

War between the Generations Federal Spending on the Elderly Set to Explode

by Chris Edwards and Tad DeHaven

Executive Summary

At the signing ceremony for the new Medicare program in 1965, President Lyndon Johnson said, “No longer will young families see their own incomes, and their own hopes, eaten away simply because they are carrying out their deep moral obligations to their parents.” But taxes to support growth in Medicare and Social Security will severely eat away at young people’s income in coming years unless those programs undergo fundamental reforms.

In the 20th century politicians replaced personal savings, family obligations, and private charities with giant centralized transfer systems to support the elderly. The main programs for the elderly, Social Security and Medicare, are primarily funded by taxes on the young. That funding mechanism has set the nation on a financial collision course as the number of elderly will soar 116 percent by 2040 while the number of workers supporting them will grow just 22 percent. Without reforms, the combined cost of Social Security and Medicare Part A is expected to rise from 13.8 percent of taxable wages today to 24.2 percent by 2040. Adding in projected spending on Part B of Medicare pushes up the total projected costs of the two programs to 30 percent of wages by 2040.

Congress is considering making the looming fiscal crisis much worse with a costly and unfunded prescription drug program. But increasing the already high transfers from the young to the old is neither economically sound nor fair. Consider that, on average, the elderly used to consume less than the young, but now they consume more. Also, the elderly today are in better physical shape and better able to earn income to support themselves than before. Major entitlement reforms are needed to reduce taxpayer costs and head off a generational war between the old and the young.

A wide range of reforms is needed to deal with rising entitlement costs. Social Security and Medicare should be turned into savings-based systems with payroll contributions funding personal health care and retirement accounts. Taxes on saving should be sharply reduced so that Americans can put more money aside for their own future. Medicare reforms should reduce health care costs by increasing competition and relying more on out-of-pocket payments. Centralized redistribution systems for the elderly need to be replaced by personal savings and greater individual responsibility for retirement in the new century.

**Tomorrow's
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Introduction

At the signing ceremony for the new Medicare program in 1965, President Lyndon Johnson said, "No longer will young families see their own incomes, and their own hopes, eaten away simply because they are carrying out their deep moral obligations to their parents."¹ But unless Medicare and Social Security are reformed, young people's incomes will be eaten away by skyrocketing taxes to support a federal government of unprecedented size.

The nation is on a financial collision course between young and old as demographics change dramatically in coming years. By 2040 the number of workers will have risen by only 22 percent, but the number of elderly (those aged 65 and older) will have risen by 116 percent.² Jagadeesh Gokhale and Laurence Kotlikoff, leading experts on the coming changes, note that, as baby boomers begin retiring later this decade, it "will mark the beginning of an enormous conflict over resources. Indeed, it is probably no exaggeration to say that we are approaching generational warfare."³

The government has made overly generous promises to future retirees without any plan to pay for those promises. As a result, current policies "are generating a huge implicit debt that future generations will have to pay off."⁴ Looking forward, Social Security and Medicare's promised benefits exceed available taxes by \$18 trillion, expressed in today's dollars.⁵ Another recent estimate placed the financial imbalance of Social Security at \$7 trillion and that of Medicare at \$37 trillion.⁶

Those enormous liabilities suggest that tomorrow's young workers face a huge tax threat as entitlement spending soars. Already, the federal government spends 35 percent of its \$2.2 trillion budget on benefits for the elderly.⁷ Spending on Social Security is estimated to be \$471 billion in fiscal year 2003, making it the largest federal program (Table 1).⁸ Spending on Medicare (net of premiums) is estimated to be \$244 billion in FY03. Medicare is set to grow even faster than Social Security in coming decades.

That programs for the elderly are a fiscal time bomb is widely recognized, but policy-

**Table 1
Main Programs for the Elderly in the Federal Budget, FY03**

Social Security—old age, survivors, and disability insurance (OASDI)	Funded by 12.4 percent tax on wages up to \$87,000. Outlays of \$471 billion.
Medicare Part A—hospital insurance (HI)	Funded by 2.9 percent tax on all wages. Outlays of \$151 billion.
Medicare Part B—supplementary medical insurance (SMI)	Funded 25 percent by participant premiums and 75 percent by general tax revenues. Outlays of \$93 billion, net of premiums.
Medicaid—elderly benefits	Funded by general tax revenues. Benefits for the elderly are about 29 percent of Medicaid spending (\$162 billion), or \$47 billion.
Other elderly benefits, such as civil service retirement and veterans' health care	Outlays of about \$100 billion.

Sources: *Mid-Session Review, Budget of the United States Government, Fiscal Year 2004* (Washington: Government Printing Office, July 2003); and Congressional Budget Office, "Federal Spending on the Elderly and Children," July 28, 2000.

makers were lulled into a false sense of security during the late 1990s as growth in entitlement spending moderated. That was just the calm before the storm. The number of Social Security beneficiaries grew 14 percent during the 1990s but will grow 30 percent during the decade beginning in 2010, causing spending to explode.⁹

This study discusses the long-term outlook for taxpayers if entitlement spending is not reformed, examines the rising share of the federal budget going to the elderly, discusses the rising income and consumption levels of the elderly, looks at the generational accounting method for understanding the entitlement crisis, and concludes with policy options that can be implemented to avert the crisis.

The Federal Government in 2040 without Reform

The coming demographic tidal wave will forever alter the federal budget. As the baby boomers begin to retire in 2008, the costs of Social Security and Medicare will escalate. More retirees, longer life spans, and rising health costs will thrust a huge tax burden on future workers unless major spending reforms are implemented. The Congressional Budget Office and other authorities have repeatedly called attention to the huge long-term cost increases in the entitlement programs, but Congress has not yet heeded calls for reform.

Congress was complacent about the need for spending cuts in the 1990s when the economic boom caused government revenues to soar and pushed the budget into temporary balance. Also, growth of spending on the three main entitlements (Social Security, Medicare, and Medicaid) slowed during the late 1990s. Average annual Social Security growth slowed from 5.4 percent (FY91–FY96) to 4.3 percent (FY96–FY01); Medicare growth slowed from 10.9 percent to 4.5 percent; and Medicaid growth slowed from 11.9 percent to 7.2 percent.¹⁰

Today, the revenue boom has ended and entitlement spending is rising rapidly once

again. Medicaid spending jumped 14.7 percent in FY02 and is expected to grow 9.5 percent in FY03.¹¹ Social Security and Medicare spending will accelerate rapidly when the baby boomers begin retiring in 2008.

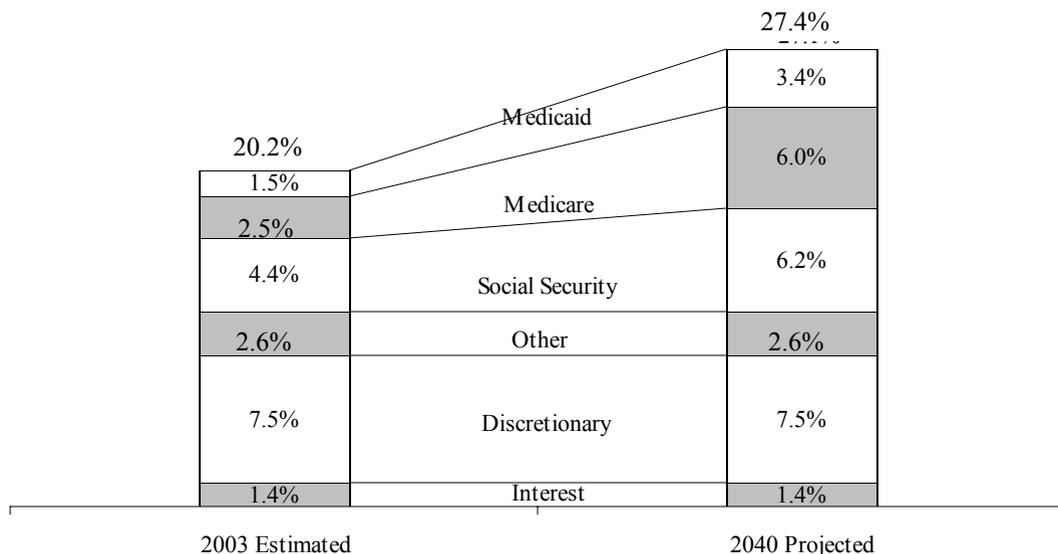
CBO baseline projections show that the sum of Social Security, Medicare, and Medicaid spending will almost double from 8.4 percent of gross domestic product today to more than 15.6 percent by 2040.¹² Thus, without reform, the government would have to almost double the share of income that is taxed to pay for promised benefits.

The left-hand column in Figure 1 shows CBO figures for federal outlays as a percentage of GDP in 2003. The right-hand column provides a scenario for 2040 if policymakers do not make any entitlement reforms. It uses CBO projections for Social Security, Medicare, and Medicaid but assumes that outlays for all other programs stay the same size relative to GDP that they are today. In that case, federal spending would rise from 20.2 percent of GDP to 27.4 percent—a 36 percent expansion in the government's fiscal command over the economy. If such a 7.2 percentage point cost increase were thrust on today's taxpayers, it would be equivalent to a \$774 billion annual tax hike. By comparison, President Bush's income tax rate cuts saved taxpayers about \$100 billion per year.

Long-term projections from the CBO frequently present a more optimistic picture of overall federal spending. For example, CBO figures often assume that discretionary spending, interest, and other federal spending will fall relative to GDP in coming decades to partly offset the increase in entitlement spending.¹³ Such reductions would entail large spending reforms by Congress and many program eliminations. That would be a needed and refreshing change in policy. However, federal discretionary outlays rose 8.4 percent annually between FY98 and FY03, representing a rapidly increasing, not decreasing, share of GDP. Also, current projections do not include the costs of a prescription drug benefit or other new programs that Congress may add in coming years. Thus, the right-hand col-

Federal discretionary outlays rose 8.4 percent annually between FY98 and FY03.

Figure 1
Federal Spending in 2040 without Reform (percent of GDP)



Sources: Authors' assumptions and entitlement projections from Douglas Holtz-Eakin, Congressional Budget Office, "The Economic Costs of Long-Term Federal Obligations," Testimony before the House Committee on the Budget, July 24, 2003.

umn in Figure 1 and CBO's long-range spending projections are probably low-end, optimistic estimates unless policymakers change course and make major spending cuts.

The economic damage done by the spending increase shown in Figure 1 would be enormous. The cost to taxpayers will not be just the extra income handed over to retirees. Harvard's Martin Feldstein points out that a tax-financed rise in entitlement spending will create large "deadweight losses," or inefficiency costs, to the economy.¹⁴ Those costs rise as tax rates increase because taxpayers reduce their productive activities, such as work and entrepreneurship, and increase their unproductive activities, such as tax avoidance. Feldstein estimates that deadweight losses from higher tax rates to pay for entitlement spending would create added costs equal to about two-thirds of the tax increases themselves. Thus, he estimates that, if the payroll tax to fund Medicare were increased by 9.0 percentage points of wages, it would create additional costs to the economy equal to 6.2 percentage points of wages.¹⁵

Feldstein points out another problem often not considered when estimating the future tax hikes needed to fund unreformed entitlement programs. As tax rates rise, the tax base shrinks as productive efforts decline and tax avoidance increases. Those feedback effects of higher taxes would require that government raise tax rates much higher than static calculations indicate in order to fund cost increases. For example, if a simple static calculation indicated that payroll taxes needed to be 9.0 percentage points higher, Feldstein estimates that the government would actually need to hike the payroll tax rate by 14.3 percentage points to get all the revenue that it wanted.¹⁶

To avoid crippling tax burdens on the next generation, a wide range of major spending reforms will be needed. Not only must entitlement programs be overhauled, Congress must begin cutting or terminating discretionary spending programs. If large cuts are not made, the federal government will expand to an unprecedented peacetime size and America's powerful economic engine will be smothered under European-sized tax burdens.

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Federal Spending on the Elderly to Soar

Spending on entitlement programs is consuming an ever-increasing share of the total federal budget. Figure 2 shows that combined spending for Social Security, Medicare, and Medicaid rose from 27.8 percent of the budget in 1980 to 41.3 percent in 2000. Looking ahead, suppose that entitlements are not reformed but the overall size of the federal government is limited to today's 20 percent of GDP. Figure 2 indicates that nearly all other federal programs will be squeezed out as Social Security, Medicare, and Medicaid explode to nearly 80 percent of the budget by 2040.

The share of each program's spending that goes to elderly beneficiaries has been estimated by CBO.¹⁷ The share of outlays going to the elderly was 76 percent for Social Security, 87 percent for Medicare, and 29 percent for Medicaid in 2000. The analysis also included spending on civil service retirement and other programs to calculate total spending on benefits for the elderly. All in all, CBO calculated that federal spending on pro-

grams for the elderly averaged \$17,688 per elderly person in 2000.

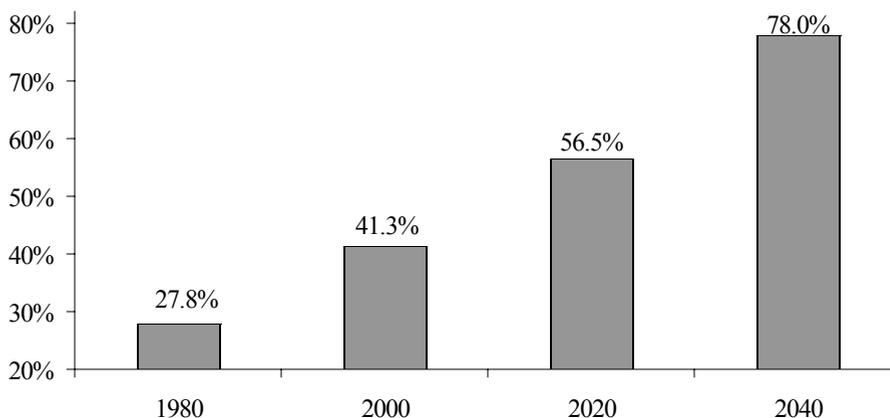
CBO found that total federal spending on the elderly rose from 24 percent of total federal outlays in 1980 to 35 percent in 2000, and the share will rise to 43 percent by 2010 and continue rising thereafter.¹⁸ Should that occur, the elderly will elbow aside all other citizens as they seize the bulk of the federal budget. Clearly, if Americans want to keep their government from growing even larger than it already is, let alone reduce its size, then budget costs for the elderly must be radically cut. If entitlements are not reformed, young families will be laboring under a huge tax burden and receiving very little in return.

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Demographic Changes Make Status Quo Unsustainable

Unavoidable demographic changes during the next few decades will force Congress to make large changes to entitlement programs for the elderly and the entire federal budget.

Figure 2
Social Security, Medicare, and Medicaid as a Share of Total Federal Spending (future total spending fixed at today's 20% of GDP)



Sources: Authors' assumptions and entitlement projections from Douglas Holtz-Eakin, Congressional Budget Office, "The Economic Costs of Long-Term Federal Obligations," Testimony before the House Committee on the Budget, July 24, 2003.

By 2040 the number of elderly people will have risen 116 percent but the number of working-age people will have increased only 22 percent.

The economy will experience a huge transition as the baby boomer generation (those born between 1946 and 1964) begins retiring in 2008. As the number of elderly people rises, taxpayers and the federal budget will be severely squeezed without major program cuts.

Figure 3 shows that by 2020 the number of elderly citizens will increase by 51 percent, but the number of working-age Americans will increase only 16 percent. By 2040 the number of elderly people will have risen 116 percent but the number of working-age people will have increased only 22 percent.¹⁹ In addition to the baby boomers' retirement, increased longevity will cause the number of the elderly to swell. Life expectancy for males at 65 will increase from 15.9 years today to 18.3 years by 2040, according to the Social Security trustees' intermediate scenario.²⁰ Numerous experts believe that the trustees' intermediate scenario understates likely increases. For example, the 1999 Social Security Technical Panel recommended a four-year increase in age assumptions, but only a one-year change was implemented.²¹ Similarly, many experts believe that the Medicare trustees intermediate projections are too optimistic.

As the number of elderly persons soars, the number of workers available to support them will not keep up as the U.S. birthrate stag-

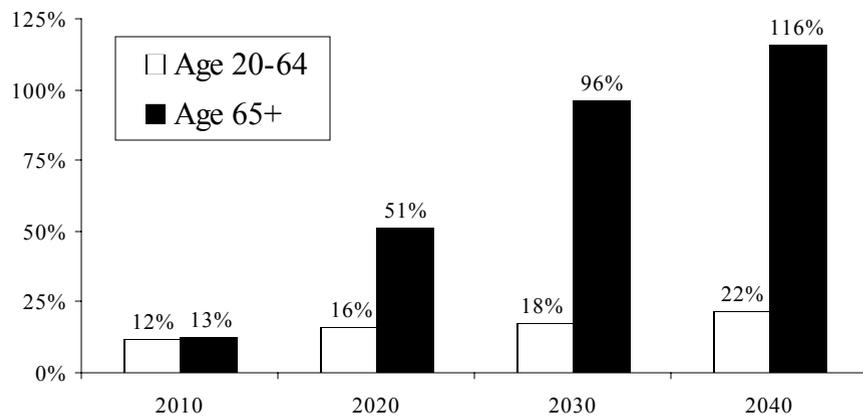
nates. Birthrates averaged three children per woman when the baby boomers were being born but are projected to be less than two in the future.²² The number of Social Security beneficiaries as a percentage of the number of workers paying taxes to support them will rise from 30 percent today to 49 percent by 2040.²³

The general direction and size of the coming demographic changes are unambiguous. Those changes will cause a financial crisis unless policymakers begin making changes soon. Policymakers should particularly focus on the less optimistic projections from the Social Security and Medicare trustees—it would be better for future generations to receive a positive financial surprise than to get hit with unexpected tax hikes or benefit cuts. Either way, near-term reforms will create a much better deal for future taxpayers and retirees.

High Consumption by the Elderly Funded by the Young

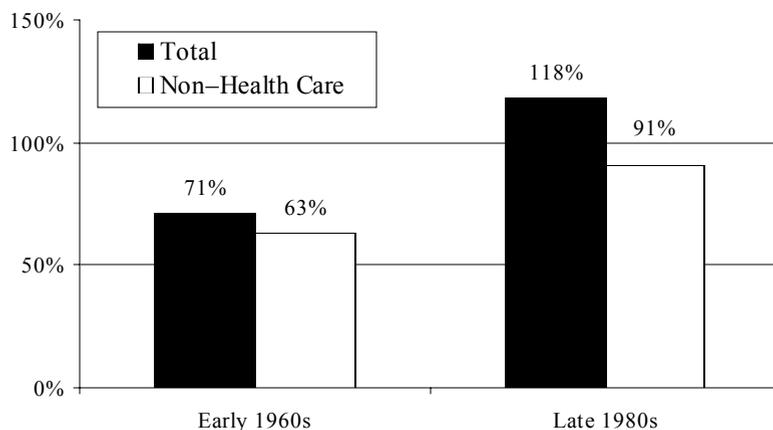
The fiscal problems caused by the increasing number of elderly Americans are exacerbated by high and rising levels of consumption by the elderly, much of which is supported by government transfers. Today's elderly consume far

Figure 3
Growth of U.S. Population by Age Group (percent change from 2000)



Source: Authors' calculations based on 2003 Social Security Trustees Report, p. 82.

Figure 4
Average Consumption of 70-Year-Olds vs. 30-Year-Olds



Source: Jagadeesh Gokhale, Lawrence Kotlikoff, and John Sabelhaus, “Understanding the Postwar Decline in U.S. Saving: A Cohort Analysis,” National Bureau of Economic Research Working Paper no. 5571, May 1996.

more relative to the young than ever before, and young taxpayers are financing much of that consumption. It used to be that the elderly consumed less than the young, on average. But rising federal transfers have reversed that situation and now the elderly consume more than the young.

Jagadeesh Gokhale, Laurence Kotlikoff, and John Sabelhaus examined changes in levels of consumption by the elderly and the nonelderly in recent decades.²⁴ They calculated that in the early 1960s an average 70-year-old consumed about one-third less than an average 30-year-old. But by the late 1980s, an average 70-year-old consumed about one-fifth more than an average 30-year-old (Figure 4). Rising health care consumption through Medicare is a key cause of the change. But the economists found that the elderly have greatly increased their non-health care consumption as well. In the early 1960s, 70-year-olds consumed 63 percent of what 30-year-olds did in non-health care goods and services. By the late 1980s they consumed 91 percent of what 30-year-olds did. Similarly, 60-year-olds consumed 81 percent of a typical 30-year-old’s non-health care goods and services in the early 1960s; they now consume slightly more.

High and rising consumption by the elder-

ly can be funded from three main sources: current earnings, personal savings, or government transfers. Today’s elderly retire earlier than before and thus have reduced current earnings. Although the elderly have enjoyed rising levels of personal savings, those savings have not been enough to fund their rapidly growing consumption. As a result, transfers from the young have funded much of the rapid rise in consumption by the elderly. Stanford University’s Victor Fuchs has studied the funding sources for consumption by the elderly and concluded that 56 percent of the “full income” of the elderly today comes from government transfers from the young; only 44 percent comes from their own resources.²⁵ (Full income refers to the sum of personal income plus health care expenses not paid from personal income.)

That most consumption by the elderly is funded by taxing the young rather than personal savings or current earnings is the result of government policy. The elderly have responded to policy incentives to work less, consume more, and reach retirement with inadequate savings. Government has created a vicious cycle wherein high taxes are used to fund retirement programs and expand government in general, leaving less money avail-

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able for young families to save for their own retirement. Indeed, the promise of expansive government benefits during retirement has created a strong disincentive for the young to save for their own retirement. Meanwhile, the government has thrown up large tax barriers to personal savings with high income taxes and restrictions on retirement savings vehicles such as 401(k) plans and individual retirement accounts (IRAs).

Without major reforms, this vicious cycle will get worse. Rapidly rising costs for Social Security and Medicare will tempt policymakers to raise payroll and income taxes even higher, which would leave families with even less cash and fewer incentives to save. If politicians choose that path, Americans will lose even more economic independence as the young have more of their earnings taxed away and the elderly become even more dependent on government.

The vicious tax and transfer cycle caused by unreformed entitlements will also cause U.S. economic growth to decline. The growth in entitlements for the elderly has been a factor behind the decline in the nation's savings rate. Resources have been shifted from the young to the old, who have a much lower propensity to save. Gokhale, Kotlikoff, and Sabelhaus conclude that "anemic rates of U.S. saving will spell anemic rates of U.S. domestic investment, labor productivity growth, and real wage growth. This, unfortunately, is the legacy of the uncontrolled intergenerational redistribution from young savers to old spenders that has been fueling ever higher rates of U.S. consumption."²⁶ To escape from this economic death spiral, policymakers need to remove barriers to greater individual savings and reduce government intergenerational transfers.

Accounting for Generational Inequity

To shed further light on the long-range economic problems caused by the graying of America, economists have developed "generational accounting." The technique was pio-

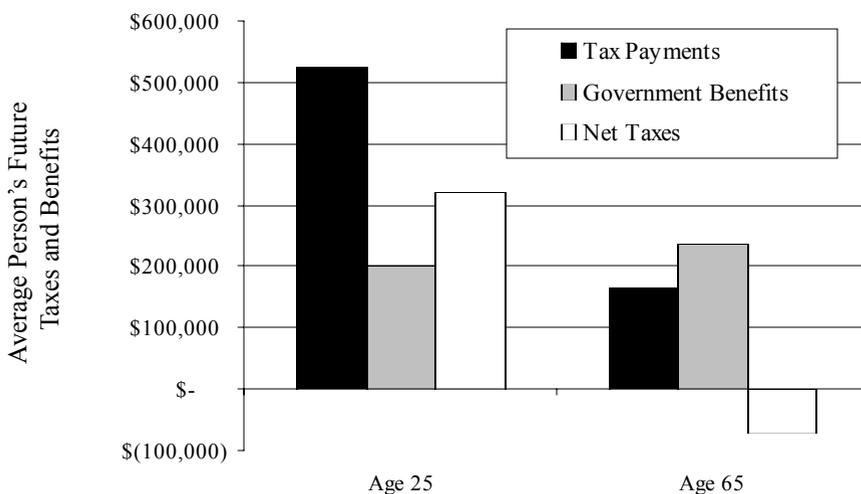
neered by economists Laurence Kotlikoff, Jagadeesh Gokhale, and Alan Auerbach. Generational accounting estimates are complementary to regular federal budget data and are occasionally included in federal budget documents.²⁷

Generational accounting data show taxes compared to government transfer benefits that Americans at each age may expect to pay and receive in their remaining lifetime. Transfer benefits include Social Security, Medicare, Medicaid, welfare, and other programs. Some transfer programs benefit the young, but the bulk of transfers goes to the elderly. Future benefits and taxes are summed and expressed in present value terms. A lifetime net tax figure based on the difference between taxes and benefits may be calculated.

Those calculations shed light on the raw deal politicians have set up for the young compared with the old. For example, recent estimates by Gokhale and Kotlikoff show that under current policy a male reaching 65 years of age today can expect to receive \$238,000 in Social Security, Medicare, and other transfers during the rest of his life in present value terms (Figure 5).²⁸ Since he will pay \$167,000 in taxes the rest of life, he will secure a net gain of \$71,000 from the government. That net gain comes at the expense of the young. A 25-year-old male today can expect to receive \$202,000 from transfer programs in the future, but pay \$524,000 in taxes during his lifetime, for a net loss of \$322,000.

Net tax rates are calculated for each generation as taxes less transfer benefits received, divided by projected lifetime labor income. Net taxes pay for all government spending other than transfers. Gokhale and Kotlikoff find that net tax rates will rise from 18 percent of lifetime income for a person born this year to 36 percent, on average, for future generations.²⁹ Thus, unreformed transfer programs will impose a tax cost on future taxpayers that is twice as high as the tax cost those programs impose today.³⁰ Rising net tax rates indicate that current federal fiscal policies are unsustainable and that transfer programs are shifting large costs to future taxpayers.

Figure 5
Generational Accounts for Average 25- and 65-Year-Olds



Source: Jagadeesh Gokhale, Laurence Kotlikoff, and John Sabelhaus, "Understanding the Postwar Decline in U.S. Saving: A Cohort Analysis," National Bureau of Economic Research Working Paper no. 5571, May 1996.

Gokhale and Kent Smetters recently produced another set of estimates that highlight the long-term imbalances of today's budget policies. Those "fiscal and generational imbalance" estimates measure the gap between future tax revenues and federal spending based on current entitlement promises. In present value terms, Gokhale and Smetters find that Social Security has a \$7 trillion imbalance and Medicare has a \$37 trillion imbalance.³¹ Gokhale and Joseph Antos have calculated that the current prescription drug bill would increase the Medicare imbalance by \$7 trillion to \$12 trillion.³²

These sorts of long-term projections rely on numerous assumptions, so they are not carved in stone. However, they clearly indicate the fiscal crisis that Congress has set up for the country with its expansive and unfunded entitlement programs. The estimates also raise fundamental issues of generational fairness. Federal policies have transferred enormous resources from the young to the old. Seniors have received Social Security and Medicare benefits far in excess of the taxes they paid for those programs.³³ Although past inequities cannot be

changed, policymakers can reform the programs now to avoid even larger intergenerational government transfers in the future.

Do the Elderly Need Such Large Budget Transfers?

Today's elderly are in a much different situation than those in prior decades when Social Security and Medicare were created. General levels of well-being, measured by lifespan, health, wealth, and income, all point to much higher living standards for today's elderly. The elderly are working less than before and enjoying higher consumption levels. That is good news for the elderly, but it is creating a big problem for the young who are financing a large share of consumption by the elderly.

Labor force participation by the elderly has declined markedly in the past half century. The share of men 65 and older who are in the labor force fell from 46 percent in 1950, to 27 percent in 1970, to just 18 percent in 2002.³⁴ (However, participation by the elderly has been fairly stable or trending up slightly

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since the mid-1980s). Early retirement creates an economic strain as fewer workers are adding to the nation's GDP and fewer are paying payroll taxes to support the entitlement programs.

The dramatic decline in the number of elderly workers has occurred despite a decline in the rate of disability among the elderly.³⁵ The share of the elderly with chronic disabilities fell from 26 percent in 1982 to 20 percent by 1999.³⁶ By the mid-1990s, 72 percent of the elderly reported their health to be good or excellent.³⁷ Improved health means that more elderly people are capable of working today and providing for themselves. Yet fewer are working because the government is handing them large transfer benefits.

Not only has the physical condition of the elderly improved, so has their financial condition. Social Security was created partly in response to the substantial share of the elderly population who lived in poverty and were unable to care for themselves. Census Bureau figures show that 35 percent of the elderly lived in poverty in 1959, compared to 27 percent of the overall population.³⁸ But since then poverty has plummeted, as shown in Figure 6, and there has been a reversal in the

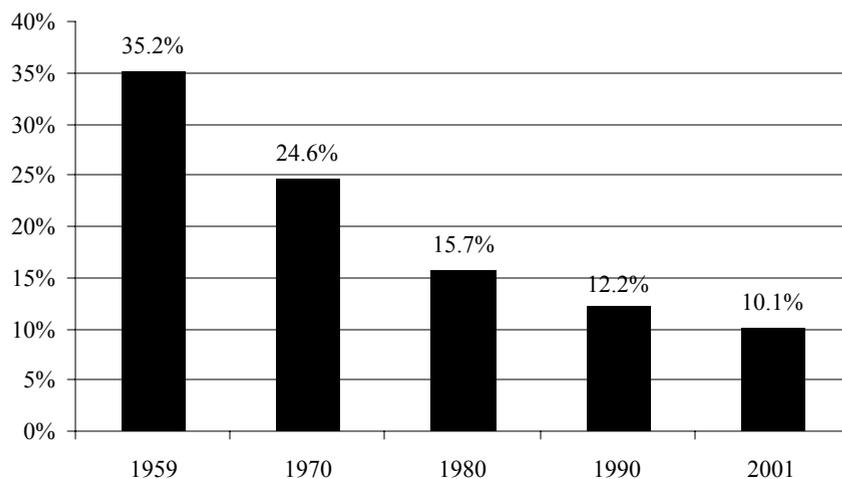
relative position of the elderly and the general population. The percentage of the elderly living in poverty has steadily declined; it was just 10 percent in 2001, compared to 12 percent for the overall U.S. population.³⁹

Other Census data also support this picture of the relative prosperity of the elderly. The Census classifies the elderly as in poverty or having "low," "medium," or "high" income. The data show that the share with low income fell from 35 percent in 1974 to 27 percent in 1998, the share with medium income increased from 33 to 35 percent, and the share with high income increased from 18 to 28 percent.⁴⁰

Federal Reserve Board wealth data also show that the elderly are in a better position today.⁴¹ Figure 7 shows that between 1989 and 2001 the net worth (measured in constant 2001 dollars) of the elderly increased much faster than that of the young. For example, the median net worth of families with a head of household aged 65 to 74 increased from \$105,000 to \$176,300 during this period, while median net worth for the 35 to 44 age group increased only slightly from \$77,000 to \$77,600.

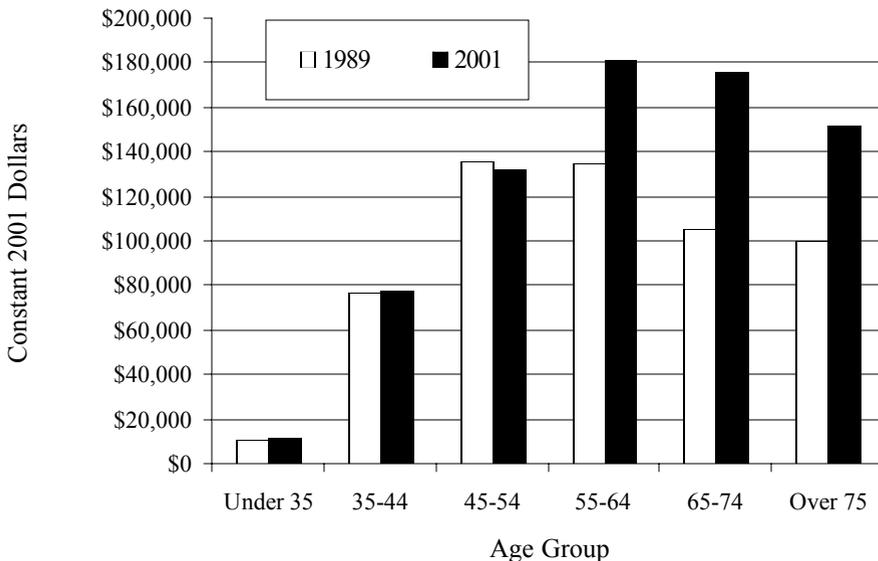
Since the elderly today are in much better financial shape relative to the young, it is unfair to continue expanding government

Figure 6
Percentage of the Elderly Living in Poverty



Source: Bureau of the Census, *Historical Poverty Tables*, www.census.gov/hhes/poverty/histpov/hstpov3.html.

Figure 7
Median Family Net Worth, 1989 and 2001



Source: Ana Aizcorbe, Arthur Kennickell, and Kevin Moore, “Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances,” *Federal Reserve Bulletin*, January 2003, p. 7.

transfers from the young to the old. Victor Fuchs finds that “although today’s elderly are on average healthier and wealthier than any previous generation in the nation’s history, their desires and expectations regarding life in retirement are outpacing the ability of society to fulfill them.”⁴² To fulfill those expectations, the elderly should work more, entitlement programs should be turned into savings-based systems, and the taxation of savings should be reduced to allow families to build bigger retirement nest eggs.

Reforming entitlements can create concerns among those lower-income Americans who assume that current programs are highly progressive, or disproportionately helpful to the poor. But entitlements for the elderly may be less progressive than is usually thought.⁴³ Lower-income Americans tend to die younger; thus they receive fewer years of Social Security and Medicare benefits than do others. Also, Social Security tends to transfer income from single workers to more financially stable married couples through spousal benefit provisions.

Higher-income recipients tend to live longer and incur higher annual health care expenses

than poor recipients. Some analyses have found that Medicare can be neutral, or even regressive, in overall impact. For example, a 1997 study by economists Mark McClellan and Jonathan Skinner concluded, “Medicare has led to net transfers from the poor to the wealthy.”⁴⁴

Social Security and Medicare reforms can be structured to benefit all Americans if they reduce inefficiencies, create faster economic growth, and increase choice and financial security. Partial privatization of Social Security could be very progressive with the poorest benefiting relatively more than those with higher incomes.⁴⁵ By contrast, research has found that not reforming Social Security would be highly regressive.⁴⁶ That is because payroll taxes would skyrocket to pay for promised benefits and thus impose a heavy burden on average workers.

Policy Solutions

The pay-as-you-go entitlements of the 20th century will create a major policy crisis in the 21st century unless Congress begins reforms soon. Numerous workable proposals

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for entitlement reform have been advanced in recent years. Yet Congress has hesitated on reform, perhaps waiting for a perfect and painless solution. But there is no perfect solution. Instead, averting a war between the generations will involve numerous reforms that Congress can begin pursuing immediately in incremental steps.

The first step is creating more personal saving. Workers should be given the opportunity to direct a portion of their payroll taxes into private accounts to fund their own retirement. A thick layer of voluntary savings should be built on top of those payroll contributions by sharply reducing taxes on saving. Next, disincentives for greater workforce participation by the elderly should be removed. Meanwhile, both entitlement and nonentitlement programs need to be cut to make way for higher costs as the number of elderly citizens soars. For example, Medicare costs can be cut by requiring more costs to be paid by beneficiaries out-of-pocket, and many programs in the \$858 billion discretionary federal budget should be terminated or privatized.

Social Security Reform

Social Security is the largest federal program, accounting for 21 percent of the federal budget in 2003. Under its pay-as-you-go structure, hundreds of billions of dollars are redistributed each year to the elderly from payroll taxes on workers. The pay-as-you-go structure will become unsustainable in future decades because growth in promised benefits far exceeds the program's tax revenues.

The key to understanding Social Security is to focus on the system's cash flows rather than the "trust fund." The Social Security Trust Fund does not represent money saved for the future and does not affect the level of taxes needed to support future retirees. Social Security assets invested in government bonds do not shield future generations from high taxes. That has been understood by experts for decades, but it continues to cause confusion among politicians and the public. In 1939 *Life* magazine ran a special on Social

Security and noted the mirage of a government reserve fund:

The most criticized feature of the Act has been its scheme for financing old-age insurance, under which it was planned to pile up a fantastic 47-billion-dollar reserve by 1980. The joker in this is that the Government has been spending Social Security tax money for ordinary expenses and putting its own I.O.U.'s in the reserve fund. Thus, when the time came to pay old-age annuities partly out of the interest on the bonds, the money could be raised only by taxing the people a second time.⁴⁷

In 1939 those concerns led to amendments to Social Security that set the program on a pay-as-you-go basis that is still in place today. The trust fund became a small contingency fund or bookkeeping entry of no real importance.

The Social Security problem is best understood by looking at future cash-flow shortfalls. By 2018 Social Security expenditures will begin exceeding revenues, according to the program's trustees.⁴⁸ By 2040 Social Security taxes will fund just 75 percent of benefits. If no reforms are made, that gap will be closed by either huge tax increases or huge benefit cuts.

The solution is to begin filling that future cash-flow gap today, which can be achieved with a funded system built on personal savings accounts. Funded retirement systems build up large pools of private capital from which future benefits are paid. Those pools of private capital will fuel higher business investment and growth, which make paying future retirement claims easier. A funded system allows members of each generation to pay for their own retirement through savings accumulated during their working years.

Numerous plans for a partially funded Social Security system have been proposed. The 1997 Social Security Advisory Council report supported moving toward a funded system.⁴⁹ In 2001 a bipartisan commission appointed by President Bush supported adding a system of

personal savings accounts to Social Security. The President's Commission to Strengthen Social Security proposed three reform options.⁵⁰ Option 1 was designed to illustrate the benefits of accounts funded by 2 percent of wages. Option 2 would redirect 4 percentage points of the 12.4 percent Social Security payroll tax into private accounts (with the contributions capped at \$1,000 annually). Option 3 would redirect 2.5 percentage points of the payroll tax into private accounts (capped at \$1,000) and would require that workers pay another 1 percent of wages to the accounts.

Under Options 2 and 3, traditional benefits would be reduced, but overall retirement income would generally increase. Private accounts would have various investment restrictions and minimum benefit guarantees in case investments did poorly. The accounts would be held until retirement, at which point benefits would be taken in the form of annuities or minimum withdrawals.

All in all, the President's Commission's proposals were quite timid. A number of reform plans introduced in Congress in the 1990s called for higher payroll carve-outs for private accounts in the range of 6 to 10 percentage points.⁵¹ Nonetheless, the commission made a strong case for personal accounts and addressed the concerns of a broad constituency. Enactment of any of the proposals would be a big step forward. After all, Congress need not design accounts perfectly from the outset. Once the public gains experience with private accounts, Congress could adjust and improve them. For example, accounts could begin with a 4 percent payroll contribution and then be expanded as Americans gained trust in them. In addition, there are unknowns with regard to the best method of account administration. Such details could be fine-tuned as the public and financial institutions gained experience.

Americans are more ready than ever for the responsibility and security that personal Social Security accounts would provide. Consider that when President Roosevelt introduced the system in 1930s only 10 percent of Americans held stocks.⁵² Today the

popularity of mutual funds has given more than half of all households experience with investment accounts.⁵³ It would be an exciting project to introduce the other half of Americans to the growth potential and security of private investment accounts.

The President's Commission noted that more than 20 other countries have moved toward retirement systems based on individual accounts. Personal accounts have numerous advantages over pay-as-you-go systems. They provide higher rates of return, create protection against the political risk of benefit cuts, stimulate economic growth, create greater economic freedom, and ensure greater fairness for beneficiaries by allowing bequests to heirs. Those advantages have been discussed in great detail elsewhere.⁵⁴

Another advantage of moving to a Social Security system with private accounts would be the reduction in deadweight losses that would occur.⁵⁵ If a portion of current payroll taxes were diverted into personal accounts, it would essentially act as a tax cut, thus reducing deadweight losses.⁵⁶ Work incentives would be strengthened as individuals noticed that taxes on their pay stubs were converted into true savings in private accounts. That would spur growth and give workers a much stronger interest in building a secure future for their families.

Medicare Reform

Unless reformed, Medicare will be a bigger time bomb for future taxpayers than Social Security. Not only are Medicare costs growing as the number of the elderly increases, but costs are being pushed up by health care inflation caused by new medical technologies and unrestrained demand.⁵⁷ Although new technologies and expanded treatment are great for the elderly, those benefits are coming at a large cost to the taxpayers footing the bills.

Medicare Part A (Hospital Insurance) is financed by a payroll tax of 2.9 percent on all wages. The combined expenditures of Social Security and the HI part of Medicare are expected to rise from 13.8 percent of taxable wages today to 24.2 percent by 2040, and

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thus grab a 75 percent larger share of workers' wages.⁵⁸ Adding in projected spending on Part B of Medicare pushes up the total projected costs of the two programs to 30 percent of wages by 2040.⁵⁹

Medicare Part B (Supplemental Medical Insurance) is financed 25 percent by user premiums and 75 percent by general federal revenues. Most general revenue for Part B comes from the nonelderly through income taxation.⁶⁰ Part B represents about 42 percent of gross Medicare spending and is growing faster than Part A.⁶¹

Like Social Security, Medicare is financed on a pay-as-you-go basis, creating a large transfer from the young to the old. In both entitlement programs, early generations of recipients received large benefits compared to the small amount of taxes paid. By contrast, future generations will receive low rates of return unless the programs are reformed.⁶² Indeed, in a 2000 study, economists David Cutler and Louise Sheiner found that "the Medicare system is shifting a greater share of the burden on future workers than is Social Security."⁶³ Unfortunately, Congress is considering making that problem worse with a huge unfunded prescription drug benefit.

Options for Medicare and Social Security reform share some common ground. In both cases, reforms should create partially funded benefits for the elderly based on defined-contribution personal savings accounts. That compares favorably to current entitlement systems, which are unfunded defined benefits. Medicare's unfunded defined benefit exposes taxpayers to whatever uncontrolled cost explosions occur in the program. By contrast, a defined-contribution plan would limit taxpayer liability and create incentives for cost control.

Under a partially funded Medicare system, workers would deposit a portion of their payroll tax into personal accounts that would be invested in debt and equity securities. Those accounts would be used to buy health care insurance upon retirement. Martin Feldstein has calculated that retiree health care savings accounts financed by an average 1.4 percent of

wages would be enough to make up the future funding shortfall of Medicare.⁶⁴ (To cover funding for the transition to the new accounts, other federal programs should be cut.) Feldstein concludes that private health care accounts "would eliminate the need for massive taxes that would otherwise reduce the disposable income of low and middle income workers by 20 percent and impose an extra deadweight loss equal to more than six percent of existing wages."⁶⁵

When people retired, balances in their personal health care savings accounts would go toward purchasing a health insurance policy. Seniors would choose among competing insurance providers with various coverage options, including an option for catastrophic coverage with a high deductible. Leftover balances in Medicare savings accounts would go toward covering various out-of-pocket health expenses.

Baby steps were taken toward a savings-based health care system in 1996 with the creation of medical savings accounts (MSAs).⁶⁶ MSAs need to be reauthorized by the end of 2003, and various proposals to expand and improve them have been introduced. MSAs, which combine a high-deductible insurance plan with tax-favored savings accounts for out-of-pocket health expenses, can be used by individuals of any age. If mandatory health care accounts funded by the payroll tax were created, MSAs would provide a voluntary and complementary add-on to cover health expenses during both working and retirement years.

Congress should liberalize MSAs and make them permanent. Currently, MSAs are underused because of their many restrictions. Congress limited MSAs to the self-employed and small companies, limited the total number of MSAs, and imposed limits on deductibles and other items. If liberalized, MSAs can begin moving health care away from today's system dominated by third-party payment through the government and insurance companies, which pushes up health care costs. An MSA-based system could reduce health care costs by increasing competition between providers and making

consumers more responsive to cost tradeoffs. In addition, an MSA-based system could reduce high administrative costs because many payments would be made immediately upon patient treatment rather than through third-party billing.

Certainly, Medicare reform involves many complex problems. That is partly due to the current top-down regulatory structure that has created detailed lists of mandated benefits, price controls on some 7,000 specified services, and 110,000 pages of regulations.⁶⁷ Congress should revisit the proposals made by the 1999 Bipartisan Commission on the Future of Medicare. The commission proposed moving in the direction of greater patient choice and more market competition to keep costs down. Medicare would be moved away from price controls toward choice and competition, with government support aimed at helping finance individual insurance premiums.

The Bush administration supports encouraging greater competition in the provision of Medicare services. For example, it has sought to expand the Medicare+Choice program begun in 1997 to provide retirees choice among competing health providers while reducing costs. Under the program, private insurers contract with the government to provide Medicare benefits through a health maintenance organization, a preferred provider organization, or some other form of benefit delivery. The program has not had much success because the government imposed a mass of regulations and distorted funding formulas, thus discouraging participation.⁶⁸ Nonetheless, with reforms, this approach could produce long-run cost efficiencies.⁶⁹

Top-down Medicare regulations should be removed as the system moves toward a competitive, savings-based structure. For example, regulations that prevent providers from offering stripped-down health insurance options should be removed. Medicare benefits that provide full coverage without substantial deductibles should be ended. Also, regulations on medigap policies should be changed to allow for high-deductible coverage (medigap policies are supplementary private insurance plans).⁷⁰ Under a reformed system, con-

sumers could have broader insurance coverage with higher deductibles. Savings in health care accounts could be allocated to meet the expenses that individuals believe are most important.⁷¹

Asking the elderly to pay more expenses out-of-pocket makes economic sense because it would keep health costs down. It is also reasonable from a fairness perspective, given that out-of-pocket expenses for health care for the elderly are currently quite small. In 1998 elderly households had annual out-of-pocket health expenses ranging from 9 percent to 16 percent of their total household expenditures depending on income level.⁷² Given that transfers from the young already cover 75 percent of the cost of health care consumption by the elderly, the system should move back toward a user-pays approach.⁷³

One way to reduce third-party payment would be to change the rules so that medigap providers offered high-deductible coverage instead of today's first-dollar coverage. The CBO finds that first-dollar coverage causes cost inflation and that policyholders end up consuming 25 percent more services than they would if they had to pay initial costs out-of-pocket.⁷⁴ If medigap plans did not pay the first \$1,500 of enrollees' costs, it would save taxpayers about \$98 billion over 10 years, according to the CBO. To offset enrollees' added costs, the CBO believes that medigap premiums would fall.

Another reform would be to increase Part B premiums to cover Medicare cost increases. Younger workers pay for most of Part B expenses through income taxes.⁷⁵ Part B premiums were originally intended to cover 50 percent of program costs, but premiums cover only about 25 percent of costs today. That decline in costs paid through premiums has come at the expense of the young. The CBO estimates that raising the premiums for Part B modestly to 30 percent of costs would save taxpayers about \$75 billion over the first 10 years.⁷⁶

Prescription drug benefits should be handled within the context of overall Medicare

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reform. Unfortunately, the drug situation is being falsely portrayed as a crisis to push Congress into adding benefits without any real reform. The average out-of-pocket cost of prescription drugs for Medicare enrollees in 2003 is a reasonable \$999 per year; just 5 percent of enrollees have costs of more than \$4,000.⁷⁷ Those figures do not indicate any pressing need to add drug benefits. Adding a drug benefit would just make Medicare's financial problems worse.

Tax Reform to Eliminate Bias against Saving

In addition to moving Social Security and Medicare toward savings-based systems, policy reforms should remove barriers to individual saving in general. Personal savings provide individuals with financial security and independence and allow for reduced dependence on government. Savings are the fuel that stokes economic growth by providing the capital that businesses need to invest in new and better equipment and technology.

It is generally recognized that Social Security and Medicare reduce workers' ability and incentive to save for retirement. Pay-as-you-go entitlement programs crowd out private savings, although the magnitude of this effect is subject to a range of estimates.⁷⁸ A system of personal accounts financed through mandatory payroll contributions is likely to increase overall national savings.⁷⁹

To complement mandatory retirement accounts, private savings can be increased by replacing the income tax with a consumption-based system to eliminate the current tax bias against saving. President Bush's tax reforms have moved in that direction by cutting the dividend and capital gains tax rates to 15 percent. That cut should be made permanent and further pro-saving reforms pursued.

One promising reform route is to continue liberalizing personal savings vehicles, particularly IRAs. Regular IRAs allow an up-front deduction for savings but subject withdrawals to tax. Roth IRAs provide for savings deposits from after-tax income, but qualified withdrawals are tax-free. To encourage greater sav-

ing, contribution limits should be increased, eligibility restrictions repealed, and withdrawal restrictions eased. Withdrawal restrictions reduce account liquidity and dissuade individuals from using the accounts to begin with.

President Bush proposed reforms along those lines in his FY04 budget.⁸⁰ His plan would create lifetime savings accounts (LSAs) based on a Roth IRA structure. LSAs would be savings accounts for all income and age groups. They would allow contributions of up to \$7,500 per year and allow withdrawals at any time with no taxes or penalties.

It is true that some lower-income families cannot afford to save more for their retirement, but research shows that many can. Although savings rates generally rise as income rises, savings rates also vary widely within income groups, even at lower income levels.⁸¹ Examining the data on income and savings, Victor Fuchs has concluded that "most low income elderly could have saved more prior to age 65."⁸² That suggests that removing barriers to saving by reducing taxes and liberalizing rules on personal savings vehicles can help Americans at all income levels build larger nest eggs for their retirement.

Remove Barriers to Work Participation by the Elderly

In recent decades retirement has become much more of a voluntary decision than a physical necessity. As the health of the elderly has improved, the workforce has shifted away from blue-collar work toward less strenuous white-collar work. As a result, retirement has become more of a discretionary choice for seniors today, which makes public policy incentives more important. If the elderly work more and pay for a greater share of their high consumption, the future burden on taxpayers can be reduced.

Despite steady improvements in the health and longevity of the elderly, there has been a long-term trend toward earlier retirement. Today, the average annual work hours for those at age 65 is just 701 for men and 423 for women, compared to a standard work-year of 2,000 hours.⁸³ Thus, there

appears to be plenty of room for greater work effort by the elderly to support their high levels of consumption.

A key policy problem is that Social Security and Medicare encourage workers to leave the labor force too early when they become eligible for benefits.⁸⁴ A detailed new study by economists Jonathan Gruber and David Wise concludes that government retirement programs in the 12 countries they examined, including the United States, clearly affect retirement decisions.⁸⁵ For example, the countries with the largest government benefits have the strongest early retirement trend.

Although Social Security provides reduced monthly benefits for early retirees and increased benefits for late retirees, many of the elderly are eager to receive benefits as soon as they are eligible at age 62. Indeed, a large spike in retirement occurs at 62.⁸⁶ Another large spike occurs at 65, the normal retirement age for Social Security and the eligibility age for Medicare. Similar effects occur in other countries. For example, Gruber and Wise find a spike in retirement at 60 in France when benefits become available. In a large review of the evidence, Feldstein and Liebman similarly conclude that “Social Security systems do appear to have important impacts on retirement behavior.”⁸⁷

Those findings suggest that Congress could increase work participation of seniors by raising the eligibility ages for Social Security and Medicare. Simulations by Gruber and Wise find that raising the eligibility age for retirement benefits by three years would reduce the share of men aged 56 to 65 not working by between 23 and 36 percent, a big improvement.⁸⁸

Moving to a retirement system based on personal accounts would provide incentives for seniors to continue to work. By working, seniors would be able to keep adding to their savings balances or pass on larger legacies to heirs. Congress should also assess whether labor regulations and other policies create roadblocks to greater work participation by the elderly. After all, the elderly have a lifetime of skills and experience that the

American economy will need more than ever in the decades ahead.

Cutting Federal Spending

The magnitude of growth of entitlement spending in future years poses a challenge to policymakers to find large savings across the entire \$2.2 trillion federal budget. All else being equal, unreformed entitlements will push federal spending up from about 20 percent to more than 27 percent of GDP by 2040. That would represent a massive government expansion. If Americans want to limit the government to its current size relative to the economy, let alone cut it, entitlements must be reformed and large cuts made to discretionary spending.

Unfortunately, Congress has been going in the opposite direction in recent years. Discretionary spending growth averaged 8.4 percent annually between FY98 and FY03.⁸⁹ In his first two years in office, President Bush presided over huge defense and nondefense outlay increases. For example, nondefense outlays rose 12.2 percent in FY02 and 8.8 percent in FY03.

Continued growth in discretionary spending will only cause the coming entitlement crunch to be even worse for taxpayers. Elsewhere, I have proposed reducing federal discretionary spending from the current 8 percent of GDP to no more than 5 percent and set out a detailed list of cuts totaling about \$300 billion.⁹⁰ Many federal programs need to be either terminated or privatized.

To help structure program cuts, Congress should establish a federal “sunset” commission.⁹¹ Sunsetting is a process of automatically terminating government agencies and programs after a period of time unless they are specifically reauthorized. A sunset commission would review federal programs on a rotating basis and recommend major overhauls, privatization, or elimination. Such a commission could recommend programs that should be ended because they duplicate state and private functions, such as education. Remarkably, while the entitlement crisis has loomed over the federal budget, Congress has expanded

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spending in many areas outside its constitutional authority. For example, federal education outlays skyrocketed from \$36 billion in FY2000 to \$60 billion in FY03.⁹² Federal mission creep should be reversed, with the federal government exiting from areas that are state, local, and private responsibilities.

Many federal programs should be privatized. Not only would that generate long-term savings, it would generate up-front cash to pay down the federal debt. Some federal activities that could be privatized include the U.S. Postal Service, the Tennessee Valley Authority, the power marketing administrations, and the air traffic control system. Air traffic control has been privatized in Canada with great success. The Bush administration has moved to open about one-quarter of federal positions to competitive sourcing. That process should be expanded to include the option of outright privatization of federal activities that are already classified as “commercial in nature.”⁹³

The Bush administration has embraced reforms in federal budget management. It has begun detailed reviews of programs, flagging those that are “ineffective.” Congress should support the effort by spending more time on executive branch oversight and terminating ineffective and unneeded programs. The president should require that department secretaries come up with detailed lists of cuts and downsizing proposals to be included in each federal budget update. Even needed agencies have a great deal of waste that should be cut. For example, the GAO finds that the \$400 billion Defense Department has “serious financial management problems that are pervasive, complex, longstanding, and deeply rooted in virtually all business operations throughout the department.”⁹⁴ There is simply no room for such waste with the coming entitlement crunch.

House Budget Committee chairman Jim Nussle’s (R-Iowa) current campaign to root out waste and fraud in federal programs such as Medicare, Medicaid, and agricultural subsidies shows that savings are not hard to find.⁹⁵ Medicare is one of the biggest money wasters in the federal government. For example, it has

been on GAO’s “high-risk” waste list for more than a decade and makes erroneous or fraudulent payments of at least \$13 billion or more every year.⁹⁶ It is not surprising that the Soviet-style structures of such programs create huge amounts of waste and abuse. Health care for the elderly must be moved away from top-down planning toward individual spending decisions, and every department in government needs to be scoured for cuts and terminations. The next generation does not deserve to be handed a massive entitlement problem on top of a bloated and ill-functioning federal government.

Conclusion

Social Security is ripe for real reform. Reform is a political challenge, but the political rewards are great considering that private accounts would give 155 million potential voters an option to gain more financial freedom. Franklin Roosevelt gained great fame in the 20th century as the champion of Social Security. President Bush would gain no less fame by delivering on the promise of a savings-based Social Security system for the 21st century.

Entitlement reforms have been paralyzed in Congress partly because the problems are so huge. But both Social Security and Medicare reforms can be incremental. The direction of Social Security reform is clear—prefunding of benefits in personal savings accounts. Congress could begin with modest accounts and expand them as the public gains more experience with them. For Medicare, the reform direction is also clear—personal savings accounts, cost cutting, high-deductible plans, and provider competition.

It is also clear that adding an unfunded prescription drug benefit to Medicare moves directly against reform because it puts the program’s spending on an even more unsustainable path. Unfortunately, tomorrow’s young taxpayers are not here to defend themselves against the huge burdens that are being foisted on them by Congress.

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