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Budget Crisis at the Door

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I am going to talk about the fiscal implications of the aging of our society. Most people know that our population is aging and that the process is going to accelerate over the coming decades. The shorthand description of the phenomenon is that the baby boomers are going to start retiring within a very few years, but that is a bit of an over simplification. If we look out over the coming decades, really it is the continued increase in life expectancy that is quantitatively more important to the aging of the population than is the aging of the baby boomer themselves.

Even more important, the average age of the population is going up — not just because the number of older people is soaring but also because the number of younger people has been stagnating because birthrates have not been so low since the early 1960s. What that means is that we are going to have a stagnating labor force that will be expected to pay through their taxes for this growing elderly population. Those darn baby boomers just did not produce enough little potential taxpayers. It is not too late for some of you to contribute here.

This aging process is going to have a profound impact on our whole society and the economy. I would suggest that it is going to involve the biggest reallocation of resources since World War II. The reallocation will proceed much more slowly than it did then — but still a reallocation that is going to be just huge. Companies are going to

begin losing many of their workers to retirement. They will be very experienced workers and they won't find it easy to replace them among the younger people in the economy. You will see more and more companies like General Motors that will become more of a pension fund manager than a car manufacturer. I think they have more retirees now than they have active employees.

I chose to focus on the gloomiest aspect of all of this and that is the impact on the federal budget. That is a way of extracting really bad news from the really good news of people living longer and longer.

I do not think it is widely understood how much our federal budget is driven by demographics. Almost one half of spending outside of defense and interest goes to people 65 and older. Obviously Social Security and Medicare are the two programs that dominate that but you can find a lot of elderly recipients in other varied expensive programs. For example, military and civil service retirement is taking up quite a big chunk of the federal budget. Older people are growing in numbers in programs like Medicaid, food stamps, SSI, and so on. We have a peculiar division of labor in this country where the feds take care of the older people and the state and local governments spend a lot on the younger people and their education budgets.

What I would call reasonable projections for Social Security, Medicare, and Medicaid suggests that the cost for just these three programs will be absorbing somewhere between six and nine percent more of our GDP in 2030 than they are today assuming they are not reformed. Now the bulk of this increase is in the Medicare and Medicaid programs that are affected by two forces: (1) the aging of the population, and (2) the rapid increase in the relative costs of health care.

If we chose to finance the increased cost of just these three programs by raising taxes you would be talking about an increase in the tax burden and every tax in the system between one-third and one-half compared to the average of the previous thirty years. That calculation assumes quite unrealistically that you could raise taxes that much without damaging the economy. Today Social Security, Medicare and Medicaid absorb about eight percent of the GDP. If you look back fifty years, Medicare and Medicaid had not even been invented and Social Security was 13th back, say, in 1950. So it is a legitimate question, how did we finance this great increase in cost amounting to eight percent of the GDP over the last fifty years and if we did it then, can't we do the same thing over to finance the increase over the next thirty years?

Let me say first how we did not finance it. We did not raise taxes. Indeed, tax burdens at the federal level have been remarkably constant for about fifty years. The total burden in 2003 was 16.9 percent of the GDP, exactly the same number as in 1947. Indeed, there seems to be a magical rule in this country, that whenever the tax burden goes over 19 percent of the GDP, we have a major tax cut. That rule was followed with the big tax cut in 2001 after the burden had been over 19 percent for about five years. That's actually the only time that's happened since World War II that it stayed that high for so long.

Because we came closer to balancing the budget in the 50s and 60s than we have since, you might argue that some of the increase in cost was just financed by an upward trend in the deficit, but the deficit is so erratic that it's kind of hard to say how much. If you just sort of artificially look at this year, the deficit will be less than four percent of the GDP, probably even less next year. Even if you compare the recent

times with the balanced budget you would be talking about financing quite a bit less than half of this big increase in programs for the elderly.

The most important long-run source of financing for the growth in Social Security, Medicare, and Medicaid has been a secular down turn in the importance of the defense budget. Indeed, if you plot them on the chart and look at the defense relative to GDP and look at Social Security, Medicare, and Medicaid, they are almost a mirror image of each other.

Right after the Korean War, defense was about ten percent of the GDP. Recently it has been less than four percent even though we have wars in Iraq and Afghanistan. Unless we take defense *negative* and you cannot do that unless you run out of armed forces, we are coming to an end of using defense as a financing source for older people's programs. Therefore, radical departures from past history are going to be necessary to deal with this problem. If the programs are not reformed, either taxes are going to have to be increased dramatically, the rest of government spending will have to virtually disappear, or deficits will reach intolerable levels.

Unfortunately, there is little indication that our political system is interested in solving this problem. We made it a good deal worse recently by passing the Medicare prescription drug program that will impose an enormous cost on future generations. President Bush bravely mentioned possible reforms in Social Security in the last election campaign and after he was elected he appointed the Social Security Commission. It was over the protest of his fellow Republicans in the Congress who desperately did not want him to do that and desperately wanted to avoid the issue.

Given the dismal outlook for reform and this terrible fiscal burden coming down the street, why are financial markets so active? The other day I read a Standard and Poor report on our sovereign debt. They give us the highest possible credit rating. They note the need to reform Social Security and Medicare, but they place great confidence in our flexible markets and our transparent political system.

They also, by the way, give the highest possible rating to France and Germany, countries that face a far more severe demographic problem than we do. Their analyses for those two countries are similar to that of the United States. They have great faith in the political system. They have a report on all of Western Europe. Those authors were a little bit tougher. They suggest that unless programs for the elderly are reformed pretty soon, they may have to downgrade that for most Western European countries. Nevertheless, they seem to have a lot of faith that Western democracies will be able to solve the problem.

As much as I love democracy, I'm not so sure. Winston Churchill once said that democracy is the worst form of government except for all the others. I'm afraid that democracy is at its worst in dealing with special interest groups and the elderly are about as powerful a special interest group as you can imagine. Now some European countries have reformed their systems but only when prodded by the potential of a financial and budget crisis. Britain, Sweden, and Italy have reformed their systems to an extent that they no longer have the demographic problem, presuming they have the courage to persist in their reforms.

I think politicians in democratic countries sometimes use crises as an excuse for doing the right thing even though there may be only a remote connection between the

crisis and the reform that they are talking about. We saw that in 1983 in the United States the last time we did reform our Social Security System. It was more a political crisis than an economic crisis. The trust fund was empty. The headlines were very alarmist and the elderly were afraid they'd lose all their benefits even though in fact there was just a tiny gap between the outlays and the revenues percentage wise. We fixed the short-run problem with some minor increases in taxes and reductions in benefits. Very quietly the Congress passed the enormously important reform at that time which increased the normal retirement age, a reform that didn't affect anybody over 45 at the time of reform. It had no effect on this short-run crisis whatsoever, but they used it as an excuse to do something really important.

We saw something similar in Sweden. They were confronted with a very severe economic and budget crisis. It provoked a profound reform in their Social Security System. However, the reform was so big and complicated it took a very long time to design and to implement and the crisis passed before the reform was done. However, they persisted and now have a system that is being emulated in a lot of former communist countries.

When might a crisis occur here, absent reform? Financial markets are too fickle to forecast but the budget projections that I've been talking about really do get bad in the 2020s. Most have our debt passing 100 percent of the GDP in current policy sometime in the 2020s and even projections that postpone reaching this important psychological threshold — they come a little later — even there you see the debt rising by several percentage points of GDP every year. The question is, do the financial markets have to wait to actually see it happen before they panic or do they believe the

projections of Congressional Budget Office, OMB, and so on, so that when these appear in their ten year projections they might get scared.

The point is, we have such projections now so it's just not clear what they might be waiting for. Some people think we can grow our way out of the problem. That just simply does not work for Social Security because Social Security benefits are indexed to wages so the faster GDP grows, the faster wages grow, the faster the cost of our promises grow. Growth provides a small dividend in that, after people retire, they are only indexed to the inflation rate but it's a very small dividend indeed and it's hard to imagine growth solving the problem.

The issue as it relates to Medicare and Medicaid is more complicated. Increased growth will increase wages and to the extent their labor-intensive programs will increase the relative costs of health care but that's probably not real important. My colleague, Gene Steuerle, and I, who have written on all of this, believe maybe somewhat controversially that healthcare is a luxury good that people will demand disproportionately more of it as their incomes rise so that faster growth would increase demand even faster and cause relative costs to rise faster.

Oddly enough this to my knowledge has not been studied very much and it would really be interesting to try to figure out what the impact of growth on Medicare and Medicaid is. Even if my view is totally wrong it would take a lot of growth to catch up with health cost growth. That really is quite impossible.

What about immigration? A lot of people talk about that. Immigration is very important to the American economy. I would never deny that. Without it we would look very much like countries like Japan, France, Germany, countries that can expect an

actual decline in their labor force in coming years. The trouble with immigrants is that they get old too, and they tend to demand more government services per capita than the native-born American. Consequently, unless you create a situation where the flow of immigrants forever grows faster than the rest of the labor force, and I find that politically impossible, you really can't get a lot of benefit from immigration in the very long run.

What is the solution? Here I start delving in the realm of the totally unrealistic. One of the most important components to any solution is to get people to work longer. Then they'd obviously be paying taxes longer and maybe drawing benefits for a shorter period of time. It shouldn't be hard to get people to work longer because they used to. If you look back at 1950, the average age at which a male applied for Social Security was 68. Today the average age a male applies for social security is 63 even though the older population is much healthier than it was in 1950, even though the number of physically demanding jobs has been greatly decreased in the economy.

As a result of the earlier retirement age and longer life expectancy, the average male is spending twice as many years in retirement today as he did in 1950. Longer work can be induced with sticks or carrots. The stick of lowering benefits would force people to work longer. Carrots I think can be provided by allowing more flexible arrangements in the labor force. A lot of older people would gladly work longer if they could do it part time or have longer vacations.

A fundamental problem exists in our society because early retirement used to be thought of as a really good thing. It was a relatively painless way of downsizing firms. It made room for this great mob of baby boomers that were working their way up the

career ladder. It will not be considered to be a good thing as demographic conditions change but while it was considered a good thing numerous customs and laws have grown up that encourage early retirement and it will be very difficult to change.

A second component of the solution would be to reduce our reliance on pay-as-you-go financing. Today almost all of the support for the elderly comes directly from the payroll tax and various sources of general revenue financing. There's no real investment supporting this system. Obviously in a pay-as-you-go system, the financial health of that system depends on how many people are paying in versus how many people are taking out and that's a demographic problem. The system is very subject to demographic risks. If we could move toward pre-funding the system and put some real investment behind it then its financial health would depend on the rate of return to capital and not directly on demographics. Many think it's impossible to move in this direction because of the dreaded so-called transition problem.

Obviously society cannot just walk away from those already retired and those near retirement. The taxpaying public will have to support those people for a good long time. If you ask them then to save more for their own retirement either collectively or individually, you're imposing a double burden on them. I think this problem is much exaggerated but I'm in the minority view here. If you look at what people could earn on individual accounts where they could use private investment versus the totally dismal rate of return, the younger people, people younger than me, are going to get on the payroll taxes they pay. The difference is so large that it seems to me you can exploit that to finance a good part of the transition problem. You will have to borrow more, I think, to transfer some of it to future generations. The arithmetic I've done suggests it

wouldn't be all that painful. There are a lot of challenges involved in designing such a system. I won't go into them now because I'm going over my time a bit. You've got to do it very carefully would be my point.

As another component of reform we've got to try to improve the efficiency of our health system in general and Medicare and Medicaid in particular. They're incredibly inefficient programs. They're run with an enormous number of price controls and regulations that are gained by the medical profession. There's no reason that they should cost as much as they do. The new Medicare prescription drug law tries to improve things by introducing more private competition in the system, but if you read the rules in the section of the law governing private competition, you'll see that the private market is so highly regulated that competition is being combined with a heavy dose of Soviet-style planning. Frankly, I don't have a lot of optimism that that law is going to work very well.

There are a lot of other things we could do in the tax code and so forth to make our system more efficient. I could go into those later if you like. You could also have higher deductibles and co-insurance and Medicare, while providing some protection for the poor. That would give doctors and patients a mutual interest in economizing, an interest they don't have now. I'm afraid that's not a very politically popular idea either.

Another possible reform is to introduce some means of testing into the system and I suspect that will be a component of reform in the long run. It's the only reform to my knowledge mentioned by Senator Kerry so far in the campaign. It is a bit weird that my wife and I get more in Social Security benefits than the welfare payment given a single mother. Mind you, I like my benefits and I thank you taxpayers for providing them

to me but it does seem a bit weird to lavish our national treasure on fairly affluent people. However, again you've got to do it carefully if you do it. You don't want to create a situation where people would be foolish to save for their own retirement. Australia did that a few years back. They had a means-tested system which sent people on a big spending binge just before they retired so they could get their wealth down to the level that qualified them for their benefits.

It's hard to believe that any of my favorite reforms are coming soon. Unfortunately, the longer we wait the harder it will be to reform because benefit adjustments will have to be more abrupt. We won't be able to give people as much notice about them.

I promised to end on a high note so I'll try to do that. Reform really should not be as hard as it is. We would have no economic problem whatsoever maintaining the elderly population in the life style they have today. Indeed, you just look at current payroll taxes: they will rise sufficiently to provide the average Social Security beneficiary a five percent increase in real benefits between now and 2030.

The problem is, as I said before, the benefits are indexed to wages and given projections of economic growth, we promised people about a 40 percent increase in their real average benefits. If you try to reform the system I'm afraid the demagogues will characterize the reduction between a 40 percent increase and a five percent increase as a 25 percent cut in benefits. The elderly will read that headline. They'll panic. They'll think naturally it means a 25 percent cut from today's level and we'll be thwarted once again.

The situation in healthcare is similar. The reason we project such a large increase in health costs is that we presume that technology will continue to improve. Unlike other areas of the economy, technology here seems to make medical care here more expensive all the time so there would be no problem whatsoever in providing the elderly with the same quality of healthcare as they have today. The problem is that we have promised them that they can utilize any technology that comes down the street regardless of how expensive it is. That's what's so hard to afford in the future.

While the political debate makes it sound as though those of us who advocate reform would have the elderly eating dog food while they die in the streets, nothing really could be further from the truth. We somehow have to get across the fact that this debate is about how much to improve the living conditions of the elderly as the standard of living of the rest of the population rises. That should be an easier debate than one that discusses how much to hurt people. The improvements that we have promised are extremely expensive. I think society has to ask whether we want working generations to continually face higher tax bills to finance longer and longer retirements and even better health care for a population that is already becoming more affluent and healthier over time. I personally think there are better ways to use our precious resources.

Thank you.

Questions

Question 1.) I've had young people tell me how quickly we retirees recapture all of the Social Security taxes that we and our employers have paid. Do you have the number of years it takes on average?

Answer 1.) I've read that number and being an older fellow myself, I've forgotten it already. The point about that number is that it's getting longer very fast so your kids will probably never get their taxes all back with a positive rate of return.

Question 2.) It is being taxed, too?

Answer 2.) It is being taxed, yes, 85 percent of it is brought into taxable income. There's still some people alive who started to work before the system started. They got a tremendously good deal. I think if you look at some of our 85-year-olds, you'd see that it only took a couple of years to pay the whole thing back.

Question 3.) Is that a relevant question? The reason I ask that is, are we talking about a financial system or is this a social system? Is it institutionalizing the fourth commandment of honor thy father and recognizing that there are those who can't, won't, don't provide for their future — talking about eating dog food as they starve in the street? So is it a social question of how hard is the working generation willing to work to take care of the old folks of the time?

Answer 3.) I think there are a lot of points to make about that. You can think of the system being a socialization of the traditional system. First of all it has to be pointed out that retirement is a relatively recent invention in human history. Before the 19th century, only the very, very rich retired. The rest of the people worked till they dropped, and if

you were still alive when you dropped you were liable to be treated very badly. The traditional system treated people very, very badly compared to how they are treated by the socialized system we have now. Secondly, the system of children looking after their parents works quite well when people are having five or six kids. What we see now in the Social Security system is the number of taxpayers supporting each recipient is plummeting. It was four not long ago. It's about three today. By 2030 it will be two, so you guys better identify those two people who are looking after you and take care of them very well.

Frankly, I don't think that's unrelated to socialization of the system. As soon as kids individually were not responsible for their parents anymore, their economic value went down a good deal so I, without any proof whatsoever, would speculate that the great fall in birthrates has something to do with the socialization of the system. The main point is that the system isn't going to work very well when people are having as few kids as they have today. There aren't enough kids to honor their fathers, let alone their mothers.

Question 4.) What about consideration in terms of a transition if we were to go with some of the ways you suggested? What about raising the cap on Social Security taxes paid now on the higher salaries that are capped right now? What if you were to lift that cap for a certain number of years to keep the terror factor down as it were?

Answer 4.) You would have to raise it permanently if you weren't willing to contemplate benefit cuts. I don't like talking about the system in terms of the trust fund. I think that is very misleading economically but we do have these actuaries that calculate these things all the time. They now say there's a gap of two percentage points of payroll

between what's coming in over the next 75 years and what's going out. You could double the base of the payroll tax and that would only close about half of that gap. The cap is now over \$80,000 a year. Thus, we are taxing a very large portion of wages. You have to remember that to the extent that households pay on a lot more than the cap it is usually because there are two working people. The household's cap can go up over \$160,000.

Question 5.) There's been an expansion of 401K plans, college savings plans, and so on, I'm wondering if that has a significant impact on the long-term retirement situation?

Answer 5.) It doesn't really because while you say there's an expansion it's not an expansion in terms of the number of people who engage in that sort of thing. Only about 50 percent of the labor force at any one particular time is contributing to such accounts and only about 60 percent contribute at some time in their lifetime so they'll have some eligibility. There's a lot of controversy among economists as to whether that's really saving or do people just move it from one kind of saving to another. I tend to think more of it as saving than some other economists but that's a big issue. First of all, I'm amazed, looking at the micro data, the vast differences in the savings behavior of individual people who look alike, in all respects, and all of the same income group. Some people really save a lot at all levels of the income distribution. Some people really spend a lot. Generalizing, the top 50% of baby boomers are okay. They've saved enough. They'll have retirement incomes quite a bit higher than their parents did. The next quarter down is in somewhat a dubious shape. They may have pretty good incomes but they may not do as well as their parents. The last quarter, the bottom quarter of the income distribution, is in really pretty bad shape in terms of their own

savings for retirement. There's a growing problem coming down the street because of the change in the structure of the American family. When you look at retirees, the worst off people are single people, most particularly single mothers and most particularly divorcees. When you look at the great increase of the numbers of these people we have coming into the retired population, the income distribution among the elderly is actually going to widen. We did some projections at the Urban Institute that initially suggested that the poverty population would actually go up even though the average income of the elderly would go up as well. We changed our growth assumptions a little bit and that didn't quite happen. Nevertheless, the distribution of wealth among the retirees becomes very much more unequal as time goes on.

Question 6.) You mentioned Sweden, what did Sweden do to turn things around?

Didn't Chile also have some change that they implemented?

Answer 6.) There are Social Security reforms going on all over the world and we've got a lot to learn from them. Some have made horrible mistakes and we can learn from that and some have had big successes. The Swedish reform is really ingenious. It's complicated though. Let me step back one step. There are two kinds of reforms going on in the world. In places like Chile the system had totally crumbled. There was no retirement system. The same is true in the former communist countries where pensions for the elderly got down to two dollars a month or something like that. Then it's easy to reform if you've got nothing to replace. Where you have a fairly generous system like we do and like Sweden did, it's politically excruciating to reform. Nevertheless, it's happened.

What Sweden did was take their pay-as-you-go defined benefits system that looks something like ours except it's a lot more generous and they converted it to what they call a pay-as-you-go defined contribution system. The way it works is that as you go through life you accumulate credits for all the taxes you paid, all your payroll taxes. That's recorded on paper, there's nothing really there because it's a pay-as-you-go system. These balances accumulate and you are paid a sort of shadow rate of interest on them equal to the rate of growth of wages in the economy. You can retire; they don't get into the argument about increasing the retirement age which is very divisive in our country. They say you can retire as early as age 61 if you like. However, based on your accumulations on paper you'll get an annuity that's appropriate to when you retire and to the expected life of your age cohort. So they automatically adjust the system to changes in expected life. They automatically adjust for surprises in economic growth because if their trust fund reaches a certain level you don't get the full interest rate equal to wage growth any more. In addition, you are forced to contribute two and a half percent of your wages to an individual account system. One of the weird things about that is they've given people the choice between over 400 different mutual funds. If I were designing the system I'd have three. The government thrift plan started that way.

This reform is very neat in that it adjusts for surprises in demographics or economic growth. That is the crux of the system and the World Bank's pushing this around the world and a lot of former communist countries are doing it. One of the great problems the Swedes had was that they greatly underestimated the problem of setting up the information system for the reform. The Poles with less technological knowledge

tried to set up a system like the Swedes and they've lost all the money. They don't know what went into people's individual accounts.

Question 7.) In light of what you said about the projected forty plus trillion dollar money transfer in this country between now and 2050, what do you think should be done with regard to repealing the estate tax? Second, if you're going to have reductions in taxation, do you feel it's better to redistribute the burden?

Answer 7.) On the first question with regard to the estate tax I really wish we could broaden the nature of the debate. There seems to be a consensus forming in the Congress not to do away with it altogether but just to greatly increase the exemptions, and lower the rates, which doesn't lose you that much revenue.

I think it's a horrible tax as it's now structured. The Brookings Institute had a book a few years back that called it a voluntary tax. The amount you paid depends on how much you paid lawyers. That's ridiculous. There's just so many outrageous loopholes in it that it really is a voluntary tax. I wish that we could get to debate what Canada did quite a large number of years ago. The estate tax was just as unpopular there as it was here so they abolished it. They replaced the estate tax with the assumption that capital gains would be deemed realized on death and that's one of the reasons you have an estate tax, to capture those capital gains.

In terms of your other question about how the tax burden should be distributed, given today's levels of taxation, that's really a value judgment and my personal values are that the system is quite progressive enough. It is pretty progressive but other people differ on that. I wrote a piece, I originally called it "Groping for Tax Justice" but then Arnold got into all that trouble in California so I had to change the title. It's on my

website at the Urban Institute if you are interested in pursuing the matter. If you are, I'd be interested in your comments. That's just www.urban.org.

Question 8.) What is your title now?

Answer 8.) It's "Searching for Tax Justice."

Question 9.) With reform of social programs such a hot potato politically, are there any politicians willing to have the courage to do what should be done?

Answer 9.) That's really a good question and in a way my prepared remarks were maybe too pessimistic in that regard. It used to be said that Social Security was the third rail in politics. Touch it and you die. Politicians really didn't discuss it except in the sanctity of their own home. They were so frightened of it. Now we have a few brave souls out there who actually are willing to debate it. It's a handful of Congressmen and Senators but I don't think you can point to any instance where those people brave enough to put a courageous Social Security reform on the street have been defeated in the next election. They've been demagogued to death by their opponents but they have prevailed. A group of House members who are interested in reform, they refer to themselves as the "Pain Caucus," have made a pledge. They are a bipartisan group who promised that if anyone was being demagogued in their district during the election campaign somebody from the opposite party would show up to defend them. I think that helped a lot. Charlie Stenholm in Texas, for instance. He is the conservative democrat who is very courageous on the issue of Social Security reform. He was, I think, defended against demagoguery by Jim Kolbe, a courageous Republican from Arizona. Among the reformers, you have Nick Smith in Michigan on the Senate side,

Senator Breaux on the Democratic side, Senator Gregg on the Republican side. These are people who are really willing to stick their neck out.

The really scary thing to me though is how many of these people are leaving or have left voluntarily because they are just getting so frustrated with the system. I think the loss of Senator Breaux, who recently retired, is a terrible blow for the Senate. He is just a very, very able person. Bob Kerrey who was very courageous on Social Security reform but he also left. Luckily we still have Senator Gregg, but Nick Smith is leaving the House. These people are throwing in the towel.

Question 10.) I know medical costs are absolutely wild these days from a personal experience but I think it's fine with all you young people taking care of me. I think that's terrific but how much water is there in these medical costs? I know you can get an insurance policy in Mississippi for let's say \$80,000 to \$90,000. You get the same coverage in Louisiana for \$10,000 or \$12,000. Is there anything that can be squeezed out, a significant amount that can be squeezed out of our medical expenses?

Answer 10.) You've really put your finger on it and you put your finger on the evidence about how inefficient the system is. I don't know the difference between the two states you mentioned but I know there's a similar difference, for example, between per eligible cost in Minneapolis and in Miami. I forgot the exact number but I think it's three times higher in Miami so if we could get the high-cost states down to where the low-cost states are, we could make a huge, huge difference. It would put off the time that we have to start rationing technology.

The fundamental political problem is that we economists think that the way to solve the problem is to bring more market incentives into the system. The ordinary

public really doesn't like market rationing in this business. They prefer bureaucratic rationing which is what we've got. It's extremely, extremely inefficient. I don't know what to do about that. I'd be quite willing to protect the poor against the vagaries of the market. I said I think one of the things to do is to increase co-payments in Medicare. They're pretty high now but for the more affluent it wouldn't be a really big problem. Persuading the public to do that is extremely, extremely difficult.

Question 11.) I'm going to ask you this as a kind of corollary of what you were discussing, if you are as pessimistic as you say you are about future reforms, over the next few years if assets underperform, what do investors do, what should people do in an environment that seems to be deteriorating?

Answer 11.) Frankly, I'm really puzzled why the financial community as a whole is not more concerned about this problem and is not hollering at your elected representatives about it. They should be on the forefront of reform. As I sit, it's really hard to know when this will cause financial instability. I think it absolutely inevitable if the system is not reformed. What we have to hope for is a financial crisis that's serious enough to provoke the politicians to act but not serious enough to do lasting harm to the U.S. economy. That could happen. That's one quite possible scenario, sort of like the '87 stock market crash which got everybody's attention. Can't really argue that it did horrible harm to the U. S. economy in the long run.

A mild scenario is one where you get financial instability and the Fed responds to that by putting liquidity into the economy. Hopefully, the politicians respond to it by reforming the system. The Fed does have a tendency to overdo it under these circumstances. I'm not really criticizing them but if you take '87 as an example, they

poured liquidity into the market when the stock market went down and a lot of people blamed the growing inflation through 1990 on the Fed overdoing it. They did exactly the same with respect to the bubble and we've yet to see whether they're overdoing it or not. I'd rather suspect they will in the end.

What I'm trying to say is that the danger here is really inflation. You can spin that into a horror story where the politicians get themselves into a fix where the debt is going up so fast, the interest bill is going up so fast. They can't tolerate more borrowing. They don't have the political courage to raise taxes or cut spending. What is the last option? The last option is to create money. Having worked a lot in former communist countries, what I found remarkable about their hyperinflations is that the politicians can grab a lot of resources that way. It doesn't cost much to create money so you have a profit which is of some significance. Even more significant is that hyperinflation is a huge tax on asset holdings denominated in money. Between the tax and seigniorage, the politicians got about five percent of the GDP from a 10,000 percent inflation rate in Georgia in the 1990s. You can only do it for one year because after that people stop holding money and the whole system collapses and you revert to a barter economy. That's a real nightmare. The prospect of that happening in the United States, I think and I hope, is very, very small. But that is the ultimate, ultimate risk.