The Other National Debt

[This is my commentary I sent to friends on June 16, 2010 about an article with the same title that appeared in the very reactionary magazine National Review. (That article is appended below.) –S.H.]

Hi everybody,

Today I’m doing something that may surprise you; I’m forwarding an article from the arch-reactionary magazine National Review. This article, entitled “The Other National Debt”, argues that the real national debt is not the “mere” $14 trillion the government claims it to be, but rather something more like $130 trillion!

You might want to scroll down and read or skim through the article first before continuing with my comments here about some of what I think is correct or incorrect about the article. (If you don’t choose to read it first, that’s fine too!)

* * *

The method used in the article to arrive at this figure of $130 trillion involves what is known as the “capitalization” of the future debt obligations. Capitalization means calculating how big a lump sum it would take today, earning today’s prevailing interest rate, to achieve a specified income stream in the future. Only in this case it is not income that is being talked about, but expenditure. Thus the author of the article (Kevin Williamson) is calculating the amount of money you would need to have earning interest right now to cover all the outgo for future pensions and so forth that the federal and state governments are already legally obligated to cover.

So the first question is, is this method valid in this case? The answer is not really. Williamson is arguing that the government must use the same conservative accounting principles as businesses use, and that would mean they have to use the method he uses.

However, the federal government can do things that businesses can’t (at least directly), including levy taxes, borrow much more freely, just print money, and change the laws (which can in turn wipe out many of their supposed “obligations”).

While the present obligations of government constitute a future stream of money outgo, the tax income of governments constitute a future stream of money income. If you are going to capitalize future expenditures then to properly evaluate the situation you should also capitalize future income. Thus the real size (in terms of today’s money) of the total government debt is $130 trillion minus the capitalization of future tax income for the same period. (Businesses can’t, and shouldn’t be allowed to, use this same method because they are not in full control of their future income. But governments are (at least in theory) in full control of the amount of taxes they pull in—since they take the money by force if necessary.)
So how much is today’s capitalization of all the future tax income by the federal and state governments (for the period in question)? Well, nobody knows. It could be guessed at on the basis of today’s tax rates, but that would still require some additional very dubious guesswork as to how much actual money that will bring in given the uncertain prospects for the future economy.

For reasons like this, it is customary for governments to deal with (in large part) their future financial obligations as they come due, rather than by entirely dealing with them up front (by setting aside all the money immediately which will eventually be required, or via a fund which is expected to generate that money). This is not irrational, and is in fact necessary for governments, at least to some degree.

Thus when we hear claims that Social Security is “going broke” we should keep in mind that this will only be true if the government does not raise taxes, or cut benefits, or stop borrowing (or inflating the currency), etc., all things which it will certainly keep on doing. Of course many of these “solutions” are themselves very bad! (Cutting retiree’s benefits, especially!)

OK, having now given one of the several reasons for thinking that the federal debt problem is not nearly as bad as Williamson believes it to be, let’s turn around and agree that it is still extremely bad indeed, and much worse than the government has been officially admitting!

What if I were to say that the current actual government debt, while much bigger than the official $14 trillion, is way, way less than $130 trillion? Would that make you happy? It shouldn’t! The debt is still outrageous and growing extremely rapidly.

It is impossible to precisely determine the true current government debt (federal, state and local) in this country, including all the hidden debt (such as that of Government Sponsored Enterprises like Fannie May and Freddie Mac). By my very rough guess it is probably at least $18 trillion, and perhaps even $25 trillion or more.

But one thing is certain, the debt is already way out of control, and while there are some ups and downs in its rate of expansion, it is overall growing faster and faster. Bush junior’s last year in office was the biggest year of growth in federal debt up to that time. But since then the Obama administration has hugely topped that. They have had to do so; if they hadn’t we would already be in a new depression. Even as it is, the “recovery” has been pitifully weak, with unemployment staying near 10 percent (even using the government’s lying statistics).

The government imagines that it will be able to get the constantly growing federal debt under control in the future, but this is what they have been imagining for decades already. They simply won’t be able to do so. They will indeed make efforts from time to time to cut back the growth rate of the debt, but shortly after they do so the economy will sink into recession again. This pattern will repeat itself several times (as it has already done twice this past decade, until things take a turn toward something even worse.

The federal government, even if it disowns many of its supposed financial “obligations”, and even if it refuses to help bail out the state governments (which are already sinking into insoluble
crisis), will never really be able to resolve its perpetually building deficit problem. It will get worse and worse until it results in a true economic and social disaster.

This is something that is inherent in modern capitalism because of the only way the government has available to try to deal with overproduction crises, namely the ever-greater expansion of debt.

Scott

The Other National Debt

$14 trillion does not begin to cover the REAL extent of our indebtedness

National Review | 06/13/2010 | Kevin Williamson
Posted on Monday, June 14, 2010 6:49:20 AM by SeekAndFind

About that $14 trillion national debt: Get ready to tack some zeroes onto it. Taken alone, the amount of debt issued by the federal government — that $14 trillion figure that shows up on the national ledger — is a terrifying, awesome, hellacious number: Fourteen trillion seconds ago, Greenland was covered by lush and verdant forests, and the Neanderthals had not yet been outwitted and driven into extinction by Homo sapiens sapiens, because we did not yet exist. Big number, 14 trillion, and yet it doesn’t even begin to cover the real indebtedness of American governments at the federal, state, and local levels, because governments don’t count up their liabilities the same way businesses do.

Accountants get a bad rap — boring, green-eyeshades-wearing, nebbishy little men chained to their desks down in the fluorescent-lit basements of Corporate America — but, in truth, accountants wield an awesome power. In the case of the federal government, they wield the power to make vast amounts of debt disappear — from the public discourse, at least. A couple of months ago, you may recall, Rep. Henry Waxman (D., State of Bankruptcy) got his Fruit of the Looms in a full-on buntline hitch when AT&T, Caterpillar, Verizon, and a host of other blue-chip behemoths started taking plus-size writedowns in response to some of the more punitive provisions of the health-care legislation Mr. Waxman had helped to pass. His little mustache no doubt bristling in indignation, Representative Waxman sent dunning letters to the CEOs of these companies and demanded that they come before Congress to explain their accounting practices. One White House staffer told reporters that the writedowns appeared to be designed “to embarrass the president and Democrats.”

A few discreet whispers from better-informed Democrats, along with a helpful explanation from The Atlantic’s Megan McArdle under the headline “Henry Waxman’s War on Accounting,” helped to clarify the issue: The companies in question are required by law to adjust their financial statements to reflect the new liabilities: “When a company experiences what accountants call ‘a material adverse impact’ on its expected future earnings, and those changes
affect an item that is already on the balance sheet, the company is required to record the negative impact — ‘to take the charge against earnings’ — as soon as it knows that the change is reasonably likely to occur,” McArdle wrote. “The Democrats, however, seem to believe that Generally Accepted Accounting Principles are some sort of conspiracy against Obamacare, and all that is good and right in America.” But don’t be too hard on the gentleman from California: Government does not work that way. If governments did follow normal accounting practices, taking account of future liabilities today instead of pretending they don’t exist, then the national-debt numbers we talk about would be worse — far worse, dreadfully worse — than that monster $14 trillion—and–ratcheting–upward figure we throw around.

Beyond the official federal debt, there is another $2.5 trillion or so in state and local debt, according to Federal Reserve figures. Why so much? A lot of that debt comes from spending that is extraordinarily stupid and wasteful, even by government standards. Because state and local authorities can issue tax-free securities — municipal bonds — there’s a lot of appetite for their debt on the marketplace, and a whole platoon of local special-interest hustlers looking to get a piece. This results in a lot of misallocated capital: By shaking up with your local economic-development authority, you can build yourself a new major-league sports stadium with tax-free bonds, but you have to use old-fashioned financing, with no tax benefits, if you want to build a factory — which is to say, you can use tax-free municipal bonds to help create jobs, so long as those jobs are selling hot dogs to sports fans.

Also, local political machines tend to be dominated by politically connected law firms that enjoy a steady stream of basically free money from legal fees charged when those municipal bonds are issued, so they have every incentive to push for more and more indebtedness at the state and local levels. For instance, the Philadelphia law firm of Ballard, Spahr kept Ed Rendell on the payroll to the tune of $250,000 a year while he was running for governor — he described his duties at the firm as “very little” — and the firm’s partners donated nearly $1 million to his campaign. They’re big in the bond-counsel business, as they advertise in their marketing materials: “We have one of the premier public finance practices in the country, participating since 1987 in the issuance of more than $250 billion of tax-exempt obligations in 49 states, the District of Columbia, and three territories.” Other Pennsylvania bond-counsel firms were big Rendell donors, too, and they get paid from 35 cents to 50 cents per $1,000 in municipal bonds issued, so they love it when the local powers borrow money.

So that’s $14 trillion in federal debt and $2.5 trillion in state-and-local debt: $16.5 trillion. But I’ve got some bad news for you, Sunshine: We haven’t even hit all the big-ticket items.

One of the biggest is the pension payments owed to government workers. And here’s where the state-and-local story actually gets quite a bit worse than what’s happening in Washington — it’s the sort of thing that might make you rethink that whole federalism business. While the federal government runs a reasonably well-administered retirement program for its workers, the states, in their capacity as the laboratories of democracy, have been running a mad-scientist experiment in their pension funds, making huge promises but skipping the part where they sock away the money to pay for them. Every year, the pension funds’ actuaries calculate how much money must be saved and invested that year to fund future benefits, and every year the fund managers ignore them. In 2009, for instance, the New Jersey public-school teachers’ pension system
invested just 6 percent of the amount of money its actuaries calculated was needed. And New Jersey is hardly alone in this. With a handful of exceptions, practically every state’s pension fund is poised to run out of money in the coming decades. A federal bailout is almost inevitable, which means that those state obligations will probably end up on the national balance sheet in one form or another.

“We’re facing a full-fledged state-level debt crisis later this decade,” says Prof. Joshua D. Rauh of the Kellogg School of Management at Northwestern University, who recently published a paper titled “Are State Public Pensions Sustainable?” Good question. Professor Rauh is a bit more nuanced than John Boehner, but he comes to the same conclusion: Hell, no. “Half the states’ pension funds could run out of money by 2025,” he says, “and that’s assuming decent investment returns. The federal government should be worried about its exposure. Are these states too big to fail? If something isn’t done, we’re facing another trillion-dollar bailout.”

The problem, Professor Rauh explains, is that pension funds are used to hide government borrowing. “A defined-benefit plan is politicians making promises on time horizons that go beyond their political careers, so it’s really cheap,” he says. “They say, ‘Maybe we don’t want to give you a pay raise, but we’ll give you a really generous pension in 40 years.’ It’s a way to borrow off the books.” The resulting liability runs into the trillions of dollars.

Ground Zero for the state-pension meltdown is Springfield, Ill., and D-Day comes around 2018: That’s when the state that nurtured the political career of Barack Obama is expected to be the first state to run out of money to cover its retirees’ pension checks. Eight years — and that’s assuming an 8 percent average return on its investments. (You making 8 percent a year lately?) Under the same projections, Illinois will be joined in 2019 by Connecticut, New Jersey, and Indiana. If investment returns are 6 percent, then 31 U.S. states will run out of pension-fund money by 2025, according to Rauh’s projections.

States aren’t going to be able to make up those pension shortfalls out of general tax revenue, at least not at current levels of taxation. In Ohio, for instance, the benefit payments in 2031 would total 55 percent of projected 2031 tax revenues. For most states, pension payments will total more than a quarter of all tax revenues in the years after they run out of money. Most of those pensions cannot be modified: Illinois, for instance, has a constitutional provision that prevents reducing them. Unless there is a radical restructuring of these programs, and soon, states will either have to subsidize their pension systems with onerous new taxes or seek a bailout from Washington.

So how much would the states have to book to fully fund those liabilities? Drop in another $3 trillion. Properly accounting for these obligations, that takes us up to a total of $19.5 trillion in governmental liabilities. Bad, right? You know how the doctor looks at you in that recurring nightmare, when the test results come back and he has to tell you not to bother buying any green bananas? Imagine that look on Tim Geithner’s face right now, because we still have to account for the biggest crater in the national ledger: entitlement liabilities.

The debt numbers start to get really hairy when you add in liabilities under Social Security and Medicare — in other words, when you account for the present value of those future payments in
the same way that businesses have to account for the obligations they incur. Start with the entitlements and those numbers get run-for-the-hills ugly in a hurry: a combined $106 trillion in liabilities for Social Security and Medicare, or more than five times the total federal, state, and local debt we’ve totaled up so far. In real terms, what that means is that we’d need $106 trillion in real, investable capital, earning 6 percent a year, on hand, today, to meet the obligations we have under those entitlement programs. For perspective, that’s about twice the total private net worth of the United States. (A little more, in fact.)

Suffice it to say, we’re a bit short of that $106 trillion. In fact, we’re exactly $106 trillion short, since the total value of the Social Security “trust fund” is less than the value of the change you’ve got rattling around behind your couch cushions, its precise worth being: $0.00. Because the “trust fund” (which is not a trust fund) is by law “invested” (meaning, not invested) in Treasury bonds, there is no national nest egg to fund these entitlements. As Bruce Bartlett explained in Forbes, “The trust fund does not have any actual resources with which to pay Social Security benefits. It’s as if you wrote an IOU to yourself; no matter how large the IOU is it doesn’t increase your net worth. . . . Consequently, whether there is $2.4 trillion in the Social Security trust fund or $240 trillion has no bearing on the federal government’s ability to pay benefits that have been promised.” Seeing no political incentives to reduce benefits, Bartlett calculates that an 81 percent tax increase will be necessary to pay those obligations. “Those who think otherwise are either grossly ignorant of the fiscal facts, in denial, or living in a fantasy world.”

There’s more, of course. Much more. Besides those monthly pension checks, the states are on the hook for retirees’ health care and other benefits, to the tune of another $1 trillion. And, depending on how you account for it, another half a trillion or so (conservatively estimated) in liabilities related to the government’s guarantee of Fannie Mae, Freddie Mac, and securities supported under the bailouts. Now, these aren’t perfect numbers, but that’s the rough picture: Call it $130 trillion or so, or just under ten times the official national debt. Putting Nancy Pelosi in a smaller jet isn’t going to make that go away.

— Kevin D. Williamson is deputy managing editor of *National Review*