

## Our Interview with George P. Shultz

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George P. Shultz is the Thomas W. and Susan B. Ford Distinguished Fellow at the Hoover Institution. He was sworn in on July 16, 1982, as the sixtieth U.S. secretary of state and served until January 20, 1989. In January 1989, he rejoined Stanford University as the Jack Steele Parker Professor of International Economics at the Graduate School of Business and as a distinguished fellow at the Hoover Institution.

Professor Shultz' book, *Putting Our House in Order: A Guide to Social Security and Health Care Reform*, which he co-authored with Stanford economics professor John B. Shoven, is available through the link above.

We interviewed Professor Shultz on September 22, 2008.

### **How have your career path and interests have taken you from foreign diplomacy to the study of entitlement programs?**

I started out as an economist. My first cabinet position was secretary of labor, after which I was the director of the Office of Management and Budget and then secretary of the treasury. I am only best known as secretary of state. I have always been interested in these problems. As I look at the fiscal implications of entitlements, I see it is a calamity we cannot allow to happen. This is not a partisan position. Everyone agrees it needs to be solved.

### **One of the central themes in your book is the importance of expanding the GDP or, as you characterize it, the “size of the pie.” Can you discuss this and, in particular, the “lump of labor” misconception?**

Somehow there is a notion that there is only so much work to be done. There is an assumption that, if you get people out of the labor force, then there is more work for younger people to do. This thinking lurks in the shadows of a lot of policy decisions. The evidence is that it is completely untrue. There is a gigantic expansion in jobs in the US. By contrast, in Europe, they get people out of the labor force to provide opportunities for the young, and these policies have created unemployment for the young. It is a total fallacy.



As the population grows to have a lot more older people, we will need to spend a bigger portion of GDP on their income and support. The growth of this slice of the GDP pie is inevitable, and we need to make the overall pie as big as we can.

You always have all the problems of intergeneration tension – the older generation needs to be supported, but the younger generation has its own set of needs. This does not remove the need to try to grow the overall pie.

In a number of ways, the operation of the Social Security and health care systems inhibits people from working or fails to take advantage of their full potential for work. But if you change incentive structures, you can get people to participate more fully and work longer, if they desire.

You can expect that we will live longer and lead healthier lives. Compare two scenarios. First, assume that people retire at the same age as today. Second, assume they retire in such a way that the total time spent in retirement is the same as today. The difference, projected to 2050, is \$1 trillion - a very significant amount. Allowing people to work longer grows the pie in such a way that everyone benefits.

**What is the level of shortfall in each of the three entitlement programs (Social Security, Medicare, and Medicaid), and for which is help most urgently needed?**

This is the time to get busy on all of them. In January of 2007, Federal Reserve Board chairman Ben Bernanke was asked when these problems should be addressed, and he said, "I think the right time to start is about ten years ago." The sooner we get to work, the easier the transition will be and the more successful we will be.

For Social Security, in less than ten years the amount of money we collect will be less than the money we pay out. We have some time to manage the transition in a way that older people will not see any change. At the same time, everyone's benefits can go up, although more for some than for others. Most importantly, we can ensure that the system is solvent.

In Medicare and Medicaid, the amount of money flowing out is huge and growing rapidly. The system is not satisfactory. Too much money is wasted and too many people are not covered. Somewhere between one-third and 40% of the money spent is misallocated or wasted.



**Your solution for Social Security, which you say is the easiest of the three programs to fix, includes indexing benefits to prices instead of wages, gradually postponing the retirement age (when benefits kick in), and personal savings accounts. Which of these will have the greatest impact?**

First, we have to address the solvency problem. We can do this by changing the method of indexing for further benefits, changing this from wage-based to price-based indexing. This protects the real value of benefits. We can make this change of indexing in two main ways. First is progressive indexing. We keep the present system in operation for those in low-income brackets and implement the change for those with higher income. Second, we can go to price indexing for everyone, in which case we will have money left over, which we can use to create a safety net for those most in need.

Personal savings accounts have nothing to do with the solvency problem.

**Why have personal savings accounts faced such vocal opposition? Are they misunderstood by the public?**

It's easy for people to get frightened when they hear talk of "privatizing the Social Security system." Nobody is talking about anything remotely like that. The indexing proposals will change the system so nobody loses. Some people will have a faster rate of gain than others. If you want to introduce private accounts over and above that, it will be an added benefit. Despite all of the distress in the markets, if you take any 40-year period, equities have outperformed fixed-income securities. It is a historical fact, and I don't see any reason that will change. If that is the case, then a relatively small portion of funds can go into an index fund, which would mirror the equities market, and participants will be ahead of the game.

Nobody is talking about putting Social Security funds into highly leveraged subprime mortgages.

This is not a purely partisan issue. One of Barack Obama's colleagues, Congressman Rahm Emanuel (D-IL), has made a suggestion for a 1% private account.

**How do the Presidential candidates' positions differ with respect to Social Security?**

As far as I can see, both are afraid to talk about it in any serious way. Maybe McCain has mentioned private accounts, but I don't know for sure. This is the wrong way to start. The right way is to say we are facing a period of time when benefits exceed revenue. There are solutions, they are well known,



and the solutions have nothing to do with private accounts. Private accounts can further improve the system. They will be in index funds, and could be run by the government in an arithmetic fashion, with no active management.

**Your prescription for reforming Medicare and Medicaid is based on strengthening the “third leg of the stool.” The provider and financier legs of the system are in place. Why is the construction of the consumer leg essential to strengthening Medicare and Medicaid?**

Right now we have a health care system with a structure that has evolved in such a way that it has produced a provider leg (doctors, hospitals, nurses) and a supplier-of-funds leg (the government, employers, and individuals). But that is a two-legged stool and it is not stable. We need a third leg, which is the consumer leg. We know that informed consumers, with appropriate resources, have historically made good judgments about how to spend their money. US consumers have created an economy characterized by high quality products, low prices, and low levels of fraud and abuse. This can work in the medical field.

There are three big things that are part of building the consumer leg.

First, the debate about health insurance implies that insurance has led to a longer and healthier life for Americans. This is not the case. Those benefits were produced by research about the human body, medications that help diseases, and diagnostic techniques. We can go inside and examine people without cutting them open. We have eliminated major diseases. This was not due to insurance, but due to important discoveries. This comes from basic research, supported by the National Institutes of Health (NIH). It is a tragedy that the NIH budget, after having gone up, has not kept pace with inflation over the last three to five years. It has cooled off burgeoning research centers in universities that were making advances that really mattered. In terms of numbers, the money is not small, but it is very high powered. The first thing is to get back to supporting our scientific budget.

Second, as I already mentioned, there is a huge amount of wasted money. Partly this is the result of fraud, as was shown in a major study by the *New York Times* of Medicaid practices in New York. There is a misallocation of resources, such as performing procedures that are not needed. This is distressing, and shows that, if we get it right, we can produce good medicine at an affordable cost.

Third, in addition to your own intuition, studies upon studies have shown that your lifestyle has a tremendous impact on your health. This is very much under the control of individuals. We need to make a lot more out of this, and



build incentives to motivate individuals to improve their lifestyles. I was at a recent meeting of corporate executives, talking about my book, and toward the end of the meeting one executive asked, "What can I do in my company?" I asked whether employees were offered any information or incentives to look after their lifestyle. Creating such programs can be an enormously cost-effective way to lower the cost of health care.

**Your proposals place a strong emphasis on vouchers, in order to stimulate competition among providers, thereby improving the quality of care and reducing prices. Why are vouchers so critical, and what do you see as the primary resistance to this approach? Are individuals, particularly those faced with sudden and critical illnesses, willing to shop around and make good choices about medical treatments?**

As we decide how to deploy the dollars to be spent, vouchers allow us to put a good fraction of this money into the hands of patients. The evidence is that consumers will spend it wisely, particularly if information about prices and outcomes is available. This information is not as available in health care as in other markets. It is beginning to grow, as information becomes available through health care plan providers.

If someone has a heart attack, they have to go to the nearest hospital and take the chance they will get the appropriate care. But if, at the same time, there is a system that produces good care, it becomes much more likely that individual will get proper treatment than with a system that doesn't provide these incentives. So, even if the consumer is in a situation without a choice, the system will work.

I recently had knee surgery. It was not urgent, and I had the opportunity to look around and find the best and most experienced surgeon. It was amazing to see the amount of information available, and I was delighted to find that the best people were at Stanford, where I live and work.

**What role should incentives for health care providers, based on quality and efficacy of care, have in a reform of Medicare and Medicaid?**

We want positive incentives. The best incentive is a discerning consumer who asks questions. Good consumers may bother their doctors by asking a lot of questions. Consumers can obtain a lot of information on-line to ask these questions of their doctors. Some doctors may be put off by patients with too many questions, but most realize it will enhance and improve things in the long run. It will result in fewer unnecessary or irrelevant procedures.



**Perhaps the most striking divergence in the positions of the Presidential candidates is with respect to health care. Can you briefly discuss their positions, and how they compare to your recommendations?**

I am not up to speed on details of each candidate's recommendations. It is refreshing that both have said the essence of the problem is that costs are too high and rising too rapidly. They understand the big problem.

McCain's proposals are along the lines of giving consumers more control. He advocates changing where you place the tax incentives. Individuals will have health insurance and health savings accounts to deal with problems.

I can't quite figure out where Obama is going. It is much more toward a government-operated system.

**What effect does the mounting cost of the bailout programs, the escalating deficit, and the potential for inflation have on your recommendations?**

This underscores the urgency of getting control of these issues. It is an eminently solvable problem, so let's solve it. Many parts of the solution to the entitlement problems are not the subject of partisan debate. Where the bailout programs will lead is unclear. The taxpayer will have a considerable bill. But we ought to get control over the entitlement programs as soon as we can.

**Thank you very much.**

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