

Passing the generational buck

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IN THIS ARTICLE we will investigate the U.S. government's treatment of children. We will begin with a look at the flow of transfer payments to children, and then consider the government services purchased on their behalf. We will also consider the benefits and services that today's children will receive in the future, as well as the taxes they will pay when they become adults.

By doing so, we seek to answer this question: Are today's children being treated fairly compared with other generations? To address this issue, we will rely on a new method called generational accounting, which compares the "lifetime net tax burden" (taxes paid minus transfer payments received) of different generations. With its lifetime perspective, generational accounting overcomes the difficulty encountered with the usual

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comparisons between two generations, namely that the two generations are at different stages of their life cycles.

To understand this difficulty, imagine a country with a longstanding policy of transfer payments to children, financed by taxes on the elderly. While the usual comparison would suggest that children are being treated favorably compared to the elderly, such a comparison ignores the fact that the elderly received the same when they were young, as well as the fact that the children will pay the same taxes when they are old. Thus from a lifetime perspective, the children are being treated just as favorably as the elderly.

How are children in America actually being treated compared to adults and the elderly? The evidence we will consider includes the rising poverty rate of children over the past two decades and the decline in the elderly poverty rate over the same span, as well as an accompanying rise in the consumption level of older generations compared to that of younger ones.

Poverty in America

Twenty percent of American children live in poverty. The rate among Hispanic children is 37 percent; among blacks it is 45 percent. Moreover, because there is considerable mobility in and out of poverty, we can surmise that if 20 percent of American children are poor at any given moment, substantially more than 20 percent experience periods of poverty before reaching adulthood.

This rate is considerably higher than in the past. In 1970, for example, only 15 percent of children were poor. Yet at the same time that poverty rates have been rising for children, they have been declining for older Americans. In 1970, almost one quarter of Americans aged 65 and older were officially poor. Today's figure is about 12 percent.

The difference in poverty trends between young and old raises the question of the equity of government policy. Still, other factors besides government action seem to be at play in raising child poverty rates. One of the most important factors is the increase in the fraction of America's children living with a single parent. In 1989, 73 percent of all American children, 67 percent of Hispanic children, and 38 percent of black children lived with both parents. The respective 1970 figures: 85 percent, 78 per-

cent, and 59 percent. Rates of child poverty are far higher among single-parent than among two-parent households. Almost 50 percent of children living with a single parent are poor, compared to only 10 percent of children living with two parents. All told, about two in every three poor children live in single-parent families.

The increase in children living with one parent can be traced to two factors—the increase in the U.S. divorce rate and the increase in the fraction of children born out-of-wedlock. Today, 13 percent of Americans aged 35 to 44 are divorced, compared to only 3 percent in 1960. As a consequence, two children in five now grow up in divorced families.

The increase in the fraction of children born to unmarried women is even more dramatic. In 1970 just over 10 percent of children were born to unwed mothers; today, the figure is over 25 percent. This explosion of out-of-wedlock births has affected both whites and minorities. In the case of whites, the 1970 share of births to unwed mothers was 6 percent; it was 18 percent by 1988. In the case of blacks, the share of births to unwed mothers grew from 38 percent in 1970 to 64 percent in 1988.

Consumption then and now

The increase in the poverty rate of children relative to that of adults suggests a deterioration in the relative living standards of children, but is not conclusive for the simple reason that impoverished children make up only a portion of the entire population of children.

One way to assess the change in living standards of all children vis-a-vis all adults is to consider changes over time in the age-consumption profile. Consider, for example, the average consumption of children aged 10 versus the average consumption of adults aged 70. In 1972-73, the consumption of children aged 10 averaged 37 percent of the consumption of 70-year olds. But by 1987-90, it averaged only 31 percent. Thus, the consumption of 10-year olds relative to that of 70-year olds fell by over 16 percent across the two periods.

What explains the recent increase in the relative consumption of the elderly? The answer is that over the past twenty or so years their income has grown much more rapidly than that of other age groups. In 1968, income per elderly household aver-

aged 43 percent of income per household aged 35-44. By 1984, this figure had risen to an average of 54 percent. Thus the income of the elderly relative to that of households aged 35-44 rose by 26 percent over the sixteen-year period. It rose by an even larger percentage—45 percent—relative to that of households aged 25-34.

If anything, these numbers are likely to understate the recent growth in the relative income of the elderly, because they do not include the value of government-provided health care benefits, such as those from Medicare and Medicaid.

Plusses and minuses

Has the government helped to offset or worsen these trends? One way to approach this question is to consider the government's direct transfer payments to different age groups, as well as the taxes the government collects from the various groups.

Older Americans receive transfer payments that are many times greater than those received by children. In 1970, for example, the average transfer payment made to 70-year old women was \$5120, while the average transfer payment to 10-year old girls was just \$350. In 1990, the comparable figures were \$10,467 paid to 70-year old women and \$410 paid to 10-year old girls.

The elderly do, of course, pay far more in taxes than children, even if we impute sales and excise tax payments to children. In 1990, for example, the average tax payment of 70-year old women was \$7262, while the average tax payment of 10-year old girls was \$799. However, if one subtracts these tax payments from the transfer payments received, the resulting net payment figures, \$3,205 and -\$389 respectively, still show that the elderly benefit much more than children from government transfers and taxes.

The transfers and taxes just considered do not provide a complete picture of the annual flow of economic resources between the government and the private sector. The main omission is the flow of services provided directly by the government. These services are wide-ranging, and include the protection afforded by national defense, the reduction of travel time and transportation costs arising from the federal, state, and local road systems, the provision of public education, and the general knowledge produced by the space program. With the exception of educational

expenditures, however, which in the main benefit children, government purchases consist of public goods, the benefits of which cannot clearly be ascribed to particular generations or groups within generations.

Nevertheless, educational expenditures are still worth considering because they are fairly large (albeit of dubious quality). In 1990, spending on elementary education by federal, state, and local governments totaled \$220 billion in 1991 dollars—pretty close to the amount spent that year on Social Security retirement and survivor benefit payments. If we divide the \$220 billion spent on elementary education in 1990 by the 72.3 million children alive in 1990, we arrive at a per child expenditure of \$3042. The comparable calculation for 1970 reveals an average educational expenditure of \$1785 per child (measured in 1991 dollars).

These figures indicate that educational expenditures far outweigh transfer payments as a means of providing assistance to children. They also show that since 1970 there has been a dramatic increase (70 percent) in real spending per elementary school-age child. Finally, they show that even if one adds to current per child transfer payments today's historically high educational spending, one still arrives at a total government payment flow to children that is considerably smaller than the flow to the elderly. This is true whether one calculates this flow net or gross of tax payments.

While the flow figures are striking, ignoring the fact that children and the elderly are at different stages of their life cycles seems clearly inappropriate. Does it make sense, for example, to claim that the elderly are being treated better than children because they receive large Social Security benefits? Such an assertion ignores, among other things, the fact that the elderly didn't receive much in the way of benefits when they were children, and the fact that today's children may receive large Social Security benefits when they become old.

Fortunately, generational accounting can help us assess the true generational equity of government policy. Generational accounts reflect what members of a generation can expect to pay, on average, in net taxes (tax payments minus transfers received) over their lifetimes. Such accounts can be used to compare the government's treatment of different generations, since they take

account of all taxes and transfers over the life cycle.

What we pay

What generational policy is actually in place? One way to determine this is to examine the net tax rate of each generation: the average amount of taxes a generation will pay minus the benefits it will receive, all divided by its lifetime income. This figure has risen significantly over time, increasing from 22 percent for the generation born in 1900 to 34 percent for the generation born in 1991.

Gross tax and transfer rates have also risen over this period. The lifetime transfer rate (transfers divided by income) nearly quadrupled between 1900 and 1991, from 3.3 percent in 1900 to 12.2 percent in 1991. The increase was more rapid, in both relative and absolute terms, for the generations born before World War II than for those born after.

Because of the need to pay for higher transfers and government purchases, the gross tax rate has also risen in the past two decades, while the net tax rate (taxes minus transfers) has stayed fairly constant. The gross tax rate is 25 percent for the generation born in 1900, and 46 percent for the generation born in 1991.

What our children will pay

We've not yet discussed the tax rates to be paid by future generations. Some generation must pay the government's bills, and if current generations do not pay as much in taxes as they receive in benefits, future generations will be forced to cover the difference.

Unless present-day Americans are made to pay more, on net, over their remaining lives, future Americans will face lifetime net tax rates of 71 percent—more than twice the lifetime net tax rate to be paid by Americans born in 1991. This figure assumes that the generations living now will continue paying no more than they are at present. Of course this is just an assumption. It is made not because of its infallibility, but rather to illustrate the extent of the imbalance in U.S. generational policy. As we discuss in the next subsection, other assumptions about the evolution of future U.S. fiscal policy lead to lower lifetime net tax

rates for future generations, albeit at the price of higher rates for current generations, particularly younger ones.

Is current policy equitable?

Today's American children face much higher lifetime net tax rates than do today's elderly. The generation born in 1991, for example, faces a lifetime net tax rate that is 27 percent greater than that of the generation born in 1920. This discrepancy would be exacerbated by changes in U.S. fiscal policy that might be taken to prevent future generations from paying over 70 percent of their lifetime net incomes to the government.

Consider two possible changes in U.S. fiscal policy. The first of these involves placing a cap from 1993 to 2004 on all federal spending on mandatory programs, with the exception of Social Security and deposit insurance. Medicare and Medicaid are the two programs that would experience the largest cuts. The second possible policy is a surtax on the federal individual income tax, which would last from 1993 to 2004 and produce the same deficit reduction as the cap.

Both of these policies would dramatically lower the lifetime net tax rates of future generations. Under the mandatory cap policy, future generations would pay only 41 percent of their lifetime incomes to the government. Under the surtax policy, future generations would pay 46 percent. While these means of bringing U.S. generational policy into closer balance are good for future generations, they would of course harm current generations. The surtax, for example, would force children born in 1991 to pay 40 percent of their lifetime incomes to the government rather than 34 percent. The cap and surtax would also raise the lifetime net tax rate of today's older Americans. If the surtax were implemented, there would be a 53 percent difference in the lifetime net tax rates of children born in 1991 and those born in 1920.

Is it fair that today's children may have to hand upwards of 40 percent of their lifetime income over to the government while their grandparents will end up paying just over a quarter of their lifetime income? The answer depends on several factors. First, today's children will, it appears, receive more services in the form of educational expenditures and public goods than will today's elderly. Second, certain types of contributions made by

today's elderly, such as fighting World War II, are not factored into the analysis. Consideration of these special contributions might suggest a lower lifetime tax rate for the current elderly. Third, the steep increase in lifetime tax rates may be justified to the extent that society's notion of generational equity entails equalizing the after-tax incomes of current and future generations.

If, however, society's notion of generational equity entails extracting an equal proportional sacrifice from each generation, these numbers are highly discomfoting. They reveal a U.S. generational policy that will burden today's children much more than today's elderly. Tomorrow's children, meanwhile, are likely to be burdened even more.

Regardless of how one views the data presented above, it is worth pointing out that they are likely to understate the generational differences in economic well-being generated by U.S. fiscal policy. The reason is that every tax dollar the government has failed to collect from past and present generations has meant another dollar available to finance additional consumption. In consuming more, these generations have raised total U.S. consumption and lowered total saving. While there are certainly other factors beyond generational policy at play in explaining the recent decline in U.S. saving, generational policy has surely played a significant role. The U.S. is now saving at record low levels. In 1991, for example, the U.S. saving rate was only 1.7 percent—dramatically lower than the almost 9 percent rate observed during the years 1950-1969.

Lower saving means lower investment, which means a slower rate of growth of the U.S. capital stock relative to the U.S. labor force. Since labor productivity depends on the amount of capital available per worker and since wages reflect labor productivity, the decline in saving is responsible for lower U.S. wage growth. It is also responsible for raising the return to capital, since it has made capital more scarce relative to the other factor of production—labor—than would otherwise have been the case. Those who have been harmed most by slower wage growth are today's young and middle-aged workers, who have experienced very slow growth in their hourly pay over the past two decades. If the low rate of U.S. saving continues, today's children will also experience very slow wage growth once they enter the workforce.

Since the late 1970s, on the other hand, the return to capital has been quite high, and the main beneficiaries of this high return have been today's elderly, who are the primary owners of capital.

Passing the buck

A significant body of evidence points to a deterioration in the living standard of children relative to that of adults. There also has been a rapid increase in the lifetime net tax rates of American generations born through the course of this century. Americans born at the turn of this century paid just over a fifth of their lifetime incomes to the government. Those born at the beginning of the next century are likely to pay well over half of their lifetime net incomes to the government.

Does this considerable disparity imply that U.S. fiscal policy is generationally inequitable? The answer depends on society's notion of generational equity, on society's assessment of the special contributions that particular generations have made to the country, and on the level of benefits being provided to different generations as a result of government purchases of goods and services. But it is undeniable that the cost of the U.S. government's kind treatment of today's elderly will be borne on the backs of tomorrow's children.