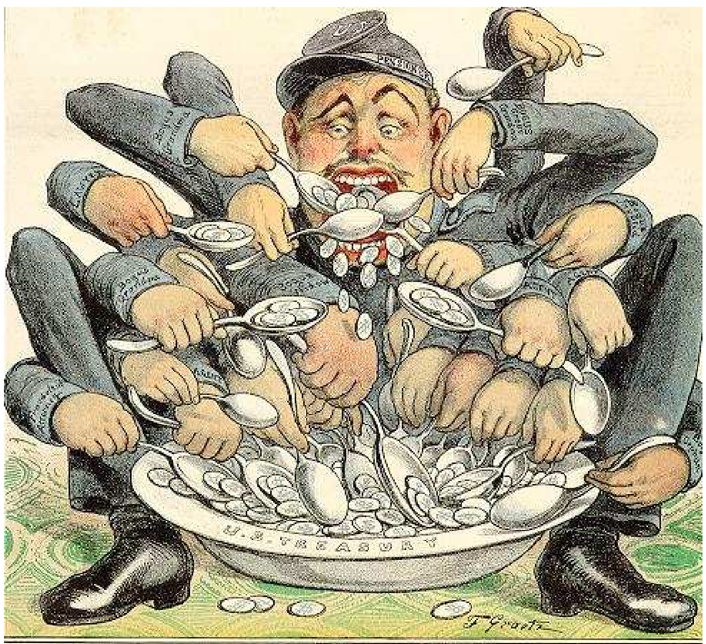
Money and Power in the Western World: 1700–2000

Final Essay

May 2, 2004



THE INSATIABLE GLUTTON.

Question 1: What are the implications of imbalances in generational accounts?

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Generational Accounts – The Storm Approaches:

Generational accounting is a relatively new area of fiscal focus. In essence, generational accounting attempts to measure the lifetime financial balance of a generational cohort without regard to intra-generational transfers. A fair balance should be close to $0, as any imbalance, either positive or negative, would accrue to a future generation – a consequence of the government's inter-temporal budget constraint. Over the past ~30-years, most major economies have developed severe projected generational account imbalances. Increased transfer payments and changing demographics are largely behind this looming fiscal crisis for many of the world's governments. Three statistics do an excellent job of highlighting the factors contributing to potentially debilitating GA imbalances[1, 2]:

- In the middle of the 20th century approximately 2 per cent of Britons where on national assistance; less than 50-years later, more roughly 9 per cent were receiving similar benefits;
- today, "roughly half of all income of [British] pensioners now comes from social security;"
- in 2030 in the US, the number of elderly will double, with only a 15% increase in the number of workers.

Given the above-listed statistics, it is clear the potential for enormous generational imbalances are looming. The implication if these imbalances and their true magnitude are less clear. It is easy to state estimated, immediate reductions in government expenditures (~21% for the US) or increases in taxes (~11% of the US) required to achieve generational balance going forward or rattle off projected dependence ratios for the year 2030 (~66% for the US)[3]. We can also study the impact of current policies, if unchanged, on the tax burden of future generations: future US generations will pay 1.5-times the taxes paid by "newborns"[4]. Nonetheless, these statistics do not provide clear insight into the likely implications of generational imbalances.

As Lenin put it: "Who whom". Or more eloquently expressed by our esteemed professor, Niall Ferguson: "who is screwing who(m)." What was once a question squarely separating rich and poor is obviously becoming more

[1] Ferguson, Niall (2002). The Cash Nexus: Money and Power in the Modern World. Page 204.
[2] Ferguson, Presentation 7, Slide 29
[3] Ferguson, Presentation 7, Slides 36 and 43
[4] Collard D. (2000). Generational Accounting and Generational Transfers.

relevant across young and old or more broadly across those living today and those who will live in the future. Underlying this complex question, as noted above, are broad, inescapable trends. This paper will focus primarily on the implications of impending generational account (GA) imbalances in developed nations.

The Macroeconomics Perspective and Implications:

Much of the current discussion is focused on the negative generational accounts (receipts>payments) projected for today's aging (e.g., "baby boomers"). Viewing the implications across basic macro-economic accounts shows us increased government spending today has some serious implications on the future:

$S + (T - G) = I + (NX \text{ or } NFI)$	- or -	Personal Savings plus Government Savings - equals - Investment plus Net Exports or Net Foreign Investment [5]

Much of the discussion in "Money and Power in the Western World: 1700 to 2000" has focused on "T-G"; however the implications, as we see, are more varied than the focus on net government savings implies. Without an offsetting increase in savings (as prescribed by Ricardian Equivalence), deficit spending by the government to support projected GA imbalances will either lower savings/ investment or increase net exports/ net foreign investment. As current generations consume more, reduced saving and investment will impact productivity and wage growth, constraining economic growth. This recessionary pressure will surely compound any existing welfare balancing issues. Financing this imbalance through increased government debt, a popular solution today, should ultimately place upward pressure on interest rates. Increased supply of and interest rates on government debt raises a "crowding out" argument, which states capital is diverted from private investment to support the welfare system – another recessionary pressure. The Keynesian (supply-side) counterargument would imply an expansionary impact. One must assume there is a limit to the long-run returns of governmental overspending and ill-balanced budgets, however.

[5] Miles D and Snow A. (2002). Macroeconomics – Understanding the Wealth of Nations. Ch. 11.

The widespread negative GAs in today's modern economies will likely impact economic growth on a global level. Clearly, this "implication" is suboptimal, and long-term feasibility of long-term continued negative GAs is weak at best.

<u>Change in Fiscal Direction (and Potential Political Redistribution):</u>

Focusing on the US, immediately raising taxes / cutting expenditures at proposed levels would certainly impact the current strong performance of the US economy, and potentially that of the world. This immediate change is not a realistic implication or outcome of the forecasted GA imbalances. Given recent incremental moves and a general aversion to fiscal overhauls, many of the earlier stated statistics seem too extreme (or possibly too extreme to be politically palatable); either an immediate change or no change at all seems unlikely. Fundamental, evolutionary changes to major tax and entitlement programs seem to be one of the most logical implications of projected GA imbalances. Broadly, most countries will look to moderately raise taxes and cut benefits (increasing "T-G"). Furthermore, in the US there is a greater focus on shifting responsibility away from the federal government, towards the private sector. Increasing private savings ("S") will begin to appear as the possibility of fiscal changes becomes more clear – The starting point has been discussion of private pension accounts (moving from an "unfunded" to a "funded" or "private" environment to some extent) and government sponsorship of increased savings through various policy changes (e.g., creation of the Roth IRA).

Movement to an environment where increased fiscal responsibility is the norm rather than the exception is the most likely implication of the increasing focus on generational accounting. This is potentially the most advantageous long-term solution to generational accounting problems: leaving no cohort responsible for gross overspending by its predecessors.

If a nation fails in its attempt to combat gross GA imbalances through fiscal reform, classic debt management and wealth redistribution solutions may become a more attractive option. From this perspective, we fall back to a more classic "who is screwing who(m)" in balancing the cumulative generational accounts contained in the national debt. This is particularly relevant since current spending has been largely financed though increasing levels of national debt. Assuming a country wants to reduce its effective debt load, there are "essentially four options: (a) to default; (b) to introduce an extraordinary tax on wealth (capital levy) 'once and for all'; (c) generate inflation to reduce the value of nominally denominated debt; (d) to create surpluses by reducing expenditure on transfers and/or by increasing income taxes and indirect taxes.[6]" Case "d", carried across generational lines is the fear of generational accounting thinkers in their discussion of potential future tax loads. In all of these cases, however, if addressed in the short- and mid-term, current generations would not impose a huge debt load (cumulatively negative account balance) on future generations. Instead, the impact of funding the generational imbalance is directed to one or more currently living classes ("*Rentier* (bondholder)…Business [owner]…Proletariat"[7]).

<u>Competition for Tax Payers:</u>

Increased focus on attracting and integrating immigrants is another possible repercussion of GA imbalances in developed nations. During the mid- to late-1990s, the global community experienced ~5% compound annual growth in people living outside their country of origin. This equates to approximately 5 million potential tax-paying "free-agents" on the market annually. One could envision a world with increased competition for immigrants and policy constructs which allows for their efficient integration into the tax system. The United States provides an interesting case study. Since the1980s the US has attracted approximately 850,000 immigrants per year – a potentially strong boost the government revenues[8]. Recent proposals from the George Bush White House to enact measures which provide legal status to millions of undocumented workers in the United States (lower-wage workers), as well as increase the level of green cards issued (higher-wage workers) each year, are evidence this possibility may be gaining momentum. Though it seems George Bush thinks our market share of global immigration is too low, a return to the days when the US Congress offered 160-acre tracts of farmland for a

[6] Alesina, Alberto (1988), 'The End of Large Public Debts', in F. Giavazzi and L. Spaventa (eds.), High Public Debt: the Italian Experience, Cambridge, p. 36.
[7] Ferguson, Presentation 7, Slides 11
[8] Ferguson, Niall (2002). The Cash Nexus: Money and Power in the Modern World. p. 214-215.

small filing fee (Homestead Act of 1862) is not likely. Nevertheless, the days of the Homestead Act show the extent to which the forces of supply and demand can push competition in immigration market.

We assume immigrants will provide a boost to the current negative GAs, since "immigrants are generally of working age, with above-average economic motivation.[9]" The country of origin pays the cost of moving these people through their first dependency period (birth though teens). Conversely, the country of settlement receives the benefit of the immigrant's most productive years, while being responsibly for only the second dependency period. Taken to an unlikely extreme, GAs would benefit to a greater extent if the immigrants' retirement years were again spent in their country of origin (or any other country, for that matter) with a suspension or curtailment in pension benefits. Though GAs would benefit here, falling consumption associated with the wholesale immigration of "old spenders" would likely have a negative economic impact.

<u>Manipulation of GAs:</u>

If the above implications turn out to be less than a complete solution, I expect politicians to take a path often taken by corporate executives in their own pension systems[10]: Manipulation. Similar to corporate employee-related liabilities, GA projections can be manipulated by pulling any number of valuation levers. This is not surprising given the broad range of assumptions and projections various political players apply to the budget deficit, a measure some argue GAs should replace. Some tricks used by corporate America which would be relevant to GA manipulation are displayed in the right-shown graphic. Clearly, there are no shortages of mechanisms for GA manipulation.

Manipulation Levers

Lever	Impact
Discount rate on benefit cost / liability	• Present value of projected welfare benefits
Growth in esisting benefit costs / liability	• Projected value of payments to welfare recipients
Projected life-span	• Projected value of lifetime benefits, particularly those which are pension and healthcare related
Future Policy	• Scope and depth of future welfare commitments based – future cost

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[9] Ferguson, Niall (2002). The Cash Nexus: Money and Power in the Modern World. p. 209.
[10] Corporate pension systems in the US and elsewhere have been regulated over the past decades in an attempt to halt manipulation.

Once broadly acknowledged, I envision partisan arguments which focus on how those in power mismanage generational spending or those vying for power would succeed in better managing spending, and thus balancing generational accounts. "The more things change, the more they remain the same,[11]" seems appropriate to describe this scenario. Just as the deficit is endlessly manipulated and debated across various political venues, generational accounts will most certainly be subject to a similar bureaucratic dog pile.

Action by the People:

Citizens will modify their behavior in an attempt to protect their standard of living or counterbalance the impending fiscal imbalance. In an attempt to protect their own welfare, tax payers/ entitlement recipients will likely increase their retirement age to both abridge their dependency period and continue to save for their ultimate retirement. This may be because of government-led changes in the workforce or independent action by citizens. Increased levels of personal saving in anticipation of entitlement spending cuts are also likely. Since this would be seen as a positive development by most imbalanced nations, government marketing campaigns and savings enticements (e.g., tax abatements) will also show up to reinforce trends of increased savings. Interestingly, private groups (e.g., asset management companies) are broadly extolling the virtues of increased saving and investment to the citizens of virtually all developed nations. With a significant degree of success, these companies and national entities would drive increase saving rates and ultimately bequests from current generations to the next. Rising levels of intra-generational bequests would have a balancing effect on current GAs.

Ricardian Equivalence is relevant to current GA imbalances through increased levels of intra-generational giving (e.g., inheritance) which counterbalance the increased tax burden associated with current overspending. One facet which is not sufficiently addressed even with broadly increased intra-generational giving is wealth distribution across classes. Logically, the rich will bequest large amounts to their heirs, helping them to offset increased

[11] Quoted from Jean Baptiste Alphonse Karr, 19th century French novelist

taxes. The poor will have no equivalent cash infusion. If this turns out to be true, tax systems must become more progressive or societies risk increasingly imbalanced wealth distribution.

Summary and Conclusion:

The scope of class discussion was sufficient to highlight the approaching generational account crisis. Further analysis of the longer-term implications of generational imbalances in developed economies yields a diverse range of potential implications and solutions.

Many possible solutions have the potential to impact currently projected imbalances only incrementally. Increased competition for tax payers (immigrants), higher savings levels, and moderate policy changes may lessen the severity of any adverse GA imbalance implication, but will not likely reverse the imbalance to the point of impotence. Extreme changes in spending or taxation, as well as "managing" away the underlying debts are so politically unpalatable that these potential implications are highly unlikely. Also, the possibility of "growing" out of any adverse impact in some sort of Keynesian dream economy seems unlikely.

In a more absolute sense, an increasing focus on generational accounts brings increased manipulation of relevant statistics. We will find negative savings, investment, and productivity implications over the mid- and long-term. Over the next decade, governments which oversee countries with the most severe demographic changes and generational imbalances will be forced to start addressing growing generational imbalances and ballooning deficits. It is at this point, political parties, special interest groups, and others will begin to weigh-in on solutions and feasibility of the matters discussed in this paper. Ultimately, increased taxes and savings, and reduced government expenditures will be employed to begin a long GA balancing act.