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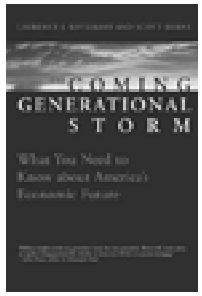
Boomer Decisions

by Peter T. Ittig, Feature Editor



The Coming Generational Storm: What You Need to Know about America's Economic Future
by Laurence Kotlikoff & Scott Burns
MIT Press; 2004: 264 pages
mitpress.mit.edu

One of the great demographic issues of our time has concerned the consequences of the "baby boom," the unusually large crop of children born after World War II (roughly from 1946 to 1964). The number of babies born in the U.S. hit an all time high in 1957. The large size of the boomer generation and choices that they made as a group have had substantial consequences. Some important decisions are still to come as the boomers near retirement. This column reviews a new book that considers some of the decisions that face the nation, individual citizens, and the boomers themselves. The authors, Laurence Kotlikoff and Scott Burns, have chosen a relatively dramatic title for their analysis, *The Coming Generational Storm*, published by the MIT Press. Kotlikoff is a professor of economics at Boston University who has written about "generational accounting" and the financial problems of the Social Security system. Burns is a syndicated personal finance columnist. Together, they have written a thoughtful and provocative book

The boomers have seen a number of factors tilt against them at various stages of life. When the boomers were old enough to go to school, the schools weren't ready and class sizes rose. When the boomers reached college age, the admission standards tightened. When the boomers wanted homes in the suburbs, the prices rose. You can probably guess what will happen to the relative prices of homes in suburban and in retirement communities when the boomers want to sell one and purchase the other. You can probably also guess whether Social Security will be more or less generous for the boomers in comparison with current retirees. The retirement age for "full" benefits is already being been moved out for the boomers as one way to cut their benefits. For an excellent discussion of some other strategies see, "The Declining Role of Social Security" by Alicia Munnell, 2003, available free online at http://www.bc.edu/centers/crr/jtf_6.shtml. Dr. Munnell is the Drucker Professor of Management Sciences in the Carroll School of Management at Boston College and director of their Center for Retirement Research. She notes that "Recognizing the declining role of Social Security is important because future retirees will need to find alternative income sources as they age." Additional consequences are less obvious, including consequences for your investment decisions, as discussed below.

An issue that aggravates the impact of the boomer demographic bulge is that the boomers have had very few children. In comparison with their parents, the boomers married later, divorced more often and had smaller families with few or no children. Thus, the baby boom generation is not only more numerous than the preceding generation, but it is followed by a smaller generation, or a baby bust (with apologies to generations X and Y). This results in a kind of demographic tidal wave! The authors project that by 2030, the U.S. will have twice as many retirees but only 15 percent more workers. They also

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project that the generational imbalance in Japan and in Europe will be worse than that in the U.S.! One of their conclusions is that the U.S. Social Security program cannot be sustained in its present form after the boomers retire. This is because Social Security and Medicare together constitute an unfunded (pay as you go) pension program; that is, the cost is paid by current taxes on current workers. This represents a transfer from one generation to another. This scheme was terrific for the early beneficiaries of the system in the 1930s and 1940s, who received much more in benefits than they contributed in payroll taxes. However, this model won't work for the boomers with anything approaching the current levels of benefits. Fortunately, on average, boomers are better off financially than their parents, at least partly because the boomer women went to work in large numbers in jobs outside the home.

Chapter 1 describes the demographic issues concerning the boomers and is quite engaging. The next two chapters discuss present values of unfunded liabilities or "implicit debt," with some formulas. Some of this is material that only an economist could love, with the notable exception of the "Menu of pain" on pages 65 and 66. That "menu" provides estimates of the outrageous changes that will be needed if only one selection is made from a menu consisting of raising payroll taxes, raising income taxes, cutting federal spending, or cutting Social Security. The authors argue persuasively that we can probably expect some mix of these and an increase in inflation as well.

The authors examine the probable consequences of several possible public policy responses in Chapters 4 and 5. Much of this is quite good. The authors also attempt to forecast, for decades into the future, the unpleasant economic effects and interest rate consequences of various strategies by using a complex simulation model developed by Kotlikoff together with Kent Smetters (University of Pennsylvania) and Jan Walliser (World Bank). The details of the model are not presented in the book. However, there are serious difficulties in using complex multi-equation models for forecasting (for a discussion of some of these issues, see the January 2002 Bookshelf column at http://www.decisionsciences.org/DecisionLine/Vol33/33_1/). Further, it is profoundly difficult to predict time series driven by markets, including bond prices and the interest rates implied by those prices. The resulting scenarios should probably be seen as an attempt at computer-aided speculation, including the projection that "real wages fall" and of "a long-term 300 basis point (3%) rise in the real return to capital." Another recent book (not reviewed here), *The Triumph of Contrarian Investing* (McGraw-Hill, 2004) reported an analysis of the forecast accuracy of the consensus of about 50 economists for 42 forecasts of interest rates only six months into the future, as reported in *The Wall Street Journal* from 1982 to 2002. In that study, the economist consensus provided the right direction for the change in interest rates in only 12 of the 42 cases, or less than 1 of 3 tries! To paraphrase J. K. Galbraith on forecasting interest rates: "There are two kinds of forecasters (who forecast interest rates) those who don't know (how to forecast interest rates), and those who don't know they don't know (how to forecast interest rates)." (See *The Wall Street Journal*, January 22, 1993.) However, it does seem plausible that the financial markets will be under sustained pressure for an extended period when the boomers begin to liquidate their 401k's and IRA's.

The U.S. economy is too complex for computer models to offer accurate forecasts for the long future. The response curves (short-term and long-term elasticities) are particularly difficult to estimate and some of the responses are nonlinear in nature. For example, a small model of the U.S. economy might involve over 200 variables and parameters. In order to estimate 200 parameters from monthly data, we need at least 200 data points or over 16 years of data. Such a model would be obsolete as soon as it was constructed.

The authors present their own recommendations for public policy decisions in Chapter 6. A key recommendation is that the pension part of Social Security be terminated in a manner similar to that used for terminating a corporate pension plan; that is, benefits accrued now would be paid, but no new credits would occur. They would leave the survivor and disability parts funded by payroll taxes. They propose to replace Social Security with a fully funded system somewhat similar to a 401k defined contribution plan invested in an index fund and institute a national sales tax of about 12 percent to fund the transition. The authors propose that the sales tax be temporary and gradually diminish as the obligations of the old system are paid off. However, the experience of other countries suggests that it may be difficult to undo it later. For comparison, the sales tax in Canada is now 15 percent in their most populous province (Ontario), 17.5 percent in the U.K. (there called a Value Added Tax or VAT), 19.6 percent in France and 20 percent in Italy (see http://europa.eu.int/comm/taxation_customs/publications/). An advantage of a sales tax is that it hits current retirees when they spend money regardless of the source—that is, it would whack the boomers. It is argued that benefits for the poor could be adjusted to diminish the regressive nature of a sales tax.

Recommended decisions at the individual level are quite good in some cases. For example, it is not widely known that there is a tax trap that negates the benefit of deferred compensation pension plans for many retirees. If your pension plan is a 401k or 403b plan, this tax trap will cancel the tax advantage of deferral and more. A key element of the trap was passed in 1993 during the Clinton administration. This imaginative scheme provides that for each $1,000 in taxable income that you take from your pension plan, you may need to shift $850 of Social Security to the taxable column of your tax return. This has the effect of converting a 25 percent tax bracket to about 46 percent for pension income! The income thresholds for this game are not indexed for inflation. The analysis reported in Chapter 7 concludes that, if your pension plan is a 401k (or 403b or other deferred compensation plan), you should not put money into it unless your family income is over $150,000! Many people, including many financial planners, are not familiar with this trap. There is an important exception if your employer matches your contributions. Think "Roth IRA" to avoid this trap, though a national sales tax will still get you. Also think "inflation indexed bonds" to deal with the threat of inflation.

The book notes that with sufficient inflation, even inflation indexed bonds will produce a negative real yield after taxes. This is because the income tax hits both the real interest rate and the inflation adjustment. As this article is written, the yield on inflation indexed bonds is about 1.6 percent plus inflation in the Vanguard Inflation Bond Fund (http://www.vanguard.com), while inflation was 3.1 percent for the 12 months ending May 2004 (see http://www.bls.gov). Thus, if you are in the 25 percent bracket, your real yield in a taxable account is only about 0.4 percent [(3.1+1.6) * .75 – 3.1]. At higher rates of inflation these effects become more pernicious. Consider putting the inflation indexed bonds in a Roth IRA to avoid this problem. Note that an inflation rate of 3.1 percent will cause prices to double in about 23 years.

Historical note: Bonds in the U.S. were indexed for inflation directly and indirectly prior to the 1930's by being tied to gold. The indirect link was that the U.S. dollar was convertible into gold. The direct link was that many corporate bonds specified that they were payable in gold. In 1933/34 the U.S. government called in the gold, nullified the gold clause in bond contracts and devalued the dollar! Ultimately, the U.S. severed all ties between the dollar and gold. For abstract currencies, such as the U.S. dollar, the inflation rate is essentially a policy choice by government.

The authors also recommend a home as a great investment because the "imputed income" from living in it is exempt from tax. While a home may be a good investment, the logic of this common argument is flawed as it ignores the impact of the property tax, which has an effect that is similar to a tax on imputed income. If interest rates are 5 percent, then a 1 percent tax on property is equivalent to a 20 percent income tax on "imputed income." As examples of the scale of current property taxes, note that in California the property tax on homes is limited to 1 percent and in Massachusetts it is limited to 2.5 percent (that 2.5 percent rate is also applied to cars and boats). A 2.5 percent property tax is equivalent to a 50 percent tax on "imputed income" if interest rates are 5 percent. It is much worse if real interest rates are only 1.6 percent. Some of this is discussed in my paper "Tax Subsidy of Home Ownership" in the *Journal of Public Policy* (v4, n2, 1984, Cambridge University Press).

Other recommendations in the book are good, emphasizing diversification of your portfolio (including inflation indexed bonds), holding down fees, and paying down debt. The authors refer to the "excessive fees" charged by most financial services firms. They also refer to TIAA-CREF as "one of the most reputable financial institutions." This is also a major holder of retirement funds for professors. However, this reviewer has been disappointed to see the expenses for TIAA-CREF drift upward. For example, the CREF Inflation Linked Bond fund has expenses of 0.39 percent while the similar Vanguard Inflation Protected Securities fund has expenses of only 0.18 percent (less than half as large). The expenses for the CREF Equity Index fund are 0.36 percent while the expenses for the similar Vanguard 500 Index stock fund are only 0.18 percent, or 0.12 percent for their "Admiral" shares (one half to one third as large). Still, most mutual funds are much more expensive and many insurance company tax-deferred-annuities have outrageous fees.

The *Coming Generational Storm* is a highly readable book on an important subject. You should consider taking it with you on your next trip or vacation and contemplate working longer before you retire.

Web Links:

"The Declining Role of Social Security" by Alicia Munnell, 2003, **www.bc.edu/centers/crr/jtf_6.shtml**

January 2002 *Decision Line* Bookshelf column discussing issues of complex models for forecasting, **www.decisionsciences.org/DecisionLine/Vol33/33_1/**

International comparisons of taxes, **europa.eu.int/comm/taxation_customs/publications/**

Vanguard, **www.vanguard.com**

TIAA-CREF, **www.tiaa-cref.org**

U.S. inflation rates, **www.bls.gov** ■

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