Running on Empty

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I am often asked, “Why did you write this book now?” There are several answers to that. One is, I’m a terminal masochist, and I love being assaulted by my best friends. On my last book, Ted Sorensen issued the infamous and now famous comment about Gray Dawn. He said, “Gray Dawn is a book that once you put it down, you won’t be able to pick it up.” He called me the other day on getting my new book, called Running on Empty, and said, “When I saw the title of your new book, Running on Empty, I assumed it was an autobiography.”

I thought John Whitehead was a great friend. He preceded me as Chairman of the New York Fed. I thought I was being gracious in co-hosting a big 80th birthday celebration for him. He got up and said, “I just finished reading Gray Dawn. It’s the only book I’ve ever read where you learn more from reading the blurbs than from reading the book.” So that’s one reason I write books: my masochism is being more fully fed.

I have a second reason that sounds sanctimonious and self-righteous. But it has the virtue of being true. I am the happy father of five kids and nine grandkids. And, I am lucky enough to have carved out a life where I can spend some real quality time with them. And as I think about them, a comment by Dietrich Bonhoeffer, the German theologian, rings in my ears, “The ultimate test of a moral society is the kind of world it leaves to its children.” And as we quietly pass on huge, and I think unthinkable, taxes and debts, as we quietly slip our kids and grandkids the check for our free lunch, I say we are failing that moral test.

I go further and suggest that in this political season it might not be a bad idea to reformulate the famous Ronald Reagan question, “Are we better off than we were four years ago?” by asking instead, “Is the future going to be better off? Are our kids and grandkids going to be better off than we are today?”

When I say that, some parents ask, “Are you suggesting that we don’t care about our children?” And I say, “Absolutely not.” But I am saying that parents and grandparents are being grossly misinformed and disinfomed by an unhealthy combination of political and bureaucratic amnesia and anesthesia.

I once asked Margaret Thatcher, the only developed-country leader who has successfully attacked the long-term entitlement and fiscal problems, “Lady Thatcher, what do you people talk about at your G-7 meetings? Are the other leaders aware of this long-term problem?” She said, “Oh my yes, Mr. Peterson. They are very much aware of it, but their theory is it’s going to hit on somebody else’s watch, and why should I take the pain for somebody else’s gain?”
Now, permit me to give you a few examples of what I consider to be the political high jinks, hypocrisies, and chutzpah, if you will, that anesthetize the American public. Let us start off with the unfunded, off the books, long-term liabilities—or if you prefer, hidden liabilities.

Official sources, and many unofficial, put the dollar level of unfunded liabilities at between $45 trillion and $74 trillion, depending on the timeframe. That is more than our collective net worth of about $42 trillion!

Now some hypocrisy and chutzpah. We passed unanimously in the Senate the Sarbanes-Oxley bill, in which we put public CEOs in jail if they don’t accurately report their liabilities. Under the Employee Retirement Income Security Act of 1974 (ERISA), corporations are required to fund their long-term pensions over no more than 30 years. Were ERISA and the Sarbanes-Oxley bill to apply to the US government, it would add over one and a half trillion dollars to the annual budget.

While I suggest a number of reforms in the budget process—including first, reinstalling the budget reinforcement act, including pay-as-you-go; second, issuing a comprehensive long-term budget; and finally, developing accrual and generational accounting—I call my most fanciful the suggestion that Congress should now legislate that our government and public budgets be subjected to the same Sarbanes-Oxley/ERISA requirements as the rest of the public corporations.

And why is that fanciful? Because we can safely assume that the enthusiasm of Congress for that idea would be highly restrained. Why? For one thing, they would be jailed if they were to continue their current reporting, or I should say, non-reporting of these vast liabilities.

A second example of political high jinks is the so-called Trust Fund. When I was Secretary of Commerce, for reasons that are not clear to me, *Time* magazine referred to me as the most powerful Secretary of Commerce since Herbert Hoover. I burst out laughing, because anybody who has ever had that job knows there has never been a powerful Secretary of Commerce. In any event, I started collecting oxymorons.

I believe the Social Security Trust Fund belongs in the first tier of classic oxymorons. In the first place, the Social Security Trust Fund should not be trusted, and it is not funded. We anesthetize the public with highly reassuring long-term statements that the trust funds are solvent for decades. Yet, we do not tell the public that the payroll taxes of our children and grandchildren would have to double to cover the costs of Social Security and Medicare. That is an unthinkable burden. We do not tell the public that whether you have a trust fund or not, you still face the same three hard choices: increase taxes, cut benefits, or try to borrow unprecedented amounts.

Now how much would we have to borrow? I think it’s time we started thinking in cash flow terms, because these programs are obviously pay-as-you-go programs. The
projected cash flow deficits for Social Security and Medicare go from a modest $25 billion in 2003, to a projected $783 billion in 2020, and trillions of dollars thereafter.

Then, of course, our political dialogue includes a lot of euphemisms and soothing dysphemisms. “We shall not pass our problems on to the next generation.” Well, who the heck do we think we’re passing them onto? Or, “It’s your money. You deserve to get it back.” Who, then, does the debt belong to? The ages, or what?

Milton Friedman tried to educate me, presumably, when I was at the University of Chicago. He used to teach us that a long-term tax cut is not a tax cut at all, if it is not accompanied by long-term spending cuts. It is just a deferred tax increase on your children. Obviously, we have not cut long-term spending: we have increased it!

Now another reassuring absurdity that we inflict on the American people is referring to these entitlements programs as a social contract. I had one course in commercial law in business school. And, I was taught a contract is not valid unless there is a meeting of the minds of the parties involved. Recently, some good friends gave a book party, and I thought I’d try to dramatize this point by inviting my wonderful seven-year-old granddaughter, Chloe, up to the stage. And I said, “Chloe darling, have you signed on to trillions of dollars of unfunded liabilities? And this doubling of payroll taxes?”

She first asks the simple question: “Papa,”—as she calls me—“is a trillion more than a billion?” I reply, “yes, darling, it is a thousand times bigger.” And then, this adorable girl says “Papa, I am going to have to sell a lot more lemonade, and you’re going to have to increase my allowance.” Indeed.

Now in my apparent need in this book to offend everyone, I attack what I call the theologies of both parties. I use the word theologies deliberately, because a lot of these policies seem faith directed and relatively untouched by analysis, history or evidence. And they are nearly always delivered with a kind of moral certitude.

My party, the Republican Party, seems to have adopted a tax cut theology, which has morphed into “any tax cut, any time.” Now, to continue the theological metaphor: the tax cutters have formed an unholy alliance with the big-spending, big-government Republicans. Alas, a new oxymoron: the big-government Republicans.

Not just Pete Peterson, the curmudgeon, but highly conservative institutions and individuals agree. The CATO Institute refers to the “spending explosion.” Dick Armey, the former very conservative majority leader, says, “We can’t pin this one on the Democrats, we’re in control of everything.” Senator Chuck Hagel says, “Our party has lost its moorings.” In his new book, Pat Buchanan says, “George Bush has compiled a record of startling fiscal recklessness.”

In this vain, I was chagrined that my party, the so-called fiscally responsible party, voided the very budget enforcement mechanisms—pay-as-you-go, spending caps, and the like—that had made such a difference in the fiscally responsible 1990s.
Finally, these Republicans are joined by their fellow “Starve-the-Beasters.” Paradoxically, their argument is in sharp contrast to that of the supply side Republicans, who might argue that increased revenues would grow us out of any problem. The “Starve-the-Beasters” take the opposite view: cut taxes, they tell us, and revenues will fall. Then, we can get rid of or drastically cut these awful benefit programs.

I say to the “Starve-the-Beasters,” you had better be careful what you wish for. Have you considered certain melancholy facts? One-third of the people at retirement age have no net financial savings. According to the Fed, half of all people aged 45 to 54 have total gross financial assets—not net, but gross—of less than $46,000. According to the Social Security Administration, Social Security and other benefits account for 91 percent of the total cash income in the year 2000 for elderly households in the bottom fifth of the income distribution.

Now picture the scene, 77 million baby boomers, some significant portion of whom are in serious need of support. Am I to believe that if we suddenly say, “Sorry folks, there is a big cut in your benefits,” there will be no political or social effects. And, the elderly will say, “Thanks… I needed that and I deserved that.” By the way, when in a major crisis did governments get smaller? And, by the way, if you are so concerned about reducing the size of government, where are your specific proposals for reducing the big entitlement spending programs?

And, if I am permitted one more by the way, it might not be unfair to ask the President: “Sir, in the face of this spending explosion, how is it that you are the first full term President since John Quincy Adams not to veto a single bill?”

So, to sum up what my party has done, they’ve done Lyndon B. Johnson one better. We have guns, butter, and tax cuts.

Now, to my Democratic friends. If my party cannot see a tax cut it does not like, it might be charged that many Democrats have hardly ever seen a universal entitlement program that they didn’t like. Viewed historically, I think it is fair to say that they have been the prime movers, along with a few co-conspirators, I have to admit, from my party, of the following rather startling trend. Over the last forty years, federal benefits to individuals have gone up six times in inflation-adjusted terms.

As for Social Security reform, I asked Senator Bob Kerrey where the Democratic plan was. “Oh,” he said, “we do have a plan. It’s the ‘Do Nothing’ Plan.”

Let’s review the current Medicare prescription drug benefit. In spite of the fact that most serious analysts say that the projected costs of the current Medicare program are unsustainable, we heard hardly a single word from the Democrats about controlling the cost of the current program. Instead, Democrats complained that the new Medicare drug benefit plan does not go nearly far enough. In other words, let’s make this unsustainable program even more unsustainable.
So, both parties have adopted a kind of what one might call a pragmatic theology—
win at any cost—including to our own children.

One might well ask: In this all gain and no pain, all get and no give political world,
has it become too politically incorrect to suggest there are ever times when some of us
might be expected to give up something for the greater good?

Now one might ask, Peterson, you have been boring us relentlessly since the early
1980s about the entitlements. What is new; that is, beyond the obvious reality that the first
baby boomers retire in only five years, and the next President is going to confront this
reality directly on his watch?

I suggest there are three important new realities we must deal with. All three center
around the basic theme of some profound disconnects between ends and means. All three
are about our unwillingness to confront the long-term tradeoffs between national security,
economic security, retirement security and global economic and development security.

First, we confront an unprecedented national security agenda to fight two wars: the
war on terror abroad and the war on terror at home. While we say we’ll pay any price, and
we say that we know these wars will go on for years to come, we have in fact seriously
underestimated the cost. And, we are fighting both wars without a war budget.

Some have forgotten that while our superpower military is stunningly effective, it is
also stunningly expensive. It is very different from the good old days—World War II, for
example, which was a bit like organizing a federal jobs program, with quick training of
inexpensive troops with inexpensive equipment. In today’s hi-tech high-cost military, the
brute fact is that these costs have ballooned—for example, a billion dollars a week for just
two divisions in Iraq conducting “stability operations.”

Some quick factoids. The Congressional Budget Office (CBO), which is after all
under Republican control, has looked at our budget estimates for the next ten years for
defense and said they should be at least 18 percent higher or a trillion dollars more than the
official estimates. And they remind us that the official budgets have no provisions for any
wars. They also have no provision for additional troops, which 54 out of 61 members of
the House Armed Services Committee have proposed. Were we to meet the criticism of
having a ten-division army to meet our 12 decision priorities, the personnel-related
expenses alone would come to about $40 billion annually.

Then, of course, there is the war on terror at home. I am very proud of the work that
the Council on Foreign Relations has done on homeland defense. Now in spite of all the
rhetoric, there are obvious critical holes in our homeland defense: cargo containers, first
responders, health care systems, immigration control, protecting critical infrastructures
such as energy sources, pipelines, refineries, and so on. Just to cover only three of these
vulnerabilities—equipping our emergency responders, expanding our medical facilities,
and protecting our ports—would cost over $120 billion over the next five years.
The second new reality that I think is receiving far too little attention are not simply the budget deficits, but the huge foreign or current account deficits—the so-called twin deficit. The previous record was in the 1980s, 3.7 percent of GDP. The dollar then fell by a third, and we experienced a stock market crash. Today, it is at 5.7 percent of the GDP, heading north by most accounts, into utterly uncharted territory.

Catherine Mann, a fellow at the Institute for International Economics (IIE), has some future estimates of current account deficits that might daunt even the most passionate optimist. On the current course, she predicts substantial increases in our current account deficits.

Currently, we import $4 billion of foreign capital every day—half to finance war deficits, half for current foreign investments abroad. And even the International Monetary Fund (IMF) is giving us hell. The IMF reminds us that a current account deficit of five percent of GDP is typically a danger point. The IMF also reminds us that external debt at 40 percent of the GDP—where we’ll be in a few years—is “an unprecedented level for a large industrial country.”

So as part of this book, I interviewed a dozen leading experts about the twin deficits, experts who are much smarter than I am about such things. None of these people believe that our current account deficits are sustainable. In the administration I served, Herb Stein was our Nixon humorist, which I guess is another oxymoron. But you’ll recall his famous words, “If something is unsustainable, it tends to stop.” And he said, if you don’t like that, “If your horse dies, I suggest you dismount.” So the question we confront here is: do we get off gently, or do we get thrown off?

Now, roughly half of these experts say there is a substantial risk of some kind of hard landing. Paul Volcker, for example, says that there is a 75 percent chance of a crisis in five years. Rubin, who speaks with his usual understated and constructive ambiguity—by which I mean no one knows what he is saying—refers to “a day of serious reckoning.”

Remember that a hard landing envisions a sudden big drop in the dollar, a big spike in interest rates, nasty effects on financial markets in the economy, and so forth. The other experts predict a softer landing where these effects are more gradual. But make no mistake; we’re talking about a landing and not a takeoff.

I find it instructive that the costs of outsourcing jobs has received major press and political attention while, at the same time, very little is said about the dangers of our outsourcing savings.

Now in truth, I don’t think anyone knows how and when these deficits will be made lower and sustainable. But we know they must be.

The US now directly or indirectly absorbs two-thirds of the total current surpluses run by every nation of the world. This cannot continue. But redressing this unsustainable global imbalance will require some profound and perhaps even traumatic structural and
indeed cultural changes of our own and other countries’ political economies. America must consume more, import relatively less, save relatively more, and export more, and the rest of the world will need to do the opposite.

Given the difficulties of these adjustments, our esteemed Chairman of the Federal Reserve, Alan Greenspan, has said that nothing worries him more than the “clouds of emerging protectionism” as a possible “solution.” And speaking of our Chairman, I wonder, as tough as the agenda he has had on his watch, whether he might turn out to prefer it over that of his successor.

Whatever the outcome, I think these unprecedented twin deficits are great risks that a great country should not be taking. And I am not simply talking about the economic risk, I am talking about the national security risk and the foreign policy risk, of betting how long the biggest debtor and the biggest borrower can also be a great leader and a great superpower.

Remembering that one speech from me is one too many—permit me to only say that I have suggested to Richard Haass that the Council on Foreign Relations might well consider some major studies and task forces on the daunting implications on foreign policy, on the national security and international development as well as domestic tradeoffs of these burgeoning and ultimately unsustainable domestic commitments. Given the enormous political power of the senior lobbies, I ask you to contemplate the political war between funding these benefits and funding national security and global development budgets.

The third new reality is a rapidly aging world and the gargantuan fiscal demands that come with it. We in the United States say that our 77 million baby boomer problem is huge. However, the problem in other developed countries is far more severe and will hit sooner and harder. Why?

Their birth rates are far lower than ours. Thus, they confront a big drop in young tax-paying workers. Remembering that a birth rate of 2.1 babies per woman is the so-called replacement rate that would keep a population stable. The birth rate in Italy and Spain is 1.2, in Japan it is 1.3 and France it’s 1.4; their benefits are much higher; they retire much earlier—in France only 34 percent of the people stay employed between the ages of 55 and 64; only seven percent in continental Europe have a pension plan; the unions are much more powerful; the taxes are already much higher, averaging about 35 percent of payroll tax in Europe, 45 percent of the GDP overall tax burden.

Our friends at the Center for Strategic and International Studies have projected that the public benefits spending demand for the elderly in Japan, France, Germany and Italy will grow from 15 to 28 percent of GDP in the next 40 years. That’s unthinkable, it seems to me.

Speaking of Japan, let me tell you a little anecdote. I found myself at the Council on Foreign Relations, sitting next to Mr. Kuroda, who until recently had been the Vice
Minister of Finance and International Affairs of Japan. The conversation goes roughly as follows: “Mr. Kuroda, is the aging society in Japan and the related demands going to present a significant problem to your country”...“Oh yes, very serious problem”...“Mr. Kuroda, how are you going to finance these burdens?”...“Well, Mr. Peterson, we have a high savings rate and a big current account surplus. And for a while we’ll be able to sustain it that way”...“Mr. Kuroda, aren’t you financing 25 percent of our current account deficit? And have you figured out a way of spending the same money twice?”...“A serious problem, Mr. Peterson.”

Finally, I lay out reforms in this book. They are built around the notion that we must substantially increase our rate of net national saving, which is now hovering near zero. And, obviously, there are two ways to do this: One is to reduce the dissavings, or negative savings of the budget deficit, and without fundamental reform of the entitlements—this is a fool’s mission, in my opinion. And the second is we have to increase personal savings directly per se. Since 1990, personal savings have plummeted from 5.5 percent of GDP to 0.9 percent.

As to reforming entitlements, may I say that both Social Security and Medicare require reform? However, I believe that not only is Medicare the biggest fiscal problem, accounting for well over three-fourths of the unfunded liabilities, but also a far more daunting problem in political and even moral or ethical terms.

Some say just drop Bush’s tax cuts, at least on the wealthy. But the CBO tells us that even if we repeal all of the Bush tax cuts, they are only about ten percent of the problem. So we must confront the brute reality that reductions in benefits are absolutely essential in Social Security and Medicare.

Let’s start with Social Security. After proposing in times past a variety of what we might call micro changes, such as gradually increasing the retirement age or an affluence test, or a diet cost-of-living adjustment (COLA), I’ve decided that this mille-step approach tends to aggregate a consensus of negatives. I have come to feel that a simpler macro approach has much to say for itself—not just simpler to execute but simpler to explain to parents and their children, which I consider crucial to a long-term political solution.

It is quite widely known that Social Security benefits are indexed to inflation with 100 percent COLAs. It is not widely known that these benefits are also indexed to wages, and that makes it very difficult to grow out of the cost problem.

If we were to eliminate the wage indexing, we would essentially eliminate the unfunded liabilities of Social Security. If we have time to discuss it, I can explain why I believe that parents and their children being told that they are getting the same benefits in real terms can be presented as a fair and simple proposal, given the alternatives of staying on the current course.
My second proposal is for mandatory savings in personal retirement accounts of workers, of roughly two to three percent of the pay, with some subsidy for the poor. These funds would be managed by a public/private board.

Why mandatory you might ask? Fred Bergsten of the IIE will recall that some years ago, when he chaired the Competitiveness Policy Council created by the Congress and the President, I was Chairman of a Subcommittee on Capital Formation—a subject about which I knew virtually nothing. So I invited the best savings economists from the left, right, and center. I asked that they educate me on the net effects on national savings—that is net, after considering all the costs of tax incentives. The general conclusion was that the effect is both limited and ambiguous. But, I said, you keep saying that we have to increase our savings in this consumption-obsessed culture of ours so that we are not so recklessly dependent on foreign capital. So, how do you propose that we do it? And virtually unanimously they said: In our consumption culture, it would have to be mandatory as Singapore, Chile and Australia have already done.

How to invest it? I propose these monies be put in global index funds, equity and fixed income. Why indexed funds? Because, in the first place, they reduce administrative costs substantially and thereby increase net returns. I want to remind you that many of these individual accounts we keep talking about will be very small for a while and would be very costly to administer, thereby substantially reducing the net return to the individual. And second, index funds avoid the political issues of which industries to invest in or not invest in. That becomes a political football.

Why a public/private board? I think it is essential that we get this money out of the hands of government, who have demonstrated that they will spend it. And, we must get the funds invested in the private sector.

Now what about Medicare? It is a much bigger and much more formidable problem. Why? Because it presents highly ethical life and death issues, and who decides, and how one decides who gets what treatments. Because it confronts what Dan Yankelovich calls a “maximum right” mentality—that Americans are “entitled”—not one of my favorite words—to all the latest high-tech, high-cost treatments. This is a mentality that has led our spending to be about two times that of the developed world, without any measurable difference in health outcomes. In this book, I present half a dozen proposals for controlling the cost of health care in ways that I hope are rational and humane.

Finally, what does one need to do politically? What are the possible scenarios? I give you two options or scenarios.

Option A, one I vastly prefer: A massive dose of truth telling. And, given the momentum and impact of the recent September 11 Commission, I recommend that the next President immediately appoint such a bipartisan twin deficit commission of trusted Americans, of the quality of Tom Kean and Lee Hamilton. I’m talking about people like Paul Volcker, Bob Rubin, Sam Nunn, Warren Rudman, Alan Simpson, and Bob Kerrey—Americans of that quality, and not the usual special interest devotees.
It will also require, in my opinion, bold leadership by a President, who not only educates but also leads Americans to take constructive action and ideally, creates a global consensus for other developed countries to also take action. This is indeed, in my view, a global problem if I ever saw one.

Next, entitlement reform has to be in a bipartisan setting. A partisan approach to reform energizes the “turkey shoot” phenomenon, which I used to experience in my home state of Nebraska. In other words, the “turkey” who lifts his or her head with a proposal gets shot. In a partisan setting, that would be the outcome and who would want to be that turkey?

Scenario B, much to be deplored, is a crisis scenario. And there are a lot of hard heads that I have talked to who believe this is what it will take to solve our long-term fiscal problem. Let us pray this is not the case, because it will engender all kinds of profound costs.

In closing, let me remind you that if you pick this book up, don’t put it down. You won’t be able to pick it up.

Thank you very much.*

* Editor’s Note: This text is based on a speech that Mr. Peterson delivered on October 5, 2004.