

Introductory Remarks (Notes)
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Introductory Remarks: Is the Pension/Medical Care Overhang a Threat to Prosperity? to Dynamism? to the Economic Systems Itself?

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I'm delighted to see the 2nd Annual Conference of Columbia's Center on Capitalism & Society coming to realization. The Center came into existence in 2001 and joined the Earth Institute in 2002 at the invitation of Jeffrey Sachs. As for presentation in public, we opened last year, in New York, with our Inaugural Conference and next year it's on to Venice. Some of the Center members who would have liked to be here were unable to come but we do have Andrzej Rapaczynsky and Jeff and myself carrying the banner.

I'm grateful to various entities within the University of Iceland – particularly to Gylfi Magnússon, Dean of the Faculty of Economics and Business Administration, Tryggvie Herbertsson, head of the Institute of Economics, and Gylfi Zoega, of the Department of Economics – grateful also to the Central Bank and to President Grimsson.

This conference is not just my inspiration, of course – but part of the inspiration is mine. So let me say a few words about my thinking on this subject.

Early in my career I set out a model of how consumer demand and the demand for leisure too are functions of expected future incomes net of future taxes; I went on to argue that households may be misled into believing they are wealthier than they really are if the *present* rate of (lump-sum) taxation is below the *steady* tax rate that would just suffice to cover government expenditures and transfer payments. So I was horrified when Pres. George Bush pushed through legislation reducing tax rates in 2001 and again in 2003 at a time when experts such as Larry Kotlikoff were calculating that tax rates

needed to be *raised* to cover the upcoming entitlement spending. I thought that, as a result of the Bush cuts, the economy's consumption would go far above its equilibrium path and labor-force participation far below its equilibrium path – at the cost of a wrenching downward adjustment once households came to perceive correctly how much their taxes would be increased (or how much their entitlement benefits would be decreased).

In the age of Rational Expectations, however, it is not politically correct to suppose that households would seriously under-forecast their future tax bills or over-forecast their future entitlement benefits. So Hian Teck Hoon and I have worked on a series of papers in which households correctly predict the future. Yet there is a problem. I won't trespass on Hian Teck's exposition except to say this: The implication of the analysis, I believe, is that if the theoretical economy faces a correctly anticipated bulge of entitlement spending in the future, then the stock market will already be on a downhill path—and present share prices will be *already depressed in the present* relative to what they would otherwise be in anticipation of the still-more-depressed shares prices that will prevail in the years of the entitlement bulge.

In the model – and in my kind of model generally – the implication is that along the RE path, investment activities are already reduced on account of the prospect of the entitlement bulge, and will be still more reduced in the future until the economy passes through the bulge and gradually recovers. And theoretically that implies in turn a reduced level of employment already and employment getting worse before it finally gets better. (Empirically, we don't yet observe historically high unemployment rates except in Italy, France and Germany; but I have the impression there is a wide tendency toward falling labor-force participation rates.) In this model, *when* tax rates are raised or benefits are cut is of less importance, though interesting.

The question I hope we can address from time to time is this: If such a scenario has predictive value, what will be the side-effects on people's satisfactions from work in the market economy – particularly in the more entrepreneurial economies where employment involvement has been relatively high. Will market institutions lose popular support? Will it mean a very tough period for capitalism, just as the 1930s proved challenging for

capitalism? For me those are troubling questions. On the other hand, maybe something will turn up. Or maybe the numbers are not really bad. Let's talk.