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# ALTERNATIVE APPROACHES TO BUDGETING: IMPROVING LONG-TERM DECISIONMAKING IN GOVERNMENT

## HEARING

BEFORE THE

## JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

ONE HUNDRED SECOND CONGRESS

SECOND SESSION

JUNE 11, 1992

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# ALTERNATIVE APPROACHES TO BUDGETING: IMPROVING LONG-TERM DECISIONMAKING IN GOVERNMENT

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**THURSDAY, JUNE 11, 1992**

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
*Washington, DC.*

The Committee met, pursuant to notice, at 10:20 a.m., in room 2247, Rayburn House Office Building, Honorable Lee H. Hamilton (vice chairman of the Committee) presiding.

Present: Representative Hamilton

Also present: Charles Stone, professional staff member.

## OPENING STATEMENT OF REPRESENTATIVE HAMILTON, VICE CHAIRMAN

REPRESENTATIVE HAMILTON. The Joint Economic Committee will come to order.

Today's hearing will focus on one of the most important problems we face in government today, our failure to adequately take into account the long-term impacts of our budget decisions.

Persistent large budget deficits are one obvious symptom of this problem, but the real problem seems to be that we tend to favor current needs over future needs, in a way that ultimately hurts productivity and long-term economic performance.

We're fortunate to have three witnesses who can discuss these longer-term issues associated with budget policy, and perhaps suggest changes in budget presentations or procedures that can give greater prominence to a longer-term perspective in budgeting.

Herbert Stein is a senior fellow at the American Enterprise Institute, a former chairman of the Council of Economic Advisers, and author of *Governing the Five-Trillion-Dollar Economy*.

Sidney Winter is chief economist, the General Accounting Office, which has just issued a report, *Budget Policy—Prompt Action Necessary To Avert Long-Term Damage to the Economy*.

And Laurence Kotlikoff, professor of economics, Boston University, author of the book, *Generational Accounting–Knowing Who Pays and When and For What We Spend*.

Gentlemen, we're very, very pleased to have you with us today. Your written statements will be entered into the record in full. I'll ask you to summarize those statements to open up our discussion, and then we'll turn to questions.

Mr. Stein, we'll begin with you and just move across the table, from my left to right.

Mr. Stein, please proceed.

**STATEMENT OF HERBERT STEIN, SENIOR FELLOW, AMERICAN ENTERPRISE INSTITUTE**

MR. STEIN. Thank you, Mr. Chairman. Thank you for holding this hearing and for your courtesy in accommodating my various problems in scheduling this meeting.

I appreciate your concern with the long-term consequences of our federal budget policy. I don't think you should imply by your concentration on the long term that our short-term consequences are all optimum, either. I think the trouble with our budget policy is that it doesn't meet either our short-term or our long-term needs.

The obvious shallowness of current discussion and consideration of fiscal matters points to the need for better ways to think about the budget.

For example, we talk about the budget deficit as if it were a sin, which excludes the possibility of any realistic, pragmatic decision about the deficit.

The decision to have a deficit is like all other fiscal decisions—it has effects on the economy, some negative and some positive. These effects are in principle measurable and subject to a comparison of costs and benefits. But present attitudes rule out rational consideration of the deficit.

Many people are obsessed by the difference between taxing and spending, and by the belief that cutting taxes is always a virtue and increasing expenditures is always a vice.

The Administration, for example, is all for giving a tax credit to first-time homebuyers. I am sure they would be appalled at the notion of giving out checks, which would appear as budget expenditures, to the same homebuyers. In a great many cases, increasing expenditures and cutting taxes are just alternative ways of achieving the same objective, and do not deserve the emotional attachments that people have for the distinction.

We characteristically ignore the fact that budget decisions are two-sided transactions that both give and take away. The discussion of cutting the capital gains tax is a case in point. There is much talk about the investment that would be stimulated by such an action, but no one, except a few grumpy economists, ask where the savings will come from to finance that investment.

We mandate expenditures by state and local governments and by private businesses, and act as if these expenditures were free because they do not appear in the federal budget.

I think it is fair to say that much of the time, in making fiscal decisions, we simply do not know what we're doing and are not even thinking about what we are doing in terms of the real effects of our actions on objectives we are interested in.

We need a procedure that will inform and discipline budget policy by insisting on two principles.

First, budgeting is a process of allocating a limited resource among competing uses so that devoting more to one use requires devoting less to some other.

And second, the limited resource that is to be allocated is the total national output, which I am old-fashioned enough to call the GNP, still.

The idea that the government should think of itself as allocating the GNP is surprising to many people and even offensive to some. But it is only a recognition of reality. The Federal Government cannot escape from profoundly influencing the use of the whole GNP and the part of it that is in the budget.

The deficit influences private investment. The forms of taxation influence the direction of private consumption. The deductibility of fringe benefits, for example, influences private expenditure on medical care. Transfer payments influence private consumption.

If the government is to look at what it is doing, it has to look at what it is doing to the use of the whole GNP.

Moreover, the idea of budgeting as the allocation of a given resource requires looking at the GNP, not the federal budget. The size of the federal budget is not given, but it's controlled by the government itself. The government can escape the discipline of having to choose among competing claims by expanding the size of the total budget. But it cannot escape that discipline with relation to the GNP, which it does not control.

My proposal is that the government should make and explain its budget policy at the most general strategic level in terms of the effect of the policy upon the division of the national output among its major uses. I have suggested that these uses might be classified as defense, consumption of the not poor, consumption of the poor, education, health, private investment, public investment, and the general administrative functions of government.

This particular classification is not critical to the idea, and I can imagine that the classification would change from time to time as national concerns changed.

I have spelled this idea out at some length in a book, *Governing the Five-Trillion-Dollar Economy*, published in 1989. I have also discussed it in an article, "America's Second Fiscal Revolution," which was first published in the same year, and I attach a copy of the article and would like to have it included in the record.

Thank you.

[The prepared statement of Mr. Stein, along with an attachment, follows:]

## PREPARED STATEMENT OF HERBERT STEIN

The obvious shallowness of current discussion and consideration of fiscal matters points to the need for better ways to think about the budget.

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We mandate expenditures by state and local governments and by private businesses, and act as if these expenditures were free because they do not appear in the federal budget.

I think it is fair to say that much of the time in making fiscal decisions we simply do not know what we are doing and are not even thinking about what we are doing—in terms of the real effects of our actions on objectives we are interested in.

We need a procedure that will inform and discipline budget policy by insisting on two principles:

1. Budgeting is a process of allocating a limited resource among competing uses, so that devoting more to one use requires devoting less to some other.

2. The limited resource that is to be allocated is the total national output (which I am old-fashioned enough to call the GNP still.)

The idea that the government should think of itself as allocating the GNP is surprising to many people and even offensive to some. But it is only a recognition of reality. The Federal Government cannot escape profoundly influencing the use of the whole GNP and not just that part that is in the budget. The deficit influences private investment. The forms of taxation influence the direction of private consumption. The deductibility of fringe benefits, for example, influences private expenditure on medical care. Transfer payments influence private consumption. If the government is to look at what it is doing it has to look at what it is doing to the use of the whole GNP.

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My proposal is that the government should make and explain its budget policy, at the most general, strategic level, in terms of the effect of the policy upon the division of the national output among its major uses. I have suggested that these uses might be classified as defense, consumption of the not-poor, consumption of the poor, education, health, private investment, public investment and the general administrative functions of government. This particular classification is not critical to the idea and I can imagine that the classification would change from time to time as national concerns changed.

I have speed this idea out at some length in a book, *Governing the $Five Trillion Economy*, published in 1989. I have also discussed it in an article, "America's Second Fiscal Revolution," that was first published in the same year. I attach a copy of the article and would like to have it included in the record.

# *America's Second Fiscal Revolution*

The Great Depression of the 1930s, with an assist from John Maynard Keynes, created a fiscal revolution in America, a new way of thinking and acting about the budget. Before the revolution, the budget problem was how to provide and pay for a limited list of uniquely governmental functions absorbing a small fraction of the national income. Calvin Coolidge, for example, presided over a budget equal to about 3 percent of GNP and devoted almost entirely to defense, interest, care of veterans, the post office, and the administration of justice.

The Depression focused attention on the role of the budget as a stabilizer of the economy. It brought us "functional finance," in which the function of the budget was to affect aggregate demand in a way that would yield full employment and, it was hoped, price level stability.

This new way of thinking led to several specific developments. One was the Employment Act of 1946, assigning new responsibilities to the Government, with the clear implication that the budget was to be the major instrument for carrying out these responsibilities. From the Employment Act we got the Council of Economic Advisers (CEA) and the Joint Economic Committee. A natural consequence was the emergence of the troika as the central body for making economic policy in the executive branch of the Government. Composed of the Treasury secretary, the budget director, and the CEA chairman, it reflected the assumed interaction of the budget and the aggregate performance of the economy.

The view of stabilization as the critical economic function of the budget gave rise to new ways of measuring the budget—the unified budget, the national income accounts budget, and the high employment budget—and to much research by economists on the relations between the budget, total output, employment, and the price level. And, to a considerable degree, this view of the budget function affected the policy that was actuallv followed.

But now we need, and I believe we are in the process of getting, a second fiscal revolution. It is not a revolution counter to the one that began fifty years ago. That revolution already has been subject to much revision. What I am talking about is something entirely different. It deals with the role of the budget as an allocator of the national output, a subject that needs new consideration regardless of how the budget is to be managed in relation to the stabilization problem.

This new revolution will address four basic facts:

1. The federal budget now directly absorbs, through its expenditures, more than 20 percent of GNP.
2. Probably half of federal budget expenditures goes to nonfederal sectors—private, state, or local—and covers healt education, investment, and, most of all, personal consumption.
3. The federal Government strongly influences the direction of uses of the national output that are not ordinarily considered federal, not only through expenditures but also through taxes, borrowing, and regulations. Federal borrowing affects private investment. Federal tax provisions affect private spending for health. Federal regulations affect private spending for protecting the environment, and so on.
4. There is a national interest, justifying governmental concern, with many of the private uses of the national output that federal policy affects.

Given these facts, it would appear that the Government ought to be responsible for the allocation of the entire national output, not just the federal budget. It should use the budget and other policies of Government as instruments for effectuating the desired allocation of the national output. It should make the decisions about the desired allocation of the national output as self-consciously, as explicitly, and with as much information as possible.

The main object of my book *Governing the $5 Trillion Economy* is to explain the importance of this approach and to suggest ways of implementing it.

## Using Our National Output

This way of looking at the budget, this second fiscal revolution, is necessary not only because it would be neat and logical but also because it addresses today's most important economic problem: we are not using our national output wisely. Although we are enormously rich, with a real national output previously undreamed of, we seem unable to do many of the things we expect we should be able to do. We find ourselves lacking in our ability to defend ourselves, educate our children, take care of the poor, and provide for the future. Others might describe our deficiencies differently, but that does not change the basic point.

TABLE 1
Use of National Output

| | Percentage of 1986 GNP |
|---|---|
| Investment owned by Americans, including Government investment | 14.3 |
| Defense | 6.6 |
| Health care | 10.3 |
| Education | 6.2 |
| Other consumption by the very poor | 1.9 |
| Other private consumption | 54.7 |
| Other federal uses of output | 1.3 |
| Other state and local uses of output | 3.8 |
| Government transfers and interest payments abroad | 0.9 |

Source: All data except consumption by the poor from Bureau of Economic Analysis, Department of Commerce, National Income and Product Accounts, and Survey of Current Business. Consumption by the poor based on author's estimates.

What I am saying no doubt immediately raises in some minds the specter of "national economic planning"—a subject on which I have written my share of scandalized criticism. Some imagine a federal czar squeezing the entire national output into the cells of a giant 1,000-by-1,000 matrix of the economy. This is not what I am talking about at all. I am talking about the allocation of the national output among a few—say, ten—uses where the federal influence is large and inevitable, where there is a strong national interest in the allocation, and where the federal influence is exerted without serious discrimination among individuals or power over them. Table 1 shows the categories I am thinking of, together with an estimate of the share of the national output they absorbed in 1986, the latest year for which necessary data are available.

Others might construct a different list. Some might want to add housing and research, or drop the distinction between consumption of the very poor and other consumption. Such differences are not critical to my proposal. What is important is that the list should exhaust the national output, so that if there is to be more of something on the list there has to be less of something else. The list should carry out the basic principle that the cost of something is the other things that must be forgone to get it.

I can illustrate the meaning of my proposal by referring to the very real issue that first made me think of it. In 1969, when I became a member of President Nixon's Council of Economic Advisers, I was made head of a task force to study the economic consequences of decisions about the size of the defense program. We very quickly realized that the most obvious cost of an increase or decrease of the defense program was that less or more of the national output would be left for nondefense uses.

Moreover, the effect would not be on nondefense uses in general. Which of several major categories of nondefense uses would be affected would depend upon policy decisions about finance that would inevitably accompany the defense decision. If a larger defense program were financed by borrowing, there would be less investment, which, in the conditions of 1969, we thought mainly would translate into less housing. If taxes were raised, there would be less private consumption. If federal grants-in-aid were cut, there would be fewer state and local services.

Furthermore, we thought that the question of whether an increase of the defense program was worthwhile could not be separated from the question of which share of the national output would be sacrificed to achieve it. So we were already in the process of thinking about making a budgetary decision within the context of a decision about allocation of the national output among a few major categories.

## Being Superficial or Being Explicit

My continuing interest in this subject has been fueled by what has seemed to me the dangerously superficial way in which we have been thinking about the defense program to this day. People keep talking about being unable to "afford" a larger defense program. I think they should be saying that they prefer some other use of the national output, such as private consumption or investment. If people could be induced to be explicit about these preferences, they would make better decisions.

The same superficiality is apparent in the talk about the federal deficit. We have gotten over saying that a deficit of a certain size is necessary to achieve high employment or is dangerous because it will cause inflation. So we are left with no anchor for considering the proper size of the deficit or surplus—no national objective for which that decision is consequential. We therefore rely on totally arbitrary targets, like Gramm-Rudman-Hollings.

I propose that we look upon the deficit or surplus as an instrument for influencing the amount of investment owned by Americans and determine the size of the deficit or surplus by deciding how much of the national output should go for that rather than for consumption or defense or the other major purposes I would distinguish.

I am trying to demythologize the talk about the budget and deficits and taxes and spending. I want to promote talk about the budget in which expenditures and taxes and deficits are not considered totems, or ends-in-themselves, but are looked upon as instruments for achieving certain uses of the national output. Decisions about these instruments should be made by reference to the character and magnitude of their effects on the allocation of national output.

Thinking about the budget *initially* as an instrument for allocating the national output has three main advantages:

1. It gets us closer to the goals we are really interested in rather than just thinking about variables like deficits and taxes. Of course, categories like investment, private consumption, and total health expenditures are not the ***ultimate*** objects of policy either. But they are much closer to the ultimate objects—welfare or social solidarity or whatever—than the numbers we usually talk about.

2. Allocating the national output brings home the point that decision-making involves choice and that if you want more of something, you have to have less of something else. The national output is, in the short run at least, a given total, and you cannot allocate more than 100 percent of it. But the size of the federal budget is not a given, and you can always make it appear that more is being given to one purpose without less to another by making the total larger.
3. Allocating the national output eliminates the possibility and temptation to evade the constraints of the budget by recourse to other policies, such as regulations, that have similar effects. The most notable current instance is the proposal to establish national health insurance by requiring employers to provide insurance for their workers. If one looks only at the federal budget, that seems devoid of cost. But it does involve devotion of more of the national output to medical care and, consequently, less to something else. A GNP budget would reveal that.

A less obvious case would be an effort by the President, as is sometimes suggested, to use his "bully pulpit" to induce states, localities, and private parties to spend more for education. This would also involve a shift in the use of resources, which would have its costs, and, if the amounts were large enough, they would show up in the GNP budget.

Of course, I am not suggesting a law enacting the GNP budget and saying how much of the national income should go for investment or for consumption or for others of the grand categories that would be identified. I am only talking about a framework for thinking about and discussing the budget and for proposing and evaluating the specific tax, expenditure, borrowing, lending, and regulating programs of the Government.

## Setting Priorities

I visualize a President some day saying in his State of the Union message what he thinks the country's main priorities are. He would tell us what he thinks we most need—whether it is more economic growth to provide for the future or a higher standard of living for the great mass of Americans or strengthened national security or whatever it may be. He would indicate what changes in the allocation of the national output would conform to those priorities—what changes in the proportions of the national output should go to investment, or to private consumption, or to defense. And if he suggests that some uses should be increased, he would have to suggest which uses should be reduced.

All of this would be preliminary and explanatory, but the President would base upon it a set of specific proposals for taxes, expenditures, lending, borrowing, and regulations intended to conform to those priorities. The statement of priorities and desired allocations of the national output, at the level of generality that I am suggesting, would not uniquely determine the specific proposals.

If the desire, for example, is to reduce the share of the national output going to consumption by Americans who are not poor, there still remain many questions about how to do that. Should taxes be raised? If so, which ones? Should social security benefits or farm subsidies or other transfer payments be reduced? Similar questions would be raised about the means for implementing other goals for the allocation of the national output. At this point all the usual questions about equity and efficiency would arise, but they would arise within the context of some objectives that had been explicitly stated.

Many of the proposals made these days for reforming the budget process would fit comfortably with the suggestions I have made. We need, for example, a longer-run—four- or five-year—budget to guide the major expenditure and revenue decisions. We need two-year appropriations. We need to reduce drastically the number of appropriation items into which the budget is divided, in order to focus the attention of Congress on the big issues and cut down on micromanagement. We need cooperation between the White House and the congressional leadership in the early stages of budget development. My proposal would put another level of decision-making on top of all that in order to relate the usual tax and expenditure actions to the grand allocations of the national output and through that to the grand national priorities.

## Two Complaints

Aside from the worry about planning, which I have already discussed, the proposal to "budget the GNP" has elicited two main complaints. One is whether we know enough to do what is proposed. The idea assumes that we know that if we reduce the deficit, savings and investment will increase, and by how much. It assumes that we know that if we raise taxes, consumption will be decreased, and by how much. It assumes that we know how national expenditures on medical care will be affected if we alter the tax treatment of employers' contributions for health insurance.

We do not, however, "know" such things, if knowing means knowing precisely and with a high degree of reliability. No one is more aware of this than I am, or, at least, no economist has written about our ignorance so much. Though this ignorance is a problem, it is not, in my opinion, a serious objection to my proposal.

The decisions we are now making, and cannot escape making, already imply some answers to questions that we cannot answer precisely and reliably. When these implied answers are exposed to the light of day, we may discover that they contradict what little we do know. Perhaps we will find that the implied answers assume that we know with confidence something that we do not really know at all.

Policy about taxation, for example, assumes that we *know* that a tax increase will be fully matched by an expenditure increase, or that it will depress the economy, or that it will reduce saving by an equal amount, or that it will reduce the revenue. The possibility of prudent decisions would be enhanced by a revelation of the true state of our knowledge about these questions. As Artemus Ward said, "It ain't what we don't know that hurts us, it's the things we know that ain't so."

Allocating the GNP would be a step toward revealing what we need to know anyway in order to make intelligent decisions and toward exposing what we do and do not know. One consequence would be to direct attention to trying to learn more. The second fiscal revolution provides a research agenda for economists, just as the first revolution did, although I hope no one will think that is the motive for it.

One of the most elementary things we need is a more reliable classification of the national output by uses or functions. We cannot now tell very well, for example, how much of the national output goes for education or medical care because in the national income accounts much of the expenditure for these functions is included in the costs of producing other goods and services.

Another major complaint about my proposal is that "It may be good economics, logical and rational, but it isn't politically realistic." Politicians, it is said, have no interest in good economics, logic, or rationality. They do not want to expose the consequences of their actions any more than they have to and they are certainly not looking out for something called "the national objectives."

I have lived in Washington, in and around Government, for fifty-one years and have heard this argument repeatedly. (I also have been in Washington long enough to learn that politicians, political scientists, and political journalists do not know very much about what is "good politics.") I appreciate the force of the argument, but I do not think it is an insuperable objection to trying to introduce more information and rationality into the process, for several reasons:

1. There really is no alternative. Some people think there is an alternative, which is to impose upon "uninformed and unprincipled politicians" a set of rules devised by "outsiders" who are both "informed and principled." Balanced-budget amendments and expenditure-limitation amendments are examples of such rules. But we now see how difficult it is to get the politicians to put those blinkers on, and Gramm-Rudman-Hollings shows how adept the politicians are at evading the rules if they do not accept the reasons for them.

   In any case, such rules at best can deal only with the big aggregates, such as the size of the deficit or total spending. They cannot deal with questions of the direction of expenditures, which may be more important.
2. The utility of my proposal does not depend upon politicians becoming "good," in the sense of more public-spirited and honest. I assume that the politicians will strive to serve their own interests, with as high or as low ethical standards as ever. I want only to transfer the struggle to a better-illuminated playing field. I want the participants to be better informed about the consequences of what they are doing and, especially, of what is being done to them.

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The errors of policy, from the standpoint of the national interest, are partly due to the difference between the interest of the decision-makers and the national interest. But policy errors are also, and to a considerable degree, caused by ignorance all around. It is this second cause of error that I hope to correct. I do not know what to do about the first.

3. The budget reform movement that has been going on in the United States for at least seventy-five years has always been an effort to inject more information about the ultimate consequences of decisions into the decision-making process. This movement has had considerable success over that period.

   Even in recent years there has been progress. The Budget Reform Act of 1974, the increased emphasis on broad categories and long periods in making decisions, the "budget summits" between the White House and the congressional leadership, the general agreement on the need for two-year appropriations, even Gramm-Rudman-Hollings, for all its faults, are steps forward. The proposal to put the decisions in the framework of the allocation of the national output is a logical step in this process and there is no reason to despair of achieving it.

4. In my opinion, movement toward this new way of looking at the budget and other Government policies is not only possible but also highly probable simply because some participants in the struggle will find this movement in their interest. Proponents of higher defense spending, whatever their motives, will not be content with the answer that we cannot afford it. They will want to know why a 10 percent increase in defense spending is less valuable to the nation than a 1 percent increase in private consumption.

   Opponents of mandated national health insurance will ask why we should increase the share of the national output going to medical care—even if it does not show in the budget—when the already-high share shows little benefit. The argument about the size of the budget deficit already is becoming an argument about the share of the national output going to investment, and the consequent effects on economic growth. The competition of claims on the national output will be forced into the arena of real effects because some of the claimants will find their strongest case there and others will have to join them.

I do not count upon politicians alone for improvement of the policy-making process. Much of the leadership in this direction has always come from the private sector, where there are some people with broader and longer interests than politicians may think they can afford. If the public discussion of budget policy focuses on real effects, rather than on symbols and shibboleths, the politicians will have to follow.

REPRESENTATIVE HAMILTON. Without objection, that will be made part of the record. Thank you very much.

Mr. Winter, please proceed.

**STATEMENT OF SIDNEY WINTER, CHIEF ECONOMIST, GENERAL ACCOUNTING OFFICE**

MR. WINTER. Thank you, Mr. Chairman.

I appreciate the opportunity to contribute to your deliberations here on the improvement of long-term decisionmaking in government. This, of course, is a matter of continuing interest and concern to the GAO. And as it happens, we have recently completed a major study that addresses some of these problems.

I understand that the members of the Committee have been supplied with copies of the study, which was originally requested by Senators Bradley and Domenici. That request was later joined by Senator Sasser and by Representative Panetta and yourself, Mr. Chairman.

Long-term planning is essential to good management in a business or a household, or in government. But it is beset with major difficulties because the future is always enveloped in a great cloud of uncertainty.

I'm going to present some projections of the economic future today, and I hope the Committee will receive and consider these in the spirit in which they are offered. We claim no advanced degrees in crystal ball gazing and no special gift of prophecy. The projections are a sort of mirror in which we can examine the logic of recent and current policy and not a forecast of the future as it will be.

Although there are some inescapable difficulties presented by the uncertainty of the future, there is one principle that I would recommend for your consideration as you consider the problems of long-term planning.

There is rarely a good excuse for being blind-sided by demographics. Mostly, demographic factors are quite predictable, deriving, as they do, from the fact that people generally get a year older with each passing year.

Our recent work at the GAO started in fact from the idea that we should explore the implications of a major and quite predictable demographic change. By 2010, some members of the baby boom generation will have retired, some will be retiring, and others contemplating retirement. We will then be at the foot of a long demographic ramp on which the number of retired people per member of the active work force rises with each passing year.

Although it is not inevitable, it does seem very likely that this transition will put downward pressure on living standards.

The working population after 2020 may have to be taxed heavily to support the baby boomers in their retirement. The financing of social security benefits is the most obvious problem here, but only the most obvious. Actually, this problem is much broader, affecting private pension plans as well as the social security trust funds.

As a matter of public policy, it seems that the least we can do for those future workers is to leave them a healthy and highly productive economy to work with. That is also the most that we can do for them, the only way that we can ease the burden of supporting not only themselves, but a large retired population.

In fact, however, the trend of recent policy is in the opposite direction. Instead of acting more concerned about a challenging economic future, we are acting less concerned.

Our key question is this—what is the relationship between the budget deficit and the problem of arriving at the year 2010 with a strong economy? That is the question we tried to illuminate with our projections.

And the starting observation is this—the budget deficit weakens the future economy because it soaks up national savings that would otherwise be available for productive investment. Our first chart shows what has happened. It is derived simply from the saving and investment account of the national income and product accounts, and it shows that in the decade of the 1960s, the federal deficit, as measured on a national income and product account basis, merely nicked the level of savings that were provided by the rest of the economy. By the 1980s, the deficit was taking 50 percent. And in 1990, it has surpassed that level.

To explore the implications of this, we used an economic model which was adapted from one developed by economists at the Federal Reserve Bank of New York. The details of our model are explained in the report, and I can't do it justice here, but let me mention two key features of this model.

First, there is the saving and investment equation of national income accounting that I just mentioned. The total national savings is the sum of savings of persons, businesses, state and local governments, and the Federal Government. The state and local contribution is small and likely to remain so. The contribution of the Federal Government has been negative—that's the federal deficit calculated on the national income and product account basis.

Since the determinants of levels and change in personal and business saving are not well understood, we decided to make a specific, but somewhat optimistic, assumption and leave it there. We assumed saving by the nonfederal contributors at 16.5 percent of GNP, and that leaves the federal deficit as the determinant of changes in the national saving rate.

Our review of federal budgetary trends produced two facts of central importance. First, as projected by the CBO, receipts appear likely to continue at something over 20 percent of GDP, again on a NIIP basis.

Second, there is a trend and a prospect of quite rapid increases in expenditures for health care in the near term and in social security in the long term.

On the basis of projections by actuaries at the relevant agencies, we project an increase in spending for Medicare, Medicaid, and social security of over 5 percentage points of GNP between 1992 and 2020.

While 28 years is a lot of time, 5 percent of GNP is a lot of money. It is roughly what we now spend on defense. It is roughly the size of the current deficit in this fiscal year. And it is five times as large as the nondefense federal payroll.

Let's look at the chart for the no-action scenario and see how these elements fit together.

This chart shows how the dynamic factors interact over the years, or how they would interact if there were a completely passive stance toward the deficit problem. It shows a strong, vicious circle effect, pushing the deficit up. Every year, the deficit detracts from saving and weakens the future economy. But it also adds to the debt, thus increasing future interest costs and future deficits and further weakening the economy.

Ultimately, in this projection, the economy is going down and spending is going up as the system struggles to meet the health care and social security challenge without additional revenues or spending cuts elsewhere.

We do not believe that this fiscal path is plausible or sustainable. It is not plausible at the policy level. It is probably much too extreme in its passivity toward the problem of the budget deficit.

However, if such a policy were pursued, it would probably prove economically unsustainable well before 2020. There are economic mechanisms that are not reflected in the model that would probably force a departure from this path somewhat earlier.

Naturally, having concluded that the no-action scenario was not feasible, we explored alternatives to it. Each involves a particular assumed path for the deficit. We did not, however, identify specific spending cuts or tax changes that might be required to achieve these paths.

This next chart shows the various alternative assumptions that we made. The line headed south on the bottom is the no-action trajectory. Above that, we have a scenario we call muddling through, which assumes that the deficit is held at 3 percent of GNP until 2020. And then we have a balanced budget scenario, where we achieve balance in 2001 and maintain it for the rest of the projection period. And on top, we have the surplus scenario in which we proceed to a 2 percent of GNP surplus in 2005, and then continue that for five years and then phase back down to balance in 2020.

If you have my prepared statement available, you can see the effects of these deficit reduction programs stated in per-capita terms.

Between muddling through and surplus, for example, there's a difference in real GNP per capita of about $3,000 in 1992 dollars.

Even more striking is the ability of the deficit reduction programs to reduce the national debt and the level of foreign indebtedness. In short, the balance and surplus policies break out of the vicious circle process that I described before, while muddling through seems to be always on the brink of getting sucked into the same whirlpool represented by no action.

And on the final chart, you see the different tracks of real GNP itself that our projections generated.

We do not want to leave the impression that increasing national saving is the only thing that needs to be done. There is a critically important set of issues involving the international allocation of capital.

In a competitive world economy, we need to make this nation an attractive place to invest. Public policies affecting human capital, infra- structure and research can help to retain this country's status as a productive platform for economic growth and development. To improve the economic future, we must assure that more funds are made available for private investment through deficit reduction, but also that the investment component of federal spending is strengthened relative to the consumption component.

There is a complementarity between these two sets of policy actions.

Let me conclude, Mr. Chairman, by reiterating the view of the General Accounting Office that the deficit problem requires prompt action, that earlier and stronger action is generally superior, and let me address once more the question of improving long-term decisionmaking.

We hope that our report itself will make a contribution in that direction, and provide the Congress with a basis for addressing the deficit problem and the issue of the investment orientation of the federal budget.

But we recognize that there are many different types of information that could be helpful, and in fact are needed, and that these requirements extend to all levels of aggregation and detail, and to the Executive Branch, as well as the Congress.

In all these cases, we believe that there are opportunities that exist for substantially improving the basis of long-term decisionmaking.

I applaud the Committee's efforts to address these issues, and I would like to thank you once again for the opportunity to appear here.

[The prepared statement of Mr. Winter follows:]

## PREPARED STATEMENT OF SIDNEY WINTER

Mr. Chairman and Members of the Committee:

I appreciate having this opportunity to participate in your hearing on improving long-term decision making in government. As you know, the topic is one that has been of continuing interest and concern to the GAO. Just last week, we released a major new report[1] on budget policy that was prepared at the request of Senators Bradley and Domenici, a request subsequently joined by Senator Sasser and by Representatives Panetta and Hamilton. The report takes a long-term view of the deficit problem and of federal spending priorities. It also identifies areas where better information, presented in more informative ways, may help the Congress to grapple more effectively with the substantive issues.

In my remarks today, I will draw heavily on our new report, focusing primarily on our analysis of the long-term economic consequences of the budget deficit and the benefits that deficit reduction would bring to the economy. I will also address briefly the steps that might be taken to shift federal spending priorities toward investment -- a shift that we believe is badly needed.

BACKDROP: THE NO ACTION SCENARIO

When we began work on this report, one major purpose was to examine the budget deficit as a factor affecting the long-term

[1] Budget Policy: Prompt Action Necessary to Avert Long-Term Damage to the Economy (GAO/OCG-92-2, June 5, 1992).

health of the economy. There is, of course, a broad consensus that the deficit is dangerous to our economic health because it absorbs national savings. As figure 1 shows, the rising deficit in the 1980s and early 1990s coincided with a sharp drop in the net national savings available for investment. The share of net national savings absorbed by the deficit grew from 2 percent in the 1960s to 58 percent in 1990. In earlier work[2], we set forth the reasoning that links the deficit to the saving rate and hence to economic growth, identified several packages of options for deficit reduction, and analyzed the short and medium-term implications of deficit reduction for the economy. Our new effort included a more systematic look at the deficit's long-term implications for economic growth. In particular, we wanted to explore the relationship between the deficit problem and the demographic transition that will occur about 2010, as the baby boom generation begins to retire.

Only when our work was well advanced did we fully realize that our subject, the deficit problem, would itself be transformed in the decades ahead into something quite different from the all-too-familiar deficit problem of the past. The projected levels of the deficit and the national debt for the next few years are important, but become even more so when regarded as the critical starting point for a new and more

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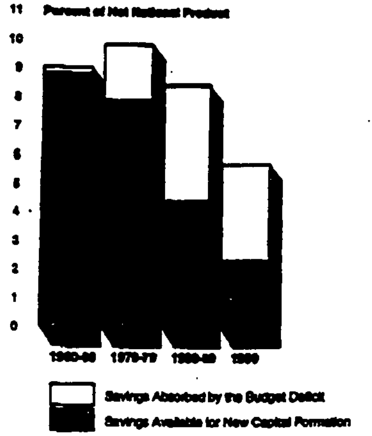
[2] The Budget Deficit: Outlook, Implications and Choices (GAO/OCG-90-5, September 12, 1990), and the companion report Budget Deficit: Appendixes on Outlook, Implications, and Choices (GAO/OCG, September 28, 1990).

dangerous deficit dynamic. The principal drivers of this new dynamic are expenditures for health care, interest, and (particularly after 2010) Social Security.

ure 1: Effect of the Federal Budget
icit on Net National Savings
60-1990)




Source: Economic Report of the President, February 1992

As input to our own economic projections, we used projections of expenditures for Medicare, Medicaid and Social Security prepared by actuaries at the Health Care Financing Administration (HCFA) and the Social Security Administration (SSA). Expressed as percentages of GNP and added together, these show an increase of over five percentage points over the period 1992-2020, or about one percentage point every five and a half years. By itself, of course, this has no implications for the budget deficit. If something is done about it, this expenditure increase need not increase the deficit at all. A period of almost three decades should provide ample occasion to do something about it. In considering what "doing something about it" would involve, however, it is sobering to consider five percentage points of GNP from various perspectives, for example:

-- It is only slightly less than we now spend on defense.

-- It is about the size of the deficit for this fiscal year.

-- It is five times as large as the total federal non-defense payroll, which in recent years has been very close to 1 percent of GNP.

An alternative version of this last perspective: if the non-defense federal payroll were somehow eliminated entirely, the emerging budgetary challenge of Social Security and health expenditures would be successfully addressed for 1.4 presidential terms, and then the problem would have to be addressed again.

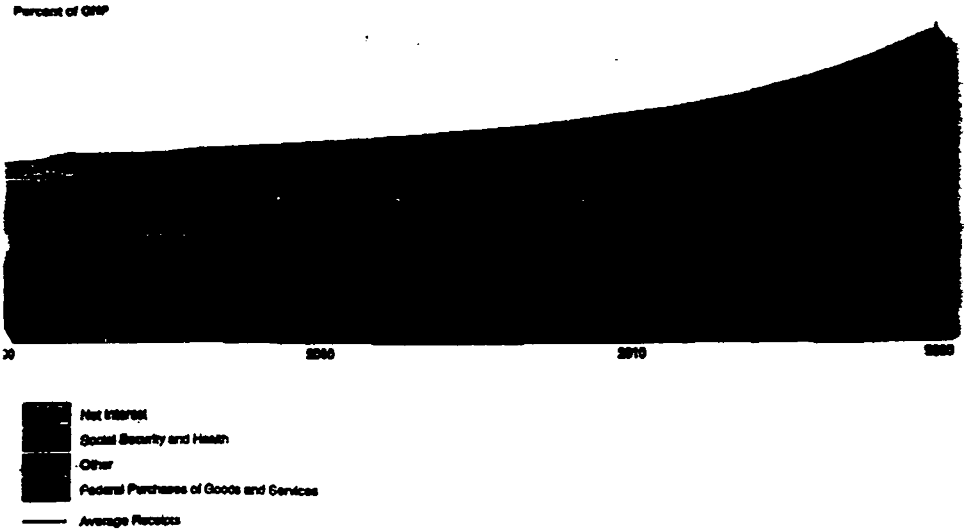
If there are no changes in these three major entitlement programs or major policy adjustments affecting receipts or other spending, the deficit will necessarily increase. Expenditures for net interest on the national debt already absorb about one dollar in seven of federal expenditure; they will rise further as the deficit and the debt increase.

The "no action" scenario in our report links this budgetary outlook to the prospects for economic growth. It assumes that the change in the federal deficit is the principal driver of the national saving rate. Saving from non-federal sources -- individuals, businesses and state and local governments -- is assumed to be a constant 16.5 percent of GNP. Total national saving is non-federal saving plus federal saving -- or, in this case, dissaving in the form of the budget deficit.

To explore the implications of these assumptions, and other discussed subsequently, we used an economic model adapted from one developed by economists at the Federal Reserve Bank of New York. In the model -- and we believe in reality -- a lower saving rate means a lower rate of investment in plant and equipment and other forms of physical capital. Lower investment is reflected in lower output in subsequent years. The model thus provides a picture of the vicious circle linking the deficit, interest costs and the national saving rate. This year's deficit not only reduces this year's national saving rate, it also increases interest costs and deficits in future years, further depressing saving and economic growth. The model and its underlying assumptions are described in our recent report.

Figure 2 shows what the "no action" scenario implies in terms of the behavior of federal expenditures in relation to GNP. We have projected federal expenditures other than Social Security, health and net interest at a constant share of 12.3 percent of GNP, down slightly from recent levels. Federal receipts are a roughly constant share of GNP at around 21 percent of GNP. When Social Security, health and net interest costs are factored in, the result is that expenditures explode to over 40 percent of GNP in 2020, and the deficit to over 20 percent. This dismaying picture reflects all elements of the vicious circle described above. It is not just that Social Security and health care expenditures rise, but that interest costs magnify the effect. And it is not just that the deficit increases, but that economic growth declines as a result. In fact, at the end of the "no action" projection, GNP is actually declining.

ure 2: Federal Expenditures in the No Action Scenario




We do not believe that the no action scenario depicts a plausible policy path. There are, however, at least two distinct reasons why this projection might be implausible. The first reason is that it assumes an extreme policy passivity as the deficit burgeons out of control. Although the temptations of procrastination on the deficit problem are strong, it is hard to credit the notion that such extreme passivity would prevail for such an extended period. The second reason is much less cheerful. *If* the nation were to proceed down such a path for another decade or more, then it is quite likely that our no action projection errs on the side of optimism. A number of the assumptions underlying the projection are conservative in the sense that they neglect economic mechanisms that could produce worse trouble, and sooner. The dismaying picture shown for 2020 may never happen, because even more severe stresses would emerge at an earlier date.

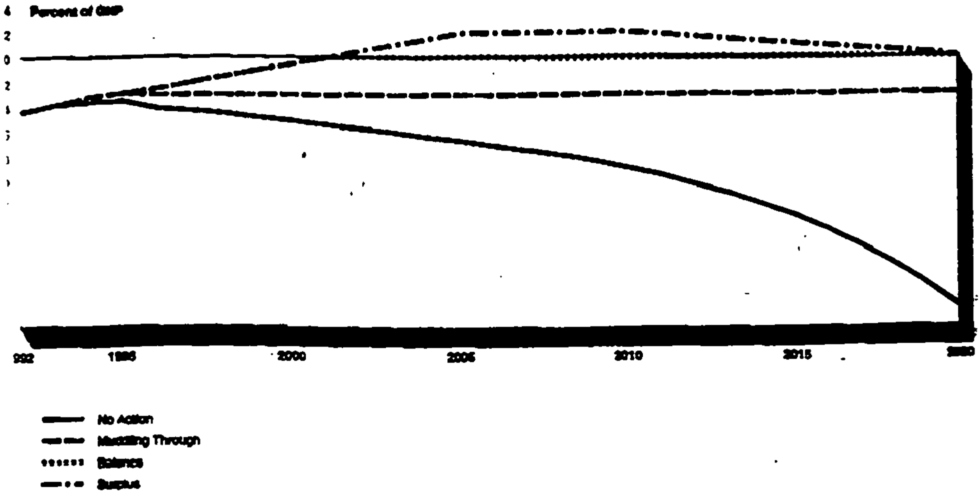
In short, the no action projection makes a compelling case that major policy action must be taken. The question is when and how much.

ALTERNATIVE FISCAL PATHS

Recognizing that the path of "no action" is unsustainable, we examined three alternative approaches to deal with the deficit. Each of these projections involves a particular assumed path for the deficit. The national debt, and with it net interest costs, are assumed to develop according to the assumed deficit path. We identified the magnitude of the policy adjustments required to achieve these paths but not the specific changes in spending and revenues that might be adopted to reach the result.

The first alternative we called "muddling through" because it involves continuing efforts to control the deficit, but no discrete and decisive action. Under "muddling through" the deficit is held at 3 percent of GNP after 1995. We compared this to (1) a path where budget balance is achieved in 2001 and then maintained, and (2) a surplus scenario where a 2 percent budget surplus is reached in 2005, maintained until 2010, and then phased back down to balance in 2020. This last assumption was motivated in part by recognition that the demographic transition beginning about 2010 will itself put downward pressure on living standards, making a higher national saving rate harder to maintain. The important implication is that a major effort to strengthen the economy for the long term should be completed by 2010.

Figure 3: Alternate Deficit/Surplus Paths (1992-2020)



The three alternative paths for the deficit are shown in figure 3, along with the result of the no action scenario.

Our analysis of the three alternative paths shows that the balance and surplus paths present strong advantages relative to muddling through. During the early part of the period, the muddling through option seems easier, but as time passes the amount of policy action required to maintain the 3 percent deficit becomes larger and larger. The largest problem of all is at the end of the projection period. To hold the deficit to 3 percent of GNP in 2020, the deficit reduction actions affecting that year (whenever they might be enacted) would have to total half a trillion 1992 dollars. Adopting either a balance or surplus path would provide the greatest benefit to the long-term health of the economy. As shown in table 1, real GNP would grow significantly while both foreign debt and public debt shrink toward zero.

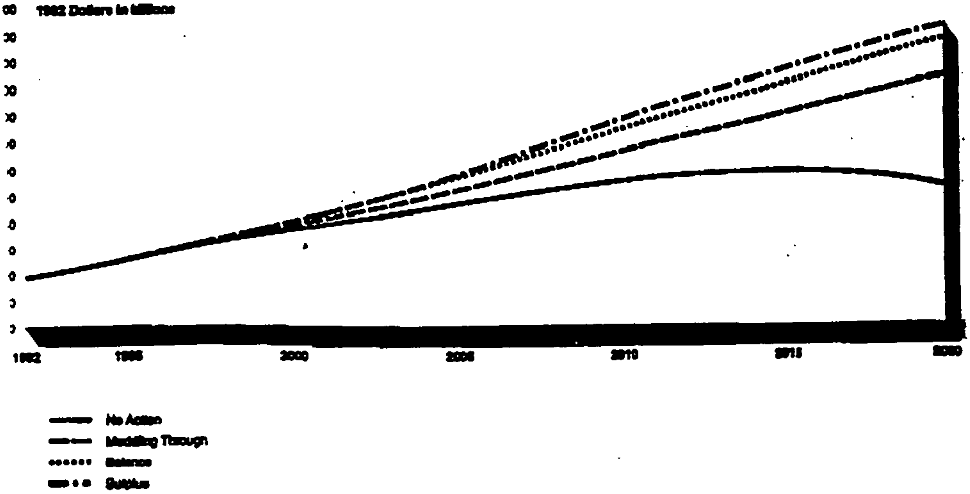
Table 1: Results of Alternative Deficit Paths for 2020
(Per capita 1992 dollars)

| Deficit Paths | Real GNP | Foreign Debt[a] | Debt Held By the Public[a] |
|---|---|---|---|
| No action | $23,875 | $19,243 | $45,816 |
| Muddling through | $30,374 | $ 8,460 | $16,702 |
| Balance | $32,555 | $ 3,748 | $ 4,665 |
| Surplus | $33,353 | $ 1,979 | $ 219 |

a The value identified as "foreign debt" in the table is the negative of the Net International Investment Position; the narrow term "debt" is not strictly appropriate. Also, the value for foreign debt and federal debt held by the public cannot meaningfully be added, since some of the U.S. debt held by the public is held by foreigners and forms part of the Net International Investment Position.

Figure 4 shows the different GNP growth paths generated by our different assumptions about the deficit and national saving.

ure 4: Real GNP (1992-2020)

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Since the major purpose of deficit reduction is to use more of current output for investment and less for consumption, it is no surprise that consumption is adversely affected in the near term. More stringent deficit reduction measures produce correspondingly larger adverse effects. In the long term, however, the higher national saving rate brought about by deficit reduction is reflected in higher levels of consumption as well as in greater output and reduced indebtedness.

Choosing either the balance or the surplus policy path can be a preemptive strike against the inexorable spiral driven by Social Security, health and interest payments. These policies reduce the national debt in relation to GNP; indeed, the surplus path virtually eliminates it. In the long term, shrinking the claim of interest costs on the budget can make room for the rising expenditures on Social Security and health -- or, if those programs themselves are reduced, permit tax reductions or finance other needed expenditures.

The economy that emerges from the balance and surplus scenarios in 2020 is a healthy economy, capable of meeting the needs and aspirations of Americans in the years after that. By contrast, the economy that emerges from "muddling through" is a sick economy threatened by the prospect of serious crisis.

## THE INTERNATIONAL DIMENSION

Recently, the U.S. system of national income and product accounts was revised to make Gross Domestic Product (GDP) rather than Gross National Product (GNP) the primary measure of national output. This step brought the U.S. system of accounts into conformity with those used in most other countries. As has already become apparent, we nevertheless used the GNP in our analysis. The GNP is the superior measure when, as here, national saving and investment rates are central issues.

The difference between the GNP and the GDP is the Rest of the World (ROW) account. The ROW account reflects the incomes that Americans receive from earnings on assets located abroad, less the amount of income foreigners receive from earnings on assets located in the United States. The model employed in our projections incorporates a simple representation of the determination of these income flows. Essentially, the rest of the world is treated as analogous to a bank where the U.S. can make deposits or withdrawals or draw on a credit line. Every year there are income flows to or from this bank, corresponding to interest received on deposits or paid on advances. The quantity corresponding to the bank balance (positive or negative) is the Net International Investment Position (NIIP) of the United States. Every year, the level of the NIIP changes for a variety of reasons. One of these is captured in the model -- the level of net foreign investment (NFI), which is the excess of amount that Americans invest abroad over the amount that foreigners invest in the U.S.

The international dimension of the long-run economic outlook is important, contentious and analytically difficult. In the

1980s, an inflow of foreign capital permitted the U.S. to sustain domestic investment in the face of a decline in national saving. The associated shift in the Net International Investment Position in the course of the decade is imposing in magnitude: almost one trillion 1992 dollars. The long-term price of this reliance on foreign capital is that future profits and interest payments will flow abroad. Metaphorically speaking, while it is nice to have the bank credit line available if you are a little short, it is better not to be a little short in the first place.

By the same token, one of the benefits of increased national saving achieved through deficit reduction is that reliance on foreign capital will be reduced, and the Net International Investment Position may improve. Such an improvement would be a useful complement to increased domestic investment. Increasing our national "bank balance" -- or at least stopping its decline -- is a sensible way to prepare for a future in which there will be fewer American workers to support the population.

There is another side to this story, however. Foreign investment flows respond not just to the availability of savings, but also to the attractiveness of investment opportunities. And more attractive investment opportunities mean more jobs and a more prosperous economy, regardless of whether the investment is financed from domestic or foreign savings.

International capital flows thus establish an important link between the problem of the deficit and the other major concern of our new report, federal spending priorities. A major shift in the nation's fiscal policy is long overdue, but simply making more resources available for private investment will not be enough. In a competitive world economy, we need to make this nation an attractive place to invest. Public policies encouraging the development of human capital, infrastructure, and research will help retain this country's status as a productive platform for economic growth and development. In this regard, it is particularly disturbing that federal programs oriented toward investment actually lost ground in the 1980s, surpassed as a share of GNP by federal interest payments and health care spending.

IMPROVING LONG-TERM DECISION MAKING

The analysis that I have outlined here, and that is presented in greater detail in our report, is itself intended to improve long-term decision making. It provides a long term perspective on the consequences of the deficit, the character of spending trends, and the implications of demographic factors. We hope that it will aid the Congress in setting a course away from the major hazards that confront us and toward a more prosperous economic future.

Thus, one suggestion for improving long-term decision making would be to continue to pursue the kind of analysis that we have undertaken, so as to establish a better framework for decision making year by year. Current practices place too little emphasis on the future effects of either aggregate fiscal policy or the displays the likely impacts of current decisions on long-term growth would help focus the debate on the choices we face. The significant but short-term sacrifices of deficit reduction could be more easily compared to the long-term benefits accruing from such changes in budget policy.

Any process that promotes a long-term focus would also direct attention to how the components of federal spending affect long-term productivity and growth. Although federal programs vary greatly in their impacts on the economy, the present budget process and structure do not encourage decision makers to take these differences into account in allocating resources.

Further, there is no framework to consider the investment implications of federal tax policy subsidies, such as depreciation rules or the research and experimentation tax credit, when making decisions on related spending programs. If planning for long-term economic growth is to become a central feature of the budget process, a new framework for decision making is needed -- one in which the choice between consumption and investment spending is highlighted throughout the decision process rather than being displayed for information purposes after the fact.

If such a framework were in place, the Congress, each year, could determine explicitly the aggregate funding for total investment-related programs, as well as for the physical capital, human capital and research and development components of that total. To support such a decision process focusing on investment choices, improvements would be needed in the tools and information used to evaluate the relative impacts or rates of return of the various federal investment programs, to ensure that limited federal resources are used to promote the best choices among competing strategies and programs. Better information and a stronger long-term focus are needed throughout the budget process, at all levels of aggregation or detail, and in the Executive Branch as well as in the Congress.

In our report, we present a modified version of GAO's proposal for a revised budget structure that would distinguish between capital and operating expenses. The modification involves a new distinction between "federally-owned capital" and "developmental investments" -- essentially, the distinction is between investment in capital assets that the federal government itself uses and investment that strengthens the economy as a whole. We believe that this structure provides helpful insight and would help to support a long-term focus in decision making. We are not, however, under the illusion that this proposal is a silver bullet. Where information to support decision making is concerned, there are no silver bullets -- and if there were, we would still need good management in implementing the decisions. There are, however, numerous opportunities to provide better informational support for decision making that we have provided in the past.

REPRESENTATIVE HAMILTON. Thank you very much, Mr. Winter.

Mr. Kotlikoff, please proceed.

**STATEMENT OF LAURENCE J. KOTLIKOFF, PROFESSOR OF ECONOMICS, BOSTON UNIVERSITY**

MR. KOTLIKOFF. Mr. Chairman, I am honored by this opportunity to discuss U.S. fiscal policy, specifically the critical need for long-term decisionmaking in federal budgeting.

If there was ever a time for long-term fiscal planning, it is now. The U.S. economy stands at a crossroads. Our nation is a saving and investing at rates comparable to those of less developed countries.

Last year's net national saving and investment rates were only 1.7 percent and 2 percent, respectively. Both of these rates represent postwar lows.

Nations that fail to invest experience slower growth in labor productivity, and consequently slower growth in real wages. This is certainly the U.S. experience.

Postwar U.S. fiscal policy appears, in large part, responsible for our failure to save and invest. For four decades in a row, our government, at the federal, state and local levels, has played pass-the-generational buck. Pass-the-generational-buck refers to shifting fiscal burdens from older generations to younger and future generations.

Our game of pass-the-generational-buck has, to a considerable extent, let those generations who retired during the past four decades off the hook for paying for the government's bills, with the consequence that those who are now middle-aged and young, as well as those who will be born in the future, are paying and will be paying very, very high taxes, leaving them with very little left over from which they can save.

What can we do to stop further rounds of pass-the-generational-buck?

The answer, Mr. Chairman, is certainly not to pass the balanced budget amendment. Down deep, we know that this will just end up in another round of smoke and mirrors bookkeeping. What we don't know, and what we need to know, is the likely size of the fiscal burden to be piled on our children's and grandchildren's shoulders.

Unfortunately, we'll never learn the answer to that question by focusing on the federal deficit.

First, there are almost as many definitions of the deficit as there are economists. The Congressional Budget Office is so confused as to which deficit to discuss that it has taken to reporting five different figures, ranging from 2 percent to 7 percent of the gross national product.

To which of the five deficit definitions or the many other definitions that economists can invent, and politicians as well, will the balanced budget amendment apply?

Second, the deficit only tells us about our immediate cash flows. It ignores the future, including the demographic changes that will over 35 years leave the United States with the same age profile as current-day Florida.

Will balancing the budget be sufficient to keep tax rates from soaring when the baby boomers retire?

Third, even if we could all agree on the definition of the deficit, the deficit would still miss most of the government's redistribution across generations. The colossal growth since 1950 of pay-as-you-go social security and Medicare is a prime example. While the taxes collected by these programs have in the past years equaled benefits that they paid out and thus have not increased the deficit, the programs have redistributed huge sums across generations.

The generations fortunate enough to be old during the buildup of these programs receive much more in benefits than the sum of principal-plus-interest on their prior tax contributions. The consequence is that middle-aged and young Americans will receive substantially less in benefits than the sum of what they contributed, plus interest.

There are other examples of generational redistribution which did not show up in the deficit, and I don't have time to go into them. But I think we need to understand that the deficit is really not telling us the central question that needs to be addressed.

Now, rather than fret about this number, the federal deficit that tells us really next to nothing from the perspective of economic analysis, why not measure directly how much current and future generations are being asked to pay and will be asked to pay? This generational accounting is not a pie-in-the-sky alternative to deficit accounting. The accounts have been calculated; indeed, they were published in the President's budget for fiscal year 1993. They provide a very troubling picture of the burden that federal, state and local governments are imposing on our progeny.

Today's children will pay more than 40 percent of their lifetime incomes to the government. Even worse, future generations, those born after the year 2000, will face a 60 percent or greater lifetime net tax rate, unless current policies are changed and changed soon.

Even a 40 percent lifetime tax rate is a huge proportion when compared with the lifetime tax rates paid by today's older generations and by previous generations.

If we are to begin to make conscious social choices about generational policy, we need a means of directly measuring the generational consequences of our policies. Generational accounting constitutes such a means. It provides a comprehensive view of the treatment by federal, state and local governments of current and future generations. It can be used to compare the fiscal burdens to be foisted on future generations with those facing current newborns. It can also be used to assess the gains and losses to different generations of specific policy changes.

It remains to be seen whether information about the imbalance of generational policy makes a difference to our actual policies. If our society is truly present-oriented, as we seem to have been in our actions of the last four decades, then the intergenerational policy imbalance may even be allowed to worsen. But there are limits to the burdens that we can foist on our descendants.

For 1990, as I mentioned, male and female newborns are estimated to pay over 40 percent of their lifetime incomes to the government. If future males and females are forced to pay substantially more, as much as 60 to 75 percent of their lifetime incomes, this lifetime tax may not be collectable. And if we can't levy such large taxes on future Americans, then the arithmetic of generational accounting implies that we're going to have to levy larger taxes or give less in the way of transfers to current generations—those of us who are currently alive.

So we are really on a collision course with respect to the treatment of different generations, including those who are currently alive.

Thus, it is in our interest, as well as in the interest of our descendants, to start immediately bringing our generational policy into balance. Congress should take the lead in this regard by, first, abandoning its use of ill-defined cashflow deficits as a guide to fiscal policy. Second, by establishing an independent board, similar to the trustees of the Social Security Administration, to provide the Congress and the Administration with a generational accounting of each of its major policy proposals and decisions on an ongoing basis. And three, to outline a time path of fiscal policy that will eliminate the grave imbalance in generational policy now facing our Nation.

Thank you.

[The prepared statement of Mr. Kotlikoff follows:]

## PREPARED STATEMENT OF LAURENCE J. KOTLIKOFF

The Need for Long-Term Fiscal Planning

Mr. Chairman and Members of the Joint Economic Committee, I am honored by this opportunity to discuss U. S. fiscal policy, specifically the critical need for long-term decision-making in Federal budgeting. If there was ever a time for long-term fiscal planning, it is now. The U.S. economy stands at a cross-roads. Our nation is saving and investing at rates comparable to those of less developed countries. Last year's net national saving and investment rates were only 1.7 and 2.0 percent, respectively. Both of these rates represent postwar lows. Nations that fail to invest experience slower growth in labor productivity and, consequently, slower growth in real wages. Since 1970 the productivity of U.S. workers has increased at just over 1 percent per year, which is 60 percent less than the productivity growth rate recorded from 1950 through 1969. It's only about a third of the Japanese rate during the same period. Total compensation (wages plus fringes) per employee in the U.S. has increased in real terms by less than 3 percent since 1975. This is a terribly poor record considering that in the 15 years leading up to 1975 total compensation per worker rose by 35 percent.

Postwar U.S. fiscal policy appears, in large part, responsible for our failure to save and invest. For four decades in a row our government (federal, state, and local) has played "pass the generational buck." "Pass the generational buck" refers to shifting fiscal burdens from older generations to younger and future generations. Our game of "pass the generational buck" has, to a considerable extent, let those generations who retired during the past four decades off the hook for paying for the government's bills, with the consequence that those who are now middle aged and young, as well as those who will be born in the future, must pay considerably more in taxes net of transfers as a share of their lifetime incomes that would otherwise have been the case. Today's children can expect to pay almost 40 percent of their lifetime incomes to the government. Those born in the future will face a much higher tax rate on their lifetime incomes unless U.S. fiscal policy is changed and changed soon. Because today's workers are paying such high taxes, they have relatively little funds left over from which to save.

The process by which "pass the generational buck" reduces national saving, investment, and growth is gradual, making it difficult to document statistically. But in the past decade economists have developed detailed fiscal policy simulation models to study the consequences of postwar U.S. generational policy. These models predict precisely the kind of decline in national saving and investment that our nation is experiencing.

Will Budget Balance Restrict Our Passing the Generational Buck?

How can we gain control of our generational policies to prevent further passing of the generational buck? The answer is certainly not by adopting a balanced budget amendment. Running a balanced budget is no guarantee that we will stop playing pass the generational buck. Indeed, most postwar intergenerational redistribution reflects policies that had little or no impact on the level of official government debt. The most important of these policies is the expansion of "pay-as-you-go" Social Security and Medicare. While the taxes collected by these programs have historically equaled the benefits they paid out, and thus have not increased the deficit, these programs have, nonetheless, redistributed huge sums across generations. Those generations who were fortunate enough to be old during the buildup of these programs received very much more in benefits than the sum of principal plus interest on their prior tax contributions, with the consequence that middle aged, young, and future Americans will receive substantially less in benefits than the sum of what they contributed plus interest.

A second example of postwar generational policy that has been missed by the deficit is the very significant shift in the U.S. tax structure away from sales and excise taxes, which disproportionately fall on the elderly, toward labor income taxes, which disproportionately fall on the young. In 1950 labor income taxes represented a third of total government taxes. Today they represent almost three-fifths. Does it matter whether one pays the same amount of taxes when young or when old? It certainly does once one realizes that in deferring paying taxes until old age, one can earn a great deal of interest on the deferred tax payment.

Balancing the Budget Through Redefinition

Unfortunately, in paying attention to the Federal deficit, we are paying attention to the wrong number, or, should I say numbers, since no one seems to agree on which deficit is the correct deficit. In its recent projection of the FY93 deficit, the Congressional Budget Office reported a variety of deficits, ranging from 7 percent to 2 percent of GNP — a roughly $300 billion difference. To which of these five deficit definitions, or the myriad other possible definitions, will the balanced budget amendment apply? The answer, I fear, is the definition that will require the least fiscal adjustment. This fear is borne out by the pending balanced budget legislation which reverses the 1990 redefinition of the deficit, which left the social security surplus out, by including the social security surplus for purposes of achieving budget balance. We have here a perfect example of what the balanced budget amendment will produce — balancing the budget through redefining the deficit.

**Using Generational Accounting to Look Beyond Our Immediate Cash Flows**

Even setting aside the problem of defining the deficit, the deficit, at best, tells us only about our immediate cash flows. It completely ignores the future, including future changes in demographics that will, in the course of 35 years, leave the U.S. with the same age-profile as modern day Florida. Will balancing the Federal budget be sufficient to keep tax rates from soaring when the baby boomers retire? If not, why should we be targeting for a balanced budget. Shouldn't we be trying to run surpluses?

Rather than obsessing about a number — the Federal deficit — that tells us next to nothing about our true generational policies, why not simply measure directly how much current and future generations are being asked and will be asked to pay? Such generational accounting is not a pie-in-the-sky alternative to deficit accounting. The accounts have been calculated, indeed, even published in the President's FY93 budget. They provide a very troubling picture of the fiscal burden federal, state, and local governments are collectively imposing on our progeny through deficit and non deficit policies alike.

Like the Social Security Administration's Annual Trustee's Report, generational accounting looks at our future fiscal finances in light of projected demographic change. But unlike the Trustee's Report, which considers only a single aspect of the Federal government's fiscal policy, namely social security, generational accounting considers all federal, state, and local fiscal policy programs.

**Balancing the Government's Intertemporal Budget**

Generational accounts indicate not only what existing generations will pay, but also the likely payments required of future generations. The burden on future generations is determined by working through what economists call the government's intertemporal budget constraint. This constraint says that the present value of the government's spending on goods and services cannot exceed the sum of three terms: 1) the government's net wealth, 2) the present value of net payments by current generations (the sum of the generational accounts multiplied by the number of people in each generation), and 3) the present value of net payments of future generations. At any point in time we can project the present value of the government's spending and also estimate terms 1) and 2). By subtracting 1) and 2) from the present value of government spending we can determine the aggregate present value burden on future generations. According to the intertemporal budget constraint, all spending that the government cannot cover through its net worth or through net taxes assessed on current generations must be obtained from future generations. This is the zero-sum nature of generational policy alluded to above.

Generational accounting automatically deals with each of the major concerns raised by those who mistakenly think the deficit is conceptually sound, but simply needs adjustment. It deals with inflation by measuring all payments and receipts in inflation-adjusted (constant) dollars. It does capital accounting by netting all the government's real assets against all its real liabilities (including liabilities such as the S&L bailout) to form the value of government net worth which is ultimately used to help determine the burden on future generations. It directly considers the government's implicit obligations to future transfer payments (e.g., on food stamps) and future spending (e.g., on national parks) and the public's implicit obligations to pay future taxes. It accounts for state and local as well as federal government fiscal policy. Finally, in projecting transfer payments, spending, and taxes through time and the implied burden on future generations, generational accounting deals with how the levels of these fiscal variables will grow through time, including growth arising from demographic change.

1990 Generational Accounts

Table 1 presents 1990 generational accounts for males and females, respectively, for every fifth generation alive in 1990. The first column, denoted "net payment," indicates the present value difference between the taxes and transfers that members of these generations will pay, on average, over their remaining lives. The remaining columns show that this present value net payment is the difference between the present value of remaining lifetime labor income taxes, capital income taxes, payroll taxes, and excise taxes less the present value of remaining Social Security transfers, health transfers (Medicare and Medicaid), and welfare and other transfers. All NIPA taxes and transfers of Federal, state, and local governments are included in the analysis.

As the tables show, young and middle aged generations will pay, in the future, substantially more taxes in present value than they will receive in transfers. For males who were age 40 in 1990, the present value of projected taxes is $177,400 more than the present value of projected transfers. For newborn males the present value net payment is smaller, $76,400. Children in general have a smaller fiscal burden than young and middle age workers because they will not pay much in the way of taxes for a number of years. Net fiscal burdens are largest for those generations in their late twenties and early thirties, reflecting the fact that they are nearing their peak tax paying years. Older generations, who are largely retired, have negative net fiscal burdens; in present value terms, these generations will receive more social security, Medicare, Medicaid, and other future benefits than they will pay in taxes. Women have a smaller fiscal burden than men, mostly because they earn less income and, therefore, pay less income and social security taxes.

The generational accounts are strictly forward-looking and, as such, do not take into account the taxes paid to the government in the past or the transfers received from the government in the past. This point needs to be kept in mind in considering the accounts of those currently alive. The fact that 40 year old males can expect, in present value, to pay more in the future than they receive, while the reverse is true for 65 year old males, does not necessarily mean the government is treating 40 year old males unfairly. Males who are now 65 years old paid considerable taxes when they were younger, and those past taxes are not included in this analysis. Consequently, a direct comparison of the accounts of these two generations is inappropriate. The usefulness of generational accounting is not in such comparisons, but rather in 1) analyzing the intergenerational effects of a particular policy change by comparing the values of the generational accounts with and without that change and 2) comparing the fiscal burdens on newborns and future generations (the last row in the tables) that will occur under existing policies. For both these comparisons, all the taxes and transfers being analyzed are in the future. These comparisons, therefore, rather than the initial baseline level of the accounts, should be the focus of attention.

To understand in per capita terms the size of the total burden to be imposed on all future generations, let us assume the total burden is spread smoothly across all future generations, such that each new generation's burden keeps pace with the economy's rate of productivity growth. Then knowing the total amount future generations will pay and projecting the number of people showing up in the future, one can determine the growth-adjusted burden (generational account) on the average Americans who will be born in the future.

As Table 1 indicates, if policy toward those generations now alive is not changed, future generations - those born in 1991 and beyond — are projected to bear a 79.2 (136.9/76.4 - 53.2/29.7 - 1.792) percent larger fiscal burden than will 1990 newborns. The $136,900 net burden of future males and the $53,200 net burden of future females assume that all those of a particular sex born in the future pay the same amount over their lifetimes after adjusting for growth. They also assume that the ratio of net burdens of future females to that of future males is the same as for newborns in 1990.

The growth adjustment is needed because future generations can be expected to pay more taxes net of transfers received since their incomes will be higher. To assess properly the excess burden to be imposed on future generations, it is necessary to calculate the increase in the fiscal burden that is above and beyond the amount that would arise due to economic growth. The growth adjustment may be understood by considering the present value net fiscal burdens of successive newborns. First, take the case of males. Those males born in 1991 pay $136,900 times the growth factor, which equals one plus the growth rate. Those males born in 1992 pay $136,900 times the growth factor squared. Those males born in 1993 pay $136,900 times the growth factor cubed. And so forth. Next consider females. Females born in 1991 pay $53,200 times the growth factor. Those born in 1992 pay $53,200 times the growth factor squared. And so forth.

The generational policy imbalance is sensitive to the assumption that all future generations of a particular sex bear the same growth-adjusted burden. As an alternative, suppose one assumes that those generations born over the 10 year period 1991-2000, pay, on a growth-adjusted basis, the same as newborns born in 1990; in other words, suppose these 10 generations escape, because of a delay in the inevitable policy adjustment, having to pay higher taxes net of transfers received. Then the growth-adjusted fiscal burdens of those born after 2001 will be 138 percent larger, rather than 82 percent larger, than the payments of 1990 newborns. In short, the more generations born after 1990 who fail to pay growth-adjusted amounts that exceed those of 1990 newborns, the larger will be the net fiscal burden on subsequent future generations.

The alternative to future generations bearing a larger fiscal burden than current newborns is for Americans now alive to pay more, on net. If all Americans alive as of 1990 were to pay, over their remaining lives, 8 percent more in taxes, the growth-adjusted burden on future Americans would be equalized with that of 1990 newborn males and females at the present value amounts of $84,000 and $35,000, respectively. Alternatively, if all Americans alive as of 1990 were to received, over their remaining lives, 35 percent less in transfer payments, the growth-adjusted burden on future Americans would be equalized with that of 1990 newborn males and females at the present value amounts of $80,000 and $35,000.

### The 1990 Budget Agreement from the Perspective of Generational Accounts

To see how generational accounting can be used to evaluate generational effects of policy changes, let's consider in the first column of Table 2 the The Omnibus Budget Reconciliation Act of 1990 (OBRA) from the perspective of generational accounting. This column shows the difference between the 1990 baseline generational accounts (columns one of Table 1) and the 1990 generational accounts that would have prevailed in the absence of OBRA. Had OBRA not been enacted future generations of males would have had to pay $10,700 more on a growth-adjusted basis, and future generations of females would have had to pay $3,100 more. This reduction in the fiscal burdens on future Americans came at the cost of increased fiscal burdens on current generations. For males alive in 1990, these increased burdens range from $1,500 for newborns, to $2,900 for 30 year-olds, to $300 dollars for 80 year-olds. For females alive in 1990, the increased burdens range from $1,100 for newborns, to $2,000 for 30 year-olds, to $300 for 80 year-olds.

Illustrative Policy Changes

The second, third, and fourth columns of Table 2 further illustrate the use of generational accounting in analyzing policy changes. Column two shows the change in the 1990 generational accounts that would result from a conversion of Social Security to pay-as-you-go finance. In this simulation Social Security taxes are adjusted on an annual basis so that the Social Security's trust fund's receipts from taxes, interest, and other sources are just enough to meet projected Social Security benefit payments. While this policy would lower fiscal burdens on Americans alive in 1990 who were in their teens or older, the reduced fiscal burden on these generations would come at the price of a larger fiscal burden on American children alive in 1990 as well as future Americans.

The third and fourth columns of Table 2 show the impact on the 1990 generational accounts of two alternative time-paths of government health care spending. The baseline accounts incorporate HCFA's middle scenario projection of total government health care spending through 2030. After 2030 health care spending, apart from demographic change, is assumed to grow at the assume rate of productivity growth. Columns three and four show the change in generational accounts that would result from stabilizing health care spending either after 1995 or after 2000. The figures in column three are based on HCFA's projections of health care spending through 1995. After 1995 health care spending is assumed to grow due to demographic change and the assumed productivity growth. In column four the HCFA projections are used through 2000, after which health care spending again grows at the assumed productivity growth rate with an adjustment for demographic change.

Since the HCFA projections through 2030 assume faster growth in health care spending than is assumed after 1995 in the case of column three and 2000 in the case of column four, the policies of columns three and four entail less Medicare and Medicaid transfer payments to existing generations than underlie the baseline generational accounts. The associated increase in fiscal burdens facing existing generations due to earlier stabilization of health care spending means a smaller fiscal burden on future generations. As the numbers in columns three and four indicate, the impacts of early stabilization of health care spending on different generations can be quite significant. If health care spending is stabilized after 1995, the fiscal burdens of future generations of males and females are reduced by $45,000 and $13,000, respectively. If health care spending is stabilized starting in 2000, the fiscal burden on future generations of males and females will be reduced by $26,600 and $7,100, respectively. With the health care spending scenario of column three there is a 15.5 percent difference in fiscal burdens of future generations and newborns. With the health care spending scenario of column four there is a 40.8 percent difference. These results indicate that even if government health care spending relative to GNP is stabilized later in this decade (a scenario that many analysts view as unlikely), the imbalance in generational policy will still be quite substantial.

## Conclusion

If we are to begin to make conscious social choices about generational policy we need a means of directly measuring the generational consequences of our policies. Generational accounting constitutes such a means. It provides a comprehensive view of the treatment by Federal, state, and local governments of current and future generations. It can be used to compare the fiscal burdens to be foisted on future generations with those facing current newborns. It can also be used to assess the gains and losses to different generations of specific policy changes.

The application of generational accounting to the United States suggests a very sizable imbalance in U.S. generational policy. The 1990 baseline estimate reported in the President's FY93 Budget indicates that future Americans will pay, in present value, almost 80 percent more in taxes over their lifetimes net of transfers received than will Americans who have just been born. This larger fiscal burden is above and beyond the larger net tax payments that future generations will pay due to economic growth. This generational imbalance can be eliminated with a number of fiscal policies. Specifically, curtailing growth in government purchases of goods and services and health care spending can make a significant contribution to restoring balance in the fiscal treatment of current and future generations of Americans.

It remains to be seen whether information about the imbalance of generational policy makes a difference to our health care spending and other policy decisions. If our society is truly present-oriented, as its policies over the past 40 years suggest, then the intergenerational policy imbalance may even be allowed to worsen. But there are limits to the burdens that can be foisted on our descendants. As mentioned, for 1990 male newborns the lifetime net tax burden (their generational account) is estimated to be 40 percent of their lifetime income. If future males are indeed forced to pay 80 percent more than current newborns on a growth-adjusted basis, their lifetime net tax bills will equal 72 percent of their lifetime incomes. The size of this potential lifetime net tax is so large that its collection may be infeasible. But if such large taxes can't be levied on future Americans, the arithmetic of generational accounting implies that current generations — namely those of us alive today — will ultimately experience significant increases in our lifetime net tax payments.

Thus it is in our own interest as well as the interest of our descendants to start immediately bringing our generational policy into balance. Congress should take the lead in this regard by 1) abandoning its use of ill-defined cash-flow deficits as a guide to fiscal policy, 2) establishing an independent board, similar to that of the Trustees of the Social Security Administration, to provide the Congress and the Administration with a generational accounting of each of its major policy proposals and decisions, and 3) to outline a time-path of fiscal policy that will eliminate the grave imbalance in generational policy now facing our nation.

Table 1

The Composition of Male Generational Accounts as of 1990

Present Values of Receipts and Payments

(thousands of dollars)

| Generation's Age in 1990 | Net Payment | Payments: Labor Income Taxes | Capital Income Taxes | Payroll Taxes | Excise Taxes | Receipts: Social Security | Health | Welfare |
|---|---|---|---|---|---|---|---|---|
| 0 | 76.4 | 28.6 | 10.9 | 30.3 | 26.3 | 5.5 | 10.9 | 3.3 |
| 5 | 98.1 | 36.7 | 14.1 | 38.9 | 30.5 | 6.8 | 11.1 | 4.2 |
| 10 | 123.6 | 46.9 | 17.9 | 49.7 | 34.8 | 8.2 | 12.1 | 5.4 |
| 15 | 154.8 | 59.9 | 23.0 | 63.5 | 38.9 | 10.0 | 13.7 | 6.9 |
| 20 | 182.2 | 71.3 | 28.7 | 75.9 | 41.4 | 11.9 | 15.1 | 8.1 |
| 25 | 196.8 | 76.5 | 35.5 | 81.5 | 42.5 | 14.1 | 16.6 | 8.5 |
| 30 | 201.1 | 77.1 | 42.7 | 82.3 | 42.8 | 17.1 | 18.5 | 8.1 |
| 35 | 195.2 | 74.0 | 49.8 | 79.1 | 42.3 | 21.2 | 21.3 | 7.5 |
| 40 | 177.4 | 67.5 | 55.3 | 72.3 | 40.7 | 26.6 | 24.9 | 6.9 |
| 45 | 146.3 | 58.1 | 58.2 | 62.3 | 37.8 | 34.5 | 29.3 | 6.4 |
| 50 | 103.9 | 46.7 | 57.8 | 50.2 | 34.0 | 44.9 | 34.2 | 5.8 |
| 55 | 52.2 | 34.5 | 54.2 | 37.1 | 29.9 | 58.5 | 39.8 | 5.2 |
| 60 | -6.4 | 21.5 | 47.9 | 23.3 | 25.6 | 74.5 | 45.7 | 4.6 |
| 65 | -58.3 | 9.7 | 40.0 | 10.5 | 21.4 | 83.0 | 52.9 | 4.0 |
| 70 | -65.1 | 4.3 | 31.6 | 4.6 | 17.5 | 71.7 | 47.9 | 3.5 |
| 75 | -58.2 | 1.9 | 23.9 | 2.1 | 14.0 | 55.7 | 41.6 | 2.8 |
| 80 | -47.5 | 0.6 | 18.2 | 0.6 | 11.0 | 41.8 | 34.3 | 1.9 |
| 85 | -35.8 | - | 15.1 | - | 8.9 | 31.6 | 27.3 | 0.8 |
| 90 | -2.0 | - | 6.9 | - | 1.8 | 5.8 | 4.9 | - |
| Future Generations | 136.9 | | | | | | | |
| Percentage Difference Future versus Age Zero | 79.2 | | | | | | | |

Source: "Generational Accounts Presentation," Budget of the United States Government Fiscal Year 1993.

Table 1 (continued)

The Composition of Female Generational Accounts as of 1990

Present Values of Receipts and Payments

(thousands of dollars)

| | | Payments | | | | Receipts | | |
|---|---|---|---|---|---|---|---|---|
| Generation's Age in 1990 | Net Payment | Labor Income Taxes | Capital Income Taxes | Payroll Taxes | Excise Taxes | Social Security | Health | Welfare |
| 0 | 29.7 | 16.1 | 4.1 | 17.0 | 24.0 | 6.1 | 18.7 | 6.6 |
| 5 | 41.0 | 20.6 | 5.2 | 21.8 | 27.9 | 7.5 | 18.6 | 8.5 |
| 10 | 53.5 | 26.3 | 6.7 | 27.9 | 32.5 | 8.9 | 20.1 | 10.9 |
| 15 | 67.8 | 33.5 | 8.6 | 35.6 | 37.2 | 11.0 | 22.3 | 13.8 |
| 20 | 79.4 | 39.4 | 10.7 | 42.0 | 40.6 | 13.2 | 24.3 | 15.7 |
| 25 | 83.4 | 40.5 | 13.3 | 43.3 | 42.5 | 15.8 | 26.2 | 14.1 |
| 30 | 81.4 | 39.0 | 16.7 | 41.6 | 43.1 | 18.7 | 28.7 | 11.6 |
| 35 | 74.8 | 36.4 | 20.4 | 38.9 | 42.6 | 22.1 | 32.2 | 9.3 |
| 40 | 62.5 | 32.7 | 23.7 | 35.0 | 41.1 | 26.0 | 36.7 | 7.3 |
| 45 | 42.6 | 27.9 | 26.2 | 29.9 | 38.5 | 31.9 | 42.4 | 5.6 |
| 50 | 15.4 | 22.3 | 27.4 | 23.9 | 35.1 | 40.1 | 48.9 | 4.3 |
| 55 | −19.4 | 16.1 | 27.2 | 17.3 | 31.2 | 51.5 | 56.1 | 3.5 |
| 60 | −58.0 | 10.0 | 25.4 | 10.8 | 27.1 | 64.8 | 63.4 | 3.0 |
| 65 | −88.4 | 5.1 | 22.4 | 5.5 | 23.1 | 70.9 | 70.9 | 2.7 |
| 70 | −90.0 | 2.2 | 18.5 | 2.3 | 19.4 | 64.9 | 65.0 | 2.4 |
| 75 | −81.0 | 0.7 | 14.0 | 0.7 | 16.0 | 54.0 | 56.3 | 2.1 |
| 80 | −67.5 | – | 9.3 | – | 13.0 | 42.5 | 45.7 | 1.7 |
| 85 | −53.0 | – | 4.7 | – | 10.5 | 32.3 | 34.6 | 1.3 |
| 90 | −8.1 | – | 0.5 | – | 1.8 | 5.0 | 5.2 | 0.2 |
| Future Generations | 53.2 | | | | | | | |
| Percentage Difference Future versus Age Zero | 79.2 | | | | | | | |

Source: "Generational Accounts Presentation," Budget of the United States Government Fiscal Year 1993.

Table 2

**Changes in Generational Accounts Arising from Four Alternative Policies**

(thousands of 1990 dollars)

| | Eliminating OBRA | Reverting to Pay-As-You-Go Social Security Finance | Stabilizing Health Care Spending After 1995 | 2000 |
|---|---|---|---|---|
| **Males** | | | | |
| **Ages** | | | | |
| 0 | -1.5 | 4.0 | 3.1 | 1.9 |
| 5 | -1.8 | 3.4 | 3.6 | 2.2 |
| 10 | -2.1 | 2.3 | 4.0 | 2.5 |
| 15 | -2.5 | 0.7 | 4.7 | 2.9 |
| 20 | -2.8 | -1.2 | 5.2 | 3.3 |
| 25 | -2.9 | -2.7 | 5.9 | 3.8 |
| 30 | -2.9 | -3.7 | 6.8 | 4.4 |
| 35 | -2.8 | -4.3 | 8.0 | 5.3 |
| 40 | -2.6 | -4.5 | 9.5 | 6.3 |
| 45 | -2.3 | -4.2 | 11.1 | 7.2 |
| 50 | -2.0 | -3.5 | 12.3 | 7.4 |
| 55 | -1.6 | -2.7 | 12.7 | 6.5 |
| 60 | -1.2 | -1.7 | 11.2 | 4.9 |
| 65 | -0.8 | -0.8 | 8.6 | 3.2 |
| 70 | -0.6 | -0.3 | 6.0 | 1.8 |
| 75 | -0.4 | -0.2 | 3.5 | 0.7 |
| 80 | -0.3 | -0.1 | 1.7 | - |
| 85 | -0.2 | - | - | - |
| 90 | -0.1 | - | - | - |
| Future Generations | 10.7 | 4.6 | -45.0 | -26.6 |
| Percentage Difference Future versus Age Zero | 97.1 | 76.0 | 15.5 | 40.8 |

Source: "Generational Accounts Presentation," Budget of the United States Government Fiscal Year 1993.

Table 2 (continued)

**Changes in Generational Accounts Arising from Four Alternative Policies**

(thousands of 1990 dollars)

| | Eliminating OBRA | Reverting to Pay-As-You-Go Social Security Finance | Stabilizing Health Care Spending After 1995 | Stabilizing Health Care Spending After 2000 |
|---|---|---|---|---|
| **Females** | | | | |
| **Ages** | | | | |
| 0 | -1.1 | 2.0 | 5.1 | 3.1 |
| 5 | -1.3 | 1.6 | 5.7 | 3.5 |
| 10 | -1.5 | 0.9 | 6.4 | 3.9 |
| 15 | -1.8 | - | 7.2 | 4.4 |
| 20 | -2.0 | -0.9 | 8.0 | 5.0 |
| 25 | -2.1 | -1.6 | 8.8 | 5.6 |
| 30 | -2.1 | -1.9 | 10.0 | 6.4 |
| 35 | -2.0 | -2.1 | 11.5 | 7.4 |
| 40 | -1.9 | -2.2 | 13.4 | 8.7 |
| 45 | -1.7 | -2.0 | 15.5 | 9.9 |
| 50 | -1.4 | -1.7 | 17.2 | 10.4 |
| 55 | -1.2 | -1.2 | 18.0 | 9.6 |
| 60 | -0.9 | -0.8 | 16.5 | 7.8 |
| 65 | -0.7 | -0.4 | 13.3 | 5.5 |
| 70 | -0.5 | -0.2 | 9.8 | 3.3 |
| 75 | -0.4 | -0.1 | 6.1 | 1.4 |
| 80 | -0.3 | - | 2.9 | - |
| 85 | -0.2 | - | - | - |
| 90 | - | - | - | - |
| Future Generations | 3.1 | 2.6 | -13.0 | -7.1 |
| Percentage Difference Future versus Age Zero | 97.1 | 76.0 | 15.5 | 40.8 |

Source: "Generational Accounts Presentation," Budget of the United States Government Fiscal Year 1993.

REPRESENTATIVE HAMILTON. Thank you very much, gentlemen. We'll turn to discussion.

Let's begin with addressing the question: How does the short-term focus that we have when we make our budget decisions affect our economic performance as a nation?

MR. KOTLIKOFF. Well, I think, in looking at our cashflow deficits, we are missing a lot of the real underlying action.

As I mentioned, if you consider what has happened to social security and Medicare over the last four decades—these programs have grow from essentially zero to 6 or 7 percent of GNP. This growth was financed basically on a balanced budget basis, and did not show up in our cashflow federal deficit.

But those programs, as I just mentioned, effected this huge intergenerational redistribution, which allowed generations who were older at the time to consume more, and are leaving those who are currently middle-aged and young, and future generations with lifetime net tax bills. And as a result, we have saved less and have less left over right now from which to save.

So I think, in looking at these cashflow numbers, which are not really giving us the answer to any specific question, we are really avoiding asking the more interesting and important questions, which are how exactly are we fiscally treating different generations, not only this year, but over their entire lifetimes? And had we been doing generational accounting, we would have seen that, year after year, as we jacked up the social security and Medicare programs, that the bill for that was falling on our children and grandchildren.

REPRESENTATIVE HAMILTON. One of the things that strikes me about your comments on generational accounting, Mr. Kotlikoff—and it's a very creative way of looking at the budget—is that it really does single out the generational impact with respect to the budget. You identify that as the most important, if not the exclusive, problem that you confront with the budget.

But isn't that a rather narrow focus on the budget, just to look at it in generational terms?

MR. KOTLIKOFF. Well, as I pointed out in my book, there are four fundamental aspects of fiscal policy, as I understand it.

One is the generational policy. Another is the level of government spending. The generational policy is basically which generations are going to pay for that spending. The level of government spending has have been a fairly stable fraction of GNP for the last few decades.

So what I see as the real policy that we've been conducting is not raising the spending as a share of GNP, but really changing who is going to pay for it, and pushing the burden of paying for that onto future generations.

The other two policies that are fundamental to fiscal policy are, first, the question of which members of particular generations are paying their generation's total bill. Second, the fact that in collecting these from, and giving transfers to, different generations and individuals within generations, we distort incentives.

So we have four fundamental features of fiscal policy, none of which are being measured correctly and discussed intelligently at this time.

REPRESENTATIVE HAMILTON. Okay. Mr. Stein?

MR. STEIN. I'd like to comment on the question you asked—what have been the effects, up to this point, of our failure to take a longer view?

I think that you have to say, or at least I have to say, they have not been very great. I just made a calculation that the federal budget deficits in the 1980s exceeded the federal budget deficits of the 1970s by about $1.1 trillion in 1990 dollars. That's something less than 10 percent of America's capital stock.

And if you use a number that economists commonly do, that capital contributes about 30 percent of the national output, that means, it seems to me, that the GNP in 1990 was about 3 percent less than it would have been if we had just had the same deficits as in the 1970s.

You can regard 3 percent of the GNP as a large number or as a small number, but it's not a disaster, in my mind. I think if there is a disaster, it is out there in 2020, or in that area.

I think we have had other problems in our fiscal policy. I think it is true that we have taxed too little and given too many benefits to middle- and upper-income Americans during this period, in which the condition of the very poor has languished and has probably deteriorated in some respects. I think we have made bad priority decisions about how we are treating the present generation, as well as making bad decisions about how we are treating the next generation.

REPRESENTATIVE HAMILTON. Is your view that if we continue this short-term focus that we've had when we make budget decisions, it has not had—a disastrous impact, if I understand you correctly. But if we continue it far into the future, do our problems get a lot worse?

MR. STEIN. Well, if continuing it means that we allow the budget deficit to get up to 20 percent of GNP, as Mr. Winter suggests, of course, that would be disastrous. But I once learned that the fact that a pig grows up to be a hog doesn't mean that it will grow up to become an elephant.

There may be some corrective mechanisms at work here, of which, of course, the Congress is a part.

So I think we should be alarmed by that prospect. It is a warning to us to behave ourselves. But I think we have not so far demonstrated an inability to behave ourselves.

REPRESENTATIVE HAMILTON. In your statement, you say that much of the time we simply don't know what we're doing—that's a pretty harsh criticism, Mr. Stein. What do you really mean by that?

MR. STEIN. I mean we don't know, or at least people who talk about the deficit, don't have any idea about what the effects of the deficit are on the behavior of the economy, what they are on the level of investment, what the effect of the level of investment is on the rate of economic growth.

Take the whole story that Mr. Kotlikoff tells us, that we do not know what the implications of present policy are for future generations.

I think we make all kinds of decisions, for example, about health care, without realizing what we are doing to the total share of the national output that is being devoted to health care, what the effect of that is on the cost of health care and on the availability of health care for people who are not covered.

So I think we are not looking out into the real economic effects of what we're doing.

REPRESENTATIVE HAMILTON. Okay. How do we structure our budget procedures in order to get the kind of long-term focus that you all think is necessary?

How do we structure it? Mr. Winter?

MR. WINTER. I'll address that, Mr. Chairman.

REPRESENTATIVE HAMILTON. Yes.

MR. WINTER. First, let me second the comment that Dr. Stein just made, that we are actually not capable of answering the question that you posed before. We don't know enough about what the past effects have been because the relevant sort of analysis has not been done.

REPRESENTATIVE HAMILTON. Can it be done?

MR. WINTER. I believe it can, yes. Although I did not refer to it in my summary, my prepared statement refers to the GAO's effort to try to present the budget in a modified structure, which would distinguish capital and operating accounts in both the general fund and in trust fund and government enterprises.

In addition, in this report, we have modified that standing proposal to call for a distinction between what we call federal capital and developmental capital.

REPRESENTATIVE HAMILTON. You favor a capital budget.

MR. WINTER. I believe that the information that could be assembled in the form of a capital budget is very desirable information to have. I think that question has to be isolated from the question of whether any modification of the budget process should be made.

REPRESENTATIVE HAMILTON. I understand, but let's just go back to this capital budget business.

By capital budget, you would make separation. The current operating budget would have to be balanced every year. Is that right?

MR. WINTER. No.

REPRESENTATIVE HAMILTON. The capital budget would not?

MR. WINTER. That's exactly the issue that I'm concerned about. From a fiscal policy point of view, spending is spending, transfers are transfers, and so on. For the purposes of near-term fiscal policy, these operating versus capital distinctions are not of critical importance. They are of critical importance from the point of view of the long-term impact, and that is why we need to know about it.

REPRESENTATIVE HAMILTON. Is the GAO recommending a capital budget?

MR. WINTER. The GAO is recommending the presentation of the budget in a more informative way so that people can understand what the government's money is being spent for. It is not advocating a capital budget on the model used in some states where there is a requirement for balancing the operating budget.

REPRESENTATIVE HAMILTON. Do you think it would be helpful in our budget if we made the distinction between operating and capital expenditures?

MR. WINTER. I do believe that that would be helpful, yes.

REPRESENTATIVE HAMILTON. Do all of you agree with that?

MR. STEIN. Yes. I think an important point has just come up, and that is the distinction between trying to increase the quantity and sophistication and relevance of the information that is available to the decisionmakers, on the one hand, as compared, on the other hand, with imposing on them some arbitrary rule that is to substitute for the exercise of their discretion over time.

I think what we are all talking about is more and better information and not some different rule.

REPRESENTATIVE HAMILTON. What do you mean by that? What do you mean, more and better?

MR. STEIN. I refer to the distinction between capital budgeting, in the sense that you have a requirement that the operating budget be balanced, and capital budgeting, in the sense that this is a source of information on the basis of which you might decide from time to time that you don't want to balance the operating budget, that you want to have a deficit in it.

In my mind, those are decisions that you have to make in terms of your view of the longer run future.

REPRESENTATIVE HAMILTON. And if you have that kind of a distinction made in your budgeting, isn't everybody going to want to put their expenditures into the capital side?

MR. STEIN. That's why you want to avoid making a rule that you can run a deficit, that you can finance the capital side by deficit.

REPRESENTATIVE HAMILTON. Mr. Kotlikoff?

MR. KOTLIKOFF. The generational accounting framework contains budgeting within it, because it says that here's the time of past government spending. And, given this path of spending, which has a certain present value, here's what the government has as net assets to cover that spending. Here's also what current generations are going to pay. The rest has got to come out of future generations. I'm considering the government's net assets, generational accounting incorporates capital budgeting.

This equation—somebody has to pay for the government's spending—is what economists call the government's intertemporal budget constraint. Economic theory instructs us to look at our generational policy using this equation. That is to say, do not do capital budgeting or deficit accounting alone, but do generational accounting.

Even if we did capital accounting, we would still have the question of how to classify different governments' receipts and payments. Take, for example, social security.

REPRESENTATIVE HAMILTON. What is the key question in generational accounting?

MR. KOTLIKOFF. The fundamental question is who's going to pay.

REPRESENTATIVE HAMILTON. Who's going to pay. What generation's going to pay, right?

MR. KOTLIKOFF. Right, and whether we're going to have to have rising tax burdens on future generations. It is a longer term analysis—very much like the social security's long-term projections, only it's dealing with all the government entities and programs.

Congress and the Administrations have benefited greatly from the social security's projections. But that's only one program, and what we're seeing is that the surplus of the social security system is being dissipated by other policies that aren't being properly accounted for.

REPRESENTATIVE HAMILTON. Well, let me ask this. If the key question in generational accounting is what generation pays—and that's an important question, obviously—but what does that have to do with the question of economic growth and productivity and all those things?

MR. KOTLIKOFF. Well, it's completely connected to the questions of growth and productivity, because if you let current generations pay less, if you let them off the hook for paying for the bills, they're going to consume more. And that's actually what's been happening. That's why our national saving rate last year was 1.7 percent, compared with an average of around 10 percent between 1950 and 1970. In saving less, we have less investment and thus less capital accumulation, and less output and productivity growth.

REPRESENTATIVE HAMILTON. So generational accounting will increase investments.

MR. KOTLIKOFF. By showing that those generations who are currently alive have to contribute more to pay for this burden, generational accounting can lead us to adopt policies that will get more net taxes from current generations, leading current generations to consumer less. That's absolutely critical. If we're going to turn around our national savings situation, we have to have current people consume less.

REPRESENTATIVE HAMILTON. Okay. What kind of short-term steps do we need to take right now to get our fiscal house in order?

MR. KOTLIKOFF. What I'm advocating is that the Congress, with the Administration, put together an independent agency for generational accounting which would do the kinds of projections that have been done by both myself and GAO, looking at the time path of spending on consumption by the government, looking at the government's net assets, looking at how much current generations are going to pay, and figure out whether we have a big imbalance on the entire fiscal situation with respect to the treatment of future generations.

If that analysis comes out the way the numbers that I've produced come out, which shows that there's an enormous generational imbalance, then we need to take immediate steps to reduce that imbalance. And that involves getting control of health-care spending, Medicare and Medicaid, and making clear to the American public that if we wait even ten years to get control of those programs, we will basically bankrupt the next generation.

REPRESENTATIVE HAMILTON. How do you get control of them?

MR. KOTLIKOFF. I'm not an expert on the micro-issues, but I think we need to have some very hard rationing decisions.

REPRESENTATIVE HAMILTON. That would be pretty macro, in my view.

MR. KOTLIKOFF. Yes, I realize that they're macro, by implication.

We need to have some very hard rationing decisions made with respect to Medicare and Medicaid spending. I think that's really inevitable. And then there are other policies, keeping tabs on government spending, on purchases in different areas.

If we need to, I would advocate some implementation of a value-added tax, not a complete transformation to a value-added tax, but some small, 3- to 5-percent value-added tax.

REPRESENTATIVE HAMILTON. You don't think much of the balanced budget amendment that we have under consideration today.

MR. KOTLIKOFF. I think it's a recipe for avoiding the hard problems that we face and for continuing to look at the wrong numbers.

We have to understand that there's not just one deficit out there. There's really as many deficits as you want to create.

The social security trustees tell us that there's something like $7 or $8 trillion of unfunded social security liabilities out there. That's to say, obligations to pay current retirees and near-term retirees, their social security benefits.

That's a debt which is no less real than the official $3 trillion or $4 trillion debt that we currently have.

So what deficit are we dealing with? If we use different words to describe social security's receipts and payments, we would have an $11 trillion total debt rather than a $4 trillion debt.

So, historically, we've used particular words, and that's why we're looking at this official deficit of $400 billion this year. But if we had used different words, and everybody's free to use their own words in describing what's going on, we'd have a completely different deficit.

So there's really an infinity of deficits. That's what economic theory tells us. And therefore, we need to ask, what question are we trying to answer with these numbers? And ultimately, it comes down to how we're treating different generations. That's the ultimate economic question here.

REPRESENTATIVE HAMILTON. Mr. Stein, Mr. Winter, how do you feel about this balanced budget amendment, of improving our long-term decisionmaking?

MR. WINTER. I might say first that the GAO has not taken any position on the balanced budget amendment. But our stance is very strong on the point that more fiscal restraint is needed over the long term, and that the action taken should be taken soon.

So I agree with Professor Kotlikoff that whatever we do, we should not procrastinate further and put off the hard choices that confront us.

REPRESENTATIVE HAMILTON. Can you speak personally or other than a GAO representative?

MR. WINTER. Well, I could speak personally on the pros and cons of the situation, Mr. Chairman, if that would be helpful.

REPRESENTATIVE HAMILTON: How about the conclusion?

MR. WINTER. The conclusion, I'd rather not draw.

REPRESENTATIVE HAMILTON. Let's ask MR. STEIN. He's not so constrained.

MR. STEIN. No, I'm not so constrained. I'm opposed to the balanced budget amendment. I think it's sheer hypocrisy and escapism and an attempt to conceal the unwillingness—not only the unwillingness of Congress—it's the unwillingness of the public to do the things that are required to balance the budget.

Second, I do not think balancing the budget is the ideal definition of our objective with respect to the budget. And I think—things being as they are and people being no more aware of the consequences of their actions than they now are—if the balanced budget amendment were adopted, we would just resort to more subterfuges of the kind that we dealt with in Gramm-Rudman and in many other things.

So I don't think the objective is a good one and I think that even if the objective were a good one, it wouldn't be accomplished.

MR. KOTLIKOFF. Can I pipe in on just one point?

REPRESENTATIVE HAMILTON. Sure.

MR. KOTLIKOFF. The point that I'm trying to make about the fact that the definition of the deficit is really up for grabs, it's not just a theoretical point. It's a practical point.

Right now, Congress is debating a balanced budget amendment which includes the social security surplus as part of the budget that would be balanced.

Now, we've known for at least ten years that because of the demographics, we're going to have a cashflow surplus in social security. So Congress and the Administration, two years ago, took social security out of the deficit. Now, they're adding it back in.

They're continually changing the definition of the deficit. If we're talking about balancing a budget that includes social security taxes and transfers in 1997, that surplus could be something like 3 percent of GNP.

So that's going to make an enormous difference whether or not you include social security in the definition of the budget that needs to be balanced.

So what I see going on here is that we'll pass this balanced budget amendment and then we'll choose the definition of the deficit which is comfortable, which leads us not to have to take any painful actions, and then we will continue to look at these misleading cashflow indicators and then find ourselves in the year 2020 with a huge problem on our hands.

REPRESENTATIVE HAMILTON. Let me ask you, we now have a unified budget. You go after it, Mr. Kotlikoff, on the basis that it doesn't really give us a lot of useful information about the true impact of fiscal policy and the impact on generations.

Mr. Stein thinks it's a poor tool for focusing on the broader policy objectives. It doesn't force us to make the choices that we ought to make, the trade-offs and that kind of thing.

Mr. Winter, you talk about the current unified budget as not very good in terms of separating investment from consumption.

Are your criticisms of the unified budget and your alternative suggestions supplements to the unified budget, or would you just throw the whole budget out?

MR. KOTLIKOFF. Throw it out.

REPRESENTATIVE HAMILTON. You'd just throw it out and start over again?

MR. KOTLIKOFF. I mean, I wouldn't throw out the numbers. The numbers could be used for the correct analysis—generational accounting.

REPRESENTATIVE HAMILTON. Yes.

MR. STEIN. We have another interest here and that is the effect of the budget on economic stability. From that standpoint, I think there is a possible rule that will at least prevent the budget from being a source of short-run economic instability. That is, that the surplus or the deficit in the budget, probably defined in the national income accounts way, ought to be stable from time to time when measured at high employment.

That is, the notion of stable high employment budget deficit or surplus, I think, still has value, and from that standpoint we need a definition of the budget that has something to do with the impact of the budget on aggregate demand in the short run.

So I would not throw out that budget, and I think that we need to recognize that we are talking here essentially about the long-run shape of the budget and not its year-to-year variations.

That's a different question, I think, for which we do need a certain budget.

MR. WINTER. Could I comment?

REPRESENTATIVE HAMILTON. Certainly, MR. WINTER. Go ahead.

MR. WINTER. I'd like to emphasize that the federal deficit on national income and product account, which is computed by the Department of Commerce, has not flopped around in its definition over the years as the Congress has changed its mind about how to compute the deficit.

I continue to believe that the system of national income and product accounts, as a whole, is a very useful source of insight into what's going on in the economy. It does not answer the intergenerational questions that Professor Kotlikoff properly regards as important. It does not answer many other questions. It does not do a very good job on some things that should be within its ordinary scope, and one of those is the treatment of federal investment in physical capital.

So there are definitely limitations to the national income and product account versions of the deficit, but I would not myself agree that we should abandon that particular source of insight into what's going on.

Now, as it happens, the national income and product account deficit is typically quite close to the unified budget deficit, although divergences do appear.

MR. KOTLIKOFF. I had just one other comment, if I could make it.

REPRESENTATIVE HAMILTON. Sure. Go right ahead.

MR. KOTLIKOFF. I think another way that we can phrase this question is, do we want to look at just this year's cash flows, do we just want to look at this year's taxes and this year's transfer payments and purchases? Or do we want to look at the next five years and avoid all years into the future? Or do we want to look at the entire future, properly discounting in order to take into account that a dollar of taxes or transfers in the future is not the same as a dollar today.

Basically, what I'm saying is that we need to look at the entire future. We should not just be working with blinders and looking at this year's numbers, but really looking at what we're doing over time.

We should do the longer term generational accounting on an annual basis. So, as we see that our projections of the future need to be corrected, we would make those corrections and continue to move along in a long-term fiscal planning manner.

REPRESENTATIVE HAMILTON. Let me ask you to comment, Mr. Winter and Mr. Kotlikoff, on Mr. Stein's suggestion in his statement, in which he talks about this choice among the national priorities.

He says:

> My proposal is that the government should make and explain budget policy at the most general, strategic level in terms of the effect of the policy upon the division of the national output among its major uses.

If I understand what you say, Mr. Stein, you would look at all of these various uses that you've identified as a percentage of the GNP. Right?

MR. STEIN. Right.

REPRESENTATIVE HAMILTON. And that would make us focus, then, on the question of priorities, which of course is the big question in government, how you allocate what you got.

MR. STEIN. Right.

REPRESENTATIVE HAMILTON. Why doesn't that make sense? Do you have any comment on that, Mr. Winter?

MR. WINTER. I think it makes excellent sense, Mr. Chairman.

Once again, in this area, it's very clear that superior information on these issues would be very desirable to have. And it's quite clear that the Federal Government often takes actions which passes off some of the problems to other governments or to private individuals, and are not constructive actions from the point of view of the economy as a whole.

And as I understand Dr. Stein's proposal, he would seek to provide the basis for avoiding that. The difficulty would come in the question of what process would then implement the use of this information, whether it should have a process counterpart.

I can see some obstacles to its use in the budget process. But I certainly think that the information is desirable.

REPRESENTATIVE HAMILTON. Well, what are the obstacles?

MR. WINTER. One big obstacle is the federal system.

REPRESENTATIVE HAMILTON. What do you mean by that?

MR. WINTER. We can have a good discussion about how various functions should be divided, for example, among the various levels of government. But the fact is that the Federal Government does not have detailed control over the behavior of state and local governments, and sometimes when it tries to have such detailed control, the consequences are counterproductive.

So I think there is some tension between the way we are structured in our federal system and the notion of trying to budget the GNP.

REPRESENTATIVE HAMILTON. Mr. Stein?

MR. STEIN. As I visualize this thing operating, I can imagine the President saying, "Well, the GNP is now distributed in a certain way and 15 percent of it is going for private investment. My proposal is that we ought to increase private investment to 18 percent of GNP, and in order to do that I propose to reduce the budget deficit from 5 percent to 2 percent."

That is, he's not going to be controlling private investment in the sense that he is issuing orders to private investors. He looks out at the economy and sees what he expects the behavior of the private economy to be and makes recommendations for government action that will affect that outcome in a desired way.

I also think, in making that decision, he would look at the kind of information that Mr. Kotlikoff presents, because what Mr. Kotlikoff is saying is that we really need to have a lot more investment in order to provide the income for the people who are going to be claiming income in the year 2020.

So his decision about whether we want to get private investment up from 15 percent to 18 percent of GNP would be highly influenced by his view of the longer run future of the economy and its needs.

So I don't think that there's any inconsistency between what I am proposing and what Mr. Kotlikoff proposes.

Now, I'm not suggesting that there should be a federal law saying private investment should be 15 percent of GNP.

REPRESENTATIVE HAMILTON. I understand. Our data base and knowledge are sufficient so that your approach to budgeting could be carried out, I presume.

MR. STEIN. Well, I think that the Bureau of Economic Analysis would have to do a certain readjustment of the GNP accounts, which are quite feasible. And of course, there would be a lot of estimation to be done. But, of course, all budgeting requires a lot of information.

REPRESENTATIVE HAMILTON. Yes. Mr. Kotlikoff?

MR. KOTLIKOFF. I think I agree with Herb, that there's not any real conflict between what I'm suggesting and what he's suggesting. I think he's saying, we need to have a discussion about the broader problems rather than just making pat statements, like the budget has to be balanced, when, in truth, nobody knows what budget they're talking about.

But I think that we need ultimately to measure what the government's doing. There's a private sector and there's the government. So we need to measure the government's policies. And there are just these four key policies—generational policy, intragenerational policy, spending policy and incentive policy. We need to measure each of those differently from the way we're going about it now.

REPRESENTATIVE HAMILTON. Mr. Winter, you're recommending in the GAO report a longer planning horizon, five-year budgets, in the context of a 20- or 30-year fiscal policy path? Is that right?

MR. WINTER. I think we would favor the continuation of five-year plans as an instrument for fiscal planning at the federal level. And, as you say, we also believe that as these decisions are made, they should be made in the context of an awareness of the longer term implications.

That's especially true right now because we have these strong, dynamic factors in the situation—demographic and otherwise—which are going to give us a future which is quite different from our present.

I'd like to come back, if I could, Mr. Chairman, to a question you asked earlier about what are the urgent short-term problems.

REPRESENTATIVE HAMILTON. Yes.

MR. WINTER. And one urgent short-term problem is the reform of the health-care system, because if we do not have a fundamental reform of the health care system, the budgetary burdens of our existing system are just going to run away with the federal budget. That's part of what's going on.

REPRESENTATIVE HAMILTON. That's the item of the budget that's really out of control.

MR. WINTER. That is certainly a source of a major deficit-increasing dynamic, that's right.

REPRESENTATIVE HAMILTON. How much are health-care costs to the government going up each year?

MR. WINTER. In percentage of GNP, our calculations show 3.2 percent for this year. They show 4.6 percent for the year 2000; 5.2 percent for the year 2005; and 5.8 percent for the year 2010.

REPRESENTATIVE HAMILTON. What are you giving us?

MR. WINTER. These are federal expenditures for Medicare and Medicaid which are the growing programs. The other components of federal health spending are not changing very much.

So, in the course of the eight years, from now to 2000, we're up by 1.5 percentage points of GNP, and that sort of thing continues.

REPRESENTATIVE HAMILTON. Do you know the figure in billions of dollars of how much are health-care costs going up each year?

MR. WINTER. Let me see. I'm afraid we don't have that one at the moment, Mr. Chairman. We could submit it for the record, if you'd like it.

[The material subsequently supplied for the record follows:]

MATERIAL SUPPLIED FOR THE RECORD

GAO projections of federal health care expenditures in 1992 dollars -- Medicare and Medicaid only, excluding administrative costs.

| | |
|---|---|
| 1990 | 161.1 |
| 1991 | 177.6 |
| 1992 | 189.3 |
| 1993 | 202.5 |
| 1994 | 218.3 |
| 1995 | 235.2 |
| 1996 | 252.1 |
| 1997 | 268.5 |
| 1998 | 285.6 |
| 1999 | 302.7 |
| 2000 | 319.8 |
| 2001 | 336.8 |
| 2002 | 353.4 |
| 2003 | 369.2 |
| 2004 | 384.1 |
| 2005 | 398.4 |
| 2006 | 412.7 |
| 2007 | 428.3 |
| 2008 | 444.9 |
| 2009 | 461.9 |
| 2010 | 478.8 |
| 2011 | 497.2 |
| 2012 | 518.6 |
| 2013 | 542.0 |
| 2014 | 565.1 |
| 2015 | 589.1 |
| 2016 | 613.2 |
| 2017 | 638.6 |
| 2018 | 664.5 |
| 2019 | 690.8 |
| 2020 | 718.0 |

Underlying data are from Health Care Financing Administration, but HCFA figures are slightly higher because of inclusion of administrative costs and slightly different economic assumptions. In 2020, the HCFA figure is about 5% above the GAO figure.

REPRESENTATIVE HAMILTON. Okay. I just want to make sure that your feelings about the difficulties with the current budget procedures are on record. Have we made that clear in the testimony, thus far?

MR. STEIN. I'd like to make one point before we close.

If we think about the future generations, our children and grandchildren, and what we're leaving them, we should not just think in terms of tax burdens and GNPs. If we're going to leave them a hostile, disaffected, impoverished population in our urban ghettos, that's going to be a great drain and blot upon the future of American life. That has to be weighed when you think about the budget and what we might want to spend for correcting that problem.

We have also, I think, relieved future generations of the threat of nuclear war, which was quite a contribution to future generations. We spent a lot for that, and I think we should take some credit for it.

That is, I think we should look at the future in some terms other than GNP and tax rates. We have a lot of problems there, and some things to be satisfied with.

REPRESENTATIVE HAMILTON. With the approach that you're suggesting, Mr. Stein, this budgeting national priority approach, how do you address that? How would your proposal help you address the concern you've just stated?

MR. STEIN. Well, that's one reason in my breakdown of the way I would divide the national output, I did make a special allocation for the consumption of the not-poor. I don't say that my breakdown would solve that problem alone, but it would let us look at how much of our national output we are devoting to the consumption of people who are not poor and what we therefore could transfer to the solution of other problems.

REPRESENTATIVE HAMILTON. You have a breakdown—consumption of the not-poor—and another category—consumption of the poor. Your view would be that that kind of a breakdown in the major uses of the national output would bring home to us, that we're not putting very many resources into helping the very poor. Is that the idea?

MR. STEIN. It would help us to see that problem. But, of course, I don't say that my nine-way division of the national output will solve that.

REPRESENTATIVE HAMILTON. I understand.

MR. STEIN. I'm just calling to your attention the need to look at some other problems about the future other than the size of the budget, the rate of taxation, and so on.

REPRESENTATIVE HAMILTON. Okay. To conclude here, what are the longer term steps that we need to take to enhance the long-term focus of the federal budget policy? And how much of it involves changes in budget presentation or procedure, and how much of it involves a greater will on the part of the Congress and the President and the American people?

We've been discussing that, but let's sum it up. Can we do that as we conclude?

MR. KOTLIKOFF. Well, we need to understand what problem we face. We need to measure what we're doing, not only this year, but over time. The fundamental question that the fiscal policy really presents for us, based on our policies of the last four decades, is how we will be treating today's children and tomorrow's children compared to current adults.

And to get a handle on that, we need to do this longer term generational accounting. The accounting itself is not particularly difficult. It's basically just addition and subtraction and some division. The Congressional Budget Office has the computer program. They've been able to run it. Congress can, at any point, request that they do generational accounting for any particular policy changes that Congress wishes to think about.

I think it would be helpful if an independent body, such as the General Accounting Agency, was authorized to do this generational accounting in a nonpartisan manner, to show the entire nation what kind of a time path we're on with respect to the treatment of people in the future. That is, whether their net tax burden is going to have to rise.

If that proves to be the case—and I'm quite confident that the facts will show that to be the case—then I think the same kind of consensus will emerge to do something that was there in 1983 when the social security trustees told us we had a long-term problem.

And then we can put into place these time paths of policies which do not have a huge impact right now, but over time regain control of our fiscal policies.

So the first step really is to understand what's going on, and unfortunately it's not well understood exactly where we stand with respect to our generational policy.

REPRESENTATIVE HAMILTON. Mr. Winter? Mr. Stein? Do you want to make any concluding comments?

MR. STEIN. I think what we're all talking about is trying to improve the quality of information and understanding that people have about our budget problems.

I think we need to begin by having some responsible people who are regarded as authorities in the country, and not just a panel of three economists, talking in these terms—in terms of what are the true effects now and in the future of what we're doing, and not in terms of all these shibboleths that we use and repeat over and over again.

I think, obviously, there needs to be greater willingness on the part of the public to make the sacrifices that would be necessary for improving conditions, but I don't see any way to bring that about, except for people who are now concerned about this, to talk honestly, candidly, and with information to the American people. And that isn't going on.

REPRESENTATIVE HAMILTON. The big difficulty for most people is just the complexity of it. They're overwhelmed by the numbers, the political rhetoric, the debate, and the confusion that all of this generates in their mind.

MR. STEIN. Somebody's going to have to synthesize this.

REPRESENTATIVE HAMILTON. I understand.

MR. STEIN. Into something that people can understand.

REPRESENTATIVE HAMILTON. Well, that's one of the things about your proposal that makes some sense to me. It looks to me as if it presents the question of national priorities in a fairly digestible, understandable way, and makes people focus on the question of priorities, which is always the central question in budgeting.

Mr. Winter, and then Mr. Kotlikoff.

MR. WINTER. Yes. I'd like to second Herb Stein's comments. I think better information can be gathered and better forms of presentation can be established. Perhaps better rules and procedures can be put in place.

But, in the end, we really rely upon the political will to solve these problems, and the basis of that political will has to be some better public understanding than we now have of what the issues actually are that are facing the country.

So I think we all have to work to try to build that understanding.

MR. KOTLIKOFF. Mr. Chairman, you just referred to how we can put this in a form that the American public can understand.

Well, the generational accounting really does put it in a very simple form. It shows for each generation how they're being treated in per-capita terms.

So, for example, it says, to a 40-year-old, under current policies, we project your remaining lifetime net tax bill to be, on balance, $177,000 in today's dollars.

And if we change policy—for example, our 1990 budget agree-ment—it tells the 40-year-old that the cost to him is another $2,600.

So the numbers are really very straightforward for different generations to look at. They can look themselves up and see, okay, this policy has helped our generation or hurt our generation. Also, the sacrifice which we're making and which other older generations are making is clearly benefiting future generations because this is zero-sum accounting. It shows that if you hurt current generations, you're helping other generations and holding the spending path of the government fixed.

So I think it really is actually very simple for people to understand. Whereas, what we have now, I don't think anyone can really say that they understand because it's not understandable. From a theoretical perspective, it makes no sense.

REPRESENTATIVE HAMILTON. Thank you very much. We've tried to focus on the long-term impacts of our budget decisions for a few minutes, and I thank you very much for your contributions.

We stand adjourned.

[Whereupon, at 11:33 a.m., the Committee adjourned, subject to the call of the Chair.]

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