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The Intergenerational Conflict – Après le Deluge

We meet at a time of severe global economic stress. Whether we call this the Great Recession or the Second Coming of the Great Depression, the economic situation is terrible. The World Bank is forecasting a 3 percent drop in world output this year compared with last year.¹ Unemployment in the U.S. and EU is reaching 10 percent. In Spain and Latvia it is near 18 percent. Japan's exports have fallen in half.² Sweden's industrial production is down 9 percent.³ Name the place and measure the fallout.

The crash of 2008 is affecting all generations. The elderly have seen much of their retirement savings evaporate overnight in the financial markets. The young have seen their job prospects greatly narrowed. And children, at least in parts of the U.S., are seeing their teachers being laid off, their state parks closed, and their access to healthcare denied.⁴

¹ <http://www.indiainfo.com/news/innernews.asp?storyId=105646&lmn=1>

² <http://www.dailymarkets.com/economy/2009/03/09/markets-continue-to-decline-as-world-bank-predicts-that-global-gdp-may-contract-for-first-time-since-wwii/>

³ <http://uk.biz.yahoo.com/29052009/323/instant-view-3-swedish-q1-gdp-posts-record-fall.htm>

⁴ "States are Turning to Last Resorts in Budget Crisis," The New York Times, June 22, 2009, pp. 1, 12.

The crisis is being blamed on lots of things – from Federal Reserve interest rate policy, to global saving imbalances, to greedy bankers, to unregulated derivatives, to rating agencies, to politicians, to securitization, to financial malfeasance. Accurately apportioning the blame will occupy economists for decades, but, for now, my favorite villain is non-disclosure. The public wasn't told that trillions of dollars of AAA-rated securities were actually DDD. It wasn't told about "liar" and "no-doc" mortgages. It wasn't told that major financial companies were leveraged 30 to 1 and that relatively small losses could take them and the financial system down. It wasn't told about a \$60 trillion unregulated and undocumented credit default swap market and that the world's largest insurance company was using this market to insure the uninsurable. It wasn't told that the banks, themselves, didn't understand what risks they faced because their assets and liabilities were too complex and interconnected. And the list goes on.

Non-disclosure of pertinent financial facts in a form that the public can digest is, at its heart, dishonest and deceitful. And it is the widespread recognition that the financial sector is no longer to be trusted that makes the current economic crisis so scary. The world economy needs a properly functioning financial system, but that means a financial system we can trust. Maintaining the old financial system -- the policy now being pursued -- is a prescription for ongoing economic decline, which will do more damage to our children than we can imagine.

In a series of columns, I and several co-authors have laid out a simple plan, called Limited Purpose Banking, which would fundamentally reform the financial system by transforming all financial corporations (banks, insurance companies, hedge funds, brokerages, financial exchanges, credit unions, etc.) into pass-through mutual funds and having the

government verify, disclose, and supervise the custody and rating of all securities sold by these mutual funds.⁵ Under Limited Purpose Banking, people, not banks, insurers, or any other type of financial company, hold risky securities. Consequently, no bank or insurance company would ever again be in a position to fail.

Limited Purpose Banking has some intellectual roots in Narrow Banking, which was proposed by Henry Simon, Irving Fisher, and Frank Knight in the 1930s. It is a simple, efficient fix for our financial system. But economics also offers simple, efficient, and progressive fixes for our healthcare systems, our tax systems, and our old-age pension systems. These are the Medical Security System (an individual-specific voucher system), the FairTax (a single rate consumption tax with a demo grant that makes it highly progressive), the Personal Security System (individual accounts with progressive government-provided matching contributions, zero-cost investment in a single global index, government guarantees of the real value of contributions, and government inflation-protected annuitization of account balances at retirement).⁶

For our children, the hour is getting very late to make the radical reforms needed to restore our fiscal and financial systems. As we economists know, the developed world's fiscal operations have been endangering our children for decades. But governments have spent decades carefully concealing this fact. Indeed, governments have spent decades teaching their

⁵ See, for example, <http://people.bu.edu/kotlikof/newweb/BacktoBasics51409.pdf>

⁶ See Kotlikoff, Laurence J., *The Healthcare Fix*, The MIT Press, 2007; <http://people.bu.edu/kotlikof/New%20Kotlikoff%20Web%20Page/Why%20Democrats%20Should%20Love%20the%20FairTax%20Boston%20Globe%202-24-08.pdf>; and <http://people.bu.edu/kotlikof/New%20Kotlikoff%20Web%20Page/Boston%20Globe%20oped,%20November%202021,%202004.pdf>

financial sectors the fine art of non-disclosure. In particular, governments have failed to systematically account for their treatment of future generations by spelling out what current policies imply for the future tax burdens of today's and tomorrow's children.

Rather than use generational accounting to steer their fiscal affairs, governments rely on deficit account. But deficit accounting is an economically vacuous method of fiscal analysis. What deficits are reported is entirely a result of what words governments choose to use to label their receipts and payments.⁷ And governments have carefully selected their labels to ensure that the great mass of obligations encumbering future generations is off the books.

In the U.S., paying for what the government intends to spend will, it appears, require a doubling of lifetime net tax rates facing future generations.⁸ In Europe and Japan the situation seems somewhat less extreme given the adoption of pension and healthcare reforms. But here's the rub. One cannot extract blood from a stone, and one can't get more revenue from young workers than they are willing to supply given the marginal work and saving tax disincentives. So the magnitude of the generational policy imbalance is really telling us that current middle aged and older generations will, themselves, ultimately have to pay much higher net taxes in the years ahead. The alternative – attempting to maintain unsustainable fiscal policies on an indefinite basis -- will culminate in hyperinflation as the government tries and, ultimately, fails to make money by making money. This too would visit a loss on older adults,

⁷ <http://people.bu.edu/kotlikof/New%20Kotlikoff%20Web%20Page/General%20Relativity%207-6-07%20posted%20January%203,%202008.pdf>

⁸ These calculations do not adjust for risk in the discounting. Recent work by Alex Blocker, Steve Ross, and me suggests risk adjusting could raise the implied burden facing future generations. See <http://people.bu.edu/kotlikoff/newweb/TrueCostofSocSecurity3-29-09.pdf>.

since they are the ones holding nominal assets whose real values would be wiped out. The only question is which generation's ox will be gored.

In fact, the markets are now answering this question, at least in part. Some of the requisite reverse redistribution from the old to the young is going on right now right before our eyes as a byproduct of the current financial crisis. The global decline in asset values represents a transfer of wealth from the old owners of these assets to the young buyers of these assets provided the young of each country (as opposed to foreign nationals) are actually able to purchase the existing assets at their much lower prices. This depends, of course, on the ability of the young to stay employed, to save, and to muster up enough courage to invest their savings in stocks, bonds, and real estate at what seem to be highly favorable valuations.

Governments can assist the young here by borrowing at the current very low rates prevailing on government short-term bills and using the proceeds to purchase claims to an index of domestic or, even better, global equities. This policy – buying up the nation's capital stock on behalf of the next generation – would provide the government a source of income, once the market recovers – to help pay for the benefits it's promised to the current elderly and baby boomers.

Of course, if markets are really valuing assets correctly and the government has no ability to influence the equilibrium of the economy via such a policy, the policy provides no real advantage once one adjusts for risk. But there is reason to believe that assets markets are undervaluing equities as well as corporate and personal debt, and governments may be able to effectively pick the equilibrium by their confidence-building actions. Purchasing stocks and

bonds in the global market via index funds is one very clear way for governments to express optimism in their own and foreign economies. These investments can be done by rolling over futures contracts to ensure that governments do not acquire voting rights and start micromanaging private companies.

So far my comments have been partial equilibrium in nature. But general equilibrium considerations make matters worse. The ongoing process of taking from young (including unborn) savers and giving to old spenders, whether that happens in France, the U.S., China, Russia, Israel, or Argentina spells less global savings and capital formation for the simple reason that the young have lower current propensities to spend. In the case of the unborn young, their current propensity to spend is zero. As Hans Fehr, Sabine Jokisch, and I have shown,⁹ the capital deepening and associated higher real wages that one would naturally expect to arise in aging life-cycle economies can easily be offset by the generational expropriation policies now underway. So yes, there will be, in twenty years, lots of retired baby boomers who should have large holdings of capital the availability of which should raise real wages, but “should” is not “would.” If the baby boomers are holding mostly claims to government pension and healthcare benefits as opposed to claims to capital, there can be crowding out, not crowding in of capital associated with population aging.

In this regard, it’s important to note that in at least the U.S., healthcare benefits provided to the elderly courtesy of young and future generations continue to grow much more rapidly than does per capital GDP. Indeed, when the baby boomers retire, their average Social

⁹ <http://people.bu.edu/kotlikoff/newweb/Globalization.pdf>;
<http://people.bu.edu/kotlikoff/Will%20China%20Eat%20Our%20Lunch,%20March%2028,%202007.pdf>

Security, Medicare, and Medicaid benefits will exceed per capita GDP! And this estimate is based on very conservative assumptions about future benefit level growth rates.¹⁰

Given the developed world's generational expropriation policies, there would be little prospect of capital deepening over this century were it not for the saving factory that is China. If China continues to grow at its torrid pace and continues to save north of 30 percent of its national income, it will be able to continue to provide lots of capital to the developed world. But these are two big ifs and not to be counted on. Lots of Chinese saving appears to reflect that lack of health insurance and government old age pensions. But the Chinese government is expanding the provision of both. To the extent that it finances these programs, which are targeted for the most part to the elderly, by taking from the young (which seems to be what's happening), China's national saving rate will fall just as has happened in the U.S., Japan, and the EU in recent decades. This will mean smaller Chinese current account surpluses and less capital in developed countries with which workers can work.¹¹

To summarize, the global economy is in a very dangerous spot and developed economies are particularly vulnerable given their aging and large-scale beggar-thy-children policies. Economists have been warning for decades that these two forces would spell big trouble. Politicians ignored those warnings and did their best to conceal the Ponzi game they

¹⁰ See *The Healthcare Fix*, op. cit.

¹¹ An additional concern about China's impact on the developed world is its education policy. As <http://people.bu.edu/kotlikoff/newweb/Globalization.pdf> points out, if China continues to produce relatively more unskilled than skilled workers, the wages of unskilled workers relative to the wages of skilled workers will fall dramatically over time, not just in China, but globally. The reason is that productivity improvements in China will make all Chinese workers more efficient. But given the relative endowments of unskilled and skilled workers in China and the size of China's population, higher productivity in China will expand the world's effective supply of unskilled labor much more rapidly than it expands the world's effective supply of skilled labor.

were playing. The game is over, and this is no time for business as usual. We need to adopt radical, efficient, and simple reforms of our financial, healthcare, pension, and tax systems, and we need to do it now.