

General Discussion: Solutions for Developed Economies

Chairman: Jacob Frenkel

Mr. Frenkel: Thank you very much for reminding us that there are only two answers: The right answer and the wrong answer. Reminds me of the brilliant speech by Vaclav Klaus given at this conference a few years ago which stated there are only two ways: The right way and the wrong way; and anyone who looks for the third way is bound to end up on the way to the Third World. I would like to open the floor now to a brief discussion.

Mr. Wojnilower: Many of the speakers have pointed out that in twenty years or so there will be a severe shock, as the elderly exert a substantially larger claim on our resources. The shock will be severe, no matter how the elderly try to collect this claim—whether as parents from our own children, as voters from public budgets or, as sellers of accumulated financial assets, from other private savers.

It is misleading to convey the idea that this confrontation can be financially finessed in advance. And it is damaging to discuss these issues in the context of the current budget debate. There may be good reasons to reduce the budget deficit, but doing so would have no relevance to and will have no positive effect on the future intergenerational problem which has dominated this conference.

For a moment, I hoped that Pete Peterson's Charts 1-5 were going to lead to a discussion of the true issues—actually the issues of life

and death. How can we limit the benefits afforded by the current system and the entitlement expectations we hold for the future? But then his focus veered toward trying to establish a new fund, or saving the existing fund, which would be of no help in providing the *real* resources the elderly will demand when the time comes.

It confuses the issues to try to deal with these matters in the context of the budget. Both the defunct Clinton health plan and the current Republican Medicare proposals were foredoomed with respect to promoting long-range solutions, by being viewed mainly as short-term devices to reduce the federal deficit and facilitate tax reductions.

One further note: in the past, intergenerational conflicts have sometimes been mitigated by inflation. Inflation is a means whereby the younger generation can reduce the purchasing power of the accumulated claims of their elders. If this should no longer be feasible because of greater central bank vigilance, the obvious next solution is the repudiation or unilaterally enforced reduction of existing claims. This is where matters are headed. The Balanced Budget Amendment that barely failed in the Senate asserted that, in the event of a deficit, the government would be forbidden either to borrow (because of the debt limit), or to raise taxes (because a 60 percent Congressional supermajority would have been required). Orange County has already done it.

Mr. Frenkel: Thank you very much. Mr. Peterson, I assume the comment is addressed to you.

Mr. Peterson: Al, again I hate to keep quoting the University of Chicago, but another of our friends there, Jacob Viner, once said that a transition period is but a period between two other transition periods. And, I would like to argue that the demographic bomb is just not another transition period. It's going to be a transformational period, and it's going to transform a great deal more. I agree totally with what I think was the thrust of your comments—that the issues confronting us go far beyond the narrow definitions of our fiscal affairs. Let's take some of the other transformations. Over the last forty to fifty years, we have gone from being the biggest saver and

investor in the world to the biggest consumer and borrower. That was not just an economic phenomenon. It was a cultural phenomenon, affected by our hubris after the Second World War that told us we could “have it all,” the tax systems that encouraged borrowing and consumption and discouraged savings and investment, as well as by television, by the Vietnam War, by the rise of special interests politics, and so forth. The transformation back to more of a savings economy is going to involve a dialogue in America of the deepest sort. It certainly isn’t going to happen without a lot of public discussion.

Let’s visualize another transformation of the kind you referred to—the way our sense of ethics about life and death itself will have to change. We in the United States are now spending a stunning amount of money on health care in the last few months of our lives. No other country in the world spends what we do. A neurologist friend of mine tells me that in European countries more-or-less hopeless stroke patients are sent home to die, because not much else can be done for them. That’s the way we used to die in the United States, but today, there are legal requirements absent a living will to hook us up to the most expensive apparatus around. We will simply not be able to continue paying these costs for prolonging death as the numbers of “old-old” patients at the end of life mount and as the costs for high-tech equipment continue to spiral. This kind of transformation is an ethical transformation. It has a lot to do about who decides life, who decides death, what the relationships are between children and their parents, and so forth. It is not going to change by some public policy wonk standing up and proposing bureaucratic legislative reforms, but by having serious dialogue in America about this.

Let’s take another transformation: the issue of immigration. We’re seeing now, on the one hand, furious debate in California and elsewhere on limiting immigration. And yet there are other people saying that a big increase in immigration is one of the solutions to our demographic time bomb, because a lot of young workers are available in Latin America and elsewhere. That, again, is a national debate that is going to have to take place.

Visualize the political transformation that's coming. I'm not smart enough to tell you how this is going to be resolved. But there are at least two scenarios that I can envision. Senators Tsongas and Rudman and I have been supporting financially several organizations of American young people. One is called Lead . . . or Leave, another is called Third Millennium, and there are others in which the young people get involved with these fiscal, generational, transformational issues, including The Concord Coalition. Growing numbers of informed young people understand it is *their* future we're talking about. In one scenario they begin having not only a private dialogue with their parents, but a public dialogue; and the young become a major political force in America. That is Alternative A. Alternative B is that this dialogue never flourishes. The AARP grows by another thirty or forty million, and at that point they simply inflict their will on the rest of the country. What I've been arguing for is that academic institutes, universities, public policy organizations, and other leadership institutions should take this entire amalgam of complex issues, this gestalt we are calling a demographic transformation, and start thinking about all of the interrelated effects. Until that happens, it is going to be very difficult to get the reforms done. So I think I'm agreeing with you, Al. I'm not suggesting it is as simple as stating a reform. It's going to require a transformation really of our culture and our values, as well as public education of the deepest type. And that's why we are trying to encourage a major public dialogue on this problem.

Mr. Frenkel: Thank you very much. A transition period is always the period in which we live. Somebody said that a pier is a frustrated bridge. Yes, please.

Mr. Santow: I have a question for Pete Peterson. The adjustments of your three programs are basically all on the benefits side—nothing on the receipt side. And I just wonder from a political point of view if it would make sense. Right now, we have about 15 percent maximum pay—a little over 15 percent employee/employer—up to about \$53,000. Suppose, for sake of example, that, on just the individual side, above those numbers there was a 1 percent tax—open-ended, just on individuals above that amount. With that amount

taken, say you bought zero-coupon issues with the maturities based on when the system gets into great difficulty. Politically or economically, that seems to me to be a pretty good start. I have no problems with the three things that you propose—but this may cushion the degree of the changes that you would need to make in those three areas, might make them more politically palatable and more politically possible.

Mr. Peterson: Of course, I've gotten into a rhetorical debate with what one means by a spending cut and what one means by a tax increase. For example, the only practical way we have been able to figure out of applying the affluence test is by looking annually at the income of the individual and, in fact, increasing their taxes at that time. So, obviously if you are in the "increase tax" school, you could argue that we are in effect doing that. I think we are probably going to end up with some combination, as we often do, of all of these—some tax increase on those working, whose effects will be steeply progressive and some significant but again, steeply progressive benefit cut at the other end. So, I am not saying there isn't going to be some tax increase; I am just trying to say that the AARP is disingenuous, for example, when its spokesman told our commission, that "actuarially speaking"—whatever that means in this crazy world—all you have to do is raise taxes a couple percent. It's that kind of misleading information that we can't tolerate. But, clearly, we may have some tax increases of the type you talk about as part of a compromise solution. That wouldn't surprise me at all.

Mr. Frenkel: Thank you. Yes, please.

Mr. Berry: A question for Alan Auerbach. One of the assumptions that you make in your Figure 2, about the size of the primary surplus that we're going to need, is a 1.2 percent productivity growth rate. The administration for its longer-term calculations is currently working with 1.5 percent. I suspect most people in the room would say that your number is reasonably conservative, but theirs is not outlandish either. If you had an additional 0.3 percent over this kind of time horizon, you'd be talking about a 10 percent or more increase in GDP by 2003. Current tax yield is what—25 or 30 percent at the

margin of GDP for the federal government? That would bring you down to, say, a two-percentage-point primary surplus. Problem: Is that arithmetic right? And is it possible that with added investment we will have that kind of higher productivity growth?

Mr. Auerbach: Well, we're back to the right side of the blackboard again. The thing to keep in mind is that, with extra productivity growth, we don't just get more taxes. Social security benefits are indexed to real wages; and real wages, we think, grow with productivity. And so, you'd lose all that. It wouldn't be as much of a gain as one might think. A lot of it has to do with what you assume happens to other government purchases. And in the work I've done, I've typically assumed that government purchases stay roughly constant as a share of GDP, because historically that's a reasonable assumption to make if you look at the 1950s, 1960s, 1970s, and so forth. It makes a lot of difference, obviously, if you were to freeze government spending or to allow government spending only to grow with prices but not to grow with changes in productivity. If you have a lid on these various things, if you cause benefits to rise only with prices and not with wages—and you've got a productivity bonus—then that would be one way of making the problem less severe.

Mr. Frenkel: Somebody from the back.

Mr. White: One observation and one question. The observation is that virtually everybody here seems to be saying that, in light of the unfunded liabilities of the United States government, there is a very significant problem of intergenerational redistribution that has to be faced. In light of this, I would like to refer back to the paper we had yesterday from Mankiw and Ball. I agree with the concern expressed about hard landings, which I think are a very dangerous possibility. But the idea that, in fact, there is only a moderate redistribution of taxation required, and that therefore there is really nothing very much to worry about—which is the impression that paper left—I think the discussion this morning has indicated that perception is totally wrong. That is my observation. Now a question. If the United States is going to have real difficulties in this regard, what about everybody else? Going back to the paper that Mussa and Masson

presented yesterday, their Table 7 indicates that the net pension liabilities that are unfunded in the United States is 31 percent of GNP, which is a large number. The comparable numbers for Japan are 110 percent; and so on and so on. I suppose I'm addressing the question now either to Mr. Giovannini or to Mr. Stark. If the problems in the United States are perhaps unmanageable, how unmanageable are the problems of the European states?

Mr. Frenkel: Alberto.

Mr. Giovannini: I talked about Italy a little bit before. I can again elaborate on what is happening in that country. I think the table of Mussa and Masson is very well known. It is again, I hate to say, a question of how to go through this period until these reforms will work in full swing. In Italy, there has been a great tradition of political activity of pensioners. There used to be—before the big scandals—even a pensioners' party that was quite prominent in government. The party was able to swing the balance on a number of occasions and even had ministers in office for awhile. And yet, much to my surprise, despite, of course, some rough times all in all, these reforms all went through; and now people are expecting more. People are expecting more of these reforms because there is a view that the system is unsustainable. In Italy, there is also a question of an unevenness of the system that is being addressed. The question is how to get to the steady state. But the steady state is already a sustainable one, according to the current reforms.

Mr. Frenkel: Thank you. June O'Neill.

Ms. O'Neill: I think everybody agrees that current fiscal policy is unsustainable in the future, that something has to be done. And, there are many ways of illustrating the problem. Generational accounts are one way. But there are other long-term models that demonstrate it. Pete Peterson's charts also demonstrate aspects of the problem. However, the focus on the future should not let us think that controlling the deficit right now is irrelevant. As Alan's chart hinted, there is a cost of waiting; and work ongoing at the Congressional Budget Office illustrates the same point: That there is a cost of waiting.

Moreover, if a 3 percent deficit is difficult to deal with, how about a 20 percent deficit? Just getting a 20 percent deficit down to 15 percent would be an enormous problem. So I don't think that we should be lulled into believing that whatever we do now to control the budget doesn't mean anything. The future can be so much worse if we fail to address the current problem. Programmatic changes made now can also ease the budgetary strains that will arise when the baby boomers retire. CBO now estimates that even over the next ten years the annual rate of increase in Medicare will average about 10 percent. Only a small component of that increase will stem from population growth, because in the near term the upcoming retirees will be drawn from the small cohort born in the 1930s. Nor will exogenous factors such as medical inflation increasing account for very much of Medicare spending. Instead, more than half of the increase stems from uncontrolled increases in utilization of services. Looking at the components of the budget problem, in this case, would be highly important. One of the comments suggested that the composition of deficit reduction wouldn't make much difference. But it would make a difference if we could bring the government's per capita contribution to Medicare under control. Obviously that could have a significant effect on the future budget problem. Finally, I think that members of Congress are beginning to get the message that we face a big future problem. In one hearing of the Senate Budget Committee, the chairman and the ranking minority sparred about who cares more about the future, pointing to the number of children and grandchildren that they each have.

Mr. Frenkel: Thank you. We have all heard the adage that you should not wait for the final judgment since it takes place every day. John Makin, please.

Mr. Makin: Pete Peterson's frequent references to the University of Chicago emboldened me to suggest, perhaps, a more radical solution to the problem of maintaining living standards over an age, let's say, of 65 or 70. Whenever I'm confronted, or have been confronted over the years, with the AARP telling me what a wonderful system we have, I always counter by suggesting that we make participation voluntary, which causes them great discomfort. But a

suggestion might be to take a long-run transition toward voluntary participation in what is really not a very well-designed pension system, and then to deal with the issue of maintaining living standards over a certain age with a negative income tax. What is wrong with that?

Mr. Frenkel: Thank you. Mr. Peterson, would you like to pick it up?

Mr. Peterson: Well, it must be obvious I am not an economist. On the other hand, that hasn't been a terminal problem, I guess, in my business life. But whenever I look at some of these proposals, I always try to get some economist to help me understand through the transitional problems—you know, of going from one system to the other. I don't think there is much question that the creators of social security had little notion originally that the benefits would have been increased in such a mindless way, and incidentally, with such bipartisan irresponsibility. I happened to be in the White House at the time that the venerable Wilbur Mills, who later became famous for other things, was the chairman of the Ways and Means Committee. He decided, of all things, to run for President. You may recall that he proposed a 20 percent increase in real benefits, and 100 percent cost-of-living allowances. Certainly, nothing like that had ever been contemplated. While my field was international economics and not the domestic side and I may not have been in every domestic policy discussion, I don't recall any serious discussion in the White House about the longer-term implications of adopting the Mills proposal. Yet, in the last ten years, the 100 percent cost-of-living allowance has added, I think, \$120 billion a year to social security costs or something in that range. It was just done in a mindless way.

I think moving toward a funded, self-directed pension system, as we have begun to see in Chile, Australia, and elsewhere would be a very wholesome thing. These systems seem to have had some very positive effects on economies. Real net savings increases get invested in the private sector rather than simply being spent on mindless benefit increases that promote consumption. But I think what those of you who are experts in this field have to help us with

is how to manage the transition from the current system—where you have a lot of elderly who don't have any savings, and something needs to be done for them—to a funded, self-directed pension system of the type you are talking about. I would welcome any such proposals to move toward privatization plans of various types. But help us think through how to handle the transition—that would be my response.

Mr. Frenkel: Well, we've made good progress into this long-term solution. As somebody said, "We have found one horseshoe." The only thing left now is to find the horse and another three horseshoes; then we can start the journey. Mickey Levy.

Mr. Levy: While we all recognize the need to close the huge financing gap, doing so is more than just an arithmetic exercise. The way in which you close the gap is crucial. This is related to yesterday's discussion about the allocative impact of a change in fiscal policy: the economic and financial responses to a change in the deficit depends on how the deficit is changed. With regard to social security, closing the financing gap by raising taxes would have a significantly different impact than lowering future benefits—not just on short-term economic activity, but on labor supply, savings, and long-run productive capacity. With regard to the labor force, the participation rate of people between age 55 and 65 has declined sharply and raising payroll taxes would further damage social security's dependency ratios, generating unintended consequences. Another important issue concerns credibility and public acceptance. Closing the gap by lowering future benefits would have a significantly more favorable impact on credibility and acceptance than merely raising taxes.

Mr. Frenkel: There is time for one last question.

Mr. Chandross: This is addressed to Pete Peterson, but I would also welcome Alberto and Jürgen Stark to comment. One of the big issues in the United States, of course, is Medicare, which you touched on less so than pensions. And it seems to me, one thing which has kind of slipped by the wayside is medical care cost reform,

as opposed to medical care service-provision reform. I wonder—is it not necessary as part of this to really get back into this political thicket of reducing the annual growth in medical care costs, which really means taking on the providers of medical care services? And I wonder also how this issue is being dealt with in Europe?

Mr. Peterson: Well, you know, one speech from me is one too many, I'm sure. The Medicare problem, I think, started as so many of these things start—politically. Richard Nixon once gave me an explanation of LBJ's psychology in launching Medicare the way it was done. Johnson stuck with the Vietnam War, felt very insecure about his small-Texas-college background and, did not want to live in the shadow of his Ivy League colleagues from the Kennedy Administration. He was determined—like no other president was—to have his own domestic program. His problem was that due to the Vietnam War, his political support was so minimal that he had to engage in what has been called the “Great Bribe of the AMA” and the American Hospital Association to go along with the Medicare program, and back down from their cries about “socialized medicine” and so forth. So we ended up with this open-ended, cost-plus, fee-for-service system, in which the bigger the cost, the bigger the plus. And if you look at all the numbers and what happened after we put in Medicare in 1965, all hell has broken loose on the cost side of things. In my view, we are going to have to get a lot of cost discipline into this system, not just at the provider end, but at the *consumer* end. I think we are going to see a lot more emphasis given to managed care. Our company does a lot of investing and we've even been looking at the Medicaid costs. There are now managed care operators who are squeezing a lot of costs up it and are providing quality care that is, as best as I can determine, at least as good as was previously being offered, but at 15 to 20 percent less than the government has been providing it. I also think you are going to see a lot of attempts both to make the consumer far more cost-conscious, with cost-sharing and deductibles, and to get much more competition into the system. All of this will inevitably lower costs. Now the other thing that we haven't mentioned on the cost side is that America is the largest consumer, by huge numbers, of very high-cost, high-tech medicine that has rather marginal benefits. For

example, we have eight times the MRI units per capita as Canada does; we have something like four or five times the open heart operations, and so forth. One of the virtues, I think, of the utilization review approach in managed care is that a lot more emphasis is going to be put on what the cost-benefit relationship is between the treatment and the effects of the treatment—and the costs of doing it in the first place. When Oregon came up with their rationing plan, which I thought very rational—you may all recall what they did: they listed the 650 major treatments and their costs and benefits, and then got the whole community to agree on their priorities. But politicians in America said, “Oh, my God, that’s rationing!” Well, what do we think we are talking about if it isn’t rationing when we talk about managed care, cost sharing, or deductibles? I think you are going to see a squeeze across the board, not just on providers but also on consumers. Decent health care may be a “right” by the usage of ever more expansive high-tech medicine in the search for immortality by every consumer at public expense, but it cannot possibly be a more important value than investing in our young people and our future.