

Laurence J. Kotlikoff

Professor of Economics
Department of Economics
Boston University
617-353-4002
kotlikof@bu.edu

Author of *Generational Accounting*

February 1, 2001

The Case for a Tax Hike

With almost \$6 trillion in federal budget surpluses projected over this decade, everyone is for cutting taxes. The only question is by how much. Not me. I'm convinced that far from cutting taxes, we need to raise taxes dramatically to deal with our coming perfect fiscal storm. I base this judgment on a little-known generational accounting study conducted by economists at the Congressional Budget Office (CBO) and the Federal Reserve Bank.

The study, which has been kept quiet by the CBO, was recently published in the *American Economic Review*. It considers the size of the federal income-tax hike needed to handle the baby boomer's retirement and ensure that our children aren't saddled with higher tax rates than those we face. In addition to assuming the tax hike is immediate and permanent, that no other taxes are raised, and that Social Security, Medicare, and other federal benefits are paid in full, the CBO and Fed economists assumed that federal discretionary spending would grow with the economy.

The study, updated this past fall to incorporate the latest CBO forecasts, shows that we need an immediate and permanent 31 percent hike in both personal and corporate income-tax rates. How can that be? How can we be in such hot water if we're in the black to the tune of \$6 trillion dollars over the next ten years?

There are three reasons. First, the CBO's vaunted \$6 trillion surplus doesn't assume that federal spending keeps pace with the economy. Instead, it assumes the federal government will spend exactly the same number of dollars on purchasing goods and services every year for the next ten. To be polite, this projection is a hoax. It means that federal spending keeps up neither with inflation, population growth, nor productivity growth. And it implies a roughly one third shrinkage in federal spending as a share of GDP by 2010.

Federal purchases relative to GDP are already at a postwar low. The government's supposed disappearing act would require either huge cuts in the absolute and relative real incomes of government workers or massive government layoffs. It would also mean giving up on the anti-missile missiles and this administration's other plans for building up the military. A much more reasonable assumption is that federal spending will keep pace with the economy. This, by the way, is what happened last year.

The second reason is that the CBO's surplus projection looks only 10 years into the future, so it stops just when the baby boomers start to retire. The third and most important reason is that the fiscal liabilities arising from the baby boomers' retirement are colossal. In thirty years we're going to have 100 percent more elderly, but only 15 percent more workers. And that's an optimistic forecast. The nation's top academic demographers think people will live a lot longer than our government expects.

Here's another way to break down the math. If you assume federal spending grows with the economy, about two fifths of the surplus disappears. Another two fifths of the surplus is supposed to be kept for Social Security and Medicare. But two fifths of the surplus or even three fifths is far too small to deal with their long-term liabilities. Indeed, both of these programs are roughly 40 percent underfunded once one factors in realistic lifespan projections.

Can we afford to wait to raise taxes until the economy improves? Not really. As the study shows, the longer we wait, the larger the requisite tax hike. And a recession will mean less short-term revenue, making the need for a tax hike that much greater. Can we outgrow our fiscal dilemma? Again, the answer is no. The study incorporates the CBO's quite optimistic assumptions about future economic growth.

The real alternative to raising taxes now is ending up with sky-high tax rates in the future, substantial Social Security and Medicare benefit cuts, and a government that does what other government do when they get into this kind of jam – print massive amounts of money to pay its bills. The result will be very high inflation, if not hyperinflation, that effectively defaults on nominal government debt and all other nominal government expenditure commitments.

Instead of congratulating ourselves for the current surplus, deceiving ourselves about future surpluses, and spending future surpluses before they materialize, we should be asking whether the likely surpluses are large enough to deal with what's coming. The answer is clearly no. Indeed, the Fed-CBO study suggests this year's surplus should be three times larger than is likely to be the case. Over time, we need to retire fully the existing stock of government debt and then begin accumulating a massive reserve of government assets to deal with all our coming bills.

Yes, everyone wants a tax cut, everyone that is except our kids.