

Lecture 16: Policy IV – Issues in Long Term Policy

East Elmore

In East Elmore, government purchases of goods and services as a percentage of GDP had been rising steadily over the past 30 years from about 15 percent of GDP to about 20 percent of GDP. The panel was worried about the percentage of GDP going to government spending. Was it too high? Alternatively, was it too low?

In an important sense, this is a silly debate. Spending decisions should be made on a program-by-program basis. Consider two projects:

- Buying fireworks for Independence Day Celebrations.
- Building new highways.

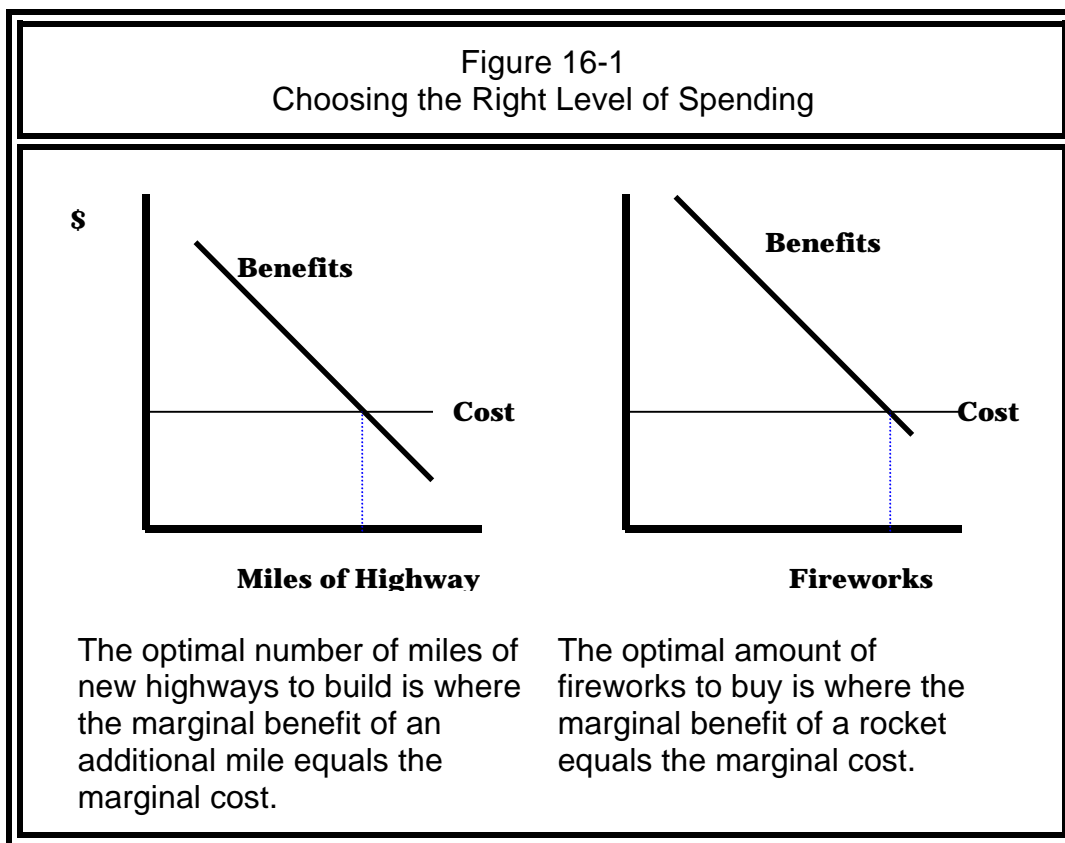
The first represents a government consumption project; the second represents an investment project.

Each project has benefits and costs. Figure 16-1 shows how to make the decisions. Each dollar spent on fireworks and highways has a marginal cost, but also has a marginal benefit. Each dollar has a marginal benefit, though the marginal benefit declines as the number of dollars spent increases. The right amount to be spent on each project occurs when the marginal benefit equals the marginal cost.

These costs and benefits are not easy to calculate. To give some simple examples:

- In the case of the fireworks display, it may be easy to estimate the cost of the fireworks, but the costs also include the costs visited upon people who want to sleep but are kept awake by the noise. As to the benefits, large crowds gathered each year to see the fireworks display, suggesting that they got pleasure from the displays? But how much pleasure?
- In the case of the new highway, the costs include not only construction costs but also environmental costs and dislocation costs imposed on those who must move to make way for the new highway. As to the benefits, many people will make trips faster and in greater safety when the highway is complete. How do we measure those benefits?

- In all cases, we know taxes must be levied to pay for the project. All taxes involve distortion costs but those costs are hard to calculate.



The panel agreed that these were important issues, and that it was important that the analysis be done correctly. It was easy for special interest groups to cause resources to be wasted for programs which only served their special interests, and it was also possible that political considerations could result in important programs being under funded.

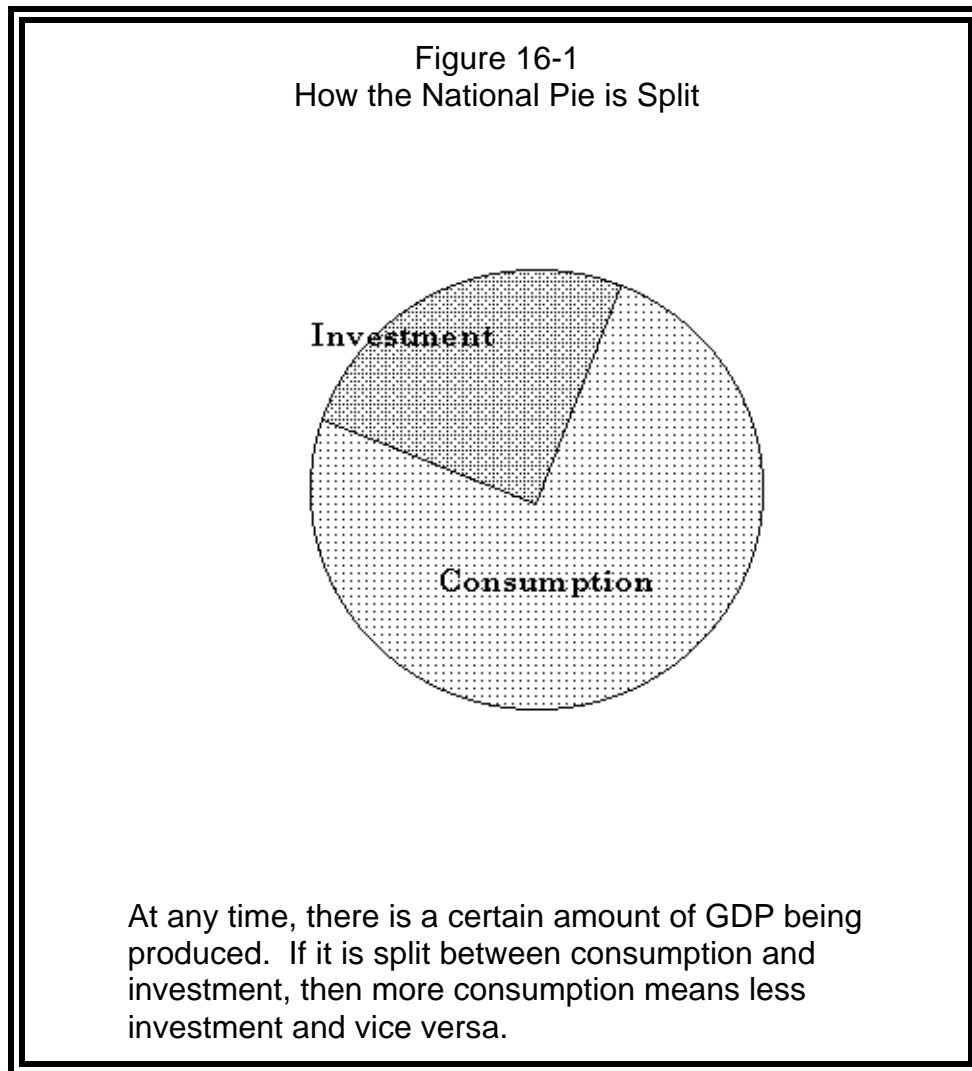
The panel also agreed that inasmuch as the analysis should properly be done on a project-by-project basis, it was possible – indeed likely – that the government was spending too much on some projects and not enough on others.

They noted that in the United States, Republicans, generally not thought of as big spenders, usually favored increased spending on national defense and highways, while opposing the current level of spending on other projects such as public housing. On the other hand, Democrats generally had the opposite priorities. All recognized this as an over simplification, but one that contained a significant element of truth.

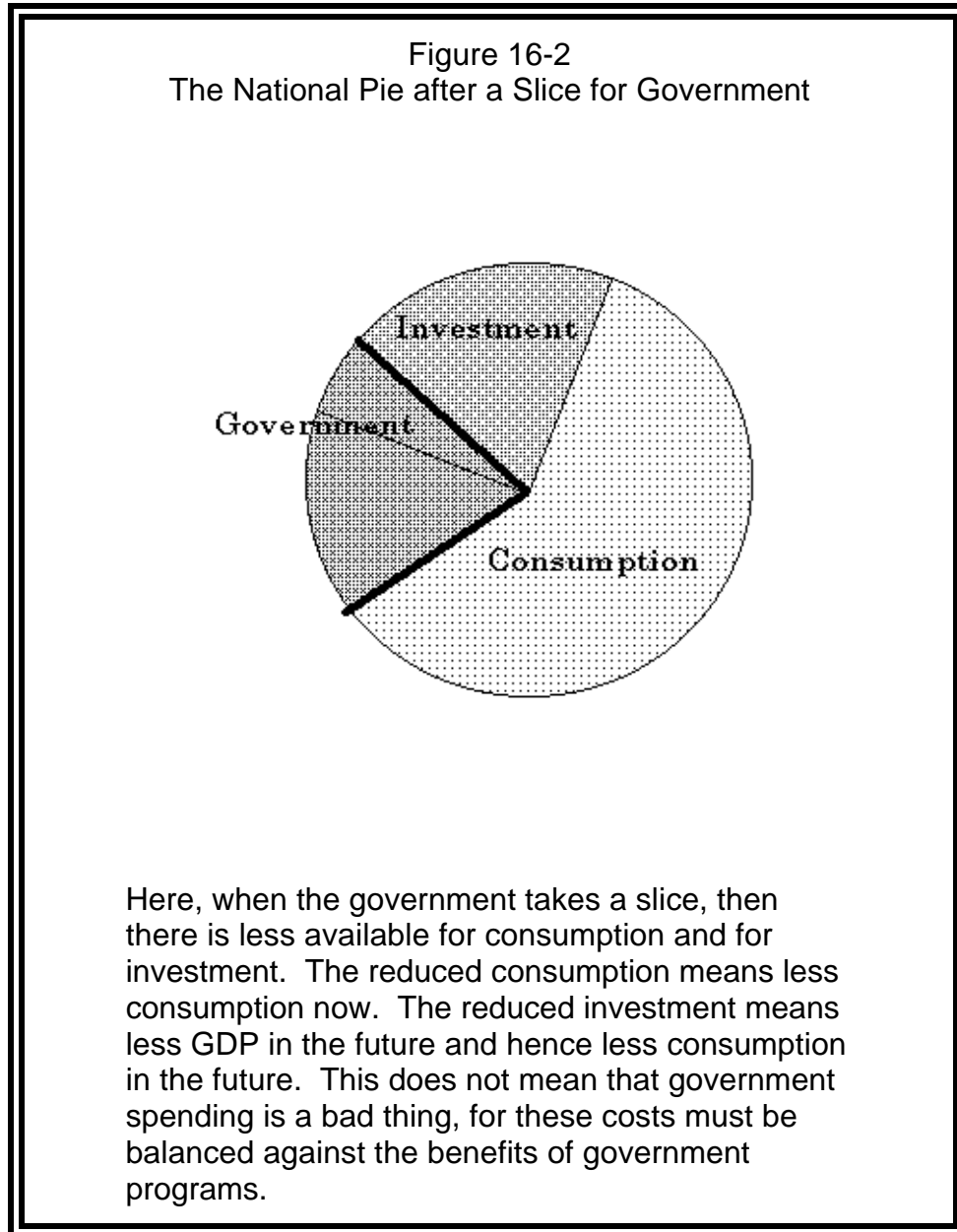
Finally, the government also noted that there was always the issue of whether an activity should be publicly funded. Many beneficial projects were privately funded. In some cases, it was possible that when the government funded a project, its spending would simply substitute for private spending.

The Government as a Consumer of Resources

The panel thought it important to emphasize that none of these government programs were "free". To make sure that the audience understood these issues, the panel produced two graphs. As Figure 16-1 shows, if there were no government spending, GDP would be spent on private consumption, which gives pleasure now, and private investment, which adds to the productive capacity of the economy in the future.



When we allow for government, another slice comes out of the same pie. (And indeed when we allow for the costs of taxation, then the pie may get slightly smaller). That is, we must slice the pie as Figure 16-2 shows:



Transfer Payments

The panel noted that special rules applied to one important category of government expenditures, Transfer Payments, by far the fastest growing sector of government spending. A transfer payment takes place when the government transfers funds from one individual to another. There are

numerous examples of transfer payments, such as social security and welfare payments. Note that, if the government does that, it does not influence GDP and it does not affect the amount of funds available for private consumption and investment.

Social Security

The economists from Central Elmore were not concerned about government purchases of goods and services, but about transfer payments. Specifically, there are proposals to establish a government-run retirement system in Central Elmore.

Government-run retirement plans have been around a long time. In the 19th century, Prince Otto von Bismarck of Germany instituted a government run pension system. The government paid retirees a tax-financed pension. Bismarck seldom did anything out of a concern for social welfare, and, in this case, his objective was probably to give people an interest in the survival of the new German Empire: their pensions depended on it.

The American Experience

In the 1930's, the United States Government implemented a program of federal pensions. The idea was quite simple. Individuals would contribute through a payroll tax to fund their program. Their employers would match their donations, a way of disguising that the program cost twice as much. The contributions would be used to fund a social security trust fund, which would pay pensions to contributors when they reached old age. The first social security checks came in 1940. Since then, the program has grown enormously.

The social security program now, by far, the largest government program in the United States has changed in a number of ways.

- Social Security Pensions have grown substantially over time.
- So too, have Social Security Taxes.
- The notion of a trust fund, while continuing in theory, has become largely a fiction. The government runs a unified budget, counting social security receipts and expenditures as part of the budget. The program has essentially become a "pay as you go" program.

Three Proposals

There is strong pressure in Central Elmore to establish a retirement system. As is the case in the United States, people are retiring earlier and living longer. Most people are making adequate financial provisions for their retirement either through company-sponsored pension plans or through individual retirement accounts much like the IRA and 401k plans so popular in the United States. Inevitably, some people do not, ending up aged and indigent. These horror stories always make the newspapers and the television news and the government always looks foolish: how can they allow this to happen in a country as wealthy as Central Elmore. It makes no difference that the government knows that the folly is on the part of people failing to make adequate provisions for their old age.

The government is considering three different plans:

- Adopt the American plan. The government would collect enough taxes each year to cover the cost of pensions. To phase the program in, retirees would only be covered if they had worked a number of years. Thus, most of the people currently over the retirement age would not be covered. In the meantime, the government would set the old age tax rate relatively high, collecting far more revenue than required to furnish pensions. It would claim that it was investing the proceeds into a trust fund, though the reality would be a disguised tax hike to cover other programs.¹
- Some argue for adopting a variant of the American plan, the *stock market variant*. Here, taxes would be collected but the proceeds from the taxes would be invested in a real trust fund, not a fictional trust fund. The trust fund would then be invested in the stock market. Economists had noted the high return on stock market investments in the United States since 1982, and thought with this plan would earn enough extra revenue to cover any deficit in any old age pension plan.
- Some propose that Central Elmore adopt a plan similar to that of Chile, the so-called privatization option. Here, the

¹ Certainly that was what the Americans had accomplished. The United States Government had, throughout the second half of the 20th century, collected more in Social Security Taxes than it paid out in social security benefits. In theory the government was contributing the surplus to a special trust fund. In reality, the government was using the revenues to cover the cost of other programs. Some economists were projecting that, around 2025, the cost of the American Social Security Program would exceed the revenues from Social Security Taxes.

government would require that citizens put part of their salary each year into a private pension plan. The government would have a list of approved pension programs, to make sure that citizens were not taken by some shyster plan, and it might have requirements about approved investments. For example, the pension plan might be prohibited from making very risky investments. The idea is that the plan will be able to guarantee you a pension, no matter how badly the stock market does. When people retired then their own private pension plan would provide for their golden years.

Comments

The American Plan

This plan seemed the simplest one to adopt. It had a cynical advantage of raising taxes for other government programs for years to come. The economists on the panel who were also government employees were generally supportive. They dismissed questions about the funding of the plan "in the long run" by repeating an old chestnut attributable to John Maynard Keynes² that "in the long run we are all dead".

The Stock Market Variant

This idea is generally dead on arrival. Many people find the idea of the government buying – and then being in a position to control – corporations frightening. On top of this problem, there is another issue. While the period since 1982 has been a very good period for investors in the stock market, there have been long periods when the market has not been a good buy. Suppose we invested the trust fund in the stock market, which then proceeded to drop by 40% (yes, that can happen). The problem of funding social security would become even worse.

The Privatization Option

This option would mandate participation into something like TIAA/CREF, an American pension plan run for private colleges and universities. Professors at many private universities as well as several state universities – though not Kent State University – contribute to TIAA/CREF. Part of the contribution comes from the professor's salary; part is a matching contribution. The details vary from university to university. TIAA/CREF

² Many junior economists wondered who this guy Keynes was. The Economist General explained that Keynes, a British Economist from the 1930's, introduced the idea of aggregate demand into economist's lingo, and argued that the economy could be managed without any consideration of supply conditions. Keynes, as well as this notion, is now out of date.

takes the funds, now over \$100 billion, and invests them in a mix of stocks and bonds at the discretion of the professor. When the professor retires, he or she can use his funds to purchase a pension.

Is this a good system? Any young person offered the chance to bail out of social security and to have his or her social security taxes invested in TIAA/CREF or something like it would be foolish not to jump at the chance.

The panel saw the choice as one between the American plan and the Privatization option. The breakdown was generally along age lines. The older members saw that if the government adopted the American plan, they would get something out of the program. The younger members saw the choice the other way. They would not receive benefits as valuable as their "contributions".

What Should the Americans Do?

The panel was asked for advice for the Americans. The United States had already introduced its plan. By law, the United States government can only pay pensions out of the trust fund. This will become important in the future. The period after World War II saw a huge baby boom. Around 2010, the "baby boomers" will begin to retire in large numbers. As they do, the number of elderly receiving social security will swell, a process aided by longer life expectancies. Current projections show that, with the program in effect, the social security program will run out of money about when the current generation of college students retires. The precise year at which the money runs out changes from projection to projection. None of these projections is that reliable, but they all point to a time in about 30 years when the system will be bankrupt.

While thirty years may seem like a long time, the problem requires attention. The United States will be far better off fixing the problem now rather than sticking its head in the sand for 30 years and then attempting a fix.

Fundamentally, the problem the United States faced was a simple one. It had passed taxes to pay for old age pensions. The tax was soon going to be inadequate to pay for the program. The government has three choices.

- End the program
- Cut the program
- Raise Taxes

Ending the Program

Some suggested that the American government simply abolish the program and replace it with mandatory private plans. If the United States were to do so, there would be a problem. Any young person offered the chance to drop out of the program (no taxes, no benefits) would be smart to do so. They could do a better job of saving for their retirement themselves. The magic age at which the present value of the benefits exceeds the present value of the taxes is sometime in the late 40's. However persons over fifty benefit, either now or in the very near future, from the program. If the United States were to eliminate the program, these people would lose.

The only practical method would seem to be a "phase out"; let the young people opt out and the older people stay in. This option has its own complication. In a few years, however, as young people "opted out" of the system, social security taxes would decline and the system would be unable to pay benefits to people who elected to stay with social security. The United States could use general revenues to cover the deficit, or perhaps tell young people that, while they could switch to private social security, they had to continue paying reduced social security taxes to effect the transition. Older people worry about this transition. Consider someone aged 55. He would definitely stay with the old system. He would – or should – worry about what would come in 15 years when he turned seventy. By that time, a significant portion of the public would have opted out of the social security system. When the issue of continuing to meet obligations to elderly came up for a vote, few people would have an interest in the integrity of social security. Thus, he would worry about the government keeping its promise to facilitate the transition. After all, had it not already reneged on a promise to maintain social security forever? Might it not renege on a promise to manage the transition?

Cut the program

About 10 years ago, a panel recommended some changes in social security. They recommended that

- Social security payments be taxable for high-income senior citizens. The idea was to make sure that more of the benefits went to low income senior citizens.
- A higher retirement age. Right now, the retirement age is 65. In a few years, it will begin rising to 67. It is possible to retire early – and it will continue to be possible to do so – but at a reduced pension.

Actually, these were clever ideas. While they looked like social security "reforms", they were nothing more or less than cuts in the benefits. The panel thought it had cut benefits enough with these and other "reforms" to keep the system solvent, but they did not. (That these changes did not "fix" the system should give one pause when you think about current projections and proposals to fix the current system.)

The obvious solution is to cut benefits once again, by increasing the retirement age. The planners of the social security trust fund made a serious mistake when they wrote the retirement age in stone. In Bismarck's time, someone 65 was old. Life expectancies are up significantly and age 65 is not, plainly put, as old as it used to be. Part of the reason for retirement is that, a century ago, work was much more physically demanding than it is now. Thus, the desirability of retirement is less pressing that it was then. Of course, Congress has made the problem worse by continually making social security benefits available to younger people: you can now receive reduced benefits at 62 if you retire and at age 65 even if you don't.

Some people have suggested that we deal with the problems of raising the social security retirement age to, perhaps, 70. The idea would be to provide a safety net for the genuinely elderly, and not just for those who want to retire and enjoy themselves. Since many people are doing just that – as life expectancies rise, the retirement age continues to fall – this idea is not that popular. However, it is an effective means of cutting the benefits, which will certainly "fix" the program.

Raise Taxes

It is certainly possible to continue paying pensions, by raising other taxes. The taxes required would be substantial. There is good reason to believe the program will continue for decades. Life expectancy is rising, and will probably continue to rise. The new taxes would have to be large, and would probably get even larger in the future. Young people will probably object vociferously to any such increases, and will be in a position to block their enactment. As a practical matter, the panel suggested that no one expecting to draw social security in 2030 count on this approach. Would you want your retirement income to depend on someone being willing to tax themselves?

Conclusion

In 2030, approximately 100 years after the enactment of the American Social Security system, some difficult choices must be made. And the panel does seem to be dead out of good ideas to avoid tough choices. Perhaps Keynes was right after all.

West Elmore

West Elmore was just undergoing a revision of its tax system, and wanted to share some of its thoughts with the audience. After several years of running deficits, it had recently begun running a budgetary surplus. There were a number of hot topics on the agenda.

- One political party was proposing a significant tax cut, which the opposition was labeling "dangerous and risky".
- The party was also proposing to eliminate inheritance taxes. The opposition labeled the plan "dangerous and risky".
- Finally, in West Elmore, as in the rest of the world, the use of the Internet was growing. While the government had a sales tax, it did not currently levy that tax on Internet sales. Some officials were advocating that Internet sales continue to be exempt from the sales tax, while others wanted to extend the sales tax to Internet sales.

The Right Timing for Taxes

The panel first took up the question of the tax cut. It noticed that both political parties were, not surprisingly, proposing tax cuts that primarily benefited their constituencies. This decision came as no surprise, for one of the fundamental rules of politics is "reward your friends and punish your enemies". However, the panel fully agreed with the conclusion of the background paper that economists had little to say about what was essentially a question of tax equity.

As to the question of a tax cut, the panel observed:

- Economic efficiency requires uniform taxes. If government spending is projected to be below the current tax rate, it makes sense to cut taxes to a rate that can be sustained for the near future. The only case against cutting taxes would have to be
 - Spending as a percent of GDP is expected to rise in the future.
 - Tax revenues as a percent of GDP are expected to fall in the future, holding tax rates constant.

Some members of the panel made a different argument. Just as nature abhors a vacuum and moves to fill it, so too does a government abhor unspent revenue and moves to create a government program to spend that

money. They argued that if the government continued to run a surplus the net effect would be to increase spending.

Death and Taxes

The panel next turned to proposals to cut inheritance taxes. The inheritance tax in West Elmore is modeled on that of the United States. There, estates above \$1,000,000 are subject to a tax rate of approximately 50%.³ The panel noted that one of the reasons people saved was clearly to pass money along to their children. Thus, the higher the tax, the lower the amount saved. At the same time, these taxes were levied on funds already taxed when the individual earned the money.⁴ Thus, the combined tax rate seemed high in light of the advice for uniform tax rates. Of course, the panel also recognized that there were significant equity issues. Few people leave estates of \$1,000,000.

Internet Taxes

The panel split on the Internet tax. One group took the position that economic efficiency required uniform tax rates, and it made no sense to leave some sales untaxed while others were taxed. The other group suggested a different argument. Logic required that Internet sales be taxed if the revenue from taxing Internet sales was to be used to cut other sales taxes. However, they doubted this would be the case. Instead, they suggested that the tax revenue would be used for new government programs, and the question really was whether the benefits of these programs would exceed their costs.

A Final Point

Some wondered why the government ever bothered taxing people to pay the cost of government anyway. We know that the deficit has no real impact and we also know that taxes have disincentive effects. The problem with carrying this argument to an extreme is that it makes government policy a Ponzi scheme. People simply won't lend the government money. Thus, while it is possible to defer paying for expenses, there is such a thing as too much of a good thing. Once again, the credibility problem rears its head.

³ In 2000, the exemption is \$675,000 but it is scheduled to rise to \$1,000,000.

⁴ There is an exception: unrealized capital gains are not taxed. The cost basis of securities is "stepped up" at death. Thus any Microsoft stock that Bill Gates leaves to his children will not be subject to capital gains tax.

It is like the state of Ohio borrowing \$100 million to pay for highways and answering the question “when will you pay this back” by saying, “we’ll get around to thinking about this issue some day”. It just will not fly.

Relation to the Text

Each lecture ends with a section relating it to the text. In some cases, material is omitted, either because the text covers it well enough or because it is not worth learning. In other cases, material is added. Each of these “lectures” will end with a brief note relating the lecture to the text, describing what material is left to the student to learn alone and what material may safely be skipped.

Which Chapters does this lecture cover?

Section from Stockman	Coverage
Chapter 14	This lecture covers the parts of Chapter 14 dealing with taxation.

What material is new?

Much of this is new.

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