



# MONETARY & ECONOMIC REVIEW

Volume XXII, No. 1

Spring 2007

## Can the United States Go Broke?

By the American Institute for Economic Research

*The Federal Budget deficit and the U.S. trade deficit have been sources of concern for the past quarter century or more. Recently the notion that the United States has become a net debtor nation has been added to the hand-writing. These trends have been widely noted and, to the extent that they are “unsustainable,” their correction may be long and difficult, but not the reason for a crisis of one sort or another. Crises are precipitated by the unexpected, rather than the familiar.*

When the Federal Reserve Bank of St. Louis published a paper by Laurence Kotlikoff (“Is the United States Bankrupt?”) last summer it created quite a stir. Kotlikoff, a professor at Boston University, believes that the sum of future Social Security, Medicare, and Medicaid obligations is so far beyond what current tax rates, or any conceivable tax regime, can produce that a crisis is inevitable and only a matter of time. In an editorial, the *Wall Street Journal* offered a simple rebuttal: there is no likelihood of a literal “bankruptcy” because, if promised expenditures for Social Security and health care outrun tax revenues, there is nothing to stop the Congress from slashing such entitlements until some new balance is attained (*Wall Street Journal*, “The Entitlement Panic,” August 22, 2006).

### **Twin Deficits, Twin Debts**

The question transcends more familiar concerns over the budget deficit and the trade deficit, and the increasing share of U.S. government securities owned by foreigners. Here it helps to recall some basic definitions: First, the federal budget deficit is the difference between the federal government’s spending and its receipts. As recently as 2001, there was a surplus – revenues exceeded outlay. However, during the following five fiscal years, 2002-2006, deficits totaled more than \$1.5 trillion. The current annual deficit is about \$250 billion, which is the difference between an “off-budget” surplus of \$200 billion. The latter amount is the excess of receipts reserved for specific programs (Social Security being the largest) over spending on those programs, which is held in various government trust funds, which are little more than bookkeeping artifices. However, the \$200 billion added to the trust funds includes about \$100 billion of interest (reported as an on-budget outlay and an off-budget receipt). In short, the fact is that the Federal Government is currently spending about \$350 billion more on general programs than it receives in general revenue, and about \$100 billion less on specific programs than the taxes received to support them.

As has been understood for quite some time, outlays for entitlement programs for the elderly will soon increase rapidly after many years of slow growth. This reflects the relatively small birth cohorts during the Depression and World War II and the subsequent birth of 77 million people between 1946 and 1964 (the Baby Boomers). They are rapidly approaching retirement age and the sheer number of new recipients, first for Social Security benefits, then for Medicare, will drive government outlays higher in a hurry, and for years to come. The galloping costs of health care will up the ante still further.

The national debt (the sum of all past budget surpluses and deficits) now equals about \$8.7 trillion. Of this, about \$3.8 trillion is held in U.S. government accounts, notably the Social Security trust fund, whose annual surpluses have served to reduce the reported overall deficit. About \$800 billion is held by Federal Reserve Banks, with the remaining \$4.1 trillion held by other investors.

It used to be said of the national debt that “we owe the debt to ourselves,” i.e., the debt never had to be paid off, but could be rolled over from one generation of (American) owners of U.S. securities to the next. By implication, default was not an issue.

Since 2002, however, “the public” has been mostly foreign. During the last five fiscal years, the amount of Treasury securities held by the public (excluding holdings by the Federal Reserve and government trust funds) increased by \$1.30 trillion. But only \$129 billion of that total was acquired by private domestic investors. Foreigners purchased the remaining \$1.17 trillion.

In short, the Treasury now owes a substantial portion of its debt foreigners, more than \$2.2 trillion in all. Most of this total is held by foreign central banks. The dollar continues to function as the major international reserve currency, but many foreign monetary authorities have retained dollars well in excess of their needs for liquidity. This has kept their currencies from appreciating against the dollar and kept their exports competitive. About \$1 trillion in U.S. Treasury securities are held by just two countries, Japan and China, which have run huge trade surpluses, especially with the United States.

The United States has incurred increasingly large trade deficits (the difference between our imports and our exports) for decades. The deficit has recently surged to a record level of more than \$700 billion per year, mainly as a result of high oil prices.

The debate on the threat posed to the United States by the budget deficit and/or the trade deficit has raged for more than 20 years, yet our unemployment and inflation rates trended downward during the period. Why then should anybody worry about the deficits? For one, as is commonly asserted, they are “unsustainable.” For example, The Peterson Institute for International Economics, a private, nonprofit, nonpartisan research institution devoted to the study of international economic policy, recently stated that:

The global current account deficit of the United States is now larger than it has ever been – nearing \$800 billion, almost 7 percent of U.S. GDP. To finance both the current account deficit and its own sizable foreign investments, the United States must import about \$1 trillion of foreign capital every year... The situation is unsustainable in both international financial and domestic political (i.e., trade policy) terms. Correcting it must be the highest priority for U.S. foreign economic policy.

In addition, as a result of our ballooning payments deficits, the U.S. is now said to be the world’s largest debtor nation. Reportedly, U.S. investors owned about \$10 trillion of assets in the rest of the world in 2005, while foreign ownership of U.S. assets surpassed \$12 trillion, giving us a net foreign debt of more than \$2 trillion.

Foreign holdings in the United States are dominated by fixed-dollar claims, while U.S. holdings of foreign assets are dominated by equity investments, both portfolio and direct. The latter are apparently reported at their book values (the value of the initial investment, which may have been made many years ago) plus subsequent retained earnings. The official data exclude appreciation of those equity investments, plus a variety of presumably unreported transactions, which may well make the apparent net debtor position of the United States a reflection of inadequate bookkeeping. These offsets have been called “dark matter” (in astrophysics dark matter is the stuff in the universe that we can identify only by its gravitational pull) which presumably has enabled the United States to run large current account deficits while maintaining the value of the dollar against other currencies.

In any event, as Herbert Stein famously remarked, a trend that is unsustainable will not be sustained. In the instance of the trade deficit, it has always been clear that a sufficient depreciation of the dollar against other currencies would restore it to balance. Similarly, the budget deficit and the burden of the national debt can be eased by some combination of tax increases, spending cuts, and price inflation.

None of these are attractive prospects, but they are not necessarily the ingredients of a crisis of one sort or another. There is an old saying that “if you owe the bank \$1,000 and can’t pay it, you have a problem, but if you owe the bank \$10 million and can’t pay it, the bank has a problem.” The plain fact of the matter is that if foreign central bankers were to rush to unload dollars and dollar-denominated Treasury securities, it could cause havoc in our financial markets and our economy, but it would destroy the reserves of the foreign central banks in the process. However scary such a scenario may seem, it does not actually translate into “bankruptcy” in the conventional sense, i.e., a default on contractual bond obligations.

### **What’s the Problem? Just Cut Benefits**

This is where the *Wall Street Journal’s* editorial writers have a point to make in their rebuttal, “The Entitlement Panic.” Because they oppose any call for higher taxes, they offer a few perfunctory objections to the basic argument while also acknowledging that there is a problem. Then they offer their most powerful argument, on the constitutional issue of bankruptcy. Yes, defaulting on U.S. Treasury securities (by refusing to redeem a T-Bond at its maturity) would indeed constitute a form of national bankruptcy.

By contrast, unfunded liabilities, the entitlements in question, have no constitutional protection. As the editorial puts it, Kotlikoff’s “biggest false assumption... is that the current level of benefits will ever be paid.” Why? “Entitlement benefits are not a contractual government obligation in the sense that a T-bond is.” Whenever Congress finds the political will, in other words, the cuts can be made as needed. In fact Kotlikoff’s position may not be that far from the editors at the *Journal*. He states that:

...at heart, ours is not a demographic problem. Were there no fiscal policy in place promising, on average, \$21,000 (and growing!) in Social Security, Medicare, and Medicaid benefits to each American age 65 and older, our having a much larger share of oldsters in the United States would be of little economic concern.

The Social Security trust fund will not, on current projections, begin to decrease until 2020 or so, and it will not run out until the year 2042. However, these projections are not grounds for complacency. That \$100 billion current annual excess of payroll tax receipts over benefit payments is likely to represent a peak (it grew from nothing after the reform of the early 1980s) and it will begin to decrease in 2008 and 2009, eventually to zero and then into a shortfall that must be made up with general revenues. As this source of financing for general programs dries up, budget problems will be increasingly exacerbated.

Again, that there would be a problem paying for the retirement of the baby boomers has been evident for a very long time (since the Greenspan Commission produced its recommendations for reform, at least). Many of our politicians have talked about the problem, very often incoherently – remember Al Gore’s “lock box”? Bewailing the fact that the government had spent the money in the trust funds passed for sophisticated analysis in some circles, often by the very same people that ridiculed proposals to put some of the money in the stock market rather than government bonds. Government bonds may indeed be safe, but can it really be a surprise that the government spends what it has borrowed?

The fact is that the politicians have dithered for many years. There can be little doubt that the coming budget difficulties will be all the more excruciating because nothing has been done, despite years of opportunity. If there are no changes in the law, all Social Security benefits will have to be cut to roughly 30 percent when the trust fund is exhausted. We can expect that something will have been done before then and that something will include benefits cuts of one sort or another.

While one can disagree that the solution lies solely in benefit cuts or postponements (rather than including tax increases as well), it is hard to argue with the *Journal’s* semantic point. A country does not face bankruptcy just because its currency loses value. When the dollar does fall, the economy may suffer as import prices and interest rates rise. But that’s all. However unpleasant, such disruptions would fall far short of “national bankruptcy.”

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Dr. R.D. Norton, an AIER Visiting Research Fellow, contributed to this article. The article above was reprinted in *Monetary & Economic Review* with permission from the American Institute for Economic Research, Great Barrington, MA 01230.