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Laurence J. Kotlikoff
Boston University



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Fiscal Illusion and Fiscal Reality: Do the Budget “Deficits” Have Clothes?

Laurence J. Kotlikoff
Boston University and
National Bureau of Economic Research

Fiscal policy has been a hot topic in recent years and remains so today. No wonder. Since 1981 the federal government has made substantial cuts in personal income taxes, provided the largest investment incentives in the country’s history, significantly altered the projected course of Social Security benefits, and run enormous official budget deficits. However, all this fiscal action has apparently just whetted the appetites of fiscal enthusiasts who are now proposing what has been billed as fundamental tax reform.

My focus in this talk is not to review recent fiscal history or presage current tax reform bills, but to discuss an issue that has bothered me repeatedly over the past few years. Put simply, my question is the following: in thinking about fiscal policy and particularly about government debt, have we been taken in by the accountants and have we, as a result, been missing the economic forest for the trees? I hope to convince you that the answer, if not yes, is at least maybe. My sniping at economic accounting is not to disparage the accounting profession; indeed my real gripe is not with accountants, but rather with economists who are so often misled by the labeling of economic variables and then compound the error by misleading others.

Before I turn to substantive points, let me say that I am not arguing for different or better accounting. In my view, ac-

counting is properly chosen after, not before, one chooses one's economic model. The accounting constructs that are appropriate for one model may be totally inappropriate for another. For example, while one can conceive of a model in which the government's current definition of the deficit is meaningful, one can also write down other models in which the current definition has little or no relation to the government's fundamental debt policy. Unfortunately, economists, when speaking publicly, typically fail to explicate their models and take the easy route of discussing the official numbers that are available and generally familiar, despite the fact that these numbers may be highly misleading indicators of the numbers actually suggested by their theories.

In this and other respects, we are tyrannized by our accounting. Somehow or other, official numbers invite concern and comment, and, when research funding is available, official numbers also invite investigation. A prime example is the industry of international finance economists who investigate changes in countries' balances of payment. Fortunately, we do not keep balance of payment accounts for each state in the U.S. or we would have an industry of economists studying the balance of payments crisis between Michigan and Tennessee and related nonsense.

Let me illustrate my concern about fiscal illusion by asking you to consider the Social Security taxes you pay to the government. Notice that the word "taxes" has been ascribed to the Social Security payments you and your employer send to the government. But why is the word "taxes" used? It's used because some accountant or economist arbitrarily chose that word back in 1936 or thereabouts. Suppose we label these payments to the government differently. Let's label them "loans" from you to the government. You may object to this nomenclature, but bear with it for the moment.

Loans are typically repaid, so let's also label Social Security benefit payments "return of principal plus interest." Note that from your point of view the new terminology is not completely foreign. With the new language, you can now think of yourselves as lending money to the government (in the form of Social Security contributions) during your working years and receiving principal plus interest (in the form of Social Security benefit payments) during your retirement. Surely this sequence of payments and receipts is very similar to those associated with purchasing a government Treasury bond. When you purchase a Treasury bond or other security, you make payments to the government now in exchange for future receipts from the government. Hence, from your point of view, your payment of what is called Social Security "taxes" is, in most respects, equivalent to your purchase of a government liability. While the mean return and risk properties of your invisible Social Security bonds differ from those of official government bonds, such differences in risk properties provide no basis for labeling one set of payments to the government "taxes" and the other set of payments "loans."

Let's now make the invisible Social Security bonds visible by supposing that the federal government, starting at the inception of the Social Security system, had also adopted the language of lending and borrowing to describe its flows of payments from and to the public sector and, indeed, had issued explicit Social Security bonds to the public in exchange for Social Security contributions. We are supposing then that Social Security system sends a piece of paper marked Social Security bond to each worker in exchange for his or her Social Security contribution.

Consider now the impact on the government's measure of official debt of switching from the "tax" and "transfer" language to the language of "lending" and "repayment." As you can read in the Appendix to chapter 4 of the 1982

Economic Report of the President, this change in language, while involving no change in fundamentals, would have radically altered current and past reports of the federal debt and federal deficits. The government would have reported official deficits in the 1960s over \$300 billion dollars for several years and deficits over \$100 billion dollars for most years during the 1960s and 1970s. Since the price level and size of the economy was much smaller then than now, as a fraction of GNP these alternative deficit figures would swamp those of recent years. With this alternative labeling of Social Security receipts and payments 1985 official government debt would exceed its current \$1.5 trillion value by a factor of roughly 5.

Presumably, such a redefinition of official government liabilities would raise the question of classifying other implicit commitments to future expenditures as government debt. If one is willing to label implicit promises to pay future retirement benefits official liabilities, why not include implicit expenditure commitments to maintain the national parks, to defend the country, or to provide minimum sustenance to the poor?

A heated debate about the appropriate definition of government debt would likely lead some shrewd economist to suggest eliminating official government debt and deficits entirely by just using some more of what is essentially innovative accounting. This economist would suggest that rather than raise additional funds by issuing government securities, the government should simply levy a head "tax" per adult promising to provide each adult in the following or some subsequent year a refundable tax credit equal to the "tax" plus interest on the "tax." If the adult died before repayment, the "tax" credit would be paid to his or her estate. Furthermore, those who are liquidity-constrained would be permitted to borrow against their future "tax" credits.

The equality, in present value, between each household's head tax and its head tax credit leaves household budgets and, therefore, private behavior unaltered. However, since future tax credits, like future Social Security benefit payments, are not reported in the current federal budget, this policy permits the government to report a smaller deficit. If the head tax is sufficiently large, the government could potentially eliminate not only this year's official deficit, but indeed the entire stock of outstanding government debt. If it made the head "tax" sufficiently large, the government could report a very substantial surplus. Those of you who are following closely the details of this head "tax"—"tax" credit policy—will see that it effectively amounts to relabeling as "taxes" the receipts the government obtains from selling bonds, and relabeling as "tax" credits the payments made by the government of interest plus principal on its sale of bonds.

To summarize, I've pointed out that with a little change in labeling of Social Security receipts and payments, the government's reported debt would be roughly five times its current value; alternatively, with a little relabeling of the money it receives and pays out in its bond transactions, the government could wipe out any reported debt and report instead enormous surpluses. But my point is not that we can color red what is really black or color black what is really red. My point is that in most economic models, particularly the standard neoclassical model, there is really no fundamental distinction between what is currently painted red and what is currently painted black, i.e., in most models there are no real reds and blacks when it comes to labeling government receipts and payments.

If I have you scratching your heads, I'm happy. I'm delighted if you believe, as do I, that money which the government calls taxes could just as well be called borrowing

and vice versa. But if I've gotten you to agree with me that our official debt numbers are inherently arbitrary, then you should also agree that these numbers provide little guide to the fundamental stance of fiscal policy. If we can't rely on these numbers, how do we go about assessing the extent of redistribution from younger to older generations, which is what most economists and perhaps most noneconomists associate with the concern about government debt?

The answer is that we need to examine directly the lifetime budget constraints of different generations and ask whether government policies have expanded the lifetime consumption opportunities of older generations at the price of reduced lifetime consumption opportunities of younger and future generations. The answer to this question is invariant to how we label particular receipts and payments between the private economy and the government. Accounting doesn't matter when looking at a generation's budget constraint because the bottom line is how much can the generation afford to consume; this depends on the generations' lifetime receipts from the government net of payments to the government, not on how particular receipts and payments are labeled.

Once one becomes attuned to thinking about economic debt policy in terms of intergenerational redistribution, it becomes clear that a variety of government policies, many of which have no direct effect on reported government deficits, transfer resources from later to earlier generations. Before describing these mechanisms, it's worth mentioning why one should care about intergenerational redistribution towards older generations. The answer is that, as a result of such a transfer, older generations are likely to increase their consumption by more than younger generations lower their consumption. The reason is that older generations have fewer years left to live and consequently have fewer years over which

to consume the additional resources. Younger generations, on the other hand, spread their reduction in lifetime resources over more years; hence, their response to the transfer is to lower their consumption this year somewhat, knowing they will also lower their consumption for many years in the future. In the jargon of economists, older generations are likely to have larger marginal propensities to consume than younger generations. If this is true, then intergenerational redistribution will eventuate in an increase in total national consumption and, according to neoclassical models, a decline in total national saving. The decline in saving may also spell a decline in investment and higher real interest rates as capital becomes a relatively scarce factor of production.

Economists and others in the U.S. are properly concerned about this crowding-out process. Since 1980 we have been saving only 4.7 percent of our net national product. In contrast, we saved 7.8 percent of NNP in the 1970s, 8.7 percent in the 1960s, and 8.8 percent in the 1950s. While the current saving rate of 5.2 percent is above that of the early 1980s, it is still 41 percent lower than the saving rate of the 1950s.

In addition to redistributing to older generations by cutting “taxes” now and raising “taxes” in the future, i.e., reducing payments from the private sector to the government now and increasing such payments in the future, the government employs several other mechanisms of intergenerational redistribution, some of which are quite subtle. One somewhat subtle mechanism is running an unfunded, “pay as you go” Social Security system.

In this Ponzi scheme, younger working generations pay money to Social Security which hands the money over to older, retired generations in the form of retirement benefits. In this scheme, every generation pays for the retirement benefits

of the previous generation with one exception; at the initiation of the program the first generation receives benefits without having to finance the retirement of its immediate predecessors. This generation receives a windfall at the expense of younger and future generations whose lifetime budgets would be greater were they not enrolled in Social Security.

While many of the big winners from Social Security are already deceased, there is still significant intergenerational redistribution from Social Security. Middle income households who were born in 1930 are predicted roughly to break even from the system. In contrast, middle income households in the cohort born in 1990 are projected over their lifetimes to lose, on net, roughly \$60,000 in present value as a consequence of participating in Social Security.

Another subtle intergenerational transfer mechanism is changes in the tax base that shift the burden of “taxation” (payments to the government) from older to younger generations. An example here is switching from an income tax that taxes the capital income of the elderly as well as the labor earnings of the young and middle-aged to a wage tax that hits only the young and middle-aged. A variant of this type of fundamental debt policy is increases in the progressivity of the income tax. Switching from a less to a more progressive income tax shifts more of the tax burden onto middle-aged and younger workers whose annual incomes are larger than those of retired elderly for whom income consists simply of the return on savings.

Perhaps the most subtle mechanism of intergenerational redistribution is government policies that lower the market value of financial assets. Since older generations are the primary owners of assets, a reduction in asset values reduces the consumption opportunities of the elderly; at the same time, it expands the consumption opportunities of younger

generations who, through time, can purchase these assets from older generations at a lower price.

An example of such a policy is reducing investment incentives, which, by the way, is part of the President's tax reform proposal. Since investment incentives in the U.S. are effectively restricted to new investment, old capital, capital that has been fully or partially written off, sells at a discount reflecting the preferential tax treatment available to new capital. A reduction in investment incentives means a smaller discount on old capital, i.e., a capital gain to owners of old capital. This capital gain accrues to older generations, and young and middle-aged generations are worse off because they must pay a higher price to acquire claims to the economy's capital stock.

Having pointed out these various mechanisms for running true economic debt policies and having argued strongly that one cannot gauge these policies by looking at official debt numbers, it's time to look at the reality of recent economic debt policy. The Reagan personal income tax cuts have certainly enhanced the lifetime budgets of older generations at the expense of younger generations, but, up to the present, the magnitude of this intergenerational redistribution appears small when set against the massive intergenerational redistribution in the 1960s and 1970s associated with Social Security.

A second feature of Reagan's fiscal policy is the sizable investment incentives passed in 1981. As argued above, this policy generates capital losses to owners of existing (old) capital and constitutes an economic surplus policy. My sense of the magnitude of this redistribution when set against the redistribution from the tax cuts is that it corresponds, very roughly, to having postponed the tax cuts by one year.

The third significant fiscal policy altering the intergenerational resource distribution is the 1983 Social Security reform.

From the perspective of at least 1977, Social Security's long-run finances seemed fairly secure. But the ensuing recessions and other economic and demographic events changed the long- as well as short-run picture. The 1983 reforms made very substantial cuts in the future benefits of all current young generations. The new Social Security law gradually raises the retirement age to 67 and envisions, through the process of bracket creep, the eventual income taxation of Social Security benefits of all retirees, not simply high income retirees as is now the case.

For current young generations, these legislated long-term cuts in Social Security benefits are very sizable when compared, for example, with the tax savings they have enjoyed to date from the Reagan tax cut. Hence this policy also represents a significant economic surplus policy since it is reducing the welfare of current young generations while improving the projected welfare of future generations.

My assessment is that the Reagan fiscal policy has, to date, generated, on net, a small economic surplus, although this assessment could change signs if tax rates are not raised in the near future. However, whether one views the policy *in toto* as transferring to older or to younger generations, it is clear that the national hysteria concerning deficits has been predicated on a set of numbers that have little or no relationship to the issue of fundamental concern. Asserting that the deficit numbers have no clothes is not the same as asserting that all is fine in our economic house. On the contrary, it appears clear that the country is experiencing a secular decline in saving which may well be the result of the unreported enormous economic deficits associated with Social Security in the last three decades.

In closing, let me point out that a very real problem with the current fixation on the official budget deficit is that once that

number is fixed, through either a real or an accounting policy, the public and the government will lose interest in the question of debt, and, indeed, may return to the kinds of hidden debt policies of the last 30 years. It is high time to remove the blinders. Fiscal illusion is a very real problem; it not only blinds us to current fiscal reality, it also leaves us very little guide to improving our economic future.