

Kotlikoff, Laurence

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PENSION AND MEDICOST REFORM – AVERTING THE DEMOGRAPHIC/FISCAL DEMISE

LAURENCE J. KOTLIKOFF*

The developed world is facing a much greater fiscal/demographic problem than is commonly believed. Take the U.S., which, arguably, is in better fiscal shape than Japan and most EU countries. It faces a fiscal gap of \$65.9 trillion, where “fiscal gap” refers to the present value difference between all projected future federal government expenditures and all future government tax receipts.

The \$65.9 trillion estimate comes courtesy of Jagadeesh Gokhale and Kent Smetters (2005) who based their calculation on US government projections, which, incidentally, tend to be overly optimistic.

One way to put the US fiscal gap in perspective is to ask how much of a tax hike would be required to eliminate it in present value? The answer is that US federal personal and corporate income taxes would have to be doubled, immediately and permanently! Alternatively, the gap could be closed by immediately and permanently cutting by two thirds the elderly’s Medicare health benefits as well as their Social Security pension benefits!

Either of these policies or any combination of them would impose a huge burden on current adults. But American adults appear in no mood to endorse any fiscal adjustments that either raise their taxes or cut their benefits. Of course, what people want and what they can get are often far removed. As the government’s intertemporal budget constraint reminds us, generational policy is a zero-sum game. So leaving today’s adults off the hook means forcing young and future Americans to pay this bill in its entirety. Such a policy is not only ethically abhorrent. It also appears to be economically unfeasible since it would entail a doubling of the average lifetime net tax rates levied on today’s young and future generations.

Laying blame

Much of the US fiscal gap can be ascribed to Social Security, Medicare, and Medicaid, i.e., to state pension and medical systems, if one wants to follow the

traditional accounting classifications. The same, presumably, would be true of fiscal gaps in other developed countries. But as discussed in Kotlikoff (2003), those classifications as well as cash flow (as opposed to present value) measurements of taxes, transfer payments, and deficits have no basis in economic theory. Consequently, one can adopt other classifications and conclude that those programs are in fine fiscal shape, while the rest of the government’s finances are the true problem.

Economic theory dictates, then, that we look at the overall fiscal picture. Slicing it and dicing it doesn’t cut it. Unfortunately, this is what the governments of virtually all developed countries are doing. They are looking at the individual trees and, potentially, missing the forests. The tree that gets the most attention is, of course, the official debt. In the U.S., the official debt is only one twelfth of the fiscal gap, so it’s doing a fine job hiding the true picture.

If the US fiscal gap is so big relative to its GDP, how big are the fiscal gaps of other developed countries relative to their GDPs? Unfortunately, we can only guess because, with a couple notable exceptions, none of these countries are doing fiscal gap accounting, let alone generational accounting, on an ongoing and systematic basis. Hence, we are heading into a huge generational storm without turning on the weather satellites. This is a very unwise course of action.

The reason why Japan and most EU countries may be in worse fiscal shape than the U.S. is that they are scheduled to age much more rapidly than the U.S. thanks to much lower past, current, and projected fertility and immigration rates. Italy’s current fertility rate, for example, is only 1.2 percent, making it the lowest of any country in the developed world. In addition, the generosity of benefits paid to the elderly seems to be greater in Japan and other EU countries when scaled by per capita income.

The role of growth in health expenditures

The big unknown in determining which developed country gets the prize for being the most bankrupt, is the future growth in health expenditures per recipient. As Table 1 indicates, the U.S. beat Japan and Germany and a number of other developed countries over the period 1970 through 2002 when it

* Boston University, National Bureau of Economic Research.

Table 1
Average Annual Growth Rates in Real Health Expenditures per Recipient and Real GDP Per Capita, 1970 to 2002

Country	Real Health Expenditures Per Recipient	Real Health Expenditures Per Capita	Real GDP Per Capita	Relative Growth of Health Expenditures and GDP
Australia	3.15	3.65	1.75	2.1
Austria	3.22	3.49	2.16	1.6
Canada	2.08	2.63	1.91	1.4
Germany	2.82	3.12	1.63	1.9
Japan	3.07	4.56	2.16	2.1
Norway	4.82	5.22	2.62	2.0
Spain	4.26	4.88	2.10	2.3
Sweden	2.11	2.26	1.71	1.3
UK	2.97	3.21	1.95	1.6
US	4.24	4.91	1.89	2.6

Source: Christian Hagist and Laurence J. Kotlikoff, "Who's Going Broke? Rising Health Care Costs in Ten OECD Countries," mimeo, Boston University, June 2005.

comes to letting its health expenditures grow relative to its economy. Over this period, US government health spending grew 2.6 times faster than the economy on an average annual basis. In Japan and Germany the comparable ratios were 2.1 and 1.9.

Table 1 helps us see how much of the excess growth in government health care spending is due to growth in spending per recipient as opposed to demographics, i.e., the increase in the number of recipients per capita and the shift in the age structure toward relatively expensive recipients.

Take the U.S. and Japan. Real health spending per recipient grew at annual rates of 4.24 percent and 3.07 percent in those countries, respectively. But the rapid aging of the Japanese society coupled with the higher health costs of the elderly meant that health expenditures per capita grew almost as rapidly in Japan as in the U.S. over the 22 years.

Table 2
Projected Future Health Spending as Percent of Projected Future GDP

Country	Discount Rate		
	r = 3%	r = 5%	r = 7%
Australia	10.67	9.61	8.93
Austria	7.82	7.25	6.86
Canada	11.00	9.72	8.92
Germany	12.47	11.67	11.10
Japan	10.54	9.67	9.09
Norway	11.98	11.08	10.47
Spain	8.76	8.15	7.67
Sweden	9.84	9.42	9.13
UK	9.15	8.47	8.05
US	12.71	11.01	9.94

Source: Christian Hagist and Laurence J. Kotlikoff, "Who's going broke? Rising Health Care Costs in Ten OECD Countries," mimeo, Boston University, June 2005.

Table 2 compares the present value costs of projected health expenditures in the different countries assuming that current expenditure growth rates per recipient are maintained for the next twenty years and then decline over the following 30 years to equal the rate of growth of per capita GDP.

At a 3 percent discount rate, the U.S. has the highest present value projected cost measured relative to the projected present value of GDP. At a 7 percent discount rate, Germany comes out

on top. The Japanese figures as well as those of the other countries are also quite high.

The bottom line here is that while the U.S. has been taking the lead in permitting unsustainable growth in health care spending, it's not far ahead of the pack and may actually soon be passed by other developed countries.

Macroeconomic repercussions

There are lots of ways – most of them bad – that the U.S. and other developed countries can achieve a sustainable fiscal policy. One is to raise taxes over the transition. As discussed in Fehr, Jokisch, and Kotlikoff (2004), raising payroll and income taxes over the transition to meet promised benefits will precipitate a significant capital shortage as young workers will have even less take-home pay to save and invest in capital. The capital shortage will, as simulated, drive down real wages by one fifth and drive up real interest rates by roughly 50 percent. Alternatively, if governments simply print money to pay their bills, we're likely see very high rates of inflation if not hyperinflation. The third option is simply to cut benefits. This seems politically the most difficult since elderly voters are very well organized politically.

The uncertainty about the resolution of the fiscal imbalances in the developed world as well as the size of these imbalances could precipitate a financial crisis under which interest rates, nominal and real, shoot up dramatically in response to concerns that governments will simply print money to pay their bills.

What to do?

Some have suggested that the developed world can cure its aging problems by simply increasing immigration. As discussed in Fehr, et. al. (2004) and Auerbach and Oreopoulous (1999), immigrants are likely to cost governments as much as they make for them. Other supposed cures like productivity growth, increased fertility, and delayed retirement do remarkably little. Getting control of excess growth in health expenditures could, on the other hand, make a significant contribution to restoring sanity.

Addressing the growth of health care expenditures

As mentioned, one can classify whatever revenue stream one wants as available for spending on health care programs, so saying that the health care system is the problem gets us back to substituting linguistics for economics. But no matter how one classifies such expenditures and how one measures their contribution to the overall problem, it's clear that letting health expenditures per recipient grow on an ongoing basis much more rapidly than the real wages of workers paying those benefits is a big problem. Somehow the developed countries must find a way to keep health spending from growing at the past and projected rates. They must also come up with new and more efficient state pension and tax systems. In this regard, let me briefly describe a new New Deal that Niall Ferguson and I (Ferguson and Kotlikoff, 2005) are proposing to reform US fiscal institutions.¹

The three proposals covering taxes, Social Security, and health care are interconnected and interdependent. In particular, tax reform provides the funding needed to finance Social Security and healthcare reform. Each of these reforms can and should be carried out by other developed countries.

Tax reform: FRST

Let's start with tax reform. Our 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 (FRST) 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 house-

holds at the federal poverty line with the same demographics.

Most of the public believes a sales tax is regressive. But our sales tax has three highly progressive elements. First, thanks to the rebate, poor households pay no sales taxes in net terms. Second, our reform eliminates the highly regressive FICA tax, which is levied only on the first \$90,000 of earnings. Third, FRST would effectively tax wealth as well as wages, because when the rich spent their wealth and when workers spent their wages, they would both pay sales taxes.

Our 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 compliance costs. It would significantly reduce effective marginal taxes facing most Americans when they work and save. Finally, FRST 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 the automatic CPI adjustment that would raise their Social Security benefits to account for the increase in the retail price level).

Social security reform: PSS

Our second proposed reform deals with Social Security. We would 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 benefits, but current workers would receive benefits in retirement that are based only on covered wages earned prior to the reform. The retail sales tax would pay off all accrued retirement benefits, which eventually will equal zero. The current Social Security Survivor and Disability programs would remain unchanged except that their benefits would be paid by the sales tax.

In place of the existing Social Security retirement system, we would establish the Personal Security System (PSS) – a system of individual accounts, but one with very different properties from the scheme proposed by the President. All workers would be

¹ The remainder of this paper draws heavily on Ferguson and Kotlikoff (2005).

required to contribute 7.15 percent of their wages up to what is now the Social Security covered earnings ceiling (i.e., they would 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. Consequently, 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.

Healthcare reform: MSS

Our third and final reform deals not just with our public health care programs, Medicare and Medicaid, but with the private health insurance system as well. That system, as is notorious, leaves some 45 million Americans uninsured. Our reform 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). 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.

The vouchers would pay for basic in- and out-patient medical care as well as for prescription medications over the course of the year. If you ended up costing the insurance company more than the amount of your voucher, the insurance company would make up the difference. If you ended up costing the company less than the voucher, the company would pocket the difference. 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.

The beauty of our 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.

The 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 would 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. Added together, the elimination of this roughly \$150 billion of tax expenditures, the reduction in the costs of hospital emergency rooms (which are currently subsidized out of the federal budget), and the abolition of the huge subsidies to insurers in the recent Medicare drug bill would provide a large part of the additional funding needed for MSS to cover the entire population.

Summing up

These three radical, but progressive, market oriented, transparent, generationally equitable, and sensible reforms can be adopted by any developed country or, for that matter, any developing country.

They are, in my view, the best way to position countries for the demographic and fiscal stresses that lie ahead.

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