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Generational Accounting: From the Me Generation to Generation X

ST. LOUIS — Would you pay higher taxes now if it meant that the next generation — namely, your children or grandchildren — would pay lower taxes? That might be one option if policymakers analyzed fiscal policies using "generational accounting," which measures the burden on both current and future generations of taxpayers.

Economist Kevin L. Kliesen weighs the pros and cons of generational accounting in the current issue of ***The Regional Economist***, the St. Louis Fed's quarterly magazine of business and economic issues.

"Our current fiscal policy was created decades ago under the assumption that the number of workers supporting each retiree would be greater than it is today," explained Kliesen. "For example, those 65 and older made up 8 percent of the total population in 1950, with six to seven workers for every retiree. By 2010, when the baby boomers begin retiring, those 65 and older will make up 13 percent of the population. And when most of the boomers will have retired by 2030, the 65-and-older Americans will comprise 20 percent of the population, with less than three workers paying taxes to support each retiree's Social Security and health benefits."

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Kliesen said that the country's fiscal policy from the time after World War II until the early 1970s — a so-called era of balanced budgets — placed large burdens on future generations through increases in the Medicare and Medicaid programs and Social Security benefits. "These policies essentially increased the financial burden on younger workers while reducing the burden on the elderly," said Kliesen.

Under generational accounting, generational tax burdens are calculated according to the total amount of net taxes that each member of each generation will owe to the government for the rest of his or her life based on existing policy. This amount is the difference between the expected taxes that must be paid, minus the expected transfers (Social Security or Medicare) that will be received. Therefore, each generation's "account" is the amount of money that will be needed to make up the shortfall after future tax payments from the current generation are applied to both current and projected government spending and debt service payments. Dividing this amount by each generation's expected lifetime labor incomes produces a net lifetime tax rate.

"This method of analysis," said Kliesen, "assumes that income, taxes and transfer payments of future generations will grow at some fixed rate of economic growth. Although it's implausible to assume that these rates will stay fixed, it's necessary for this type of analysis. To a large extent, though, this shortcoming is typical of any long-term forecasting method."

Kliesen noted that, as a tool to analyze fiscal policy, generational accounting has found a home among a mostly small, but growing, group of economists. Even critics, however, concede its fundamental point: Maintaining current fiscal policy indefinitely means that future generations will have to bear a larger tax burden than those alive today, even under more optimistic growth assumptions.

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Alternatively, Kliesen suggested, policymakers could distribute the fiscal burden more equally by changing the level of health and retirement benefits for future taxpayers. "For example," he said, "if policymakers waited until 2001, we would need to immediately cut all transfer payments — Social Security, Medicare and Medicaid — by 38 percent. That would equalize lifetime net tax rates for current and future generations at about 40 percent. If we wait until 2016, we would need to cut benefits by 63 percent, resulting in a net tax burden of 43 percent. As frightening as those cuts are, though, they would be better than the 84 percent assumed under no change whatsoever — and those cuts in health and retirement benefits that would occur if taxes alone were raised."

"We know that future generations will have to bear a larger tax burden," said Kliesen. "The question is how much."

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