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## Social Security, Generational Justice, and Long-Term Deficits

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### Social Security, Generational Justice, and Long-Term Deficits

Neil H. Buchanan

#### Abstract

This paper assesses current methods for evaluating the long-term viability and desirability of government activities, especially Social Security and other bigticket budget items. I reach four conclusions: (1) There are several simple ways to improve the current debate about fiscal policy by adjusting our crude deficit measures, improvements which ought not to be controversial, (2) Separately measuring Social Security's long-term balance is inappropriate and misleading, (3) The methods available to measure very long-term government financing (Fiscal Gaps and their cousins, Generational Accounts) are of very limited value in setting public policy today, principally because there is no reliable baseline of the government's likely future expenditures and receipts, and therefore (4) The government's current annual and 10-year deficit projections, while highly imperfect, are nonetheless the best measure available for assessing fiscal policy, especially compared with Fiscal Gaps and Generational Accounts. Draft, March 3, 2005: Not for citation or quotation without the express permission of the author

"Social Security, Generational Justice, and Long-Term Deficits"

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#### ABSTRACT:

This paper assesses current methods for evaluating the long-term viability and desirability of government activities, especially Social Security and other big-ticket budget items. I reach four conclusions: (1) There are several simple ways to improve the current debate about fiscal policy by adjusting our crude deficit measures, improvements which ought not to be controversial, (2) Separately measuring Social Security's long-term balance is inappropriate and misleading, (3) The methods available to measure very long-term government financing (Fiscal Gaps and their cousins, Generational Accounts) are of very limited value in setting public policy today, principally because there is no reliable baseline of the government's likely future expenditures and receipts, and therefore (4) The government's current annual and 10-year deficit projections, while highly imperfect, are nonetheless the best measure available for assessing fiscal policy, especially compared with Fiscal Gaps and Generational Accounts.



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The future of the Social Security system has become the focus of intense public debate as President George W. Bush's administration moves into its second term. The contours of the debate are shaped by guesses about the adequacy of long-term funding for the system, the consequences of diverting tax revenues into private accounts, and the interaction of Social Security's finances with the rest of the government's spending and revenues. Acting today instead of tomorrow, some argue, is necessary to stave off future disaster. This is almost certainly false. Moreover, the focus on Social Security's finances in isolation from the rest of public finance distorts the debate. The goal of fiscal policy should be, as it always should have been, to balance our current well-being against concern for the well-being of generations to come. Current policy discussions, unfortunately, often allude to that goal but fail to address it meaningfully.

If current and future well-being is to be the focus, the question then becomes how best to measure an unknowable future in a way that will assist policymakers in making difficult trade-offs. Ideally, we would like to be able measure the effects of our fiscal choices into the indefinite future and decide how and when to provide benefits and to raise revenue. The further we look into the future, however, the cloudier the picture becomes. We ultimately must choose between imprecise ideal measures and incomplete realistic measures.

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This paper assesses current methods for evaluating the long-term viability and desirability of government activities, especially Social Security and other big-ticket budget items. I reach four conclusions: (1) There are several simple ways to improve the current debate about fiscal policy by adjusting our crude deficit measures, improvements which ought not to be controversial, (2) Separately measuring Social Security's long-term balance is inappropriate and misleading, (3) The methods available to measure very long-term government financing (Fiscal Gaps and their cousins, Generational Accounts) are of very limited value in setting public policy today, principally because there is no reliable baseline of the government's likely future expenditures and receipts, and therefore (4) The government's current annual and 10-year deficit projections, while highly imperfect, are nonetheless the best measure available for assessing fiscal policy, especially compared with Fiscal Gaps and Generational Accounts.

This paper thus provides a summary of several prominent lines of economic thinking on issues of public finance, especially regarding long-term spending and taxing issues. Moving beyond that, however, this essay also offers new and extended critiques of those mainstream theories and of the public policy choices that we face. The conclusions and policy prescriptions offered here are, to my knowledge, new to the literature.

There is little doubt that our current fiscal policy path is unwise, but it is essential to determine how best to assess what is wrong with current policies before we can understand how to change them.

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#### I. Introduction: Fundamental Challenges in Measuring Governments' Activities

The decisions thatwe make today regarding taxes and government spending have profound effects not only on those of us living today, but on future generations as well. These effects arise for two reasons. First, our current taxing and spending decisions help to determine how the economy's productive resources will be used now and in the future—whether, for example, a piece of land becomes the site for a casino, a day care center, or a cancer research institute. Second, the laws thatwe pass generally commit the government to courses of action that can last well into the future. While it is surely true that some laws that claim to set policy for years in advance do not really do so (such as tax policies passed in 2001 that purport to expire in 2010), others just as surely represent commitments from which governments would have some difficulty withdrawing.

These effects of taxing and spending policies—on the current uses of productive resources, as well as on the somewhat-credible commitments to future policies that they frequently represent—ought to be of concern to anyone whose time horizon extends past the current fiscal year. For those who care about the state of the world that we leave to future generations, the challenge is to find an analytical framework with which to predict the impact of current policy choices on future standards of living. Typically, these analytical frameworks are found in macroeconomic analysis of fiscal policy.

Macroeconomics does not, however, figure prominently in legal analysis. While the legal literature that relies on microeconomics has mushroomed over the last two

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decades or so,<sup>1</sup> macroeconomics has largely remained in the background. With some exceptions,<sup>2</sup> legal scholars have tended not to include in their analyses the aggregate economy within which microeconomic efficiency analysis operates. Certainly, some very good work has been done analyzing proposed constitutional amendments to constrain government spending or to limit tax increases; but such analyses need not directly address the question (in both its normative and positive dimensions) of how best to measure the fiscal status of the public sector.<sup>3</sup>

#### A. Deficits and Accounting Issues

The default position in public debate has typically been that fiscal responsibility is synonymous with annually balanced budgets (or, more extremely, with zero public

<sup>&</sup>lt;sup>1</sup> The law and economics literature is too vast to summarize here. For a good bibliography of the literature, *see* Robert C. Cooter and Thomas Ulen, Law & Economics (3<sup>rd</sup> Ed. 2000).

<sup>&</sup>lt;sup>2</sup> See Mark R. Kelman, *Could Lawyers Stop Recessions? Speculations on Law and Macroeconomics*, 45 Stan. L. Rev. 1215 (1993) (surveying recent macroeconomic literature, noting that many current models blame poor macroeconomic performance on incomplete contracting, and suggesting that lawyers can help to solve such problems). *See also* Paul G. Mahoney, *Contract Law and Macroeconomics*, 6 Virginia J. 84 (2003) (defining law and macroeconomics in an unusual way, describing the effects of law on economic actors); Steven A. Ramirez, *The Law and Macroeconomics of the New Deal at 70*, 62 Md. L. Rev. 515 (2002); Steven A. Ramirez, *Fear and Social Capitalism: The Law and Macroeconomics of Investor Confidence*, 42 Washburn L.J. 31 (2003).

<sup>&</sup>lt;sup>3</sup> See, for example, Nancy C. Staudt, *Constitutional Politics and Balanced Budgets*, 1998 U. Ill. L. Rev. 1105 (1998) (arguing that it is important to balance the budget, but a constitutional amendment is unnecessary because the budget balancers have won the political debate).

debt).<sup>4</sup> Indeed, even in the face of a weakening economy and the threat of a double-dip recession, President George W. Bush decided to show his economic seriousness during his August 2002 economic summit in Waco, Texas by announcing that he would refuse to spend \$5.1 billion that Congress had already approved for domestic security and the military.<sup>5</sup> Explaining the decision, he declared: "More money spent in Washington means less money in the hands of American families and entrepreneurs, less money in the hands of risk takers and job creators."<sup>6</sup>

#### **1.** Accounting Periods

Setting aside Bush's implication that government spending is presumptively harmful to the economy, the more immediate question is why we should be so concerned about an *annual* shortfall of revenues to cover expenditures. Why not measure the government's cash flows quarterly, monthly, or weekly? Or, for that matter, why not instead evaluate the public sector's fiscal health biannually or under Five Year Plans? Annual accounting is not necessarily worse than any of those alternatives, but it is not obviously better, either.

<sup>6</sup> Carle Hulse, *Citing Economy, Bush Won't Spend \$5.1 Billion Approve for Security and Other Uses*, N.Y.Times, August 15, 2002, at A15.

<sup>&</sup>lt;sup>4</sup> When there is no deficit, of course, the political environment changes. *See, for example*, Richard W. Stevenson, *Budget Deficit Is Said to Be \$159 Billion*, N.Y. Times, October 25, 2002, at A27 ("The return to red ink brought an end to the four-year period in which surpluses and the promise of more had left both parties almost giddy with the possibility of addressing the nation's needs without painful tradeoffs.") <sup>5</sup> Note that \$5.1 billion is approximately one-fourth of one percent of the overall 2002 federal

budget and less than 0.05% of 2002 U.S. GDP.

If it were simply a matter of choosing among arbitrary accounting periods, then it might certainly be possible that annual accounting would emerge as a reasonable choice. On the other hand, it might be better to explore ways to measure government finances not based on an arbitrary accounting period but rather to determine whether the totality of the government's commitments, both short-term and long-term, can be paid for.

In the case of individual projects, such as building a bridge, familiar accounting methods can be used to determine whether the dedicated funds to pay for the project will cover expenses plus interest. In the case of projects that have no known or planned completion date, the challenge is to determine whether the permanent funding for a project can cover its projected outlays. Social Security is a perfect example of this type of project, because it has a dedicated source of financing and is set to continue forever. This will be explored in detail in Section III below.

#### 2. Separating Spending From Financing

The majority of government activities, however, are not so easy to isolate. The F.B.I., for example, has no dedicated source of financing, so it is not meaningful to ask whether the F.B.I. is "in balance" in an accounting sense. The defense budget, the Centers for Disease Control, and so on are all simply part of an aggregated total of government expenditure. Measuring their individual long-term financial viability is neither possible nor meaningful.

#### **B.** Long-Term Fiscal Measurement

This suggests that we should look at the government as a whole and determine whether, in total, its commitments can be financed with its expected tax revenues. This sidesteps both the question of setting an arbitrary accounting period and of looking only at those items that happen to have been created with nominally-separate financing mechanisms. The goal then becomes measuring whether there is a mismatch between the government's aggregate long-term spending commitments and its aggregate long-term revenue streams. In other words, we would like to have an analogue to the notion of a cash-flow periodic deficit that captures all present and future activities of a government.

#### 1. The Fiscal Gap (FG) and Generational Accounting (GA)

One attempt to build such a long-term analytical model is called "Generational Accounting."<sup>7</sup> Responding to the political focus on annual cash-flow defcits, in the early 1990's the economist Laurence Kotlikoff and his frequent co-authors Alan J. Auerbach and Jagadeesh Gokhale developed a theory that was motivated by concerns about the long-term effects of federal fiscal commitments. Importantly, moreover, they attempted not only to determine whether current projections of fiscal flows will balance but also to

<sup>&</sup>lt;sup>7</sup> See Alan J., Auerbach, Jagadeesh Gokhale, and Laurence J. Kotlikoff. *Generational Accounts: A Meaningful Alternative to Deficit Accounting*, 5 Tax Pol'y & Econ. 55 (David Bradford ed., 1991); Laurence J. Kotlikoff, Generational Accounting: Knowing Who Pays, and When, for What We Spend (1992); Lawrence Kotlikoff, *From Deficit Delusion to Generational Accounting*, Harv. Bus. Rev., May-June 1993, at 104-05; Alan J. Auerbach, Jagadeesh Gokhale, and Laurence J. Kotlikoff, *Generational Accounting: A Meaningful Way to Evaluate Fiscal Policy*, 8 J. of Econ. Perspectives 73 (1994); Laurence J. Kotlikoff, *Reply to Diamond's and Cutler's reviews of generational accounting*, 50 National Tax Journal 303 (1997); Alan J. Auerbach, Laurence J. Kotlikoff, and Willi Leibfritz, eds., Generational Accounting Around the World (1998); Laurence J. Kotlikoff, *Generational Policy*, National Bureau of Economic Research Working Paper 8163, March 2001, forthcoming in Handbook of Public Economics (2<sup>nd</sup> Ed.).

determine whether the government's treatment of different generations of its citizens was, in some meaningful way, fair.

An initial note of caution is, however, in order. Whatever its analytical merits and shortcomings (discussed in some detail below), the Generational Accounting approach would put an even greater constraint on legal analysts or anyone else who might propose a change in public policy. No longer would it be enough to prove that a policy would not increase the current deficit; Kotlikoff et al. offer opponents of government activism an even more powerful trump card. Their approach requires not merely that there be enough money to pay for the program today, but it also requires that the program be "affordable" into the indefinite future, as measured by long-range budget forecasts.

Adding a political (and somewhat emotional) slant to the discussion, these analysts further suggest thata nything that is not affordable in this way is a transfer to the (voting) living generations from (politically defenseless) unborn generations. If this approach is well-founded, of course, then the political implications should not be ignored merely because they might be unwelcome or inconvenient; but it raises the stakes in the analysis of this alternative method of measuring fiscal policy.

#### 2. The FG/GA Baseline

The basic notion behind generational accounting is quite simple (though such conceptual simplicity makes the intractable measurement problems discussed below all the more frustrating). If current spending and tax laws were to stay in effect in perpetuity, the flows of expenditures and revenues would vary depending on future economic growth, population changes, weather patterns, medical developments, etc. To measure the infinite-future Fiscal Gap (FG), one must make assumptions about the

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directions and magnitudes of the most important of thosefuture trends and apply the accounting concept of net present value to discount all of those projected future expenditures and revenues into current dollar terms. The resulting estimate, FG, tells us how much money the government would have to borrow today in order to pay for all of its future deficits in a lump sum.

Generational Accounting (GA) takes this one important step further. Starting with the FG measure, GA provides estimates of the lifetime net tax rates for different generations implied by current fiscal policies. Each generational cohort's lifetime government-provided benefits are subtracted from its net taxes and divided by income. Hence, Kotlikoff and his co-authors claim that GA provides a way to measure whether current generations are being "fair" to those that will follow.

#### C. The Current State of the Literature and Policy Debates

*Tax Notes*—the periodical of record for tax practitioners, policymakers, and academics—has carried at least eight articles that in some way deal with GA since 1991, when the theory was first introduced.<sup>8</sup> To date, the appearances of GA in the general

<sup>&</sup>lt;sup>8</sup> Alan D. Viard, *The Social Security Surplus, the Trust Fund, and the Federal Budget*, 94 Tax Notes 891 (2002); Sheldon D. Pollack, *Professor Supports 'PAYGO' To Restrain Worst Impulses Of Both Parties*, 82 Tax Notes 1035 (1999); Daniel Shaviro, *Understanding the Generational Challenge*, 75 Tax Notes 714 (1997); Karen C. Burke, *VATs and Flat Taxes Reconsidered*, 70 Tax Notes 899 (1996); Richard Goode & C. Eugene Steuerle, *Generational Accounts and Fiscal Policy*, 65 Tax Notes 1027 (1994); Barbara Kirchheimer, *Generational Accounting: Are We Soaking the Young*? 62 Tax Notes 945 (1994); David M. Cutler, *Generational Accounting: Knowing Who Pays, and When, for What We Spend*, 60 Tax Notes 361

legal literature have not been extensive,<sup>9</sup> but Professor Daniel Shaviro of New York University Law School has written extensively in support of the argument that the

(1993); J. Andrew Hoerner, NBER Conferees Discuss IRAs, Integration, Corporate Tax Shifts, 53 Tax Notes 878 (1991).

A Lexis search of all law reviews turned up eighteen citations to "generational accounting," starting in 1993: Axel P. Gosseries, Symposium: Intergenerational Equity: What Do We Owe the Next Generations? 35 Loy. L.A. L. Rev. 293 (2001); Reuven S. Avi-Yonah, Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State, 113 Harv. L. Rev. 1573 (2000); Alan Newman, Incorporating the Partnership Theory of Marriage Into Elective-Share Law: The Approximation System of the Uniform Probate Code and the Deferred-Community-Property Alternative, 49 Emory L.J. 487 (2000); Mary L. Heen, Reinventing Tax Expenditure Reform: Improving Program Oversight Under The Government Performance And Results Act, 35 Wake Forest L. Rev. 751, (2000); Maria O'Brien Hylton, Evaluating the Case for Social Security Reform: Elderly Poverty, Paternalism and Private Pensions, 64 Brooklyn L. Rev. 749 (1998); Elizabeth Garrett, Harnessing Politics: The Dynamics of Offset Requirements in the Tax Legislative Process, 65 U. Chi. L. Rev. 501 (1998); Evelyn Brody, Charitable Endowments and the Democratization of Dynasty, 39 Ariz. L. Rev. 873 (1997); Marjorie E. Kornhauser, The Rise of Rhetoric in Tax Reform Debate: An Example, 70 Tul. L. Rev. 2345 (1996); Peter Diamond, Generational Accounts and Generational Balance: An Assessment, 49 National Tax Journal 597 (1996); Michael J. Graetz, Paint-By-Numbers Tax Lawmaking, 95 Colum. L. Rev. 609 (1995); Joseph M. Dodge, A Combined Mark-to-Market and Pass-Through Corporate-Shareholder Integration, 50 Tax L. Rev. 265 (1995); Jonathan Barry, Reconsidering the Income Tax Treatment of the Elderly: It's Time for the Elderly to Pay Their Fair Share, 56 U. Pitt. L. Rev. 589, 614 n.95 (1995)(Reprinted in 69 Tax Notes 485)(citing generally Kotlikoff, GENERATIONAL ACCOUNTING, supra note \_\_\_, but not explicitly discussing or endorsing the generational accounting framework); Jane Maslow Cohen, Competitive and Cooperative Dependencies: The Case for Children, 81 Va. L. Rev. 2217 (1995); Katherine Pratt, Funding Health Care with an Employer Mandate: Efficiency and Equity Concerns, 39 St. Louis L.J. 155 (1994); Edward J. McCaffery, The UCLA Tax Policy Conference: Cognitive Theory and Tax, 41 UCLA L. Rev. 1861 (1994); Evelyn Brody, Paying Back Your

FG/GA approach should be imported into legal analyses of Social Security policy and Medicare policy—and more generally into allegal analyses of fiscal policy.<sup>10</sup> Finding that there is a long-term fiscal imbalance that makes "the current policy fiscally unsustainable,"<sup>11</sup> Shaviro asserts that it is necessary to think about these issues through the lens of FG/GA<sup>12</sup>—and such an analysis, we learn, shows a grim future indeed.<sup>13</sup>

The stakes in this debate, therefore, could hardly be higher. Anyone who wishes to write about Medicare or Social Security, and indeed anyone who might ever wish to

Country through Income-Contingent Student Loans, 31 San Diego L. Rev. 449 (1994); Edith Brown Weiss, Environmentally Sustainable Competitiveness: A Comment, 102 Yale L.J. 2123 (1993); David Cutler, Review of Generational Accounting: Knowing Who Pays, and When, for What We Spend, 46 National Tax Journal 61 (1993).

While some of these references are merely *pro forma* (e.g., McCaffery, Garrett, Newman), and Kornhauser directly criticizes the theory, several of the articles (esp. Brody's pieces and Forman's article) appear to endorse GA.

<sup>10</sup> Shaviro's writing on this topic includes, in book-length form: Daniel Shaviro, Who Should Pay for Medicare? (2004); Daniel Shaviro, Making Sense of Social Security Reform (2000); Daniel Shaviro, Do Deficits Matter? (1997).

<sup>11</sup> Shaviro, *supra* note 8, at 715.

<sup>12</sup> *Id.* at 716 ("Perhaps the best tool for enhancing our understanding of who wins and loses from alternative reforms is generational accounting....") Shaviro is not, however, explicitly wedded to FG/GA to the exclusion of all else. Instead, he has suggested that we should use FG/GA as well as other theories to learn as much as we can from a variety of approaches.

<sup>13</sup> Recently, Shaviro has more enthusiastically endorsed the Fiscal Gap measure of long-term fiscal balance and has not emphasized explicit Generational Accounting approaches. *See, e.g.*, Daniel N. Shaviro, *Reckless Disregard: The Bush Administration's Policy of Cutting Taxes in the Face of an Enormous Fiscal Gap*, 45 B.C.L.Rev. 1285 (2004). suggest that the government should spend money on any project, might plausibly be forced to contend with the implications of FG/GA.

If FG/GA lived up to its billing, of course, it would simply be good policy to use it as a starting point for fiscal analysis. Unfortunately, it is not a neutral analytical tool and cannot be used dispassionately to assess the fiscal consequences of a government project, even by those who begin their analysis without a political agenda. Instead, FG/GA is based on highly contestable assumptions, arbitrary analytical choices, and manipulable policy projections that fatally compromise most of its analytical value. Understanding the promise and limitations of FG/GA is essential for anyone who wishes to understand the current debate over government spending and taxation.

The debate, therefore, is not over whether the future matters—that is, this is not a debate between the grasshoppers and the ants. Clearly, we must always think carefully about the future consequences of our fiscal policies. The question is *how* to think about the future—what we would like to bequeath to future generations and how best to deliver it.

#### D. The Imperfect vs. the Fundamentally Flawed

Because we are attempting to peer into the future, any measure of the effects of fiscal policy will be imperfect. The alternatives to FG/GA-style measures are, therefore, also imperfect. Choosing among those imperfect alternatives is not easy. Given the available options, however, I argue that we should choose traditional deficit measures over the fundamentally flawed FG/GA-based measures.



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Traditional measures of the deficit can be perfected to some degree, and many official forecasts have extended the accounting period to a standard ten year window.<sup>14</sup> Acknowledging that there is always some value in learning what we can from a variety of approaches to analyzing fiscal policy, I nevertheless conclude thatFiscal Gaps and Generational Accounting are too often empty or even misleadingmeasure s of future fiscal developments.

#### II. Traditional Fiscal Deficit Measures

Even the most casual observer of U.S. political debates cannot have missed the fact that our politicians are obsessed with "the deficit." After decades in which Republicans regularly attacked Democrats for their spendthrift ways, Democrats delighted in turning the tables in the 1980s, as Ronald Reagan presided over the largest nominal peacetime deficits in American history. Undaunted, conservative Republicans insisted that they were the truly responsible fiscal custodians, culminating in the promise to balance the budget in 1994's Contract With America.

Capitulating to the political heat generated by this headline-grabbing issue, former President Clinton announced in 1995 that he, too, was committed to balancing the budget.<sup>15</sup> When the budget moved from deficit, to balance, and then to surplus under his

<sup>14</sup> See esp. William G. Gale and Peter R. Orszag, Bush Administration Tax Policy:

Revenue and Budget Effects, Tax Notes, Oct. 4, 2004.

<sup>15</sup> Indeed, Clinton's pre-1994 actions showed that he was strongly predisposed to the balancedbudget mantra, as he immediately jettisoned his proposals for long-term capital spending and instead

watch, Clinton never missed an opportunity to take credit for this "achievement." With their own party's leadership having abandoned them, even the most progressive members of the Democratic Party became committed budget balancers. Senator Russell Feingold, for example, eagerly pointed out that he opposed President Clinton's proposed middleclass tax cut in the early 1990's. "I was for deficit reduction."<sup>16</sup> Writing in 1998, Professor Nancy Staudt could reasonably conclude that, even if one believed in the importance of budget balance, it was unnecessary to pass a constitutional balancedbudget amendment because politicians were overwhelmingly committed to that goal already.<sup>17</sup>

The politics of fiscal deficits can, however, change rapidly. As recently as the late autumn of 2002, it seemed that there were no longer any major voices in American politics arguing in favor of deficit spending.<sup>18</sup> As 2002 turned to 2003, though, the fiscal ink turned red again, and a new consensus arose that the return to short-run deficits was not a serious problem—but that long term deficits represent a virtual "cancer" eating

pushed through a major tax increase. (For those who approve of tax progressivity, however, one can at least note that Clinton's tax bill was top-loaded.)

16 Matthew Rothschild, The Progressive Interview: Russ Feingold, The Progressive, May 2002, at 31.

17 Staudt, note 3, supra.

18 There were, of course, some outside of the mainstream who opposed the orthodoxy, not all of whom were at the liberal end of the spectrum. Former Congressman Jack Kemp, for example, was once the most prominent political advocate of so-called Supply Side Economics, which holds that low tax rates are much more important than balanced budgets in generating high economic growth rates.

away at future prosperity.<sup>19</sup> During the 2004 presidential campaign, finger-pointing about the deficit again rose to a fevered pitch. The tentative consensus emerging from the presidential campaign was that cutting the deficit in half within five years was the best available policy, with disagreement only over which candidate could meet that goal.<sup>20</sup> In the aftermath of the election, the administration's budget proposals appear unlikely to reduce the annual deficit even by that much.<sup>21</sup>

To some degree, this political obsession with annual deficits is quite surprising, because the economic arguments in favor of deficit spending in various circumstances are well known and, to a large extent, uncontroversial among fiscal economists.<sup>22</sup> While it is certainly possible to argue that, in spite of the economic case in favor of deficits in some circumstances, there is a stronger political case against them,<sup>23</sup> it is at least worth remembering what the economic issues are.

<sup>19</sup> See, e.g., Suddenly, Deficits Are No Big Deal, The New York Times, Nov. 18, 2002, at C1 (quoting Kotlikoff). See also David Leonhardt, That Big Fat Budget Deficit. Yawn. The New York Times, Feb. 8, 2004, Sec. 3, at 1.

<sup>20</sup> Dustin Stamper, *GOP Criticized as OMB Misses Midyear Budget Review Deadline*, Tax Notes Today, 2004 TNT 137-3 (Jul. 17, 2004) ("According to [Office of Management and Budget spokesman Chad] Kolton, Bush has offered the only credible plan to cut the deficit in half over the next five years. Presumptive Democratic presidential nominee Sen. John F. Kerry of Massachusetts has pledged to equal that feat if he is elected, but each side has taken issue with the other's numbers.")

Edmund L. Andrews, *Trim Deficit? Only if Bush Uses Magic*, N.Y. Times, Feb. 7, 2005, at C1.
 See, e.g., Alan S. Blinder, *Is the National Debt Really—I Mean*, Really—*a Burden?* in James S.
 Rock, ed., Debt and the Twin Deficits Debate, at 209-25, 1991.

Id. at 224 (arguing that, even though the deficits of the 1980's and early 1990's were relatively minor, there could be no political peace unless everyone agreed to balance the budget).

In addition, the discussion below highlights measurement problems that could be relatively easily changed to the benefit of public debate. Without even reaching the question of Fiscal Gap/Generational Accounting vs. traditional deficit measures, analytical clarity could be improved through some relatively non-controversial adjustments to our measurements and our rhetoric.

#### **A. Preliminary Concepts**

Economists differentiate between stock variables and flow variables. The difference between the two has to do with the passage of time. Stock variables can be measured at a moment in time, while flow variables are only meaningful *per unit of time*. Thus, distance is a stock variable, while speed (miles per hour, for example) is a flow variable. In economics, common stock/flow distinctions include prices (stock) versus inflation (flow) and wealth (stock) versus income (flow).

#### 1. Debt and Deficits

In government accounting, debt is a stock variable, because it measures the total amount of money at any given moment that a government owes its creditors. The deficit is a flow variable, measuring the net amount of new borrowing that the government has engaged in during the course of a year (or any other unit of time). Deficits are, properly measured, the change in debt as time passes.

Importantly, the total amount of federal government debt that exists at a given moment is also tautologically equal to the total number of dollars of Treasury securities in circulation at any moment. Since the federal government borrows money by selling

Treasury securities, the face value of those outstanding securities is equal to the National Debt.

Here, however, is one of the first instances where reality and theory diverge. The different agencies of the federal government often hold each other's debt instruments, so the *net* federal debt is lower than the number of bonds that have been issued but not redeemed. The difference is not trivial. While the infamous "National Debt Clock" on display in several major cities (the ever-rising digital readout of the nation's supposed indebtedness, expressed both in the aggregate and as "Your Family's Share") showed an outstanding federal debt of over \$7.1 trillion in April 2004,<sup>24</sup> just over \$4 trillion of that total was held outside of the federal government's own offices.<sup>25</sup> This was why the National Debt Clock did not initially decline when the federal government ran surpluses in the late twentieth century. Even though the government was extinguishing debt held by the public, the total number of bonds in existence was not going down, so "the national debt"—by that meaningless measure—was not shrinking.

#### 2. Dollars vs. Percentages

The common practice of expressing debt and deficits in total dollars rather than as percentages of national income can also be highly misleading. Politicians in the late 1980s talked of "\$200 billion deficits as far as the eye can see" as if that was an unimaginable calamity. In fact, given that nominal GDP doubles roughly every twelve

<sup>&</sup>lt;sup>24</sup> U.S. National Debt Clock, <u>http://www.brillig.com/debt\_clock/</u> (visited April 7, 2004).

<sup>&</sup>lt;sup>25</sup> Federal Reserve Board, Flow of Funds Accounts, Table D.3 (Debt Outstanding by Sector), March
4, 2004.

years, \$200 billion annual deficits would be trivial in relatively short order.<sup>26</sup> Referring to deficits in nominal dollar terms also makes deficits in later years look larger than they really are, making references to "record-setting" deficits an empty description.<sup>27</sup>

In the U.S., deficits as a percentage of GDP peaked in the mid-1980s at roughly 6%, and the publicly-held debt peaked at around the same time at 60% of GDP. This was, of course, only the recent peak and was not even close to the 125% debt level reached at the end of World War II, when we wisely spent enormous sums of borrowed money to finance the war against the Axis powers. This ratio had steadily fallen to the point where it was below 50% by the early 1980's, and then rose for over a decade before falling again in the late 1990's and early in the new century. The current return to deficit

<sup>&</sup>lt;sup>26</sup> In the first quarter of 1984, for example, U.S. GDP was \$3.8 trillion, meaning that a \$200 billion deficit was equal to more than 5¼ % of GDP. Twenty years later, with GDP in the first quarter of 2004 nearing \$11.5 trillion, a \$200 billion deficit would be under 1¾ % of GDP. United States Bureau of Economic Analysis, National Income and Product Accounts Table, Table 1.1.5. Gross Domestic Product <http://bea.gov/bea/dn/nipaweb/SelectTable.asp?Popular=Y> (Visited July 5, 2004; Last Revised on June 25, 2004).

See, e.g., Dustin Stamper, GOP Criticized as OMB Misses Midyear Budget Review Deadline, Tax Notes Today, 2004 TNT 137-3 (Jul. 17, 2004) ("House Budget Committee ranking minority member John M. Spratt Jr., D-S.C. ... said even the new deficit figure, which Democrats estimate to be in excess of \$425 billion, is record-setting." See also Louis Uchitelle, It's the Economy, Right? Guess Again. The New York Times, Jul. 5, 2004, Sec. 3, at 1 (describing plans "to cut the deficit in half . . . from its projected record level of more than \$450 billion in the current fiscal year"). A \$450 billion annual deficit in 2004 is roughly 3.9% of GDP—not even close to the post-WWII record of 6.0% in 1983, and tied only for the eighth-largest deficits in the last twenty-five years.

spending finds projected deficits at about 4.2% of GDP in 2004 (\$477 billion), and the federal debt at 38.2% (\$4,385 billion).<sup>28</sup>

#### **3.** Federal vs. State and Local

A third measurement issue carries more direct implications for policy debates. Typically, commentators separate the federal debt and deficit from the state and local fiscal positions. Since the state and local sector tended until very recently to run aggregate operating surpluses, the decision to exclude the state and local sector when discussing the "government" deficit and debt naturally made the situation look worse while the current situation of chronic state deficits is ignored by federal measures of borrowing. Foreign economists view this practice as nothing less than bizarre, because the macroeconomic consequences of debt and deficits surely do not depend on the hierarchical level of the government entity that is doing the borrowing.<sup>29</sup>

In addition to being logically incoherent, this practice has perverse policy affects as well. When national politicians view their job as reducing the federal deficit or debt,

<sup>&</sup>lt;sup>28</sup> Congressional Budget Office, CBO's Current Budget Projections (March Baseline Projections), March 2004.

<sup>&</sup>lt;sup>29</sup> Wynne Godley, *Seven Unsustainable Processes: Medium-Term Prospects and Policies for the United States and the World.* Special Report: The Levy Economics Institute (revised Oct. 5, 2000), at 2 ("In the United States the public discussion of fiscal policy concentrates almost exclusively on the operations of the federal government. Yet state and local governments account for about a third of all public expenditure and taxes; moreover, their budgets are generally in surplus so that these authorities are now in substantial credit . . . . In what follows, government inflows and outflows--and debts--will always refer to the operations of the "general government" (the combined federal, state, and local governments).")

they are tempted either to ignore the consequences of their decisions on lower levels of government or even deliberately to shift spending obligations downward.<sup>30</sup> Indeed, this seems to be a primary explanation for the fiscal crisis in the states over the last few years.

#### **B.** Cash-Flow Deficit Measures

While the issues discussed briefly above have important implications for discussing the status of fiscal policy in the United States, the discussion that follows attempts to follow the current norms in describing deficit measures. Even within the federal-only measures, however, there are significant disagreements about what is the true measure of fiscal policy.

#### 1. On-Budget and Off-Budget

Even if one looks only at the federal government, the annual deficit is more manipulable than it might seem. A spending program can exist in a netherworld outside of the official budget simply by act of Congress. There need be no economic rationale for the decision. The 1991 Gulf War was carried off budget, for example, and the current operations in Iraq are being funded by emergency appropriations. By far the biggest offbudget item, of course, is the Social Security system. The current surplus in that system (approximately \$161 billion in 2004, or 1.4% of GDP) makes the total deficit smaller than the on-budget deficit (\$638 billion, or 5.6% of GDP), but when Social Security starts

<sup>&</sup>lt;sup>30</sup> See, for example, Kevin Sack, States Expecting to Lose Billions From Repeal of U.S. Estate Tax, N.Y. Times, Jun. 21, 2001.

to run deficits after the next decade or so, the on-budget deficit will be smaller than the total deficit.<sup>31</sup>

The debate about whether the Social Security Trust Fund has any meaning is, of course, an important factor in determining whether the on-budget or total deficit is the proper measure. Because I conclude that the total deficit is the better of the two, in that it measures the amount of money that the federal government is draining from the financial markets in a given year, I will focus on that measure of the deficit and possible ways to improve it.<sup>32</sup>

A fuller discussion of Social Security's financing and long-term prospects appears in Section III below.

#### 2. Cyclical Adjustment

For macroeconomists, one of the most important measurement issues in deficit accounting is adjustment of the deficit for changes in the health of the economy. When the business cycle turns, tax receipts and government expenditures naturally change along

<sup>&</sup>lt;sup>31</sup> All estimates in this paragraph are from Congressional Budget Office, *CBO's Current Budget Projections (March Baseline Projections)*, March 2004. As the data discussed in Section III below indicate, however, these estimates have been subsequently revised. The contingent nature of the estimates should be borne in mind throughout this analysis.

<sup>&</sup>lt;sup>32</sup> For a persuasive argument that the Social Security system should not be seen as an individualized benefit plan but rather as a redistributive fiscal program, *see*, Deborah A. Geier, *Integrating the Federal Tax Burden on Labor Income*, 98 Tax Notes 563, 574 (Jan. 27, 2003) (citing generally Patricia E. Dilley, *Taking Public Rights Private: The Rhetoric and Reality of Social Security Privatization*. 41 B.C. L. Rev. 975 (2000)).

with the GDP. Recessions bring lower revenues and higher expenditures, and boom times do the opposite. When comparing deficits at two points in time, therefore, it is important to ask, "What would the deficit be today if the economy were fully healthy?"

What it means to be "fully healthy" is, of course, a matter of contention. Nevertheless, there is a widely-accepted measure of the cyclically-adjusted deficit known as the Standardized-Budget Deficit, computed by determining the flows of revenues and expenditures if the unemployment rate were at its trend rate. In 2003, because of the lingering effects of the recession, the unadjusted total deficit was \$375 billion (3.4% of GDP), while the Standardized-Budget Deficit was \$313 billion (2.8% of GDP).<sup>33</sup>

Failing to adjust the deficit for cyclical effects is likely to lead to policyerrors. First, it confuses cause and effect. Improvements in the economy cause decreases in the non-adjusted deficit; but decreases in the cyclically-adjusted deficit (all else constant) cause the economy to decline. Because of this, it causes perverse policy moves, as a worsening economy causes the deficit to rise, such that policymakers who attempt to reduce the deficit with further cuts in spending (and perhaps increases in taxes) will only further weaken the economy. President Bush's symbolic refusal to spend money that Congress had allocated, noted above, clearly demonstrates this perversity.<sup>34</sup>

Nor is this failure to comprehend simple macroeconomics confined to the United States. The Japanese economy went into its first of several severe downturns in 1989. By 1996, with the domestic economy still in deep trouble, Japanese policymakers relied

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<sup>33</sup> Congressional Budget Office, The Budget and Economic Outlook: Fiscal Years 2005 to 2014,

App. F, Tab. F-12 and F-13, January 2004. See note 5 above and accompanying text.

on more budget-cutting and tax increases to improve the economy-the macroeconomic equivalent of "bleeding" a patient to restore her to health. Yet policymakers there and elsewhere remained puzzled by their patients' continued ill health.<sup>35</sup> Now, "many economists believe that Japan's long stagnation in the 1990s largely reflected timid policymakers unwilling to boldly use the levers of fiscal and monetary policy."<sup>36</sup>

The practical consequences of failing to adjust for the business cycle are especially severe for state and local governments, most of which operate under (modified) balanced budget requirements. When the economy is strong (which means that, by definition, workers are scarce because their prospects are so good in the private sector), states flush with money compete with prosperous companies for workers and other economic resources. Roads are torn up and re-built precisely when the disruption from such projects is the most damaging, as the overburdened highways are filled with vehicles carrying the evidence of economic prosperity. Then, when the economy

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<sup>35</sup> "Exasperation as Tight Budgets Don't Deliver Growth..." Nomura Securities Research Report, August, 1996 ("Low inflation and trimming of fiscal deficits have always been regarded as a foolproof recipe for economic growth. However, that conventional wisdom has been turned upside down in the past few years, as politicians in developed economies have grown exasperated by the failure of high growth to materialize despite their belt tightening efforts. Average real GDP growth in the major industrialized nations was 4.0-4.5% in the 1970s, and 3.0-3.5% in the 1980s- but in the 1990smany believe the figure will be a meager 2.0%.") Just who it was who regarded deficit cutting as a "foolproof recipe for economic growth" is unclear, but their identity is probably best kept a secret. Christopher Farrell, Capitalism's Savior, Business Week, Apr. 12, 2004, at 20.

weakens, states see their tax revenues decline, lay off workers, and leave highways in disrepair. It would be difficult to design a more perverse system.<sup>37</sup>

#### 3. Unfunded Liabilities

The closest one comes in the traditional deficit debates to the central issues of long-term budgeting (which are the focus of the Fiscal Gap/Generational Accounting approach described below) is the discussion of "unfunded liabilities." The basic idea is that government projects that involve spending in the future can be thought of as liabilities that must be accounted for when looking forward. This sensible observation, though, can only be useful inasmuch as projects have dedicated financing. If a high school is built with proceeds from a bond sale, for example, the liability is funded if the school district commits the funds in future budgets to cover the bond payments. Otherwise, the project is unfunded. Since most government programs are not financed through dedicated funds, of course, most projects are unfunded liabilities. The Interior Department, the Army Corps of Engineers, etc., are all unfunded, and they will almost certainly continue to be so for as long as they last.

Estimates of unfunded liabilities are highly responsive to changes in the law, and their size can dwarf the rest of the budget. The estimate of unfunded liabilities in the Social Security system after the change in withholding taxes in the early 1980's, for example, swung from several trillion dollars in unfunded liability to several trillion

<sup>&</sup>lt;sup>37</sup> This is not to say that highways are the be-all and end-all of economic spending. In this analysis, they are simply the most intuitive example of public spending on infrastructure.

dollars in long-term surplus.<sup>38</sup> FG/GA is arguably an improvement on the arbitrary nature of these estimates, as I discuss below; but its other shortcomings ultimately make it an unappealing alternative.

#### 4. Extended Budget Projections

All of the budget measures discussed above are calculated in annual terms. It is possible, of course, to use a different arbitrary time period in such an analysis. During the Clinton Administration, it became common to provide ten-year projections of budgets, to allow policymakers to look into the relatively foreseeable future and determine whether a budget or tax measure was likely to become more or less manageable over time. The current Bush Administration has sometimes issued five-year projections rather than ten year projections, a move that has generated suspicion that the full costs of their policy proposals are "back-loaded."

It is, of course, possible to back-load even on a ten-year horizon; and within a tenyear horizon, it is also possible to play games for different political purposes, such as the Bush Administration's proposal to "encourage savers to move money from one type of individual retirement account to another, thus increasing tax receipts by \$14.6 billion over the next four years—the period over which the president promises to reduce the deficit—while costing the government twice as much money in the following six years."<sup>39</sup>

<sup>39</sup> Floyd Norris, *Games Politicians Play: More Tax Cuts as U.S. Faces Large Deficits*, N.Y. Times,
 Feb. 11, 2005, at C1.

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<sup>&</sup>lt;sup>38</sup> *See* Neil H. Buchanan, Debt, Deficits, and Fiscal Policy: Three Essays (1996) (unpublished Ph.D. dissertation, Harvard University) (on file with author).

The arbitrary nature of these cutoffs is, as discussed in the next section, a strong argument in favor of adopting an infinite-horizon model along the lines of the FG/GA approach. Nevertheless, because of the critical problems in lengthening the time horizon, the ten-year projections are probably the best compromise available. This point will be taken up further below.

#### C. Effects on Consumption and Investment

The payoff for making these adjustments to the measurement of the fiscal deficit comes in analyzing the effects of current deficits on the use of society's productive resources (labor, machinery, factories, land, etc.). If the government hires resources to build or produce goods and services, and if those resources would have been used to produce something of value to private citizens, then the government has "crowded out" private activity. If the government crowds out private consumption, then there is at worst no effect on future generations, because private consumption would not have benefited future generations in any case. In such a situation, the government can make future generations better off if it replaces private consumption with public investment, or it can simply substitute one kind of consumption for another—leaving future generations unaffected.

The serious concern, of course, is that the government will not crowd out private consumption but will, instead, crowd out private investment. If the government wastes money that would have gone toward private investment in productive equipment, for example, then the future standard of living of the country is compromised. In fact, even if the government invests resources in productive assets, it can still make matters worse if the assets it crowds out would have been more productive than the government's investment projects. What is often forgotten, however, is the other possibility—that the government might crowd out a private investment project with a public investment project that is even more productive. Rather than building a strip mall, for example, resources might be used to build a children's hospital.<sup>40</sup>

While there is no precise way to know the exact nature of these tradeoffs, the fundamental question could not be more important: What effect will the government's decisions today have on the economy's productive capacity—and thus the real standard of living—tomorrow? It is here that our concern for future generations should be concentrated.

#### **D.** Annual and Ten-Year Deficit Estimates

In summary, if we are to improve public discussion of the government's fiscal situation, the least radical alternative would be to adopt a cyclically-adjusted deficit (preferably for the entire government sector, though that appears unlikely). Such a measure, while still imperfect, would allow policymakers to focus on the possible crowding out caused by its annual fiscal policies.

Medium-term forecasts are also valuable. While imperfect, such measures provide policymakers with useful guidance in looking past the current fiscal year. The use of annual and 10-year estimates of fiscal deficits, moreover, will allow policymakers to see the effects of their decisions on the path of the economy during the time period

<sup>40</sup> Although the discussion here focuses on spending projects, taxing decisions can be analyzed in precisely the same fashion. Every aspect of the tax code has the potential to change consumption decisions into investment decisions, investments into consumption, less productive investments into more productive investments, etc.

over which they have the most direct control. The effect of current fiscal policies on the standard of living of future generations arises most directly from the effect of borrowing on private investment; so policymakers could honor their future commitments by deciding how much borrowing they are willing to vote for during the ensuing ten years.

Admittedly, having longer-term estimates available can potentially help keep politicians more honest, by preventing them from playing games with arbitrary time periods, as described above. We do not, of course, face a stark all-or-nothing choice between standard deficit measures alone or long-term estimates alone. As argued below, however, the knowledge that can be gained from the longer-term measures is so tentative that they should only be used if they send an unmistakable signal that is invariant to plausible changes in assumptions about the future.

#### III. Social Security and Long-Term Solvency

Given the intense focus in popular discourse on Social Security as a separate program,<sup>41</sup> it is important to describe the structure of that program in light of its history and goals. Such an analysis permits a deeper look at the real issues behind the notion of program-specific solvency (i.e., will Social Security go "bust," as President Bush claims?<sup>42</sup>) as well as the broader effects of Social Security's financing on the rest of the budget and on the economy.

See, e.g., Karen Tumulty and Eric Roston, Social Security: Is There Really a Crisis? Time, Jan.
 24, 2005, at 22 (including a series of six related articles)

<sup>&</sup>lt;sup>42</sup> Richard Stevenson, *For Bush, a Long Embrace of Social Security Plan*, N.Y. Times, Feb. 27,
2005, at § 1, p. 1 ("Social Security 'will be bust in 10 years unless there are some changes,' [Bush] said.")

#### A. Supporting People in Retirement, Infancy, and Otherwise

The basic economic problem posed by retirees is that they no longer produce goods and services by working, but they continue to consume goods and services while they are still alive. Indeed, this concept extends to children and the disabled as well, such that, at any given moment, those who are working must produce sufficient goods and services to satisfy not only themselves but everyone who is not working for any reason. Total U.S. employment in January 2005 was just over 140 million workers,<sup>43</sup> while the total population was nearing 300 million,<sup>44</sup> meaning that every worker is supporting herself and slightly more than one other person, on average.

The methods of providing consumption to non-workers fall into several simple categories. Direct provision of consumption simply involves having some workers pay for the goods and services consumed by a non-worker. Family arrangements are the prototype of this method, which is in part what the Social Security system was designed to replace, because some non-workers had no families (or less economically prosperous families) on which to rely.

Absent familial connection and absent government transfer programs, the two remaining basic methods of financing non-workers' consumption involve saving during

<sup>&</sup>lt;sup>43</sup> U.S. Bureau of Labor Statistics, *Employment Situation Summary*, Feb. 4, 2005, http://www.bls.gov/news.release/empsit.nr0.htm (visited Mar. 1, 2005).

<sup>&</sup>lt;sup>44</sup> U.S. Bureau of the Census, *Annual Population Estimates 2000 to 2004*, Table 1,

http://www.census.gov/popest/states/NST-ann-est.html (visited Mar. 1, 2005) (population estimate for July 1, 2004 of 293,655,404)

working years and consuming during retirement years. While structurally quite distinct, these methods can be seen to boil down to precisely the same tradeoffs.

#### 1. Individual Savings Accounts and Social Security Contributions

The government can assist workers in providing for their retirement years by structuring contract and property rules (and sometimes tax rules) that allow workers to save part of their incomes in interest-bearing accounts. This can range from simple voluntary savings accounts to employer-matched, tax-preferred retirement savings plans (such as 401(k) accounts and Individual Retirement Accounts). No matter the contractual complexities, the purpose is to give workers the confidence that their funds will be legally protected and available when they decide to stop working.

The Social Security system, on the other hand, looks quite different. There, workers reduce their current consumption not by making deposits into savings accounts but by making contributions to the system through payroll taxes. The result is not an individual account with funds growing at a market-set interest rate, but a programmatic guarantee that the worker's contributions today will be rewarded with benefits paid by future workers when current workers are retired.

#### 2. National Saving

From the standpoint of the aggregate economy, these formally different financing methods are indistinguishable. Imagine a country in which there is one retiree and two workers. The retiree is consuming \$1000 per month of goods and services. The workers are both consuming \$2000 per month. Shared equally, each worker must be made to produce \$2500 per month and give \$500 units per month to the retiree.
The method of financing cannot change this fundamental arithmetic. If the retiree is financing consumption by drawing down a savings account, he or she would withdraw \$1000 a month, which would count as negative saving. Simultaneously, the workers would be forbearing from the opportunity to consume all of the goods and services that their incomes could purchase, putting \$500 each per month into their retirement accounts and leaving \$1000 worth of goods available for the retiree to purchase. If the amounts do not balance (i.e., if the retiree tries to buy more goods than the workers are willing to forsake), and if the total amount of goods and services is already determined, then prices would have to change to balance the system. Crucially, though, the net amount of annual saving in such a system is precisely zero, because the retiree's dissaving will exactly offset the workers' saving.

A direct financing method like Social Security's achieves the same result. In any time period (such as a year), workers divert \$500 each from current consumption to allow the retiree to consume \$1000 of goods and services. Neither the retiree nor the workers would have any official saving or dissaving, but the government's accounts would show \$1000 in total taxes (national saving) and \$1000 in retirement benefits (national dissaving), again with a perfect offset. The form differs, but the macroeconomic substance is the same.

# **B.** Long-Term Balance and Imbalance

If the simple world described above were to continue in perpetuity, there would be no long-range funding problems and no macroeconomic effects created by different methods of financing. If there were already a Social Security-like funding mechanism in place, there would be no reason to change to any other mechanism. Each year's benefits

would be available to retirees because workers would be consuming less than they could otherwise purchase.

The world described above, however, assumes a stable demographic environment in which workers pass into retirement and are replaced by an appropriate number of new workers. That assumption is, of course, not true for the current U.S. retirement system. The current difficulty with the Social Security system arose because of concern over the retirement of the Baby Boom.<sup>45</sup> One consequence of the long-term demographic changes is, of course, that the number of workers per retiree will soon change dramatically. Starting in the mid-1970's through the present, the ratio of workers to retirees has fluctuated between 3.2 and 3.4, but that number is projected to fall to 2.6 in 2020 and to level off at 1.9 starting in 2065.<sup>46</sup>

While this decline might seem to suggest that there is no way to save the system short of significant benefit cuts,<sup>47</sup> the worker-to-retiree ratio is only half the story. If, as projected, the average productivity of each worker rises by enough to offset the decline in

For a brief summary of the recent history of the Social Security system, *see* Neil H. Buchanan, *The Trillion Dollar Breach of Contract: Social Security and the American Worker*, FindLaw's Writ, Aug. 30, 2001, <a href="http://writ.news.findlaw.com/commentary/20010830\_buchanan.html">http://writ.news.findlaw.com/commentary/20010830\_buchanan.html</a>

<sup>&</sup>lt;sup>46</sup> Board of Trustees of the Federal Old-Age and Survivors Trust Fund and the Federal Disability Insurance Trust Fund, *Annual Report*, at 47, Tab. IV.B2 (2004) (hereinafter "Trustees' Report").

<sup>&</sup>lt;sup>47</sup> For example, a recent letter to the New York Times treated the workers-to-retiree ratio as the only relevant datum for understanding long-term solvency. Karen Burke, *Social Security: We Count On It*, N.Y. Times, Dec. 10, 2004, at A40 ("When benefits exceed the payroll tax receipts ..., demography is destiny: a ballooning cohort of retirees will be dependent upon a relatively stable working-age population.").

the relative number of workers producing goods, then the demographic change need not portend lower standards of living for either future workers or future retirees.<sup>48</sup>

## 1. The Trust Funds

When a government-run retirement system is in annual balance, there is no need to carry over balances or to borrow in any given year. In 1983, the Social Security system was changed to deliberately collect more in taxes every year than would be paid in benefits, while the Baby Boom was still in its prime earning years.<sup>49</sup> Then, when the Baby Boomers worked their way through retirement, the system would deliberately be underfunded, with benefits exceeding revenues for several more decades. During the fat years, the excess tax revenues would be credited to a trust fund, and in the lean years, the deficit in the system would be counted as a withdrawal from the funds.<sup>50</sup>

This accounting convention was, of course, consciously set up only as a bookkeeping matter. In any given year, given that the rest of the government's budget would almost certainly be in deficit, the excess from Social Security would finance all or part of that deficit. In 2004, for example, the non-Social Security deficit was \$567.4 billion, while Social Security ran a surplus of \$151.1 billion.<sup>51</sup>

<sup>49</sup> See Buchanan, note 45.

See generally Paul Krugman, Confusions About Social Security, The Economists' Voice, Jan.
2005.

<sup>51</sup> Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2006 to 2015*, App. F, Tab. 1, Jan. 25, 2005.

<sup>&</sup>lt;sup>48</sup> For some simple numerical examples of this phenomenon, *see* Robert Eisner, *No Need to Sacrifice Seniors or Children*, Wall St. J., Feb. 2, 1996, at A10.

It should be remembered, moreover, that there is no aggregate difference between having the Treasury directly use the annual Social Security surplus and having the Treasury borrow more on the financial markets while Social Security lends on those same financial markets. Either way, in 2004, the federal government would have drawn a *net* \$412.1 billion from the financial markets.<sup>52</sup>

## 2. Turning Points in the Trust Funds

Since the trust funds were created to deal with the large, but gradual, shifts in the financing of the nation's retirement system, the system was designed to go through two phases. In the first phase, the Social Security system would run surpluses that grew from year to year. At some point, revenues would stop growing faster than benefits, such that there would still be annual surpluses, but they would shrink inexorably each year. The second phase would see the emergence and growth of annual deficits, followed by gradually shrinking deficits trending toward annual balance.

The date when the system moves from the first phase to the second phase is, from the standpoint of 1983, not particularly interesting. It is simply an artifact of the system's design. There had to be a turning point, and it would happen somewhere between when the trust funds began and when the system returned to annual balance. This was part of the plan, not a crisis date.

In addition, with the system no longer designed to generate annual balance, the possibility arose that the system would not only be financially imbalanced in specific years but also as measured in the aggregate over all future years. There was thus a



possibility that the system might not perfectly hit a "smooth landing," as it were, with benefits exceeding revenues for more years than originally planned. Again, this was implicit in the system's design from the beginning. If the surplus years did not last as long (or were not as bountiful) as originally projected, or if the deficit years lasted longer (or were leaner) than projected, then there would be a date at which the trust fund would go negative.

## **3.** Are the Turning Points Important?

The important point to recognize is that those two dates—the turning point from annual surpluses to annual deficits, and the date of possible trust fund depletion—are not dates at which something dramatic must change in the system. The year before the first turning point would have a very small annual surplus, and the year after would have a very small deficit; but the difference between those two years would not be meaningfully larger than the difference between any other two year span in that era.

The lack of drama is even more pronounced regarding the date of possible trust fund depletion.<sup>53</sup> There, Social Security would be running annual deficits both before and after the depletion dates, and those deficits would be of relatively equal size. Unless the depletion date arrives much earlier than anticipated, in fact, the year after depletion would actually see a somewhat smaller deficit than the year before depletion.

The decades-long maturation and eventual passing of the Baby Boom generation, therefore, does not cause sudden shifts that must automatically throw a system out of

<sup>53</sup> This assumes that the law allows continued borrowing after a depletion date. See the discussion below.

balance. Nor need this evolution create any specific dates when a crisis occurs. The dates that we might focus on are artifacts of the system, not points of real economic interest. The important economic issue is, instead, whether the long-term balances or imbalances will lead to unfortunate consequences. It is long-term trends that matter, not the dates associated with specific turning points. The political discussion, unfortunately, has tended to focus almost exclusively on those turning points.

## C. Competing Analyses of Long-Term Solvency

Two government agencies, the Social Security Administration and the Congressional Budget Office, provide regular analyses of the long term finances of the system. The most recent Trustees Report from the Social Security Administration provides estimates that are, on the whole, less optimistic than those provided by CBO. The Trustees use three sets of economic assumptions to generate their forecasts, whereas CBO provides a mid-range estimate and a probability distribution of possible alternative paths.<sup>54</sup> Each agency focuses on the intermediate assumptions when summarizing their findings. Differences arising from these assumptions are noted below.

## 1. The First Turning Point

As noted above, the point at which the system turns from annual surpluses to annual deficits is interesting more as a symbolic matter than as a real one. Even so, because public discussion has begun to focus on these issues, both agencies have provided estimates of this turning point. The Trustees estimate that, under their

<sup>&</sup>lt;sup>54</sup> Congressional Budget Office, *The Outlook for Social Security*, at 31 (June 2004) (hereinafter "CBO 2004").

intermediate set of assumptions, the system will swing to deficit from surpluses in 2018.<sup>55</sup> Under the most pessimistic assumptions, the turning point comes in 2014, and under the more optimistic assumptions, the turning point is in 2020.

The CBO's estimates are not much different. In its 2004 report, CBO estimated (under what it views as the most reasonable economic assumptions) that the turning point would come in 2019.<sup>56</sup> Only seven months after issuing that estimate, though, CBO's revised estimates put the turning point a year later, in 2020.<sup>57</sup>

Given that the first turning point is driven by the retirement of the Baby Boomers, which is not very far in the future, it is not surprising that CBO and the Trustees provide similar estimates. Their differing estimates of the depletion date, though, bear some consideration.

## 2. Trust Fund Depletion

The Trustees' forecasts of the date of trust fund depletion are 2031 under the most pessimistic assumptions and 2042 under the mid-range assumptions, whereas the trust fund is never depleted at all under the more optimistic assumptions.<sup>58</sup> CBO's mid-range estimate projects that the trust fund will be depleted in 2052, ten years later than the Trustees' intermediate estimate.<sup>59</sup>

CBO Update at 1.

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Trustees Report at 15, Fig. II.D7.

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<sup>&</sup>lt;sup>55</sup> Trustees' Report at 8.

<sup>&</sup>lt;sup>56</sup> CBO 2004 at vii.

<sup>&</sup>lt;sup>57</sup> Congressional Budget Office, *Updated Long-Term Projections for Social Security* (Jan. 2005) (hereinafter "CBO Update"), http://cbo.gov/showdoc.cfm?index=6064&sequence=0.

CBO presents an analysis of the difference between their projections and the Trustees' projections. While CBO relies on the Trustees' demographic assumptions, it uses different economic assumptions.<sup>60</sup> "Some of those differences in assumptions improve the financial outlook for Social Security and others worsen it."<sup>61</sup> Specifically, CBO assumes that real earnings will grow at a 1.3% annual rate, as opposed to the Trustees' assumption of 1.1% annual growth. CBO assumes an average real interest rate of 3.3%, higher than the Trustees' assumed 3.0% rate. CBO also assumes lower inflation (2.2% per year against 2.8%) and unemployment (5.2% vs. 5.5%).<sup>62</sup>

It is not my purpose here to delve into the vagaries of economic forecasting. Instead, it is important simply to point out how widely varying the long term projections are based on relatively minor (and utterly defensible) differences in economic assumptions.

## D. A Key Question: What is "Current Law"?

As described in part IV below, the baseline used to compute the Fiscal Gap (and thus Generational Accounts) is "current law." That is, the mental exercise involves asking what would happen if current law were completely unchanged forever. In the context of Social Security, however, there is a conflict between two aspects of existing law. The benefits and revenues anticipated under current law, under the intermediate and most pessimistic assumptions, lead to a point at which the trust fund is depleted. If the

Id.

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Id. at 29, Tab. A-1. ess Legal Repository

<sup>&</sup>lt;sup>60</sup> CBO 2004 at 29.

system is not allowed to borrow to cover full benefits after that point, benefits must be cut immediately, by 22% starting in 2053, under CBO's assumptions.<sup>63</sup>

On the other hand, if the scheduled benefits continue to be paid after the depletion date, the Social Security system continues to run annual deficits unless and until it comes back into balance or surplus. Indeed, CBO's updated estimates changed the label of these two scenarios. The "scheduled benefits" scenario remains in place, but the "trust-fund financed" scenario has now become the "current law" scenario.<sup>64</sup>

Under the assumption that benefits will continue to be paid even after trust fund depletion, the Trusteesestimate that the aggregate Social Security gap over the 75-year period from 2004-78 is \$3.7 trillion, while the gap over the infinite future is \$10.4 trillion.<sup>65</sup> These rather dramatic differences highlight just how artificial is the "current law" assumption. The current law that CBO assumes actually provides a less pessimistic forecast, because Social Security benefits must be cut absent intervention by policymakers.<sup>66</sup> The more dramatic measures of long-term imbalance, on the other hand, are based on the assumption that a future Congress will prevent such automatic cuts. Further discussion of this issue is provided below.

<sup>65</sup> Trustees' Report at 58. Note that \$10.4 trillion is only 1.2% of GDP over the infinite future. *Id.* <sup>66</sup> Because all spending laws require the appropriation of funds, but no appropriation has been enacted to permit borrowing by Social Security after the trust fund has been depleted, the system will be forced to cut benefits to the level supported by incoming revenues. The law is silent, however, on how the cuts must be made. While CBO assumes across-the-board cuts, *see* CBO Update, Figs. 2-1, 2-2, 2-3 and Tab. 2-1, there is no statutory authority for that position. Here, therefore, there is no current law at all.

<sup>&</sup>lt;sup>63</sup> CBO Update at 1.

<sup>&</sup>lt;sup>64</sup> Id.

# IV. Fiscal Gaps and Generational Accounting

The Fiscal Gap/Generational Accounting approach is built upon some very appealing foundational arguments and uses an apparatus similar to that described in Section III regarding long-term Social Security forecasts. First, as noted above, deficit accounting is arbitrary, because there is nothing special about a year as the unit of analysis.<sup>67</sup> Second, even withut any political games, there is no good analytical reason to assess government programs on an annual basis. Projects that last longer than a year should be analyzed in their relevant time frame. Surely, a year is fartoo short a time in which to measure meaningfully the impact on the economy of the vast majority of government programs and tax policies.

Of course, once one realizes that a year is arbitrary, one must also recognize that there is no non-arbitrary alternative. The infinite future is out there, and perhaps the best way to proceed is to use the simple financial concept of net present value discounting to

As above, arbitrarily aiming to balance annual books can introduce its own set of bizarre games. After taking office in 2001, the second Bush administration changed the national accounts such that some corporate tax revenues would be credited in October 2001 rather than in September of that year. Because the federal government's fiscal year runs from October 1 through September 30, this move reduced the (then-projected) surplus for fiscal 2001 and increased it for fiscal 2002. This gamesmanship came to light after the 2001 tax cut was passed, when it appeared that the on-budget surplus might actually slip into deficit for the first time in several years. Democrats were quick to accuse the new administration of fiscal irresponsibility, and the administration quickly assured everyone that the on-budget surplus would still be \$8 billion. In a \$10 trillion economy with a \$2 trillion budget, the idea that we can predict an \$8 *billion* surplus—less than one half of one percent of spending—stretches credulity. Such a small number is little more than a rounding error.

bring all future receipts and expenditures into one current estimate. This approach has an added benefit in that it avoids the issue noted earlier of whether a program has a dedicated financing mechanism. While it arguably makes sense to compare the long-term planned expenditures and expected receipts for something like the highway trust fund, the majority of government programs can only meaningfully be assessed in the aggregate, because most programs are not supported by their own tax regimes.

## A. Computing the Accounts

## 1. The Fiscal Gap

The fundamental analytical achievement of the generational accounting framework is its attempt to compute an aggregate, discounted federal deficit or surplus into the infinite future.<sup>68</sup> Estimates generated using an FG/GA framework have been included in many federal budget documents starting more than ten years ago,<sup>69</sup> and Professor Kotlikoff has provided a great deal of input over the years to the work of the Congressional Budget Office.

The basic logic of FG/GA is, as described above, based on the assumption that current law remains unchanged indefinitely (assuming, of course, that we know what current law is<sup>70</sup>). What are the likely paths of government spending and tax receipts,

See note 66.

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 <sup>&</sup>lt;sup>68</sup> Note, though, that this is still only a federal calculation. If one were to adopt FG/GA as the
<sup>69</sup> See citations in Robert Haveman, Should Generational Accounts Replace the Annual Budget

Estimates? Journal of Economic Perspectives, 1994, at 95 n.1.

given expected trends in population, economic growth, etc.? Given those likely paths, what is the aggregate gap between spending and tax revenues into the infinite future? Taking the analysis one step further, it is then theoretically possible to estimate thenet amount of money that an individual will pay in taxes to the government over his or her lifetime, which is the Generational Accounting part of the FG/GA approach.

The appeal of moving to long-term budget calculations loses its luster rather quickly, however, in the face of the complexity of long term budget estimation. If the Social Security calculations described earlier are challenging, these calculations are significantly more so. Consider the inputs necessary to generate an FG/GA estimate. Tax receipts for each future year must be calculated on the basis of estimates of the number of taxpayers, their gross incomes, their deductions (and exclusions and exemptions), and their tax rates. Only the last of these numbers is written into law (and highly variable law at that), whereas the others depend on long-term estimates of birth rates, death rates, net immigration rates, productivity growth rates, homeownership rates, trends in medical insurance coverage by the private sector, and on and on.

Certainly, some long-term estimates can be quite reliable. Birth and death rates change rather slowly, so projecting the number of native-born Americans likely to be living in thirty or forty years is not much of a stretch. On the other hand, other estimates are notoriously volatile. The CBO has changed its estimates of annual deficits, for example, by as much as 100% over the space of several months. Even longer-term forecasts, which are plausibly less prone to temporary blips, are more prone to



cumulative error.<sup>71</sup> Indeed, even history is unstable, as the "New Economy's" performance in the 1990's has been substantially reduced by updated official estimates.

A recent calculation of the Fiscal Gap, using the most current version of the FG/GA methodology, has been provided by Gokhale and Smetters.<sup>72</sup> Admirably transparent in its description of how the calculations were derived,<sup>73</sup> this study estimates a Fiscal Gap of \$44.2 trillion, of which \$7 trillion is attributable to Social Security, \$36.6 trillion is attributable to Medicare (split roughly equally between Part A and Part B), and only \$0.5 trillion is attributable to the rest of the federal government.<sup>74</sup>

Gokhale and Smetters provide a range of scenarios under which the Fiscal Gap could be erased, suggesting as their most likely choice an immediate and permanent 16.6% increase in wage taxes.<sup>75</sup> Updated estimates based on the same model (crucially

72 Jagadeesh Gokhale and Kent Smetters. Fiscal and Generational Imbalances: New Budget Measures for New Budget Priorities. The AEI Press (2003).

73 While the discussion of the mechanics of their estimates is clear, it is hardly dispassionate. Words like "drastic" permeate the discussion, which (given the study's conclusions) perhaps understandably presents an urgent (even alarmist) tone.

74 Id. at 3. (Gokhale and Smetters prefer the term Fiscal Imbalance, but I will use the more common Fiscal Gap.) This is a midpoint estimate. The lower bound is \$29 trillion, while the higher bound—"under still quite conservative assumptions"-is \$64 trillion. Id. at 6. gal Repository

Id. at 6.

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<sup>71</sup> The pioneering economic forecaster Otto Eckstein, founder of Data Resources, Inc. (now DRI/McGraw-Hill) once offered advice to his graduate students in words to the following effect: "You can believe our quarterly forecasts rounded to a full percentage point (e.g., 4.3% growth forecasts mean that growth will be somewhere in the neighborhood of 4% in the next quarter). You can believe the sign of our annual forecasts. And you should just ignore our five-year projections."

including the just-passed Medicare drug benefit) show the Fiscal Gap to have reached approximately \$73 trillion.<sup>76</sup> (Note, however, that these estimates are presented as dollar figures with no standard of comparison. \$44 trillion is simply a big number. Since the corresponding measure of discounted infinite-horizon GDP is \$615 trillion,<sup>77</sup> the FG-to-GDP ratio is approximately seven percent—perhaps an important number, but much less likely to grab headlines.<sup>78</sup>)

The analysis below will show that the exact estimates provided by such studies whether \$44 trillion, \$73 trillion, or some other large number—are ultimately not very helpful in fiscal analysis. The purpose, again, is not to engage in dueling long-term estimates, but to assess what can be learned from such long-term estimates.

### 2. Lifetime Net Tax Rates

Although it is analytically separable from the long-term budgeting calculation, the "generational" part of Generational Accounting provides perhaps its most potent political impact. Kotlikoff arguesthat it is possible to move from the "What if we did nothing?" question to compare the treatment of different generations based on their lifetime receipts of government benefits and their lifetime tax payments. Using the same method described above, it is possible to choose arbitrary cutoff dates for different generations and then to calculate their "lifetime net tax rates," i.e., the net present value of their

<sup>77</sup> Gokhale and Smetters at 4.

The \$44 trillion figure has received prominent placement in The New York Times. *See* Edmund
L. Andrews, *Fearing That a Gap Will Become a Chasm*, N.Y. Times, Mar. 2, 2004, at C1.

 <sup>&</sup>lt;sup>76</sup> Daniel N. Shaviro, Reckless Disregard: The Bush Administration's Policy of Cutting Taxes in the
Face of an Enormous Fiscal Gap, 45 B.C.L.Rev. 1285, 1299 (2004).

lifetime tax payments minus the net present value of their lifetime government-paid benefits.

Seeming to confirm the suspicion that a large population cohort in a democracy could distort the benefit system in its favor (especially in a democracy in which the young are less likely to vote), Kotlikoff made national headlines when he announced in 1993 that the lifetime net tax rate of younger generations would be 71%, whereas the rate for Baby Boomers would be 35%, and the rate for current retirees was 21%.<sup>79</sup> A few years later, the numbers became even more dramatic, when the 71% figure was increased to 84%.<sup>80</sup>

## **B.** Weaknesses in the FG/GA Framework

As appealing as the basic foundations of FG/GA might be, the theory does not deliver what it promises. Far from being a neutral tool for dispassionate evaluation by policymakers, the generational accounting model makes the fiscal horizon look far worse than it will probably be, and these results can color the policy debate for the worse. Moreover, the hope that FG/GA calculations can act as a default early-warning system is at best overdrawn. It is simply not possible to define a clean baseline. Finally, the economic assumptions on which FG/GA is based are too contestable to use for meaningful policy analysis.

<sup>&</sup>lt;sup>79</sup> Kotlikoff, *supra* note 4 ("Deficit Delusion").

<sup>&</sup>lt;sup>80</sup> Cohen, *supra* note 6, cites this higher figure, as does Shaviro, *supra* note 8, at 716. On the other hand, when Kotlikoff recently recalculated his generational accounts and found that the 84% rate for future generations had fallen to 35.81% (cited in Shaviro, *supra* note 12, at 150), the "good" news was not met with fanfare. (The incredible precision of those estimates is a separate issue.)

## 1. Paying Down the Debt

The source of the huge differences between generations noted above is quite peculiar. The generational accounts assume that, as of the date that an account is calculated, there are two groups of citizens: the generations that are already born and the one that is about to be born.<sup>81</sup> Then, the accounts compute the taxes that the already-born will pay minus the direct cash benefits that they will receive (both of which are in part known, because some taxes and expenditures are already history), under the current tax and spending regimes.

The soon-to-be-born are, however, treated differently.<sup>82</sup> For them, lifetime taxes include not just those that they would be forced to pay under current law, but also taxes sufficient to pay down the entire national debt (accumulated before they were born) during their lifetimes.<sup>83</sup> There is no good reason to assume that the entire national debt will or must be paid in that time, but that is the assumption that drove the dramatic 84% result.

On its own, of course, this assumption cannot help but make things look much worse for the new generation. With an entire lifetime of work ahead of them, and with the government unable to borrow money, they must pay for their own benefits as well as

<sup>83</sup> *Id.* at n.5 ("In effect, there are two implicit fiscal regimes in place during the future years when both members of current generations and members of future generations are living.")

<sup>&</sup>lt;sup>81</sup> This means, of course, that the political audience for these estimates, the younger non-voters, was in fact not included in the group that is supposed to be paying nearly all of their lifetime income in net taxes.

<sup>&</sup>lt;sup>82</sup> Haveman, *supra* note \_\_, at 100.

those of their parents and grandparents. The older generations, meanwhile, had a good ride, and they are allowed to continue that ride even while their heirs are paying for the difference.<sup>84</sup>

The generational impact of current fiscal policy, however, is better viewed through the more traditional crowding-out lens. Current deficits are likely to decrease future growth in GDP, which makes future generations worse off than they otherwise would be. The inter-generational comparisons are becoming less relevant as the generations that benefited from the expansion of Social Security and Medicare die off. Moving forward, the real question is reduced to the now-versus-later question that should always have been the central focus of budgetary analysis. We cannot know whether any single future generation will be called upon to pay down the debt; but we can say that any decision that raises deficits at one point in time—assuming that those deficits do not finance productive public investment—is likely to cumulatively decrease future GDP.

## 2. Benefits Not Counted in a Generation's Accounts

The calculation of any particular generation's lifetime net tax rate also excludes many of the indirect benefits provided by governments—indeed, the very benefits for which governments are traditionally thought to exist. The only benefits that go into the FG/GA calculation are those that are paid in cash. The benefits from cleaner air, pleasant

<sup>84</sup> Since the government's bondholders tend to be older (especially indirectly through retirement funds), this also skews the inter-generational comparison as income is redistributed upward.

parks, medical research and development, lower crime, etc. are not counted as benefits. Taxes pay for them, but they are a net cost of government in the FG/GA calculations.<sup>85</sup>

It is not clear *a priori* how this fault in the generational accounts would affect inter-generational comparisons. Indeed, it is imaginable that these benefits are so diffuse that they benefit every citizen equally. It is also possible, though, that some of these benefits are disproportionately shared. The cost of educating the Baby Boomers was borne by our parents, yet all future generations will benefit from it.

Leaving that very open question aside, though, the fact that the FG/GA calculations of lifetime net tax rates are skewed upward is important simply because it skews the political response. If the members of Gen X are told that their net tax rate is 84%, while that of their parents is 35%, they are likely to have two responses: 1) Our generation is being cheated, and 2) *All* generations are being cheated! After all, while 35% is better than 84%, paying more than a third of your lifetime earnings to a government that (according to this model) does not do anything useful with the money is likely to be rather upsetting.

If, on the other hand, the numbers were 8.4% and 3.5%, the magnitude of the inter-generational backlash would be muted (since outrage is likely to be at least partly based on the magnitude of the difference as well as the proportional comparison), and the anti-government reaction might not even register politically.

<sup>&</sup>lt;sup>85</sup> It is, of course, always possible to adjust the FG/GA calculations to take these non-cash benefits into account. To the extent that this can be done, FG/GA begins to resemble capital budgeting.

In other words, the effects on society of this widely-quoted statistic go beyond the simple, modest claim that FG/GA is just a diagnostic tool. It is a political tool, and its affects are predictable.

#### 3. Demographic Trends and Health Care Spending

As discussed above, the most important demographic phenomenon facing the U.S. and other Western countries is the Baby Boom and the subsequent dramatic decline in birth rates after 1964. While this phenomenon will end within a few decades, at least some parts of the fiscal gap are not going to be solved simply by the death of the Boomers.

An important trend is the general increase in life expectancies over the long term. Indeed, given long-term trends in health, even after the 75-year window, the paths of receipts and expenditures continue to diverge, as an increasingly large non-working aged population consumes more of the economy's resources, largely through the health care system.

If this turns out to be true, it would mean that our focus should not be on the effects of the Baby Boomers but on eventually reining in our seemingly insatiable appetites for medical care. While that might be a wise policy on its own, however, the FG/GA framework does not provide a compelling reason to adopt such limits.

For example, Shaviro cites research indicating that healthcare expenditures on the elderly will continue to rise significantly relative to GDP.<sup>86</sup> This, however, assumes that health care spending on an aging population will show the same trends as current health



care expenditures. For example, if the typical 75-year-old today consumes a given amount of health care, and if there will be twice as many living 75-year-olds in 50 years, then it would appear that health care spending would have to double in the future. This assumes, in turn, that even though life expectancies will rise, elder health at specific ages will not improve.

We know, however, that a large fraction of the money spent on health care is spent at the very end of life—heroic, life-prolonging procedures that add a few weeks or months to the lives of chronically ill patients.<sup>87</sup> If those chronically ill patients do not become chronically ill until twenty years later in life, however, there is no reason why overall health care spending must rise—even if we never change the way we deal with end-of-life decisions.

This is not to say that it is impossible to imagine a future with higher health care expenditures. It does indicate, however, just how difficult it is to rely on estimates of health-related spending decades in the future. Current estimates indicate that healthcare spending will rise from 15.4% of GDP in 2004 to 18.7% in 2014 and that the federal government's share of that spending will rise to 49 percent of the total.<sup>88</sup>

The calculations in Gokhale and Smetters, on the other hand, are based on a much simpler assumption, that medical care will grow for the next 75 years at a rate one

<sup>88</sup> Robert Pear, *Health Costs Will Keep Rising, U.S. Says, Along With Government Share of Paying Them*, N.Y. Times, Feb. 24, 2005, at A20.

<sup>&</sup>lt;sup>87</sup> Daniel Altman, *How to Save Medicare? Die Sooner*, N.Y.Times, Feb. 27, 2005, at § 3, p. 1 ("For the last few decades, the share of Medicare costs incurred by patients in their last year of life has stayed at about 28 percent.")

percentage point faster than the growth rate of GDP, then fall over the ensuing 20 years to grow at a rate equal to GDP growth. These assumptions mirror those made by the Medicare Trustees.<sup>89</sup> The vast majority of their estimated Fiscal Gap, both pre- and post-2078, is caused by the Medicare growth assumption,<sup>90</sup> suggesting that it is probably more accurate to describe any long-term fiscal crisis as an economy-wide health care crisis.<sup>91</sup>

If the cost of medical care continues to grow in future decades at rates consistently exceeding the growth rate of GDP, then certainly a policy intervention will become necessary. While it is possible to starve everything else in the service of health care, it would be more sensible to recognize that the core of the problem lies not in public finance but in health policy. Fixing that problem will prevent needless and possibly unwise cuts in other fiscal priorities.

## 4. After-tax Standard of Living

Finally, it is important to emphasize that the estimates of lifetime net tax rates are analytically incomplete. What is left out is the question of whether future generations are worse off because of the higher net tax rates. If pre-tax income is rising faster than tax rates, future generations can be better off even though they will pay higher tax rates.

According to the CBO, this is precisely what would happen under their mid-range assumptions (that is, the assumptions that lead to trust fund depletion in 2052). In its

<sup>&</sup>lt;sup>89</sup> Gokhale and Smetters at 23.

<sup>&</sup>lt;sup>90</sup> See note 105 and accompanying text.

<sup>&</sup>lt;sup>91</sup> Paul R. Krugman, *Social Security Scares*, N.Y. Times, Mar. 5, 2004, at A23 ("The projected rise in Medicare expenses is mainly driven not by demography, but by the rising cost of medical care, which in turn mainly reflects medical progress, which allows doctors to treat a wider range of conditions.")

most recent report, CBO analyzed the benefits received by workers, organized in ten-year birth cohorts from 1940 (the group that is currently retiring) to 2000 (today's toddlers).<sup>92</sup> Even after assuming an across-the-board cut in benefits starting in 2053 ("current law"), CBO's estimates show that no birth cohort has a lower present value of inflation-adjusted lifetime benefits than any previous generation. Only the lowest quintile of the population shows any cohort facing a net decrease in real lifetime benefits (for the 1980 and 1990 cohorts), and even those cohorts do better than the 1940, 1950, and 1960 cohorts.<sup>93</sup> (This difference could also be addressed by future policymakers if they choose not to make cuts across the board but rather adjusted relative benefits to prevent low-income workers from facing cuts.)

In short, the issue presented by the Generational Accounts estimates is misleading in that it focuses on lifetime tax rates rather than lifetime standard of living. While dramatically high tax rates grab headlines, they should not be the focus of fiscal policymakers or the public.

## C. Generational Accounting Without Generations?

Populist appeal aside, the importance of the generational part of the FG/GA approach should not be underestimated. Kotlikoff and his co authors argue that they have created a meaningful baseline, allowing us to assess the effects of any proposed government policy over the long run, and potentially comparing that affect on different

CBO Update, Tab. 2-1. Id. Depress Legal Repository

age groups. If these claims were true, then it would be important for everyone to send their policy proposals through the FG/GA machine. If the results of such an analysis turned out negative, the policy would be presumed harmful until proven beneficial.

On the other hand, we could also take a step back and remove the generations out of generational accounting, simply stopping after we compute the Fiscal Gap. We could thereby look at long-term trends and calculate long-term tax revenues and government spending assuming a continuation of current policies. If this calculation were to show a deficit, then it is a warning: Unless something is changed, the government will have to cut spending or raise taxes on future generations. While we might still choose to do nothing, the argument continues, at least the FG would give us a fair number from which to work.<sup>94</sup>

#### 1. Another Baseline Problem

The asserted agnosticism behind FG calculations thus rests on the idea that they are warnings, not predictions. Indeed, if FG is used as its proponents suggest, we enable ourselves to make "tough but sensible" choices now to prevent the disaster that surely awaits us if we fail to act.<sup>95</sup> In fact, though, the theory is not agnostic, and its proponents' call to action rests on weak assumptions.

The underlying question is one of default. Once the cross-generational comparisons are set aside, FG claims to ask, in essence: "If we were to change absolutely

<sup>95</sup> Shaviro, *supra* note \_\_\_, at 716 (arguing that politicians should "openly fac[e] today painful choices that ultimately will have to be faced anyway.")

<sup>&</sup>lt;sup>94</sup> Even Haveman, *supra* note \_\_\_, despite offering a withering criticism of GA, allows that this "base case" analysis can provide useful information. *Id.* at 100, 110.

nothing, and if we can believe the forecasts on which our estimates are based, are our current fiscal policies allowing living generations to steal economic resources from their grandchildren and their grandchildren's grandchildren?" But it does not stop there. If the answer to that question is yes, then the argument is that we must act *now*. Why now? Because our current path is unsustainable, and delay is only going to allow matters to worsen.<sup>96</sup> Sacrifice today means sowing a greater harvest tomorrow.

While this logic surely appeals to our Puritan roots, it is misleading. We should only enact new policies now if we believe that we will not change policies along the way for other reasons. By way of analogy, consider theconcept(known as "bracket creep") that tax rates in the 1970's would have led to an ever-higher percentage of GDP being collected by the IRS, because inflation was pushing everyone inexorably into the highest tax brackets. If that argument had been coupled with a call to raise government spending immediately, because we can count on ever-higher revenues in the future, surely that would have been widely derided as a foolish conclusion. Everyone knew that Congress would pass regular tax cuts to undo the effects of bracket creep; so even if no one anticipated the indexing of brackets to inflation in the 1981 tax bill, certainly no one thought that everyone would end up in the 70% tax bracket when inflation had made even a street-sweeper "rich."<sup>97</sup>

 <sup>&</sup>lt;sup>96</sup> *Id.* (arguing that we should act "sooner rather than later"). *See also* Gokhale and Smetters at 3.
<sup>97</sup> There are, of course, strong political economy arguments for indexing the tax code rather than
relying on *ad hoc* corrections; but those are beside the point here.

Similarly, the FG call to action loses much of its appeal when we realize that this "interesting calculation" is based on arbitrary economic forecasts<sup>98</sup> combined with the arbitrary assumption that only a few things are set in stone. Consider the current path of tax rates. Current tax law is in a bizarre state, because of the ten-year reversion feature of the 2001 tax bill.<sup>99</sup> The estate tax is set to decline, disappear, and reappear. The 28% tax bracket declines to 25% and then returns to 28% (with similar moves in the other brackets, and some brackets merging into others only to reappear in 2011). No one expects the reversion to happen. The House in 2002 passed, on partisan lines, a bill to make the 2001 cuts permanent—although no one viewed that action as anything more than election year posturing. Even with the current one-party dominance of the federal government increasing the likelihood of tax cuts, it is not clear what form those cuts will take.

With the *status quo ante* not a serious possibility, and the *status quo post* unlikely ever to become the status quo at all, how can one even formulate a call to action on the basis of an FG calculation? In addition, current projections assume that the Alternative Minimum Tax (which is not indexed to inflation) will remain in place, even though it will

<sup>&</sup>lt;sup>98</sup> See Haveman, supra note \_\_\_, at 99 n.4.

<sup>&</sup>lt;sup>99</sup> Because of a self-imposed super-majority voting requirement in the Senate, bills that would reduce tax revenues beyond ten years from the effective date of a bill require sixty votes to pass. Lacking sufficient votes, the Senate made all provisions of the 2001 tax act void in 2011.

almost surely be altered or repealed when it begins to affect large sections of the middle class.100

## 2. What Happens When People Live Longer?

Carrying this over to the demographic argument is potentially even more devastating to the FG position. If the time paths of revenues and expenditures do not come back together after the death of the Baby Boom generation because of the trends in life expectancies, then surely it is important to forecast how those longer life expectancies will change both individual behavior and government policy. The Social Security trustees estimate that the average life expectancy for men will rise from 74 in 2000 (the last year for which final calculations are available) to 78.8 in 2045 and 81.6 in 2080, with women's longevities lengthening over those same years from 79.4 to 82.9 to 85.3.<sup>101</sup>

As people live longer, they will naturally use more economic resources, possibly including medical care (as discussed above). People might also produce more economic resources. Based on current law in which retirement ages are rising to 67 and then staying put, FG/GA estimates would have us believe that in 75 years—assuming that all of the other forecasts over that time span are true—we will have a nation of impressively healthy septuagenarians (and older) living off of the sweat of a relatively tiny population of younger workers.

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<sup>100</sup> Leonard E. Burman, et al., The Individual AMT: Problems and Potential Solutions, Tax Policy Center Discussion Paper No. 5 (2002). Trustees' Report at 81, Tab. V.A.3.

Why make the assumption that the retirement age (effective if not statutory) will remain fixed as the population inevitably ages (relatively) healthfully? Boredom alone is likely to lead to a changed politics of retirement, with some people voluntarily staying employed or returning to the work force to fill the void. Moreover, the increasingly fragile financial condition of the elderly is keeping many people involuntarily in the labor force after reaching retirement age.<sup>102</sup> CBO estimates that increasing the retirement age from 67 to keep up with life expectancy would reduce Social Security benefits by 12% in 2050.<sup>103</sup> While such an increase in the retirement age would be the arithmetic equivalent of a benefit cut, the point is that it or something like it is likely to happen in any case, making the "nothing else changes" baseline assumption particularly problematic.

While an advocate of FG/GA can always claim that their calculations can tell us what happens if retirement ages do not change, that is a far cry from justifying the argument that we need to cut benefits and raise taxes today on retirees in order to bring the long-term budget into balance.

Indeed, Gokhale and Smetters do allow themselves to make a single departure from their blanket assumption that policy is set in stone. Separate from the "bracket creep" caused by inflation, real economic growth can cause "real bracket creep," whereby increases in real income cause every taxpayer's income ultimately to rise to the highest

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<sup>102</sup> See, e.g., Jennifer Bayot, As Bills Mount, Debts on Homes Rise for Elderly. N.Y. Times, Jul. 5, 2004, Sec. 1, at 1 ("Many [elderly borrowers] are forgoing retirement and taking on part-time work."); Eduardo Porter and Mary Williams Walsh, Retirement Becomes Rest Stop As Pensions and Benefits Shrink, N.Y. Times, Feb. 9, 2005, at A1 Congressional Budget Office, Budget Options, at 239 (Feb. 2005).

bracket. Gokhale and Smetters quite reasonably view this as absurd and thus assume that the brackets will be adjusted over time to prevent this from happening. This, of course, makes the estimated Fiscal Gap look worse; but more importantly, it raises the question of why this is the *only* concession to reality that is allowed in the estimates going forward.

#### 3. The Fiscal Gap and the Annual Deficit

Perhaps the FG calculation should not be viewed as an important measure of the *level* of future deficits, but rather as a way to measure *changes* in future deficits. In other words, even if we do not feel confident that a \$44 trillion FG estimate (or any other estimate) is reliable, we might still use it to measure the effects of the change in policy. (By analogy, we know that GDP is an imperfect measure of well-being; but if we conclude that the unmeasured aspects of GDP move roughly in proportion to measured GDP, we might use GDP as an acceptable proxy for well-being.) If a new policy raised the FG calculation from \$50 trillion to \$60 trillion, under this view, thatwould be valuable information.

There is something to be said for this argument; and it certainly supports the conclusion that there is no reason to have our statistical agencies simply discontinue FG calculations entirely. It remains to be proven—although it seems plausible—thatthe weakness of the FG calculations does not make estimated changes in FG just as weak as the FG calculations themselves. Unless that can be shown, relying on FG estimates for this purpose is a leap of faith.

The absolute level of the estimated Fiscal Gap is important for another reason. "[T]he [Fiscal Gap] grows by about \$1.6 trillion per year to \$54 trillion by just 2008

unless corrective policies are implemented before then. This rapid annual increment is also about ten times as large as the official annual deficit reported for fiscal year 2002."<sup>104</sup> Gokhale and Smetters thus suggest that the "true" deficit is not measured accurately by the annual cash-flow deficit but by the change in the Fiscal Gap from year to year. Because that annual change, in the absence of policy enactments, is simply equal to the previous year's Fiscal Gap times the assumed annual interest rate, this annual quasi-deficit measure will be much smaller if we allow the forecasts in the Fiscal Gap to include changes in retirement ages, health care cost trends, etc. If the estimated Fiscal Gap were something like \$15 trillion, in other words, the annual quasi-deficit would be just over \$500 billion, whereas a Fiscal Gap of \$88 trillion would imply an annual quasi-deficit of \$3.2 trillion. The annual changes depend completely on the accuracy of the aggregate estimate of the level of FG.

## 4. Making the Fiscal Gap Disappear

Even if it were possible to agree on the likely future path of policy decisions, the Fiscal Gap can be manipulated simply by enacting policies which will take effect in the future. If, instead of Gokhale and Smetters's suggested immediate increase in wage taxes of 16.6%, Congress enacted an increase in wage taxes that started at 0.1% in twenty years and rose to some level well in excess of 16.6% twenty years later, the Fiscal Gap would immediately become zero. Cynics would argue that this is non-credible, and they would have a point. As enacted policy ("current law"), however, such a law would make the Fiscal Gap equal to zero, by definition. The annual quasi-deficit would then also equal

<sup>104</sup> Gokhale and Smetters, at 3. S Legal Repository

zero. While nothing would have changed, these fiscal measures would show nothing amiss.

It is true that there would still be a relative burdening of future generations. As discussed below, it is not immediately clear that relatively burdening future generations is to be avoided, given that even the most pessimistic estimates of future GDP predict that future generations are likely to enjoy significantly higher levels of income than we currently do.

## 5. How Far Into the Future?

Finally, Gokhale and Smetters use an infinite horizon rather than the 75-year horizon that is the norm in such analyses. As they point out, their model predicts a Social Security gap of \$1.6 trillion over the 75-year horizon, compared to an infinite-horizon gap of \$7 trillion, while the 75-year Medicare gap is \$15.1 trillion, compared to the \$36.6 trillion in their infinite-horizon model.<sup>105</sup> In other words, over sixty percent of the Fiscal Gap occurs from 2078 through infinity. Prescribing policy initiatives for current lawmakers on the basis of such long-term projections borders on being arbitrary.

In short, the Fiscal Gap and Generational Accounts are generally not useful in guiding policy, because they are based on highly questionable forecasts, they ignore the effects of likely future political decisions, and they are far too easy to manipulate. Moreover, they cannot meaningfully compare the relationships among generations in how they share the cost of running the federal government, at least in a way that is

different from the standard crowding-out approach. While the exercise of measuring Fiscal Gaps is based on a reasonable desire to see what we might be getting ourselves into, the mechanisms for such long-term forecasts are simply too crude to add meaningfully to our arsenal of policy choices.<sup>106</sup>

As noted in Section II above, though, this critique—as strongly worded as it is should not be misconstrued as a call for willful ignorance. Having long-term estimates available will at least be useful in the situation where *any* plausible set of assumptions still shows that current policies will lead to huge future fiscal imbalances. The more robust these long-term estimates are to varying assumptions, the more seriously we should take them. The current FG estimates, though, as dramatic as they may seem, do not add meaningfully to our knowledge of how wrong-headed our current fiscal policies are. The problems arising from deficits estimated over the 10-year horizon should be more than enough to give reasonable policymakers pause.<sup>107</sup>

<sup>107</sup> See William G. Gale and Peter R. Orszag, Bush Administration Tax Policy:
Revenue and Budget Effects, Tax Notes, Oct. 4, 2004. ("For example, to pay for the tax cuts in 2014

<sup>&</sup>lt;sup>106</sup> Arguably, the lesson to be drawn from an exercise like that of Gokhale and Smetters is that the news is good, i.e., outside of the more general question of how to handle health care costs (both inside and outside of Medicare), we do not apparently face significant long-term budget problems. If so, then the exercise is worthwhile in a negative sense. Still, there are less favorable assumptions that could make the Fiscal Gap calculation look worse, especially the extension the 2001 and 2003 tax cuts and the elimination or indexation of the Alternative Minimum Tax, and those assumptions are subject to all of the uncertainties described here. If Fiscal Gap calculations are to be but one piece of information among many, therefore, they at least should not be given the prominence that Gokhale and Smetters would give them.

#### V. What Does it Mean to Be Fair to Future Generations?

The unspoken assumption in all of this discussion is that the government should never make decisions that would reduce economic well-being in the future. Even if one completely agrees that the measurement problems discussed above must be addressed, one is still proceeding from the assumption that a decision is bad *per se* if it would reduce the level of real goods and services available to future generations.

The policy regime that FG/GA analysis implies is thus clear: immediate fiscal contraction, austerity, and pain. The positive spin is that the pain can be "shared." Two somewhat inconsistent norms are offered in designing policies to redress the long-term imbalances.

## A. The Norms of Generational Equality vs. Shared Sacrifice

The most obvious norm, upon which Kotlikoff and his co-authors explicitly rely, is simple cross-generational equality of tax rates.<sup>108</sup> Every generation should pay a lifetime net tax rate no higher than the last. Other than symmetry, though, there is no apparent philosophical imperative behind this norm. Indeed, since the whole notion of

would require a 45 percent reduction in Social Security benefits, a 53 percent cut in Medicare benefits, or changes of a similar magnitude.") While Gale and Orszag's paper also presents long-term FG projections, the extra information that those projections provide is marginal at best. At the very least, it is difficult to imagine how a policymaker who was not moved to action by the 10-year estimates would be somehow spurred by estimates of problems arising in 2080 or beyond. gal Repository

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See Diamond, supra note, at 1.

lifetime net tax rates tells us nothing about real after-tax living standards, there is no obvious reason to be concerned about lifetime net tax rates at all.

Recognizing this, Shaviro argues for the norm not of equal tax rates but of shared sacrifice. "With respect to generational distribution, once the members of a given age cohort have died, they can no longer be asked to share in the pain of tax increases or benefit reductions."<sup>109</sup> In other words, it is important to take the benefits away from the old people now because they are alive now. While there are certainly colorable (but highly debatable) arguments that the elderly over-consume,<sup>110</sup> the current elderly also have a strong argument that they earned it.

#### **B.** How Much is Enough?

It is possible, as noted earlier, that even a decision by the government to consume economic resources rather than to invest them will not harm future economic prospects. This will happen if the resources that the government purchases for its use would have been used to produce private consumption rather than private investment. Conceptually, if the government throws a wild party by hiring the people who would have worked at a privately-funded wild party, then future generations are unaffected. It is only if the government's party is (at least indirectly) staffed by computer programmers and construction workers that the future productive capacity of the economy is reduced.

This, however, still leaves open the question of why we must maximize what we pass on to our heirs. Given that economic growth is generally on an upward trend, why is

109 Shaviro, supra note \_\_\_, at 155. See Cohen, supra note\_SS Legal Repository

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it necessary to give our wealthy grandchildren even greater wealth? The bipartisan (within the economics profession as well as among politicians) silence on this question is notable, to say the least. While there have been preliminary attempts to estimate how much capital should be produced for future generations,<sup>111</sup> the unspoken norm is quite blunt: We should not do anything to reduce the standard of living that we bequeath to our children and grandchildren from the higher level that we have already guaranteed them.

The assumption that future generations are entitled to "their" share is tendentious. The higher living standard that future generations will enjoy arises from productivity gains that are themselves largely the results of technological innovations for which those future generations will not be responsible. If workers in the automated plant of 2030 can be expected to produce many more widgets per hour than their 2005 predecessors thanks to the invention of a robot in 2005, it is hardly clear that the 2030 workers are entitled to all the fruits of this productivity gain, even on Lockean premises.

Shaviro offers an interesting defense of favoring (richer) future generations, on utilitarian grounds.<sup>112</sup> He suggests that, precisely because future generations are likely to have higher standards of living, they might value a marginal dollar more highly than we currently do. While thought-provoking, this argument is simply a variation on the notion of "utility monsters," i.e., rich people whose subjective enjoyment from increased consumption is so much greater than other people's enjoyment that a utility-maximizing social planner would continue to shift consumption to them from poor people because the

<sup>&</sup>lt;sup>111</sup> See N. Gregory Mankiw, Macroeconomics, 2000.

<sup>&</sup>lt;sup>112</sup> Daniel N. Shaviro, *Reckless Disregard: The Bush Administration's Policy of Cutting Taxes in the Face of an Enormous Fiscal Gap*, 45 B.C.L.Rev. 1285, 1330 (2004).

monsters' increase in happiness is, in the aggregate, worth it. Redistribution from poor to rich would, under such an assumption, increase total utility.

This argument, while innovative, is simply too conjectural to guide policymakers. If we are to start redistributing upward because rich people might like consumption more than poor people do, then we can redistribute to any favored group for the same reason. More importantly, as Shaviro concedes, this argument provides no way to measure how much is enough.<sup>113</sup> Even if we were to agree that future generations' ability to enjoy their wealth might be relatively high, that does not tell us that every policy that results in smaller increases in GDP is a utilitarian loss.

Perhaps it is time, therefore, at least to question that assumption. (Moreover, although the subject for a different essay, it is equally important to account for the "intergenerational unfairness" created by problems such as environmental damage.) Although many analysts (including the present author) would be unlikely to call for policies that would absolutely decrease future living standards, there is still plenty of room for debate regarding how much of an increase is enough.

## C. The Real Inter-Generational Issues

The very language of intergenerational transfer is, therefore, potentially misleading. Indeed, it is not possible to "pass the bill to future generations" for our current spending.<sup>114</sup> When the government uses economic resources, the rest of the economy currentlycannot use those resources. (This, of course, assumes that those resources were going to be used at all. Given the prolonged slack in the global economy,



even that assumption is often contestable.) That means that *we* pay for what *we* do, in the fundamental sense of opportunity cost.

Future generations are, of course, affected by these decisions, too. If, as discussed earlier, the government's decisions are likely to decrease the net capital stock that is passed on to future generations, then their output will be lower *than it would otherwise be*. Therefore, the best approach is to think about how the government is using current resources. If it is investing them, then future generations will benefit. If it is consuming them (or simply wasting them), then they will not.

Even more fundamentally, it is not at all obvious that cutting benefits to seniors today will hurt only seniors. When the elderly lose benefits, they can turn to their children to make up the difference. Even if they do not do so directly, they can consume more of their estate than they otherwise would have, thus reducing the wealth of their children. This incidence question indicates just how difficult it is to measure meaningfully the impact on different generations of our fiscal policies.

## VI. Conclusion

The traditional debate about budget deficits witnessed a divergence between the economic analysis, which saw that deficits are poorly measured in the U.S. and argued that certain deficits are actually beneficial for the economy, and the political view that every deficit is evidence of moral failure. This peculiar stalemate is currently on hold, as the brief era of surpluses gave way to the (hopefully even more brief) era of terror and war, leading to a decreased emphasis on fiscal orthodoxy and tolerance for relatively high
annual deficits into the foreseeable future—even though most of those deficits are not related to terrorism or war.

In place of a debate over our general fiscal status, political leaders are currently focused on the supposed long-term problems faced by the Social Security system. While a need might ultimatelyarise to make some adjustments to future Social Security benefits and tax rates, the evidence available to this point does not call for immediate action but rather cautious monitoring of future developments.

In addition, an alternative approach to budgeting, the computation of Fiscal Gaps and Generational Accounts (FG/GA), has emerged over the last fifteen years. Designed to correct some of the analytical weaknesses of annual budgeting and to extend to the entire budget the long term analysis usually associated only with Social Security projections, FG/GA purports to provide an early-warning system to allow us to correct our broader long-term fiscal imbalances before it is too late. Unfortunately, as appealing as this approach is in theory, it is based on highly contestable assumptions, makes questionable analytical choices, and is inherently incapable of providing the useful baseline that its proponents promise. While long-term estimates of huge fiscal imbalances must obviouslynot be ignored out of hand , the case for responding to the current estimated fiscal gap is undermined by those estimates' sensitivity to highly volatile assumptions.

Perhaps surprisingly, then, the best response is for policymakers to continue to rely on the current (admittedly imperfect) budget measures, which at least provide some useful guidance regarding the immediate and intermediate effects of our fiscal policies. Annual and 10-year forecasts of deficits are admittedly arbitrary, but they tell us what today's politicians are committing us to over time horizons that permit relatively reliable measurement. While it is always wise to look at all of the available evidence, current policy is not well measured or guided by long-term fiscal policy estimates.



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