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The Entitlement Panic

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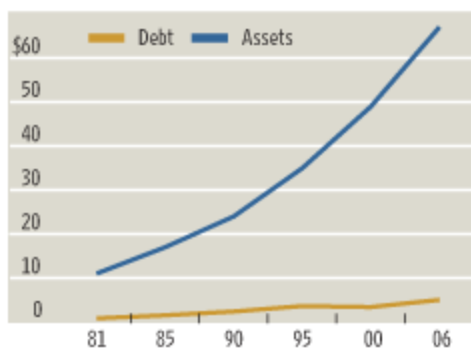
Will America have to declare Chapter 11 because of \$80 trillion in unfunded entitlement promises? That's a question posed recently by Laurence Kotlikoff, an economist at Boston University, in his attention-grabbing essay on Medicare, Medicaid and Social Security entitled: "Is the United States Bankrupt?" Mr. Kotlikoff's answer is perhaps yes: "Nations can go broke, the United States is going broke . . . and radical reform of U.S. fiscal institutions is essential."

Mr. Kotlikoff is a first-rate economist, and his gloomy predictions are gaining adherents. Some of them are on the free-market right -- at the Heritage Foundation and Cato Institute -- and among Republicans on Capitol Hill. They've begun to beat the drums for immediate solutions, including in some cases tax increases if that's what it takes to get Democrats to agree to reform. With President Bush still angling for an entitlement superdeal before he leaves office, maybe it's time to put this issue in perspective.

The budget math is simple enough: The estimated \$80 trillion in unfunded future entitlement liabilities is about six times larger than the U.S. economy and 16 times

America the Bankrupt?

National debt held by the public vs. national assets, in trillions



Source: Federal Reserve System, Flow of Funds Accounts of the United States, 2006

the federal debt held by the public. Mr. Kotlikoff calculates that future workers would have to pay tax rates from 55% to 80% over their lifetimes to fund these promises. This would indeed be a ticket on the bullet train to European socialism.

Now, we take a back seat to no one in promoting reforms in Social Security, Medicare and Medicaid. But there are also good reasons to doubt Mr. Kotlikoff's dire scenario, unless our politicians make even more policy blunders.

For one thing, the U.S. fiscal "balance sheet" isn't a static ledger and includes assets as well as liabilities. While the U.S. national debt has climbed from \$800 billion in 1981 to \$5 trillion today, the nation's assets have climbed from \$11 trillion to \$67 trillion over that same period. (See nearby chart.) Include all private assets and liabilities, and net national wealth has *increased* by \$40 trillion over the same period. Declinists have consistently underestimated American growth, productivity and technological innovation. In only the past four years, U.S. assets have risen by \$13 trillion -- much of which will be passed down to the next generation of workers to finance their parents' benefits.

Mr. Kotlikoff and allies counter that we can't grow our way out of this mess because the promised benefits are scheduled to rise at the rate of real wage increases. Technically that's right, but it misses a key point. Paying benefits to 75 million baby boomers in 2030 will be a much lighter lift if we have a \$25 trillion GDP and net worth of \$100 trillion than if slower growth in the interim years leaves us, say, a third less wealthy. The most vital policy imperative is to sustain pro-growth policies, including free trade, free capital flows, low taxes and an education system to train our human capital.

Everyone also agrees that the entitlements crisis is driven by demographics, namely fewer young workers to finance more retirees who live much longer. Japan and most European nations with birth rates well below replacement levels are in an especially difficult pickle. In the U.S., however, birthrates are typically higher and we also have the advantage of greater immigration. The Social Security actuaries calculate that the addition of one million immigrants reduces the long-term unfunded liability of Social Security by at least \$5 trillion.

The biggest false assumption, however, is that the current level of benefits will ever be paid. They won't, for many of Mr. Kotlikoff's reasons. If current politicians are too afraid to reduce future benefits or reform the programs, future politicians will have no choice -- unless they want to raise taxes to confiscatory levels or have no money to spend on other priorities, such as national defense.

There's a key legal point here: Entitlement benefits are not a contractual government obligation in the sense that a T-bond is. For the feds to default on the interest of a 10-year note would be a form of national "bankruptcy." But in its landmark 1960 decision, *Flemming v. Nestor*, the Supreme Court ruled that there is no such legal right to Social Security. Today's Congress can promise future retirees a lifetime golf pass and free trip to the moon, but it can't bind a future Congress. Rarely does a year go by that Congress doesn't already tinker with entitlements in some way, making benefits more or less generous depending on the political mood.

It is precisely the unsustainability of these future benefits that will make reform attractive to younger people who realize they have no hope of getting what they're now paying for. A crucial, if little understood, point about personal Social Security accounts is that for the first time they'd give workers an actual property right to their own savings, protecting them from future political whim.

By all means let's educate Americans about the financial ditch that Congress is driving toward. But alarmist rhetoric about impending bankruptcy isn't credible, and it only discredits reform advocates. It may even play into the hands of those on the political left who resist reform but would love to impose a vast new source of federal tax revenue, such as a European-style value-added-tax or an increase in payroll taxes. Those policies would put America on a slower growth path and make it even harder to build the wealth to finance future benefits.

The national fisc isn't what's going bankrupt. That description better applies to the New Deal and Great Society programs that were designed for another era and long ago became unsustainable. Sooner or later they'll have to be changed, and this is where reformers should focus their political effort.

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