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Public Policy in the Age of Entitlements

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It is not often remembered that fundamental public policies in the United States are rooted in the constitutional settlement of more than 200 years ago. Advocates of policy change often are mystified by "inelasticities" in the political system that frustrate efforts to solve pressing social and economic problems. They sometimes rail against the Senate for its snail-pace timetable for deciding anything or, at other times, fear the House of Representatives for the swiftness with which even the most sacred policies and programs fall to ideological majorities.

The "wise" men and women of Washington know that the roots determine the branches, and their value to advocates and clients is measured in the mountains of compensation that flows annually to K Street and to the think tanks. Those who can pull the levers of policy power know their history, their political culture, and the predictable patterns of the policy year. In years past, one could go to the great Washington watering holes (the Palm, Charlie Palmer's, or the Occidental Grill) and hear the buzz of lobbyists and strategists at work: talk about the purchasing cycle of congressional appropriation "cardinals," the periodicity of Office of Management and Budget and Congressional Budget Office reports, and the calendar of reauthorizations.

Oceans of Red Ink

You can still hear this important chatter over cocktails and in between dishes in a five-course meal, but there's a new theme that is barely above a whisper now but on everyone's lips: If we don't do something to

Talking Points

- Social Security has become the fountainhead of programs that Americans increasingly view as entitlements to income security in retirement, health security in retirement, health maintenance during the working years, and security generally.
- The unfunded amount for the retirement income portion of Social Security needs to be added to the unfunded amount for Medicare and the nursing home component of Medicaid. The present value of the crisis in U.S. pension and health programs exceeds by five times the current size of the U.S. economy.
- Social Security and Medicare need to be reformed immediately to deal with these problems. The reform should do two things: secure the ability of the system to deliver on its promises to beneficiaries and enable today's workers to look forward to more income in retirement.

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rein in the spending of Social Security, Medicare, and Medicaid and reform these programs in order to avoid the oceans of red ink that economists say is the future of public-sector finance, there won't be dollars in the federal budget for anything other than defense and highways. In short, there's a specter haunting Washington, and it's the specter of runaway entitlements.

What these masters of the policy universe sense is the possibility that policy commitments to income and health security made generations ago are fundamentally changing the roots of the American policy tree. If they are right, then politics also is changing fundamentally, since politics stems in large part from debates over policy. If that happens, we might be on the verge of a future in which politics becomes dominated by generational differences and even more by differences in income.

America's Constitutional Settlement

So what is this all about? Let me step back from the whispering and take you on a brief tour of the American constitutional settlement and its subsequent adaptations that make up the roots of policy change today. The "constitutional settlement" to which I refer is the set of underlying agreements to the U.S. Constitution and supporting documents and policies that permitted the Union to be formed in 1789 and then reformed in 1866. The settlement begins with geography.

Every American school child knows that a major debate in the Continental Congress, and subsequently in the Constitutional Convention of 1787 in Philadelphia, centered on the relative power of big and little states. The big-population states, principally Virginia, New York, Pennsylvania, and (perhaps less so) Massachusetts, insisted on more say in the determination of policy than the little states like Connecticut, Delaware, or Rhode Island. The little states, on the other hand, feared the dominance of states with large populations and incomes. Mindful of the potential that those populations and incomes held for cultural and political hegemony, they insisted on state equality: Every state gets the same vote.

Less noticed is the geography of all of the states: They generally were bordered by the Atlantic Ocean or its major estuaries in the east and by the Appalachian/Allegheny Mountains in the West. That fact of physical geography with all of its differences in climate, economy, and labor force (slavery being foremost here) created a distinct regional element that superseded big- and little-state dynamics. As the Republic grew west, a distinct though less important East/West regional element came into the settlement.

The Founders and their successors balanced tensions by structuring a federal system in which the House represented the people, the Senate represented the states, and responsibilities for policy execution were divided between the federal government (initially the minor partner) and the states. Thus, majorities could act decisively in the House to instigate policy change and move issues important to the majority of the people, with representation for the chamber calculated by a population formula.

The Senate, on the other hand, acted in many different capacities, but principally to secure the federal system of government, balance geographical and population tensions, and debate or deliberate on policy issues. That simplifies a complex antebellum institution, but it largely succeeded in performing its key roles through the 1840s: no small task given the expansion of the Republic to the west and the spread of slavery to the territories and new states.

Destroying the Federal–State Balance

The Civil War broke the back of the Founding settlement and, consequently, the Constitution itself. Not only did it destroy the careful balancing act of the antebellum period as Congress attempted to keep an equal number of slave and non-slave, North and South states, but the Civil War also undermined the Senate as a policy body representing federal and state interests. The reconstructed Senate represented federal interests, particularly as the 14th Amendment took hold, and increasingly the interests of national economic and social factions.

The tendency of such a policy system to evolve into a syndicalist form of government, where representation in the Congress was by economic or social group rather than by state and sub-state districts, was clearly present in the latter half of the 19th century. It may have been prevented from formally taking hold in the representative branch of government solely because it became a central aspect of the regulatory state. There, in the increasingly dense administrative structure of the corporate welfare state, the teeming contests between economic and social factions were balanced. The House and Senate increasingly took on the roles of expanding federal power to legitimate the regulatory state and fine-tune its mission of balancing factions.

But a curious thing happened on the way to the Federal Trade Commission. Federal power extended itself into an area that appeared economic but turned out to be something entirely different. In 1935, Congress and the President created Social Security, a program designed to keep retired elderly Americans out of poverty. It appeared, innocently enough, to be just another economic program. However, over the next 70 years, Social Security grew into something quite different. It became the fountainhead of programs that Americans increasingly came to view as entitlements: an entitlement to income security in retirement, to health security in retirement, to health maintenance during the working years, and to security generally against the many things life throws up to frustrate happiness.

These programs have become spectacularly popular, defy every effort to restrain their growth, and have crowded out large portions of privately provided income and health security. Not only did Congress and the President fundamentally alter the course of public policy by aligning it with the principles of private mutual aid, but they also established a virtually irrevocable promise to future generations. Today's workers insure themselves against certain vagaries of their future economic lives by supplying tax dollars for those who are in need today. Social Security is the quintessential intergenerational insurance program. In exchange for lower disposable incomes, current workers shift the provision of their own future retirement needs onto the earnings of future workers.

Demographic trends unimagined by the system's founders, combined with numerous expansions of Social Security's original mandate, now threaten the future of this commitment and of public policy generally. It is altogether possible that a failure to change the retirement and health elements of Social Security and Medicare will lead to significantly higher taxes on low- and moderate-income workers. Indeed, mid-century Congresses may be (in the extreme case) focused on nothing else but finding money to pay for elder entitlement programs. In short, the entitlement policies may be unfixable in a legislative arena that was crafted and re-crafted to deal with geographic and economic interests.

The Politics of Entitlements

The politics of entitlements is increasingly the politics of age, yet the political apparatus is ill-suited to represent the interests of age groups in policy debates. This is unfortunate because the great demographic trend of the next century is one of an increasingly older population. Those political leaders who established the great entitlements during the 1930s and the 20 years following World War II did so with little awareness that the aging of the population then underway would hand political leaders of the 21st century an enormous problem.

For example, Social Security's founders established a statutory retirement age of 65 at a time when average life expectancy stood at 61 years. They also had no idea that an explosion of population loomed just 10 years after Social Security's creation. The largest generation of workers in world history is steadily approaching retirement in better health than any preceding generation in world history. By 2010, about 70 million "baby boomers" will begin drawing Old Age benefits from Social Security. In fact, the fastest growing segment of the population by 2020 will be people older than 75.

These surprising statistics are part of a larger aging trend that spans the globe.

- One of every 10 persons is now 60 years old or above. By 2050, one out of five will be 60 years or older. By 2150, one out of three persons will be 60 years or older.
- The older population itself is aging. The number of very old people (aged 80-plus years) is projected to grow as much as eight to 10 times on a global scale between 1950 and 2050. Currently, the oldest of the old (those people

aged 80 and above) constitute 11 percent of the population aged 60 and above. By 2150, about a third of the older population will be 80 years or older.

- By 2050, there will be 460 million people worldwide who are over 100 years old.
- The United States is aging at a pace that reflects the pattern in other mature societies. In the U.S., 30 percent of the population was older than 45 years of age in 1988. That 45 and above population is expected to increase to 37 percent by 2005 and to 41 percent by 2020.
- Here's another way to think about aging in the U.S. In 1940, there were 9.6 million college-aged people versus 9 million retirees. In 1994, the proportion was 14 million versus 35.5 million. In 2040, the number of retirees is expected to be significantly higher: 75.2 million compared to 20.2 million college-aged young people.

Prominent actuaries and economists put the amounts of future Social Security payments for the boomers and their children at between $6 trillion and $13 trillion (after inflation). Indeed, failure to change the current system could mean a 40 percent increase in payroll taxes over the next 20 years.

Unfortunately, this same post–World War II generation failed to reproduce itself, thus assuring that many fewer workers will be paying their parents, retirement after 2010 than the system minimally needs. The currently retired population enjoys a dependency ratio of nearly 3.5 to 1. By 2020, this ratio will have fallen to 2 to 1. In 1950, the ratio stood at nearly 30 to 1.

The current population of retirees secured a retirement and medical care package for itself that competes well with very good privately financed programs. However, today's workers must pay historically high payroll taxes to fund this publicly supported retirement and medical program. These taxes fall heaviest on those workers in low- and moderate-income households.

A young, single male born in 1967 and earning the average wage of $28,400 has an inflation-adjusted rate of return from Social Security of 0.4 percent. A similarly defined female has a rate of return that reflects her longer life expectancy, but it is still only 0.7 percent. Suppose these two people are married, both working, and living in New York with two children. Their rate of return from Social Security is a paltry 0.8 percent.

For a young, single, African–American male, Social Security's retirement program contains little if any value at all. Due to lower life expectancies, many African–American males may not live long enough to collect benefits equal to their taxes. Such a low-income male born in 1970 has a rate of return of –0.7 percent. That negative percentage means that the program is more expensive for him than for someone with a positive rate of return. Indeed, this black male loses about $14,000 in the Old-Age Insurance program. Had Social Security allowed him to invest his payroll taxes in Treasury bonds, he would have at his retirement $79,800 more than Social Security promises to pay him. In other words, his participation in Social Security would not mean that he would fall further behind in the economic race.

The High Price of Failure to Reform

The failure of U.S. policymakers to reform America's old-age programs so as to give low-income workers a better retirement has come at a very high price indeed. According to the actuaries who officially monitor U.S. public pension programs, Social Security owes $5.7 trillion (in net present value terms) more in benefits than it will receive in taxes over the next 75 years. That number includes $1.7 trillion to repay the bonds in Social Security's trust fund. In just one year (between 2004 and 2005), the financial balance of Social Security has worsened by $500 billion, or 9.2 percent more than in 2004.

If we go beyond the artificial 75-year period and use a "perpetual" accounting standard, the unfunded amount in net present value terms is $12.8 trillion, including money necessary to repay bonds in the trust fund. That is about the current size of the U.S. economy. Last year's number was $11.9 trillion.

And this is actually the *good* news. The unfunded amount for the retirement income portion of America's pension program (that is, Social Security) needs to be added to the unfunded amount for the country's retirement health plan (Medicare) and the nursing home component of Medicaid. The old-age health care program is expected to have unfunded amounts that are four times larger than Social Security's. In other words, the present value of the crisis in U.S. pension and health programs exceeds by five times the current size of the U.S. economy.

Obviously, Social Security and Medicare need to be reformed immediately to deal with these problems. The reform should do two things: secure the ability of the system to deliver on its promises to beneficiaries and enable today's workers to look forward to more income in retirement. With respect to old-age income security, you could take five steps now:

1. Enact a Social Security contract between the government and citizens, specifying the benefits that today's and future retirees will receive (currently, the Supreme Court says there is no right to benefits).
2. Slow the growth of future benefits to a pace that keeps them equal to today's benefits after adjusting for inflation. Make no changes in Social Security's disability and dependents program.
3. Raise retirement income by allowing workers to place a portion of their payroll taxes now devoted to retirement income (but not disability etc.) into a personal savings/investment retirement account instead. Workers who exercised this choice would not receive the Social Security benefits associated with the portion of their taxes they placed in a private account, but they would receive the Social Security benefits financed by the rest of their payroll taxes.
4. Require that all personal retirement accounts include an annuity at least equivalent to the Social Security benefits foregone by the worker. The annuity would have to be insured, with back-up insurance provided by the federal government.
5. No worker would be required to open a personal retirement account.

Conclusion

Of course, this reform plan, like others fronted by think tanks in Washington, assumes that the Senate can deal with the challenge before it. Is this legislative body capable of acting on this public policy crisis when doing so requires that it act against the parochial interests of powerful geographic, demographic, and economic interests that have shaped the Senate's modern form?

I have my doubts. Recent history appears to indicate that the Senate is an increasingly ineffective body when it comes to serious policy issues. If the past 20 years of poor performance reflects structural limitations rather than inadequate leadership and membership, then the United States will enter the era of its greatest public financial crisis with the weakest legislative apparatus ever.

No wonder the lobbyists are nervous at Washington's top watering holes. What haunts them is nothing less than the end of Congress's ability to direct large sums of "discretionary spending" toward the many interests who employ Washington's lobbying community. What should haunt the rest of us is the continued failure of Congress, especially the Senate, to grasp the gravity of this crisis, to reform fundamental public policies dealing with the income and health care of retirees, and to arrest thereby the slide of our political system into a paralysis of policymaking not seen since our Civil War.

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