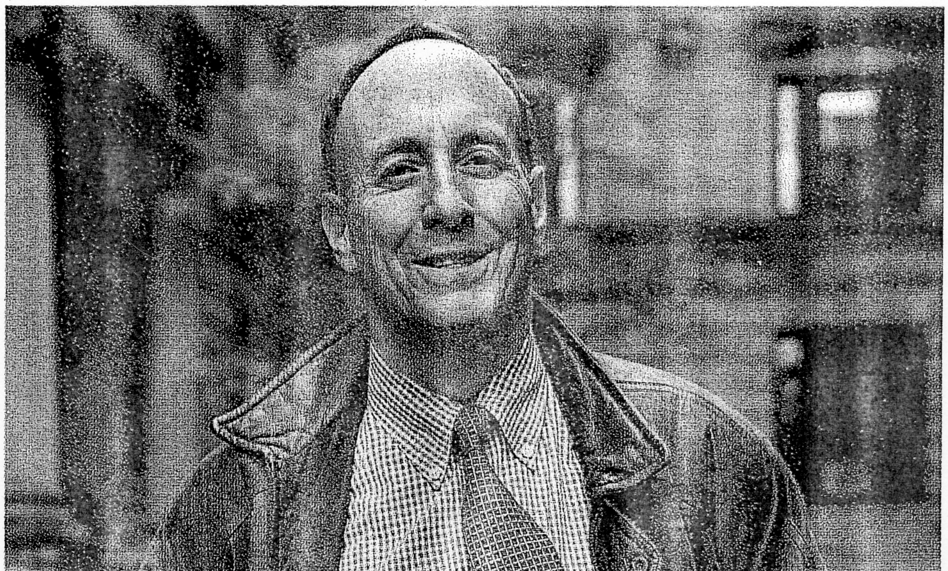
The $44 Trillion ABYSS

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.

BY ANNA BERNASEK

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.



MAN WITH A MISSION Boston University's Kotlikoff is a one-man fiscal warning system.

PHOTOGRAPH BY REUBEN COX

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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.)

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%.

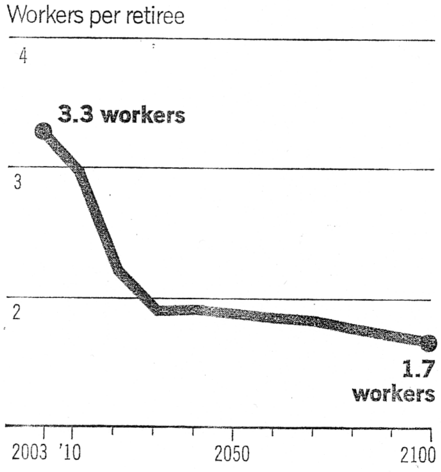
The gap between payments and income came in at $44.2 trillion. Think about $44 trillion for a moment. It's probably the biggest thing you've never heard of—and certainly the biggest number FORTUNE will publish in its pages this year. It's more than four times the size of our GDP, and 1½ times the size 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.

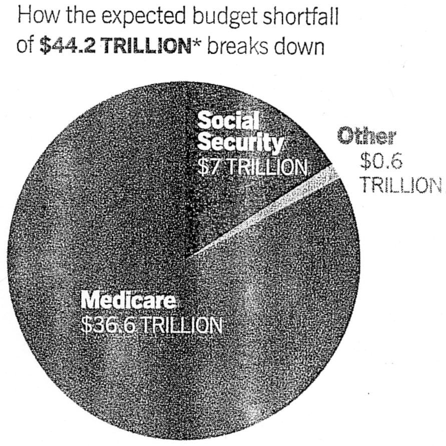
Just to be clear, that number is not a bill that comes due on a certain date. What it shows is the debt that would accumulate over years of deficits if we continue as we are. It is an honest measure of the inexorable pressure on the government's future ability to spend. This amounts to a *massive* weight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

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.





*Based on current government revenue and spending.

FORTUNE CHARTS / SOURCES: CENSUS BUREAU; SMETTERS AND GOKHALE

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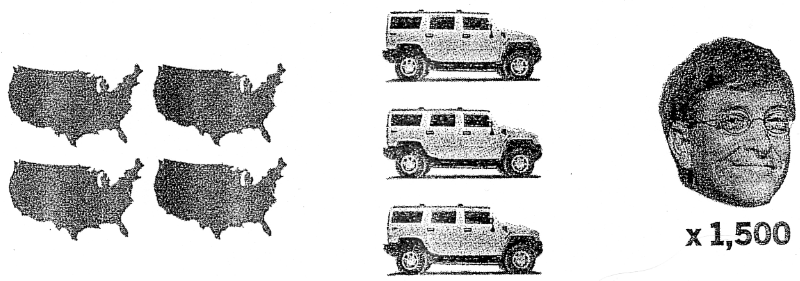
ROSY ASSUMPTIONS even for $44 Trill

tion 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.

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%

JUST HOW MUCH IS $44 TRILLION?



It's more than **FOUR TIMES** the **GDP** of the U.S.

It would buy **THREE HUMMER H2s** for every person in the U.S.

Or it's about 1,500 times the personal fortune of **BILL GATES.**

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 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.

SO, WHAT DO *YOU* THINK?

"Everybody keeps talking about how productivity is up, but it's because there are fewer employees at companies, so of course it looks like productivity is up. You look today in the papers and you see Sony is letting 20,000 people go. I mean, *20,000 people*. That's like my hometown where I grew up. Every person who was able to work would be laid off. That's overseas, but this is a huge international company. If people think that won't have an effect here and abroad, then they're fooling themselves."

—MICHAEL GELFAND
Media consultant,
New York City

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? F

FEEDBACK *abernasek@fortunemail.com*

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Business Day

The New York Times

3-2-04

Medicare and Social Security Challenge

By EDMUND L. ANDREWS

News Analysis

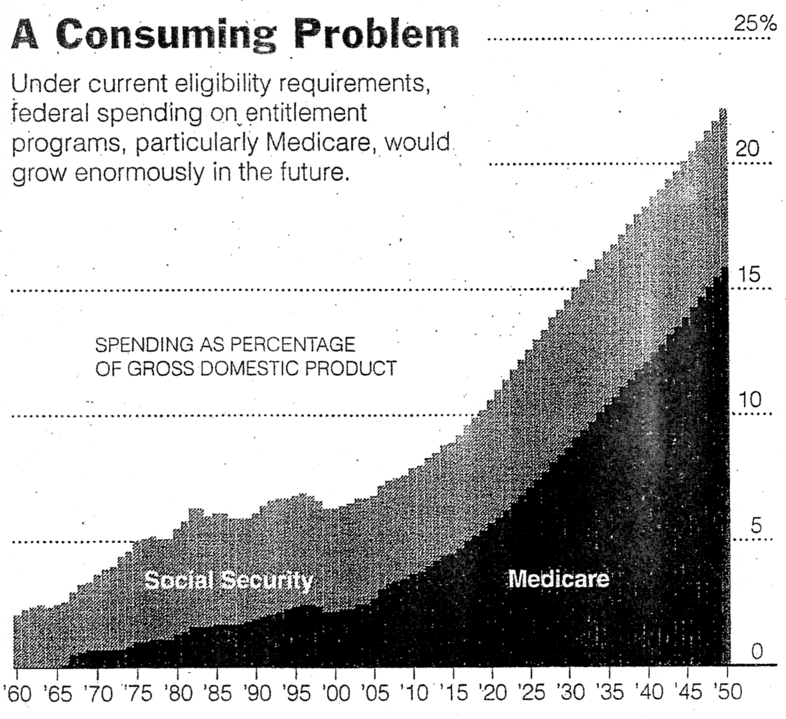
WASHINGTON, March 1 — When Alan Greenspan urged Congress last week to cut future benefits in Social Security and Medicare, sending elected officials to the barricades, he was if anything understating the magnitude of the problems ahead. Today's budget deficits are measured in the hundreds of billions, but the looming shortfalls for the two retirement programs are projected to be in the tens of trillions of dollars.

The Bush administration has estimated that the gap between promises under current law and the revenues expected will total $18 trillion over the next 75 years. But an internal study in 2002 by the Treasury Department, looking much further ahead, concluded that the gap was actually $44 trillion — and would climb each year that nothing was done.

Indeed, the numbers are so big and extend so far into the future that they border on the surreal. Analysts in both Congress and the administration warn that the flood of retiring baby boomers will cause federal spending on old-age benefits to eventually consume as much of the nation's economy as the entire federal budget does now. And while the problems would be acute even if today's federal budget were balanced, the budget deficits that seem likely for the rest of the decade make matters worse. That is because the government is borrowing more than $200 billion a year from the Social Security and Medicare trust funds to finance its operating deficits.

In theory, the two giant trust funds are accumulating huge surpluses that can be used to pay for benefits when the baby

Continued on Page 13



A Consuming Problem

Under current eligibility requirements, federal spending on entitlement programs, particularly Medicare, would grow enormously in the future.

Source: Congressional Budget Office

The New York Times

tions would be more than $10 trillion over the next 75 years. But that was before President Bush signed the law that will add prescription drug benefits to Medicare — which the administration now predicts will cost $540 billion over the next 10 years. The costs would climb rapidly after that, as the number of elderly people soars. The Congressional Budget Office has predicted that the new program could cost as much as $2 trillion in its second decade.

Mr. Bush and many administration officials contend that much of Social Security's problems could be solved by letting people divert some of their payroll contributions to private investment accounts they might manage for themselves.

But some experts say that the government would have to borrow as much as $1 trillion over the next several decades to make up for the lost revenues and pay retirees benefits earned under the old system.

And the Congressional Budget Office, in a report on privatization plans last year, said none of the proposals would have much effect.

"Using government resources to buy stocks and bonds, without other

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BIRNBAUM ON WASHINGTON
$10 Trillion in Deficits?
Federal liabilities and accumulated deficits may actually soar by tens of trillions of dollars over the next few decades, leading to fiscal catastrophe, a Congressional expert warns.
FORTUNE
Wednesday, September 10, 2003
By Jeffrey H. Birnbaum

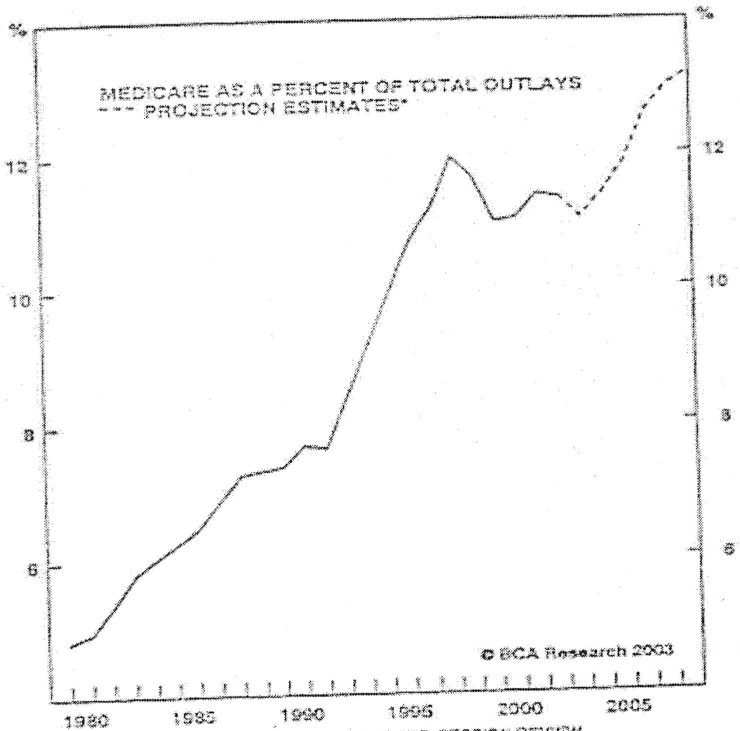
Jeffrey Birnbaum

Everyone knows that the federal budget deficit is going to be huge in the next fiscal year: a half-trillion dollars or more. And that's before the $87 billion the President has requested for rebuilding Iraq next year. But over the next few decades, the budget deficit may actually soar tens of trillions of dollars above and beyond that amount--due to largely unaccounted-for costs from entitlement programs, warned Comptroller General David Walker in an interview with Fortune.com this week.

A deficit that high could be a fiscal catastrophe, says Walker, who runs Congress's investigative arm, the General Accounting Office. Most Americans don't know about these liabilities because they don't appear in any of the ten-year estimates that official Washington relies on to write its budgets and to form new policies, says Walker, who is scheduled to give a major address to the National Press Club next Wednesday in Washington, D.C., to warn about the matter. He intends to "issue a wake-up call that we face serious and structural deficits that we need to start doing something about."

Washington experts have been forecasting annual deficits of around $500 billion, but Walker says those numbers don't take into account that, as the Baby Boom starts to retire over the next decade, entitlement programs, especially Social Security, Medicare and veterans health programs, will balloon in cost. "There are tens of trillions of dollars in discounted present value of commitments and obligations that aren't adequately

Chart III-2
Medicare: A Growing Burden



*OFFICE OF MANAGEMENT AND BUDGET, MID-SESSION REVIEW

warnings from Comptroller General!

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addressed," Walker says. "We would have to have tens of trillions of dollars invested at Treasury rates today to make good on those promises and we just don't have it." And the gap between incoming revenue and expenditures on these programs "is too great to simply grow our way out of the problem," he says. "Tough choices have to made."

Walker declined to give a complete listing of solutions he will suggest next week. But he gave a few hints. For instance, he plans to propose that better, more accurate measurements should be published about the long-term costs of programs now on the books. He also would like to begin "a massive education campaign" to inform the public about these concerns. "One of the biggest problems is that the American public doesn't understand the nature and magnitude of our challenge," he says. As the Baby Boom hits retirement age starting in 2008, "we face a demographic tidal wave that is unprecedented in the history of this country," he says.

How to fix the budget? "We're going to have to look beyond entitlement programs," Walker says. "We're going to have to review and examine a wide range of government activities on the spending side and on the tax side. We need to engage in a fundamental review and reengineering that will take years, and it's important that we start now."

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CAPITAL ◈ By DAVID WESSEL

JAN '03

Warnings from Treasury Undersecretary

U.S. Promises Are $20 Trillion in the Hole

A TOP U.S. TREASURY official last week likened the U.S. government to a profligate insurance company that can't afford to make good on promises it has made. The cost of benefits the government vows to pay in the future exceeds projected tax revenues by roughly $20 trillion, he said. And that's no typo.

No one took much notice. Maybe that's because Peter Fisher, the Treasury's undersecretary for domestic finance, spoke in Columbus, Ohio, far outside the Beltway. Or maybe it's because his alarmism was buried in a discourse on the riveting topic of government bookkeeping.

His point is worth pondering. But is anyone in the Bush administration listening?

"Think of the federal government as a gigantic insurance company with a sideline business in national defense and homeland security," Mr. Fisher said. It counts premiums and payouts as they come and go and worries little about how to pay claims in the future. "This particular insurance company, it turns out, has made promises to its policyholders that have a current value $20 trillion or so in excess of the revenues that it expects to receive," he said.

"An insurance company with cash accounting is not really an insurance company at all," he added. "It's an accident waiting to happen."

THAT'S PRETTY STRONG stuff coming from the guy whose job makes him the chief salesman for U.S. Treasury debt.

The chart accompanying this column shows the problem. The combination of an aging population—the oldest baby boomers turn 57 next year—and rapidly rising health-care spending is inexorably pushing up the tab for Social Security and Medicare. President Bush wants to draw the line on federal taxes at 19% of gross domestic product (the value of all of the goods and services produced in the U.S.). It isn't enough to pay for what the government is promising.

Focusing exclusively on this year's federal deficit and the size of next year's federal debt is a mistake, and arguing about the Social Security trust fund is a diversion. Dan Crippen, head of the Congressional Budget Office, says the real issue is: How much of our children's economy are we going to take to support ourselves in retirement? Look at the moving pieces: How much are we promising future retirees? And how big will tomorrow's economy be?

The U.S. isn't going to raise taxes sufficiently to cover the cost of keeping current promises. It ought to take steps now to reduce future costs of Social Security, Medicare and Medicaid and to make the future economy bigger so both retirees and workers can live well.

INSTEAD, MR. BUSH offers tax cuts as the cure to every economic ill and increased benefits to the politically potent, such as farmers. There are occasional bursts of rhetoric, and vague statements of principle from the White House. But, so far, there are few serious proposals and fewer practical political strategies for achieving those that have been floated.

Look at the economy through Republican eyes, and judge Mr. Bush's policies.

Mr. Bush's advisers believe that cutting marginal tax rates is a good way to improve long-run economic growth. Why then so much eagerness to continue the Clinton campaign to turn the tax code into a theme park full of special tax credits? Treasury Secretary Paul O'Neill says he is working on a far-reaching tax-overhaul proposal. Why then spend so much on traditional tax cuts—and on extending them—that there is nothing left to use as a carrot to get a tax overhaul through Congress?

Every Bush economic adviser sees what Mr. Fisher sees. Why then dangle a Social Security plan that pretends we can preserve benefits without increasing taxes, by turning to the stock market? Saving more, Bush economists say, is key to investing more, and investing more is key to keeping productivity growing. Government deficits soak up savings. So what's the Bush plan for fighting a war, protecting the homeland, cutting taxes and avoiding deficits? Health-care costs are on the rise. So where is the White House strategy for devising and getting congressional approval of a plan to make Medicare work better?

One Republican who has been in and out of government over the past 20 years quips privately that Mr. Bush's economic policy lacks only two things: a policy and someone to explain it.

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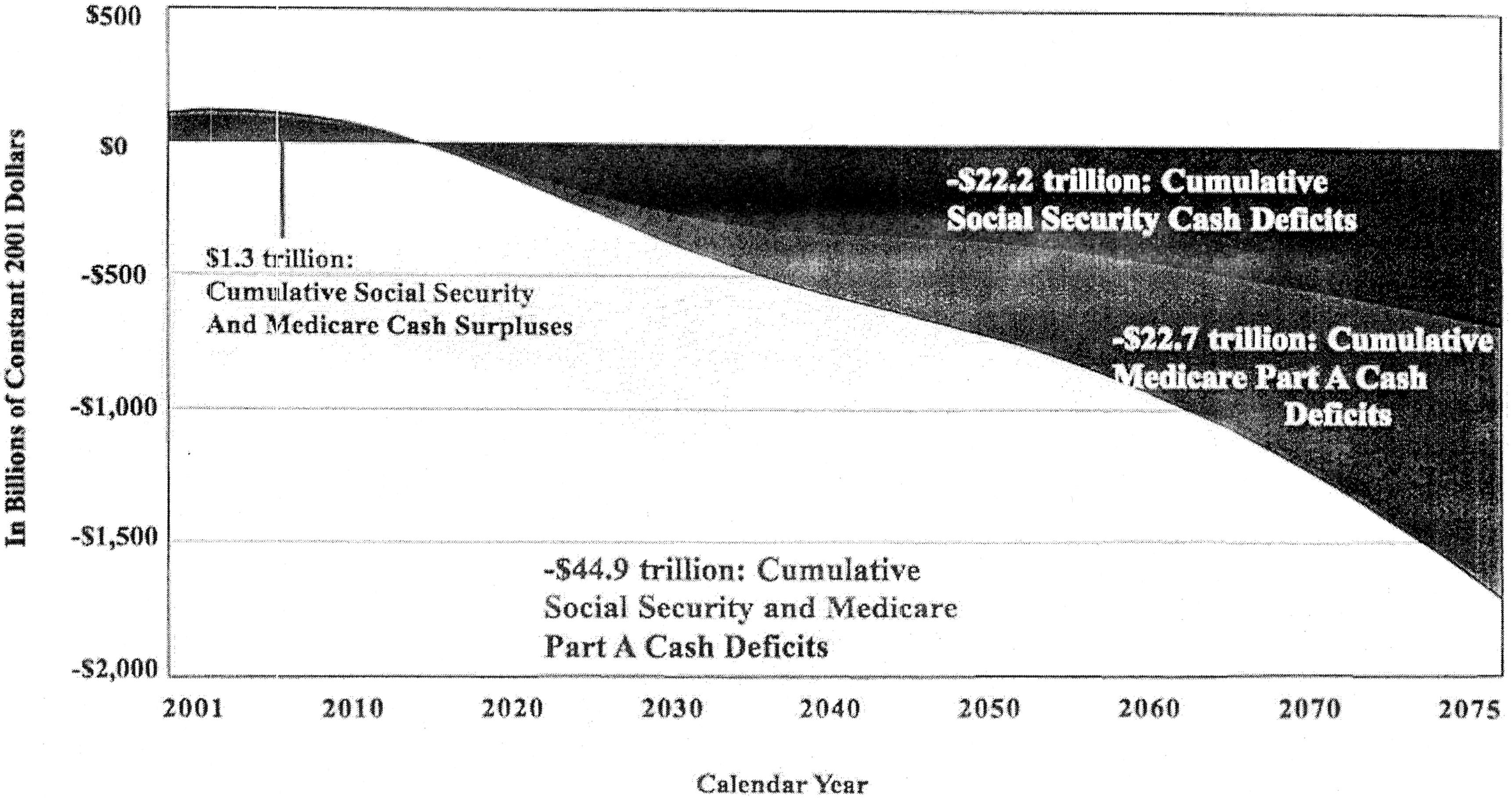
E-mail me at **capital@wsj.com**.

See questions and answers Sunday at

SOCIAL SECURITY AND MEDICARE PART A CUMULATIVE CASH SURPLUSES AND DEFICITS IN CONSTANT 2001 DOLLARS 2001-2075



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Increase the figure by $7 Trillion for the Prescription Benefit !

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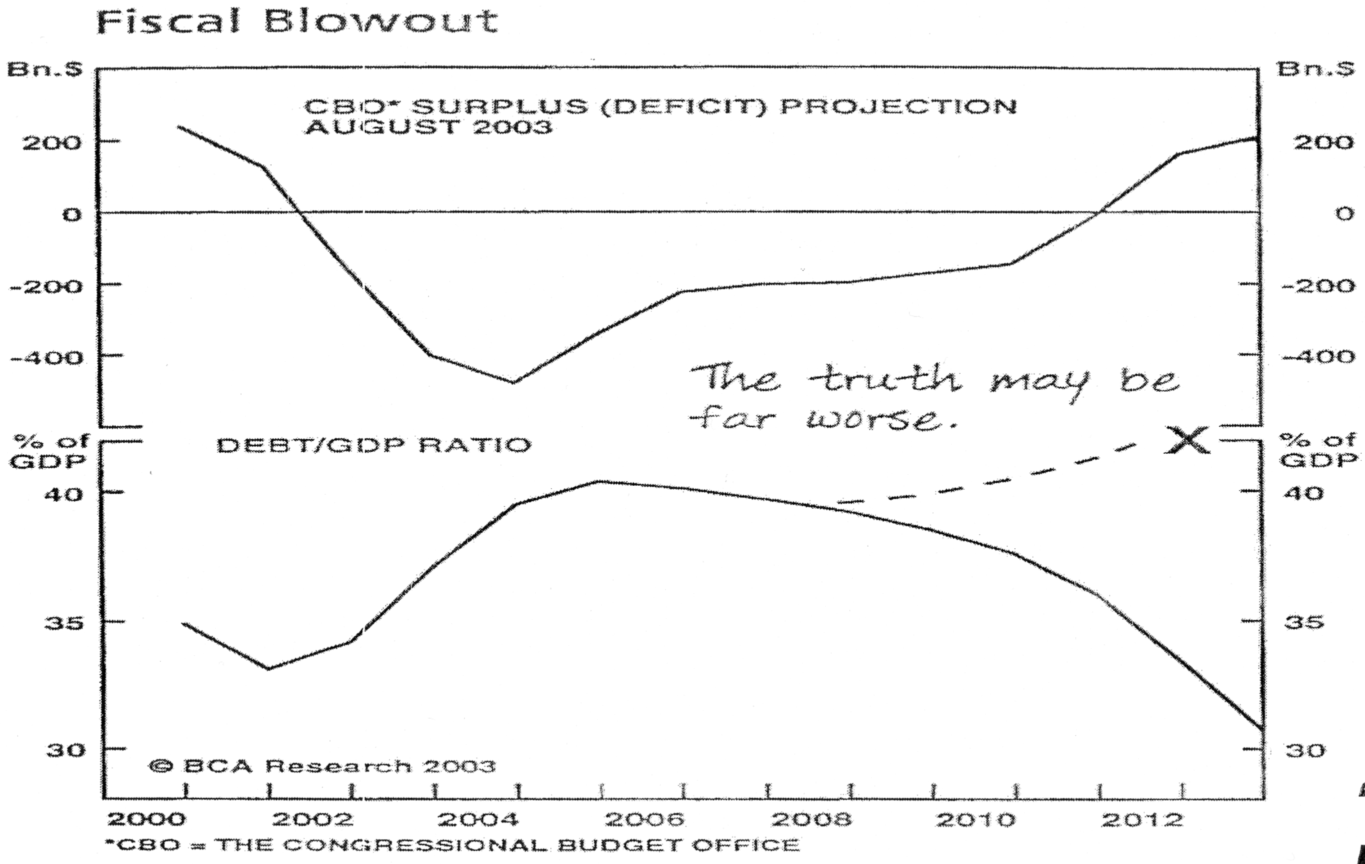
OUR BIGGEST NATIONAL CHALLENGE



"...out of Control budget Situation..."
Bank Credit Analyst

plan omitted his $87 billion request for Iraq's reconstruction, not to mention the proposed (and very pricey) prescription drug benefit plan. None of the main Democrat presidential contenders have shown how they would balance the budget. Concerns among bond investors are escalating about the lack of political will to tackle the out-of-control budget situation.

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WORLD

IMF: U.S. deficits a global time bon

Report says debt could raise rates, slow investment

By Elizabeth Becker and Edmund L. Andrews
New York Times News Service

WASHINGTON—With its rising budget deficit and ballooning trade imbalance, the United States is running up a foreign debt of such record-breaking size that it threatens the financial stability of the global economy, according to report released Wednesday by the International Monetary Fund.

Prepared by a team of IMF economists, the report sounded a loud alarm about the shaky fiscal foundation of the United States. It questions the wisdom of the Bush administration's tax cuts and warns that large budget deficits pose "significant risks" not just for the U.S. but for the rest of the world.

The report warns that the United States' net financial obligations to the rest of the world could equal 40 percent of its total economy within a few years—"an unprecedented level of external debt for a large industrial country," which could play havoc with the value of the dollar and international exchange rates.

The dangers, according to the report, are that the United States' voracious appetite for borrowing could push up global interest rates and slow investment and growth.

"Higher borrowing costs abroad would mean that the adverse effects of U.S. fiscal deficits would spill over into global investment and output," the report said.

White House officials dismissed the report as alarmist, saying that President Bush already has vowed to reduce the budget deficit by half over the next five years. The deficit reached $374 billion last year, a record in dollar terms but not as a share of the total economy, and it is expected to exceed $400 billion this year.

But many international economists said they were pleased that the IMF raised the issue.

"The IMF is right. If those twin deficits—of the federal budget and the trade deficit—continue to grow, you are increasing the risk of a day of reckoning when things can get pretty nasty," said C. Fred Bergsten, director of the Institute for International Economics in Washington.

Administration officials have made clear they are not alarmed about the country's burgeoning external debt or the declining value of the dollar, which has lost more than one-quarter of its value against the euro over in the past 18 months. "Without those tax cuts, I do not believe the downturn would have been one of the shortest and shallowest in U.S. history," said John Taylor, undersecretary of the treasury for international affairs.

> *'If those twin deficits ... continue to grow, you are increasing the risk of a day of reckoning. ...'*
>
> —C. Fred Bergsten, director of the Institute for International Economics

Though the IMF has criticized the United States on its budget and trade deficits repeatedly in the past few years, this report was unusually lengthy and pointed. And the IMF went to lengths to publicize the report and seemed intent on getting American attention.

"I think it's encouraging that these are issues that are now at play in the presidential campaign that's just now getting under way," said Charles Collyns, deputy director of the IMF's Western Hemisphere department.

In the report, IMF economists also warned that the long-term fiscal outlook is far grimmer, predicting that underfunding for Social Security and Medicare will lead to shortages as high as $47 trillion over the next 70 years or nearly 500 percent of the current gross domestic product.

Some outside economists remain sanguine.

"Is the U.S. fiscal position unique? Probably not," said Kermit Schoenholtz, chief economist at Citigroup Global Markets. Japan's budget deficit is much higher than that of the United States, Schoenholtz said, and those of Germany and France are climbing rapidly.

But in a paper presented last weekend, former Treasury Secretary Robert Rubin said the federal budget was sustainable path" a "scale of the natior budgetary imbalan large that the risk c verse consequence taken very seriousl is impossible to p such consequences

Other economist were afraid this wa the 1980s when the U went from the wo creditor nation to debtor nation after a military buildup dent Ronald Reagar

John Vail, senic for Mizuho Securiti the IMF economist flects the concerns eign investors.

"I would say the majority of interna ion about the Unite said. And he adde rency doesn't ha haven status that i recent years."

"GLOBAL TIME BOMB"

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