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Has Someone Already Spent the Future?

by Jagadeesh Gokhale

As massive budget deficits continue to push the national debt to record levels, Americans have grown increasingly concerned about how lawmakers' seemingly irresistible urge to spend now and pay later may be compromising the nation's economic future. Who among us has not wondered how much heavier the burden on our descendants will be because of the government's refusal to live within its means?

This *Economic Commentary* explores how U.S. living standards are likely to evolve over the next few decades given present trends. While peering so far into the future involves substantial uncertainty, the current economic landscape provides some fairly good clues about where we are headed. Four factors in particular can be expected to have a tremendous effect on Americans' future economic status: 1) current federal spending and tax policies, 2) the aging of the U.S. population, 3) trends in health care expenditures, and 4) the pattern of national saving.

■ The National Debt and Deficits

The national debt reflects the explicit commitment of the government to pay back, with interest, funds it has borrowed in the past. The amount borrowed each year is dictated by the gap between federal spending and tax revenues collected.

Government spending falls into two main categories: purchases of goods and services and provision of entitlements. The former, which are used for such things as highway construction, national defense, education, the judicial and legislative functions of government, and the conduct of international diplomacy, accounted for 57 percent of the government's total outlays last year. Entitlements, which include Social Security, Medicare, and welfare benefit payments to old and needy individuals, represented 37 percent of the budget.[1] To finance some of these transfer payments, the government takes contributions from current working-age Americans in exchange for implicit promises of future benefit payments.

For most public goods and services, a higher level of current provision does not entail a reduction in future provision. Extremely durable items such as highways, bridges, public parks, and military equipment benefit both current and future generations. This makes it difficult to apportion the advantages derived from such goods into amounts accruing to different generations. But it *is* possible to divide and distribute among both current and future generations the burden of paying for these items. Young and future generations cannot participate in choosing the level of provision because they are too young or not yet born when the decisions are made. They must, however, make payments at a level chosen by earlier generations.

Funds used for government expenditures arise from one of three sources: 1) printing more money, 2) taxation, and 3) borrowing from the public. The first method is dangerous because it operates through the creation of inflation; that is, the government obtains resources by imposing a loss in the value of the money that people hold. Because this tax is not legislated, it

Of the myriad problems facing the U.S. economy today, four hold the potential to escalate and to repress living standards early in the next century. A confluence of low current saving, astronomically high health care costs, an aging population, and generationally unbalanced fiscal policies may burn a large hole in the pockets of future Americans.

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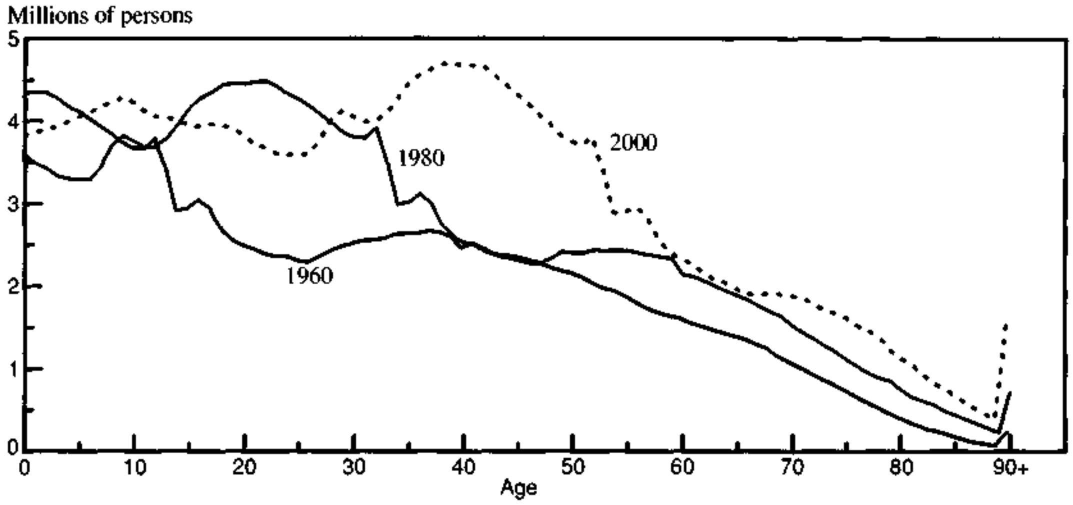
FIGURE 1 U.S. POPULATION BY AGE IN 1960, 1980, AND 2000 (PROJECTED)



SOURCE: Social Security Administration.

has at times proven to be an irresistible temptation for policymakers.

The undesirable economic consequences of financing public expenditures through an inflation tax have long been recognized. The amount of money in the U.S. economy, however, is controlled not by the government, but by an autonomous body — the Federal Reserve System — which is responsible for ensuring that the "correct" amount of money is circulating.

The second source of funding, taxation, includes taxes on labor, interest and dividend income; sales and excise taxes; and property and payroll taxes. Since the end of World War II, government expenditures have exceeded tax revenues in most years. As a result, the government has had to resort to borrowing money from the public — the third funding source.

Federal government borrowing increased dramatically during the 1980s, causing the national debt to skyrocket from just under $1 trillion in 1981 to more than $3.5 trillion in 1991.[2] How will the government obtain the funds to repay this massive debt (and interest) in the future? Through taxation, of course, unless the Federal Reserve prints more money, buys up the debt, and allows a faster rate of inflation in the years ahead. Thus, in one way or another, the obligation to repay this debt will be foisted on generations to come.

Unfortunately, the sizes of the national debt and annual deficits do not fully reveal how much of a burden will be shifted onto young and future generations. Many of the laws enacted today alter the rules about who (males or females, old or young, rich or poor) will pay the government in the future, and how much. Some policies redistribute payment burdens among different generations, but leave total current revenue unchanged. The effects of these policies are not captured in the government's annual deficits, which are based only on current revenues and expenditures.[3]

Generational accounting, a new method of measuring the payment burdens facing different generations, shows that, given current policies and plausible assumptions about Medicare and Medicaid spending down the road, future generations on average will be saddled with net-payment burdens about 40 percent larger than those facing current generations.[4] Higher future taxation implies that Americans' budgets will be smaller in the years to come.

Furthermore, calculations suggest that unless corrective policy changes are undertaken now, this imbalance will worsen over time. If future Americans perceive that much of their income will be taxed away, their incentives to work and save may be diminished, with obvious detrimental effects on future U.S. living standards.

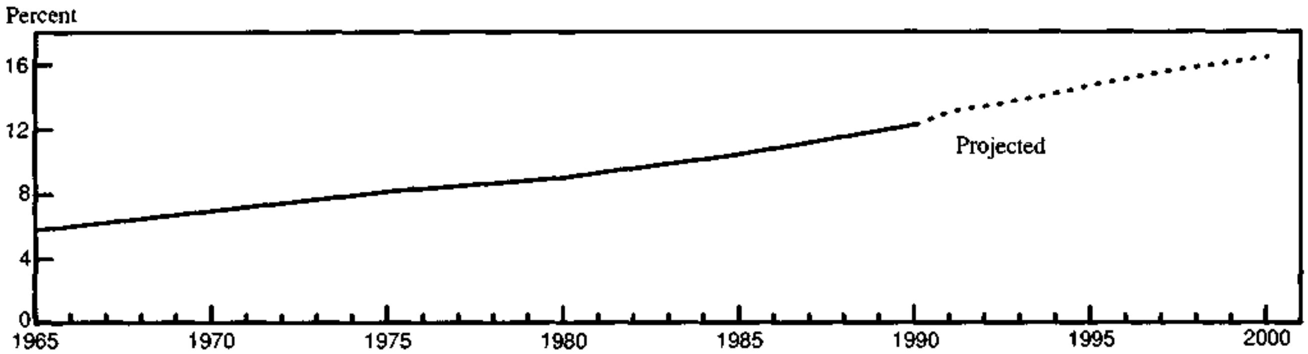
■ Population, Health Care, and Saving

Viewed in isolation, neither the national debt, deficits, or generational accounts are adequate indicators of what may be in store for the U.S. economy. One has to look at these measures as part of a broader picture that encompasses trends in the overall economy and in public policy. The current economic situation suggests that strains on the budgets of future Americans will be exacerbated by three additional factors: the age composition of the U.S. population, trends in health care expenditures, and the amount of national saving.

The postwar baby boom has created a hump in the U.S. population that is getting older (see figure 1). This trend has far-reaching economic implications.

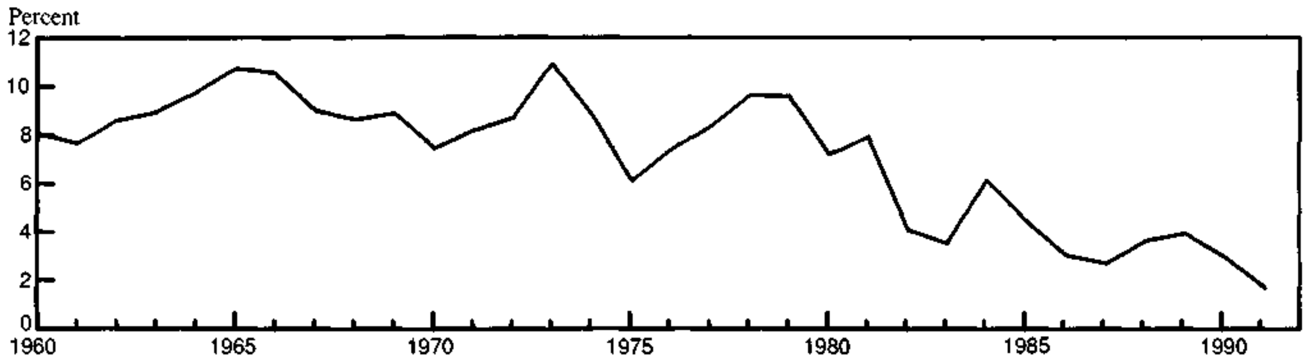
Americans on average participate in the labor force between the ages of 20 and 65, though there is evidence of a growing movement toward early retirement.[5] Moreover, advances in medical

FIGURE 2 U.S. HEALTH CARE EXPENDITURES AS A PERCENTAGE OF GROSS NATIONAL PRODUCT



SOURCE: Health Care Financing Administration.

FIGURE 3 U.S. NATIONAL SAVING AS A PERCENTAGE OF NET NATIONAL PRODUCT



SOURCE: Author's calculations based on *Economic Report of the President*, January 1992.

technology have increased average life expectancy, implying that people may spend a greater number of years in retirement. As the baby boomers, who are now between 25 and 40, begin to bow out of the work force, the growing nonworking segment of the population will have to be supported by output produced by a shrinking population of workers. The earnings of future working-age generations will thus have to sustain a larger number of dependents.

Another factor that is likely to have an adverse effect on future generations' pocketbooks is the cost of health care. Since the mid-1960s, medical expenditures as a share of gross national product have climbed steadily (see figure 2). Because people over 65 spend twice as much per capita on these services as younger individuals, the projected aging of the U.S. population will cause the demand for medical care to escalate.[6] The provision of these services, however, requires investment in specialized and costly equipment and highly trained personnel. Consequently, supply bottlenecks in the face of rising demand are likely to further constrain Americans' budgets in the years ahead.

The growing pressure to support the elderly may not manifest itself solely as a filial responsibility. Older Americans will constitute a potent political group that may be willing and powerful enough to bend Social Security, Medicare, and tax policies to its own advantage — and to the detriment of younger generations. A large chunk of future generations' income thus may be taxed away and devoted to sustaining the elderly.

These projected demographic burdens may be mitigated in several ways, perhaps most importantly through higher saving and investment today. If the baby boomers begin to put away a substantial part of their earnings, this saving could be used to finance a higher level of investment. Higher investment today will generate a larger capital stock tomorrow. As a result, more and better machinery and improved skills will be available to produce the goods and services that current and future Americans will want.

The greater saving would also provide the baby boomers with additional assets for financing their own retirement, while increased investment and improved technology would mean higher labor productivity and hence higher wages for all workers. In short, more resources would be available all around for supporting a larger dependent population in the future.

Unfortunately, the record on saving in the United States provides little reason for optimism. Coincident with the baby boomers entering the labor force during the 1970s and 1980s, U.S. saving rates have plummeted to record lows. Figure 3 depicts the clear downward trend in the national saving rate, which as a percentage of net national product dropped by almost half from the 1960s (9.1 percent) to the 1980s (4.7 percent). In 1991, this rate was a measly 1.7 percent.[7] Economists have been unable to pinpoint the reasons behind this dramatic downturn, but a reversal in the trend is clearly imperative for preventing future declines in U.S. living standards.

Conclusion

If current trends in the U.S. economy persist, high taxes, a growing dependent population, low national saving rates, and burgeoning health care costs are all likely to present serious obstacles to improving the nation's standard of living.

Although nothing can be done about the aging of the population, determined efforts to reduce the growth of health care expenditures could prove successful. Similarly, lower tax burdens on future generations may be secured through either higher current taxation or, preferably, permanently lower government spending. And baby boomers, up against a growing need to safeguard their own future, may be moved to boost current saving and investment.

That such changes are essential for a better economic future is obvious. The challenge for policymakers today lies in fostering an economic and political environment that will increase the likelihood of their realization.

Footnotes

1. The remaining 6 percent of expenditures consisted of interest payments. These numbers were obtained from *Economic Report of the President*. January 1992, p. 390.

2. Ibid., p. 385.

3. See Alan J. Auerbach, Jagadeesh Gokhale, and Laurence J. Kotlikoff, "Generational Accounts: A Meaningful Alternative to Deficit Accounting," in David Bradford, ed., *Tax Policy and the Economy*. vol. 5. Cambridge, Mass.: National Bureau of Economic Research and MIT Press, 1991, pp. 55–111. See also Laurence J. Kotlikoff, *Generational Accounting: Knowing Who Pays, and When, for What We Spend*. New York: The Free Press, 1992.

4. In the November 15, 1991 *Economic Commentary*, a 20 percent differential was reported, based on the National Income and Product Accounts for 1989. The base case reported in the 1993 *Budget of the United States Government* (table 26-1, column 1, and table 26-4, column 5) notes a differential of almost 80 percent. This assumes, however, that Medicare and Medicaid expenditures will continue to grow at their current rate of 4.5 percent per year until the year 2030. Under the more plausible assumption that future policy intervention will reduce this rate of growth to equal that of the rest of the economy by the year 2000, a differential of about 40 percent results.

5. See Laurence J. Kotlikoff and David A. Wise, "Incentive Effects of Private Pension Plans," in Zvi Bodie, John B. Shoven, and David A. Wise, eds., *Issues in Pension Economics*. Chicago: University of Chicago Press, 1987, pp. 283–339.

6. See *U.S. Health Care Spending: Trends, Contributing Factors, and Proposals for Reform*. Report to the Chairman, Committee on Ways and Means, House of Representatives. Washington, D.C.: U.S. General Accounting Office, June 1991.

7. Author's calculations are based on *Economic Report of the President*, January 1992.

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