

Employers' contributions to health and pension plans were treated as nontaxable fringe benefits from the inception of the income tax in 1913. Few were covered. Most plans went broke in the Depression. The tax exclusion became a moot point.

In World War II, labor shortages and wage controls spurred employers to offer pensions and health care coverage as inducements to attract and retain workers. The Wage and Price Board determined that such fringe benefits were not wages subject to controls. The IRS ruled that employer-paid health and pension plans were not income subject to tax.¹ What had been a de facto exclusion became an explicit exemption. Since that time, a number of laws and regulations have imposed special rules and limitations on qualified plans, i.e., plans that qualify for the tax exclusion.

Employer-based health and pension coverage continued to grow after the war. Today, 75 percent of workers are covered by employer-based health insurance. In 1940, fewer than 15 percent of full time wage and salary workers had private pension coverage; 44 percent are covered today. In addition to employer pension plans, sixty percent of the workforce now has access to tax advantaged retirement savings opportunities through employer-sponsored salary reduction plans.² Three-quarters of those who are offered such retirement savings opportunities report that they contribute to the plans.

Federal Receipts By Source

<table>
<thead>
<tr>
<th>Decade</th>
<th>Social Insurance</th>
<th>Income Taxes</th>
<th>Other</th>
<th>Total Receipts</th>
</tr>
</thead>
<tbody>
<tr>
<td>1940's</td>
<td>1.8</td>
<td>9.8</td>
<td>3.5</td>
<td>14.8</td>
</tr>
<tr>
<td>1950's</td>
<td>2.0</td>
<td>12.2</td>
<td>3.3</td>
<td>17.2</td>
</tr>
<tr>
<td>1960's</td>
<td>3.4</td>
<td>11.7</td>
<td>3.1</td>
<td>17.8</td>
</tr>
<tr>
<td>1970's</td>
<td>5.0</td>
<td>10.9</td>
<td>5.2</td>
<td>18.0</td>
</tr>
<tr>
<td>1980's</td>
<td>6.4</td>
<td>10.2</td>
<td>2.2</td>
<td>18.4</td>
</tr>
<tr>
<td>1990's</td>
<td>6.7</td>
<td>9.8</td>
<td>2.0</td>
<td>18.2</td>
</tr>
</tbody>
</table>

¹ Approximately 95% of Social Insurance contributions and taxes are dedicated to pay for Social Security retirement and disability and Medicare. The balance pays for unemployment compensation, Federal Retirement, and Federal Retiree benefits.
² Through fiscal year 1980.
Great Society programs, enacted in the 1960's, included Head Start for disadvantaged children, Higher Education Student Assistance, Food Stamps and other nutrition programs, housing assistance, and job training.

Medicare and Medicaid were by far the largest of these programs. Each would grow to be larger than all the others combined. Medicare, which covers almost everyone over 65, would grow much larger than Medicaid, which serves low-income and disabled individuals. Medicare, like Social Security, is designed to avoid the welfare stigma. All elderly benefit. The design is intended to ensure its broad support.

Popular mythology holds that taxes dedicated to support Social Security and Medicare are regressive but the benefits are progressive. That is not quite true. The Social Security benefit formula is progressive, but the benefits are not.

Social Security does provide low-income earners high wage replacement rates and many times their tax contributions. High-income earners receive lower replacement rates.
However, the money retirees receive from Social Security is connected to their wage history, not to the payroll taxes they paid. Current workers pay FICA taxes, which are used to pay current retirees benefits. Looking at that perspective, the following numbers are startling: 3

- The bottom 36 percent of Social Security beneficiaries, in terms of income, receive only about 30 percent of benefits.
- The middle 40 percent receive 44 percent of benefits each year.
- The top 23 percent receive about 27 percent of total benefit disbursements.

Higher income individuals enjoy longer average life spans than their lower income contemporaries. Given longer life spans and larger benefit payments, upper income beneficiaries receive a larger share of total Social Security benefits payments during their lifetimes than those with lower incomes.

Upper income individuals do not just live longer, they also tend to see doctors more frequently, be hospitalized more often and generally consume more expensive care. Thus, Medicare pays significantly more for the health care costs of upper-income beneficiaries, compared to their lower-income counterparts.

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**Federal Debt Held by Public**
Assuming No Changes to Current Policies

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![Graph showing Federal Debt Held by Public](image)

- **CBO with Economic Feedback**
- **CBO w/o Economic Feedback**

<table>
<thead>
<tr>
<th>Year</th>
<th>Projections</th>
</tr>
</thead>
<tbody>
<tr>
<td>1945</td>
<td>50</td>
</tr>
<tr>
<td>1955</td>
<td>60</td>
</tr>
<tr>
<td>1965</td>
<td>70</td>
</tr>
<tr>
<td>1975</td>
<td>80</td>
</tr>
<tr>
<td>1985</td>
<td>90</td>
</tr>
<tr>
<td>1995</td>
<td>100</td>
</tr>
<tr>
<td>2005</td>
<td>110</td>
</tr>
<tr>
<td>2015</td>
<td>120</td>
</tr>
<tr>
<td>2030</td>
<td>130</td>
</tr>
</tbody>
</table>
The 1970s saw the end of the post-World War II boom. Oil shocks altered economic reality for energy-dependent industrial giants such as the United States. Productivity fell. Inflation and unemployment rose.

Babyboomers grew up and went to work. Women entered the work force in droves. Individual incomes did not rise as they had done in the halcyon era after World War II. If women had not gone to work, family incomes might have gone down.

When nothing else would suffice, rather than adjust public policies or private behavior, we borrowed. In three short years at the beginning of the 1980s, the United States went from the largest creditor nation in the world to the largest debtor. In the two longest periods of peacetime expansion since World War II, the national debt grew exponentially.

 Median Income of Married Couple Families

Source: Bureau of Census. P160-184
The Social Security amendments of 1972 indexed benefits to the Consumer Price Index [CPI]. Benefits were adjusted automatically to keep pace with inflation. The 1981 Tax Act indexed income tax brackets. Reversing those policies today could reduce the deficit by almost $110 billion in 2002. Many economists believe that the CPI overstates inflation by 1/2-1 percent. A 1 percent reduction in the index today would reduce the deficit by $50 billion in 2002.

The Reagan administration argued government was the problem. They set out to slash Federal domestic activities, increase defense spending, cut taxes and balance the budget. The result was to have been balanced budgets and supply-side stimulus, which in turn were supposed to increase economic growth and prosperity. Congress rejected President Reagan’s proposed social security cuts. They passed a series of bills in the mid-1980’s to restrain the growth in Medicare.

**Deficit Reduction Initiatives**

Medicare actually grew slower than the private sector costs for sometime. Nonetheless, throughout the 1980's, Medicare and Medicaid were the fastest growing programs in the budget. Congress and the President couldn't slice enough from the rest of the budget to offset the defense build up and tax cuts. The era of $200 billion per year deficits, "as far as the eye could see," as David Stockman, then Director of the Office of Management and Budget put it, had begun.

Since 1982, deficit reduction initiatives have kept the problem from spiraling completely out of control. But the specter of historically high and potentially damaging deficits hangs like a pall over the public policy process. Deficits have hampered three Presidents and scores of legislators in their attempts to address pressing needs. Right now the deficit is relatively low, by recent standards, but projections in future years take much of the glow off the otherwise good news.

The Greenspan Commission's recommendations led to the Social Security amendments of 1983, reforms intended to ensure the system's solvency for 75 years. Recent estimates show the system running cash flow deficits shortly after 2010. Those projections tend to become more gloomy with the passage of time.

In the aftermath of the 1983 Social Security Amendments, FICA tax receipts dedicated to Social Security and Medicare continued to grow as a percentage of total revenues and relative to GDP. Other receipts declined. Government used Social Security surpluses to offset part of the resulting debt. Public debt continued to climb, but not as fast as it would have otherwise. We will borrow about $80 billion from the Social Security trust fund in 1997 and more than $130 billion in 2007. Those amounts represent promises to pay benefits in future years.

Choices to reduce the growth in spending, or raise total revenue, are tough enough today. If we do not act decisively now, the choices we confront will be infinitely more difficult and divisive. Delay would cause deep cuts in Social Security and/or the non-Social Security parts of the budget, very large tax increases, or deficits so large as to seriously threaten the overall economy.

Health care costs soared in the 1980's. Health care entitlements are the principal source of budgetary pressure. The Medicare Hospital Insurance Trust Fund is running cash flow deficits. Premiums for Part B Medicare, which pays for doctor bills and outpatient services, are declining as a percent of program costs. In 1966, when Medicare was enacted,
premiums were set to finance 50 percent of the program. They fund less than 25 percent of program costs today and could decline to 8 percent by 2030.

Medicaid is a Federal-State partnership to provide health coverage for the low-income population. The Federal government writes the rules, but pays only about half of program costs. Exploding Medicaid costs crowded out virtually all other growth in State government budgets in the 1980's.

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**Elderly Entitlement Programs Take Over the Federal Budget**

Percentage of Net Outlays: 1995-2030

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Outlays</th>
<th>Defense</th>
<th>Net Interest</th>
<th>Elderly Health Care</th>
<th>Retirement Support</th>
<th>All Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995:</td>
<td>$1,519 Billion</td>
<td>16%</td>
<td>15%</td>
<td>12%</td>
<td>28%</td>
<td></td>
</tr>
<tr>
<td>2010:</td>
<td>$2,949 Billion</td>
<td>14%</td>
<td>11%</td>
<td>22%</td>
<td>26%</td>
<td></td>
</tr>
<tr>
<td>2020:</td>
<td>$5,024 Billion</td>
<td>10%</td>
<td>12%</td>
<td>27%</td>
<td>23%</td>
<td></td>
</tr>
<tr>
<td>2030:</td>
<td>$8,818 Billion</td>
<td>18%</td>
<td>17%</td>
<td>29%</td>
<td>20%</td>
<td></td>
</tr>
</tbody>
</table>

Even if our demographic profile were stable, current public policies could not continue indefinitely. Changing demographics increase the urgency and raise the price we will pay for any further delay.

Retirees live longer and collect Social Security and Medicare benefits for many more years than anyone anticipated when those programs were written into law. The elderly population is stable today but will explode when the baby boom generation begins to retire around 2010. The population over 85 will triple by 2030.

**Baby Boom-Baby Bust**

Sources: Bureau of the Census, and National Center for Health Statistics. Projections are Census middle fertility assumptions, 1996.
In the first few decades of the twenty-first century, these demographic changes will exert tremendous pressure on public programs and our future workforce.

The baby boom generation will be followed by the baby bust, which in turn will be followed by the baby boom echo. The baby busters could be hard pressed to produce the goods and services they will require and meet the needs of the two larger cohorts that bracket them. Changing racial and ethnic demographics could make this potentially difficult set of relationships more complicated.

We no longer have a sizable pool of potential new workers. Current policies do little to entice workers to stay on the job or to lure those on the sidelines into the workforce. In the 1970’s, when similar circumstances could have produced negative net growth in incomes, women went to work. Now most affluent, educated women who want to work do so. For poorly educated women with low skills, low wage jobs and the high cost of child care provide unattractive alternatives to welfare, disability benefits, or retirement. Older workers face compelling incentives to retire longer before the end of their productive lives. Once retired, the disincentives to return to work are overwhelming. Retirees receiving Social Security, which may commence as early as age 62, experience prohibitive marginal tax rates if they return to work before age 70. Many pension systems are designed to encourage older people to retire and make room for younger workers. Polling data suggest that baby boomers want to retire early in any case.

By 2050, more than 50 percent of the U.S. workforce could be non-white or of Hispanic origin. The retired population, at that time, still will be largely White non-Hispanic. Minority populations who are poor today likely will be poor when they retire. These groups will form the backbone of our future labor force. On average, they have fewer years’ education, lower incomes, poorer health and shorter life expectancies than their White contemporaries. We must narrow income and other disparities within the population or risk causing serious social as well as economic tensions. We must invest in human capital and take other steps to improve the economic and social conditions of our future workforce. This is in our economic self-interest, and it is the right thing to do.

The status quo is not affordable. Under current laws and policies, the Congressional Budget Office projects that the deficit could be 26 percent of GDP, and the national debt could be nearly 230 percent of GDP, in 2030. According to CBO, “Those increases would clearly push Federal debt to unsustainable – indeed unthinkable – levels...With Federal debt growing so rapidly, the economy would enter a period of accelerating decline.”

Federal entitlements for the elderly will not continue to grow at current law levels because they cannot. Herb Stein’s first law of economic theory says that if something cannot go on forever it must stop. Measures such as shifting the cost of Medicare home health services to general fund financing or capping Medicare and Medicaid payments to doctors and hospitals will not suffice to meet our future needs.

Under current law total program spending would increase by 5 percent of GDP by 2030. More than 100 percent of the increase would go to Medicare and Medicaid. In the aggregate, all other spending is projected to decline. As a point of reference, 5 percent of GDP is almost 60 percent of individual income tax collections and more than twice as much as corporate income tax receipts.

Borrowing, public or private, increases current consumption and passes on the bill to future generations. That raises questions of intergenerational equity. Borrowing on the scale necessary to continue current benefits and services simply is not an option. Something will have to give, before government borrowing reaches the levels of the CBO projections for the first quarter of the next century.

Administration and other sources may differ with the CBO about timing. They may quibble about whether the national debt will be 200 percent or 250 percent of GDP in 2030. They may have different ideas about how the economy first would break down under such burdens. But they agree on about one fact: we must change what we are doing.
GOVERNMENT MAY PROMOTE SOCIALLY RESPONSIBLE BEHAVIOR IN SEVERAL WAYS.

The current public policy debate around our longer term problems tends to focus on one or more of the following three approaches: tax incentives/tax reform; mandated saving or “Social Security privatization”, and means testing Social Security, Medicare, farm price supports, and other entitlement programs.

Tax Incentives

Tax reform may sound appealing because the current tax system is so unpopular. But tax reform in and of itself will not solve all our problems. To achieve and maintain budget balance and to avoid future government borrowing, tax reform must raise more revenue than the current system, or spending must grow at rates less than 50 percent of current policy projections. That is a tall order in the current political environment.

Tax reform proposals tend to fall into one of two broad categories. The first category would expand and enhance opportunities for tax advantaged saving for retirement and other purposes, reduce tax rates on capital gains, expand incentives for employers to provide pension coverage and health insurance or for individuals to purchase insurance, create or expand incentives for other behavior deemed to be socially responsible, and introduce a flatter rate structure.

The second category of proposals focuses on flat taxes and consumption taxes. They are offered by proponents as the ultimate means of simplifying the system and providing saving incentives.

Most flat tax proposals permit some deductions or exemptions and would not tax investment income. Indeed most flat tax proposals are a form of consumption tax. Most consumption tax proposals also include deductions and exclusions.

Shifting to a pure consumption or flat tax could increase burdens on low-income households, while reducing burdens for high-income families relative to current law. Most would exempt part of the base to reduce or eliminate such shifts.

Everyone wants a simple, fair tax system, but many of us think the code could be improved by adding one or more inducements to behavior we believe to be especially important. It is a safe bet that tax debates and tax legislation will continue to resolve these tensions through compromise. The result is unlikely to produce a pure or perfect system by anybody's definition, but tax reform could produce a system most perceive to be fairer and simpler - a system more consistent with over-all public policy goals.

Mandates

There is talk today of replacing Social Security with a Federal payment to some or all retirees, supplemented by mandatory, portable individual pension accounts. Employers probably would withhold specified amounts and deposit them to approved plans selected by employees, much as they do now with 401(k) plans. Some of these proposals would continue tax incentives for employer-based pensions and other retirement savings. If these proposals increase net savings, they could increase the economic growth and enhance self-sufficiency for retirees in the future.

This is not really private. If we pass a law requiring employers to withhold wages and make deposits to government-approved accounts, denying wage earners the use of those amounts for several years, the result is not a government program. Neither is it private. It is a mandate.
If government had to borrow to facilitate the change from the old system to the new, there would be no net increase in national savings, and no boost to economic growth.

Taxes to pay for transition costs, plus government benefits, and personal retirement account deposits, could total substantially more than current Social Security taxes. Transition costs could continue for several years. Nonetheless, these proposals appear to be very appealing, especially to those who doubt Social Security will be there when they retire. Future workers and retirees would understand the division of responsibility between themselves and government. The costs could be made explicit. People could plan and save accordingly.

*Means Testing*

Tax-financed benefits such as health care and income support may be made available only to people with low incomes and/or limited assets, as a device to control costs and encourage those who are able to provide for themselves. That may not always work. For some, the current Medicaid means test operates as an incentive to transfer assets to relatives, to protect their estates and also to gain access to tax financed long-term care. Proponents of social insurance approaches to elderly income support and health care maintain that means-testing of such benefits would act as a disincentive for people to save.
TAX AND SPENDING POLICIES MUST WORK TOGETHER TO MEET FUTURE NEEDS

Some current policies derive from problems we faced two generations ago. Some won't work well to meet our future needs. We must reform or replace such policies, even if they were affordable. Given the problems we face, adding new programs on top of the old ones, and thus increasing total costs, is not a viable option.

Changes in spending and tax policies must make sense together. Otherwise one side of the budget could cancel what we set out to accomplish on the other. To avoid such perverse outcomes, it is imperative to view all spending and tax decisions in a broader economic and budgetary context - focus on the impacts our decisions will have on savings, investment and economic growth.

The Federal government cannot accomplish all of our goals alone. The private sector, individuals, State and local governments must play important roles. If the Federal government continued current benefits and services, but hid the cost by shifting responsibilities to the private sector or to State and local government, there would be no net gain. Instead, there could be real pain because such approaches could put off difficult but necessary choices.

The miracle of compound interest will permit people to live more comfortably in retirement, having put away smaller shares of lifetime incomes, if they begin early to plan and save. Unfortunately, compound interest works two ways. The cost of putting off choices shows up in the budget as interest on the debt. Those costs compound with delay.

Both public and private behavior must change if we are to realize our expectations for the future. Current workers show a strong propensity to draw down retirement savings for other purposes. Polling data suggest that they understand Social Security will provide a smaller share of their retirement income than it does today. They expect to live better than their parents in retirement even though they are not saving nearly enough to fulfill those expectations. Public officials are focused almost exclusively on the need to balance the budget in the short term. That could be a big step in the right direction, or it could make matters worse. Short term budget balance should contribute to solving longer term problems - not divert attention away from them. Short term balance must not tempt policy makers to shift costs into future years. Our future problems are too serious for that.

Careful planning and gradual transitions can minimize trauma and disruption, but common wisdom says our political leaders will not act until they are forced to do so by crisis. That is how we reached our present state.

The longer leaders delay facing hard choices they must make, the more difficult it will be to put the country back on track toward a more prosperous future. Our economy and political system have made tremendous strides over the last one hundred years. The United States literally leads the world today, economically and politically. The next century surely will bring change at least as dramatic as the last, but we are stronger and better prepared for the challenges we face than we were at the turn of the twentieth century. All we need is leadership and political will. We can continue to lead the world into the new millennium.
**The Miracle of Compound Interest**
Level of Savings Required to Achieve Desired Level of Retirement Income, both as a Percentage of Annual Salary

<table>
<thead>
<tr>
<th>Desired Retirement Income as a Percentage of Annual Salary</th>
<th>10</th>
<th>15</th>
<th>20</th>
<th>25</th>
<th>30</th>
<th>35</th>
</tr>
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<tr>
<td>30%</td>
<td>36%</td>
<td>21%</td>
<td>13%</td>
<td>9%</td>
<td>6%</td>
<td>4%</td>
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<tr>
<td>40%</td>
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<td>12%</td>
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<td>6%</td>
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<td>34%</td>
<td>22%</td>
<td>15%</td>
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<td>7%</td>
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<tr>
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<td>48%</td>
<td>31%</td>
<td>21%</td>
<td>14%</td>
<td>10%</td>
</tr>
</tbody>
</table>

Based on 6% Real Rate of Return
1. IRS ruled in 1943 that employer-paid healthcare and pensions were non-taxable fringe benefits. In 1953, IRS reversed themselves with regard to healthcare. In 1954, Congress reversed the 1953 IRS ruling.

2. 401(K)s and 403(b)s, known by the sections of the Internal Revenue Code which authorize those plans.

3. The 1996 Green Book, Committee on Ways and Means, United States House of Representatives, p.44. Source: Congressional Budget Office simulations based on data from the Current Population Survey say the percentage work this way, because the calculated data show 36 percent of all Social Security beneficiaries have incomes of $15,000 or less; and 23 percent have incomes above $40,000 per year.

4. Dr. Alan Greenspan, Chairman of the President’s Council of Economic Advisers in the Ford Administration, chaired a bipartisan commission to recommend changes to ensure the solvency of the Social Security System. Dr. Greenspan is Chairman of the Board of Governors of the Federal Reserve System today.

5. The Trustees’ June 1996 report showed an average 75 year deficit equal to 16 percent of program income and projected that the combined Trust funds would become insolvent in 2029.


7. Dr. Herbert Stein was Chairman of the President’s Council of Economic Advisors in the Nixon Administration.

8. In the case of consumption taxes, some things we buy would not be counted as part of the base. e.g. food, housing, pharmaceuticals. In the case of income taxes, some first dollar amount would be exempt from taxation.

This booklet highlights data collected in the first phase of the Graying of America project. To purchase the full report, contact the Committee for a Responsible Federal Budget at the address on the back cover of this document.
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