Professor Laurence J. Kotlikoff
Boston University
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Averting America's Bankruptcy with a New New Deal

The United States is essentially bankrupt and requires critical and immediate fiscal surgery thanks to decades of fiscal profligacy and the impending retirement of the baby boom generation. According to the latest projections of two of the nation's finest economists, Jagadeesh Gokhale and Kent Smetter, the difference between the federal government's present value of projected expenditures and the present value of projected receipts is $63.3 trillion. This fiscal gap is 8.2 percent of the present value of GDP, meaning that we need to devote that share of GDP every year for eternity to cover the shortfall.

Since federal personal and corporate income taxes represent 9.8 percent of GDP, one way to close the gap would be to immediately and permanently raise those taxes by roughly 84 percent (8.2 divided by 9.8). Advocating this hike is a political non starter. Enacting it could well be economically ruinous. Yet, doing nothing, and leaving this bill for our children and grandchildren to pay is neither feasible nor moral.

What should we do? If our government doesn't come up with a way to radically limit future spending or raise revenues, it will surely take the low road of printing money to "pay" its bills. The result will be very high interest and inflation rates, and real damage to the economy.

Neither the Republican or Democratic politicians are offering sensible solutions; and indeed present policies are making matters worse. Given this, it is time for academic economists, who care more for policy substance than for partisan advantage, to suggest sensible, efficient, and equitable solutions.
So let me suggest solutions to our three most troubled fiscal institutions – our tax system, our Social Security system, and our government healthcare system. Each solution is radical, but simple. The three reforms, in conjunction with cutbacks in federal discretionary spending, would leave us with modern fiscal institutions that can reliably pay for what the government spends. Modernizing our institutions is essential to sell the public on what will inevitably be a painful economic adjustment.

Let's start with the tax system.

Tax reform – moving to a federal retail sales tax plus a rebate

Not only does the current tax system raise too little revenue relative to the current level of expenditures; but it's also woefully complex, expensive to use, highly inefficient, and, in my view, inter- and intragenerationally inequitable.

Federal tax law now runs over 17,000 pages. The system is so complex that no one can claim to fully comprehend its provisions, incentives, or the degree to which it is redistributing resources across the current and future population. An army of well educated and highly talented lawyers, accountants, and auditors spends every hour of every working day coping with this miasma. Add to this all the taxpayer compliance costs and you're talking hundreds of billions of dollars in annual wasted resources. This is not to mention the efficiency losses from the current system's distorted incentives, which the GAO puts at 2 to 5 percent of GDP.[1]

What's worse, the tax system is geared in many ways to take from the poor and young and give to the rich and old. The shift in recent years to taxing dividends and capital gains at a 15 percent rate is a good example. Most U.S. equity is held by those over 50. Lowering the effective tax rate on their income just leaves a bigger burden on everyone else, where everyone else consists primarily of young and future generations. There are several candidates for wholesale tax simplification and reform, including a value added tax (VAT), a flat tax, and a federal retail sales tax. The most straightforward reform is the federal retail sales tax, which taxes purchases of final consumption goods and services at a single rate. In principle the VAT and flat taxes would also tax only consumption; but in practice, they will likely be implemented with very generous transition rules which would leave us taxing not consumption, but rather wages. Such a "reform" would be highly inequitable, both on intra- and intergenerational grounds. Consequently, I favor the federal retail sales tax as a means to tax all consumption (including services, food, and imputed rent on owner-occupied housing and automobiles).

The specific plan is to replace the personal income tax, the corporate income tax, the payroll (FICA) tax, and the estate and gift tax with a federal retail sales tax plus a rebate. The rebate would be paid monthly to households, be based on the household's demographic composition, and equal the sales taxes paid, on average, by households at the federal poverty line with the same demographics.

Most Democrats assume that a sales tax would be regressive. But my proposed reform, which is very similar to the FairTax (see www.fairtax.org), has three highly progressive elements. First, thanks to the rebate, poor households would pay no sales taxes in net terms. Second, the reform eliminates our highly regressive FICA tax. Third, the sales tax will effectively tax wealth as well as wages: When the rich spend their wealth and when workers spend their wages, they will both pay sales taxes. By broadening the effective tax base to include the corpus of wealth, not just the income earned on it (much of which is currently exempted or taxed at a low rate), one can lower the required sales tax rate and, thereby, reduce the tax burden on workers.

The single, flat-rate sales tax would pay for all federal expenditures. The tax would be highly transparent and efficient. It would save hundreds of billions of dollars in tax

[1] General Accountability Office, *Tax Policy Summary of Estimates of the Costs of the Federal Tax System*, GA0 – 05-878, August 2005.

compliance costs. It would significantly reduce effective marginal taxes facing most Americans when they work and save. Finally, the federal retail sales tax would enhance generational equity by asking rich and middle class older Americans to pay taxes when they spend their wealth. The poor elderly, living on Social Security, would end up better off. They would receive the sales tax rebate even though the purchasing power of their Social Security benefits would remain unchanged thanks to Social Security's automatic cost of living adjustment.

The sales tax rate paid at the store would have to be roughly 33 percent to generate enough revenue to pay for federal government expenditures arising under my Social Security, healthcare, and discretionary spending proposals. This is what public finance specialists call the "tax-exclusive" rate. The corresponding "tax-inclusive rate" is 25 percent. This latter rate is comparable to tax rates on income because we have to buy goods today with after-tax dollars. Under the sales tax system if you buy 75 cents worth of goods, you pay 25 cents in tax so that 25 percent of every dollar spent goes to tax and 75 percent to goods.

Note that a 25 percent effective marginal tax rate on labor supply is lower than the total effective wage-tax rate most workers face on their labor earnings under our current tax system. Take, as one example, a 45 year-old, married couple earning $35,000 per year with two children. Given their federal tax bracket, the claw-back of the Earned Income Tax Credit, and the FICA tax, their marginal tax rate is 47.6 percent! And marginal rates are what matter for labor supply.

In addition to either lowering or dramatically lowering most workers' marginal wage taxes, adopting a federal retail sales tax would completely eliminate marginal taxation of saving. In contrast, the current corporate and personal federal income taxes confront many savers with very high marginal rates.

A 25 percent effective sales tax rate would raise federal revenues to 21 percent of GDP – the ratio of revenues to GDP that prevailed in 2000. This is 5 percentage points more of GDP than we are now collecting in all federal taxes and would eliminate roughly three fifths of the fiscal gap. On the other hand, the sales tax rebate would cost about 4 percent of GDP. Consequently, the net reduction in the fiscal gap from the tax reform would be only about 12 percent, or one percent of GDP.

I'd close the remaining 88 percent of the gap with cuts in Social Security, healthcare, and discretionary spending. But cuts, by themselves, will not carry the day. We need to restructure Social Security and federal healthcare delivery to ensure that any cuts made today are not undone by spending increases tomorrow.

Fixing Social Security – The Personal Security System

My second proposed reform deals with Social Security. With 2528 rules in its Handbook, the system is a bureaucrat's dream come true. It's also significantly underfunded. According to Social Security's Trustees, paying all of Social Security's projected benefits through time requires an immediate and permanent 27 percent increase in the 12.4 percent OASDI tax rate.

Here's what I would do. I'd shut down the retirement portion of the current Social Security system at the margin by paying in the future only those retirement benefits that were accrued as of the time of the reform. This means that current retirees would receive their full retirement benefits, but current workers would receive retirement benefits based only on covered wages earned prior to the reform. (The Social Security Survivor and Disability programs would remain unchanged, except that their benefits would be paid by the sales tax.)

The retail sales tax would pay off all accrued retirement benefits, which eventually will equal zero. Thus, my plan finances the transition to a new federal retirement saving system, not via new borrowing, but by a) explicitly paying off the existing liabilities of the old system with the proposed sales tax and b) defining existing liabilities to equal accrued benefits, which are significantly lower than the benefits current workers would receive under an ongoing system.

The current system will be immediately replaced by a fully funded and modern system of compulsory saving, which I call the Personal Security System (PSS). PSS has individual accounts, but one with very different properties from the scheme proposed by President Bush in 2005. All workers would be required to contribute 7.15 percent of their wages up to what is now the Social Security covered earnings ceiling (i.e., they'd contribute what is now the employee FICA payment) into an individual PSS account. Married or legally partnered couples would share contributions so that each spouse/partner would receive the same contribution to his or her account. The government would contribute to the accounts of the unemployed and disabled. In addition, the government would make matching contributions on a progressive basis to workers' accounts, thereby helping the poor to save.

All PSS accounts would be private property. But they would be administered and invested by the Social Security Administration in a market-weighted global index fund of stocks, bonds, and real estate securities. Everyone would have the same portfolio and receive the same rate of return. The government would guarantee that, at retirement, the account balance would equal at least what the worker had contributed, adjusted for inflation; i.e., the government would guarantee that workers could not lose what they contributed. This would protect workers from the inevitable downside risks of investing in capital markets.

Between ages 57 and 67, account balances would be gradually sold off each day by the Social Security Administration and exchanged for inflation-protected annuities that would begin at age 62. By age 67 workers' account balances would be fully annuitized. Workers who died prior to age 67 would bequeath their account balances to their spouses/partners or children. Consequently, low income households, whose members die at younger ages than those of high income households, would be better protected.

Although this plan has individual accounts and market investment, neither Wall Street nor the insurance industry would get their hands on workers' money. There would be no loads, no commissions, and no fees. Nor would there be all the risks associated with individual investing. Like the current Social Security system, PSS would take advantage of economies of scale in operating saving systems and the government's unique ability to pool risk across generations.

The switch from paying projected Social Security benefits to paying only accrued Social Security benefits would reduce the fiscal gap by roughly $15 trillion or roughly 24 percent.[2] Together with the tax reform, I've now reduced the fiscal gap by 36 percent.

Cutting Back on Discretionary Spending

The federal government's discretionary spending currently represents 7.8 percent of GDP. This is 1.5 percentage points higher than the year-2000 figure. I propose restoring the year-2000 discretionary spending rate. This would reduce the fiscal gap by another 18 percent, leaving 46 percent to be cut via my proposed healthcare reform.

Healthcare Reform: MSS

According to the Gokhale and Smetters, the combined unfunded liabilities of Medicare and Medicaid total roughly $120 trillion. The gargantuan size of these liabilities has everything to do with the projected growth in benefit levels. Limiting benefit growth to that of labor productivity would reduce the fiscal gap by roughly $36 trillion, or 57 percent, which would more than close the remaining fiscal gap.

But cutting future benefit growth in these programs appears to be impossible under the current fee-for-service structure. Our government has tried all manner of ways to reduce healthcare benefit growth in recent decades, and all have failed. What we need is a foolproof means by which the government can set an expenditure limit in a given year and stick to it. At the same time we need a system that delivers healthcare to everyone in society, not just the aged and indigent. As is well know, some 45 million Americans currently have no health insurance coverage. This is unacceptable in a civilized society.

Consequently, I propose moving to a universal healthcare system that limits benefit growth over time. This system will cost more money in the short run, but much less over time than our current system. My proposal, culled from earlier work by John Goodman and Peter Ferrara[3], would abolish the existing fee-for-service Medicare and Medicaid programs and enroll all Americans in a universal health insurance system called the Medical Security System (MSS).

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[2] The present value of projected benefits owed to current adults used to form Social Security's closed group liability is $29.4 trillion. The accrued benefits owed to current adults, called the Maximum Liability, is $14.5 trillion. The difference is $14.9 trillion. See http://www.ssa.gov/OACT/NOTES/ran1/index.html. The closed group liability reported at this site is net of taxes and the trust fund. Alice Wade, an actuary at the Social Security Administration, informed me that the present value of gross benefit used to form the closed group liability is $29.4 trillion.

[3] See John Goodman, Peter Ferrara, Gerald Musgrave and Richard Rahn, "Solving the Problem of Medicare," National Center for Policy Analysis, NCPA Policy Report No. 109, January 1984.

In October of each year, the MSS would provide each American with an individual-specific voucher to be used to purchase health insurance for the following calendar year. The size of the voucher would depend on the recipients' expected health expenditures over the calendar year. Thus, a 75 year-old with colon cancer would receive a very large voucher, say $150,000, while a healthy 30 year-old might receive a $3,500 voucher. The MSS would have access to all medical records concerning each American and set the voucher level each year based on that information. If you ended up costing the insurance company more than the amount of your voucher, the insurance company makes up the difference. If you ended up costing the company less than the voucher, the company makes a profit. Insurers would be free to market additional services at additional costs. MSS would, at long last, promote healthy competition in the insurance market, which would go a long way to restraining health care costs.

Providing individual-specific vouchers based on full and accurate medical information obviously eliminates the adverse selection problem that has plagued private medical insurance provision since the inception of that industry. Rather than experience-rate large collections of individuals, as some reforms propose, the MSS experience rates the individual. But unlike automobile insurance, there is no penalty, but rather a reward in the form of a larger voucher, for having a bad track record. The individual experience rating used by the MSS to determine the size of each person's voucher would also factor in the level of health care costs in the area in which the person resides.

Some readers are sure to worry about a possible invasion of privacy. Yet the government already knows about millions of Medicare and Medicaid participants' health conditions because it's paying their medical bills. This information has never, to my knowledge, been disclosed or abused.

The beauty of this plan is that all Americans would receive healthcare coverage and that the government could limit its total voucher expenditure to what the nation could afford. Unlike the current fee-for-service system, under which the government has no control of the bills it receives, MSS would explicitly limit the government's liability. In setting its voucher budget through time, the government would target to spend, in present value, no more than the current system were benefit levels to grow only with labor productivity.

The MSS plan is also progressive. The poor, who are more prone to illness than the rich, would receive higher vouchers, on average, than the rich. And, because we'd be eliminating the current income tax system, all the tax breaks going to the rich in the form of non-taxed health insurance premium payments would vanish.

A Final Word

It's high time we got our fiscal house in order. Economists have a key role in keeping our country from experiencing the fiscal and financial meltdown to which current policies are pointing. To do this, we need to unite as a profession around solutions to which our discipline points. The reforms presented here are neither entirely new nor wholly original. To me they represent solid economic engineering – straightforward solutions to clear cut problems. Yes, they are radical changes. But nothing short of radical changes will help us resolve our $63.3 trillion shortfall.

References and further reading

Gokhale, Jagadeesh and Kent Smetters, "Fiscal and Generational Imbalances: An Update," forthcoming in *Tax Policy and the Economy*, James Poterba, ed., 2006.

Acknowledgments

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