

SPECIAL REPORT ON THE U.S.
ECONOMY

The \$44 Trillion Abyss

The baby-boomers are about to retire, and it's going to cost us—big. Here's what the government doesn't want you to know.

FORTUNE

Monday, November 10, 2003

By Anna Bernasek



Larry Kotlikoff
(Photo: Reuben Cox)

Last fall Paul O'Neill, then Secretary of the Treasury, wanted a simple answer to a thorny question: How prepared was the nation today to pay all its future bills? Two government experts worked for months to calculate the answer. Their findings, which shocked even them, were never published—the Bush administration made sure of that. The reason for the silence was that by the time the two researchers had completed their study, O'Neill had been thrown out of the Treasury and replaced by the more politically astute John Snow. No savvy administration power player would dare point out, right in the middle of tax-cut season, that there was a huge hole in the country's finances—a \$44 trillion hole.

That's the kind of Washington tactic that makes Larry Kotlikoff angry. So angry, in fact, that the normally composed and carefully spoken academic starts ranting about a government conspiracy to keep us all in the dark. He even refers to this particular episode as "the great Treasury cover-up." And once you start Kotlikoff on the subject, it's hard to stop him. "I hate politicians," he says, without pausing for breath. "These people are so focused on the next election, they don't care about the next generation. The thing that really turns my stomach is that they have the opportunity to do good, and they know they're doing bad, and it's okay. It's immoral."

Kotlikoff isn't some soft-headed, liberal, ivory-tower type. It's true his Boston office does resemble a tower, or at least a turret, with rounded windows overlooking the Charles River and with a view across it to those two bastions of economic thought, Harvard and MIT. But Kotlikoff is a mathematically minded, mainstream economist who heads the economics department at Boston University. He has also taken on the role of fiscal crusader. (At last count, he'd written some 11 books, 66 chapters, 80 journal articles, and 37 op-ed pieces about our financial mess.)

Gulp

The first massive wave of baby-boomer retirees will hit five years from now. That will leave fewer workers to pay for ballooning Social Security and Medicare bills.

How the expected budget shortfall of \$44.2 trillion* breaks down

Source	Amount
Social Security	\$7 trillion
Medicare	\$36.6 trillion
Other	\$0.6 trillion

*Based on current government revenue and spending.

Sources: Census bureau; Smetters and Gokhale

Two decades ago Kotlikoff, who's now 52, pondered the impact the baby-boomer generation would have once it retired. He realized the government had a looming financial crisis on its hands because, in calculating its budget, it considered only current-year Medicare and Social Security payouts—and ignored its massive future obligations. That means, absurd as it sounds, that the government doesn't know what it really owes. And a government that doesn't know what it owes has no way to judge whether it can pay up.

So in the mid-1980s Kotlikoff pioneered a new way of accounting that could do the math, and it quickly won the approval of his profession. (Jargon-loving economists call it "generational accounting.") Kotlikoff's work revealed the sheer enormousness of the financial hole the government would face. Back then it all seemed a long way off, but today, with the first boomers reaching retirement age in five years, his message has taken on new urgency. In the intervening years he's been writing books, testifying before Congress, and doing everything he can to get the message out, but still nothing has been done to resolve the problem. In fact, the way Kotlikoff sees it, we're making matters worse.

Before you dismiss Kotlikoff as a lonely prophet of doom, let's get back to that government report that never saw the light of day. The authors of the report, Kent Smetters and Jagadeesh Gokhale, had intimate knowledge of Kotlikoff's work. (Smetters had collaborated with Kotlikoff on several research projects over the years; Gokhale had been one of Kotlikoff's graduate students.) Both economists were excited by the chance to combine Kotlikoff's cutting-edge economic thinking with government policy. If President Bush published their findings in his 2004 budget, it would be the first time an administration acknowledged how big the fiscal problem facing the nation really was. It would also be the first step toward a solution.

Using the basic principles of Kotlikoff's generational accounting, they added up everything the government expects to spend—Social Security benefits, debt-service payments, salaries, and so forth—far into the future and put it in today's dollars. Then they added up all the income the government expects to earn—taxes, income from government assets—in the future in today's dollars. To perform the calculations, Smetters and Gokhale had to make certain key assumptions about the rate of growth in government spending, taxes, medical costs, and hundreds of other things. Since they wanted to be as conservative as possible, they took their numbers from the government's own budget. In one particular case—medical costs—they chose a much more optimistic number, opting for 1% growth above GDP rather than the historical rate of 3%.

The gap between payments and income came in at \$44.2 trillion. Think about \$44 trillion for a moment. It's probably the biggest thing you've

never heard of—and certainly the biggest number FORTUNE will publish in its pages this year. It's more than four times the size of our GDP, and 1 1/2 times the size of the entire world's GDP. If we had a fire sale of all our nation's assets today—stocks, bonds, and real estate—we could just about pull in \$44 trillion.

Just to be clear, that number is not a bill that comes due on a certain date. What it shows is the debt that would accumulate over years of deficits if we continue as we are. It is an honest measure of the inexorable pressure on the government's future ability to spend. This amounts to a massive weight on the economy.

Worse than that, it's getting bigger. Every year the government sits on its hands, that \$44 trillion grows by about \$1.6 trillion. Remember, Kotlikoff's generational-accounting technique estimates the present value of our future needs. It's exactly like saving for retirement—the later you start, the more you have to save each year. So if nothing is done this year, the gap will widen to nearly \$46 trillion next year.

Worse still, Smetters's and Gokhale's numbers may be on the low side. Take another look at how important the assumption about medical costs is. What Smetters and Gokhale discovered was that the two biggest factors making up the \$44 trillion black hole were Medicare and Social Security. If they assumed a growth rate above GDP for medical costs of 1.5% instead of the 1% they used in their calculations, that \$44 trillion gap would become \$65 trillion.

After O'Neill was fired, Smetters and Gokhale were left holding a controversial report that they had thought was supported at the highest level of government. And once it was clear their work would never go anywhere in Treasury, they published their findings in a conservative journal put out by the American Enterprise Institute, and returned to their pre-Treasury employers. Smetters is back at the University of Pennsylvania; Gokhale, at the Cleveland Fed.

There is rare consensus among economists regarding the wisdom of generational accounting. But some, notably Harvard economist Martin Feldstein, see the problem as just that—a problem, not an apocalypse. Feldstein was Kotlikoff's dissertation advisor and remains a close friend. He wields considerable influence with the current administration and has seen many of his ideas incorporated into its fiscal policy. "What Larry has done is to say what happens if we don't do anything to fill the gap," Feldstein explains. "That's not what will happen. Either we'll raise taxes, cut benefits, or change the way we finance the system. Or it will be some combination of all three." Feldstein points to President Bush's policy proposal to privatize Social Security as evidence that the government is committed to dealing with the problem.

That may be, but it will require a great deal more courage than any politician has shown so far. In their report, Smetters and Gokhale calculate it would take a 69% hike in all federal taxes or a 95% hike in payroll taxes to close the \$44 trillion gap. Or, if you prefer spending cuts, a 100%-plus cut across all discretionary federal spending (which, of course, is impossible) or a 45% cut to Social Security and Medicare. Solving this problem will hurt like hell.

What about economic growth? Can't that help reduce our debt? Kotlikoff shakes his head again. Growth, in fact, makes this particular problem worse, because when the economy grows faster, so do Social Security and Medicare. Kotlikoff reels off a long list of "painless" solutions he has considered: technological progress, asset sales, greater use of capital, foreign investment, inheritance, employer-based retirement plans, delaying the retirement age, increasing immigration, eliminating government waste, and on and on. He explains how each one is a drop in the bucket or counterproductive or just plain unpredictable.

One aspect of this problem that everyone agrees on is that it is so huge that no single segment of society can bear it alone. It's going to be felt across the board by all Americans. Seventy-seven million baby-boomers are going to start retiring in five years' time. As they do, the number of retirees in America will double. At the same time the workforce supporting them will grow by a mere 15%.

The longer you talk to Kotlikoff about this subject, the more dramatic his rhetoric becomes. "We're setting our kids up for a great fall," Kotlikoff says bitterly. "We were left with a much better situation than our parents and their parents before them—it's the American dream. But instead, we're leaving our kids with a fiscal crisis." He's particularly critical of the Bush administration and believes it has made matters worse by cutting taxes by so much and increasing spending so sharply. For instance, he points to President Bush's proposed prescription-drug benefit (the Democrats also back it), which could cost between \$400 billion and \$1 trillion over ten years. By his reckoning, that raises the \$44 trillion fiscal gap by another \$6 trillion.

The way Kotlikoff sees it, we're heading for a crisis with no escape. He believes that one day financial markets will wake up to the size of the problem and send interest rates through the roof. When that happens, the government will be forced to get its house in order—i.e., raise taxes and cut benefits. It will also rely on higher inflation to help reduce the debt problem. If that all sounds bad for the economy, well, it will be. "I'm scared," says Kotlikoff, "but I don't know what to tell my 13-year-old son. All I can do is try and save more. But what can you leave your children that won't be eaten up by taxes and inflation?"

It's clear nobody can solve a \$44 trillion-sized problem overnight. Yet in Washington, generational accounting is as popular as a skunk at a garden party. The real question is, Do we continue an Eyes Wide Shut fiscal policy or—and this is a huge "or"—admit there's something really big and ugly staring us in the face?

Feedback: abernasek@fortunemail.com

NOT SO FAST

Don't Fear the Big Bad Deficit

What caused it? (Stuff.) Should we be worried? (No.) Does it raise long-term concerns? (Yes, but ...)

FORTUNE

Thursday, January 24, 2002

By Rob Norton

After four fat years in which the U.S. government took in more than it spent, the big, bad budget deficit is back: The U.S. is likely to spend at least \$100 billion more than it takes in in fiscal 2002. Many politicians and pundits--mostly Democrats--are loudly bemoaning the turnabout, which the more intemperate are already calling a National Tragedy. Others--mostly Republicans--are saying it's not such a big deal.

Who's right? The answer depends on how you look at three questions.

Question No. 1: What caused it? The answer: Shit happens.

George Bush's detractors are blaming the deficit on last year's \$1.2 trillion, ten-year tax cut, and they will keep saying that so often and so volubly that six months from now most people will probably believe it.

But it's not true. Back in May, before the tax plan was enacted, the Congressional Budget Office predicted that the federal budget would produce a surplus of \$304 billion in 2002. In its August update--after the tax plan had become law--the CBO was still predicting a surplus of \$176 billion. The CBO attributed only 30% of the downward revision to the tax cuts; the rest was due to lowered economic expectations, other spending, and technical revisions.

Had the economy narrowly avoided a recession, as the CBO and most private-sector forecasters thought likely, there would have been no budget deficit in 2002. Nothing about the Bush tax cuts has changed in the meantime. What's changed, of course, is the economic outlook--which was worse than anyone thought, and then worsened a lot more as a result of the terrorist attacks of Sept. 11--and the growth rate of federal spending, which has increased sharply.

Had there been no tax cuts, the deterioration of the economy and the spending increases wrought by the terrorist attacks would have produced a deficit anyway. A smaller deficit, yes. But a deficit nevertheless.

Question No. 2: Should we be worried about this year's deficit, or the likelihood that the budget will be in deficit for another year or two?

The answer is no.

During recessions the U.S. budget typically goes into deficit as incomes and tax revenues fall and government expenditures rise. Most economists think that's a good thing. To increase taxes or cut spending to balance the budget would further weaken the economy, either prolonging the recession or slowing the recovery. The kinds of budget deficits we're talking about now--\$100 billion, these days less than 1% of GDP--are simply not worrisome from an economic perspective. (If you make \$85,000 per year and something happens that causes you to borrow \$850, do you panic?) Or think of it this way: The year after the last recession, the budget deficit rose to \$290 billion--4.6% of GDP.

Ditto for wars. The U.S. has gone into hock during every war it has fought. During World War II--to pick the most extreme example--the budget deficit exceeded 20% of GDP for several years.

Nobody, in fact, is arguing that we increase taxes right now to balance the budget. Hardly anybody is arguing that we rescind the planned Bush tax cuts, since all but the most unreconstructed liberals understand that even that would have a negative economic effect. Individuals and businesses act differently today if they know their taxes will be higher or lower in the future.

Question No. 3: Does the deficit raise long-term concerns? The answer is yes. Looking again at the pre-Sept. 11 projections, the CBO estimated that the total surplus for 2002-11--after including the effects of the tax cuts--would be \$3.4 trillion, down from a projected \$5.6 trillion before the cuts. What the Bush plan did was to wipe out most of the ten-year surpluses for everything except Social Security. This means that Democrats and Republicans alike will need to make hard choices once the recession ends. Some of the costs associated with new defense and homeland security initiatives will surely be permanent, so unless we want to raid the Social Security trust funds, we will have to either raise taxes or cut other spending to make up the shortfall.

So expect a return to the kind of fiscal-policy political trench warfare that took place in the 1980s and early 1990s. Some people may consider that a national tragedy; a better way to look at it is as an opportunity for a worthwhile debate about the nation's tax and spending priorities.

[SUBSCRIBER LOGIN](#) | [HOME](#) | [COMPANIES](#) | [CEOs](#) | [INVESTING](#) | [CAREERS](#) | [TECHNOLOGY](#) | [SMALL BUSINESS](#)

Services: [Downloads](#) | [Customer Service](#) | [Conferences](#) | [Special Sections](#) | [Free Product Info](#) | [FORTUNE Education Program](#)
Information: [Current Issue](#) | [Archive](#) | [Site Map](#) | [Press Center](#) | [Contact FORTUNE](#) | [Advertising Info](#)

© Copyright 2004 Time Inc. All rights reserved. Reproduction in whole or in part without permission is prohibited.
[Privacy Policy](#) [Terms of Use](#) [Disclaimer](#) [Contact Fortune](#)