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Scott A. Hodge: Thank you for tuning in today. I am Scott Hodge, President of the Tax Foundation. Joining me for our Tax Policy Podcast today is Laurence Kotlikoff, who is a Professor of Economics at Boston University, and a Research Associate with the National Bureau of Economic Research. Professor Kotlikoff has authored or co-authored 11 books and hundreds of articles, and is considered a premier scholar in the nation on federal tax and spending issues, especially issues such as generational accounting. Professor Kotlikoff, thank you for joining me today.

Laurence J. Kotlikoff: Yes, my pleasure.

Scott: Thanks especially for taking time from a very, very busy teaching schedule. I do want to ask you about your most recent book, *The Coming Generational Storm*. You and your co-author Scott Burns say America is facing very bleak financial future unless we change the path of our fiscal policy. And you have sort of backed it up in a more recent article with a very provocative question asking, "Is the United States bankrupt?" Well let me throw that back on you and ask, are we bankrupt? And what is this coming generational storm?

Laurence: Yes I think we are because if you look at our long term fiscal obligations and compare them with our tax receipts that are projected to come in, you end up finding the difference in present value is equal to $63 trillion. This is according to an update of a U.S Treasury study. So it is not an academic study but rather a government study. The original study was done under Secretary O'Neill, and was censored because the Bush administration did not want it to become public that they were facing this huge problem at the same time they were trying to have a third tax cut and expand the Medicare program thought the drug benefit, which by itself added about $10 trillion or so to this long term fiscal gap.

So we're facing a difference between all the projected spending and all the projected taxes which comes together to equal $63 trillion. To come with $63 trillion in present value, you would have to have an immediate and permanent roughly 70 percent hike in federal corporate and personal income taxes. Alternatively you could immediately double the payroll tax. So we are talking about gargantuan adjustments here, huge problems that we are facing, and a lot of this has to do with the fact that the society is aging.

We are currently facing 33 million people over 65. But when the Boomers retire there will be about 77 million people over 65. And we are currently handing out per old person roughly $30,000 on average in Medicare, Social Security and Medicaid benefits. But when the Boomers retire we are going to be paying them a lot higher level of benefits because these benefit levels continue to grow much more rapidly than wages per worker.

So think about 77 million Baby Boomers getting roughly $40,000 per head, and you see the magnitude of the problem. We are talking trillions of dollars. $44,000 times 77 million is a very big number. It is in the trillions, A couple trillion dollars a year in obligations. So I do not think it is an exaggeration to say the country is bankrupt.

These policies that this administration and the previous administration and others before them have been running really represent fiscal child abuse. They are trying to get more when we are old and leave the bills for the next generation, and we are doing accounting that disguises this, that keeps it as a quiet act of expropriation, as to opposed to making it public.

Scott: Well let me follow up with two questions because these are pretty scary statistics that you are throwing around here, which I am sure 99 percent of Americans are not aware of. What are some solutions that you can suggest that might remedy some of this problem? And then I'll follow up and I'd like to talk about the politics of this. But lets start out with some of the solutions. What are you recommending to Congress that they do to at least stem some of this.

Laurence: Well we have to get control of our heath care spending in terms of the Medicare and Medicaid programs. This year alone in Medicare's fiscal year, Medicare's spending is projected to grow about 17 percent adjusted for inflation, which is just astronomical. That is thanks to this new drug benefit that the elderly are receiving. It is very important for the elderly to be insured against high cost prescription drugs but they need to be asked to pay for this new entitlement program. We can not leave the whole bill to younger people. And the elderly were asked to pay none of it, and indeed their taxes have been cut by this administration, so it is a real generational rip-off. What I would say is that we need to get control of this healthcare spending. That is paramount because if we do not do that, we are just completely sunk. Now, this spending on average over the last 30 years is rising, and has grown twice as fast as the economy's per capita GDP. So it is a run-away health expenditure explosion.

To get these benefit levels under control I am recommending a dramatic change in the way we structure government health policy. And I discuss this in detail in an article called "The New New Deal" that appeared in *New Republic* about a year ago, and it is on my website. So if anyone Google's my name "Kotlikoff" and goes to my website they will find this article on the "New New Deal."

Basically it involves going to a universal healthcare system where the government provides everybody a voucher each year based on his or her health condition. So people that are sick get a big voucher, people that are healthy get a small voucher. The government determines the overall voucher budget, and it can not grow any faster than real GDP. That would be the idea that the government is going to stabilize this total expenditure, but at the same time cover the entire population.

So we get rid of Medicare and Medicaid and we replace those programs with a universal voucher system that is individual specific. If you've got cancer you get a huge voucher, if you're perfectly healthy you get a small voucher. You take that voucher and buy health insurance for the coming year, and at the end of the year you get a new voucher based on your current health status. So at the margin the health insurance companies rather than the government are responsible for paying for additional costs. And this is a way for the government to get control of the absolute amount of the expenditure that it is engaged in.

Right now under Medicare and Medicaid we just -- the participants, not “we,” as I am not a participant -- but participants in these programs get the healthcare and send the bills down to Washington and the government pays those bills without any question, and so everything is on auto pilot. All the expenditures are being determined by how much people want to use the health care system. There is no control at the overall level of the total expenditure.

Scott: Let's take off our economist hats and put on our political pundit hats. I think you and I have been around long enough to know that Washington focuses on the here and now, and the future is often left to future Congresses. Do we, and does Washington have the stomach to take on these issues?

Laurence: Well, health reform is only one of three major reforms which I am proposing with a co-author in this article. The other one is tax reform. I am talking about switching to a federal retail sales tax with a rebate, so we can have a progressive tax on consumption that the elderly, as well as everybody else, would have to pay -- the rich elderly, not the poor elderly, but the rich elderly, and the middle class elderly. And I'm also talking about a radical change in Social Security to make it a government-run, individual account system. It's much different than what the President's proposing, which I think is really awful. But this is a first-rate proposal Democrats and Republicans should both like.

So these are three radical reforms, plus cutting back on discretionary spending by the federal government -- getting out of Iraq, for example -- that we need to undertake to get to fiscal sanity. If we don't do all those things -- if we do any, or just one of them, or all of them late in the day -- the meltdown is inevitable, the financial meltdown that you're alluding to. And what individuals need to do is to be very concerned about inflation, because the government is likely to try to print money to pay these bills.

Scott A. Hodge: Is anyone in Congress taking note of this, and carrying the banner that you're trying to put forward?

Laurence: There are just a handful of people in Congress that are acting like real adults. Everybody else is interested in just maintaining power. It's really pathetic. We have people that are not grownups running the country. And so I sent out this article that was published in the *New Republic* -- the cover of the *New Republic*, the “New New Deal” -- and sent it to a hundred Senators, with a private letter from me, signed. I heard from one Senator, Senator DeMint. He's from South Carolina.

So they're not paying any attention. I don't think we're going to get any major, real reform, any significant reform. And so we're going to have a financial meltdown. And that's going to entail people realizing, waking up to the fact that this country is broke, that these deficit numbers that everybody is focused on are meaningless, for very solid economic reasons.

There's an article on my web site called "On the General Relativity of Fiscal Language," which I co-authored with Jerry Green, who's a senior theorist at Harvard, which describes why these numbers that we are conventionally looking at are absolutely meaningless and useless, and are diverting us from really looking at this fiscal gap, which is the real number to be looking at.

So I think we have to take care of ourselves, or try and protect ourselves as individuals, by investing cautiously, given what's coming.

Scott: I want to get back to, and really hear some more about, the tax reforms that you've been talking about, but I want to ask, first, about a new article that you've done, looking at the effective tax rates Americans face over their lifetime. From your research, it looks that over the life cycle, marginal tax rates are much higher than we previously thought, especially for low-income Americans. What did you find, what lessons can politicians take from this?

Laurence: Yeah, I think that the conclusion is that when you look comprehensively at all the fiscal programs we've got, including the transfer programs, the welfare programs, food stamps, transitional aid to dependent children, families with dependent children, the Medicaid program, that all these things have implicit taxes associated with them; if you earn too much money you start losing your food stamps, you start losing your income tax credit. If you look very carefully at all of these programs together, you find that almost every household, and every individual in America, is facing either a high, very high, or astronomically high tax on working more, and also we're facing very high taxes on saving.

So what this is saying is that we need to have radical tax reform to get rid of all this complexity, to get to a very simple, transparent fiscal system that people can understand. And that would be a federal retail sales tax that I'm advocating, with a rebate to make it progressive.

Scott: The FairTax, as many people know it commonly.

Laurence: Yes, the FairTax.

Laurence: And I'm the only mainstream academic economist who is really supporting this. A lot of other people are saying, "It's ridiculous. The tax rate is going to have to be super-high." And we've done a very careful study -- it's going to be on my website in a couple of days -- that suggests that a 23 percent effective tax rate would be all that you need. You pay 30 percent at the store, that sounds like a high number, but you would be getting a rebate check every month which would cover all your tax payments up to the level of poverty.

Scott: It's sort of like having a standard deduction for a sales tax, I guess.

Laurence: Yeah, exactly.

Scott: Trying to protect low-income people.

Laurence: It would protect low-income people. People who are living at or below the poverty line would pay no tax on net, and it's highly progressive, as the study I've done shows -- it's also on my web site. So it really makes some sense. And it also shifts the burden onto older rich and middle-class people that can afford to help pay for some of the bills they're leaving their grandchildren.

Scott: Well, clearly the FairTax would simplify everything -- throw out 17,000 pages worth of IRS code -- but have you looked at the broader economic benefits, or what it would do to the macroeconomy, jobs, economic growth, etc.?

Laurence: We economists have been studying this for years, and really, we're talking about moving from income to consumption taxation, and it all has very positive simulated long-run effects. I mean, I and Alan Auerbach, who's an economist at Berkeley, have spent years developing macroeconomic simulation models to examine these kinds of policies, and our models are being used right now by the Treasury, and also by the Congressional Budget Office in their dynamic tax analysis.

So these are models that are not viewed as crazy or nutty. They're based on standard neoclassical economics. They're mainstream economic models. They're dynamic models that capture the fact that people live for many years, and how the economy moves and grows through time, and they show very significant improvements in the economy's economic condition over time. Not overnight, but over time, gradually arising from switching to a consumption tax. So we have studied this, and the message is very positive.

Scott: Well I hope that the debate continues, especially next year. Obviously we need to move beyond the politics, but certainly the work you're doing is moving that debate forward, and I appreciate that. I know you have to go and teach, but before you go, what is your website, so that people can come back and look at your work?

Laurence: Well, there are two web sites I would recommend: one is http://people.bu.edu/kotlikof/. Again, if you Google "Kotlikoff" you'll find that web site. The other web site is -- I have another hat, which is that I have a financial-planning software company, which markets a software product called "ESPlanner," which can help people think about what's coming, because you can tell the program that you expect high taxes in the future, and also benefit cuts from Social Security, which I think are both going to occur, and that can help you figure out how much you really need to save. So the program is oriented to try and help people get some practical help, here, in dealing with the country's impending bankruptcy; and that web site is www.ESPlanner.com.

Scott: Thank you very much for spending so much time with me, and I appreciate the work that you're doing, and I encourage everyone to go out there and study up on it, because it really gives us all a warning sign that can't be ignored.

Laurence: My pleasure, Scott.

Scott: Thank you.

Laurence: Thank you.

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