Après Bush...

Thinking the Unthinkable

Months have passed since Congress enacted a hugely expensive Medicare drug benefit by a narrow margin. But two corpses are still rolling in their graves – those of Barry Goldwater and Lyndon Johnson. In championing the legislation, the Republicans trampled every principle of good governance that Goldwater, the conscience of conservatives, held dear. And in opposing the bill, Democrats allowed the party of Bush, Cheney and DeLay to take credit for the largest expansion of Johnson's cherished program in decades.

Yes, some Republicans voted against the bill, and some Democrats voted for it. But, on this one, most Republicans proved to be closet Democrats, and most Democrats, closet Republicans. In fact, the way the parties traded places was so remarkable that one might think they had experienced diametrically opposed epiphanies.

Think again. Had the Democrats controlled the White House and been in a position to claim victory rather than denounce the bill as not going far enough, the two sides would have switched their tunes and flipped their votes. These days, when it comes to economic policy, principle is passé and politics is king.

Le Déluge?

About Washington's Fiscal Mess

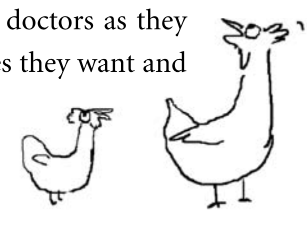
By Laurence Kotlikoff

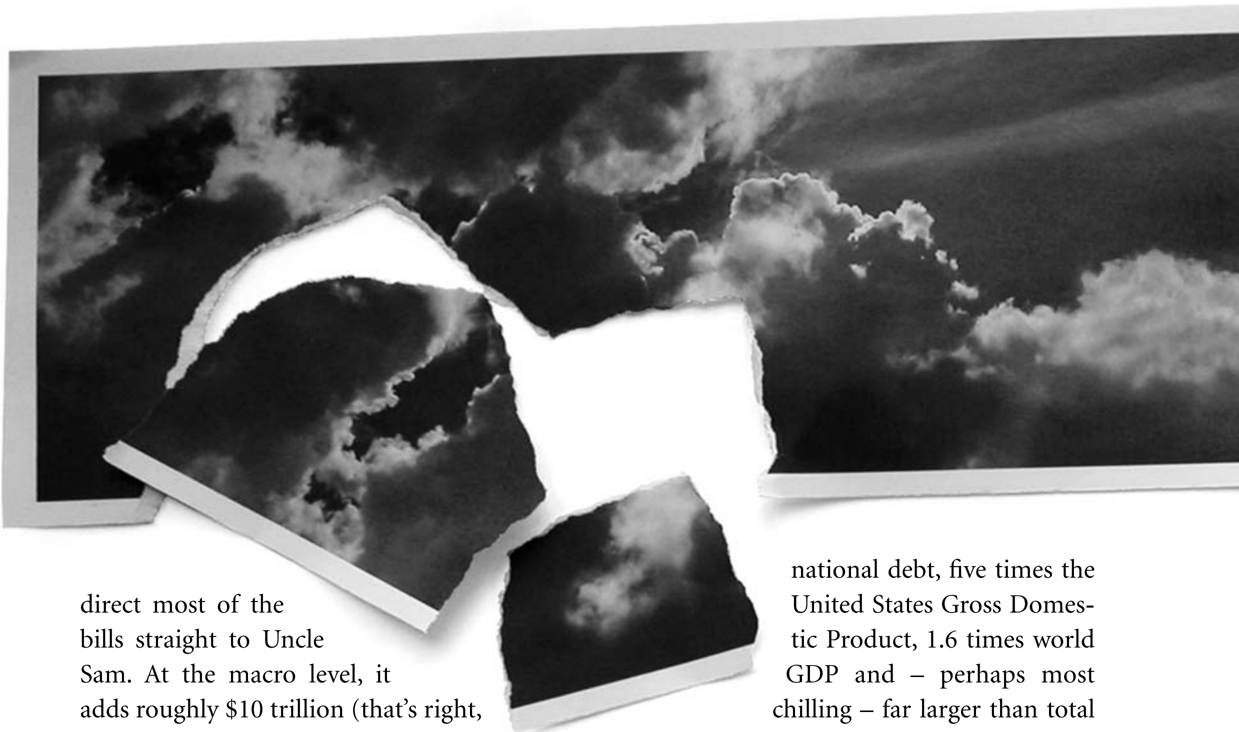
Indeed, the key principle raised by this legislation – generational equity – was not only fundamentally violated, it was hardly discussed. Instead, the parties squabbled over the size of the freebie to give 33 million current elderly and 77 million baby boomers who are now reaching for their Lipitor. Pandering to these groups makes perfect political sense. Disproportionately divided, their 110 million votes can carry any election.

In an era in which much of the technological change in medicine is through pharmaceuticals, no one would dispute that the elderly need and deserve prescription drug insurance. But the next generation is in no position to pay for existing Medicare benefits, let alone the new benefit. No wonder a handful of thoughtful politicians on both sides of the aisle viewed the bill as myopic policymaking and refused to support it.

Unfortunately, the bill is worse than a mild case of myopia. It's a micro- and macroeconomic nightmare. At the micro level, it perpetuates Medicare's fee-for-service system under which the elderly can see as many doctors as they want as often as they want, have whatever medical procedures they want and

SERGE BLOCH (ALL)





direct most of the bills straight to Uncle Sam. At the macro level, it adds roughly $10 trillion (that's right, *trillion*) to our long-term fiscal gap.

A TRILLION HERE, A TRILLION THERE…

The term "fiscal gap" refers to the difference between the federal government's future expenditures and future receipts, all discounted to "present value" terms in the same way actuaries calculate the net liabilities of private pension plans. Future expenditures include every payment the Feds make, from hunting down marijuana growers to paying Social Security benefits to servicing national debt. Future receipts include every dollar the Feds take in from income taxes, loan repayments – even snowmobile fees at Yellowstone.

With the new drug benefit, the fiscal gap totals roughly $51 trillion. Wrapping your brain around $51 trillion takes some doing. Roughly speaking, it's 12 times the nominal national debt, five times the United States Gross Domestic Product, 1.6 times world GDP and – perhaps most chilling – far larger than total United States private wealth.

The number is big for two reasons. First, thanks to the baby boom, the subsequent baby bust and the significant longevity increase we've experienced in the last few decades, our population is rapidly aging. Over the next 30 years, the number of elderly will double. In contrast, the number of workers available to pay their Social Security, Medicare and Medicaid benefits will increase by only 18 percent.

Note, too, that in addition to the entire country's aging, the elderly themselves are getting older. The oldest old – those over 85 – represent the nation's fastest growing age group. By 2050 this group would be large enough to populate all of New York, Los Angeles, Chicago, Houston and Philadelphia. And the number of centenarians – those 100 and older – will be able to fill up Washington, DC. Imagine walking around New York City and seeing only people 85 and older, and then traveling to Washington and see-

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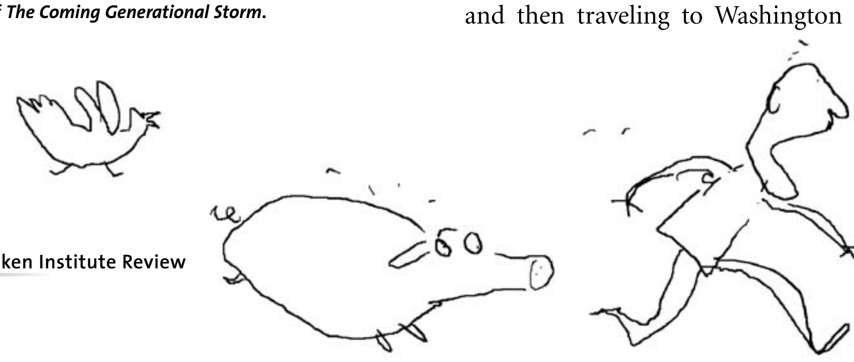
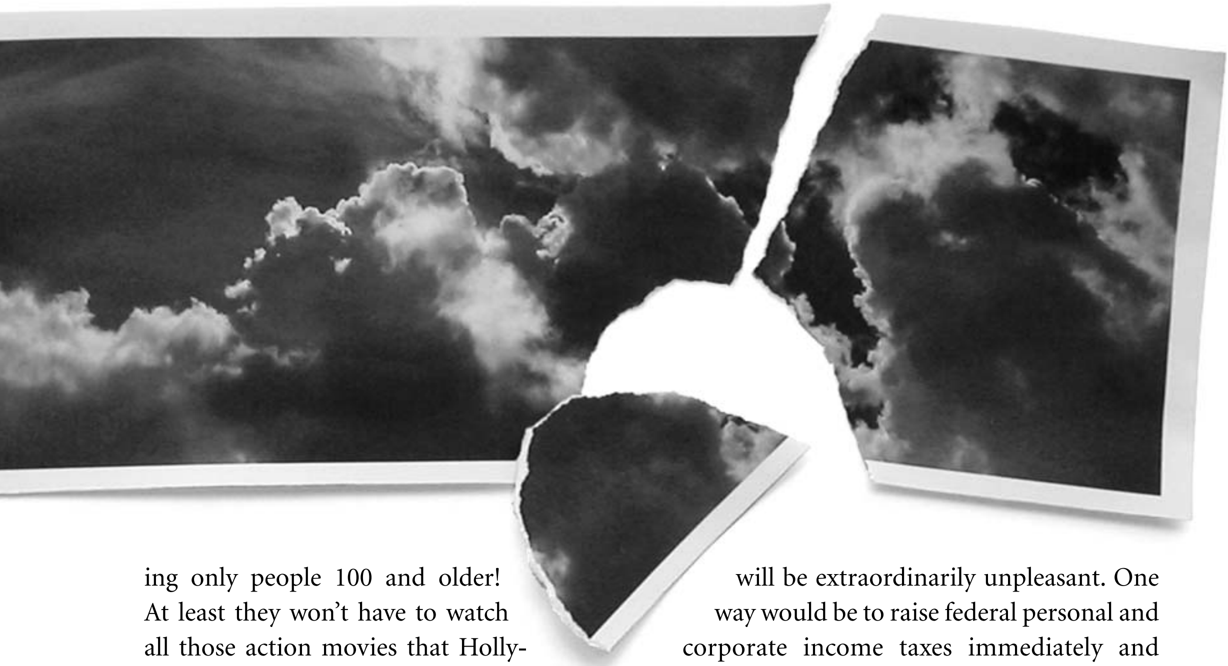




ing only people 100 and older! At least they won't have to watch all those action movies that Hollywood serves up to testosterone-addled adolescents.

Second, the elderly are very expensive. Taken together, Social Security, Medicare and Medicaid benefits currently total a whopping $23,000 per oldster annually. Worse still, this figure is sure to grow much faster than the wages of the workers footing these payments because the cost of medical services is growing rapidly and the consumption of medical services rises sharply with age (as well as with the availability of government insurance).

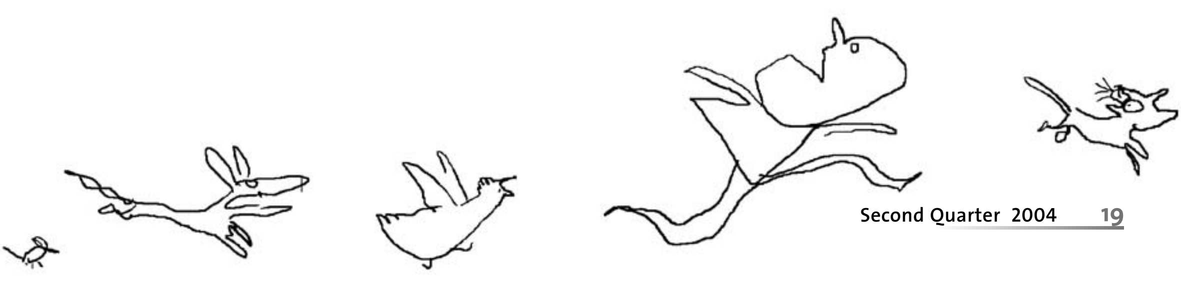
If a household's planned future expenditures on everything from groceries to car payments exceeds its future receipts when measured in terms of present value, that household is eventually forced to adjust its lifestyle. Either Mom and Dad are going to have to work and earn more, or the family is going to have to cut back on its spending. The situation for our government is no different. It, too, has to pay its bills.

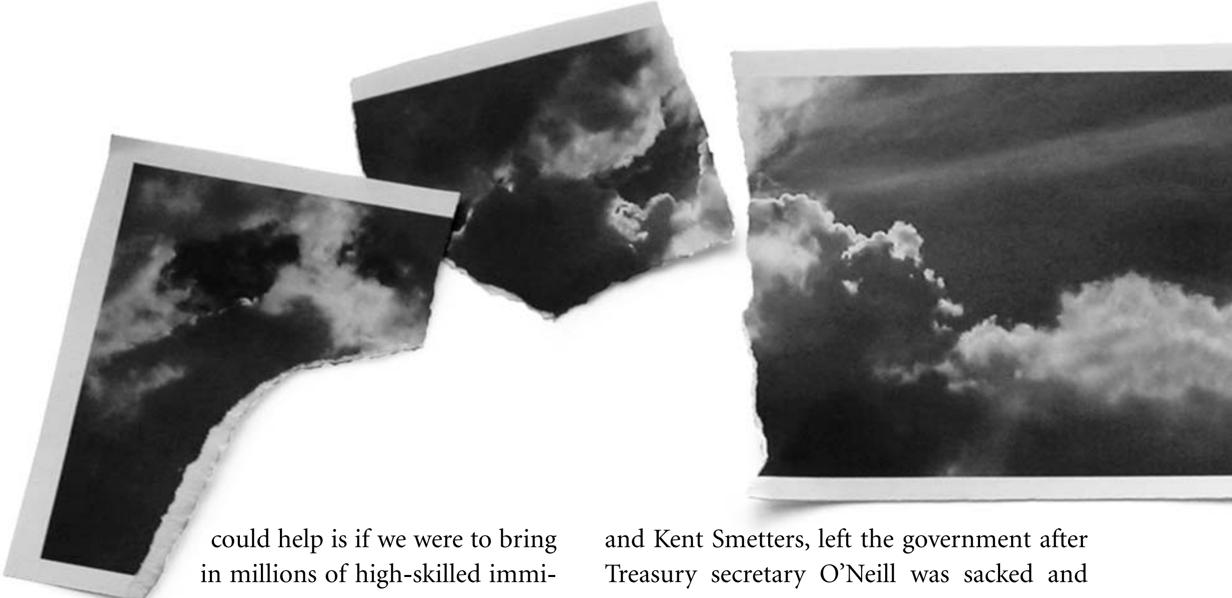
CAN ANYBODY SPARE A DIME?

Unfortunately, coming up with $51 trillion will be extraordinarily unpleasant. One way would be to raise federal personal and corporate income taxes immediately and permanently by 78 percent. Another would be to eliminate all federal discretionary spending for all time, starting today. (Actually, this move would fall several trillion dollars short of the mark.) A third option would be to immediately and permanently cut all Social Security and Medicare benefits in half.

What about economic growth and immigration of young workers? Can't they bail us out? No way. Social Security benefits are explicitly linked to the level of real wages, while Medicare and Medicaid benefits are implicitly linked to wages. Hence, faster economic growth, which will spell higher real wages, means larger entitlements for all three benefit programs. Indeed, entitlement growth is disproportionately rapid – the absolute size of the fiscal gap rises with the pace of economic growth.

Immigration is also a false elixir. That's because today's typical immigrant, who arrives with little money or marketable skills, costs slightly more in terms of public benefits like schooling and welfare than he or she generates in taxes. The only way immigration





could help is if we were to bring in millions of high-skilled immigrants in their mid-40s and persuade them to leave before they started to collect Social Security and Medicare benefits. Since most high-skilled workers outside the United States are in Europe and Japan, and since these regions will be doing everything they can to retain these workers, the notion of using immigrants to shelter us from the coming generational storm is just wishful thinking.

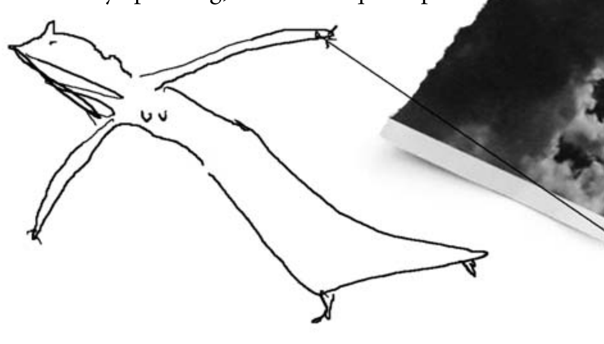
Well, OK. But is it possible the $51 trillion figure is wrong? Where did this figure come from anyway?

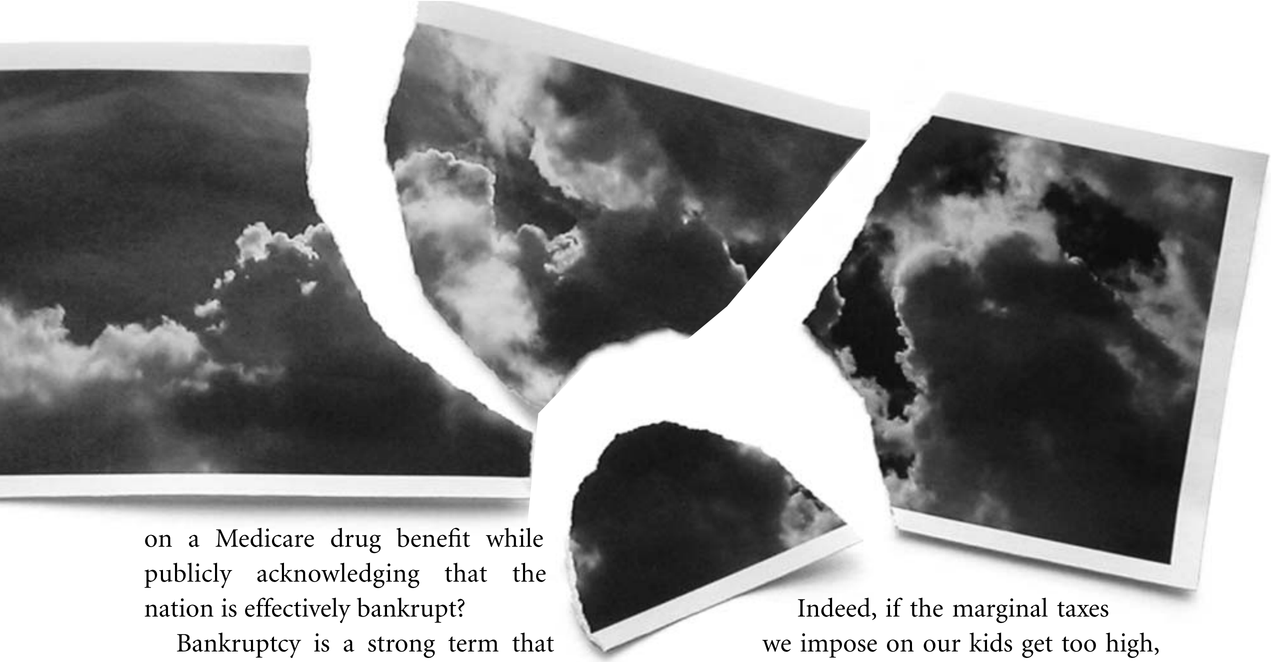
Actually, from a reliable source. The estimates of the fiscal gap as well as the different ways to eliminate it were calculated by our very own government – specifically the U.S. Treasury. In 2002, Treasury Secretary Paul H. O'Neill commissioned a study of our long-term fiscal finances. The study, which was slated to appear in last year's White House budget, never saw the light of day. O'Neill was ignominiously fired in December 2002, and within a couple of days, the study was deep-sixed.

But truth will out. The two economists who wrote the analysis, Jagadeesh Gokhale and Kent Smetters, left the government after Treasury secretary O'Neill was sacked and published the analysis last spring under their own names. The study, *Fiscal and Generational Imbalances – New Budget Measures for New Fiscal Priorities*, was released as an American Enterprise Institute book.

When the study was released, *The Financial Times* got wind of its Treasury origins and reported both the findings and the fact of its censorship. But the press coverage died overnight when the White House denied in the strongest possible terms any relationship between the study and the Treasury. This was a remarkably bald lie, given the number of people inside and outside of government who had worked on the Treasury study or knew of it. Indeed, in Ron Suskind's book, *The Price of Loyalty*, Paul O'Neill himself confirms that the study released by Gokhale and Smetters, was in fact, produced at his behest.

The administration's discomfort with the truth about our long-term finances is understandable. After all, how could it hope to enact its third big tax cut, sharply increase discretionary spending, rebuild Iraq and pile





on a Medicare drug benefit while publicly acknowledging that the nation is effectively bankrupt?

Bankruptcy is a strong term that shouldn't be used lightly. But in this case, it's the only term that fits. That's because none of the methods of eliminating the fiscal gap mentioned above, and no combination of these methods, have any realistic chance of being adopted by this or any other administration in the near future. And like failing to pay credit card bills, ignoring the fiscal gap makes things worse because the gap grows with interest. For example, waiting five years to raise federal income tax rates would leave us with a fiscal gap of $59 trillion and require, starting at that point, an 84 percent across-the-board tax increase to eliminate, rather than today's mere 78 percent tax increase. Thus, the longer we wait, the bigger the bullet someone will have to bite.

"Someone" appears to be today's and tomorrow's kids. But there's one hitch. Dumping the whole problem in their laps would leave the next generation facing lifetime net tax rates that are twice as high as those we adults now face. Unfortunately, we can't get blood from a stone, and we can't tax away more than 100 percent of what our kids earn.

Indeed, if the marginal taxes we impose on our kids get too high, they'll either stop working, engage in tax evasion – or turn their backs on the elderly.

BLOOD FROM THE STONES

Today, you'd be hard pressed to find any American household, rich, poor or middle class, in less than the 50 percent marginal tax bracket when you factor in all the explicit and implicit taxes they face. Explicit taxes include federal and state income taxes, Social Security taxes, federal excise taxes (like the telephone tax) and state sales taxes. Implicit taxes refer to the loss in earned-income tax credit benefits, food stamps, welfare benefits, Medicaid benefits, Supplemental Security Income, housing assistance and other transfer payments that households – particularly low-income households – lose when they earn more money.

How did total effective marginal tax rates get so high? In setting individual tax and transfer policies, nobody in government ever bothers to look at the sum of the parts. In particular, no one bothers to add the explicit and implicit marginal tax rates from all the



federal and state tax and transfer programs. Consequently, no one in government seems to understand that trying to double our kids' net lifetime average tax rates will mean such high marginal tax rates that Sweden will look like a tax haven.

Determining whether a company is bankrupt is always a judgment call. Even if current losses are large, there's always a chance that sales will pick up or that future cost-cutting can save the day. When it comes to the United States government's finances, there's also the possibility that things could go better than the Treasury Papers project. Unfortunately, the opposite is much more likely because the fiscal gap calculated in the Treasury Papers is based on a number of highly optimistic assumptions.

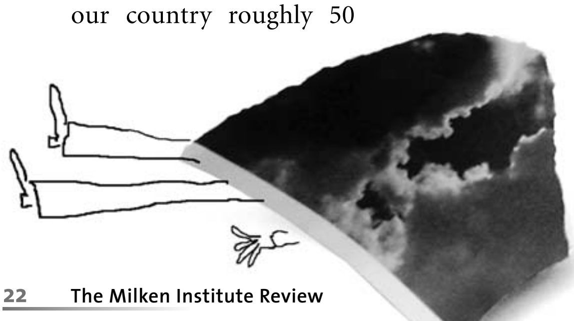
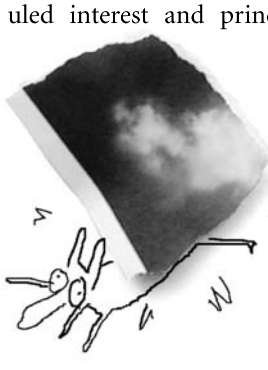
The two most important such assumptions involve the growth rate of medical expenditures and life span extension. According to the Treasury's projections, Medicare and Medicaid benefits per capita will grow only one percentage point faster than labor productivity. Historically, the differential has been 2.7 percentage points. Moreover, the Treasury Papers use Social Security's longevity projections, which assume that it will take our country roughly 50 years to achieve current Japanese life expectancy. Many of our nation's top demographers believe life span will increase far more rapidly.

In the private sector, it's up to creditors to decide when to pull the plug on companies or households that are going broke. They do so by refusing to lend them more money or by charging exorbitant rates of interest on loans. When countries go bankrupt, their creditors also pull the plug – and in much the same way. At some point the country decides that default makes more sense than continuing to service obligations that are fundamentally unaffordable.

THE B WORD

There is, however, one major difference between private and national default. Private default always has to be explicit, whereas national default can be explicit, implicit or a combination of both. Explicit default entails failing to make interest and principal payments. A good example here is Argentina, which simply declared on New Year's Eve in 2001 that it would no longer pay interest or principal on its $150 billion in outstanding government debt.

Implicit default entails meeting all scheduled interest and principal payments, but

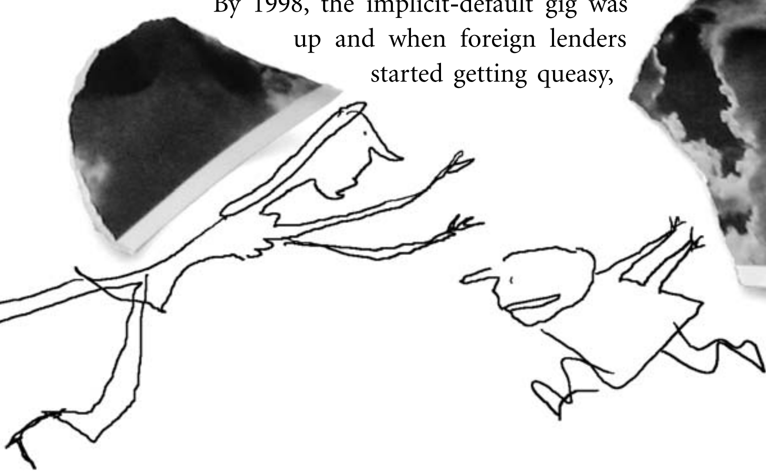



printing more money to cover the outlays. Russia in the mid-1990s provided a good illustration of implicit default. It printed rubles like crazy to cover bond obligations as well as to pay retirees their pensions, soldiers their salaries, etc. In doing so, the Russian government was able to claim it was fulfilling its commitments, when, in fact, it was making these payments in a currency whose purchasing power was rapidly shrinking. Today, many of Russia's elderly are living off state pensions worth only $50 a month.

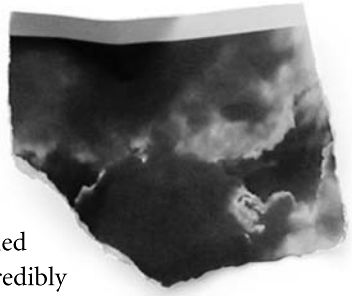
Implicit default works to the extent the country's liabilities are denominated in local currency and not indexed to inflation. In Russia's case, much of its debt was denominated in dollars. And it was forced, over time, to adjust state pensions, military salaries and other expenditure obligations for inflation. While the country achieved some permanent reductions in its real spending obligations, the public quickly wised up and started using dollars or barter for many transactions. By 1998, the implicit-default gig was up and when foreign lenders started getting queasy, the government simply declared an official default on debt.

Brazil is the latest country to walk the default line. Most lenders to Brazil believe the country will default, explicitly or implicitly, on roughly $250 billion in official debt. Their only question is when. To compensate for the default risk, they are demanding interest rates of 18 percent before inflation and 10 percent after inflation. In contrast, United States nominal rates for similar short-maturity bonds are just 1 percent, and real rates are roughly -1 percent. In other words, Brazil's real "risk premium" – the extra interest the government pays to compensate lenders for the risk of default – is roughly 11 percentage points! Any country that has to borrow at real rates like this is in big trouble.

Mind you, Brazilian default is not guaranteed. Indeed, since September 2002, when the

IMF lent Brazil $30 billion (the organization's largest loan ever), the county's real rates have declined by almost half to their current incredibly high levels. But a small amount of bad news or just increased skittishness on the part of lenders could send real rates even higher, making default inevitable.



Stated differently, default can become a self-fulfilling prophecy. All it takes is enough lenders to get more nervous about Brazil's prospects and real rates will soar, the Brazilian stock market will crash, the currency's exchange value will plummet, Brazilian banks will experience runs on their deposits, the Brazilian economy will tank and the government will throw up its hands and give the market what it expects – explicit default.

SUPERPOWER OR BANANA REPUBLIC?

For United States creditors, the question to ask is whether, in fiscal terms, the United States is Brazil or, indeed, whether it's actually in worse shape than Brazil. Brazil's explicit debt-to-GDP ratio is roughly 50 percent larger than that of the United States. And half of that debt is either denominated in dollars or explicitly indexed to inflation. This limits Brazil's ability to take advantage of inflation to welsh on its obligations.

On the other hand, Brazil is a much younger country in demographic terms. And though it, too, is aging, the elderly share of the Brazilian population is expected to remain at roughly half of the United States' share over most of this century. Hence, measured relative to its GDP, Brazil's implicit debt – the present value of its obligations to cover future state pensions, medical benefits and other transfer payments – may be much smaller than the United States' debt. I say "may" because no one has calculated Brazil's implicit debt or, for that matter, Brazil's fiscal gap.

In the United States, the fiscal gap is roughly 12 times the size of the official debt – that is, our nation's implicit debt absolutely swamps our explicit debt. Official debt may bear very little relationship to the size of the fiscal gap, which is the ultimate measure of whether a country risks going belly up. It also raises the possibility that Brazil's fiscal gap, scaled by Brazil's GDP, is smaller – indeed, much

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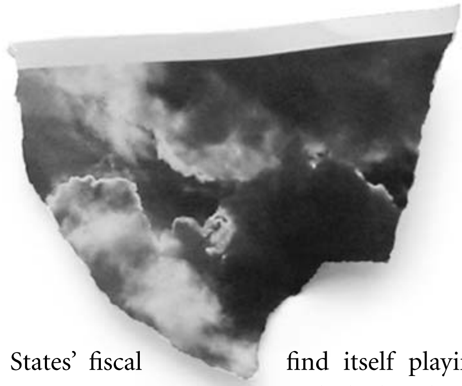
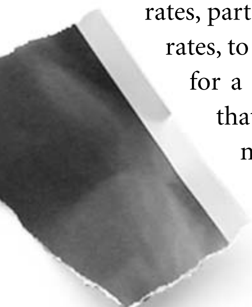


smaller – than the United States' fiscal gap, scaled by its GDP.

What would happen if bond traders were to wake up tomorrow and realize that they've been looking at the wrong measure of long-term fiscal solvency (official debt) and that when one looks at the correct measure (the fiscal gap), America's long-term fiscal position is horrible, and, potentially, much shakier than Brazil's? Presumably, they would dump U.S bonds, leading nominal interest rates, particularly long-term nominal interest rates, to soar. They would dump U.S. bonds for a good reason – the high likelihood that Washington would print tons of money to pay its bills and, therefore, implicitly default on its explicit debt by generating inflation.



If the Federal Reserve attempted to compensate by maintaining a tight monetary policy, these much-higher nominal interest rates would translate into much-higher real interest rates – which, in turn, would put the economy into deep recession. Hence, the Fed is likely to find itself playing a game of chicken with the bond market. If it delivers what the bond market expects – high inflation – it would limit the rise in real interest rates and allow the economy to continue to function. If it refused to increase the money supply and thereby kept inflation in check, the economy would go into recession and the added red ink would increase the size of the fiscal gap.

When will all this happen? Maybe tomorrow. It takes one straw to break the proverbial camel's back. The new Medicare drug bill – not to mention new estimates showing it will cost more than projected by the Congressional Budget Office – may be that straw. Or it may be the recent IMF report warning about United States fiscal insolvency. Or it may be the Congressional Budget Office's latest projection of a half-trillion-dollar official debt for the current fiscal year. Or it may be a stern warning from Alan Greenspan that we need to put our fiscal house in order.

Whatever it is that finally wakes up the bond market, once interest rates start to rise, the pressure will be on not only to print money but also to enact fundamental fiscal reforms. From that perspective, the sooner the bond market forces us to declare national bankruptcy, the better. ▪

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