

The Upcoming Generational Struggle
by Allen Buckley*
June 2007

Alexander Fraser Tytler, a Scottish Scholar who lived and worked at the time of the American Revolution, is reported to have said the following while researching the Greek democracies and the Roman Republic:

A democracy cannot exist as a permanent form of government. It can only exist until the voters discover that they can vote themselves largesse from the public treasury. From that moment on, the majority always votes for the candidates promising the most benefits from the public treasury, with the result that a democracy always collapses over loose fiscal policy, followed by a dictatorship. The average age of the world's greatest civilizations has been 200 years.

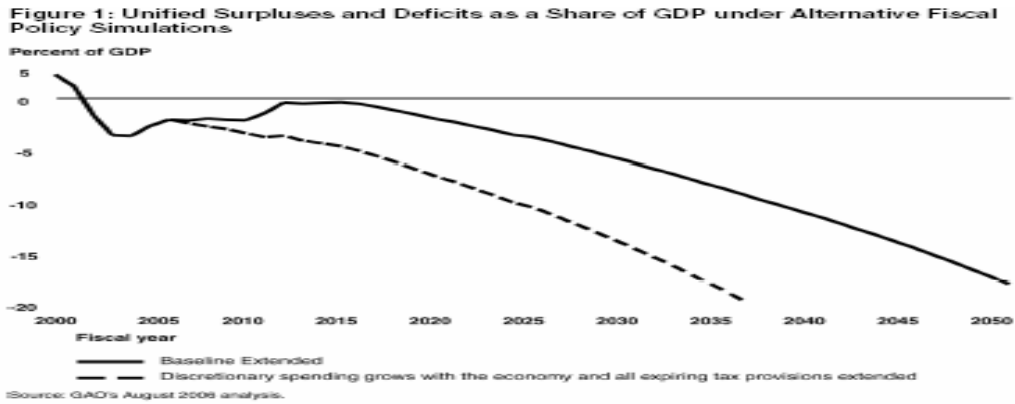
Due primarily to entitlements and demographics, the economic system of the United States will be in jeopardy of being destroyed within the next 50 years, unless substantial change occurs. The enormity of the problems has been relayed by Comptroller General David Walker and the U.S. Government Accountability Office (GAO) for years. Alan Greenspan provided similar warnings, although in lower tones and with less sense of urgency. Recently, new Federal Reserve Board Chairman Ben Bernanke gave a stern warning to Congress about the situation. His recommended date to start the fix: 10 years ago.

Encouragingly, and somewhat surprisingly, President Bush acknowledged the problems in his 2007 State of the Union address. He said: “. . . to keep this economy strong we must take on the challenge of entitlements. Social Security and Medicare and Medicaid are commitments of conscience, and so it is our duty to keep them permanently sound. Yet, we're failing in that duty. And this failure will one day leave our children with three bad options: huge tax increases, huge deficits or huge and immediate cuts in benefits. Everyone in this chamber knows this to be true--yet somehow we have not found it in ourselves to act. So, let us work together and do it now. With enough good sense and goodwill, you and I can fix Medicare and Medicaid--and save Social Security.” Note that, according to the GAO, the addition of Medicare Part D by the Bush Administration and the Congress in 2003 increased the costs of Medicare by more than **double** the cost of fixing Social Security's problems at the time.

Just how bad are the problems? A picture tells a thousand words.

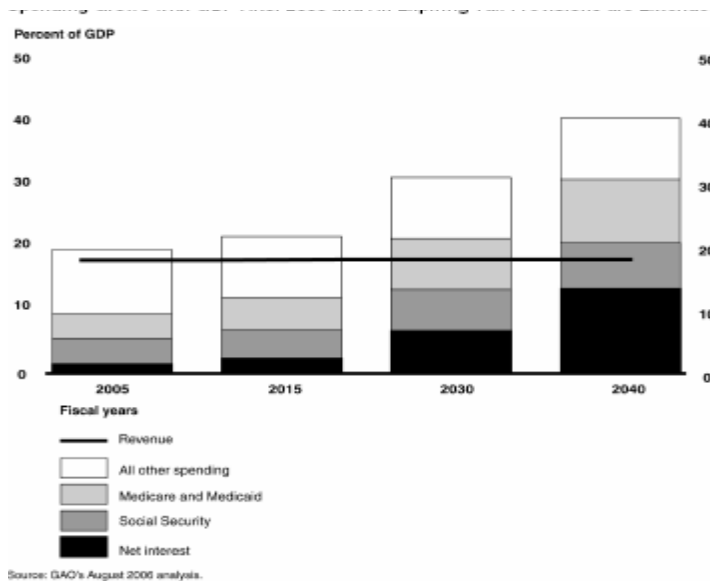
In September of 2006, the GAO issued “The Nation's Long-Term Fiscal Outlook, September 2006 Update.” The subheading of the Outlook is titled “The Bottom Line: Today's Fiscal Policy Remains Unsustainable.” A chart and quote from the first page thereof:

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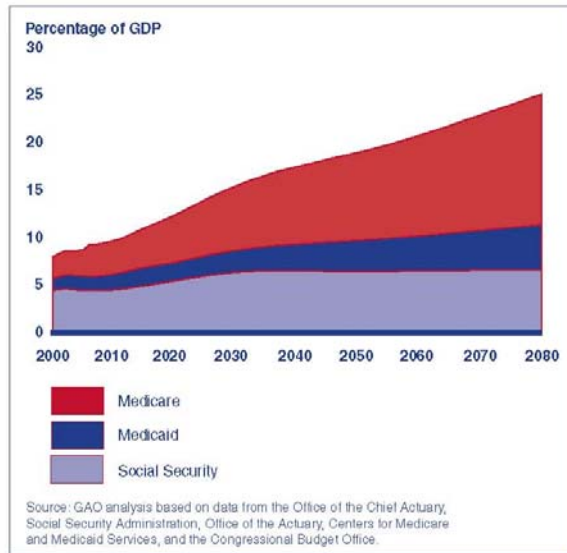
GAO's current long-term simulations continue to show ever-larger deficits resulting in a federal debt burden that ultimately spirals out of control. The timing of deficits and the resulting debt build up varies depending on the assumptions used, but under either optimistic ("Baseline extended") or more realistic assumptions, current fiscal policy is unsustainable.

Composition of Spending as a Share of GDP, Assuming Discretionary Spending Grows with GDP After 2006 and All Expiring Tax Provisions Are Extended



The projected entitlements growth chart is as follows:

Social Security, Medicare, and Medicaid Spending as a Percentage of GDP



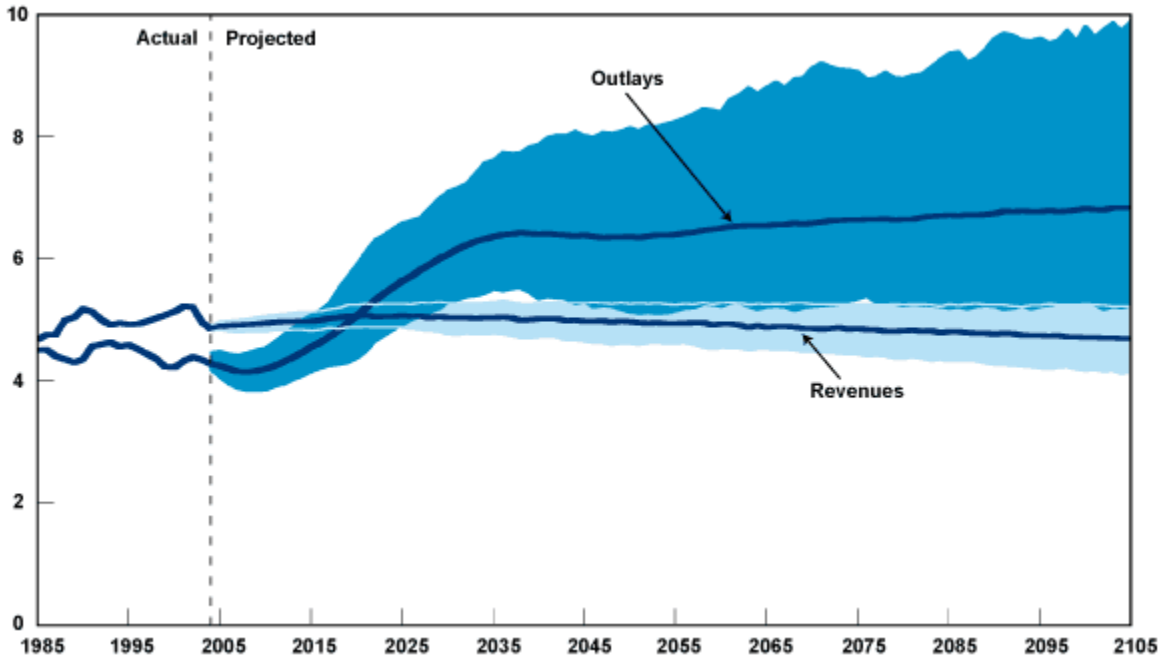
Note: Social Security and Medicare projections are based on the intermediate assumptions of the 2005 trustees' reports. Medicaid projections are based on CBO's January 2005 short-term Medicaid estimates and CBO's December 2003 long-term Medicaid projections under midrange assumptions.

Source: United States General Accountability Office, 2005.

Prior to 1981, the accumulated debt of the U.S. never exceeded \$1 Trillion. The U.S. now has debts of approximately \$9 Trillion (i.e. \$9,000,000,000,000) and, according to the GAO, unfunded obligations of about \$41 Trillion. Add all debts and unfunded liabilities, and the total is \$50.5 Trillion. Total household net worth is approximately \$53.5 Trillion. These liabilities and unfunded obligations break down to \$440,000 per American household. If the \$9 Trillion was surplus instead of debt, the situation would not be so grave.

Since the advent of Social Security approximately 70 years ago, the nation's demographics has been pretty much a cone shape, with the elderly at the point, the working people covering much of the center and younger people making up the base. That composition has worked well for the "pay-go" Social Security and Medicare systems. Under pay-go, current taxes pay the benefits of current retirees. Surpluses have existed, and they have been loaned to the federal government in exchange for unsecured IOUs. Thus, there is no "lock box" with money in it. So, when the surpluses run out, the problems will get very bad, very quickly.

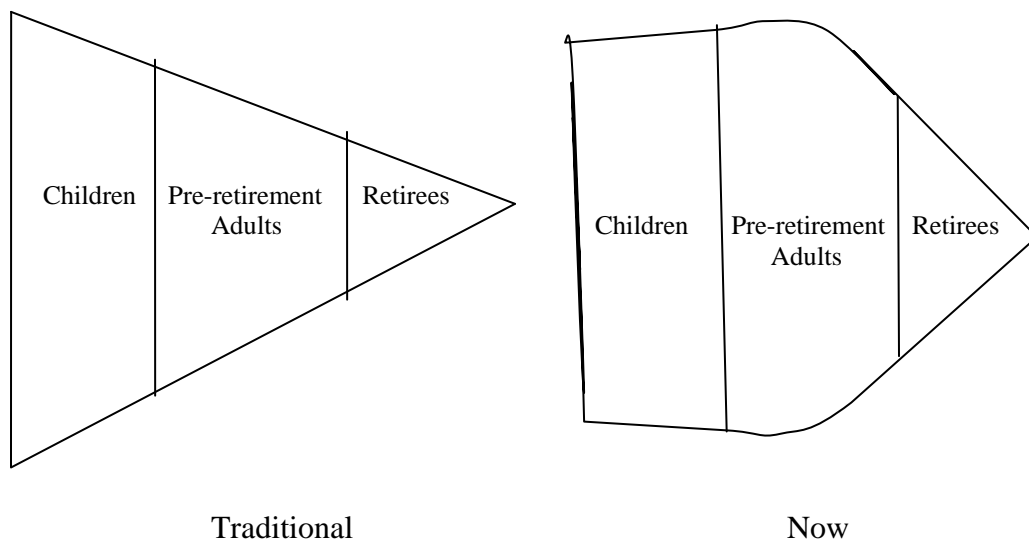
The Congressional Budget Office's chart on Social Security's anticipated revenues and expenses is provided below:

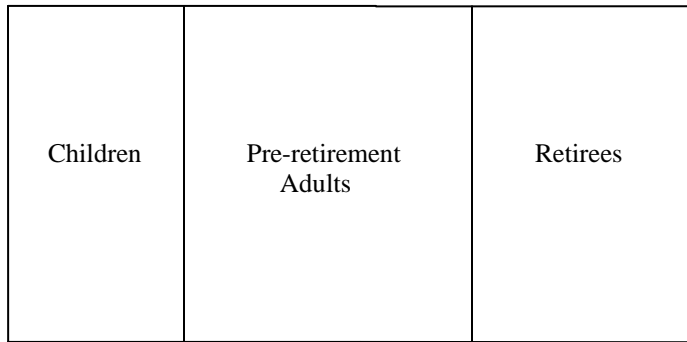


Source: Congressional Budget Office.

Based on the 2007 report of the Social Security Trustees, the switch from surpluses to deficits is now anticipated to occur in 2017.

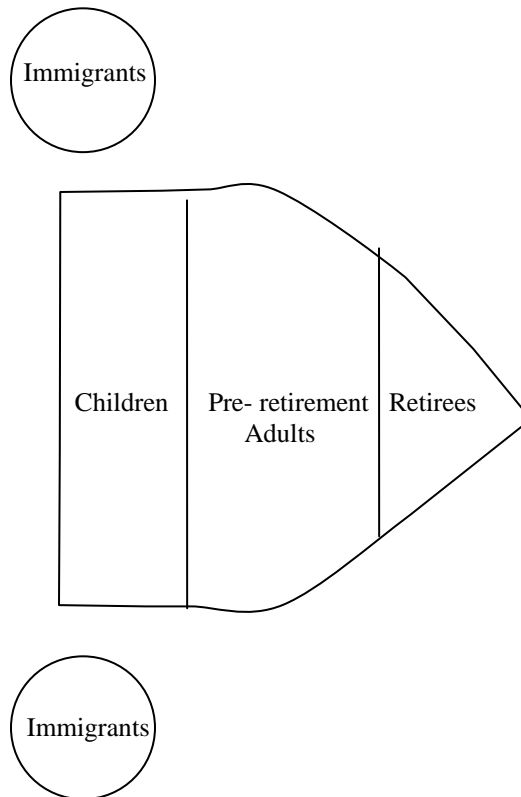
Due to World War II and the baby boom (and the end thereof), the demographics of the country now form more of an arrowhead shape. The life expectancy of a 65-year old was 12.6 years in 1940; in 2001, it was 18.1 years. Pay-go is not configured for such a situation, particularly for a country that is heavily in debt.





2037, Absent Massive Immigration

Should action be taken to convert the arrowhead to be more cone-shaped? The only way to do so in a short period of time is through massive immigration of working-aged people and their children. Is that desired? Could the infrastructure handle it? What would be the fix when the immigrants retired - more immigration? Current incentives for people to have many children?



Massive Immigration

The current and future dilemma is a function of our political system, under which vote-buying activities designed to capture seniors' votes are commonplace. Studies show that a group of senior voters will outvote an equal size group of younger voters by a ratio of 4 to 1. If the Republicans had not enacted Medicare Part D, the Democrats probably would have enacted their version of the same.

It should be remembered that whenever the "government" pays for something, that means that the taxpayers (i.e. the public) is paying for it. Corporations do pay taxes (not nearly as much as individuals), but most of the ownership interests of those entities are owned by people. Also, they often pass the taxes that they pay onto consumers, in the form of higher prices. So, it's a question of everyone paying for entitlements of recipients.

Adding to the problems: State and local governments are practicing the irresponsible habits of the federal government. According to a January 2007 *Policy Research Institute Report*: "State and local governments throughout the U.S. have made promises that they cannot afford and have financed their decisions by passing IOUs along to future generations. . . . Now those IOUs are coming due and the amount is staggering."

A generational struggle is inevitable. Consider a child born today. Assuming the child lives, he/she would attain age 18 and the right to vote in 2025. It's difficult to imagine any young person being excited about paying taxes into a system that will be irretrievably broken within 15 years. If able, the child would likely wish to make the following deal: "I'll not contribute to this system and I'll not take anything from it."

Older people can posture that they paid into the system that took care of the seniors before them. Thus, they're entitled to their due. Particularly with respect to upper income individuals and families, income tax rates were substantially higher in the 1960s and 1970s. For example, in 1976, the highest rate was 70 percent, compared to 35 percent today. Adjusted for inflation using the Consumer Price Index ("CPI"), the incremental income tax rate on taxable income for persons married filing jointly between \$42,480 and \$56,640 was 25 percent in 1976, whereas in 2006 the rate was 15 percent. However, prior to 1987, more income tax deductions were permitted. In contrast to income tax rates, Social Security and Medicare tax rates were lower in the 1960s and 1970s. The amounts subject to these payroll taxes has increased over time. Today, the Social Security tax is 6.2 percent of compensation up to the Social Security Wage Base ("SSWB") - \$97,500 for 2007. All compensation is subject to Medicare's 1.45 percent tax. In 1976, the *combined* rate was 5.85 percent, and the SSWB was the base limit for both taxes.

No doubt, many seniors and soon-to-be seniors will make the detrimental reliance argument. It goes like this: "You can't cut benefits as to me, because I planned my life under the assumption that I'd have "x" amount in Social Security income and that Uncle Sam would cover substantially all of my medical expenses. I would have lived differently, and saved, but for those promises." Taken to an extreme, to lesser degrees, this argument could be made by all but young workers.

The situation gives rise to a number of questions, including the following:

- Does old age equate to disability?
- If old age does not equate to disability, should everyone pay for some or most of the living costs of the elderly?
- What is fair?
- What is practical, assuming the Republic's economic system is to be preserved?
- Is a grandchild better served by receiving an inheritance in a decaying economic situation or no inheritance in a system in which the child can prosper?

By far, the U.S. has the largest economy in the world. If the entitlements system remains as is, and massive immigration is not implemented, then taxes must go up, and they must go up substantially. In this regard, there is only so much debt that the country can incur. With history as our guide, printing of money is not a solution.

If taxes are raised substantially, economic growth will be negatively impacted. That negative impact will reduce investment returns, including stock market returns. The entitlement problems of Western European countries are, in general, at least as great as those of the U.S. Thus, investing internationally to produce positive returns will have its limits. Western European countries don't have the massive military expenditures of the U.S., yet most of them have a value-added tax (VAT) in addition to an income tax (in many cases, similar to the income tax system of the U.S.) to fund their systems.

The President's Advisory Panel on Federal Tax Reform issued its report in November of 2005. In that Report, for a number of reasons, the Panel recommended that the current system not be replaced by a sales tax system such as the "Fair Tax" system.

Many current workers are trying to decide whether to make a "Roth 401(k)" election with respect to their 401(k) plan deferrals. By doing so, the employee's contributions are not excluded from income tax, but distributions at retirement are entirely tax-free. If the U.S. will not add a VAT or a sales tax to supplement the income tax, and entitlements won't be cut substantially, it seems logical that virtually everyone would benefit from a Roth election. In this regard, as previously noted, historically, income tax rates were higher than they are today.

There is now a substantial movement in the retirement area away from defined benefit pension plans, and to 401(k) plans. That movement puts pressure on the need of the 401(k) account, often invested by the employee, to produce solid returns. Those returns will, in a large part, determine the lifestyle options available to the employees in retirement. There is concern in the retirement profession that the stock markets will suffer when the baby boomers start getting conservative in retirement, and begin

shedding their equity securities for bonds and money market funds. What if that happens when taxes are being raised substantially to fund entitlements? It's not a rosy picture.

A 2006 study showed that a majority of Americans have negative after-tax income. Thus, debt appears to bother most people little. The vote-buys were easy. Reversing them will be very difficult.

Funding the entitlements, in whatever size and form they take, will need to be done while paying for (or otherwise dealing with) all other costs of the federal government, including the military, roads and bridges and all government agencies. It will need to be done in the aftermath of Iraq (and whatever that will entail), and while global warming is being confronted and terrorism is being combated. (Perhaps there will come a time when the U.S. will need to reduce its military installations abroad, that now exist in over 140 countries.) So, if the going concern assumption is made, there are some real challenges ahead.

What will happen when China wants to buy weaponry from General Dynamics, Inc. in 2030?

It is possible to alleviate some of the problems without increasing taxes or substantially reducing benefits. For example, the cost of drugs for seniors could be cut substantially by the receipt of government-negotiated group discounts or, alternatively, outlawing sales in the U.S. at prices greater than those charged in Canada and Western Europe. In that case, perhaps all of Medicare Part D except catastrophic coverage could be repealed, resulting in substantial drug benefits for seniors with little cost to the public. Otherwise, the questions come down to immigration, taxes and benefit cuts.

Keeping things in perspective, in the event of a nuclear war or invasion by aliens, none of this will matter. Perhaps some people believe that Armageddon is at hand, so there is no need to change course. They may be right.

Solutions to the problems exist. However, since most of the problems relate to seniors' benefits, given the 4-to-1 senior-to-younger voter voting ratio, the natural thing for politicians to do is to procrastinate – i.e. do nothing. Given the need for people to plan and the detrimental reliance argument factor, that alternative is not beneficial to the Republic or to its citizens.

The clock is ticking. The first batch of baby boomers (i.e. born in 1946) become eligible for early retirement under Social Security in 2008, and they become eligible for Medicare coverage in 2011.

Hopefully, the media and all political services will ask individuals running for Congress and the presidency *exactly* how they would deal with these problems, while demanding *specific* answers that are *logical* and *fiscally sound*.