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Economic War Calls for Full Plan of Battle: Laurence Kotlikoff

by Laurence Kotlikoff

We're in a dangerous economic war and need bold plans to avoid a deep recession, clean up the subprime mess and resolve our long-term fiscal problems.

The first step is jump-starting consumer spending, which is 70 percent of gross domestic product. Tax refunds won't help, nor will hiring subsidies. Refunds will be saved, and hiring presupposes customers.

To stimulate spending, Uncle Sam should get the states to begin a six-month, 10 percent sale on retail purchases. The federal government would pay the states to cut their sales taxes by enough to generate a revenue loss equal to 10 percent of state consumption. States with low or no sales taxes would subsidize purchases.

A deep and prolonged recession will cost \$2 trillion in lost output. This sale would cost \$500 billion.

Step two is, at long last, to buy up the toxic subprime assets at dirt-cheap, market prices. No one will trust banks until these contaminated assets are off the shelves. Treasury Secretary Paulson has decided not to buy them through a government-run auction. But there are other purchasing and swap mechanisms available.

Improved trust will help those banks with collateral to borrow and, thus, to lend. But collateral is in short supply. Banks hold some \$3.5 trillion in AAA-rated loans, including top-tranche mortgage-backed securities, but they are no longer accepted as security. Uncle Sam should resurrect this collateral by insuring these loans against default. Banks would pay the premiums for this insurance with preferred stock.

Government Insurance

With plenty of collateral, banks will be able to lend to businesses. But will they trust Main Street? Government can help here too, by selling default insurance on the [bonds](#) of top-rated companies. Banks that buy this insurance would face no risk lending to these companies. The alternative is lending directly to businesses.

By guaranteeing AAA-rated private-sector loans, the government would be insuring against systemic risk; AAA-rated securities collectively would run into trouble only if the economy collapses. The U.S. can prevent such a collapse.

The government also should purchase corporate stock. If the market continues to [crater](#), the government could borrow to buy futures on a broad index of U.S. stocks. In buying futures, the U.S. gets no voting rights and can't interfere with business decisions. The government already is buying shares of banks and securities firms.

Call this socialism, but it simply rearranges the financial furniture. Panicked investors are selling their assets for Treasuries; the government is using those proceeds to buy the sold assets. When the panic ends, the U.S. will sell the assets and buy back the Treasuries. If all goes well, the government will reap a profit and return it to the public in the form of lower taxes.

Safety Squad

The medium-term plan involves setting up a Federal Financial Authority (FFA) to certify simple, transparent financial products as safe for public use, to rate financial securities and institutions, to audit all major companies, and to require full disclosure of assets and liabilities of publicly traded companies.

The FFA would also restrict financial intermediaries from taking open positions that could jeopardize their ability to channel funds from savers to investors. The role of intermediaries is making markets, not gambling. [Fidelity Investments](#), not Lehman Brothers Holdings Inc., is the right model.

Finally, the FFA would regulate companies based on what they do, not what they say they do. In providing seals of approval, in doing its own rating, and in insuring only those mortgages and corporate bonds that it rates AAA, the federal government needs to establish financial standards and reward good behavior. Liar mortgages and other toxic assets will disappear.

Home Front

The long-term battle plan is getting the U.S.'s financial house in order.

In the current crisis, the government is [borrowing](#) to invest, not spend. But over the past 50 years the U.S. has borrowed to spend, not invest. It has taken money from younger generations to spend on Social Security, Medicaid and Medicare benefits, while promising to pay the young much larger benefits of their own when they retire. Thanks to this off-the-books pyramid scheme, the U.S. is short \$70 trillion, in present value, to pay for future spending not covered by future taxes.

Nothing short of a radical overhaul can eliminate our fiscal gap. The goal is meeting, but also fully paying for, the nation's paternalistic imperatives without destroying incentives to work and save.

Health Vouchers

Fixing health care is easy: Each American receives an annual voucher to buy a basic plan like that provided to Congress, but also with nursing-home and home-health-care coverage. The size of the voucher is based on a person's pre-existing conditions and calculated using electronic medical records.

Basic health plans will be sold by insurers who can't turn you down. Doctors and hospitals will compete for our business. Insurers can provide financial incentives to improve our health. An independent government panel would determine the basic plan's terms within a global budget that fixes total annual voucher spending as a share of gross domestic product. People can buy supplemental policies from their basic-plan providers.

The health-care fix offers universal coverage, private providers and a \$30 trillion saving in future health-care costs by limiting federal spending growth.

Golden Years

The Social Security fix is also straightforward. The U.S. freezes the system, paying retirees their full benefits and current workers in retirement only what they've accrued to date. The government then sets up an individual account system with an 8 percent contribution. Spouses would have half their contribution allocated to their partner's account. The government makes matching contributions on behalf of the poor.

All contributions are invested in a global market-weighted index of stocks, bonds and real estate investment trusts. The U.S. does all the investing and guarantees that contributors' account balances at retirement equal at least what they contributed, adjusted for inflation.

Between age 57 and 67, each worker's account is swapped for inflation-indexed annuities issued by the government. Wall Street plays no role. Nor do private insurers.

This would yield personal retirement accounts that are fully funded while significantly reducing the old system's funding shortfall by freezing the accrual of benefits.

Rewarding Thrift

Fixing taxes is simple. Federal taxes are replaced with a 22 percent tax on retail sales and rental services of homes. There also would be a monthly demogrant -- a lump-sum payment --so poor workers pay no net tax.

Of every dollar spent, 18 percent goes to taxes (18 percent is 22 percent of 82 percent). The rich find that their wealth buys 18 percent fewer goods and services. All workers find they're in an 18 percent bracket. Savers earn the full return on their thrift.

This modified version of the FairTax, which is a progressive national sales tax, would expand the economy and increase revenue.

To paraphrase [John F. Kennedy](#), our economic problems are man-made and they can be solved by man. We're at economic war and have the tools to win. Do we have the guts to use them?

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