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Old News

It's time to tear up the intergenerational contract and construct public policy around the one group of people for whom social investments really pay off: kids.

The list of issues on the progressive agenda for 2009 is long: universal health care, slowing climate change, improving public education, aiding foreclosed homeowners, rebuilding our crumbling infrastructure, and ending the war in Iraq. These are all important and vital efforts, especially after eight years of George W. Bush. But the sad fact is that the money to pursue any of these objectives doesn't exist. With a deficit approaching three quarters of a trillion dollars in the next decade, neither the will nor the way exists for future big-ticket initiatives.

Rolling back the Bush tax cuts for the wealthy or curbing earmarks won't pay for all of the campaign proposals being advanced by the Democratic or Republican presidential candidates. And no candidate has a credible plan to address the large deficits that are projected for 2009 and beyond.

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What we do know is that there are three basic policy responses to this situation: allow deficits to balloon to still higher levels, cut spending in addition to forgoing new initiatives, or raise taxes well beyond anything currently contemplated. In the absence of a longer-term strategy, any new administration will likely muddle through with a mix of all three, and in the process fail to address either the nation's domestic problems or its fiscal conundrum. What's needed instead is a fundamental rethinking of the intergenerational contract—what the government provides to whom—and when in their lives the government provides it.

Right now, the intergenerational contract favors the old at the expense of the young. It operates under the premise that the wide base of working-age Americans can, and should, support the relatively small number of Americans in retirement. But over the coming decades, there will be far more older Americans, including many in their sixties and seventies, who can work and who, with proper planning, should have sufficient assets to contribute far more to supporting themselves than was possible in the past. Right now, thanks to the current contract, older Americans are the only group in our society that has access to universal, fee-for-service medical care. Younger Americans do not have such access, have seen their incomes stagnate in recent years, and yet will be expected to pay for the current generation's morally indefensible fiscal policies. As a result, without a major change, working-age families and their children will not receive the kind of help that will eventually make the nation more productive. And a country that gives priority to its elderly over its young is arguably a country that doesn't have much of a future.

A new contract, then, would tighten the flow of funds to older generations and invest more resources in younger families and their children. During a transition period designed to protect current beneficiaries, any new commitment of resources to the young may require some tolerance of continuing deficits. But if accompanied by a simultaneous and enforceable commitment to reining in future spending on the big entitlements, such as Social Security and Medicare, those deficits need not be especially troublesome. These investments in the young would be designed to make them more productive over their lifetimes, to spread the benefits of growth more broadly, and to increase opportunity by giving more people a shot at the proverbial American Dream. As younger Americans age, the public investments made in them will pay off in higher wages, better skills, and higher savings, lessening the need for public support in their retirement years.

If we fail to tackle entitlements and invest in the young, we risk muddling through the next eight years pretending that a set of small-bore but inexpensive policies with politically appealing labels (remember "school uniforms"?) will do the job. What's really needed is a fundamental rethinking of the assumptions that underlie our current intergenerational contract.

The Rising Tide of Red Ink

The heart of the problem is that we are not paying for the government we now have, much less for the one that many progressives would like to see. Instead, we have a budget out of control and dominated by spending on the elderly.

While the fiscal waters have been relatively calm in recent years, they are about to be hit by a perfect storm. The economic downturn is already ballooning the deficit, but the real problem is structural, fueled by the retirement of the Baby Boomers, increased longevity, and above all, rising health care costs per person. Social Security is a problem, but because of growing health care costs, Medicare is an even bigger problem. As a result, by the end of the new president's second term in 2017, the projected deficit will be a truly staggering $674 billion under reasonable assumptions. And things continue to worsen. Within just a few decades, the three major entitlement programs—Social Security, Medicare, and Medicaid—will absorb as much money as the entire federal government does today. These three programs already account for 42 percent of the budget, and they are growing at a frightening pace. Their growth over the next three to four years will exceed the total investments devoted to children in the federal budget in just one year.

The young already are losing out to the old when it comes to government aid. Per capita federal spending on the elderly is almost five times as great as per capita spending on children, and that imbalance will continue to grow. To be sure, state and local spending is more heavily oriented toward the young because of the way we finance public schools. But this has its own set of problems, related to the fact that spending per child varies widely at this level, depending on where that child's parents can afford to live. Moreover, at the state level the growth of Medicaid spending on nursing home care is crowding out spending on education.

As almost all experts have emphasized, addressing the growth of entitlements now will be far less painful than if we wait until the day of reckoning has arrived. Not only will delay require sharp increases in taxes or major benefit cuts, but the intervening accumulation of debt will require a rising proportion of available revenues to be used to pay interest on that debt. Under realistic assumptions, interest on the debt is currently slated to grow to around $500 billion in 2017. Just about one out of every four income tax dollars will buy nothing except the right of the federal government to continue to borrow.

Should we even be concerned about this accumulation of debt? Most economists understand that deficits are not bad in and of themselves; they are only bad if they slow the growth of the economy or undermine our standard of living. Indeed, pro-spending liberals, such as Jeff Faux of the Economic Policy Institute and Bernard Schwartz ["Public Investment Works," Issue #6], argue with considerable merit that when it comes to wise investments that strengthen the future work force, our transportation and communication infrastructure, and the research base for innovation, even debt-financed spending may contribute to the nation's productivity.

At the same time, fiscally conservative liberals—such as Robert Rubin—argue, correctly, that we cannot endlessly ignore the sea of red ink projected in the coming decades. These deficits, they contend, are leading to an accumulation of debt that, if left unchecked, will mean not just exploding interest costs but a level of indebtedness to foreigners that is already making us dangerously dependent on the rest of the world. Even if this did not threaten the economy, it would undermine public confidence in government. In short, both sides are right. Deficits matter, but they are not all that matters.

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There are, of course, several potential solutions. We simply could pay for a more progressive agenda while simultaneously maintaining current commitments to the elderly by raising taxes. We could roll back the tax cuts of 2001 and 2003, and in addition impose a new tax on energy consumption. Or we could curb various tax preferences for both corporations and individuals. These are all worthy ideas, consistent with good policy and progressive ideals, and new revenues are clearly going to be needed. But there are real limits to any of these approaches.

First, we're going to have to take most of these revenue-raising steps anyway just to cover the costs of new initiatives. That still leaves projected spending for Medicare and Medicaid on a collision course with our ability to pay for them and would require continuously increasing tax burdens to be affordable. By 2030, taxes would have to increase by one-half to make current commitments affordable, even if we did nothing new for working-age families and their children. After 2030, they would have to rise still further to pay for ever-increasing per capita health-care costs.

Second, the public, and their elected representatives, remain quite firmly opposed to significantly higher tax burdens, especially on the middle class.

While most Americans believe the deficit is a serious issue, polls show they are opposed to raising taxes to reduce it. The Senate voted 99 to 1 this year to extend most of the Bush tax cuts and will almost certainly legislate very expensive repairs in the Alternative Minimum Tax, deepening the deficit to the tune of $150 billion to $200 billion a year by 2011. All three presidential candidates have proposed a raft of new tax cuts on top of this. Moreover, both Democratic candidates have pledged to not raise taxes for anyone with an income below $200,000 a year. Yet even taking tax rates on those who make more than $200,000 annually to pre-Bush levels would raise roughly $100 billion a year, not enough to cover all of these new promises and repair the AMT. We need to create a simpler, fairer tax system that produces greater revenue. That can help to fill the fiscal gap and should be part of the solution. But it will not begin to be sufficient.

What about savings from the defense budget? Again, some savings are possible. But the costs of winding down the wars in Iraq and Afghanistan are not included in current budget projections and thus are not contributing to the fiscal storm on the horizon. And even the toughest analysis of the rest of the defense budget is hard-pressed to come up with more than about $30 billion to $40 billion a year in savings. That will hardly cover even one year's growth in the cost of Social Security and Medicare alone.

Does this mean that there is no waste, no area where budgetary savings couldn't be found? Not at all. But the amount of savings that could be gleaned from eliminating earmarks or tightening up in a variety of areas, from farm programs to space exploration, are a drop in the bucket compared to the need.

Contrast these fiscal realities with what one hears on the campaign trail. The Democratic candidates have a raft of popular proposals to provide universal health insurance, help lower- and middle-income families afford college, encourage more retirement saving, and fund alternative sources of energy, just to name a few. On top of this, both Senator Clinton and Senator Obama have proposed new tax credits for various groups. Both campaigns have made efforts to estimate the costs of their new initiatives. Unfortunately, there are several problems with their analyses. To begin with, it is likely that the campaigns are underestimating the costs of their proposals, and indeed both sides are accusing the other of doing just that. Secondly, there are many issues that the campaigns claim that they will address for which they have not crafted specific proposals, and it is anyone's guess what the price tag of these initiatives could be. So it is clearly difficult to estimate the total cost of the Democrats' proposals. An analysis by the *Washington Post* puts the number between $250 and $350 billion per year, using figures from the campaigns.

The reality is that without major changes in the big three spending programs, much of the current progressive agenda will not be affordable, and the best progressives will be able to hope for is a sharply curtailed domestic agenda, wrapped up in liberal dressing. If nothing is done to curb the growth of entitlements, not only will these new initiatives prove to be unaffordable but *existing* domestic spending will be subjected to a terrible squeeze. An analysis by Eugene Steuerle and his colleagues at the Urban Institute shows that the three big entitlement programs, together with defense and interest on the debt, will absorb all likely revenues just a year or two after the end of the next president's second term. This means nothing will be left over for spending on other domestic programs: education, veterans' medical care, transportation, research, child care, and dozens of other programs.

But this is not just a case of necessity being the mother of invention. There are other normative reasons why we need a reallocation of resources between the generations—or more accurately over each individual's life cycle. Simply put, we should be investing more in people when they are young, thereby enabling them to contribute more to their own support when they are older.

The Intergenerational Contract

The current intergenerational contract has been in force since Social Security was enacted in the 1930s. It was expanded in the 1960s with Medicare and Medicaid (which covers nursing home care), and yet again in this decade with the addition of prescription drugs to Medicare. It is built on a number of assumptions: that no one should be expected to work after the age of 65; that most seniors have insufficient resources to pay for their own retirement or health care; and that younger Americans are, on average, better off than older Americans. The system thus relies almost entirely on contributions from working-age Americans to finance these benefits along with supporting the other major dependent population, their children. And for the most part, the old contract has been a huge success, enabling people to retire at a reasonable age and reducing insecurity in old age.

Nevertheless, the contract hasn't kept up with the times. First, consider the facts about today's elderly. Like other age groups, they are a very diverse population. But whether we look at their income, their assets, their health, their longevity, or their own preferences to stay connected to work and community, the elderly, as a group, have far more capacity to contribute to society than in the past. For example, the median household income of those 65 or over has increased 79 percent since 1967, while the median income of those in their prime earning years, aged 35 to 44, has increased by only 54 percent. Even more striking is the decline in poverty among the elderly, from 35 percent in 1959 to 9 percent in 2006. (Granted, if we excluded the Social Security benefits that the elderly receive, their poverty rate would be considerably higher.) Compare this poverty rate of 9 percent with the much higher rate of 13 percent experienced by nonelderly households. Finally, 80 percent of those 65 and over own their own homes and three quarters of these elderly homeowners own them free and clear of a mortgage.

We absolutely must maintain a robust safety net for the elderly. But all of the evidence suggests there are many older Americans who, with or without government assistance, will be comfortably well off in the future, assuming they have access to good jobs and save enough during their working years. Even now there are more than one million people over the age of 65 with incomes of more than $100,000 a year.

From a social policy point of view, there is no reason to favor the old over the young.

Not only are the elderly economically better off than they used to be, but they are living longer and healthier lives as well. In 1940, a 65-year-old could expect to live until age 78. Future retirees will live well into their eighties. Moreover, not only are today's elderly living longer, they are living better. Many of the elderly are experiencing what experts, such as Stanford researcher James Fries, call "compressed morbidity"—meaning that there has been a decline in disability rates among those over the age of 65. Because this decline in disability has exceeded the decline in mortality, it has extended not just life but healthy life and the ability to work. We should celebrate this progress, some of it made possible by the fact that the elderly—unlike the non-elderly—have universal access to health care through Medicare.

But while the elderly have improved their situation greatly, since the intergenerational contract was first formed, working America has also gone through immense changes. In the economy of the 1950s or 1960s, the United States dominated world markets, jobs tended to last for a lifetime, a high school education was sufficient for achieving a middle-class lifestyle, and firms could readily afford to provide generous benefits, in the form of health care and defined-benefit pension plans, to their employees. Similarly, schools worked better for a number of reasons, including the fact that there were fewer immigrants and educated women had few professional job opportunities outside of teaching. Today, the United States has seen high school graduation rates decline over the last few decades, and it no longer leads the world in the proportion of high school graduates who go on to college.

This is part of the reason why over the past three decades, young men have seen their wages stagnate. They are earning less, in inflation-adjusted terms, than their father's generation did at the same age. Family incomes have crept up, but only because more women have gone to work. Poverty rates are now stuck at 1970s levels. Income inequality is as high as it was in the 1920s. And access to affordable health insurance has been sharply eroded. On a range of indicators from education to health care to rates of poverty, on average, children in the United States rank eighteenth out of 21 when compared with children in other advanced countries. In addition, a college or advanced degree has become the critical ticket to a good job and a middle-class life style, while the cost of higher education has escalated beyond the reach of many of today's families.

As a result of all these changes, the role of the government in providing economic mobility to workers or better education and job-training for their children is more essential than ever. And yet, the historic commitment made to the elderly in the old intergenerational contract is placing a real burden on the working-age population. Although many people believe that Social Security and Medicare benefits are fully funded by the payroll taxes they have paid into the system, the reality is that these programs are not prefunded. Each dollar of benefits that goes to the elderly must come out of the income of younger, tax-paying Americans. So, the importance of balancing the needs of one against the other must become part of our thinking. Those progressives who argue that the way to handle the needs of both groups is to raise taxes to a much higher level seem to forget that the people who will pay those taxes are already struggling economically.

A New Contract

What we need to do, then, is rewrite the intergenerational contract. This does not mean denying low-income seniors their Social Security checks or a basic package of medical care in the future. But we should reexamine the sacrifices that the younger generation is now making to support the older one and ask whether we can craft a fairer, and more balanced, allocation of resources for the future.

As we do this, there are five principles we must keep in mind. The first is that, from a social policy point of view, there is no reason to favor the old over the young, especially if we are comparing affluent seniors with low-income families or their children. A popular argument is that we shouldn't make any changes to the benefits received by current retirees or those about to retire because it would impose too great a hardship on them. But why shouldn't smaller benefit increases or higher Medicare premiums for affluent seniors be traded off against more subsidized child care for low-income working families? Is a single working mother better able to adjust her spending when times are tough than an affluent senior, who may still be relatively young and have a nest egg to boot? Are working-age adults able to adjust to higher gas prices more easily than retirees, when the latter have no need to drive to work?

Second, borrowing to make the young more productive is qualitatively different from borrowing to enable the old to consume. It is the reason that people take out loans to go to college but not (one hopes) to go on a cruise or buy a new set of golf clubs. When the nation invests in the young, assuming those investments are wisely chosen, the power of compound interest insures that future earnings and GDP will be greatly enhanced as a result. Most economists believe that the rate of return on investments in education, for example, is at least 10 percent. Moreover, the value of such investments can compound over time, since learning begets more learning both in school and in the work force. Assume, conservatively and with some discounting of future benefits, that the nation could earn a rate of return of 5 percent on such investments. At the end of 20 years (when today's infant will be in college and today's ten-year-old will be at the start of his or her career), the value of a $1 investment would be $2.65. At the end of 40 years, it would be $7. While I would not want to argue that all government programs targeted at children and younger families can achieve these kinds of returns, the point is that investing early should pay big dividends.

Third, any proposal to invest more in the younger generation should be combined with proposals to rein in entitlements over time, ideally in legislation that links the two together. This should reassure financial markets and increase public confidence that fiscal responsibility has not been thrown to the winds. It also combines some sweet with the sour for those loathe to vote for any weakening of popular social insurance programs.

Fourth, changes in social insurance programs should be structured to occur gradually, not just because potential beneficiaries do need an opportunity to plan but because the public and our political system tend to be myopic. In short, the changes will be easier to enact if there is little immediate pain involved. Few people have complained, for example, about the increase in the retirement age that was enacted in 1983 but didn't affect anyone until the year 2000. Yes, this will lead to some short-run fiscal imbalances. However, we do not need a balanced budget every year as much as we need to be assured that we are headed toward balance over several decades.

Finally, we need to remember that this is not a competition for resources between young and old, but rather an investment in one generation when they are young in return for their commitment to pay more for their own health and retirement costs at a later stage in their own lives. It is a classic case of combining greater government responsibility to prepare people to compete in today's economy with an expectation that they will then exercise more personal responsibility in return. Just as parents invest in their children with the expectation that they will eventually be self-supporting, so the larger community should invest in the young in return for their willingness to shoulder greater burdens at a later stage in their lives.

Making the Transition

With these principles in mind, what steps should we take toward a new intergenerational contract? There are many specific options for investing in the young and for reining in the spiraling costs of entitlements, and I can only sketch the possibilities here.

To rein in entitlements, we should start with Social Security. The particular options here are well known: We could increase the retirement age and index it for longevity. We could change benefit formulas so that they protect low-income seniors but curb the growth of benefits for the more affluent. We could encourage or even require working-age families to save for the predictable costs of growing old. That could mean creating incentives for more employers to automatically enroll their employees in 401(k)-type retirement plans. If this is insufficient, it could mean requiring more savings in add-on private accounts on top of Social Security. These steps would ensure that far more of tomorrow's seniors have adequate incomes during their retirement years, and these kinds of reforms would return Social Security to the role it was originally assigned as one leg of a three-legged stool, the other two legs being private savings and employer pensions.

Social Security is the relatively easy part. The harder part is Medicare, because its cost increases derive from the continuing rise in the cost of health care. The options here include, once again, a higher age of eligibility, as well as higher premiums for the more affluent. But placing limits on the amount and type of health care the government is willing to subsidize, based on income and evidence of effectiveness, needs to be considered as well.

The argument one often hears is that it is not possible to reform Medicare without reforming the entire health care system. Any attempt to do so, it is argued, would shift costs to individuals and create a second-class medical system for seniors. What this argument misses is the fact that non-elderly Americans already have a second-class system. They are being denied care if they are uninsured or have preexisting conditions and they are being asked to pay more as costs are shifted to individuals as employers, under the pressure of competition, are forced to reduce coverage or increase employees' out-of-pocket costs.

Comprehensive health reform, not limited to Medicare, would be a highly desirable way to move beyond the constraints of the intergenerational-contract. But most realistic proposals for doing so will have to involve some limits on the subsidies that will be provided to the non-elderly. Movement to a single-payer plan with open-ended, fee-for-service subsidies—a kind of Medicare for all—is neither politically or substantively supportable, as the costs would be prohibitive. Other countries with single-payer plans set explicit budgets or payment caps on what can be spent, necessitating some implicit rationing at the provider level. So, why not begin the process by establishing some sensible limits on subsidies in the public sector, based on income and evidence-based practice standards? Given that public programs pay for almost half of all medical spending in the United States, this should not only slow the growth of health care spending but create a model for the private sector as well. In the absence of such reforms to Medicare, we are likely to end up haggling over more comprehensive reforms for many years, while the fiscal clock continues to tick with unfortunate consequences for both the economy and younger Americans.

If we revise the intergenerational contract, we will strengthen both the fiscal and economic health of the nation over the longer term.

The savings from such reforms should go toward well-chosen investments in the education, health care, and work supports (e.g., high-quality child care) for working families. These are not only a sensible use of scarce federal resources but can also, through the power of compound interest, have consequences for individual earnings, the level of GDP, and revenues, similar to what is often discussed in the context of the putative supply-side effects of tax cuts. (Retirement benefits for the elderly, by contrast, have no such benefits.)

Take, for example, universal pre-K: An analysis done at the Brookings Institution shows that an investment in universal preschool for all three- and four-year-olds would initially worsen the deficit, but over the longer run would increase the proportion of children finishing high school and enrolling in college. Higher levels of education, in turn, produce a higher level of GDP, and that throws off additional revenues more than sufficient to pay for the program. The preschool investments the analysis recommends have been shown to have huge effects on school completion and college enrollment, and the models relating higher education to economic growth are equally robust. Yet because of the press of entitlements, we are not making such investments.

Will there be a period during which some people are "double-taxed"—that is, asked to forego some promised Social Security or Medicare benefits but too old to have benefited from the new productivity-enhancing investments or savings policies? The short answer is yes. That sounds daunting, but the problem is not insurmountable. Any reforms to Social Security or Medicare would be phased in gradually, so current retirees and those about to retire would be little affected (although, again there is no reason they shouldn't be asked to contribute in modest ways to putting the fiscal house in order). No one would end up with lower benefits than seniors now receive. It is simply the *growth* of these benefits that would be curtailed, and even here the changes need not affect lower-income individuals. Next, to ease the transition, we may have to live with some level of deficit spending—perhaps the historical level of about 2 percent of GDP—for perhaps a decade. However, if the entitlement reforms were enacted now, even only in part, then longer-term projected deficits would be brought under control. Moreover, any remaining accumulation of debt would be better targeted on productivity-enhancing investments in the young, making it less troublesome. Finally, although the group caught between the old contract and the new might pay some price, their children or grandchildren at least will benefit from this new regime, and that alone should make them more willing to support such efforts.

Unless a way is found to pay for new initiatives and reduce the long-term deficit at the same time, the next administration will fail to restore the public's confidence in government. New revenues and a pruning of ineffective or wasteful programs will need to be part of the equation, but these steps will not be sufficient and could well produce more political pain per dollar raised than revising the intergenerational contract. The only way to move the country in a fundamentally different direction is to convince the public and Congress that the younger generation can take greater personal responsibility for their own retirement costs, if we invest in them now, and that today's older Americans can afford to contribute in modest ways to freeing up resources for this purpose. If we revise the intergenerational contract, we will strengthen both the fiscal and economic health of the nation over the longer term. The time for action is now—not once a fiscal crisis is upon us and our national competitiveness has further eroded. D