

Why the Debt Crisis Is Even Worse Than You Think

If Washington is deadlocked now, how will it deal with the much bigger debt problems that lurk in the decades to come?

By [Peter Coy](#)

There is a comforting story about the debt ceiling that goes like this: Back in the 1990s, the U.S. was shrinking its national debt at a rapid pace. Serious people actually worried about dislocations from having too little government debt. If it hadn't been for two wars, the tax cuts of 2001 and 2003, the housing meltdown, and the subsequent financial crisis and recession, the nation's finances would be in fine condition today. And the only obstacle to getting there again, this narrative goes, is political dysfunction in Washington. If the Republicans and Democrats would just split their differences on spending and taxes and raise the debt ceiling, we could all get back to our real lives. Problem solved.

Except it's not that way at all. For all our obsessing about it, the national debt is a singularly bad way of measuring the nation's financial condition. It includes only a small portion of the nation's total liabilities. And it's focused on the past. An honest assessment of the country's projected revenue and expenses over the next generation would show a reality different from the apocalyptic visions conjured by both Democrats and Republicans during the debt-ceiling debate. It would be much worse.

That's why the posturing about whether and how Congress should increase the debt ceiling by Aug. 2 has been a hollow exercise. Failure to increase the borrowing limit would harm American prestige and the global financial system. But that's nothing compared with the real threats to the U.S.'s long-term economic health, which will begin to strike with full force toward the end of this decade: Sharply rising per-capita health-care spending, coupled with the graying of the populace; a generation of workers turning into an outsize generation of beneficiaries. Hoover Institution Senior Fellow Michael J.

Boskin, who was President George H.W. Bush's chief economic adviser, says: "The word 'unsustainable' doesn't convey the problem enough, in my opinion."

Even the \$4 trillion "grand bargain" on debt reduction hammered out by President Barack Obama and House Speaker John Boehner (R-Ohio)—a deal that collapsed nearly as quickly as it came together—would not have gotten the U.S. where it needs to be. A June analysis by the Congressional Budget Office concluded that keeping the U.S.'s ratio of debt to gross domestic product at current levels until the year 2085 (to avoid scaring off investors) would require spending cuts, tax hikes, or a combination of both equal to 8.3 percent of GDP each year for the next 75 years, vs. the most likely (i.e. "alternative") scenario. That translates to \$15 trillion over the next decade—or more than three times what Obama and Boehner were considering.

You start to see why, absent signs of a serious commitment to deficit reduction, the rating services are warning they may downgrade the federal government's triple-A rating even if Congress does meet the Aug. 2 deadline. Fortunately, our debt hole is escapable. But digging out requires that leaders of both parties come to terms with just how deep it is.

The language we use is part of the problem. Every would-be budget balancer in Washington should read "On the General Relativity of Fiscal Language," a brilliant 2006 paper by economists Laurence J. Kotlikoff of Boston University and Jerry Green of Harvard University (available online from the National Bureau of Economic Research). The authors write that accountants and economists have something to learn from Albert Einstein's theory of relativity, about how measured quantities depend on one's frame of reference. Terms such as "deficit" and "tax," they write, "represent numbers in search of concepts that provide the illusion of meaning where none exists."

The national debt itself is one such Einsteinian (that is, squishy) concept. The Treasury Dept.'s punctilious daily accounting of it—\$14,342,841,083,049.67

as of July 25, of which just under \$14.3 trillion is subject to the ceiling and about \$10 trillion is held by the public—gives the impression that it's as real and tangible as the Washington Monument. But what to include in that sum is ultimately a political choice. For instance, the national debt held by the public doesn't include America's obligation to make Social Security payments to future generations of the elderly. Why not?

Suppose that instead of paying Social Security payroll taxes, working people used that amount of money to buy bonds from the Social Security Administration, which they would redeem in their retirement years. In such an arrangement, the current and future cash flows would be identical, but because of a simple labeling change the reported debt held by the public would skyrocket. That example alone should generate a certain queasiness about the reliability of the numbers that are taken for granted by budget combatants on both sides of the aisle.

A more revealing calculation is the CBO's measurement of what's called the fiscal gap. That figure is conceptually cleaner than the national debt—and consequently more alarming. Boston University's Kotlikoff has extended the agency's analysis from 2085 out to the infinite horizon, which he says is the only method that's invulnerable to the frame-of-reference problem. It's an approach used by actuaries to make sure that a pension system doesn't contain an instability that will manifest itself just past the last year studied. Years far in the future carry very little weight, converging toward zero, because they are discounted by the time value of money. Even so, Kotlikoff concluded that the fiscal gap—i.e., the net present value of all future expenses minus all future revenue—amounts to \$211 trillion.

Yikes! Douglas J. Holtz-Eakin, a former director of the CBO from 2003 to 2005, says he doesn't favor the infinite-horizon calculation because the result you get depends too heavily on arbitrary assumptions, such as exactly when health-care cost growth slows. But directionally, he says, Kotlikoff is "exactly right."

Which means we've been heading the wrong way for years. Even in the late 1990s, when official Washington was jubilant because the national debt

briefly shrank, fiscal-gap calculations showed that the government was quietly getting into deeper trouble. It was paying out generous benefits to the elderly while incurring big obligations to boomers, whose leading edge was then 15 years from retirement. Now the gray deluge is upon us. As Holtz-Eakin, now president of the American Action Forum, a self-described center-right policy institute, says: “We’re just in a world of hurt.”

The U.S. is in danger of reaching a generational tipping point at which older Americans have the clout to vote themselves benefits that sap the strength of the younger generation—benefits that can never be repeated. Kotlikoff argues that we may have reached that point already. He worries that the U.S. could become Argentina, which went from one of the world’s richest to lower-middle income in a century of chronic mismanagement.

Senior citizens are being told by their own lobbyists, repeatedly, that any attempt to rein in the cost of Social Security and Medicare is an unjust attack on earned benefits. “Stop the liberals from raiding the Social Security Trust Fund once and for all!” says a recent mailing from the National Retirement Security Task Force. Similar messages aimed at Democratic voters make the same charge against Republicans. No wonder Obama and Boehner were rebuffed by their own parties for putting entitlements on the table. In the end neither the House nor the Senate debt-ceiling proposals touched Social Security or Medicare. Not pretty.

In April this magazine ran a cover story featuring an alarmed rooster and the headline, “Don’t Play Chicken with the Debt Ceiling.” Washington clearly did not listen. The months of wrangling have dispirited the nation and concerned investors who lend money to the government. The cost of protecting against a U.S. sovereign default in the credit default swap market, while still low, is up 70 percent in the past year. It’s now nearly twice the cost of protecting against Swiss default.

A long, loud debate that produces a meaningful deal would be worth the pain, but a debate that produces next to nothing is worse for the nation than none

at all. It simply calls investors' attention to Washington gridlock. On July 14, Standard & Poor's made that point when it placed U.S. sovereign debt on CreditWatch for possible downgrade, citing "rising risk of policy stalemate." S&P said that "U.S. political debate is currently more focused on the need for medium-term fiscal consolidation than it has been for a decade. Based on this, we believe that an inability to reach an agreement now could indicate that an agreement will not be reached for several more years."

Economists at JPMorgan Chase said on July 26 that continued deterioration of the U.S. government's finances (not just a debt downgrade) might increase Treasury bond yields by 0.6 to 0.7 percentage point over the "medium term," adding \$100 billion a year to the government's interest expenses. "That's money being taken away from other goods and services," said Terry Belton, the global head of fixed income strategy.

While Washington is absorbed in the composition of a budget deal—how much in spending cuts vs. how much in tax increases—that's of secondary concern to macroeconomists. The more important figure to them is the size of the deal. The reason so many of the plans aim for \$4 trillion in budget balancing is because that's the amount that would (at least temporarily) stabilize the debt-to-GDP ratio and calm the bond market vigilantes. The downside, of course, is that if such a retrenchment is phased in too quickly it would drag down growth at a time of 9.2 percent unemployment.

Some economists, such as Holtz-Eakin, say any hit to growth would be small and worthwhile. "Weak-kneed Keynesians—I'm not one of those," he says. Others would favor shifting the balancing until after 2013, when the economy presumably will have strengthened. "In our view, the U.S. does not need an aggressive near-term fiscal tightening," Ian Shepherdson, chief U.S. economist of High Frequency Economics, wrote to clients on July 21. A third group, led by Princeton University economist and *New York Times* columnist Paul Krugman, says the economy needs more stimulus in the short run, not less. The logic: Getting the economy back to full speed would increase tax revenue and shrink the fiscal gap more effectively than draconian cuts. Of course, this fiscal debate is moot if the deal on the debt ceiling is just a

stopgap that's too small to have a real impact on the macroeconomy—a prospect that's pretty depressing all by itself.

If America's long-term budget problems were small, they could be fixed entirely by the Republicans' preferred method, which is spending cuts, or entirely by the Democrats' favored fix, tax increases. The challenge is not small, however. That's why nearly every bipartisan group that's looked at the problem—including the Bowles-Simpson and Domenici-Rivlin commissions—has concluded that some mix of the two will be required. The precise mixture is a political matter, but one would have to place an exceptionally high priority on the well-being of upper-income taxpayers to conclude that none of the adjustment burden should fall on them.

Republicans in Congress, not wanting to appear to defend the rich, have attempted to block any deal that includes higher taxes on the grounds that tax hikes are “job-killing.” But experience shows that in a period of slack demand like the present, tax hikes are no more job-killing than spending cuts, and probably less so. Cutting spending—say, by firing federal employees or canceling procurement—removes demand from the economy dollar-for-dollar. A dollar tax hike, on the other hand, especially one aimed at upper incomes, cuts demand by less than a dollar. Those who pay the tax cover part of it from their savings and only part by reducing their spending. If lawmakers insist on using the phrase “job-killing,” Robertson Williams, a senior fellow at the Brookings Institution-Urban Institute Tax Policy Center, wrote in a recent blog post, “they should apply it equally to both tax increases and spending cuts.”

There is one respect in which the national debt—all \$14,342,841,083,049.67 of it—is a good measure of the problems facing the U.S. It's real money that's owed to real creditors. (Actually, some is intra-governmental, so only about \$10 trillion is owed to the public.) “The numbers are hard enough. The creditors know how much they lent and how much they expect to get back,” says former Congressman Bill Frenzel, the ranking Republican on the House Budget Committee in the 1980s.

In contrast, the fiscal gap captures commitments to future spending and revenue—and while that makes the numbers more daunting, it also means that it's in our power to change them. They will have to be changed sometime, because current trends are unsustainable. The sooner the adjustments begin, the more gradual they can be. It's easier to slow down from 70 mph by stepping on the brakes than by slamming into a wall.

The good news is that this speeding vehicle does have brakes—if Washington would only use them. Eliminating deductions would broaden the base of income that's subject to taxation and increase revenue. On the spending side, it's crucial to change the incentives that lead to overconsumption and inefficiency in health care. At the same time, cuts in benefit formulas for Medicare and Social Security are painful but necessary. And they should apply at least in part to current beneficiaries. Given how hard-pressed young workers are, it's unfair to put all the adjustment on them while completely insulating today's elderly.

Sure, it's hard to imagine a real deal now, as Washington boils over with anger and partisan differences harden. But from this bitter experience may come a realization that the only way out is cooperation and compromise in the public interest. Meanwhile, that rooster we put on our cover in April? He's having a heart attack. Let's not do this again soon.

The Debt Deluge

The **current federal debt** held by the public of \$10 trillion is just the start. The **fiscal gap**, a measure of the difference between noninterest spending and projected revenue, shows the true scale of the U.S.'s problems.

The current debt
\$10 tn

