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Modernizing Financial, Tax, Healthcare, and Retirement Systems So Workers Can Productively Work and Save

Challenges and Strategies for Promoting Economic Growth

Banco de Mexico Conference

October 19-20, 2009

The world is in economic turmoil. The financial market has melted down and with it trust in a system that routinely borrows short and lend longs, guaranteeing repayment, yet investing at risk. It's a system virtually designed for hucksters, with limited liability, fractional reserves, off-balance-sheet bookkeeping, insider-rating, kick-back accounting, sales-driven bonuses, non-disclosure, director sweetheart deals, pension benefit guarantees, and government bailouts.

The collapse of asset values has destroyed the jobs or retirements of hundreds of millions of people around the globe and led governments to make enormous current and future expenditure commitments. Those who have jobs can, thus, look forward to substantial tax increases or benefit cuts to cover these costs. The same holds true for our children.

For the developed and major parts of the developing world, this crisis could not have come at a worse time. Most of these countries are facing unprecedented fiscal stresses associated with the dramatic aging of their societies and the rising costs of healthcare medications and services. These countries couldn't afford the financial crisis that's hit, and they certainly can't afford its repetition.

Tax hikes and benefit cuts will reduce incentives to work in the formal sector, leaving government with less capacity to address vial concerns. So there is a direct connection between financial and fiscal reform, improving labor market outcomes, and laying the foundation for healthy economic growth.

Fixing what's wrong, staying economically secure, and growing rapidly in the years ahead can't be done by pursuing business as usual. Business as usual is driving our economies over a common cliff. We need to reshape our fiscal and financial systems to make them as efficient, transparent, and affordable, and we need to do so immediately.

In this paper I outline four reforms of financial, tax, healthcare, and retirement saving systems that may sound radical, but are actually much safer than maintaining the status quo. I'm going to reference the U.S. in discussing these reforms, but each reform can be implemented in any country in the world. And the more countries that adopt these reforms, the more successful any one reform will be.

The four reforms invent new institutions, but they don't require new technology or resources to implement. Everything they require comes off the shelf. What they entail is using what we already have and know in different ways – ways that economics science would seem to recommend given our objectives and constraints. They also entail thinking out of the box and realizing that we economists have the ability to engineer solutions to economic problems, not just study them -- solutions that can make a real difference.

When governments need a new bridge constructed over a raging river, they turn to professional engineers for the design and implementation. They don't let politicians draw up the plans and decide where to place the supports and how to mix the concrete. That doesn't happen, in general, when it comes to economic reform. Economic reform is a goulash constructed by hundreds of political chefs, each of whom is paid by lobbyists to throw "his" own special ingredients into the pot. It's no wonder eating this concoction has made us economically sick.

But our job as economists is not to make the goulash; it's to supply the right recipe. Our job is not to provide third-rate recipes because we fear the first rate ones will be mangled. Doing so represents a form of professional malpractice and takes our science to places it can't and shouldn't go. We need to focus exclusively on being *objective* economists, not *political* economists.

Since we are meeting in Mexico, it's appropriate to point out that the type of reform I'm considering – economic reform designed and delivered by real economists, not political operatives masquerading as professionals -- has been tried and it works. Mexico's decision to use direct payments via ATM machines located in villages to incentivize local residences to send their children to schools, make healthcare investments, and take other steps to improve their nutrition and well being is a marvelous example of economics' ability to deliver strong and desperately needed policy medicine.

This policy, Progresa-Oportunidadaes, was designed by Santiago Levy when he was Deputy Finance Minister of Mexico. It's been replicated in 25 countries around the world as well as in New York City. Santiago is a real economist, not a politician. He's the product of Boston University's Department of Economics, and we're exceptionally proud of him. Indeed, my colleagues and I at BU love to bask in his achievements, imagining that we had something to do with them. But the fact is that they are solely his own and those of his Mexican colleagues. They reflect Santiago's understanding that economists have a role to play as practitioners, not simply as diagnosticians. We are not here simply to study problems. We are also here to fix them; i.e., we are economic doctors.

Let me, then, ask you to think out of the box, starting first with respect to reforming the financial system, then the tax system, then the healthcare system, and finally the retirement saving system.

Limited Purpose Banking – The Financial Fix[1]

To understand Limited Purpose banking (LPB), think about trucking companies who decided en mass one day to sell rights to their future shipping services at a guaranteed and relatively attractive price. The companies would rake in a bundle in the short run. But were gas and other trucking costs to soar, the companies would fold and the economy would shut down. One such episode would suffice for the government to outlaw this kind of unhedeged gambling by trucking companies, limiting them to their legitimate and critical purpose, namely connecting shippers and receivers of goods, while still letting their owners gamble, but solely as private citizens.

Trucking companies, gas stations, airlines, phone companies are critical intermediaries. But so are banks and insurance companies. LPB would keep all financial corporations, which I'll just refer to as "banks," from a) either going under and shutting down the economy or b) threatening to go under and extorting taxpayers to cover their losses.

Under LPB, the banks would let *us* gamble, but they would not *themselves* gamble. Banks would not be permitted to borrow to invest in risky assets. Instead, they would operate exclusively as pass-through mutual funds.

[1] This discussion of Limited Purpose Banking draws heavily from an article I co-authored with John Goodman, called "Back to Basics," in the NewRepublic.com on May 14, 2009. The rest of this paper draws heavily on the Afterward to *Jimmy Stewart Is Dead – Ending the World's Financial Plague Before It Strikes Again* -- my new book, to be published in March 2010 by John Wiley & Sons, Inc.

Specifically, they would create mutual funds, sell shares to these funds to the public, and use the proceeds to purchase assets. These mutual funds would provide as much credit as the economy needs, allow us to engage in as much risk-taking and leverage as we want, and provide plenty of liquidity.

There are already some 10,000 mutual funds on the market today. Under LPB, there'd be more, including cash mutual funds that hold only cash, pay no interest, and never break the buck. Holders of cash funds could access their dollars at ATMs, via writing checks, or by using debit cards. Thus, cash funds represent the checking accounts in the new financial system.[2]

Under LPB, people who seek to lend money to home buyers would simply purchase shares in a mutual fund investing in mortgages, with the money going directly to the mutual fund (not to the bank sponsoring the fund) and from there to the home buyer in return for his or her mortgage. Those wanting to lend to companies would buy mutual funds investing in commercial paper. Those wishing to finance credit card balances would buy mutual funds investing in those assets. Credit is ultimately supplied by people, not via some magical financial machine. And every dollar people want to lend would be provided to borrowers via mutual funds.

[2] This aspect of LPB is "Narrow Banking," which was advocated by Henry Simons, Frank Knight, and Irving Fisher in the 1930s and was presented to Congress as the *Chicago Plan*.

The Federal Financial Authority

To ensure the security of all these mutual funds, banks would be required to engage (as per the Investment Company Act of 1940) third party custodians, and a new federal regulatory authority-- the Federal Financial Authority (FFA)-- would oversee these arrangements and ensure that no Bernie Madoff or Allen Sanford could ever again self-custody his clients' assets and spend their money illegally.

The FAA would have other roles as well. For one, it would establish, like the Food and Drug Administration does, the safety of products, in this case financial securities: Every security purchased or sold by mutual funds, be it an individual mortgage, a commercial loan, a foreign security, or a share of stock, would be independently verified and rated, as well as fully disclosed on the web, by the FFA, with no exception.

Thus, the FFA would engage non-conflicted rating companies and appraisers to risk-rate securities and provide market valuations of collateral. In the case of loans, the FFA would use federal tax records to verify the income stated by the borrowers on their applications, be those borrowers prospective homeowners or small or large companies.

Information is a public good, so there is a clear economic rationale, not to mention a demonstrable need, for the government to convey the truth about securities. Yes, this would limit demand for the services of Standard & Poor's, Moody's, Fitch, etc. But the FFA would hire these companies to provide ratings, but only if they agree to do no business whatsoever with those they rate.

The FFA would cleanse the financial system of "toxic assets," but not of risky assets. "Toxic assets" references assets whose properties are neither verified nor disclosed. A CMO per se is not toxic. A CMO based on non-disclosed, liar mortgages certainly is. It's no different from a bottle marked Tylenol that's possibly been tainted with cyanide.

So the problem is not the nature of the financial assets traded in the market. Nor is the problem their securitization. The real problem is their potentially fraudulent initiation. The FFA would oversee the initiation (verification, disclosure, rating, and custodial holding) of securities so people would know what they are buying and, therefore, be able to determine what they are worth. The tainted Tylenol would stay on the shelves, but be labeled very clearly as cyanide so that people who need to kill rats would be able to purchase it. And those who want to invest in adjustable rate, no-doc mortgages could buy as much of such securities as they'd like. The FFA's role is not to proscribe financial products; it's to clarify to the best of its ability the truth about every security traded on the mutual fund market.

Some of the FFA's disclosure will be of the form "Here is a security that purports to pay X, Y, and Z in circumstances K, L, and M. We have been unable to verify anything about the parties who are issuing this security or their prospects of meeting their promises. We thus suggest great caution in purchasing this security since it may be extremely risky." Such a statement is no different from those made routinely by the FDA when it comes to their approval of herbal medications. They don't, in fact, approve such medications. Instead, they make it clear that such medications have not been clinically test and may, indeed, represent a health threat.

The Mechanics of LPB

Under LPB, a new mortgage, commercial loan, credit card, issuance of stock, new real estate trust, etc. would be initiated by a bank, sent to the FFA (and also private rating parties, as desired) for rating, income verification, collateral appraisal, and disclosure, and then auctioned on the web by the initiating bank to mutual funds, including mutual funds that the bank itself markets to the public. Once funded, the new securities would be held by the owners of the mutual fund, i.e., by people. The requirement that the securities be publicly auctioned ensures that banks aren't able to discriminate against unwitting borrowers, issuers of stock, and other demanders of funds. Such discrimination is an everyday practice in today's financial marketplace.

In requiring that cash mutual funds hold just cash, Limited Purpose Banking effectively provides for 100-percent reserve requirements on checking accounts.[3] This eliminates any need for FDIC insurance and any possibility of future bank runs. Moreover, since no bank would hold any risky assets apart from the value of its furniture, buildings, and land, and would hold no debts (apart from the mortgages on its property and any loans used to finance its operations), there would be no need for capital requirements.

Insurance Mutual Funds

Insurance companies are fundamentally engaging in the same business as today's banks--insuring us against illness or our home burning down the way financial securities insure us against the stock market crashing, the dollar falling, or the price of oil rising. So insurance companies would, as indicated, be considered banks under Limited Purpose Banking. And like all banks under Limited Purpose Banking, they would be free to do just one thing -- market mutual funds of their choosing.

[3] Under LPB, the M1 money supply would correspond identically to the balances in cash mutual funds. I.e., the money multiplier would be 1, giving government direct control of the supply of this primary type of money.

The mutual funds that insurers would issue, however, would differ from conventional mutual fund. First, purchasers of such insurance mutual funds would collect payment contingent on personal outcomes and decisions as well as economy-wide conditions. This lets people buying a fund share risk with one another. Second, they would be closed-end mutual funds, with no new issues (claims to the fund) to be sold once the fund had launched.

Take, for example, a one-year homeowner's insurance policy sold by The First Bank of Homes (FBH). Purchasers of this fund would buy their shares, let's say, by September 1, 2010, but collect on August 31, 2011 only if they experience incidents like a fire, flood, or a robbery. On that last day of the policy, the FBH would divvy up all the monies in the fund between all those experiencing a loss, with the amount paid out depending on the size of one's loss (as determined by a claims adjuster) and the number of shares one had originally purchased. Hence, Limited Purpose Banking permits people to buy as much insurance coverage as they'd like. Another key feature of this system is that each insurance policy is, in effect, subject to separate reserving; the money contributed to each insurance mutual fund is used exclusively to pay off its own shareholder claimants.

The most important feature of this Tontine structure (first developed in 1653), though, is that the insurance mutual funds pay off based not just on diversifiable risk, but also based on aggregate risk. That is, if lots of the buyers of the FBH fund lose their house to fire, the recovery per shareholder with a loss will be smaller.

This isn't the case under our current system: Life insurance companies, for example, tell their policyholders that they'll pay the face value of their policies if they die regardless of how many other claimants the company faces. Thus, life insurance companies are saying they'll pay in full even if there's a plague. This, they can't do. Neither can the paltry state life insurance reserves cover the losses. This is really no different from AIG's writing some $1.6 trillion in credit default swaps that it knew it would not be able to cover in the event of systemic risk. Moreover, AIG felt no compulsion to reserve against redemptions on these contracts.

The final point is that insurance mutual funds can be set up to bet exclusively on aggregate outcomes, like a particular company going bankrupt (this is a CDS) or the nation's mortality rate exceeding a given level. Shareholders in such closed-end funds would specify whether they were betting on the event occurring or not. If the event occurs, those betting on occurrence take the pot (the holdings of the mutual fund) in proportion to their shares. If the event doesn't occur, those betting against the occurrence share the pot based on shares. If such a system sounds familiar, it is. It's pari-mutuel betting, which has been used at race tracks around the world since 1867.

Leverage

Leverage is fully compatible with Limited Purpose Banking. Mutual funds could, as some already do, sell preferred and common shares. The preferred shares entail less downside risk and the common shares more upside opportunity. This is leverage that all can see, particularly Uncle Sam, who may want to keep a close eye on who's gambling with the potential expectation of a government bailout.

A CDO is, in effect, a mutual fund in which the different parties to the traunched securities are leveraging against one another. Such mutual funds would arise quite naturally under LPB. Again, it is not the securities, themselves, which is the problem. It is their fraudulent misrepresentation, not their existence and the fact that they were purchased with borrowed funds by entities that were "too big to fail." In short, it's the leveraging of the tax payer, not leverage per se that's the problem.

Implementing Limited Purpose Banking

Establishing LPB is straightforward. All financial corporations, if they aren't already, would register with the SEC as investment companies and begin marketing cash and other mutual funds subject to the third party custody and other regulatory provisions of the Investment Company Act.

Depository institutions would immediately transfer all their checking accounts into cash mutual fund shares and use their reserves to provide the cash to back these shares. These institutions have massive excess reserves and will have no problem covering this operation.

Since they would no longer be allowed to buy financial assets or borrow to invest in securities, banks, as broadly defined, would, over time, pay out their cash flow to their owners as dividend payments. The owners, in turn, would use these funds to purchase mutual funds issued by the banks. So the transition to Limited Purpose Banking is gradual with respect to unwinding existing bank assets and debts, but immediate with respect to issuing new mutual funds. Banks become zombies with respect to their old practices, but gazelles in exercising their new purpose.

Politically, Limited Purpose Banking should garner lots of support. The public is dying for a transparent, safe financial system, which puts a definitive end to financial crises and public bailouts. Bankers will likely fight this reform tooth and nail. They'll claim it's naïve, too radical, a non-starter, that it relies too much on the government, that it's going to limit financial sector returns – you name it. But the bankers' party is over; even the politicians are disgusted by what they've seen and the alternative to his reform is having government micromanage each and every trade of each and every financial company.

The beauty of the reform is that it's already pretty much in place. The mutual fund industry has been operating exceptionally well for 60 years. There are over 8,000 mutual funds operating in the country holding over $12 trillion in assets. And this industry is the only part of the financial sector that is still standing very tall. There's a powerful message in this fact.

The Purple Tax – The Tax Fix

My ideal tax reform, which I'll initially call the *DemoTax*, would replace all federal taxes (the FICA tax, the personal income tax, the corporate income tax, and the estate and gift tax), apart from excise taxes, with a) a one-time, 18 percent tax on wealth, b) an ongoing 18 percent tax on wages, and c) a demogrant.

I initially call this tax the DemoTax for three reasons. First, I think it will appeal to Democrats, because it's highly progressive in addition to being highly efficient. Second, Demo is a Greek word meaning people. And this is a tax, which should appeal to all the people, i.e., Republicans as well as Democrats. Indeed, if we can get Democrats to agree on the DemoTax, my guess is that Republicans will fall in line too. In fact, as you'll see in a moment, a whole army of Republicans has already signed onto it.

Getting Democrats and Republicans to agree agreeably -- to agree to agree on something on which they do, in fact, agree would be a rare and lovely thing. Getting everyone behind a single tax reform would truly make this the *DemoTax* or, if you like, the *PeoplesTax*.

Third, the DemoTax includes a *demo*grant – a fixed monthly payment to households based on their composition (number and ages of household members), not their income. Bill Gates gets the same size check as impoverished households with the same number and ages of family members.

This DemoTax sounds pretty left-wing, right? I'm proposing to tax wealth, lower taxes on labor, and send every household a monthly check. But if you are on the right wing, hang on. That army of supporters, I just referenced, is the FairTax movement, whose members are primarily right of center. The DemoTax, you see, is the FairTax with two important modifications, which ensure that the rich, particularly the superrich, can't avoid it and that the effective tax rate is just 18 percent rather than the 23 percent figure proposed in the FairTax.

For Democrats who don't like the sound of the FairTax, which so far has been championed primarily by Republicans, don't get queasy. The FairTax, you see, is the DemoTax in sheep's clothing. How often do you get Republicans pushing for a wealth tax, lowering taxes on workers, in part by eliminating the regressive FICA tax, and a demogrant!

And for you, Republicans who are getting queasy about advocating something that Democrats will like, hang on. The DemoTax is the FairTax in sheep's clothing. How often do you get Democrats pushing for something you think makes perfect sense and that also lowers marginal and average tax rates, while being revenue neutral!

The FairTax/DemoTax or, if you'd prefer, DemoTax/FairTax would be implemented in the simplest way possible, namely by sending out a monthly check to each household and by having the tax collected at retail stores when people purchase goods and services; i.e., we'd implement this

BlueRedTax/*RedBlueTax* -- this *PurpleTax* -- as a demogrant plus a tax paid at retail stores.

If you're a FairTax fan, think of the taxed collected at the stores as a federal retail sales tax. If you're are DemoTax fan, think of the tax collected at the stores as taxes levied on wages and wealth that are paid as workers spend their wages and as the rich spend their wealth.

I'm going to show you that you are free to think about the PurpleTax in either of these two different ways depending on what makes you most comfortable. If you are a supporter of the FairTax, think of the PurpleTax as a 22 percent retail sales tax, with an 18 percent effective rate. If you are a supporter of the DemoTax, think of the PurpleTax as an 18 percent tax levied on workers' wages and wealth, but that is conveyed to Uncle Sam when these monies are spent.

To keep everyone happy, the PurpleTax will be implemented by setting up two tax counters at retail stores. One will be have a big red banner with the words: FairTax Counter, and one will have a big blue banner with the words: DemoTax Counter. The FairTax counter will be situated after the checkout counter. The DemoTax counter will be placed before the checkout counter. In the example, I now present, I assume there is no demogrant to keep things simple.

Implementation of the Purple Tax

Joe is a worker who earns $50,000 a year before his employer ships any of this earnings off to Uncle Sam as a) employer FICA payments, b) employee FICA payments, and c) federal income tax withholdings.

Joe is a rabid Republican and an avid fan of the FairTax. He also loves M&Ms, spending every cent he earns on those delectables. M&Ms sell for $1.00 per bag. So if he faced no taxes whatsoever, Joe could and would buy 50,000 bags of M&Ms and eat them at one sitting. But if we were to switch to the PurpleTax, with its 18 percent effective tax, Joe will only be able to consume 41,000 bags.

To see this, note that under the FairTax, Joe gets to keep everything he earns, i.e., $50,000. When he comes to the candy store with his pockets bulging with these funds, he first hands the checkout lady $41,000. Next, he proudly struts over to the FairTax counter where be pays $9,000 in taxes. Finally, he picks up his 41,000 bags.

Note that $9,000 is 22 percent of the $41,000, so the retail sales tax rate is, indeed, 22 percent. But $9,000 is just 18 percent of $50,000, so the effective FairTax rate, when measured in terms that are comparable to the way we measure FICA and income taxes, is only 18 percent.

John, Joe's uncle, is a rabid Democrat and also a devotee of M&Ms. John has $50 million, which he made selling liar mortgages to Fannie Mae and never getting caught. But he's feeling very guilty and wants to give back to society. So when John walks into the store, he happily proceeds to the DemoTax counter and forks over $9 million before proceeding to the checkout counter to pay his remaining $41 million and take delivery of 41 million bags of M&Ms.

This is 9 million bags less than John gets to consume under the current tax system. The reason is that under the current tax system, there is no tax on wealth.[4]

So, rich John is worse off. How about relatively poor Joe? He's better off because under the current system, he pays about 30 percent of his $50,000 to Uncle Sam. This includes the 15.3 percent FICA tax (half of which is paid by his employer on his behalf) and a 12.7 percent federal income tax.[5]

Under the current tax system, Joe gets to consume 35,000 M&M bags, whereas with the PurpleTax he consumes 41,000 purple bags. So poor Joe is better off and happier, and rich John is worse off, but less guilty, and, thus, happier.

But there's still one problem. John doesn't like paying taxes in stores. Doing so makes him feel like he's paying sales taxes, which he "knows" are the most regressive taxes in the world. John realizes that he's rich and has been

[4] There is no direct taxation of wealth in our current tax system, but there are capital income taxes. In John's case, he can avoid all capital income taxation by spending his wealth immediately. Were he to live forever and live off the income on his wealth, he'd likely invest it in growth stocks and earn his capital income in the form of deferred capital gains, whose effective tax rate would likely run around ten percent. This is the maximum degree of taxation that John would likely face under our current system. An 18 percent tax is clearly higher than either a zero percent tax or a ten percent tax.

[5] This is an assumed average rate, not a marginal rate.

made worse off and that Joe is poor and has been made better off, but this doesn't change his opinion.

John expresses his concern to the owners of *Agreeable Treats* -- the candy store that he and Joe frequent. And since John is such a good customer, the store buys a building down the block to station the blue DemoTax counter. John is much relieved. He now has no sensation of paying a sales tax. Indeed, *Agreeable Treats* sets things up so that John can pay his taxes at any time and get a tax receipt so that whenever he buys his beloved M&Ms, he can do so without having to ever visit or even look at the hated FairTax counter.

Now, let's add back in the demogrant. First, let me point out that Uncle Sam has allowed Joe and John to receive their monthly check in different colored envelopes with different names inscribed on them. Joes gets his check in a red envelope with the words "Tax Prebate" (the FairTax term) stamped across the top, and John gets his check in a blue envelope with the word "Demogrant" displayed. With the monthly check, Joe and John can each buy another 1,875 bags of M&Ms. This is meaningful to Joe, but peanuts to John.

The only real problem Joe and John have is getting together at holidays. They get into vicious M&M fights about whether the PurpleTax is really the FairTax or the DemoTax. This is all to the good, because everyone needs something meaningless to argue over.

If you are still with me, I'd implement the Purple Tax – a highly progressive-sounding tax reform with a tax that sounds highly regressive. Or, said the other way around, I'd implement a highly regressive-sounding tax reform with a tax that is highly progressive.

Looks can be deceiving, and language is nothing if not flexible. The demogrant aside, we economists don't refer to the PurpleTax as the FairTax or the DemoTax. We call it a consumption tax. And we've known for years that a consumption tax can be implemented/described in a number of ways. Our mathematical models show us that taxing consumption is identical (isomorphic) to taxing what we use to pay for consumption, namely our existing wealth, plus our current and future wages. Hence, taxing consumption on an ongoing basis is equivalent to taxing wealth on a one-time basis and taxing wages as we earn them over time.

Since no one will be checking party credentials at the counters, as long as you go through one counter before leaving the store, you're all set. So if a Republicans think Democrats are getting a break paying only 18 percent out of a larger amount and if Democrats think Republicans are getting a break paying 22 percent, but on a smaller amount, they can switch counters and confirm that they end up with the same number of M&Ms either way.

Unlike the FairTax, the PurpleTax would tax all of consumption, including the imputed rent on owner occupied housing. This is a huge component of personal consumption, roughly 14 percent. It would also tax all educational consumption expenditures. As someone with over 30 years in the education industry, my view is that spending on education is primarily consumption, not investment. Finally, I would require Americans spending more than $5,000 outside of the country over the course of the year to pay the Purple Tax on all their foreign consumption expenditures.

These modifications to the FairTax will ensure that the rich don't sit in their mansions, enjoying their consumption services, while paying no taxes on those services and don't escape taxation by earning their money in the U.S. and then spending it outside the country.

I don't want to take your time here with the mechanics of collecting the PurpleTax or the precise comparisons of its progressivity and efficiency features relative to the current tax system. My website, **www.kotlikoff.net**, features a number of papers on the FairTax that pertain to the PurpleTax. My main purpose here is to signal that we can come up with a very low-rate, efficient, and transparent tax system to replace the current tax structure and that such a system will make all the difference in the world to America's, and, indeed, any county's future growth and revenue generating capacity. For developing countries, having a low-rate tax is the sine qua non for expanding the formal sector. Moreover, there are new and simple electronic and bar code technologies for enforcing collection of the PurpleTax, which make buyers and sellers both complicit in tax fraud if the proper tax is not remitted.

The Medical Security System – The Healthcare Fix

The PurpleTax will, I believe, generate a major increase in the present value of government revenue. But it won't eliminate the fiscal gap on its own. To do this we need to control our future healthcare, Social Security, defense, and other expenditures.

As I write, the Administration and Congress are about to initiate another enormously expensive federal healthcare program to cover those now uninsured, and they are going to do so with no foolproof mechanism for limiting spending on Medicare and Medicaid – two programs that are fully capable of bankrupting the country on their own.

Let me outline what I would recommend, knowing full well that the new system will likely enact a different policy, but also knowing that since the new system, coupled with the Medicare and Medicaid programs, is not affordable, healthcare reform will remain on the table.

We need to redesign the US healthcare system from scratch subject to two absolute requirements. First, we must provide all Americans with a first-rate, basic health insurance plan. Second, we must limit the costs of universal health insurance so that it doesn't drive the country broke.

The Medical Security System (MSS), which I proposed in *The Healthcare Fix* (MIT Press, 2007), delivers the goods. The MSS is very simple. Each

American would receive a voucher each year. The amount of the voucher will equal the person's expected annual healthcare costs that are covered under the MSS Basic Plan. Each person's voucher amount will be determined based on objective health indicators (e.g., blood tests, X-rays, MRI scans) reported via electronic medical records, using individual risk-adjustment software. Thus an 80-year-old, advanced diabetic male living in Miami might get a $70,000 voucher, whereas a perfectly healthy 14-year-old girl living in Kansas City might get a $3,500 voucher.

Each American would use his/her voucher to buy the Basic Plan from a health insurance company. Since health insurers would be compensated via the size of the voucher for taking on customers with pre-existing conditions, they would have no incentive to cherry pick. Nor would they be allowed to do so; no insurance company would be permitted to refuse coverage of anyone.

Those who can afford it would be free to buy supplemental insurance from the same insurance company from whom they purchase their basic plan. This eliminates cherry picking (adverse selection) in the supplemental insurance market.

Insurance companies would, however, be free to offer their clients financial and other incentives to improve their health. Insurers would also be able to establish co-pays and deductibles. These incentives to properly use, but not overuse the healthcare system would be subject to review by the independent panel of medical practitioners set up to oversee MSS.

This panel would also determine what the Basic Plan covers. It would do so subject to a strict budgetary ceiling, namely, total MSS voucher payments would not be permitted to exceed 10 per cent of GDP. Ten per cent of US GDP appears to suffice to finance basic healthcare, including nursing home care and prescription drug coverage, for the population. It is certainly a larger share of GDP than is being spent in every other developed country on basic healthcare.

Once the vouchers are handed out, Uncle Sam is off the hook. The insurance industry and doctors, hospitals, and other private providers will be responsible for providing the Basic Plan based on the vouchers provided.

Since US GDP will grow, total MSS expenditures will grow as well. Hence, the MSS panel will be able to add new medications, surgical procedures, new diagnostic technologies, etc. to the Basic Plan's coverage. But the panel will add these new coverages to the Basic Plan at a much slower pace than would occur under the current system. This will dramatically reduce the growth rate of federal healthcare spending, ensuring that the 10 percent ceiling on federal MSS expenditures relative to GDP is never violated.

How would we pay for MSS? With the Purple Tax, assuming it's enacted. Otherwise, we'd pay for MSS with federal and state government savings from closing down the new Healthcare Insurance Exchange (which I expect will be enacted), Medicare, and Medicaid and eliminating the federal income tax exclusion of insurance premiums for employer-provided healthcare benefits. Together these direct and indirect expenditures account for roughly 10 per cent of GDP.

This healthcare fix will shave trillions off the government's long-term fiscal gab. And in providing all Americans with a basic health plan, we'll all be able to sleep at night. Those now uninsured will no longer face bankruptcy from an expensive illness. And those now insured, will no longer have to fear the loss of coverage as a result of losing their job or switching jobs.

MSS achieves universal healthcare via universal health insurance. It doesn't nationalize the healthcare system. Instead, it maintains competitive provision and puts health insurers to work in generating the right incentive structure for people to improve or maintain their health, rather than cherry picking healthcare winners and losers.

Finally, by handing the public their vouchers to spend on a health plan of their choosing, the MSS makes clear that the system is not free and that we all have a stake in ensuring it remain each year within its fixed 10-per cent-share-of-GDP budget.

The Republicans will like this proposal, but the Democrats will be upset by the word "voucher." They shouldn't be. Every healthcare reform proposal includes some form of risk adjustment that keeps insurers from going broke because their clients are sicker than average. Recall, no insurer will be able to turn anyone down either directly or indirectly by charging premiums based on pre-existing conditions. So if those who are sicker than average disproportionately sign up with a particular insurance company, the company will go broke if it's not compensated for the extra costs it will bear, on average. If it charges higher premiums to all its customers, it will lose them all to another company. The insurance companies, if they aren't compensated (penalized) for an unusually unhealthy (healthy) pool of customers will try to make their plans as unattractive as possible to the sickest potential customers.

The only way to avoid these problems is to compensate insurance companies for taking on people with greater than average risks. And this can only be done by considering the objective health indicators of those being insured. If the risk adjustment is based on the care the patient actually received, the insurance companies will have an incentive to permit unlimited tests and doctor visits and pass the bill onto the government. So the risk adjustment needs to be ex-ante – "Here's what you get to cover Joe who has these and these objectively documented conditions." This ex-ante payment is, in effect, a voucher. But if Democrats prefer to provide the voucher using the words Health Stamps, that works just as well.

Medicare Part C For All

To summarize, we need to provide ex-ante, individual-specific payments to insurers, no matter what they are called, to achieve two ends. To keep insurers from attempting to cherry pick and to set a firm limit on what the government will pay. One path to achieving universal health insurance along these lines is for Republicans and Democrats to provide Medicare Part C for everyone. Under Medicare Part C, participants effectively get a voucher, which is individually risk adjusted, and use the voucher to buy a health insurance plan from an insurance company. Insurance companies participating in Medicare Part C include health maintenance organizations or HMOs. They take the annual voucher and that's that. The government owes no more over the course of the year.

Under Medicare Part C, the vouchers aren't actually handed to the participants, who then give them to the insurance companies. Instead, they are effectively given straight to the insurance companies.[6] I think it would be much better to hand the public the vouchers directly so the public understands clearly that a great deal of money is being paid on their behalf and that they need to spend this "money" seriously in deciding which health plan to join.

Democrats, like Howard Dean, former Governor of Vermont, former Presidential Candidate, and former Chairman of the Democratic Party, have

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6 http://www.cms.hhs.gov/apps/media/press/factsheet.asp?Counter=3437&intNumPerPage=10&checkDate=&checkKey=&srchType=1&numDays=3500&srchOpt=0&srchData=&keywordType=All&chkNewsType=6&intPage=&showAll=&pYear=&year=&desc=false&cboOrder=date

been pushing for Medicare for All. And Republicans are particularly fond of Medicare Part C, which is their baby. So we can make both camps happy by adopting Medicare Part C for All; i.e., by calling the Medical Security System, Medicare Part C for All and making sure that Medicare Part C for All conforms with all the provisions of MSS.

Medicare Part C is called the Medicare Advantage Plan. It's a major part of Medicare. Indeed, some 10 million elderly are enrolled in a Medicare Advantage Plan, which represents one in four Medicare participants.[7]

And, yes, I know that Democrats feel that Medicare Part C has been too expensive because of the involvement of private insurance companies. But if we set up Medicare Part C for All with all the provisions of MSS, including a clear definition of coverages under the basic plan set by the MSS medical practitioners panel, electronic medical records, streamlined billing and insurance claim procedures, and tort reform that keeps doctors from practicing defensive medicine, we will turn basic plan health insurance into a homogenized product. At that point, competition will take over and provide the best basic healthcare to the American population that can be had for 10 percent of U.S. GDP.

[7] http://www.tampabay.com/news/health/medicare-advantage-sees-rapid-growth-but-draws-fire-in-health-care-debate/1039264

The Personal Security System – The Retirement Saving Fix

The move from our current tax system to the PurpleTax will eliminate the federal income tax and, thus, the tax breaks afforded 401(k), 403(b), 401(k) Roth, 403(b) Roth, regular IRAs, Roth IRAs, non-deductible IRAs, SEPs, Keogh Accounts, defined benefit pension plans, Health Savings Accounts, and similar saving plans.

But these plans were set up to encourage saving, so won't eliminating them do the opposite? Not at all. These plans offset the disincentives to save arising under the corporate and personal income tax.[8] But the PurpleTax eliminates the federal corporate and personal income taxes as well as the federal estate and gift tax and, therefore, eliminates all federal taxation of saving. Apart from state and city corporate and personal taxes, households get to keep and spend all the interest, capital gains, dividends, and rents generated by investment of their savings.

Yes, we'll face a tax either before or after we check out at the store, but the PurpleTax is neutral as to when we spend our money. In contrast, the current system, in taxing not just our labor income, but also the income we earn on our savings, encourages us to spend more today and less tomorrow, i.e., to save

[8] The impact of the corporate income tax on the after-tax return to saving and, thus, the incentive to save, depends on the degree of international capital mobility. If American savers can earn the same amount investing in foreign as they can in domestic assets, they can avoid getting burnt by an increase in the U.S. corporate tax by simply investing abroad. This doesn't work for individual income taxes, since the personal income tax taxes asset income earned worldwide.

less. Thus, compared to the current system, the PurpleTax is much more saving friendly.

In moving to the PurpleTax, we'll need to specify transition rules to deal with existing 401(k) and other tax-deferred saving accounts as well as defined benefit pensions, so that their owners can't avoid taxes they still owe under the current system. But once the PurpleTax is in place, saving in today's 401(k) retirement and similar accounts or saving done via defined benefit pension plans will afford no special tax breaks. As a result, these saving vehicles will go the way of the dinosaurs.

This is all for the good. These vehicles are highly inequitable, not to mention very costly to administer. Furthermore, the system leaves our employers with immense power to determine not just how much we pay in taxes, but also how we invest our saving.

Why would we want our bosses making these decisions? They are our employers, not our parents or our friends, and they don't necessarily have our best interests in mind. This is clear from the amount of employer-based stock that workers hold in their 401(k) plans. Investing with employers compounds the risk from labor earnings. If your employer's business fails, you not only lose your job, you also lose your savings. Yet many employers have forced their employees to hold their savings in the form of company stock. AIG's employees, Enron's employees, Bear Stearns' employees, Lehman employees,

... – there's a long list of workers who have lost their jobs and much of their life's savings thanks to their employers violating basic fiduciary standards, at least as economists would set such standards.

The fix then for our current tax-favored savings account system is simple – just enact the PurpleTax and let the old system wither on the vine. The fix for Social Security is also simple, namely a) freeze the current system in place so no additional benefits are accrued at the margin and b) replace it with a modern version of Social Security – the Personal Security System – that's simple, efficient, transparent, safe, and progressive.

Under this game plan, existing accrued Social Security benefits are paid as they come due. This means that current retirees, whose benefits have already come due, receive their current benefits on an ongoing basis. And current workers receive, in retirement, the benefits they've accrued to date. Freezing benefit accrual is easily implemented by simply filling in zeros in workers' Social Security earnings histories for each year after the date of the freeze.

Freezing Social Security will free us from a bureaucratic, underfinanced, inefficient, inequitable, and indecipherable 800 pound gorilla. But it won't free us from the need to force all Americans to save or to aid the poor in this endeavor. That's where the Personal Security System (PSS) comes in.

PSS is a personal, yet social saving account system that features an 8 percent *compulsory* contribution rate. Spouses and legal partners would have half their 8 percent contribution allocated to their spouse's or partner's account. This way non-working or low-earning spouses and partners have the same size PSS account as the other spouse/partner.

The government makes matching contributions on behalf of the poor. The formula determining the PSS match can be as progressive as Congress wishes to make it. Hence, Social Security's current degree of progressivity could readily be emulated by the PSS.

All PSS contributions are invested at no cost by Uncle Sam in a global market-weighted index of stocks, bonds (including government bonds), and real estate investment trusts. Uncle Sam sets up one computer system (with lots of backups) to do all this investing electronically. He also guarantees that contributors' account balances at retirement equal at least what they contributed, adjusted for inflation. Thus, the government guarantees a zero real return on workers' contributions. This guarantee entails the government providing minimal insurance, but will help us all sleep at night.

Between age 57 and 67, each worker's account is gradually sold off by Uncle Sam on a daily basis at no cost to the PSS participant and used to purchase shares of a cohort-specific longevity mutual insurance fund managed at no cost by the government. Thus, Wall Street plays no role in this annuitization. Nor do private insurers. This is very different from typical privatization proposals, which rely on cherry-picking private insurance markets to provide longevity insurance to retirees.

In sum, the Personal Security System represents a modern version of Social Security, which the father of Social Security -- Otto von Bismarck -- would surely embrace were he reincarnated as an economist and asked to design a new, transparent, progressive, fully-funded, low-cost, compulsory old-age saving and longevity insurance system from scratch.[9] The move to PSS also represents another means of reducing our nation's long-term fiscal gap by many trillions of dollars. The reason is the present value of accrued benefits is much lower than the present value of benefits projected under the current system.

Given the nature of Social Security benefit accrual, workers close to retirement will suffer minor reductions in their benefits, while those far away from retirement will suffer major reductions. On the other hand, younger workers will, thanks to the PurpleTax, be delighted to see the FICA tax go bye bye even if it means giving up future benefits, much of which would not likely have been paid.

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[9] http://en.wikipedia.org/wiki/Otto_von_Bismarck#Old_Age_and_Disability_Insurance_Bill_of_1889

Removing the Fiscal and Economic Sword of Damocles

Coupled with Limited Purpose Banking, the PurpleTax (which is a serious tax reform proposal notwithstanding its whimsical title), Medicare Part C For All, and the Personal Security System would do wonders for the U.S. economy. Each reform would compliment the others, and selling them to the electorate as a joint package would be much easier than selling them individually.

The most important contribution of these policies would be to remove the fiscal and economic swords of Damocles that hang so dangerously over our children. We "adults" need to earn our title. For in the end analysis, our success is not measured by the quality or quantity of our material possessions. It's marked by the safety and security of our children. Their economic wellbeing is imperiled on many fronts. Business as usual won't keep them safe. These reforms are radical, but much safer than the status quo. We are at a turning point for our nation and our children, and we need at long last to seize the day and set our sites on their future, not our own.