



The Emperor's Dangerous Clothes

LAURENCE J. KOTLIKOFF

The subprime lending crisis reminds us that financial markets are extremely fragile and can easily lose their moorings when investments certified as highly safe turn out to be extremely risky. No accounting is perfect, and no accounting will deliver economic certainty and financial tranquility. But we play a very dangerous game when we rate junk bonds as triple A, rubber stamp

Laurence J. Kotlikoff is Professor of Economics at Boston University, a Research Associate of the National Bureau of Economic Research, and President of Economic Security Planning, Inc., which produces financial planning software. Kotlikoff has authored eleven books and hundreds of articles on saving, fiscal policy, macroeconomics, insurance, altruism, bequests, pensions, and personal finance. Kotlikoff and his co-authors pioneered computable general equilibrium dynamic life-cycle models, generational accounting, and consumption-smoothing software.

© The Berkeley Electronic Press

Enron-type bookkeeping, and blithely ignore national insolvencies.

The “we” here includes economists, analysts, actuaries, regulators, credit raters, bankers, financial journalists, and, certainly, accountants. Given our training and professional certifications, we are all financial fiduciaries, either explicit or implicit, when it comes to overseeing the finances of business and government. The world relies on us to keep financial score on a completely honest basis and to blow very loud whistles when we see financial malfeasance, no matter its source.

A good analogy is EMS workers. Even off duty, even on vacation, when they witness an accident, they’re professionally and morally obligated to intervene and provide medical care. They are responsible to help the public for two good reasons. They can

help, and they are the only ones with the ability to help.

We financial fiduciaries are in that same boat. We are EFS workers—emergency financial services workers. But unlike EMS workers, our role is to intervene before our patient—the economy—has a heart attack.

And make no mistake, the U.S. economy is close to a heart attack. If its short-term credit crisis doesn’t put our country in the economic ER, its long-term fiscal crisis surely will.

SOUND FISCAL GAP ACCOUNTING SAYS THE UNITED STATES IS BANKRUPT

Bankruptcy is a strong term. But it is apt. Future government receipts don’t cover future expenditures as things stand. Not nearly.

In fact, future U.S. federal expenditures are \$70 trillion more than federal receipts,

Economists’ Voice www.bepress.com/ev April, 2007

according to my extrapolation of 2005 fiscal gap accounting by Jagadeesh Gokhale and Kent Smetters.

This fiscal gap, which is the true measure of the nation's indebtedness, is rising by over \$1 trillion per year just due to the accumulation of interest. We EFS workers should be sounding the alarm.

WHAT WILL HAPPEN?

Unless we change our path, the nation will default on its creditors—those expecting to receive interest and principal on U.S. Treasuries, those expecting to receive government healthcare, pension, welfare, and other benefits, and those expecting to be employed by the government. In addition the government is likely to jack up tax rates as well as make money by making money, i.e., by resorting to the printing press.

Anyone who thinks the U.S. is immune from fiscal meltdown and high inflation, if not hyperinflation, should think again. Too many countries, big and small, rich and poor, have learned that, sooner or later, fiscal profligacy comes at a very high price.

CONVENTIONAL GOVERNMENT ACCOUNTING IS MYOPIC AND ARBITRARY

The nation has been lulled into inaction by focusing on the official debt, rather than the fiscal gap and its associated generational imbalance. Together with my coauthors, Alan Auerbach and Jagadeesh Gokhale, I developed generational accounting to take the long view. This form of fiscal accounting, whether implemented on a cohort specific basis or presented in the condensed form as present value fiscal gap accounting, has been conducted in some 40 countries around the world by finance ministries, treasuries, central banks, the IMF, the World Bank, and academics. The analyses suggest that many relatively young and quite poor countries, like Mexico and Brazil, are in much better long-term fiscal shape than older, wealthier countries like the United States.

A MORE REFINED VIEW OF OUR TROUBLE

There are increasing signs that Uncle Sam is driving our economy in the wrong direction and that the rest of the world is taking notice. Our nation's national saving rate is now running below 3 percent. In 1960 it was close

to 13 percent. Our incredibly low saving rate has led to an incredibly high current account deficit, which has led to an incredibly low value of the dollar.

Why is our saving rate so low? Simple: We are consuming too much. For one thing, the federal government is consuming at roughly twice the rate it did a decade ago as a share of national income. But the main explanation for the decline in U.S. saving is not Uncle Sam's spending: It's the spending of households. And among households, the group whose consumption has been rising most rapidly is the elderly. Since 1960 average consumption per oldster has roughly doubled relative to average consumption per youngster.

Who's paying for this growth in the consumption of oldsters? The answer, in large part, is Uncle Sam. Take Medicare and Medicaid benefits, the vast majority of which go to the elderly. Every year that Uncle Sam allows these benefits to grow much more rapidly than the economy—and we are talking about virtually each one of the past 40 years—the government directly expands the consumption of the elderly. Uncle Sam has also been cutting taxes on the

elderly, which has also permitted them to consume much more.

So the picture provided by generational accounting of Uncle Sam taking resources from young savers and giving them to old spenders is showing up in the level of consumption of the elderly, in the rate of U.S. national saving, in our current account deficit, and in the value of the dollar.

THE CONTRAST BETWEEN GENERATIONAL ACCOUNTING AND CONVENTIONAL MYOPIC ACCOUNTING

To be sure, fiscal gap and generational accounting have their challenges and limitations. The greatest of these is knowing how to find the present-value of highly uncertain government receipts and payments. Fortunately, modern finance provides a pretty clear prescription for how to proceed on this front. Steve Ross and I are now using Arbitrage and Derivative Pricing Theory to show how future government receipts and payments should be valued in the present given their risk. Our preliminary findings suggest the U.S. may be in worse fiscal shape than non risk-adjusted generational accounting reveals.

WHY THERE IS NOTHING RELIABLE ABOUT TRADITIONAL FISCAL BUDGETING REPORTS

Generational accounting requires predicting the future and skeptics will always correctly claim that the future is unknowable and argue that traditional short-term fiscal budgeting, i.e., deficit accounting, while imperfect, is at least based on reliable numbers.

Let me disabuse you of this notion. We can't learn anything whatsoever from short-term deficit accounting for the simple reason that what we measure as the deficit depends on how we label government receipts and payments. And, as shown in a recent paper that I wrote with Harvard's Jerry Green, this choice of labeling/language is not pinned down by economic theory.

Take a simple economy in which the government takes an amount H each period from the young. What should we call the H ? Should we call it a tax of H ? Or should we call it a tax of $50H$ less a loan back to the young of $49H$? Or should we call it borrowing of H ? Or should we call it borrowing of $2000H$ less a transfer payment to the young of $1999H$? The equations in our economic models don't tell us which words to use. Nor, for that matter, do

they tell us whether to discuss their implications using French or English. As long as our choice of fiscal labels/language is consistent, so that we don't misstate the true nature of the lifetime budgets facing each household, we're free to use whatever words we like and announce whatever size deficit we choose.

Consider, as an example, 30 year old Joe who hands the government \$3,000 this year and, to keep things simple, gets nothing back in the future in exchange. We could label this as a current "tax payment." Alternatively, we could call this a \$3,000 loan from Joe to the government and also say that in 2020 Joe will receive repayment of this loan with interest, but that in that year Joe will also face a tax equal to the \$3,000 plus accumulated interest. Regardless of the words, Joe hands over \$3K this year and gets nothing back in the future in exchange. But if one uses the second set of words rather than the first, this year's official deficit is \$3,000 larger.

Each dollar the federal government takes in or hands out can be labeled in a variety of arbitrary or politically motivated ways and each set of labels will produce a different measure of this year's deficit. In this sense a one year deficit,

or a deficit for any finite length of time, is an illusion, or worse, a delusion.

If we want the deficit to be \$1.6 trillion this year rather than \$160 billion, all we need do is use the right set of labels. If we want the deficit this year to be negative, say a \$5 trillion surplus, again, there are words that will deliver that result. Indeed, economic theory tells us that independent of the actual fiscal policies they are running, governments can choose words to report any time path of deficits or surpluses they'd like. It also tells us that the government has no claim to higher language—its choice of words is no more economic than yours or mine. One can fill up volumes upon volumes of books with alternative time series of the U.S. federal deficit, each based on a different choice of labels, and see that the one marked “official” has no claim to distinction.

In short, when it comes to traditional fiscal accounting, we are living in Hans Christian Anderson's world of *The Emperor's New Clothes*. The emperor is naked, everyone knows or should know he's naked, but everyone (with the exception of one young child) claims he's beautifully dressed.

We economists are the worst offenders here. It's our theory, and we should know better. But

too many of us don't see, or if we know how to see, ignore this emperor's true state of dress.

A recent experience says it all. I was asked to discuss three papers presented at a session of the American Economic Association meetings. Each of the papers was presented by a very prominent economist and each was regressing the interest rate on the deficit using different adjustments to the deficit and different time periods. Two of the economists were trying to show that deficits raised interest rates and one was trying to show the opposite.

In my comments, I pointed out that the exercise was nonsensical—that one could produce any desired effect of “the” deficit on interest rates by simply labeling receipts and payments to generate a deficit time series with the “right” (desired) statistical relationship. After the session concluded, each of the presenters came up to me to tell me they agreed entirely with me but that they were running their regressions in order to counteract regressions showing the opposite effect. In effect they were saying, “I'm doing this because he's doing this.”

This isn't economics. This is sophistry and a sorry commentary on our profession. Moreover,

it is incredibly dangerous at a time when the true deficit, the growth in the fiscal gap, is monumental.

If established academic economists won't focus on fundamentals, who will? My hope lies with new economic Ph.D.s. They are beholden to no one, not even to their past selves, and are free to join the child—the hero of *The Emperor's New Clothes*—in shouting “He's naked!”

Letters commenting on this piece or others may be submitted at <http://www.bepress.com/cgi/submit.cgi?context=ev>.

REFERENCES AND FURTHER READING

Auerbach, Alan, Laurence J. Kotlikoff, and Willi Leibfritz (1999) *Generational Accounting Around the World*, NBER volume, Chicago: University of Chicago Press.

Ferguson, Niall and Laurence J. Kotlikoff, (2005) “Benefits Without Bankruptcy – The New Deal,” *The New Republic*, August 15th. Available at: <http://people.bu.edu/kotlikof/New%20New%20Deal,%20The%20New%20Republic%20August%2015,%202005%20posted%20May%202007%20pdf.pdf>.

Gokhale, Jagadeesh and Kent Smetters (2005) “Measuring Social Security’s Financial Problems,” NBER working paper no. 11060, January.

Gokhale, Jagadeesh and Kent Smetters (2003) *Fiscal and Generational Imbalances: New Budget Measures for New Budget Priorities*. Washington, DC: The American Enterprise Press.

Gokhale, Jagadeesh, Laurence J. Kotlikoff, and John Sabelhaus (1996) “Understanding the Postwar Decline in U.S. Saving: A Cohort Analysis,” *The Brookings Papers on Economic Analysis*, 27(1):315–407. Available at: <http://people.bu.edu/kotlikof/Understanding%20the%20Postwar%20Decline%20in%20US%20Saving%20A%20Cohort%20Analysis.%20%20Brookings%201996.pdf>. (Suggesting that the ratio of the average consumption of the elderly to that of young adults has roughly doubled since 1960.)

Green, Jerry and Laurence J. Kotlikoff (2006) “On the General Relativity of Fiscal Language,” NBER working paper no. 12344, June. Forthcoming in Alan J. Auerbach and Daniel Shaviro, eds., *Key Issues in Public Finance – A Conference in Memory of David Bradford*, Harvard University Press, forthcoming 2008. Available at: <http://people.bu.edu/kotlikof/New%20Kotlikoff%20>

[Web%20Page/General%20Relativity%207-6-07%20posted%20January%203,%202008.pdf](http://people.bu.edu/kotlikof/Web%20Page/General%20Relativity%207-6-07%20posted%20January%203,%202008.pdf).

Kotlikoff, Laurence and Christian Hagist (2005) “Who’s Going Broke? Comparing Growth in Healthcare Costs in Ten OECD Countries,” NBER working paper no. 11833, December. Available at: <http://people.bu.edu/kotlikof/Who%20is%20%20going%20Broke,%20August%2029,%202006.pdf>.

Kotlikoff, Laurence J. (2003) “Generational Policy,” *The 2002 Caroli Lectures*. Cambridge: MIT Press.

Kotlikoff, Laurence J. (1986) “Deficit Delusion,” *The Public Interest*, (Summer 1986):53–65.

