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Is the U.S. Going Broke?

by

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Now that the federal government has bailed out Fannie and Freddie, who's going to bail out the federal government?

The federal government's takeover of Fannie Mae and Freddie Mac represents a huge financial tremor. These two institutions now issue 70% of Americans' mortgages. Their failure would have triggered a complete meltdown in housing and financial markets. So now Uncle Sam is on the hook for \$5 trillion, consisting of corporate debt owed by those two institutions and mortgage debt guaranteed by them.

If only the government's total debt were that low. Uncle Sam, for all his righteous indignation, is, in fact, the father of all deceptive accounting. The government has arranged its budgeting to keep the great bulk of its liabilities off the books and out of sight.

The real liability facing our government is \$70 trillion. This represents the present value difference between all the government's projected future spending obligations and all its projected future tax receipts. This fiscal gap takes into account Uncle Sam's need to service official debt--outstanding U.S. government bonds. But it also recognizes all our government's unofficial debts, including its obligation to the soon-to-be-retired baby boomers to pay their Social Security and Medicare benefits.

Given current policies, each of the 78 million boomers can expect, on average, to receive \$50,000, in today's dollars, from these programs in each and every year of retirement. Multiply 78 million boomers by a \$50,000 annual payment and you get close to \$4 trillion per year. This helps you see why our nation's true indebtedness is so extraordinarily high.

There are other obligations, too, that aren't calculated into the national debt, or even in the \$70 trillion, but for which the government remains at risk. House prices haven't stopped falling. They are down 20% from their peak two years ago. But they remain 70% above their value in early 2000. That was the year prices started going crazy. If the price pendulum swings back to 2000, we'll see the mortgage default rate, currently at a record 9%, soar. We'll also see more Americans file for personal bankruptcies and default on their credit cards. This will put many more financial institutions under water. The Federal Deposit Insurance Corp. has \$45 billion on hand to cover

bank failures, such as that of Indymac earlier this year, which cost the FDIC \$9 billion. Large-scale bank failures could leave the FDIC short hundreds of billions of dollars. The total of insured deposits in this country is \$4.5 trillion.

These are the devils we don't know. What about the one we do know--the \$70 trillion one? How do we pay for that? One option is doubling employer plus employee payroll tax rates immediately and permanently. That would take another 15% out of our pockets each payday. Not likely to happen.

Another option is to cut benefits. Medicare could be scaled back to keep its cost growth in line with the growth in the economy. Social Security is 20% underfunded, which means that its taxes have to go up or its future benefits have to come down. But neither presidential candidate is acknowledging our nation's true insolvency, let alone providing real solutions (such as raising the retirement age or indexing benefits to prices rather than wages).

The decline in the dollar and our low national saving rate reflect an old policy of the government living beyond its means. If you look at all the extra consumption, it's occurring in large part among the elderly and, in large part, in the form of health care. This is not oldster bashing. We need to care for older Americans, but we need to do so in a way that doesn't constitute fiscal child abuse.

There is still time, and there are ways to put our fiscal house in order. But the longer we wait, the more likely we're going to get hit by a true financial and economic earthquake.

The earthquake will come via a collapse in the market for U.S. government bonds as domestic and foreign investors realize that the only way Uncle Sam can meet his future spending obligations is to print massive quantities of money. The result will be sky-high inflation and interest rates and, most surely, a prolonged reduction in output and employment. This could happen today. It could happen tomorrow. But it will happen here just as it has happened in every other country that tried to spend far beyond its ability to pay.

Having our government acknowledge and fix its long-term fiscal crisis will provide our financial industry something it so desperately seems to need--an honest financial role model.

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