

## Solutions for Developed Economies

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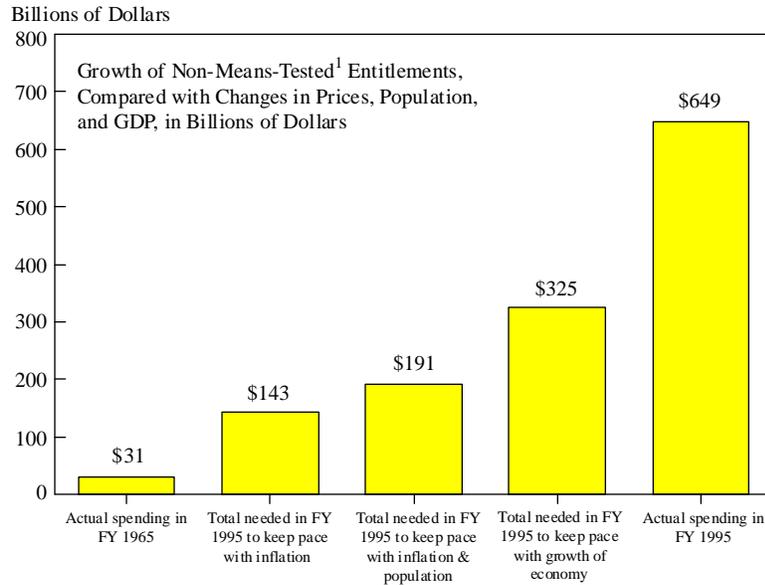
*Peter Peterson*

In my remarks today, I have decided to focus on the entitlements aspect of the budget deficit. No one who knows me is even a bit surprised. The first thing I think to notice is just how extraordinarily middle-class entitlements have grown. Chart 1 shows that middle-class entitlements have grown about  $3\frac{1}{2}$  times faster than inflation or the population.

Chart 2 shows that as a share of GDP, just the increase in middle-class entitlements is now larger than our entire defense budget. I wonder what that reviled liberal, Franklin Delano Roosevelt, who started down the path of these programs to prevent destitution as a safety net for the truly needy, would have thought about this massive flow of subsidized consumption, a veritable hammock for the broad middle class.

Chart 3 shows what the federal government now spends on the elderly American—read consumption. The spending on the elderly dwarfs what we spend on each child—to some extent, at least, read investment. As a result, Chart 4 shows the benefits to seniors in America have come increasingly to dominate the budget. And I remind you that this is during a very benign period demographically. I have had my colleagues look at every one of the current balanced budget plans and this percentage rises significantly in all of them by the year 2002.

**Chart 1**  
**The Growth in Middle-Class Entitlements has far Exceeded that of the Population or the Economy**

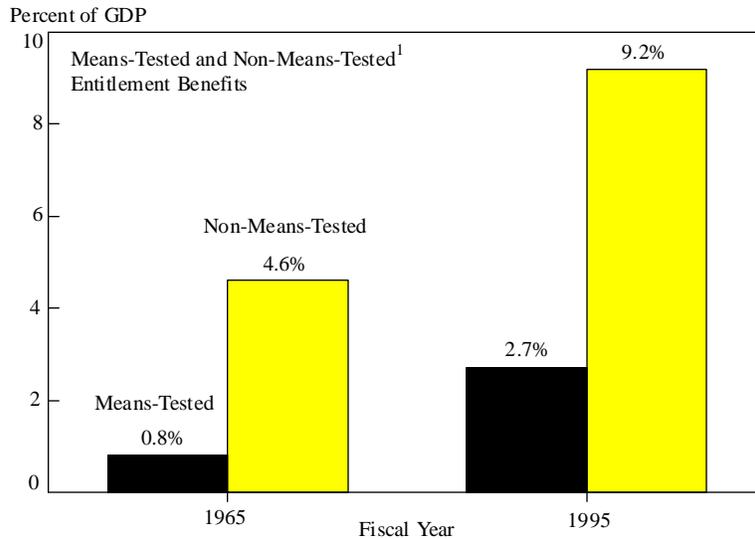


<sup>1</sup>Non-means-tested entitlements include Social Security, Medicare, federal pensions, farm aid, certain types of veterans' benefits and other smaller programs that do not look at income in determining eligibility. Source: CBO (1995) and author's calculations.

I would like to make two points about Chart 5. First, according to the work that I have been able to do, the elderly-to-child spending ratio in America is higher than any other industrial country. Second, this comes at a time when in America, on an all-in-basis, we have three times as many children as elderly in poverty.

I am going to talk about the fiscal unsustainability of all this in a moment. But we can also think of it in terms of being socially or morally unsustainable. I am reminded of what my friend, Herb Stein, once said to us in the Nixon White House, "If something is unsustainable it tends to stop." Or, if you prefer the old adage, "If your horse dies, we suggest you dismount." I think the only issue is how we dismount what is clearly morally, socially, and increasingly fiscally unsustainable.

**Chart 2**  
**Today, Middle-Class Entitlements Cost Twice the Share of GDP They Did Three Decades Ago**

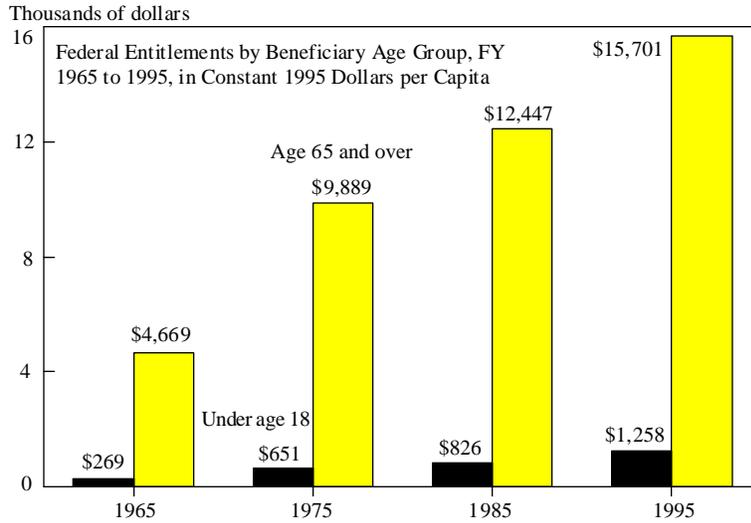


<sup>1</sup>Means-tested entitlements include AFDC, SSI, Medicaid, Food Stamps, the EITC, and other smaller programs where eligibility is based on financial need. Non-means-tested entitlements include Social Security, Medicare, federal pensions, farm aid, certain types of veterans' benefits and other smaller programs that do not look at income in determining eligibility.

Source: CBO (1995) and author's calculations.

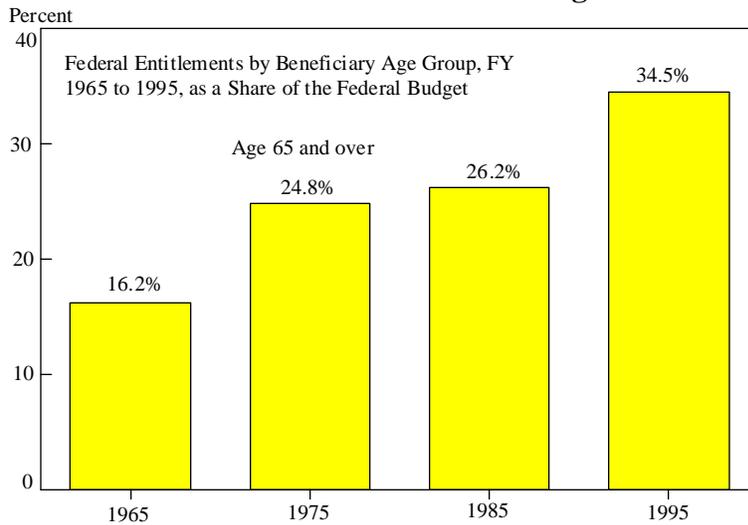
This brings us to Chart 6. I am going to focus today on social security partly because I am a masochist and partly because Medicare is already getting some attention. I am a collector of oxymorons. I think that "trust fund" qualifies as one of the best. I have been thinking of calling it a "distrust fund." But when our public policy experts tell us this system is solvent until the year 2029 because the trust funds are solvent, I do not think we should be surprised that the American public takes a somewhat benign attitude toward social security. Chairman Alan Greenspan testified to the Kerry-Danforth Commission on which I served, and made the important point that the only deficit that matters is what has to be financed, the unified budget deficit. Chart 6 provides the kind of annual deficit numbers that would clearly send shock waves through our financial markets.

**Chart 3**  
**What the Federal Budget Spends on Each Elderly American Dwarfs What it Spends on Each Child**



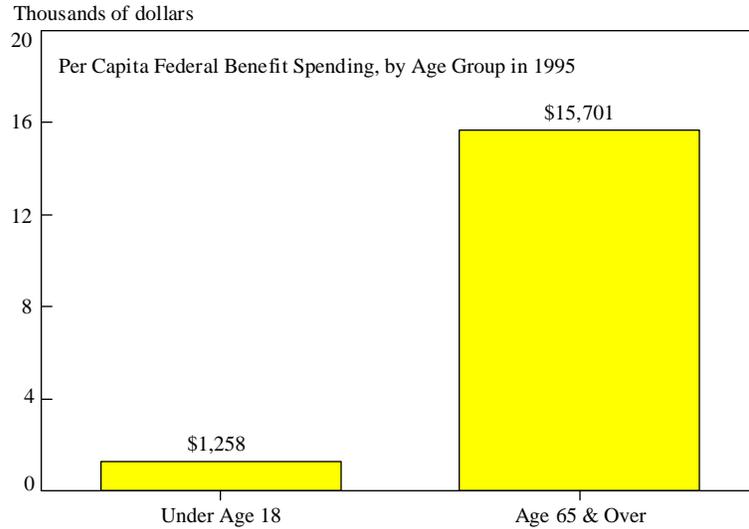
Sources: CBO, OMB, House Ways & Means Committee, and House Budget Committee (various years) and author's calculations.

**Chart 4**  
**Benefits to Seniors Have Come to Dominate the Federal Budget**



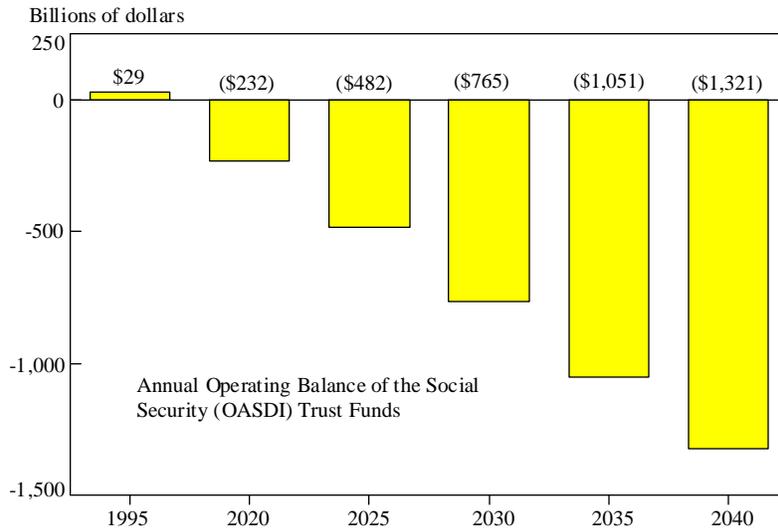
Sources: CBO, OMB, House Ways & Means Committee, and House Budget Committee (various years) and author's calculations.

**Chart 5**  
**Fact: What the Federal Budget Spends on Each Elderly American Dwarfs What it Spends on Each Child**



Source: House Ways & Means Committee 1993 Green Book and author's calculations.

**Chart 6**  
**Fact: Today's Surplus is Small—and Social Security will Start Running Deep Annual Cash Deficits Beginning Around 2015**



Source: Social Security Administration (1995).

Chart 7 shows the Medicare Trust Fund. The Medicare Trust Fund is now getting some attention because the so-called trust fund runs out much sooner.

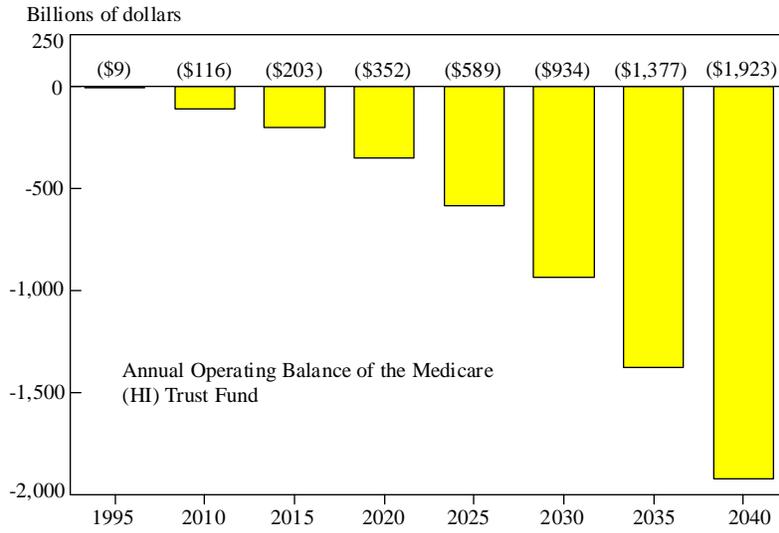
I am curious that a lot a people who look at all this say that you have got to start looking at this actuarially. You have to look at it more like a pension. So I have decided to put together the size of the unfunded liabilities and compare them to the private sector.

Chart 8 shows the unfunded liabilities just for these two programs. Our Congressmen, who tell us they want to be treated the way everybody else is, should look at these numbers. Notice that the unfunded liabilities on the lavish federal pensions, for a much smaller cohort of government workers, are twenty times larger than are the unfunded liabilities for the entire private pension system.

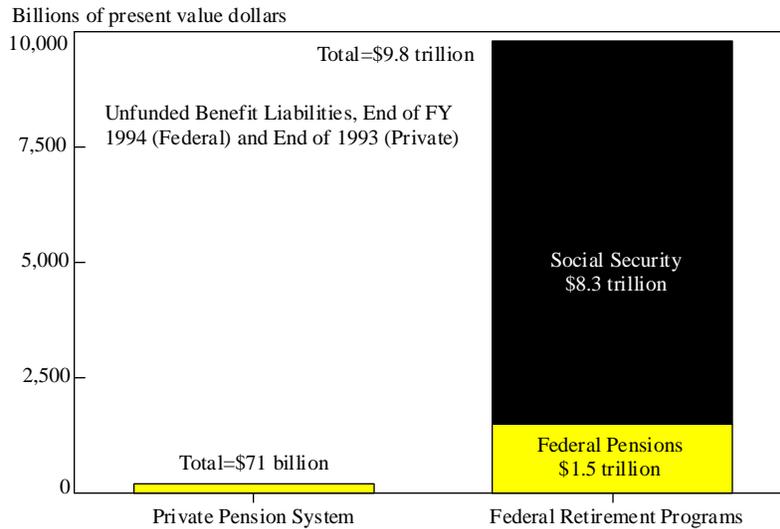
What I decided to do was to take them (the Congressmen) up on it and pretend as though we were going to fund these liabilities the way we insist the private sector funds their pensions on an ERISA basis. On this basis, as Chart 9 shows, just these two programs alone would add \$800 billion annually to the federal deficit if we applied the ERISA funding requirement.

Not only can deficits be unfinanceable, but taxes can be unsustainable. I decided to ask the question: If we are committed to a balanced budget, which we say we are, how much would payroll taxes have to rise in order to keep the budget balanced in specified years? In Chart 10, I introduce the so-called higher cost projection, which is the so-called pessimistic case. I urge all of you interested in this field to look at the underlying assumptions of the base case, the so-called intermediate projection, with regard to productivity, wage growth, longevity, birth rates, and so forth. In my experience, the pessimistic case is much closer to reality than the one that is widely used. I wonder if anyone, after looking at these numbers, would bet the ranch on it. Add in Medicare, of course, and this whole thing becomes even more fiscally unsustainable as shown in Chart 11.

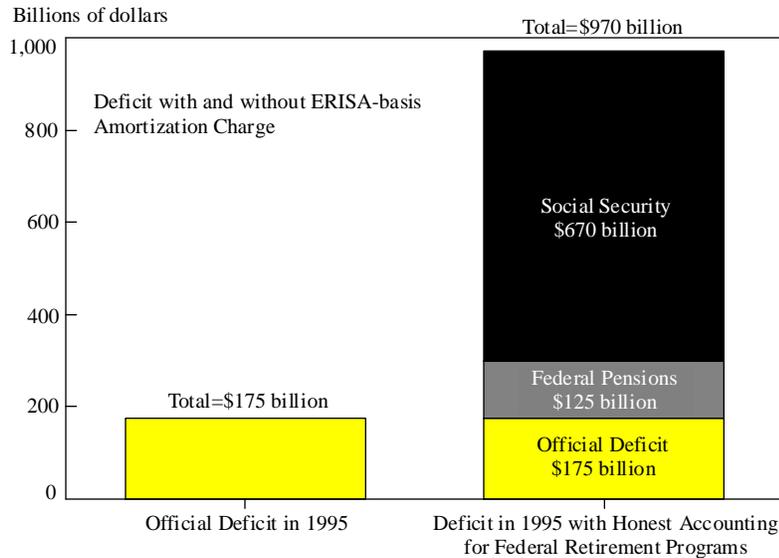
**Chart 7**  
**Fact: As for Medicare, It is *Already* Running an Annual Cash Deficit**



**Chart 8**  
**Fact: Unlike Private Pension Funds, No Money has Been Saved in Any Federal Trust Fund**



**Chart 9**  
**Fact: Accounting for These Liabilities the Way Private Companies are Required to Would Add \$800 Billion to the Official Federal Deficit**



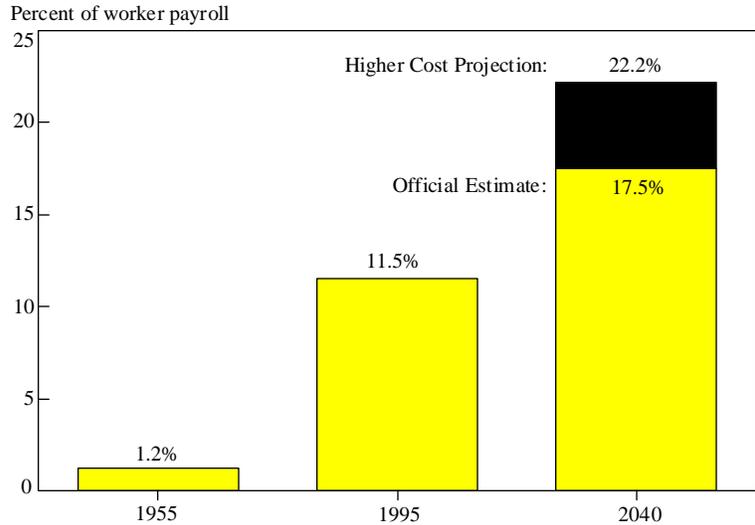
Source: Congressional Budget Office (1995) and author's calculations.

This leaves us with another alternative. If we cannot finance the unfinanceable, and we cannot have unsustainable taxes, we are left with the alternative of sudden draconian cuts. My colleagues in this field remind me that, at the present time, over half of the social security retirees make less than \$20,000 a year. And about half of what they make comes from social security. So when we talk about waiting until the crisis hits, we are talking about shredding a true safety net for many millions of Americans at a particularly vulnerable time.

Now underlying all these assumptions, these unsustainabilities, is the graying of America. I think part of the solution of this problem is to take something that seems to many Americans like a kind of an episode or some kind of a transition and dramatize for the American people, but it is truly transformational.

**Chart 10**

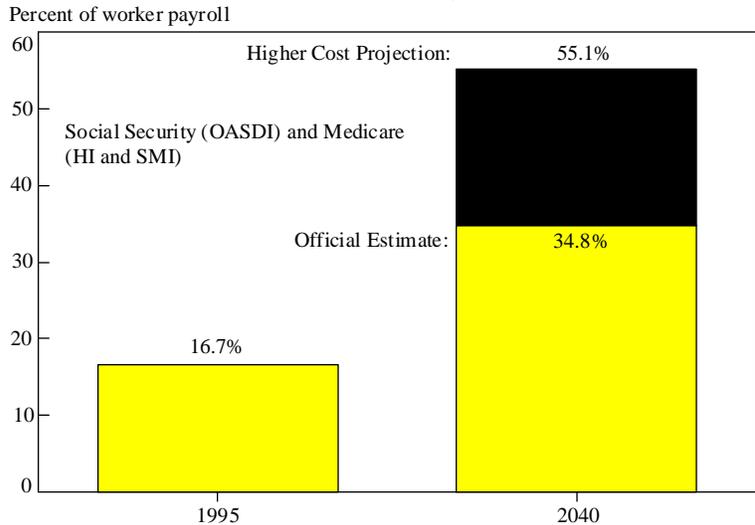
**Fact: By 2040, the Cost of Social Security is Projected to Rise From 11% to Between 17% and 22% of Worker Payroll**



Source: Social Security Administration (1995).

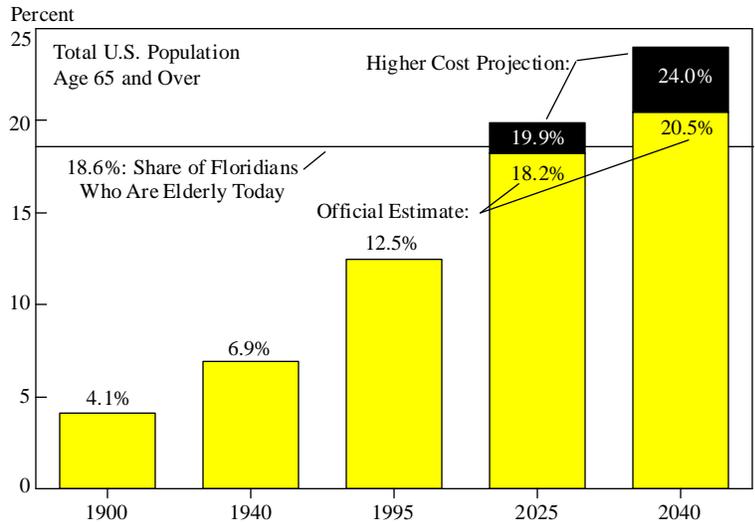
**Chart 11**

**Fact: By 2040, the Cost of Social Security Plus Medicare is Projected to Rise From 17% to Between 35% and 55% of Worker Payroll**



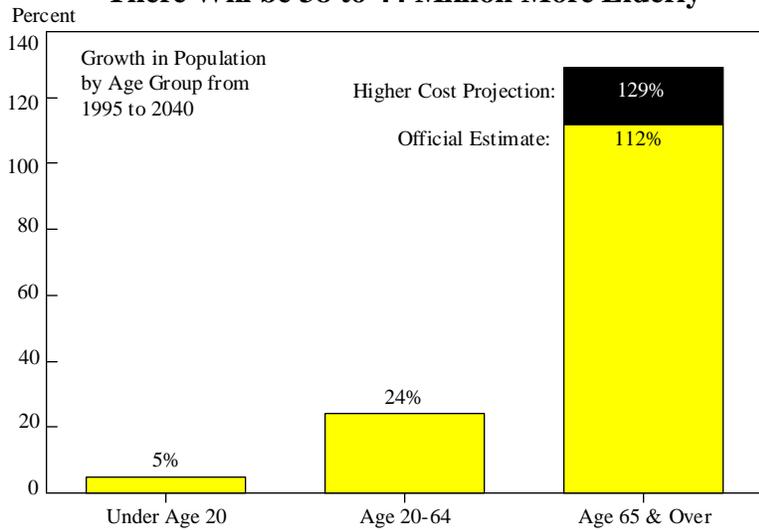
Source: Social Security Administration (1995).

**Chart 12**  
**Fact: By the mid-2020s, an Aging America will become a Nation of Floridas . . . and Then Keep Aging**



Sources: Census Bureau (various years) and Social Security Administration (1995).

**Chart 13**  
**Fact: While the Number of Young Will Grow Slowly, the Number of Elderly Will Skyrocket; by 2040, There Will be 38 to 44 Million More Elderly**



Source: Social Security Administration (1995).

We all have an image in our heads of Florida. Chart 12 shows at what years we will begin looking like a nation of Floridas. It will be sometime between 2015 and 2025 which is only twenty to thirty years from now. Chart 13 shows the tremendous growth in the elderly relative to the young. Visualize an America with 38 to 44 million more elderly, which is equal to an added elderly population of California plus all of the New England states. Of course, I find the metaphor of California full of elderly a bit shocking, but at least numerically that is about right.

Chart 14 simply shows the dramatic increase in life span, assuming no medical breakthroughs.

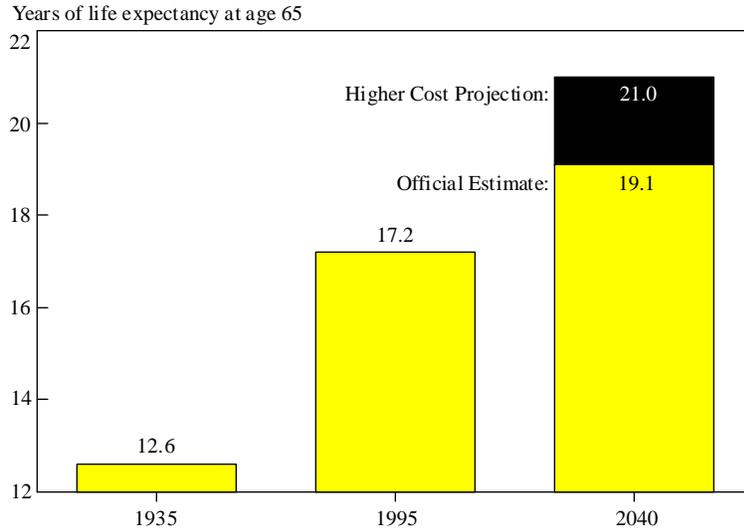
Chart 15 covers the well-known phenomenon of fewer workers to support each social security beneficiary. If we had time, we could discuss the anomaly of those few workers that must support the tremendous cohort of retirees are precisely those that have the largest level of functional illiteracy in the industrial world.

Chart 16 shows the stunning fact of the remarkable growth in the number of people over the age of 85. This group of individuals over the age of 85, of course, consume far more health care. This, in turn, is going to raise ethical issues of transcendent importance. But try to visualize adding an entire New York metropolitan area of nothing but additional over-85-year-olds. To those in Wyoming who think one New York is one too many, I am sure that is a frightening prospect.

The American Association of Retired Persons (AARP) testified before our entitlements commission. And I must admit that I lost my cool at one point and I accused them of denial, diversion, and disingenuousness. But what is happening here is, obviously, that our political system is paralyzed by the sight of 34 million members of the AARP. Until we get rid of this myriad of myths—the trust fund, people are only getting back their money—we can't hope to get a solution to this problem. Until the American people understand this is a real problem, we cannot expect them to be looking for a solution.

**Chart 14**

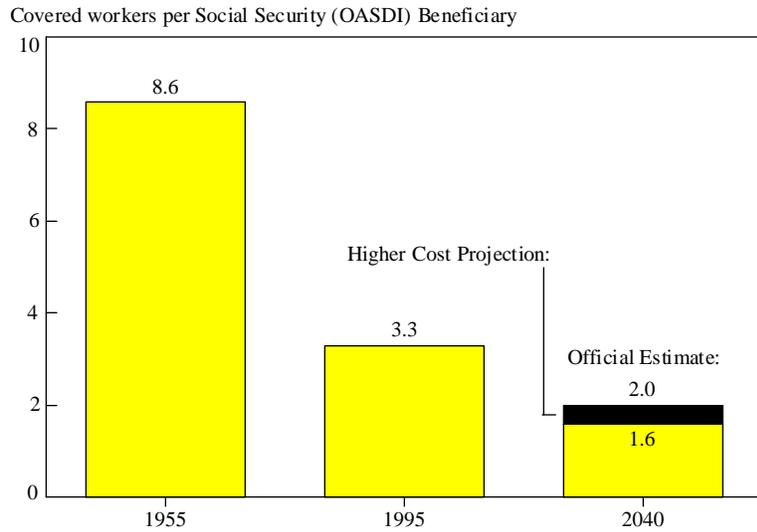
**Fact: Rising Life Spans Will Continue to Increase the Number of Years Spent in Retirement**



Source: Social Security Administration (1995).

**Chart 15**

**Fact: There Will be Many Fewer Workers to Support Each Social Security Beneficiary**



Source: Social Security Administration (1995).

**Table 1**  
**Reform One**  
**Raise Social Security Full-Benefit Eligibility Age to 70**

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- Raise by 3 months per year from 1996 to 2014.
  - Fix at age 70 from the year 2014 on.
  - Continue to allow early retirement at REDUCED benefits from age 62 through age 69.
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And finally, I think it is extremely important that we get rid of the notion that the reforms are “draconian.” We can do this by coming up with specific reform plans that indicate that if we start now we can do it gradually and humanely. I have come up with one such plan as shown in Table 1.

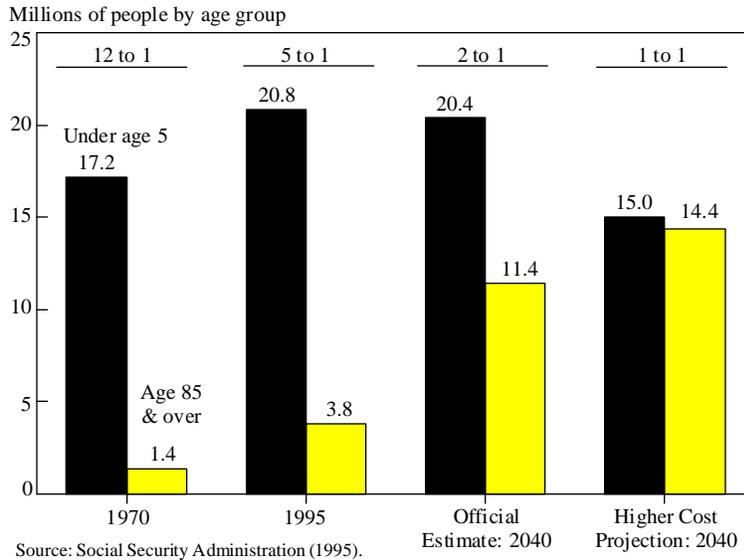
I think it is essential that we raise the retirement age. Under this plan, you raise it gradually so the baby boomers have twenty years to adjust. And even then, the baby boomers would have at least two more years of social security than the original retirees.

A second seminal fact is the large amounts of money that go to more or less affluent beneficiaries, as Chart 17 shows. And while I hear a lot of talk against any form of means testing, I find the arguments rather esoteric. I cannot imagine a political solution to the problem that would be acceptable to the American people that does not involve a reduction in benefits to the more affluent retirees.

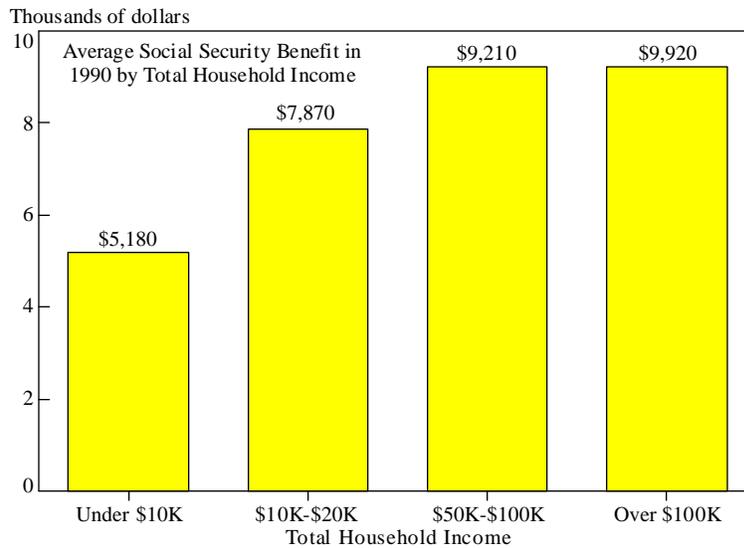
This leads me to reform two as shown in Table 2, which is what I call the “affluence test.”

I find the “affluence test” a more benign phrase than the “means test,” which sounds too much like “mean.” This particular plan involves cutting benefits 10 percent for every \$10,000 above \$40,000. It is important in my discussions with the elderly that the affluence test be applied annually. The elderly understandably feel vulnerable to unexpected events. And when they hear that, if anything untoward

**Chart 16**  
**Fact: In Time, America May Have as Many “Old Old”**  
**Age 85 and Over as Preschoolers Under Age 5**



**Chart 17**  
**Fact: Affluent Beneficiaries Collect Bigger Social**  
**Security Checks. In Fact, About 40% of Total Benefits**  
**Go to Households with Incomes Above the U.S. Median**



**Table 2**  
**Reform Two**  
**Apply Affluence Test to Social Security**

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- Withhold 10 percent of benefits from households with yearly incomes above \$40,000.
  - Withhold an additional 10 percent for each extra \$10,000 in income.
  - Fix the top withholding rate at 85 percent.
  - Index for inflation.
  - Phase-in: 1996-2000.
- 

happens to them, they get their full benefits restored, they are much more likely to be supportive.

The second important thing about the affluence test is, I believe, to include all of the middle-class benefits. The elderly, in my many discussions with them, do not want to feel that they alone are being singled out. Keep in mind that most of these elderly participated in the Second World War. They understand that was the period in which we were all in it together and everybody shared in the burden. When I tell the elderly that farm benefits, veterans benefits, and part of the federal pensions are included, the support level for this idea increases substantially. You might be interested that the Concord Coalition that I helped found with Senators Warren Rudman and Paul Tsongas has just completed a major national opinion study on this concept. About 75 to 80 percent of the affluent retirees support it; and nearly three-fourths of all elderly support this kind of affluence test. So I do not think it's as impractical as would be suggested. Table 3 simply shows how the affluence test works.

So, under this plan, James Wolfensohn, Henry Kaufman, and I would not do quite as well as we have been doing. But I think we could survive it.

**Table 3**  
**How the Affluence Test Works**

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Let us say a household receives \$10,000 this year in Social Security benefits. Then:

- If household income is under \$40,000, nothing is withheld
  - If household income is \$50,000, \$1,000 in benefits are withheld.
  - If household income is \$60,000, \$2,000 in benefits are withheld.
  - If household income is \$100,000, \$6,000 in benefits are withheld.
  - If household income is \$200,000, \$8,500 in benefits are withheld.
  - No more than \$8,500 can be withheld at any income.
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Reform 3, as shown in Table 4, makes more social security benefits taxable like every other country.

I trust you have noticed that the average retiree making \$30,000 pays about \$900 in taxes by my calculations, whereas the young worker with the same income pays about \$7,000. So, more than any country that I know, I think we have been gouging the young and it is time that we try to redress this.

Charts 18 and 19 show the results of these three reforms: the role played by increasing the retirement age, the role played by the affluence test, and finally the role played by making the benefits taxable. And I have tested this out over a long period in the future. What I like about it is that it can achieve a sustainable balance. I think the idea of a huge jolt of tax increases every three, four, or five years is not the right way to do it. We should try to do this thing structurally so that the cuts automatically increase as our society ages.

Now beyond these three social security reforms, it seems to me what we are really talking about here is retirement income. And it seems to me that the three legs that we have classically talked about—social security, individual savings, and pensions—are all wobbly.

**Table 4**  
**Reform Three**  
**Make More Social Security Benefits Taxable**

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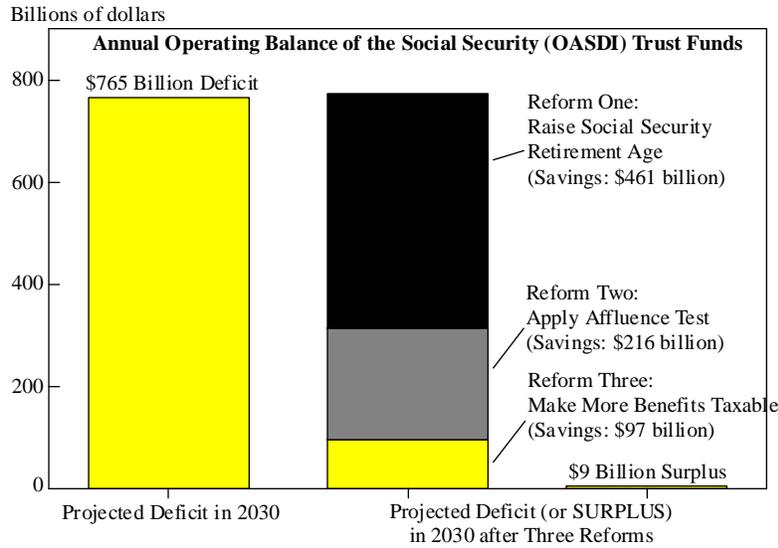
- Make 85 percent of benefits subject to the federal income tax.
  - Exempt 15 percent of Social Security benefits from taxation—with the tax-exempt amount calculated *before* any reduction required by the affluence test.
  - Phase-in: 1996-2000.
- 

Let us start with social security. It would be my view that we should seriously consider going back to its fundamental purpose of providing a floor of protection. We should also think through how to privatize it, and how to do it on a sensible transitional basis. Bob Kerry and Alan Simpson, who are on the commission, have proposed a partial privatizing. We will have to think through how we would do that. Would we start, for example, just with the young who have very little chance of getting any kind of payback on their benefits?

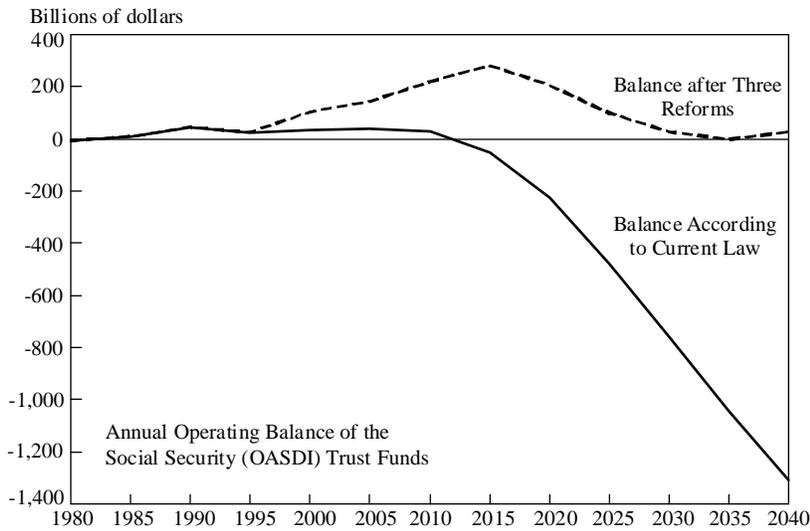
On increasing individual savings, the second leg, I chaired a commission on capital formation for Fred Bergsten on the Competitiveness Council. I consulted with most of the leading savings economists in the country, or at least many of them. It is clear that we are going to be looking seriously at tax systems that discourage consumption and increase savings, like the Nunn-Domenici progressive consumption tax. However, I was a bit sobered by listening to these experts. I asked them what is the net increase in private savings that you can expect from this tax incentive or that tax incentive? I found them less than sanguine on trying to predict precisely what the amount of this net increase would be.

Which led us all to look at the third leg which is pensions. It's a very difficult area, but all agreed that if we could have far more Americans in our pension system, it would be far more reliable to increase national net savings. I give you some numbers you are probably aware of. Less than half of the Americans today have any

**Chart 18**  
**Result of Three Reforms: Social Security Will Have a Modest Surplus Through the Year 2030**



**Chart 19**  
**Result of Three Reforms: Social Security Will be Sustainable Far Into the 21st Century**



pension at all, and many of those are inadequate. Something like less than one-third of our young workers have any pension, because of trends toward mobility, part-time work, contingency employment, and so forth. I would have thought that groups like this should seriously be looking at the ways we might move toward a more mandatory pension program. Our friend here from Australia was telling me about their plan. That kind of plan would probably do more to increase savings rates than almost anything else I can think of.

Now, inevitably, when I talk about reforms of this type, I am reminded that reforming these programs is like touching the political third rail—you know, touch it and you are toast politically. There are a couple of “ifs.” Herb Stein once said, “It is the role of the citizens to make it safer for the politicians to do the right thing.” And there is some movement on this front. Next Wednesday, September 6, Warren Rudman, Paul Tsongas, and I are meeting with heads of the Business Roundtable. That group has become sufficiently concerned about this that they are pledging millions of dollars to go into a nationally televised effort trying to demythologize this. And we are going to include young people’s organizations, senior citizens groups, and so on in a very interesting coalition.

I am indebted to Warren Buffet, who, perhaps, is the smartest of us all. I flew out to Omaha to talk to him about this. He said, “Pete, all of this other stuff will be very helpful. But ultimately, in this country, it’s going to require presidential leadership, with moral authority, that simply speaks the truth to the American people.” Some cynics would say that “presidential leadership” and “moral authority” is a quadruple oxymoron. I do not know. But one thing is very clear. Until the ground is made safer, by major communications of citizens efforts, it is very unlikely that our political leaders are going to commit suicide. I have interviewed a lot of them. I have found very few kamikaze pilots among our politicians. So it is extremely important that we, the citizens, try to make it safer.

Now I know all of this is very difficult. But, along with our chairman, Jacob Frenkel, I was presumably educated at the University of Chicago. You may remember our good friend George Stigler

used to say, "If you have no alternative, you have no problem." That has been a melancholy thought through life. But as I contemplate the alternatives, I don't think we have any alternatives but to try.