eleven
Paying the Bills

We need a new intergenerational contract that invests more in people when they are young, but then expects them to assume somewhat greater responsibility for their own support during their retirement years.

ISABEL SAWHILL

Let's pretend we're a family sitting around the kitchen table discussing the condition of our budget. Recently we wanted to take a well-deserved vacation and make some repairs on our house. The total cost was more than we could afford based on our income, so we did what millions of other Americans do and simply put the costs on our credit card. Now we have a chance to buy into some very promising investments—all but certain to generate a reasonable return at some point in the future—but we don't have the cash to pay for the investments. We could borrow some more, but we already have an alarming level of debt.

This little household tale describes the current state of the federal budget. In one of the greatest abdications of fiscal responsibility in the nation's history, starting in the early 2000s policymakers of both parties abandoned reasonable and time-tested budget principles, ignored the needs of future generations, and spent money in every imaginable way—and several ways no normal person could have dreamed up—while simultaneously cutting taxes.[1]

As the federal government accumulated one of the largest piles of IOUs in the nation's history, the nation's poverty continued at a high level and inequality reached heights not seen since the Roaring Twenties. Wages stagnated, middle-class jobs are under threat, and those at the bottom of the income ladder are having difficulty climbing up, especially if they are African American. Simultaneously, the nation's public schools have slipped into mediocrity, and a number of nations have passed the United States in both the share of their young people graduating from high school and college and student performance on international tests of academic achievement. We show in the previous three chapters that there are solid proposals that reason and evidence suggest hold promise for producing returns that will benefit both individuals and society in the short and long runs. They would also encourage behaviors that move individuals and families out of poverty and into the middle class. Most of them are also consistent with our emphasis on encouraging personal responsibility and rewarding it when it occurs. Taken together, our proposals have the potential to help millions of younger families and their children and to move the country and its economy back into a position of international educational and economic leadership.

Even so, the two of us cannot simply recommend that the federal government spend the money necessary to pursue these worthy ends and ignore the deficit implications. Along with our colleagues at Brookings and at other organizations in Washington representing widely differing political perspectives, for the past several years we have devoted considerable time and energy to studying, writing about, and traveling around the nation trying to inform the public about the fiscal crisis.[2]

Our budget analyses led to difficult recommendations about raising taxes and cutting spending that are the necessary ingredients to extricate the nation from its impossible financial promises.[3] We cannot in good conscience now turn around and recommend billions of dollars of new spending without explaining how we would finance the spending. Evidence suggests that most of the spending may produce economic and social returns at some point in the future, but we cannot be certain of that. Rather, in this chapter we intend to do what we call on policymakers to do: lay out a plan for income that will completely offset new spending.

We begin with a brief review of the fiscal challenges facing the country. We then summarize the costs of our proposals. Next we outline a general approach to paying for new investments (both those recommended in this book and others) that involves revising the intergenerational contract now defining what younger and older Americans owe each other. We end with specific recommendations for paying for the proposals advanced in this book.

Deficits Unbound

After exemplary budget discipline by the Congress and the first President George Bush during the early 1990s, and even greater budget discipline by the Clinton administration and the Republican-controlled Congress during the mid-1990s, President George W. Bush and Republican and Democratic Congresses not only reversed the discipline achieved in the 1990s but also greatly exacerbated the nation's budget problems. None of the presidents or Congresses dealt seriously with the underlying forces driving the nation's long-term deficit. When the financial crisis hit in 2007 the Bush administration, and the Obama administration later, felt compelled to add several trillion dollars to the nation's debt to rescue the financial system and to get the economy moving.[4] Now it appears that the nation will have annual deficits in the range of $1 trillion far into the future.[5]

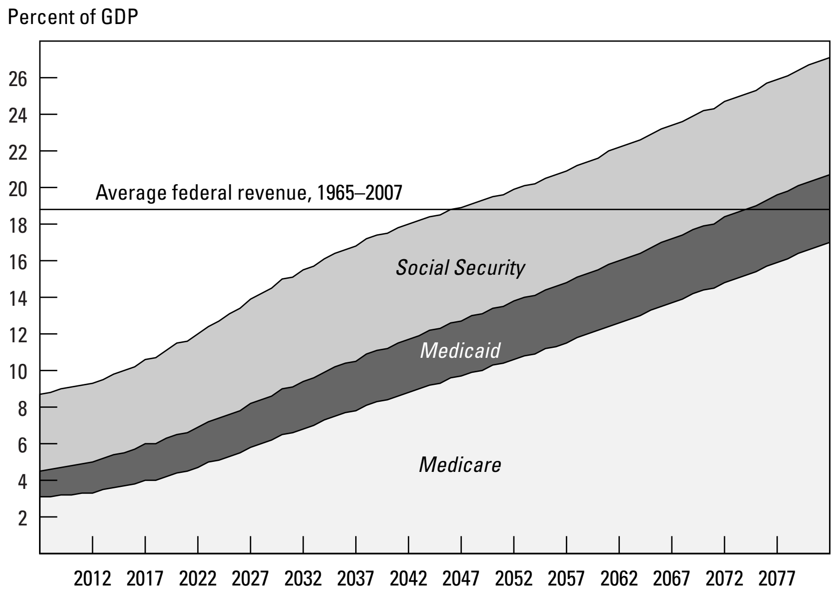
But this tale of budget woe over the next decade or so is not the worst of our financial problems. The federal government has promised to provide cash payments and health coverage to the elderly (including long-term care) that it cannot afford. Not only did recent Congresses and the Bush administration fail to address the problem, they actually made it worse by passing the Medicare drug benefit in 2003 and cutting taxes in 2001, 2002, and 2003. Each year that Congress and the president wait to solve the looming crisis of Medicare, Medicaid, and Social Security makes the required budget reforms more and more radical—which is to say that they will hurt more and more Americans.

Perhaps there would be some excuse for federal policymakers if the budget projections were exaggerated or uncertain. Of course, there is always uncertainty in any projections, but as projections go those for Social Security and Medicare are about as solid as any projections can be. In the case of Social Security, payments will exceed income beginning in 2017; the fund will run out of money in 2042; the seventy-five-year projection reveals an unfunded obligation of $4.3 trillion.[6]

The Medicare Trust Fund is in even worse shape. The fund is already being depleted because costs now exceed income; between 2008 and 2017 the fund's assets will fall from $326 billion to $96 billion. By 2019 the fund will be completely exhausted.[7] In fact for the past three years the financial condition of the Medicare Trust Fund has been so dire that the trustees have been required by statute to issue a "Medicare funding warning" and the president has been required to submit legislation to the Congress that addresses Medicare's funding problem (which Congress has ignored).

Clearly, the trustees' recent reports have been grim. An equally grim picture of the impact of Medicare, Medicaid, and Social Security on the federal budget is provided by figure 11-1. From about 9 percent of GDP and 40 percent of all federal spending in 2007, the three big entitlements are expected to grow to 18 percent of GDP and 100 percent of federal revenues by around 2040. After 2040 the programs just keep growing, reaching about 28 percent of GDP by 2080. There is nothing in sight to change any of these projections by any appreciable amount. Thus the current strategy of the federal government, which can be succinctly summarized as "What, me worry?" will soon lead us into uncharted waters that could sink the ship of state.[8]

Figure 11-1. Projected Spending for the Major Entitlement Programs, 2007–82



Source: Congressional Budget Office, *Long-Term Budget Outlook, 2007*, figure 1-1; Congressional Budget Office, *Long-Term Outlook for Health Care Spending, November 2007*, figure 1-1; unpublished data from Congressional Budget Office (http://cbo.gov/ ftpdocs/87xx/doc8758/11-13-LT-Health.pdf).

There are many reasons to be alarmed by projections like those in figure 11-1. One is that America is now dependent on foreign investors to maintain its level of spending. The Chinese, Japanese, and Saudis especially are responsible for buying up U.S. debt. Foreign investors have purchased more than 75 percent of the new debt issued by the Treasury Department since 2004.[9] What if foreign investors decide that the opportunity to invest is better in other countries or demand higher interest rates for their money? At worst, this could lead to an unprecedented economic crisis. At best, it could erode standards of living, as an increasing slice of U.S. incomes has to be earmarked to pay creditors. Interest payments were $249 billion in 2008 and are now headed much higher over the next decade, especially if interest rates rise.[10]

The budget problem isn't just an economic issue; it's a moral issue as well. The country has been putting new spending and tax cuts on the national credit card, expecting that its children and grandchildren will pick up the tab. An unfortunate aspect of passing on the debt is that the population is becoming increasingly composed of minorities, especially Hispanics, who are disproportionally less educated and low income. As the predominantly white older workers retire, their Social Security and Medicare benefits will be financed in part by the taxes paid by those who have difficulty supporting their own families, let alone the families of the more advantaged elderly.

A less direct but more worrisome aspect of the federal government's continuing profligacy is the culture of debt accumulation it has helped to create in America.[11] Perhaps people get the government they deserve, but given the sturdiness of American democracy and the track record of its elected leaders rising to the occasion in a crisis, it could be hoped that the federal government would pay its bills and stand against the rising tide of red ink, thereby serving as an example of financial rectitude that all Americans could follow. But instead the federal government led the way in establishing the culture of debt and lack of regard for consequences. Is it any wonder that, with a government like this, Americans simply followed suit and borrowed so much money against so little collateral and income that the financial crisis that began in 2007 was all but inevitable?

Ironically, one certain outcome of the financial crisis is that the federal government has had to borrow still more money to try to prop up the nation's financial system and to stimulate the economy. As a direct result of the financial crisis, the Committee for a Responsible Federal Budget estimates that the federal government spent at least $2.4 trillion on bailouts and stimulus packages in 2008. Although the numbers are sure to change as the financial crisis progresses, the committee now estimates that total exposure (the amount the federal government might lose in the long run) of the federal budget on all the 2008 stimulus and bailout actions at several trillion dollars.[12] The human mind struggles to even understand numbers this huge, let alone the size of the hole the country is digging for itself and its children.

A Summary of Our Spending Proposals

Taken together, our proposals cost a little less than $20 billion a year (table 11-1). We propose $9 billion in spending on preschool and postsecondary education, $10 billion on work and work supports, and more than $1 billion on reducing nonmarital births and promoting two-parent families. Most of the spending is on grant programs for which spending can be tightly controlled.

A number of our major proposals reflect our faith in the ability of researchers to design gold-standard evaluations that will guide policy implementation and lead to ideas about how programs can be improved. We pres-

Table 11-1. Federal Costs of Strengthening Education, Work, and Families: A Summary
Billions of dollars

Proposal	*Cost*
Improve education (chapter 8)	
Preschool	
Institute new competitive grants for early childhood education	6.000
K–12	
Institute a competitive grant to be used for teachers' bonuses	2.000
Carry out research on paternalistic schools	0.010
Postsecondary	
Terminate federal programs that support college preparation	–0.800
Create single competitive grant program to support college preparation	0.600
Increase federal grant program for state longitudinal data systems	0.200
End four federal student aid grant programs	–1.35
Increase Pell grant	1.35
Create incentive grants for state college financing voucher programs	0.500
Subtotal	8.510
Support and encourage work (chapter 9)	
Lower the threshold of the Child Tax Credit	3.100
Phase out Child Care and Dependent Tax Credit and child care exclusion between $100,000 and $150,000 for married couples ($75,000 and $100,000)	–1.000
Expand Child Care and Development Block Grant	2.000
Continue Child Support Enforcement	0.030
Create employment and training apprenticeships	0.040
Institute employment and training block grant	2.000
Institute an EITC expansion for young males	2.000
Create an inflation adjustment for TANF	1.000
Institute a TANF grant for disconnected mothers	0.500
Link housing grant program with increased work	1.000
Continue food stamps; expand work program	0.200
Subtotal	10.870
Strengthen families (chapter 10)	
Institute teen pregnancy block grant	0.500
Terminate abstinence education Title V program	–0.050
Expand Medicaid for family planning	–0.100
Institute community college grant program to reduce pregnancy	0.250
Carry out research on reducing pregnancy among twenty-somethings	0.025
Continue Bush multisite demonstration programs	0.020
Institute a social marketing campaign	0.500
Subtotal	1.145
Total	20.525

ent strong evidence that a number of small-scale programs aimed at improving education, supporting work, and reducing teen pregnancy have produced significant benefits. However, scaling up small programs is tricky. The difference in results between evaluations of the Perry Preschool and Abecedarian programs compared with the national evaluation of Head Start is a striking example. The best solution to this long-standing problem is to gradually expand the model programs while continually evaluating and adjusting.

The need to invest more in the education and training of children and adolescents is supported by a large majority of the public.[13] Moreover, unlike many areas of the federal budget, most of the education and training investments we recommend can improve the future productivity of the nation. Greater investments in early childhood education could bring society long-term benefits that exceed their costs. Investments in youth entering the labor force, investments to help teenagers and twenty-somethings avoid nonmarital pregnancies, and investments to provide financial aid to college-bound youth could also pay for themselves in the long run. Other proposals, such as expanded funding for child care and housing, will help those who play by the rules, ensure that prosperity is more broadly shared, and promote self-sufficiency.

Reframing the Budget Debate

But if we are to fund the types of investment we recommend, we first need to reframe the debate about the federal budget. Specifically, we need a new intergenerational contract that invests more in people when they are young but then expects them to assume greater responsibility for their own support during their retirement years. If we make wise investments in the young, their ability to be more self-sufficient during their later years will be enhanced, as will their productivity, so they can contribute to increased national wealth and pay taxes to finance the health care and retirement needs of those who have been less fortunate. But the country must start now. The longer it waits, the more likely that today's children and young adults will be incapable of supporting either themselves or their parents during the latter's golden years.

The need to reframe the intergenerational contract is premised on a number of assumptions.[14] First, linking investments in the young to the reform of entitlements for the elderly could have bipartisan appeal because it emphasizes both personal and social responsibility. Second, the current allocation of resources between the young and the old is premised on outmoded assumptions about the relative needs of each. Generational equity requires a recalibration of the needs of the different age groups. Third, by phasing in any changes to the intergenerational contract slowly and paying careful attention to the genuine needs of the older population, no one will be seriously hurt in the process. If change is begun now, commitments to current beneficiaries can be maintained, a robust safety net for vulnerable groups can be provided, and more public resources can be reallocated to the young.

We are convinced that unless the country makes major investments in the education of the young and in workforce programs, future generations will not be better off than previous ones and the economy will not be as competitive as it needs to be. Money alone will not solve all of the problems. However, whether it's addressing the fact that the early home environments of young children put them at risk for school failure, the fact that one-third of young people don't graduate from high school on time, or the fact that almost half of children born into poor families are still poor when they reach adulthood, money is surely needed.[15] So where is this money to come from? According to Eugene Steuerle of the Peterson Foundation, rising costs in entitlement programs for the elderly will absorb most of the currently projected revenue growth.[16] Not only will there be no new money for children, there will be a fiscal squeeze on existing programs for children. In other words, if the nation continues along the federal spending path it is on, not only will it fail to make the types of investments we recommend here, but it will be forced to actually cut currently projected spending on children and families.

Dead-End Budget Ideas

Many progressives assume that the solution is simply to raise revenues enough to simultaneously keep deficits at a reasonable level and to pay for the most promising investments in children and their families. Many conservatives assume we can eliminate congressional earmarks along with fraud, waste, and abuse to fund similar efforts. But these assumptions are wrong.

Why can't the necessary revenue be obtained simply by raising taxes? First of all, poll after poll shows that the public is not enamored of new taxes.[17] But even if the taxes (required by our scenario of funding some new programs and simultaneously addressing existing and future deficits) are imposed, these higher taxes would also impose perhaps untenable burdens on typical working-age Americans. The incomes of most members of the middle class have been stagnant, and their jobs and incomes are increasingly insecure. Reducing their take-home pay to fund these investments is neither politically realistic nor a wise idea. Further, higher taxes on productive workers and investors at some point would begin to have a serious impact on the growth of the American economy.

Why can't the needed revenues be achieved by cutting earmarks and waste? Spending on earmarks totals less than $20 billion a year.[18] Even entirely eliminating earmarks would make only a small dent in a federal budget that totals close to $3 trillion a year or in a deficit well in excess of $1 trillion. Similarly, although there is certainly waste, fraud, and abuse in the federal budget, the Government Accountability Office estimates that only a few billion could be saved with tough legislative provisions to prevent waste and fraud. Again, even a few billion is modest compared with the magnitude of the deficits the country faces.[19] Certainly waste, fraud, and abuse should be attacked with vigor, but even eliminating most of it would be at most a baby step compared with the giant steps needed to substantially reduce the deficit.

Another hope is that a major overhaul of America's broken health care system will free up resources that can then be devoted to other national priorities. This, too, is wishful thinking. Most improvements in the health care system—from the adoption of electronic medical records to covering the currently uninsured—will actually cost more than the current system.[20] Over the long haul, learning what works to improve health, and linking reimbursement of providers to evidence that their treatments are effective, could bring down costs, but not any time soon.[21] In the meantime, one of the most effective ways of getting more value for each health dollar spent is to put more emphasis on education rather than on health care per se. Education is associated with major improvements in people's health, independent of their income, their age, or the amount of health care they receive—probably because the more educated are more likely to adopt healthy lifestyles and to be intelligent users of health care.[22]

A final possibility is that elected officials, faced with such daunting federal deficits, will continue to simply say, in effect, "deficits be damned." What harm do they do anyway? In this case, advocates for children would do well to remember that it is the young who will suffer the consequences of this loose and wishful thinking. The national debt, and the amount we owe foreigners, constitutes a stealth tax on future generations. At this writing, net interest payments on the federal debt are scheduled to soon resume their position as the fastest growing item in the federal budget, and the country is financing most of each year's deficit by borrowing from abroad.[23] Eventually creditors will have to be paid back, and with interest.

The preceding statements should not be misinterpreted. The country can and should raise more revenues both to move the budget toward balance and to fund new investments. It can and should rein in earmarks and fraud. It can and should reform the health care system to cover the uninsured, improve quality, and contain health care costs. There may be some savings associated with the drawdown of troops in Iraq, but these savings will need to be reinvested in Afghanistan. None of these steps will be sufficient to fund a robust agenda of investments in working-age families and their children. For this reason, the nation should consider ways in which it can rein in future commitments to the elderly while simultaneously protecting lower-income seniors, the disabled, those in poor health, and the truly aged.

Forging a Bipartisan Compromise

Democrats in Congress are not going to preside over any dismantling of the New Deal or the Great Society that created today's Social Security, Medicare, and Medicaid programs. Not only are these programs extremely popular with the public, but Democrats fear that any savings produced by even modest changes in these programs may be devoted to providing tax cuts to those who need them least. This fear is understandable in the context of recent history. However—especially now that Democrats control both the legislative and executive branches of the federal government—such political concerns should not stand in the way of a robust discussion of the relative needs and responsibilities of people when they are young and when they are old. Still, from a Democratic perspective, any proposal to reform entitlements will need to be combined with assurances that some of the money saved can be reinvested in other areas.

Similarly, Republicans are not going to support more investments in the young if they believe the investments will require bigger government and a substantially higher burden of taxation. From their perspective, any proposals to invest more in education or other areas need to be accompanied by a commitment to reform entitlements for the elderly and to keep spending from exploding. While hardly ideal from either party's perspective, this linking of entitlement reform with greater investments in the younger generation, including lower-income families in particular, has the makings of a political compromise with long-term benefits for the nation. With strong leadership from the White House, this compromise has a decent chance of success.

Still another concern is that reallocating resources between the young and the old seems to entail pitting one group against another. However, this concern rests on a basic misunderstanding of the life-cycle process. Almost everyone who is young will eventually become old. So putting some transition issues aside for the moment, our proposals are not about a competition between the young and the old but rather about making more investments in people when they are young so that they will be in a better position to support themselves and others when they are older. Individuals have the capacity, if not always the foresight, to smooth consumption over the life cycle. They do not have the capacity to eliminate differences in ability, health, and productivity that are the products of their differing genetic and cultural endowments, and especially in the case of children from poor families, of changing investments society did or did not make in them during their childhood and adolescence. By adopting a life-cycle perspective, the country can move beyond stale arguments about generational warfare.

Generational Equity: Reassessing the Relative Well-Being of the Young and the Old

The traditional intergenerational contract has been in force since Social Security was enacted in the 1930s. It was expanded in the 1960s with Medicare and Medicaid and yet again in the first decade of the twenty-first century with the addition of prescription drugs to Medicare. These social insurance programs are built on a number of assumptions: that no one should be expected to work after the age of sixty-five; that most seniors have insufficient resources to pay for their own retirement and health care; and that younger Americans are, on average, better off than older Americans. The system relies almost entirely on contributions from working-age Americans to finance these benefits while simultaneously supporting the other major dependent population, their children. For the most part, the traditional contract has been a huge success, enabling people to retire at a reasonable age and greatly reducing insecurity and poverty in old age.

Nevertheless, the contract hasn't kept up with the times (table 11-2). First, consider the facts about today's elderly. Like other age groups, they are a very diverse population. But whether we look at their income, their assets, their health, their longevity, or their own preferences to stay connected to work and community, the elderly have far more capacity to contribute to their own well-being and to society's than in the past.[24] For example, the inflation-adjusted, median household income of those sixty-five and older increased 89 percent between 1967 and 2007, while the median income of those in their prime earning years, aged thirty-five to forty-four, increased by only 27 percent.[25] Even more striking is the decline in poverty among the elderly, from 35.0 percent in 1959 to 9.7 percent in 2007.[26] Compare this poverty rate to the much higher rate of 13 percent among nonelderly households and the still higher rate of 20 percent among children under age six. Equally striking is the fact that 80 percent of people sixty-five and over own their own homes and that three-quarters of these elderly homeowners own them free and clear of a mortgage.[27]

Tomorrow's elderly—meaning today's baby boom generation—will be the wealthiest generation in history. Projections by the McKinsey Global Institute indicate that by age sixty-five average disposable income for late baby boomer households will be a little over $100,000 a year, or about 50 percent higher than the incomes of those currently that age. Although incomes fall as people retire, even those in their seventies, according to McKinsey, will have average incomes of about $80,000 a year.[28] The problem, as the McKinsey Institute and others note, is that boomers are saving too little during peak earning years,

Table 11-2. Comparative Statistics, the Elderly and the Nonelderly
Unit as indicated

Measure	*Under age 65*	*Age 65 and older*
Poverty rate (percent)	12.7	9.4
Average income per household member (dollars)	26,350	24,095
Mean income (dollars)	72,906	41,928
Median income (dollars)	54,726	27,798
Annual change in real income, 1994–2006 (percent)	0.74	1.11
Annual change in real income, 2000–06 (percent)	–0.71	0.47
Median net worth (thousands of 2004 dollars)	69.40	190.10
Homeownership (percent)	64.3	80.0
Homeowners with no mortgage (percent)	24.0	75.0
People covered by health insurance (percent)	82.2	98.5

Source: Isabel V. Sawhill, "Paying for Investments in Children," in *Big Ideas for Children: Investing in Our Nation's Future* (Washington: First Focus, 2008), table 1.

with the result that there may be pressures not just to maintain but to increase the government benefits they receive when they retire. However, the solution to inadequate saving is not additional government benefits. It is policies that encourage, or even mandate, greater savings when people are young. This approach must be part of the new intergenerational contract: public policy must nurture or mandate the kind of personal responsibility that goes hand in hand with greater public investments in earning capacity at a young age.

Of course the country must maintain a robust safety net for the elderly. But all the evidence suggests that many older Americans—with or without government assistance—will be comfortably well off in the future, assuming they have access to good jobs and save enough during their working years. Even now, there are more than 1 million people over the age of sixty-five with incomes exceeding $100,000 a year.[29]

Not only are the elderly economically better off than they used to be, they are living longer and healthier lives as well. Many of the elderly are experiencing what experts, such as the Stanford researcher James Fries, call "compressed morbidity"—meaning a decline in disability rates.[30] Because this decline in disability has exceeded the decline in mortality, it has extended not just life but also healthy life and the ability to work. We should celebrate this progress, some of it made possible by the fact that the elderly, unlike the nonelderly, have universal health care.

Although the elderly have improved their situation greatly since the intergenerational contract was formed in the 1930s, working America has also gone through immense changes. In the economy of the 1950s and 1960s, the United States dominated world markets, jobs could last a lifetime, a high school education was sufficient for achieving a middle-class lifestyle, and firms could readily afford to provide generous benefits in the form of health care and defined-benefit pension plans. At the same time, educational opportunities expanded and the proportions graduating from high school and going on to college rose steadily. Today the United States has seen high school graduation rates decline over the last few decades, and it no longer leads the world in the proportion of high school graduates who enroll in or graduate from college.[31]

There are many other signs that working-age Americans and their children are struggling. Over the past three decades young men have seen their wages stagnate. They are earning less, in inflation-adjusted terms, than their father's generation did at the same age.[32] Family incomes have crept up but only because more wives have gone to work. Poverty rates are now stuck at 1970s levels (except for female-headed families and the elderly), income inequality is as high as it was in the Roaring Twenties, and access to affordable health insurance has been sharply eroded. The cost of a college degree has increased much more than the rate of inflation, causing millions of young people to either forgo a college education or to go into debt.[33] According to UNICEF, on a range of indicators from education to health care to rates of poverty, children in the United States rank twentieth in well-being compared to children in twenty other advanced countries.[34]

The role of government in boosting the economic mobility of workers and in providing better education and job training for their children is therefore more important than ever. And yet the historic commitment made to the elderly by the traditional intergenerational contract is placing a real burden on the working-age population. Although many people believe that Social Security and Medicare benefits are fully funded by the payroll taxes they paid into the system during their working years, the reality is that these programs are not prefunded; instead tax dollars paid into the Social Security and Medicare accounts each year are used by the federal government to pay current expenses. Every dollar of benefits that goes to the elderly must, sooner or later, come out of the income of younger, tax-paying Americans. So the importance of balancing the needs of one group against the other must become part of our thinking. Those who argue that the way to handle the needs of both groups is to raise taxes to a much higher level seem to forget that the people who will pay those taxes are already struggling economically.

The Miracle of Compound Interest

One of the strongest arguments in favor of gradually reallocating resources from the old to the young is the growth dividend these investments can produce. Spending to make the young more productive is qualitatively different from spending that enables the old to consume. It is the reason people take out loans to go to college but not (one hopes) to go on a cruise or buy a new set of golf clubs.

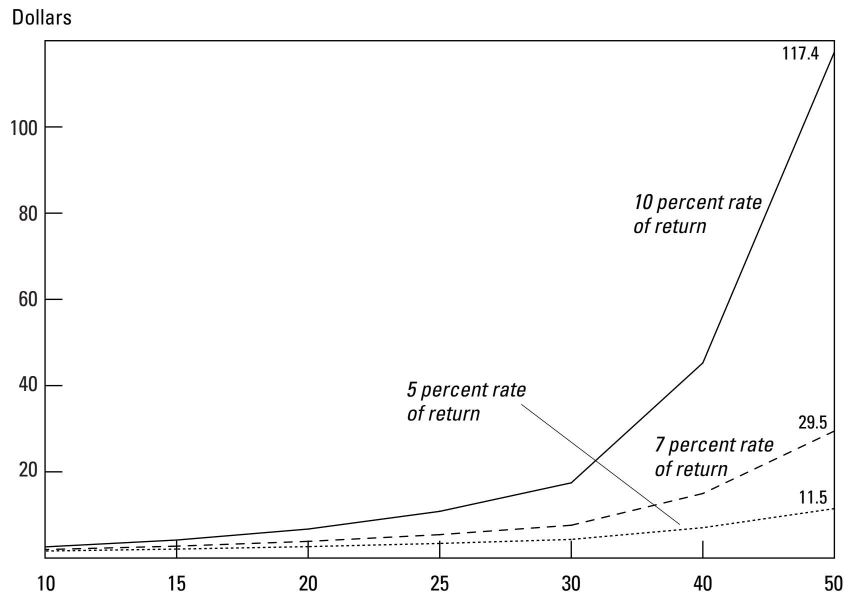
When the nation invests in the young, assuming those investments are wisely chosen, the power of compound interest ensures that future earnings and GDP will be greatly enhanced. Most economists believe that the rate of return on investments in education, for example, is at least 8 percent and could be as high as 15 percent (see chapter 8).[35] Moreover, the value of such investments can compound over time, since learning begets more learning, both in school and in the workforce.[36] Assume conservatively, and with some discounting of future benefits, that the nation could earn a rate of return of 5 percent on investments in the young (figure 11-2). At the end of twenty years (when today's infants will be in college and today's ten-year-olds will be at the start of their careers), the value of $1 would be $2.65. At the end of fifty years, it would be more than $11. If the rate of return were 10 percent, the value of a $1 investment after fifty years would be a spectacular $117.39. While we would not argue that all government programs targeted on children and younger families can achieve these kinds of returns, the point is that investing early in high-quality programs should still pay big dividends.

High-Priority Investments and How to Pay for Them

We propose to fund our proposed increases in spending on working-age families and their children with modest changes in programs for the elderly (table 11-3). Two funding options would impose minimal sacrifices on the elderly, while providing more than sufficient funds to pay for our agenda and still achieve nearly $26 billion in deficit reduction. One option would entail leveling the playing field between elderly and nonelderly citizens with the same incomes by taxing Social Security benefits more fully. Currently, only half of Social Security benefits are taxed for those with incomes above $25,000 ($32,000 for a couple), and up to 85 percent are taxed for those with incomes above $34,000 ($44,000 for a couple).[37] Fully taxing these benefits, after an exemption for the individual contributions made into the system, would raise $36.6 billion in 2012.

A second option would be to change the way Social Security benefits are indexed for inflation. Many experts believe that the current consumer price index for urban wage earners and clerical workers (CPI-W), which is used to adjust benefits, now overstates the rate of inflation because it fails to account for the fact that people's spending patterns shift in response to a change in prices. For example, when gas prices increase, people drive less or purchase

Figure 11-2. Compound Interest on Investment for Three Rates of Return, Ten through Fifty Years



Source: Isabel V. Sawhill, "Paying for Investments in Children," in Big Ideas for Children: Investing in Our Nation's Future (Washington: First Focus, 2008), chart 3.

more fuel-efficient cars. An index that more accurately accounts for these changes in purchasing patterns would, if introduced now, save $9.3 billion in 2012. If this reform were introduced for Social Security, it should also be introduced as a better way to index all benefit and tax changes. The extra resources produced by applying the improved inflation adjustment to all benefit and tax programs that are adjusted for inflation could be used to protect low-income beneficiaries.

These short-term steps need to be combined with longer-term efforts to slow the growth of entitlement spending in a way that will bring projected deficits under control, reassure financial markets, and restore confidence in government. Policy changes to accomplish these objectives need to be enacted now and phased in gradually so that they enable people to plan for the future. Our plan also provides for investments in the younger generation that would enhance their productivity and thus their ability to afford their own and their parents' retirements. In other words, the gradual phase-in of the reforms we propose, combined with upfront investments in children, is exactly what is needed to ensure that those receiving the extra help when they are young are

Table 11-3. High-Priority Investments and How to Pay for Them, 2012
Billions of dollars

Investment	*Amount*
Cost-effective investments	
Strengthen education	8.510
Strengthen work	10.270
Strengthen families	1.235
Total	20.015
Possible ways to pay for them	
Tax Social Security and Railroad Retirement Benefits like defined-benefit pensions (by 2012)	36.600
Base Social Security cost-of-living adjustments on an alternative measure of inflation	9.300
Total	45.900
Deficit reduction after paying for investments	25.885

Source: Sawhill, "Paying for Investments in Children," table 2.

the same people who are asked to contribute more as they age. To jump-start the process, it may be necessary to ask for some new taxes, some belt tightening among the currently retired population, and some forbearance of continuing deficits in the short run. But over time, each generation would be expected to invest in the next while in their prime earning years, in return for which members of the younger generation would be expected to take more responsibility for themselves as they aged.

The major Social Security options that should be debated include a gradual increase in the full retirement age (now about sixty-six) so that increased longevity does not lead to ever-higher lifetime benefits; progressive indexing of Social Security benefits that maintains future benefits for the less advantaged but entails a slower rate of growth in benefits for the most affluent; and changes in a variety of policies that might encourage later retirement. Currently, most people retire at age sixty-two or sixty-three. Some of this early retirement appears to be induced by the fact that the eligibility age for Social Security is sixty-two. Even though people get actuarially reduced benefits as a result of retiring before age sixty-six, the eligibility age sends a strong signal that may have led to a change in social norms about the appropriate time to retire. In the meantime, people are living longer and healthier lives, and far fewer jobs require the kind of physical strength or stamina that may have necessitated such early retirement in the past.[38]

The challenge of slowing the growth of Medicare will be much greater than the problem of restoring solvency to the Social Security system.[39] Like Social Security, Medicare is affected by the aging of the population. However, in addition, its explosive growth is fueled by rapidly rising health care costs per person. Many experts now believe that the most promising long-term approach to this problem is to learn what works and to base reimbursement policies for providers on this knowledge. Because Medicare is the single largest payer in the system, it can lead the way in collecting this evidence and redesigning reimbursement policies accordingly. But it will be many years before any cost savings are actually realized.

By revising the intergenerational contract, we can create a better future for all Americans, young and old. The investments we recommend would both increase the productivity of our economy and enhance the odds that every child, regardless of family background, would have a chance to do well in school, go to a two-year or four-year college, and get a good job. But programs alone will not be enough. Young Americans will need to adopt the success sequence of education-employment-marriage-parenthood that we so strongly recommend. This, along with the policies recommended in this book, would greatly improve the chances that our investments would pay off for them and for their country.