Can America Afford the Future?

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CAN AMERICA AFFORD THE FUTURE?
INTRODUCTION

Thank you and good evening.

The subject this evening concerns the nation's **financial future.** And that future frankly does not look good. We have heard a lot lately about the need to **reform Social Security,** for example, to keep the program from **going broke**. But Social Security is **not the only problem.** Rather, it is a **major contributor** to a much larger problem.

That problem is the huge deficits and consequent federal debt that will be generated by our **low level** of national saving and the **combined impact** of all future entitlement spending. Those deficits and debts are a looming financial **tsunami** that would engulf the entire economy. As former Senator **Paul Tsongas** said: "The numbers are relentless."

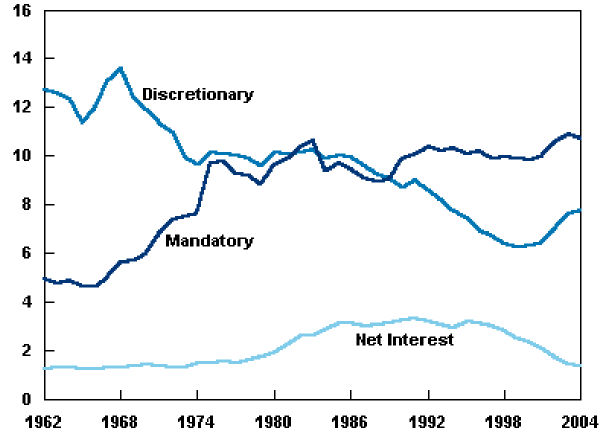
I'm going to show you some **evidence** of that problem, and hopefully it will convince you that as citizens, voters and taxpayers we must **persuade Congress** to act now to avoid a future that would be disastrous for our quality of life.

BACKGROUND

First, some background. There are two **types of federal expenditures**: Discretionary and Mandatory. **Discretionary** outlays cover government operating costs such as Defense, Homeland Security, Health, Education, Environmental programs, etc. **Mandatory** expenses pay for entitlement programs such as Social Security and Medicare. **A third category** sometimes shown separately is **interest** on government debt**.**

Major Components of Spending, 1962 to 2004

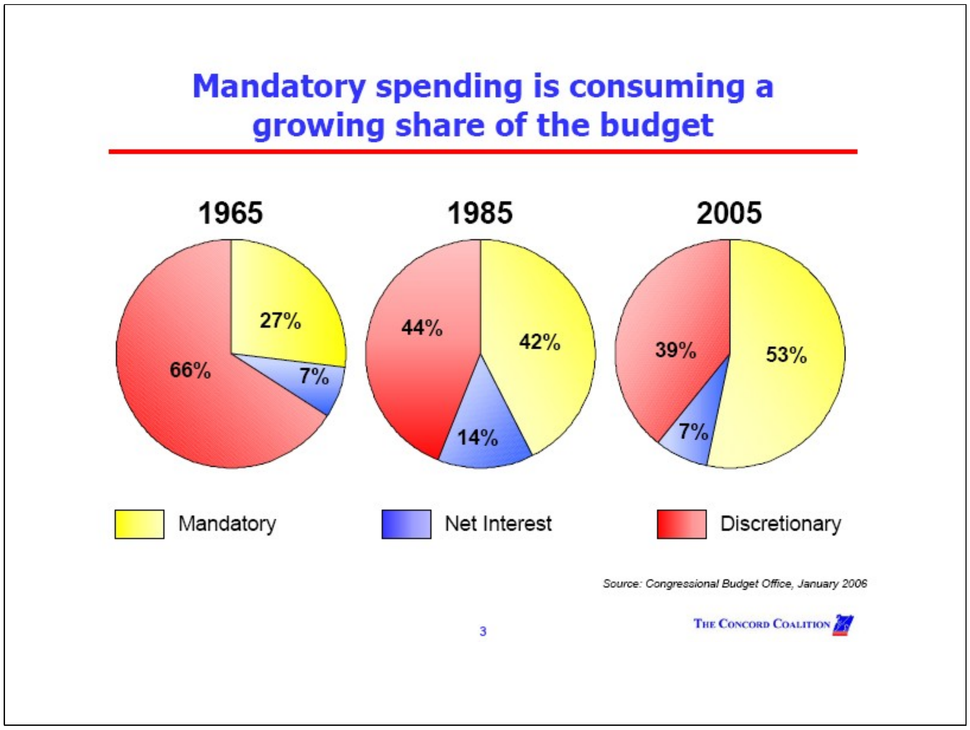
(Percentage of GDP)



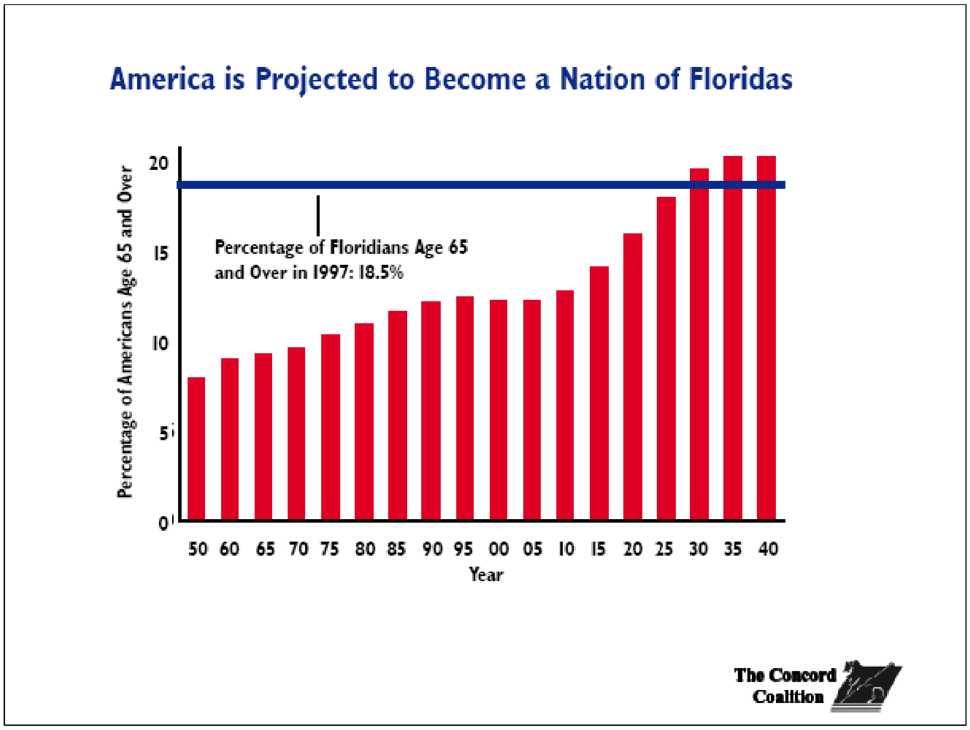
Source: Congressional Budget Office based on data from the Office of Management and Budget.

This chart compares these three categories from 1962 to 2004 as a percent of **GDP.** GDP stands for *Gross Domestic Product.* It measures the **size of our economy.** During this period, GDP grew roughly five times in real terms.

Discretionary expenses were at a high of 14% of the smaller GDB in the late 60's then steadily declined to roughly 7% today. **Mandatory** expenses that pay for entitlements did just the opposite, climbing from a low 5% of GDP in the 60's to over 10% of a much larger GDP today. As we shall see, this is an ominous trend that **continues into the future**.

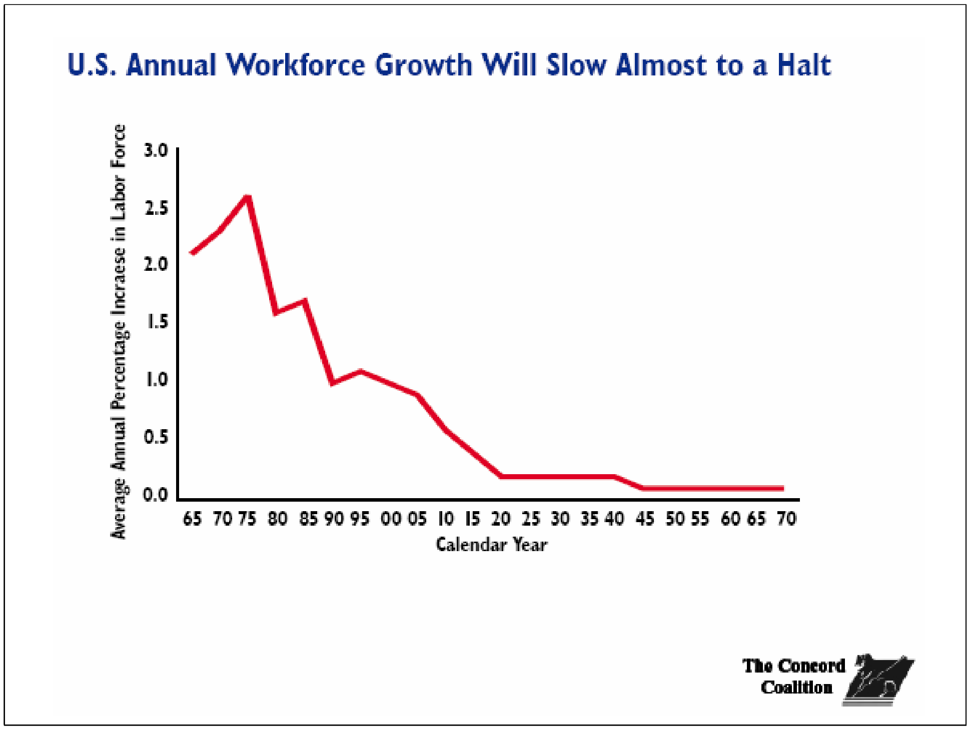


These mandatory outlays were **26% of the total federal budget** in 1964. By 1984, they were 42%. In 2004, they were 54%. They will grow to an even larger share of the total government in the future because unlike discretionary expenses they are **tied to demographics** especially as that relates to older segments of the population.

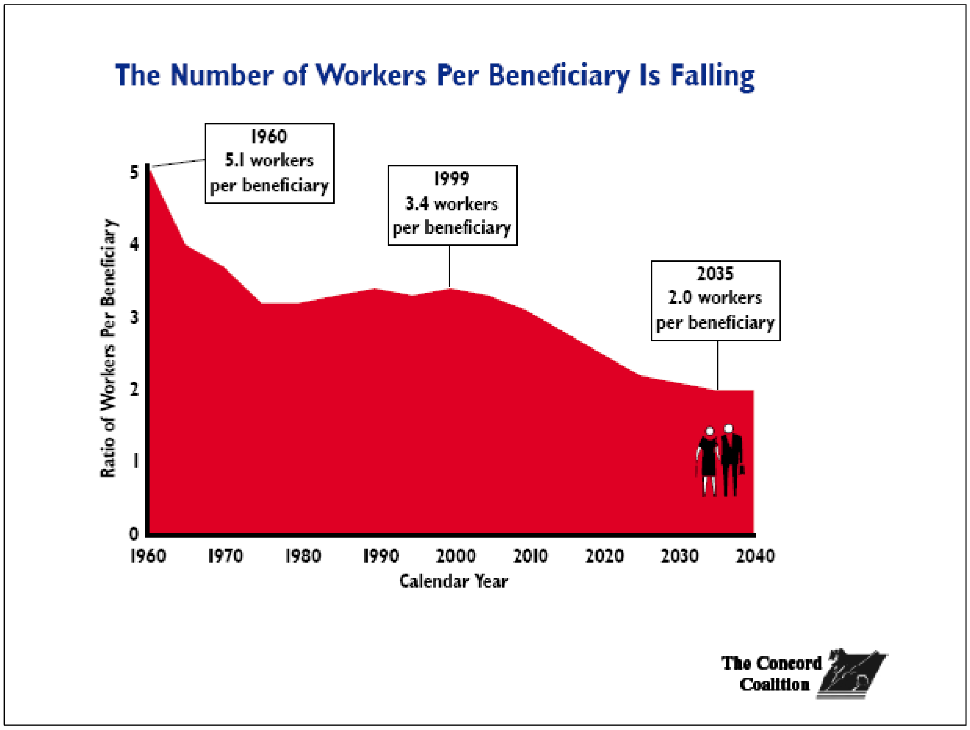


Demographics

For entitlement programs like Medicare and Social Security, demography is destiny. To understand why, look at this chart showing the percentage of the total **U.S. population over 64** from 1950 projected out to 2040. In 1950, there were 12 million people over 64. Now there are over 35 million. As shown by this chart, **by 2030**, the population of the entire U.S. will be as old, on average, as the population of Florida is today.



While the older segment of the population is growing faster and **living longer**, the growth of **working age** people is **declining**. This chart shows that trend in the labor force. This age shift in the population places an increasing burden on working Americans for funding retiree benefits through payroll taxes.



An indication of that burden is the number of **workers per retiree**. In 1960 each retiree was supported by slightly over 5 workers. By 1999, that number had dropped to 3.4 workers. By 2035, only two workers will be supporting each retiree.

The burden on working Americans is not limited to the payroll taxes they pay to support retiree benefits. Even more important is the **burden of financing** that part of benefits not funded by taxes. To understand why, it is helpful to keep in mind some **basics about trust funds**. This next slide summarizes these basics.

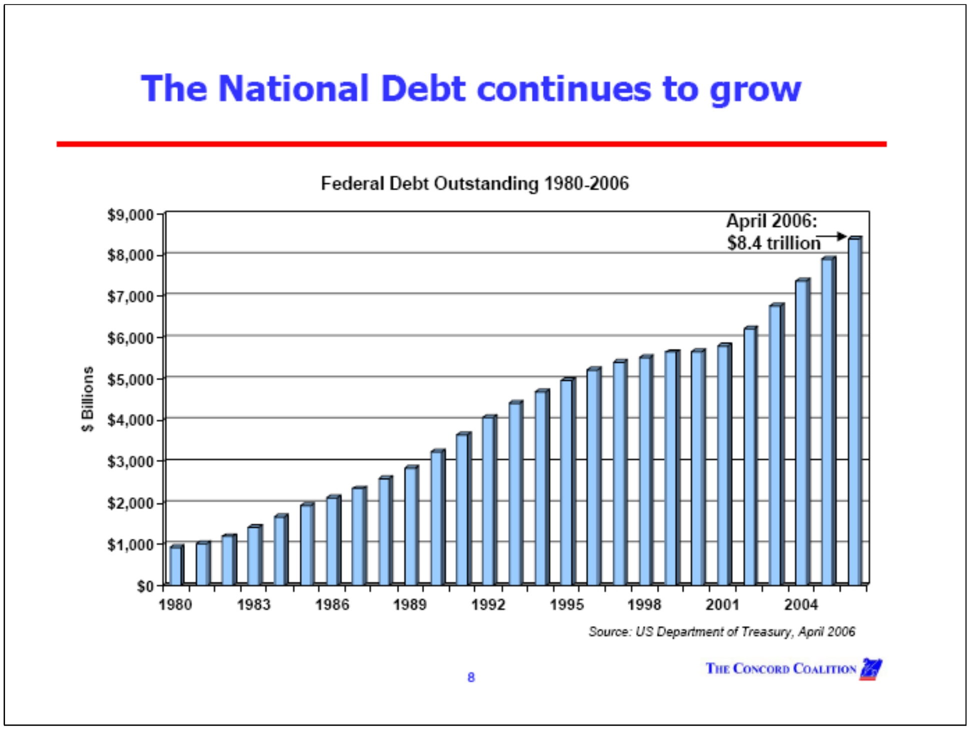
TRUST FUND BASICS

- **Trust funds contain no cash**
- **Cash from payroll taxes used**
  - **to pay benefits or**
  - **to pay discretionary expenses**
- **Cash used to pay expenses accounted for by Treasury IOU's**
- **Treasury IOU's earn interest for the fund paid with more IOU's**
- **Benefit payments from the fund that exceed cash income require collecting on Treasury IOUs**
- **Possible cash sources to pay IOU's:**
  - **reduce discretionary spending**
  - **raise income taxes**
  - **issue more public debt**

<u>Trust Funds</u>

Social Security and Medicare are paid for with **payroll taxes**. Since the taxes collected each year are usually more than the amount of the benefits paid out, the excess is recorded in a **"trust account" or fund** until it is needed to pay benefits in the future. But these trust funds are not like your **checking account** at the bank. They don't hold any cash. Their balances are simply **accounting entries**. That's because the money from payroll taxes not used to pay benefits is borrowed by the government to pay discretionary expenses. And those loans are accounted for by **Treasury I.O.U's** in the trust funds.

Those I.O.U.'s are a **special kind** of debt. They are not sold to the public. You can't buy a government bond from a trust fund.



Total federal debt is now $8.4 trillion. 42% of that or $3.5 trillion is debt held in these trust funds. The remainder is debt sold to the public.

By the way, to get some idea of **how much a trillion** is, ask yourself what number you would have to multiply times one million to get a trillion. If you wanted to convert $1 million into $1 trillion, for example, you would have to increase it a **million times**.

Since there is no actual money in the trust funds, when **payroll taxes** are less than **benefit payments**, the government has to raise **cash from somewhere else** to pay that difference, regardless of how big the trust fund balances are or of how much interest is paid on those balances.

That’s because the fund balances and interest income are **not cash**. They are Treasury I.O.U.’s that have to be converted into cash, and the only way to do that is to **raise income taxes**, **reduce discretionary spending**, **borrow more from the public** or some combination of those three.

KEY DATES FOR THE TRUST FUNDS	OASI	DI	OASDI	HI
First year outgo exceeds income excluding interest	2018	2005	2017	2004
First year outgo exceeds income including interest	2028	2014	2027	2012
Year trust fund assets are exhausted	2043	2027	2041	2020

Legend:
OASI = Old Age/Survivor Insurance (Social Security)
DI = Disability Insurance (Social Security)
OASDI = Above two combined
HI = Hospital Insurance (Medicare Part A)

Trust Fund Dates

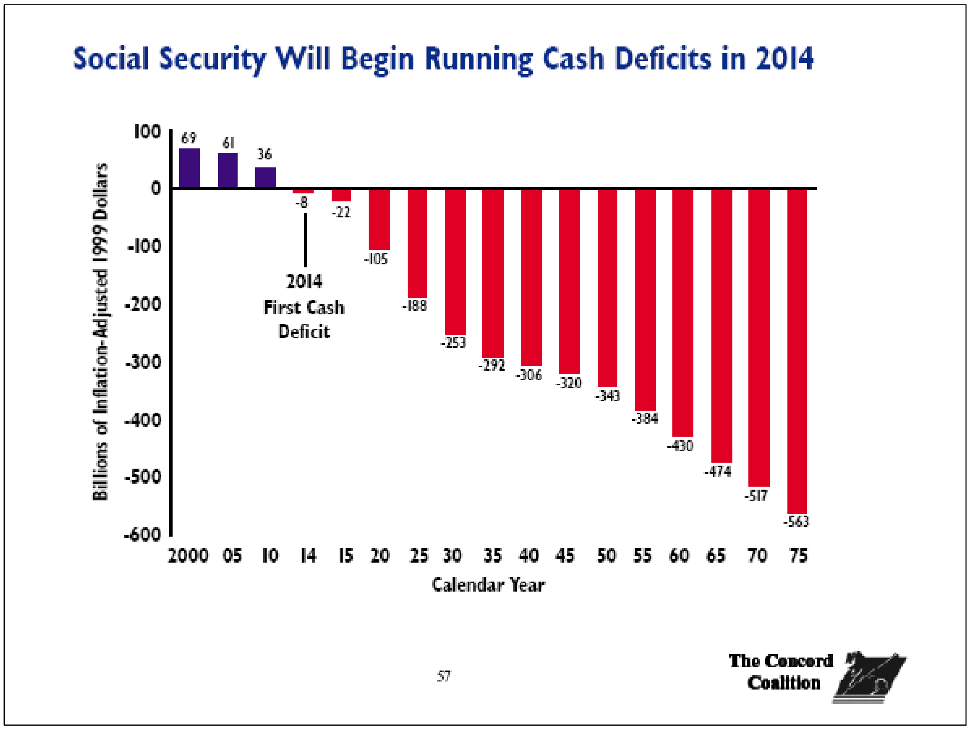
This table shows **projected dates** for the combined **Social Security** funds and the **Medicare Part A** fund (Hospital Insurance). As you can see, the latter is already in a cash deficit position, i.e. benefits payments already exceed tax revenues. That means the government right now has to **find cash** to make up that difference. By 2012, the government will have to start raising more cash to **liquidate the principle** balance in the fund. That balance should last until about 2020. But in terms of **impact on the federal budget**, it makes no difference how long the balance lasts, because all benefit payments in excess of tax revenues require additional funding.

Annual surpluses can accumulate into large trust fund balances. However, because these balances are really bookkeeping credits to the fund with the actual cash commingled with other collections, the accumulation of large balances does not by itself affect the government's ability to meet long-term commitments or make a program more sustainable in the future. In other words, accumulated balances do not increase the government's ability to acquire future resources to meet long term commitments.

The critical question is not how much a trust fund has in assets but whether the government as a whole has the economic capacity to finance the claims on the trust funds for benefits now and in the future and at the cost of other competing claims for scarce resources.

Congressional Budget Office

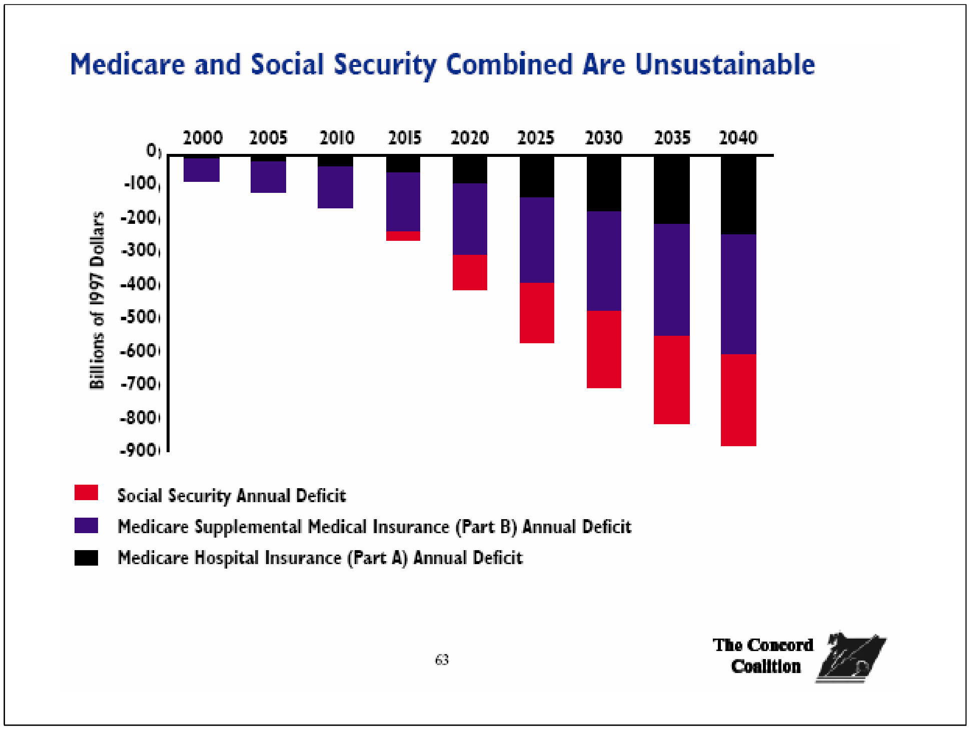
In a recent statement, the **CBO** had this to say about the impact of these future obligations: (See slide)



Social Security & Medicare Cash Deficits

To see how much that **financing requirement** will be, look at this chart showing cash deficits for Social Security through 2075. The current surplus dwindles to zero in 2014. Then deficits accelerate to an annual rate of over $500 billion.

When Medicare is included, the picture is much worse. Medicare, of course, is not limited to hospital insurance. **Medicare Part B** covers Doctors' bills and the recently added **Part D** provides a drug benefit. They are **not funded by payroll taxes**. Rather 25% of the cost is paid for by participant premiums, with the remaining 75% funded from Mandatory budget outlays.



The next chart compares the **cash deficits** of Social Security **(red**) and Medicare Part A **(black)** plus the 75% funding requirement for Medicare Part B **(blue).** This picture is a good indicator of why it is important to look at the **totality** of these programs when judging their future impact. In 2040, for example, when the government is searching for $300 billion in cash to pay for Social Security, it will also be trying to pay for the two Medicare programs at twice that amount. And these Medicare numbers don't include the effects of the recently passed Part D drug benefit. CBO cost projections for that program through 2015 come to just under $800 billion.

Estimated Fiscal Exposures
(in $ trillions)

	2000	2002	2004
• **Explicit liabilities**	**$6.9**	**$7.8**	**$9.1**
• Publicly held debt • Military & civilian pensions & retiree health • Other			
• **Commitments & Contingencies**	**0.5**	**0.8**	**0.9**
• E.g., PBGC, undelivered orders			
• **Implicit exposures**	**13.0**	**17.8**	**33.3**
• Future Social Security benefits	3.8	4.6	5.2
• Future Medicare Part A benefits	2.7	5.1	8.5
• Medicare Part B benefits	6.5	8.1	11.4
• Medicare Part D benefits	--	--	8.1
Total	**$20.4**	**$26.4**	**$43.3**

Sources: Consolidated Financial Statements.

Note: Estimates for Social Security and Medicare are PV as of January 1 of each year as reported in the Consolidated Financial Statements and all other data are as of September 30. The 2005 Trustees Reports issued in March of this year show that the Social Security and Medicare exposures have increased as follows: Social Security increased to $5.7 trillion, Medicare Part A increased to $8.8 trillion, Medicare Part B increased to $12.4 trillion and Part D increased to $8.7 trillion. Totals may not add due to rounding.

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VI CURRENT STATUS

Where does all this leave us? If we took a **snapshot view** of Uncle Sam's **total obligations** as of now, what would they add up to? Here they are. Future payments for Social Security and Medicare discounted back to a present value total $33 trillion. Payments for federal employee and veterans pensions plus public debt service will add another $10 trillion to that for a total of $43 trillion.

How can we visualize an amount that large? Well, the output of the entire U.S. economy for a full year is now around $12 trillion. So the federal government is obligated to make future payments in an amount **3.5 times greater** than our current economic output. In **balance sheet terms**, counting these future obligations as liabilities and the GDP as total assets would mean Uncle Sam has a huge negative net worth and is already bankrupt.

Growing Fiscal Burden

Another way to think about these fiscal exposures is:

	2000	2002	2004
Fiscal exposures [from previous page]	$20.4	$26.4	$43.3
Per person	72,000	92,000	147,000
Per full-time worker	165,000	214,000	350,000

Another way to look at it is from the point of view of taxpayer debt. This slide, for example, shows that each of us, no matter how old or young, owes the equivalent of $147,000 in addition to any personal debt we may have. Of course, our kids are not taxpayers yet. But those who are employed full time are, and when Uncle Sam's obligations are divided among them, they each owe $350,000.

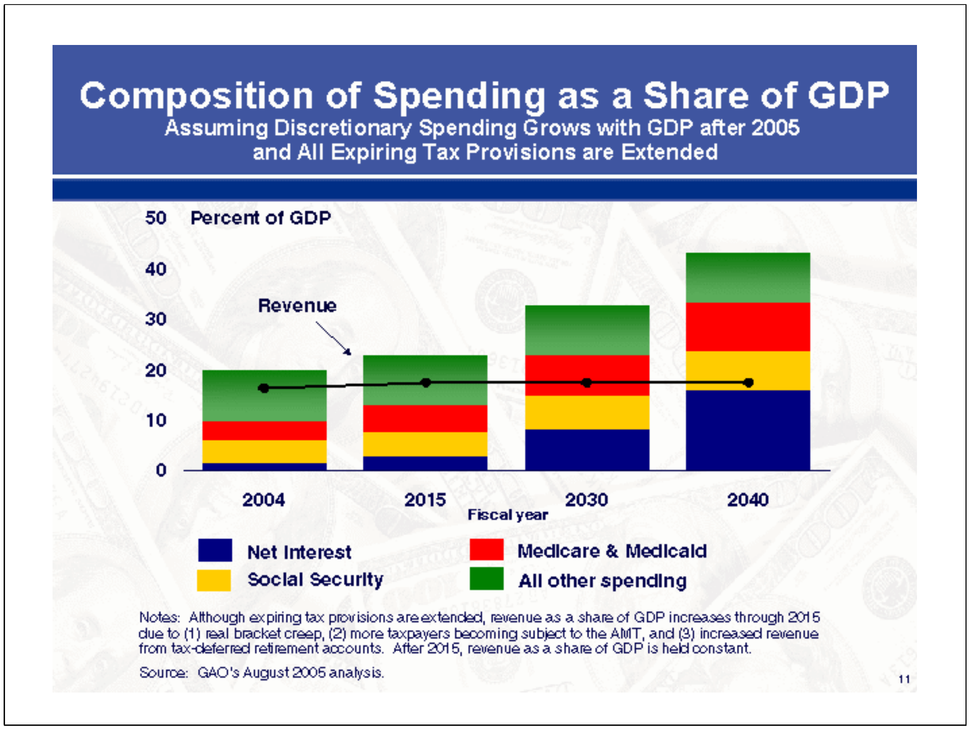
Borrowing to finance these obligations is ultimately unsustainable because borrowing cannot in perpetuity grow at a greater rate than the economy. At some point the economy will not produce enough resources to allow the government to service the debt.

Economic growth can help, but we will not be able to simply grow our way out of the problem. Closing the current long-term fiscal gap would require sustained economic growth at levels so high as to be implausible.

The fiscal policies in place today – absent substantive entitlement reform and dramatic changes in tax and spending policies – will result in large escalating, and persistent deficits that are economically unsustainable over the long term.

Government Accountability Office

The **GAO** said this about these conditions. (See slide)



The GAO issued this chart to illustrate that **unsustainable condition**. It assumes the **recent tax cuts** are extended through 2015. After that, tax revenues as shown by the black line grow with GDP. The green portion of the columns is discretionary spending that also grows with GDP. Below that are Medicare/Medicaid in red, Social Security in yellow, and interest on the federal debt in blue.

By 2015, there is enough revenue to pay for **only half** of discretionary spending. By 2040, available revenue covers little more than the **interest** on the growing federal debt.

What To Do

What can we do about this? The first and most important thing we must do is **change our attitude** about it. Larry Summers, former Secretary of the Treasury, commented on the situation by paraphrasing FDR. Summers said:

The only thing we have to fear is the lack of fear itself.

Once we are willing to admit there is a problem, we must then recognize what **won't work** to solve it. The Concord Coalition has jointly sponsored public discussions of this subject with the GAO and several **other policy groups**. They generally agree that there are three basic alternatives, none of which will work if employed to the exclusion of the other two.

Three Options

- Tax our way out of it
- Borrow our way out of it
- Cut spending

One is to **tax** our way out of the problem. Another is to **borrow** our way out of the problem. And a third is to pay for entitlements by **cutting** other spending.

In case you are wondering if there is a **partisan angle** to this, let me show you what two policy groups, one liberal and one conservative, have said.

What Do These Choices Portend to the Average Person by 2030?

- A 50% tax increase
- A major shift of responsibilities to the elderly for their own health and retirement
  - Social Security benefits reduced by about 20%
  - Health care costs paid out of pocket would almost double
- Much lower spending on defense and virtual elimination of most other programs
- Or exploding interest costs and an economic crisis

Brookings Institute

This is from the Brookings Institute, a liberal think tank in Washington. They list what they think are some likely consequences of relying on any one of the above three alternatives. A 50% tax increase, a major shift of responsibilities for retirees, a virtual elimination of non-defense discretionary spending, or (if we try to borrow our way out) exploding interest costs and an economic crisis.

What Can Be Done?

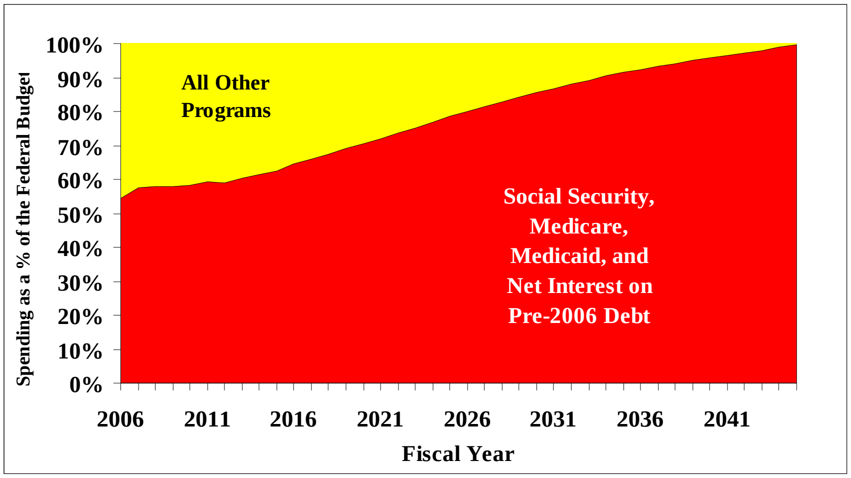
- First and foremost, public recognition that deficits are unwise and unfair:
  - Deficits financed by foreign borrowing are direct threat to our "competitiveness"
  - Unfair burden on our children and grandchildren who will have to pay it back
- Public willingness to forgo tax cuts or accept spending cutbacks

Brookings Institute

Here Brookings indicates what could be done to address the problem. First, recognize the problem **because** current foreign borrowing is a threat to our competitiveness (more on that in a moment), and because it places an **unfair burden** on future generations. Second, convince the public to forego tax cuts and/or spending increases.

<u>Option 2: Other Program Cuts</u>

Yearly Budget Breakdown, Assuming No Tax Hikes or Budget Deficits



The Heritage Foundation

Next, we have the Heritage Foundation, a conservative think tank in Washington. Here Heritage focuses on the option of cutting other programs to pay for entitlements. As you can see, all other spending basically would disappear by 2040.

Option 2: Implications

- Would have to immediately begin terminating programs to make room for Social Security, Medicare, Medicaid, and interest on past debt.
- By 2026, defense would be the only other remaining program.
- By 2045, defense would have to be eliminated too.
- By that point, 100% of the budget would go towards Social Security, Medicare, Medicaid, and interest on past debt.
- Clearly, this is not realistic.

The Heritage Foundation

Here is how Heritage describes what would happen.

Immediately terminate discretionary spending programs, with all programs (except Defense) gone by 2026.

Stop spending anything on Defense in 2045 when all spending would be for entitlements.

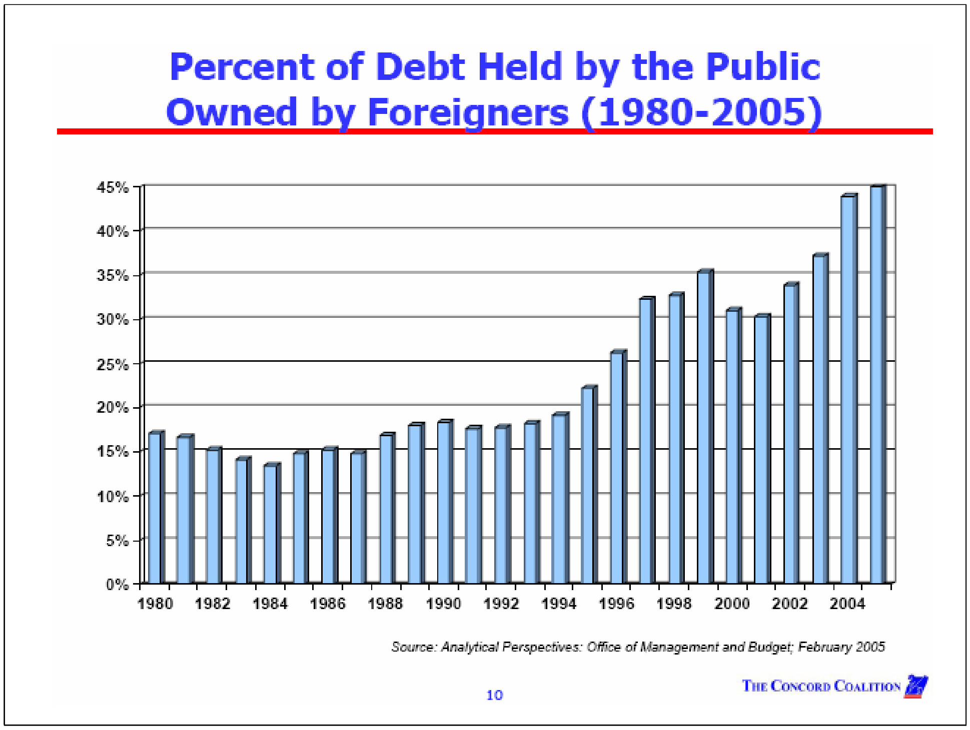
Heritage Foundation Conclusion

- This issue is about more than economics.
- There is a moral question of whether one generation should hand a multi-trillion dollar retirement bill over to the next generation.
- In the absence of fundamental reform, those entering the workforce today will experience both higher lifetime tax rates and lower incomes than their parents as a result of these retirement costs.

Finally from Heritage, their conclusions. (See slide)

CONCLUSION

Ladies and gentlemen, if we are willing to **face reality**, we must recognize that given our aging population, the federal government **cannot afford** to pay the **entitlement benefits** currently programmed for the future. Any attempt to do so would require **drastic tax increases** on working Americans, equally drastic cuts in discretionary spending, and/or a level of federal debt that could not be **absorbed domestically** and would not be **acceptable internationally**.



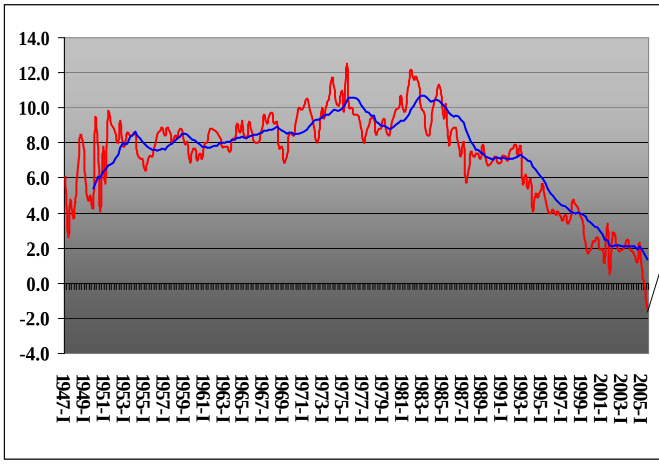
<u>The International Problem</u>

Yes, there is an international side to this problem, making it even more urgent to do something about it. It relates to **who owns** the federal debt sold to the public.

Over half, or about $2.5 trillion of that debt is held **outside the country**, principally by investors and Central Banks in Europe, Japan and China.

Americans Are Not Saving for the Future

Personal Saving as a Percentage of Disposable Income, 1947 - 2005



Starting in the second quarter of 2005, the personal saving rate fell below zero for the first time since the Great Depression.

Source: Bureau of Economic Analysis, National Income and Product Accounts, Table 2.1, Personal Income and Its Disposition

Why is that a problem? Because as this slide shows, we are a credit card society with a personal savings rate that is **virtually zero.** We used to be the world's **largest lender**. Now, since we don't save enough to pay for our **consumption**, we have become the world's **largest borrower**.

An attempt by foreign investors to **quickly liquidate** their holdings would cause a sharp rise in interest rates as bond prices fall. Since both our public and private sectors are heavily funded with debt, this would mean a wrenching adjustment to our economy.

POSSIBLE REMEDIES

Given this reality, the only way to **preserve America's solvency** is to find ways to reduce the impact of future entitlement benefits. To accomplish that, we need to take action in **three areas**: Social Security, Medicare and the federal budgeting process. Peter G. Peterson, a founding member of Concord Coalition, describes these measures in a book called *Running On Empty.* I don't have time to go into them now, but I would be happy to comment on them during the Q&A.

But in closing, I want to emphasize that nothing will be done about this unless and until the **Congress** becomes convinced that the public is so concerned about the country's fiscal condition that they **have to act**. They know about the problem. **Experts have testified** to them repeatedly about it. But Republicans won't stop cutting taxes and Democrats won't start cutting entitlements, and neither will adopt balanced budgets if they think it will jeopardize their **political status**. They didn't run for office to become political martyrs.

For Congress to take necessary action, they must be made to believe that the American people demand a **realignment of fiscal priorities** to put the economy on a **sustainable path for the future** that preserves our national solvency.

We must make it possible for politicians to do the right thing. We must compel decision-makers to translate knowledge about where current policy will lead us tomorrow into corrective action today.

***Running On Empty* – Peter G. Peterson**

As Peter G. Peterson writes:

We must make it possible for politicians to do the right thing. We must compel decision-makers to translate knowledge about where current policy will lead us tomorrow into corrective action today.

Can America afford the future? The answer depends on us, the **citizens**, **voters** and **taxpayers** of this great nation.

Thank you.