Book Reviews

Edited by Robert Herren

The Clash of Generations: Saving Ourselves, Our Kids, and Our Economy. LAURENCE J. KOTLIKOFF AND SCOTT BURNS. Cambridge, MA: The MIT Press, 2012, pp. xii, 275, $21.95

This is a three part book dealing with an important, yet often overlooked, aspect of the economy, the coming fiscal crunch due to entitlement spending. Part 1 lays out the numbers in all their depressing detail. Part 2 presents bipartisan solutions to solve the entitlement problem. Part 3 gives financial advice for families on investing with the knowledge that future entitlement benefits will be less than promised. This involves a strategy with which most economists would be familiar: invest in low-cost index funds, do not actively manage your portfolio, and avoid high cost, professional advisers in the financial services sector as much as possible.

The authors paint a bleak picture of the United States fiscal situation. The official government debt of $11 trillion obscures the real fiscal shortfall (or "gap") of $211 trillion, which is the difference between promised future entitlement benefits and what the government can afford to pay. In fact, the United States fiscal gap is currently 14 times GDP, whereas the fiscal gap in Greece is only 12 times GDP; the United States is in worse fiscal shape than any other developed country. The authors credit the problem to "turning retirement into a well-paid, long term occupation."

Indeed, this long term occupation is putting the United States federal budget in a tough spot. By 2030, Social Security, Medicare, and Medicaid will consume two-thirds of the government's total tax revenues, which is the equivalent of $3 trillion, or 13% of GDP. This means that 25% of the United States population (retirees who reach eligibility age) will consume 66% of total tax revenues. In order to eliminate the fiscal gap, all federal taxes would have to be immediately increased by 64%, or all non-entitlement spending cut by 40%. The longer this reform is postponed, the more drastic the tax increases and spending cuts that are needed. For instance, waiting 20 years necessitates a 77% tax increase or a 46% non-entitlement spending cut. Growing our way out of the problem seems unlikely. The authors report that, according to the Center for Disease Control, out of the 30 year increase in life expectancy that Americans enjoyed over the past century, over half of the increase went to people over 60 years of age. Thus, the increase in life expectancy does not translate into an increase in worker productivity and economic output; instead, it puts a strain on entitlement spending. Medicaid, which is thought of as providing health coverage to the poor, actually pays out 70% of its benefits to the elderly, mostly in the form of nursing home care.

In addition to explaining the budgetary challenges provided by entitlement spending, the authors describe how entitlement spending and the current state of the economy are adversely affecting the younger generation (hence the title of the book). Between the 1950s and now, the national savings rate has fallen from 16% to 0% while the domestic investment rate has fallen from 16% to 4%. The authors blame this on savings from young people being transferred to the elderly, who then consume it. In fact, consumption has risen dramatically for the elderly. The authors report that between the early 1960s and late 1980s, consumption by a 20-year old increased by 38% whereas consumption by an 80-year old increased by 164%. In 1960, a 20-year old consumed 36% more than an 80 year old. By the late 1980s, this reversed itself so that an 80-year old is now consuming 39% more than a 20-year old. The decline in investment puts a crimp on economic growth, which further compounds the problem of financing entitlement expenditures.

The labor market also favors older workers over younger workers. Between 1993 and 2010, the labor force participation rate for those 55 and over increased from 29.4% to 40.2% while it declined for younger workers. Demographic challenges compound labor market challenges. Currently, 40% of births occur out-of-wedlock. Female employment has also risen compared to male employment. In fact, females got 97.5% of the new jobs created between 2000 and 2010! Though the authors do not talk about it directly, the Affordable Care Act puts an additional burden on the younger generation. The flattening of insurance premiums across age groups causes the premiums for older individuals to be subsidized by younger individuals.

The authors propose a set of changes to entitlements to eliminate the fiscal gap. Their "purple health plan" ("purple" meaning a blend of red and blue to signify the bipartisan aspects of the plan) would cap total health care spending at 10% of GDP. A panel of experts would determine what services should be covered by insurance, so long as spending is capped at 10% of GDP. Health insurance companies would issue policies that cover these services, and the government would issue yearly vouchers for individuals to purchase these plans. The "Purple Personal Security Plan" would transition Social Security from a pay-as-you-go system to a fully funded system. The new system would see workers contribute 8% of their earnings into a global asset fund, with these assets gradually sold to purchase Treasury Inflation Protected Securities when the worker reaches 62 years and continues through age 70. The authors would replace the current loophole-ridden income tax system with a "Purple Tax Plan" that involves a progressive consumption tax as its backbone. The authors calculate that their health care plan would shave $127 trillion off of the $211 trillion fiscal gap, their Social Security plan would cut another $59 trillion from the gap, while the tax plan would cut another $36 trillion, which would completely close the fiscal gap with $11 trillion left over.

The $127 trillion savings from the "Purple Health Plan" involves the savings from reducing health care spending from 17% to 10% of GDP. I wonder about the political feasibility of a panel of experts being able to reduce health care spending by seven percentage points of GDP without any pushback. On one hand, because the traditional third party payment system would remain, this panel of experts would have to routinely say "no" to treatments that Americans are currently used to getting for "free." On the other hand, the sickest 1% of the population is responsible for 20% of total health care spending while the sickest 5% of the population is responsible for 50% of total health care spending, according to the Centers for Medicare and Medicaid Services National Health Expenditures Data. So, it is possible to dramatically reduce health care spending without affecting the vast majority of the population.

With that said, I would prefer the Singapore health care system over the Purple Health Plan. Such a system involves out-of-pocket payment for routine services financed through saving in a health savings account, with catastrophic insurance kicking-in once a large deductible is reached. This plan does not insulate individuals from the routine cost of health care and thus provides an incentive to economize and price shop for health services, which would help reduce health care spending. In fact, Singapore only spends 2% of its GDP on health care. If the choice is the Purple Plan or the status quo, the Purple Plan is a no-brainer.

The authors also point out that a little known aspect of Obamacare is that it levies a 0.9% income tax and 3.8% tax on asset income on single workers making over $200,000 per year and married workers making over $250,000 per year. This is a large enough tax increase to negate the 2004 Bush tax cuts on individuals at this income level, which makes it less likely that repealing the Bush-era tax cuts can help close the fiscal gap.

The book is outstanding in its presentation of the numbers and laying out the case that something must be done, and soon. It is also nice that the authors provide some concrete proposals that actually close the fiscal gap. This book is definitely a "must read" for anyone interested in the budget deficit because balancing the budget cannot be seriously discussed without discussing how to reform entitlements.

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Birth of a Market: The U.S. Treasuries Securities Market from the Great War to the Great Depression. KENNETH D. GARBADE. Cambridge, MA: The MIT Press, 2012. Pp. xi, 393, $50.00.

In the interwar period in the United States there was tremendous change in a number of facets within the society and the economy. While in some of these areas the change was fleeting, in other areas the change was more lasting when it led to the establishment of an infrastructure that would be heavily relied upon in the second half of the twentieth century. In Kenneth Garbade's "Birth of a Market: The U.S. Treasury Securities Market from the Great War to the Great Depression" the theme of great and lasting change initiated during the interwar period is explored in the market for United States Treasuries. It doesn't take much for Garbade to illustrate the dramatic change that occurred during the twentieth century in the United States Treasury market. Whereas before WWI there was only $1 billion of outstanding treasury debt with 80% of it held by banks, by 2009 there was $12.3 billion in outstanding treasury debt with over half of it owned by the public.

Garbade contends that the interwar period was a time when all but one of the central features of the present-day Treasury bond market were first used. These features included auctions offered in a regular and predictable fashion, the integration of cash and debt management by the Treasury