FLEMMING ROSE
Standing up for freedom of speech
PAGE 9

LAWRENCE WHITE
Reining in monetary authorities
PAGE 14

NEW BOOK
The country's unsustainable fiscal path
PAGE 16

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Running Out of Other People's Money

BY MICHAEL TANNER

Let's start with some good news. It was just six years ago that the federal budget deficit topped $1.4 trillion. This year, the Congressional Budget Office (CBO) projects it will be just $486 billion. Of course, we are still borrowing about 13 cents out of every dollar we spend, but this is progress of a sort.

There are several reasons for this improvement. The economy has started growing again, helping to increase revenues. The stimulus has largely played out and TARP is being repaid. Most importantly, sequestration has restrained defense spending and driven domestic discretionary spending down to the lowest level in years. Good news all around.

But don't get too excited. The reprieve is purely temporary. In the next few years, the deficit will begin to rise once more. Within a decade, we will again experience annual shortfalls of $1 trillion or more.

All this profligacy adds up. If rising annual budget deficits represent year-to-year fiscal irresponsibility, the cumulative total of that irresponsibility is the federal debt, which has now reached almost $18.2 trillion. Let's put that in perspective: The Los Angeles Dodgers have the biggest payroll in baseball. For $18.2 trillion, you could pay the Dodgers for 65,204 years, and still have money left over for a couple of free-agent pitchers. And, speaking of Los Angeles, $18.2 trillion could buy all the real estate in LA—38 times over. If we were to pay our national debt back at the rate of $1 per second, we could wipe it out in a mere 576,736 years. Each American's share of that debt is more than $56,750.

And that's the good news. America's real debt is far, far worse.

Continued on page 6

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PETER GOETTLER (left), a former managing director at Barclays Capital, took charge of the Cato Institute on April 1, replacing JOHN ALLISON as president and CEO. Allison is retiring after more than two exemplary years on the job. A longtime supporter of the Institute, Goettler is stepping up during what many have called a "libertarian moment" in American politics. "There is no more important contribution I can make to our fight than to dedicate myself fully to the ongoing success of the Cato Institute," he said. PAGE 12

Continued from page 1

OUR REAL DEBT: $90.5 TRILLION

The U.S. government officially classifies its debt in two ways. The first is "debt held by the public," which is primarily those U.S. government securities which are owned by individuals, corporations, state or local governments, foreign governments, and other entities outside the federal government itself. As of April 1, debt held by the public exceeded $13.1 trillion and represented more than 74 percent of GDP, the highest percentage of the economy since shortly after the end of World War II.

The second classification for federal debt is "intragovernmental" debt, which consists of the debts that the federal government owes to itself, such as debt it owes to the so-called Social Security Trust Fund. The more than 100 government trust funds, revolving accounts, and special accounts currently hold more than $5.06 trillion in debt, the largest portion of which is held in the Social Security ($2.73 trillion) and Medicare ($287 billion) Trust Funds. If you combine debt held by the public and intergovernmental debt, you arrive at a total federal indebtedness of almost $18.2 trillion.

That $18.2 trillion is more than 101 percent of projected GDP at the end of this year. Consider that. We currently owe more than the total value of all goods and services produced in this country over the course of this year.

But, as bad as that is, it doesn't actually capture the real level of debt facing this country. That is because there is also a third category of government indebtedness that should be considered: "implicit debt," the unfunded obligations to pay promised benefits for programs such as Social Security and Medicare.

We can estimate what those obligations are, of course. We know roughly how many people will be retired each year in the future. And we know what benefits must be paid to each of those retirees under current law.

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We also know how much money will be available to pay those benefits, given assumptions about the number of people working, their expected wages, and the payroll tax rates. Unfortunately, looking at that data, we know that we will owe more in benefits than we will be bringing in in taxes. That gap is the "unfunded liability" or "implicit debt" for those programs.

Implicit debt, of course, represents the "softest" form of debt, in that there is no legal requirement to pay all the promised benefits. But "soft" does not mean debt that can be completely dismissed. Those benefit payments are called for under current law, and it would take congressional action to change them. Unless and until Congress does so, those obligations exist. That is why, for private companies, future promises to pay benefits are generally categorized as debt according to Generally Accepted Accounting Principles (GAAP) and other accounting authorities. If the government was required to report its debt in the same way public companies do, those promises would show up as debt.

Social Security's future unfunded obligations now run to more than $24.9 trillion. Medicare's unfunded liabilities are more difficult to nail down, in part because of the uncertainty brought about by the new health care reform law. In 2009, Medicare's trustees estimated that the program's unfunded liabilities were $88.9 trillion. Since then, health care inflation has been running at a slower rate. Economists debate the reason for this decline and whether it will continue, but it has resulted in a reduction of Medicare's unfunded liabilities to just (!) $47.6 trillion.

Thus, the real combined federal debt (debt held by public + intragovernmental debt + implicit debt) actually totals at least $90.5 trillion. That's real money—even in Washington—roughly $282,000 for every man, woman, and child in America. Students graduating from college today worry about their college debt.... That's nothing compared with what they owe as a share of the country's debt.

Moreover, these projections assume that interest rates on government debt remain somewhere near current levels, which is about 2 percent. The CBO points out that, even at this low rate, interest on the debt is becoming an ever larger portion of federal spending. This year, the federal government will pay $229 billion in interest charges. By 2024, with just a modest expected increase in interest rates, that will rise to more than $808 billion. Not long afterward, we will be paying a trillion dollars every year just for interest on the debt. By 2035, in fact, interest on the debt will be tied with Medicare as the second-largest line item in the federal budget, trailing only Social Security.

And interest rates may not stay this low. It is estimated that every 1 percent increase in interest rates adds as much as $1 trillion in additional interest payments over the next decade. Over the past two decades the average rate of interest on government debt has been roughly 5.7 percent. Therefore, if interest rates were to return to anything close to traditional levels, it would add trillions to our future obligations.

A COST TODAY, NOT JUST FOR OUR CHILDREN

Once debt reaches the levels we are currently experiencing, it can slow a country's economic growth. For example, researchers with the International Monetary Fund looked at the relationship between debt levels and economic growth, concluding that from 1890 to 2000, countries with high debt levels consistently

saw their economies grow at slower rates than those with low debt levels.

Although it sounds ominous, debt of more than 100 percent of GDP does not automatically mark a path of no return. Still, a debt as large as we currently face potentially means fewer jobs and lower wages for American workers today. And, with the debt projected to grow to astronomical levels in the future, we can expect the economy to slow further still.

The Simpson-Bowles Commission estimated that if the federal debt rises to predicted levels it will reduce GDP by 3 percent by 2030 and almost 7 percent by 2037. Similar warnings come from the Congressional Budget Office. Under baseline CBO projections, real GNP per capita will be 4 percent lower by 2039 than it would be if we followed more prudent fiscal policies. That means our children will be roughly $2,000 poorer per capita. Under the more realistic alternative scenario, real GNP per capita will be as much as 7 percent lower.

Despite the undeniable fiscal facts, politicians from both parties continue to obfuscate and dodge the difficult decisions that will determine which of those two paths we follow.

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IT'S THE ENTITLEMENTS, STUPID

TheDemocrats either deny that there is a problem or insist that it could be solved if only the wealthy paid higher taxes. But even if one thought that tax increases were a good idea, and could be implemented without killing jobs or slowing economic growth, it is simply impossible to increase taxes enough to close the budget gap. In particular, raising taxes on the wealthy falls far short of what would be required to pay for our current and future obligations.

In fact, if you confiscated every penny owned by every person earning more than a million dollars a year, you would raise roughly $16.6 trillion—nowhere near enough to fund our debt.

In reality, the tax hike needed to pay our way out from under the mountain of future debt is almost beyond comprehension. Consider that, in 2008, the Congressional Budget Office estimated that in order to simply pay for then-projected spending, we would have to raise both the corporate tax rate and the top individual tax rate to 88 percent, raise the rate for middle-income workers to 63 percent, and raise the rate for low-income Americans to 25 percent. Since then we've added another $8.84 trillion in debt, meaning rates would have to be even higher today. Does anyone really believe that such tax rates are possible?

Meanwhile, Republicans give frequent lip service to the debt crisis, but pretend that you can deal with the debt crisis by eliminating "waste, fraud, and abuse" in the federal budget. Nor can you balance the budget by focusing on the usual suspects that Republicans love to criticize. Foreign aid amounts to less than 1 percent of federal spending. Federal subsidies to Planned Parenthood and the Corporation for Public Broadcasting amount to a combined 0.0002 percent.

In fact, all domestic discretionary spending—everything from the Department of Education to the FBI, from NASA to the Food and Drug Administration—accounts for just 15 percent of all federal spending. And that percentage is declining. President Obama proudly, and correctly, points out that even in his bloated budget, domestic discretionary spending will amount to just 2.2 percent of GDP by 2025, a historic low. That is not to say we shouldn't cut those programs. Many are indeed wasteful. Some do more harm than good. Most would probably be better left to the private sector and civil society. Every dollar in savings is a good thing, but the sad fact remains that cuts like that come nowhere near balancing the budget or significantly reducing the debt.

The simple truth is that there is no way to address America's debt problem without reforming entitlements, notably Social Security, Medicare, Medicaid, and our newest entitlement program, Obamacare. Social Security, Medicare, and Medicaid alone account for 46 percent of federal spending today, a portion that will only grow larger in the future. And, while the spending for Obamacare has just begun, it too will soon consume an ever larger portion of the federal budget.

Social Security will run a $69 billion cash-flow deficit this year. Every year after, that shortfall will grow worse. Altogether, Social Security is facing future shortfalls worth almost $25 trillion. The so-called Trust Fund is simply an accounting measure, specifying how much money the federal government owes the program out of general revenues, not an actual asset that can be used to pay benefits. At the same time, Social Security taxes are already so high that most young people will receive a rate of return far below historic market returns.

Medicare is in even worse financial shape. Even under the most optimistic scenarios Medicare's future shortfall will approach $48 trillion. And, if health inflation returns to previous levels, or life expectancy increases more than expected, Medicare's long-term costs could be far higher.

Medicaid's financial problems are measured somewhat differently since the federal portion is funded entirely from general revenues. Nonetheless, the program will cost the federal government $343 billion this year, and cost an additional $150 billion at the state level. Moreover, program costs

are rising rapidly. Federal Medicaid costs are estimated to more than double to $576 billion by 2025.

And, if all that was not bad enough, we have now adopted a massive new health care entitlement. The Affordable Care Act will add as much as $1.3 trillion to the federal debt over the next 10 years.

Moreover, as bad as all these numbers are, it is vital to remember that the debt is merely the most visible symptom of a much bigger issue—the size of government. The federal government currently consumes more than 20.4 percent of GDP. Add in state and local spending, and government consumes more than a third of everything produced in this country. As spending for entitlements rises in the future, government will eventually top 45 percent of GDP. Think about it: the government will consume almost half of everything produced in this country. That would be a problem regardless of whether or not the budget was balanced. Indeed, we would likely be better off with an unbalanced federal budget that spent half of what we currently spend.

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CHOOSING A FUTURE

How can entitlements be reformed? It's really not rocket science. If you have more money going out than coming in, you only have two options. You can increase the amount coming in, but raising taxes would only hurt the economy—and, as we've seen you, couldn't raise them enough to solve the problem anyway. That means that we will have to reduce the amount being paid out, cutting benefits and otherwise reducing the size of these programs.

For Social Security there are several proposals on the table for trimming benefits, ranging from raising the retirement age to reducing Cost of Living Allowances (COLAs). The best route may be to change the formula used to calculate initial benefits from one based on wage growth to one based on inflation. The problem is that, regardless of how benefits are cut back, it would make Social Security a worse deal for young people. Therefore, to offset this loss, we should allow younger workers to invest a portion of their Social Security taxes privately through personal accounts.

We face the same fundamental choice with Medicare. Seniors will ultimately have to pay more for their care or accept fewer benefits. President Obama and others would like to do this from the top down by imposing price controls on doctors and hospitals. A better approach would be to give more power to individual consumers through some type of voucher or premium-support option. This approach would provide seniors with a fixed amount of money that they could use to purchase private insurance.

And Medicaid is such a mess that it should be gotten out of Washington altogether. Funding for the program should be returned to the states as a block grant, giving them the power to experiment with a variety of cost-cutting reforms.

It is a truism that things which cannot continue forever eventually stop. Or as Margaret Thatcher said about the problem facing modern welfare states, eventually they "run out of other people's money." Clearly, we are on a course that cannot continue. The question isn't will it stop, but how. Will we find our way to a soft landing that minimizes disruption, allows for renewed economic growth, and protects those Americans who are most vulnerable? Or are we on the road for the turmoil and economic stagnation that we see in countries like Greece?

If a family were to live recklessly, running up their credit cards, and then leaving that debt for their children to pay, we would call them irresponsible. What, then, do we call politicians, from both political parties, who do the same thing on a much bigger scale? ■