

Fiscal Imbalance: Problems, Solutions, and Implications

A Summary of the 2005 Philadelphia Fed Policy Forum

BY LORETTA J. MESTER

“Fiscal Imbalance: Problems, Solutions, and Implications” was the topic of our fifth annual Philadelphia Fed Policy Forum held on December 2, 2005. This event, sponsored by the Bank’s Research Department, brought together economic scholars, policymakers, and market economists to discuss and debate the implications of fiscal imbalance for the U.S. economy. Our hope is that the 2005 Policy Forum will serve as a catalyst for both greater understanding and further research on the fiscal challenges facing the U.S. economy.

At the current pace of spending and revenue generation, the U.S. faces a worsening budget position over the coming years. While the problems with the Social Security program have garnered most of the headlines, financing health care and the Medicare system poses the greatest challenge. The size of the problem, longer-term implications of fiscal imbalance, and potential solutions were the focus of the 2005 Philadelphia Fed Policy Forum. While there is general agreement

that budget imbalance is one of the important challenges facing the U.S. economy over the medium and longer run, there is considerably less agreement on what should be done to meet those challenges.

Alan Greenspan, then Chairman of the Federal Reserve Board, opened the conference. In his view, the deficit-reducing actions necessary to stem the worsening budget position will be difficult to implement unless procedural restraints on the budget-making process, like limits on discretionary spending and the PAYGO requirements, are restored. He said that reinstating the structure in the Budget Enforcement Act of 1990 and coupling it with provisions for dealing with unexpected budget outcomes would be beneficial. But it would not be enough to solve the problem. The fundamental issue is making choices among budget priorities, especially since the

number of retirees is increasing.

Greenspan pointed out that currently 3.25 workers contribute to the Social Security system for each beneficiary. By 2030, the number of beneficiaries will have doubled and the ratio of covered workers to beneficiaries will have fallen to 2. At the same time, spending per Medicare beneficiary is expected to increase as the cost of medical care rises. In fiscal year 2005, federal outlays for Social Security, Medicare, and Medicaid totaled about 8 percent of gross domestic product (GDP). Office of Management and Budget projections suggest this share will rise to 9.5 percent by 2015 and to 13 percent by 2030. While productivity growth can help alleviate some of the strain on the budget, it won’t be the whole answer. Growing budget deficits could drain resources from private investment and thereby hurt the growth of living standards.

As Greenspan noted, some of the parameters needed to scale the problem are known. For example the size of the adult population in 2030 is fairly easy to estimate since most of that population has already been born. But other parameters, such as the amount of future medical spending, are very difficult to estimate. Medical technological innovations can improve the quality of health care and lower the cost of existing treatments, but they can also expand treatment possibilities and life expectancy, and both of these can mean higher spending.

Greenspan said that he fears the U.S. may have already committed more resources to the baby boomers than it can deliver. If so, making changes to those promises should come



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www.philadelphiafed.org/econ/br/index.html.

sooner rather than later – a theme echoed by other speakers at the Policy Forum – so people can plan their work, savings, and retirement spending accordingly. Although he believes closing the budget gap depends on changes to both the spending and tax sides, he thinks that most of the change should come on the outlay side, and he suspects that we may need to make significant structural changes to U.S. retirement and health programs. Solving the Medicare problem is more difficult than Social Security because of the difficulties in estimating the trend in medical expenditures. Greenspan concluded by saying that doing nothing to solve the budget imbalance could have severe consequences for the U.S. economy, but addressing the issue in a timely and sound fashion could produce lasting benefits.

SOCIAL SECURITY AND MEDICARE: SCALING THE PROBLEM AND PROPOSED SOLUTIONS*

This session took up the problem of how to scale the fiscal deficit problem and what can be done to solve it. Our first speaker, **Robert Shiller**, of Yale University, spoke on the underlying life-cycle issues involved in the Social Security and Medicare deficits. He expanded on many of Chairman Greenspan's themes but from the perspective of behavioral economics. One of the fundamentals underlying the government budget deficit and the low personal saving rate is the problem people and society have in planning for the distant future. In Shiller's view, these behavioral considerations justify government interventions in a broader set of circumstances than those suggested by the traditional economic

* Many of the presentations reviewed here are available on our website at www.philadelphiafed.org/econ/conf/forum2005/program.html.

theory of public goods or externalities.

Shiller listed several of the concepts from behavioral economics that are important to understanding how we think about the future. One of these is hyperbolic discounting, which refers to the tendency to behave inconsistently over time: We tend to be impulsive and put more value on today than tomorrow. Psychologists are documenting that people think about the present in concrete terms but the future in more abstract terms, and this may underlie why people place more importance on the present than the future. Another concept is that of framing. People may behave inconsistently, depending on how a situation is described to them; they react to the names things are given and the context. Psychological research has also shown that some of the biggest errors people make are errors of attention: Something else has caught their attention, and they don't get around to thinking about saving. In addition,

what people tend to think about is what other people think about (a kind of herding). There is also a wishful thinking bias: People believe what they want to believe. This makes people tend to underestimate risk. Indeed, psychologists have hypothesized that people have certain pathways in their brains to deal with risk, but they are not suited to the modern world. For example, being in a crowded room when a wild animal escapes would cause your scared reflexes to engage, but being told you are not saving enough for the future doesn't. The last behavioral concept Shiller discussed was the instinct for people to believe those in authority: People have high expectations for government authorities and tend to believe them.

In Shiller's view, we need to incorporate these concepts of behavioral economics into our thinking about ways to solve the government budget problems, and he believes this is beginning to happen. This approach need



Robert Shiller, Yale University (left), and **Peter Diamond**, Massachusetts Institute of Technology.

not imply a “big government” solution. People are in a better position to know what they need and should be allowed to express it, but they will make mistakes that have to be dealt with. He concluded his talk by discussing some of the potential solutions to the Social Security and health-care problems. Shiller has been critical of the Bush Social Security plan, although he acknowledges it had some creative elements. In particular, Shiller thinks the life-cycle part of the plan was unique in that it would automatically put people who chose the account plan into a life-cycle portfolio at the age of 47. Having this as a default option is in accord with some of the recent principles of behavioral economics – i.e., you cannot expect people to make active choices. On the other hand, he also criticizes the Bush plan, likening it to a “margin loan” whereby people could borrow against their Social Security benefits and put the money into stock portfolios. For people already saving with a diversified portfolio, it is not of much use. For people who are not saving, the plan is risky, since the stock market is volatile.

Shiller said that the Medicare Part D prescription and health savings accounts have had some implementation problems that can be viewed through a behavioral economics lens. The prescription plans afford people so many options that it is a daunting task to make an optimal choice. In Shiller’s view, there is a creative idea behind the health savings accounts, namely, insure people for catastrophic events but have them manage a budget to cover their other health spending. Unfortunately, not many people have signed up for these plans, suggesting they don’t know how to prepare for health risks. (Later Forum speakers pointed out that consumers may not have the information they need on prices and quality to make optimal

choices regarding health care.) Shiller thinks this should give government and private initiatives motivation to help people deal with these complicated issues, and he pointed to a few examples of private initiatives.

The “save more tomorrow” plan of Richard Thaler and Shlomo Benartzi offers employees the choice to funnel future pay raises automatically into a savings account. People have a tendency not to save for today, since

While poverty among the elderly has fallen, it is still at fairly high levels, especially among divorced women.

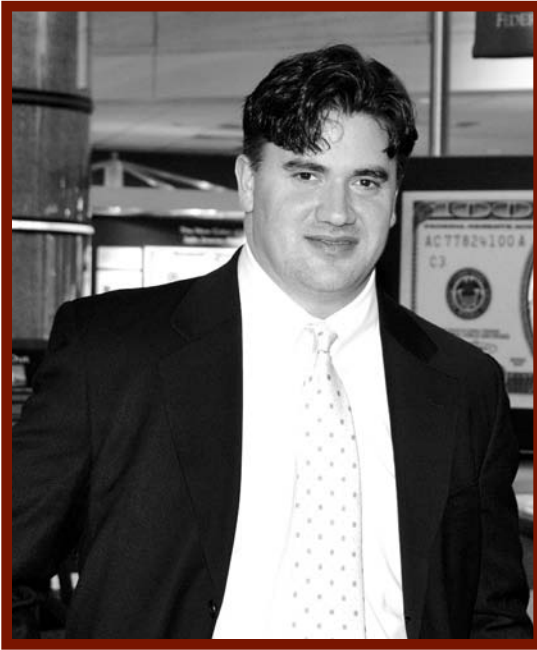
it means taking away some of today’s spending. But they are willing to sign up to save more tomorrow, and the plan has been shown to increase savings. Firms are also beginning to change their 401K plans so that the default is that the employee is in the plan rather than out of it – a simple change that takes into account human behavior. Shiller views this as a time of experimentation in which our way of thinking about basic economic problems is changing. Our solutions to the savings and health-spending problem can be more creative, since they will be based on new discoveries about the ways people make decisions.

Peter Diamond, of the Massachusetts Institute of Technology, continued the discussion with a summary of the size of the Social Security and Medicare deficit problems and a critique of proposed solutions. According to the 2005 Annual Report of the Trustees of Social Security, the Social Security trust fund will be exhausted in 2041. At that point, benefits would

be cut by about 25 percent to match revenues. Using a 75-year horizon, the unfunded portion of promised benefits is 1.8 percent of taxable payrolls as of January 1, 2005. Comparing this to the current Social Security payroll tax of 12.4 percent shows that there is a problem, but it is not an enormous one when compared with the Medicare problem.

Certain groups rely more on Social Security for a larger part of their retirement income than other groups. For example, a fifth of the elderly get all of their income from Social Security, and two-thirds get 50 percent or more. Particularly vulnerable groups include long-career low earners, widows and widowers with low benefits, disabled workers, and surviving children. While poverty among the elderly has fallen, it is still at fairly high levels, especially among divorced women. In Diamond’s view, Social Security is a part of addressing the country’s poverty issue.

Diamond was critical of the Bush Social Security plan and some of the others on the table. Diamond agreed with Shiller that to the extent that people’s private retirement plans are moving from defined benefit to defined contribution, with some investment in the stock market, he doesn’t see the individual accounts in the Bush plan as being that valuable. Moreover, the private accounts would exhaust the trust fund about a decade earlier than under the current program. Some of the other plans actually go in the wrong direction and make the 75-year Social Security trust fund shortfall larger rather than smaller. Provisions such as price indexing, which in Diamond’s view is a misnomer for real-wage deflating, and raising the age at which full benefits start result in large reductions in benefits. Regarding Medicare, the issue in Diamond’s view is how to combine universal coverage



Kent Smetters, Wharton School,
University of Pennsylvania

with quality and cost containment. Diamond said that without universal coverage, cost containment would have some unintended consequences.

The final speaker in the first session, **Kent Smetters**, of the Wharton School, University of Pennsylvania, addressed some of the measurement issues in budget accounting, arguing that the traditional budget approach worked fine when government programs were more of a bricks and mortar type; it works less well for programs with long-term liabilities, such as Medicare and Social Security. The federal budget substantially underestimates the government's liabilities by ignoring long-term liabilities. It tracks them separately, off budget. So the budget gives an incomplete picture of the country's fiscal imbalance. The traditional budget accounting also makes it hard to evaluate the impact of program reforms. If the benefit of the reform is off budget but the cost is on budget, the reform will look like it increases the fiscal imbalance. Smetters proposes a new budgetary framework that includes two integrated components: a fiscal imbalance component

that equals debt held by the public plus the present value of all future outlays minus the present value of all future revenues, and a generational imbalance component that measures the proportion of the fiscal imbalance due to spending by past and current generations relative to what they have paid into the system. Different reform proposals for Social Security will have different effects on the generational imbalance, depending on how they affect taxes and benefits now and in the future. Under the assumptions made by the Office of Management and Budget, the Department of the Treasury, and the Council of Economic Advisers, Smetters estimates that the total fiscal imbalance in Social Security in 2004 was \$8 trillion. Past and living generations have gotten about \$9.5 trillion more from Social Security than they paid into it, and under current law, future generations will pay \$1.5 trillion more into the program than they will get out of it, for a net total imbalance of \$8 trillion. Medicare has a much larger imbalance of \$61 trillion, with \$24 trillion due to past and living generations and \$37 trillion due to future generations. The rest of the federal government is in a surplus. Thus, the total fiscal imbalance was \$63 trillion in 2004, and it is growing significantly each year. This represents 18 percent of all future payrolls and is a very large problem. For example, Social Security and Medicare benefits would have to be cut by over half to close the imbalance. Alternatively, the combined employer-employee payroll tax would have to rise from 15.3 percent to over 32 percent and the payroll tax ceiling would have to be removed.

Given these dire numbers, why haven't the capital markets reacted? Smetters says it could be behavioral, along the lines Shiller discussed; that is, they don't understand the magni-

tudes. But it also could be that capital markets believe the government is going to solve the problem mainly by cutting benefits rather than raising taxes. Smetters thinks this is a somewhat irrational view, given the aging of the median voter. He ended on an optimistic note by pointing out that 50 percent of U.S. households don't hold any equities either directly or indirectly in employer-sponsored defined contribution plans. Thus, the component of the Bush plan that puts people into a life-cycle portfolio plan automatically by default is an important innovation in Smetters' view. He is less concerned than Shiller and Diamond that people will make wrong choices.

The Policy Forum's keynote luncheon speaker was **Katherine Baicker**, a member of the Council of Economic Advisers, who spoke about the important fiscal challenges the U.S. faces over the coming years on both the spending and revenue sides of the federal balance sheet and her views of what steps should be taken to meet those challenges. Baicker pointed out that while over the last 40 years spending and revenues have been relatively stable, there have been important changes in the composition of both that will help determine future stability if nothing is done to entitlement programs, the largest of which are Social Security, Medicare, and Medicaid. Without changes in those entitlement programs, Baicker says that a decade from now, government spending as a share of GDP will begin to rise swiftly, with potentially dire consequences for the U.S. economy.

On the expenditure side, federal spending as a fraction of GDP since 1962 has been relatively stable at about 20.4 percent, but the share of GDP devoted to entitlement spending has tripled, while the share of spending going to defense and other government spending, such as highways, educa-

tion, and national parks, has fallen. In 1962, entitlement spending was primarily Social Security, and it was 2.5 percent of GDP and 13 percent of the federal budget. Medicare and Medicaid were introduced in the 1960s, and in 2005, the three programs together accounted for 8 percent of GDP and made up 40 percent of the federal budget (not including the substantial contributions to Medicaid made by the states).

The revenue side of the federal budget also shows stability, with total federal revenues averaging 18.2 percent of GDP since 1962. Payroll taxes, which are used to fund Social Security and Medicare, have doubled over the period, from about 3 percent of GDP to a bit over 6 percent. Personal income tax collections have been relatively stable, while excise tax and corporate income tax collections have declined. Comparing the revenue and expenditure sides shows that the federal government has been running a deficit of about 2.2 percent of GDP a year. In 2005, the deficit was somewhat higher at 2.6 percent of GDP.

But Baicker pointed out that the stability of the fiscal situation in the U.S. over the past 40 years is in jeopardy, since the first part of the baby boomers will reach retirement age in 2008. Over the next 40 years, the costs of the three entitlement programs will rise from about 8 percent of GDP today to over 15 percent of GDP in 2045. This trend suggests that without a change in the programs, either taxes must increase substantially or spending outside of entitlements must be nearly eliminated – both poor choices in Baicker’s view. Baicker agreed with the earlier speakers that solving the Medicare/Medicaid problem was more challenging than solving Social Security, because she was optimistic that the President’s plan of progressive indexing of benefits of higher-earning

workers to prices would be an important step toward permanent solvency.

To control the cost of government-financed health care, Baicker said we need to address the costs of health care in the private sector as well. In her view, much of the spending on health care – both publicly and privately financed – is not being efficiently allocated. To alleviate this, she said it is most important to create incentives for high-value care. For example, Baicker said that the current tax code subsidizes employer-provided health insurance relative to other forms of compensation and to individually purchased health insurance. This leads to insurance coverage of routine and predictable health-care expenditures rather than paying for those out-of-pocket and insuring



Katherine Baicker, Council of Economic Advisers

increase competitiveness in these markets, leading to lower prices and improved quality. At the same time, Baicker acknowledged in the question and answer period that several difficulties would need to be solved before moving to what she calls “consumer-

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against catastrophic and unexpected expenditures. Baicker says capping the employer exclusion of health insurance premiums is one step that could be taken to increase the sensitivity of the use of health care to its cost. She is also in favor of expanding health savings accounts, which allow people to pay for health care with pre-tax dollars as long as their health insurance policy includes a sufficiently high deductible and catastrophic coverage. She believes steps like these would help ensure that health-care resources were allocated to uses with higher value, and she thinks this could also

driven health care.” One of these is a lack of transparency. For example, it is difficult to decipher the pricing of services from the bills you receive from health-care providers and to obtain information on the quality of providers. Without price and quality information, rational health-care decisions are severely hampered (even aside from the behavioral aspects of decision-making Shiller spoke about).

Our second session turned to two budget experts for their views on the current budget deficit and prognosis. **Doug Holtz-Eakin**, then director of the Congressional Budget Office, said

he viewed the U.S. fiscal situation to be the single most important economic policy challenge we face if the current programs are not reformed. In his view, adhering to the promises to spend as under current law will fundamentally impair the economic success of the U.S. It will result in a larger federal government, higher tax rates, and more reliance on mandates and regulations to achieve policy aims rather than on the budgetary process.

In the CBO's summer update to the budget outlook, the federal budget was projected to move back to baseline trends and become better in balance over the next five years. But there were several risks to that projection, for example, the path of defense spending and possible changes to the alternative minimum tax. Moreover, the hurricanes, which occurred after that update, affected the budget in three ways. They changed the cost of ongoing programs, but not by large amounts. They led to direct appropriations for relief and recovery, but the spending associated with those generally takes place over time. They might also lead to permanent changes in the law; for example, 12 pieces of legislation with hurricane relief provisions passed quickly. Holtz-Eakin explained that the spending and tax reconciliation is now an important part of the budget process. For the first time in eight years, Congress has used these procedures to cut spending in mandatory programs that are relevant to the long-term budget outlook. In Holtz-Eakin's view the important thing is not the amounts but the fact that Congress now understands that each year the mandatory programs need to be on the table and that the process of reconciliation will be part and parcel of the process of legislating.

While he suggested there are some things the government could do to improve the formulation of the budget

– such as incorporating an average level of funds in anticipation of natural disasters that recur repeatedly like hurricanes, wild fires, and droughts – Holtz-Eakin said this is not the key

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to solving our budget problems. Rather, the key is addressing the long-term cost of our mandatory spending problems. It is important that the relatively benign near-term budget outlook not seduce us into ignoring the long-term problems. In Holtz-Eakin's view, policy decisions rather than the course of the economy are central to the long-term budget outlook.

Alice Rivlin, of the Brookings Institution, continued the discussion by pointing out that it has been decades since the U.S. has seen as rapid a reduction in revenues as a percent of GDP as has occurred in the past five years. The CBO projections are based on current law. Thus, they assume the tax cuts of 2000, 2001, and 2003 expire. If instead they continue, the budget imbalance is much worse. Rivlin said we experienced a similar situation in the 1990s. Back then there was bipartisan agreement that

something needed to be done about it. There wasn't bipartisan agreement about what should be done, but rules were put in place to control spending, control entitlement spending, and control tax cuts, and the strong economy operated to reduce the deficit and turn it into a surplus. Rivlin said this time we do not have consensus that there is a problem, even though the future budget imbalance is very large as spending on Social Security, and especially on Medicare and Medicaid, increases rapidly. Echoing the earlier Policy Forum speakers, Rivlin believes the Social Security problem is manageable; Medicare and Medicaid are far larger problems. She thinks per capita health spending, both nationally and in these programs, will continue to rise 2.5 percent faster than GDP as it has over the last four decades; she is skeptical of the Medicare trustees' assumption that it will decelerate to 1 percent faster than GDP growth and eventually to the same pace as GDP growth.

Under Rivlin's assumption, there is no tax rate that will bring back fiscal balance, and if the deficit problem isn't



Alice Rivlin, Brookings Institution

solved, interest expenditures will rise to over 20 percent of GDP by 2050, so borrowing is not a sustainable option either.

According to Rivlin, to solve the budget imbalance problem, we need to slow the rise in health-care spending in the federal budget. And we need to do that in a way that will slow the per capita spending on health care not only by the government but also by the private sector, because otherwise it is just shifting the expenditures. Rivlin pointed out that the U.S. has a very expensive health-care system compared with other countries; while the rates of growth in per capita spending are similar in developing countries, our level of spending is higher. While there have been cost-saving innovations in providing health care, these innovations also tend to increase demand for the service. But there are ways to increase cost effectiveness. For example, the practice of medicine continues to be paper-based; improvements in information systems could probably reduce costs and might also result in fewer treatment errors.

Because the Medicare system is an almost universal system for the over-65 population, it holds the potential for learning about which treatments are cost-effective – provided its data can be analyzed. The next issue would be what to do with this information. Rivlin pointed out that one strategy was suggested by Baicker: to give consumers the information and let them make the choices through, for example, health savings accounts. The other strategy is to change the reimbursement system to reward effective medical care and not pay for ineffective and excessive medical care – although Rivlin admitted we don't know how to do that yet. She suggested a companion step is to use federal government research dollars to push for innovations likely to be cost saving,

especially for diseases like cancer where the innovations are unlikely to lead to expanded treatment, since these diseases already always get treated at some stage. There are political obstacles that would need to be overcome. In Rivlin's view, these include the power of insurers, pharmaceutical companies, and providers, who have been fairly negative on change. Rivlin concluded by pointing out that the U.S. is not alone in this problem, which she says is a problem of prosperity. In the U.S. and in other successful economies people are living longer and better, and part of that living better is better medical care.

In a global economy, goods, services, capital, and labor can migrate to where they can be most efficiently used and where there are fewest obstacles to putting them to efficient use.

The Policy Forum's final session took up the broader implications of fiscal imbalance for the macroeconomy. **Richard Fisher**, president of the Federal Reserve Bank of Dallas, agreed that the magnitude of the projected budget deficits is of great concern and said that, left unchecked, they have the potential of harming U.S. economic prosperity and undermining the progress we have made on infla-



Richard Fisher, President, Federal Reserve Bank of Dallas

tion. He believes it is very important to consider how the forces of globalization affect U.S. fiscal deficits. Globalization means a nation's economic potential is no longer defined by its geographic boundaries. In a global economy, goods, services, capital, and labor can migrate to where they can be most efficiently used and where there are fewest obstacles to putting them to efficient use. So countries need to compete for these resources. In Fisher's view, businesses have come to grips with globalization, and globalization has helped discipline central bankers around the world to focus on keeping inflation low. Fisher believes that globalization is also exerting some discipline on fiscal policymakers, and the U.S. is in better shape than most of its competitors. One of the ways globalization has a beneficial effect on fiscal decision-making is via tax competition. Fisher pointed out that average tax rates are falling in the world's most open economies. Also, to the extent that young people can move to escape high Social Security taxes, it is more difficult to sustain a system based on intergenerational transfers.

In theory, globalization should exert a similar discipline on the spending

side, but Fisher says we have yet to see such deficit-reduction pressures. Nonetheless, when investors are considering where to allocate their capital, it is the relative position of one country vs. another that matters. In Fisher's view the U.S. has been able to finance its spending via foreign capital because we are doing better in terms of fiscal policy compared with other countries. Fisher provided some numbers: According to OECD data, public-sector spending (including federal, state, and local government spending) was projected to be 3.7 percent of GDP in the U.S. in 2005, compared with 6.5 percent in Japan, 4.3 percent in Italy, and 3.9 percent in Germany. He thinks that the demographic challenges regarding Social Security and Medicare in the U.S. are not as severe as those facing Japan and Germany.

But while the U.S. may be better off than other countries, Fisher believes following "least-bad" policy is risky, since it is never clear whether our advantages will last, especially if a rising deficit erodes U.S. economic performance. He believes that to secure our advantages we should put our fiscal house in order before our competitors put theirs in order. Fisher pointed out that monetary policymakers cannot be indifferent to the thrust of fiscal policy because poor fiscal policies create pressure for poor monetary policies, e.g., monetizing the debt and fueling inflation. But he emphasized that the solution to the U.S. fiscal imbalance rests with fiscal policymakers and not the central bank.

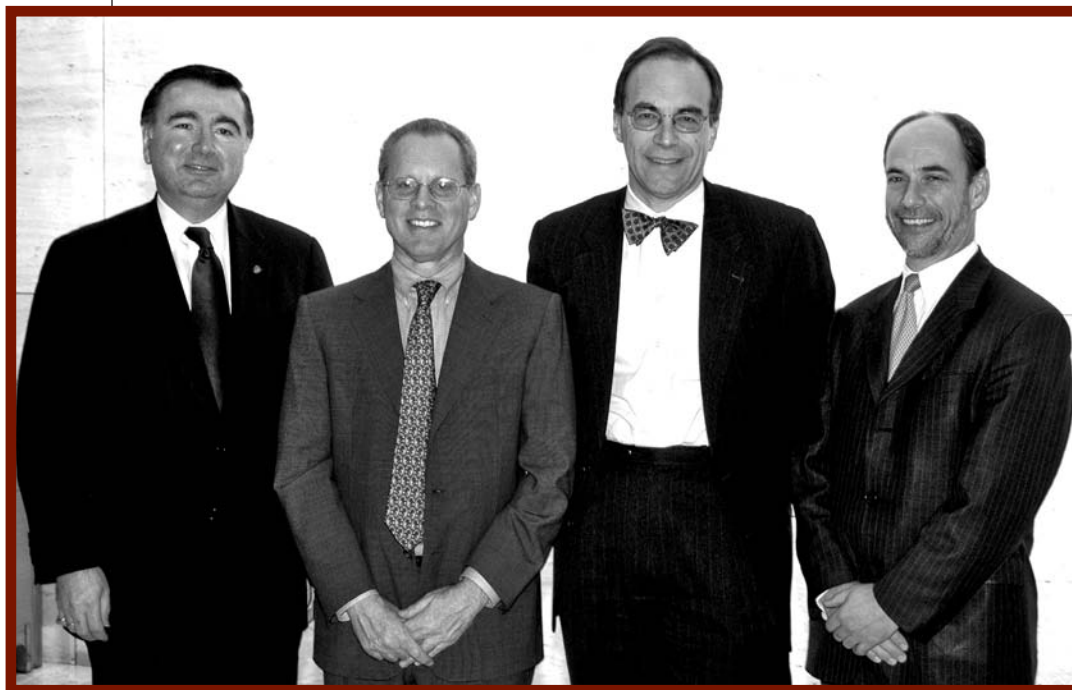
Robert Barro, of Harvard University, took up the theme of monetary policy touched on by

Fisher. In Barro's view, in the last 25 years there has been a major triumph in terms of central banks around the world achieving low and stable rates of inflation. He said he is not certain why monetary policy has worked as well as it has in the U.S. and abroad. His analysis indicates that Fed policy under former Chairman Greenspan could be characterized as a reaction function, with the federal funds rate reacting to the inflation rate and the real economy as embodied in employment growth and the unemployment rate. The analysis suggests that the Fed does not respond to changes in real GDP that are due to productivity growth. The Fed's policy is also characterized by gradualism: It moves interest rates gradually. Barro said it was not clear that the Fed's reacting to the real economy and gradualism are beneficial. Nonetheless, in Barro's view the Fed's triumph over high inflation is a remarkable achievement.

Alan Auerbach, of the University

of California at Berkeley, formulated his talk around the policy changes we should expect in response to the fiscal situation we face and the economic effects we should expect as people anticipate these policies. He agreed with earlier speakers that we face a rising imbalance that gets much larger with every year something isn't done to solve it. Auerbach said the problems policymakers need to address (in order of importance) are health-care spending and the federal contributions to Medicare and Medicaid; general revenue taxes, i.e., taxes not associated with entitlement programs and not payroll taxes; and Social Security. In Auerbach's view, most discussions of the macroeconomic effects of fiscal imbalance have focused mainly on the effect of current fiscal policy on the economy. These would include possible crowding out of private investment by government spending, higher interest rates, and current account deficits. There has been little discussion of the effects

(left to right): **Tony Santomero**, former President, Federal Reserve Bank of Philadelphia; **Robert Barro**, Harvard University; **Alan Auerbach**, University of California at Berkeley; and **Doug Holtz-Eakin**, former Director, Congressional Budget Office.



of the necessary policy changes on the economy.

Given the size of the future fiscal imbalance and the fact that federal taxes as a share of GDP are lower now than at any time since the 1960s, an eventual tax increase of 4 percent of GDP, through a combination of broadening the tax base and increasing marginal tax rates, would not be implausible in Auerbach's view. Economic models suggest that higher future tax burdens should induce people to increase effort today to be able to pay future taxes and to save. Thus, we'd expect higher labor-force participation, higher employment, and higher private saving to pay for future taxes. The higher marginal tax rates might also encourage more work today if people plan to retire earlier than otherwise as a result of the tax change and decide to work harder now to save enough to retire. However, higher marginal tax rates would also induce lower private saving, since those savings would be taxed at a higher rate.

Auerbach doesn't think much progress on the Social Security and Medicare problems will be made until there is a crisis. At that point, the problem will be too large to be solved by increased payroll taxes alone, but politically it will be nearly impossible to make sizable benefit cuts for less affluent retirees. Thus, Auerbach believes there will be means testing of entitle-

ments in the future. Means testing has mixed effects on incentives to accumulate wealth. If you are so wealthy that you know you are going to be hit by the means test, you'll have an incentive to accumulate even more wealth, since your retirement and health-care benefits have just been reduced. But if your wealth is near the level where benefits are phased out by the means

There was agreement that difficult policy choices will have to be made and that the time for making them is now, not later, if we want to reduce the impact of the fiscal imbalance on the U.S. economy.


test, you could have a strong incentive to save less so that you would qualify for benefits. And since you are saving less, you'll work less as well.

Auerbach pointed out two other potential macroeconomic effects as the economy adjusts to changes in fiscal policy. Trade deficits will shrink and turn into trade surpluses in the future. As that occurs, the composition of U.S. GDP will change toward more trade-sensitive industries. Until we know how the fiscal imbalance will be handled – how much taxes increase, how much marginal tax rates increase, how much the tax base broadens, how much benefits are cut – there will be substantial uncertainty in financial

markets. Until that uncertainty is resolved, the equity premium should be higher. At least, this should occur when people realize the current fiscal situation is not sustainable. A resolution of policy uncertainty would make us better off, and Auerbach suggested that the costs of adjustment that we know must come at some point would be lower if we adopted more gradual

systemic plans to address the fiscal imbalance. However, Auerbach said he was not encouraged by recent policy actions.

SUMMARY

The 2005 Policy Forum generated lively discussion among the program speakers and audience on the challenges facing the U.S. in dealing with its increasing fiscal imbalance. Although there was no agreement on particular solutions, there was agreement that difficult policy choices will have to be made and that the time for making them is now, not later, if we want to reduce the impact of the fiscal imbalance on the U.S. economy. 

The Philadelphia Fed

December 1, 2006

POLICY FORUM

We will hold our sixth annual Philadelphia Fed Policy Forum on Friday, December 1, 2006. This year's topic is "Economic Growth and Development: Perspectives for Policymakers." At right is the program. The Policy Forum brings together a group of distinguished economists and policymakers for a rousing discussion and debate of the issues. For further information, please contact us at PHIL.Forum@phil.frb.org.

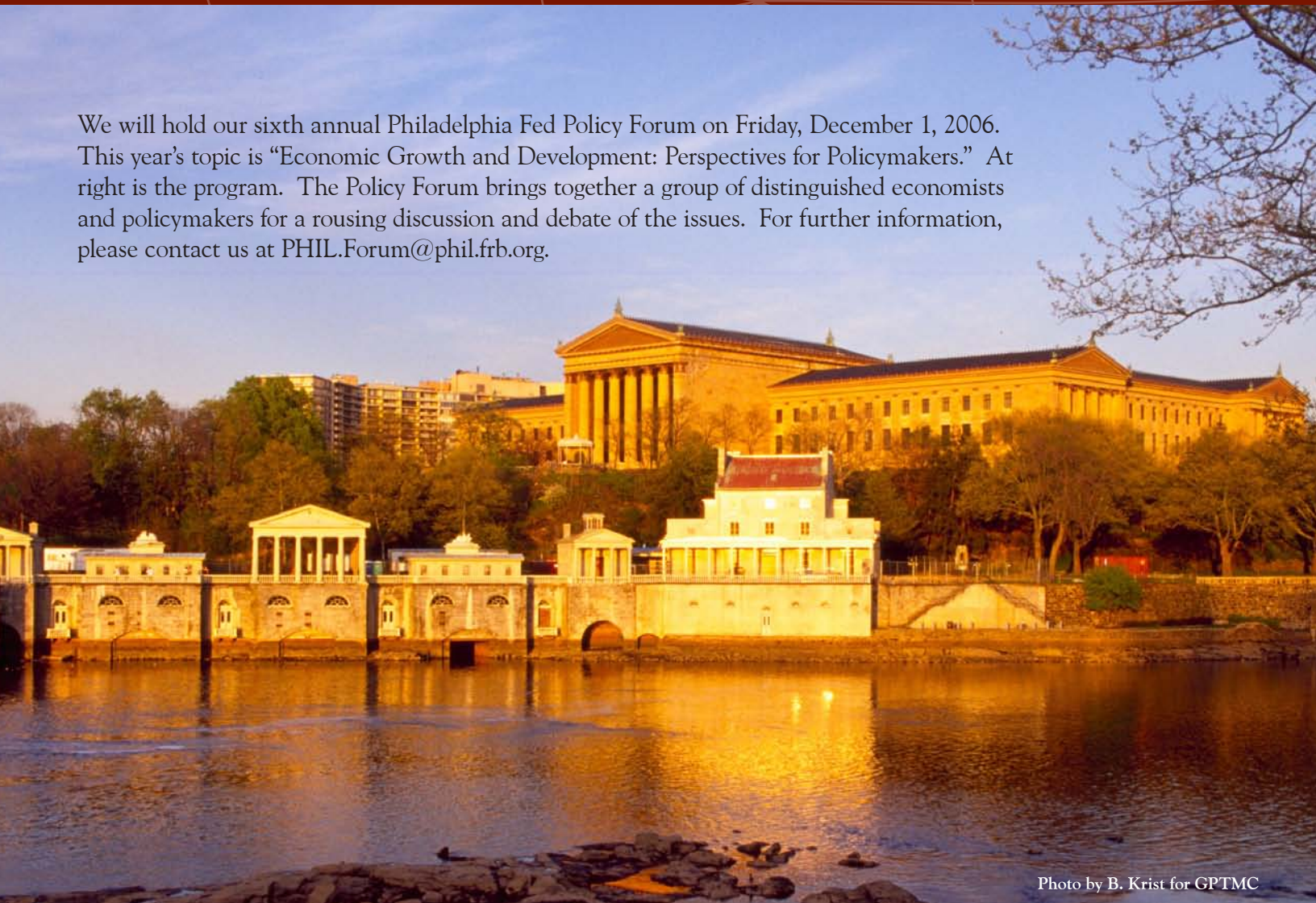


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The Philadelphia Fed Policy Forum

ECONOMIC GROWTH AND DEVELOPMENT: PERSPECTIVES FOR POLICYMAKERS

December 1, 2006

Federal Reserve Bank of Philadelphia, 6th and Arch Streets

Continental Breakfast

Opening Remarks

Charles I. Plosser, Federal Reserve Bank of Philadelphia

Economic Growth and Development: An Overview of Issues and Evidence

Moderator: Michael Dotsey, Federal Reserve Bank of Philadelphia

Roberto Zaghera, The World Bank

Xavier Sala-i-Martin, Columbia University

Discussion and Audience Participation

Policy Responses: Trade and Foreign Aid

Moderator: Kei-Mu Yi, Federal Reserve Bank of Philadelphia

Elhanan Helpman, Harvard University

William Easterly, New York University

Discussion and Audience Participation

Lunch

Financial Markets and Growth

Moderator: Loretta J. Mester, Federal Reserve Bank of Philadelphia

Jeffrey M. Lacker, President, Federal Reserve Bank of Richmond

Robert M. Townsend, University of Chicago

Discussion and Audience Participation

Institutional Arrangements and Economic Growth and Development

Moderator: George Alessandria, Federal Reserve Bank of Philadelphia

Dani Rodrik, Kennedy School of Government, Harvard University

Ross Levine, Brown University

Daron Acemoglu, Massachusetts Institute of Technology

Discussion and Audience Participation

Reception and Informal Discussion