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World

March 02, 2005

Is America going broke?

Record deficits, colossal debt and no clear plan for digging itself out. If the U.S. sinks, it will take Canada down with it.

STEVE MAICH

David Walker can see the future, and it scares the hell out of him.

That wouldn't be terribly unusual if he were one of the thousands of lobbyists, legislators and activists crawling all over Washington on any given day, pontificating about the urgency of their pet issues. There is a thriving industry here built on pushing policy prescriptions for every ailment, real or imagined. But Walker isn't a lobbyist or an activist, he's an accountant. His title is comptroller general of the United States, which makes him the head auditor for the most important and powerful government in the world. And he's desperately trying to get a message out to anyone who'll listen: the United States of America's public finances are a shambles. They're getting rapidly worse. And if something major isn't done soon to solve the country's intractable budget problems, the world will face an economic shakeup unlike anything ever seen before.

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the fact the situation is dire. "I don't like using words that are overly inflammatory," he says, leaning forward in his chair. "At the same time, I think it is critically important that the American people, as well as their elected representatives, get a better understanding of just how serious our situation is."

THE NUMBERS are staggering -- a US\$43-trillion hole in America's public finances that's getting worse every day. And the stakes are almost inconceivable for a generation of politicians and voters raised in relative prosperity, who've never known severe economic hardship. But that plush North American lifestyle to which we've all grown accustomed has been bought on credit, and the bill is rapidly nearing its due date. If the United States can't find a way to pay up, the results will spill beyond national borders, spreading economic misery far and wide. In Canada, the country whose financial well-being is most tightly tied to trade with the U.S., there wouldn't be a single region or industry left untouched by a fiscal shock south of the border.

It's the looming presence of this potential crisis that brings Walker to this office every day, through the doorway with the words "Honesty Accountability Reliability" inscribed above, in hopes that someone will listen and take up the challenge before it's too late. "The sooner we start fixing this, the better," he says, "because right now the miracle of compounding is working against us. Debt on debt is not good. We have to first stop digging, and then figure out how we're going to fill the hole."

HOW DID THE U.S. GET INTO THIS MESS?

In January 2001, George W. Bush took over leadership of a nation that was on its most solid financial footing in decades, thanks to years of strong economic growth and a booming stock market. That very month, the Congressional Budget Office projected that the federal government could expect US\$5.6 trillion in surpluses over the coming 10 years. The key political issue of the day was how to spend the windfall. Bush's team was determined to return the money to the voters in the form of massive and widespread tax relief. What the world didn't know was that this surplus cash was largely illusory, the result of faulty bookkeeping.

The CBO's rosy outlook was based on a few deeply flawed assumptions, in particular that most government spending would not exceed the pace of inflation over the following decade, even though the rest of the economy and tax revenues were projected to grow much faster. Laurence Kotlikoff, a professor of economics at Boston University and a prominent critic of U. S. budgetary planning, released a paper that year drawing attention to what he called the CBO's "fiscal fantasy." But his was a single, lonely voice, and few on Capitol Hill were listening. The tax-cut agenda had taken hold, and there would be no stopping it.

The CBO and other agencies have since gone back and found that a more realistic surplus projection would have been US\$2.2 trillion -- over 60 per cent less than initially thought. And that cushion quickly disappeared as Bush whittled or eliminated one tax provision after another, from the marriage tax and personal income tax rates to capital gains, gifts and dividends. The Center for Budget and Policy Priorities, a Washington think tank, estimates that between 2001 and 2004, federal tax revenue dropped

by some US\$600 billion. Most of the tax cuts introduced so far are temporary, but the Republicans have made it clear they intend to make the reductions permanent before the end of the current term.

In the midst of this tax-relief bonanza, and nine months into the new President's first mandate, came Sept. 11. The horror of the terrorist attacks profoundly changed the American public's attitude toward security and defence almost overnight. Within months, the U.S. military was on the ground in Afghanistan attacking terrorist camps and overthrowing the Taliban regime. From there, the troops moved on to Iraq. Between 2001 and 2004, the annual budget for the Pentagon and domestic security rose by US\$87.1 billion, an increase of 27.5 per cent in four years. In the process, a budget that had a surplus of US\$128 billion in 2001 crumbled into a deficit of US\$412 billion last year -- the biggest annual shortfall in United States history.

But that's just one symptom of a much deeper fiscal problem. The U.S. is heading for a massive demographic shift as baby boomers start retiring in three years. As they do, the costs of providing social programs and health care are going to soar. "It's not the deficits of today that are the big problem," says Josh Bivens, an economist with the non-partisan Economic Policy Institute in D.C. "It's that, if you make the Bush tax cuts permanent, you're going to have deficits as far as the eye can see."

HOW BIG IS THE PROBLEM?

A trillion is a hard number to wrap your head around. Most people know it's a thousand billion -- 12 zeroes -- but even that is difficult to fathom in terms of value. So think of it like this: a trillion U.S. dollars is roughly the size of the entire Canadian economy. The world's six biggest oil companies had combined 2004 revenues just shy of US\$1 trillion. And if you piled a trillion dollars in \$1,000 bills, the stack would be more than 109 km high.

As of February, the U.S. national debt stood at US\$7.7 trillion. And this year, the country is projecting another record deficit of US\$427 billion, increasing its debt by about US\$1.2 billion a day. Thanks to low interest rates, the cost of borrowing all that money remains relatively low, amounting to about 8.6 per cent of the federal budget for 2005. But when rates rise, so will the cost of carrying that debt, and current White House forecasts suggest that by 2010, those yearly costs will hit US\$314 billion.

But even those projections don't adequately capture the depth of America's financial hole. For one thing, current budget estimates do not include the costs of the ongoing military campaigns in Iraq and Afghanistan, which are expected to require an additional US\$80 billion in funding over the next year or so. The budget also does not factor in any costs associated with the President's plan to reform Social Security, which would give people the option of diverting some of their tax contributions into private retirement accounts they manage themselves. That plan will call for between US\$1 trillion and US\$2 trillion in additional government borrowing over the next decade. Bush has proposed cutting the budget deficit in half by 2010, but that strategy doesn't take into account his pledges to make permanent many of those temporary tax reductions introduced in 2001 and 2002, not to mention other tax cuts promised but not yet implemented.

What's more, none of this even begins to deal with the most pressing challenge of all: how to pay for the sunset years and medical costs of about 77 million baby boomers getting set to retire. Walker refers to this as a "demographic tidal wave" coming to swamp the country's finances. He estimates that when you take into account the unfunded liabilities of Social Security, Medicare and Medicaid -- programs that together comprise the heart of the U.S. social safety net, paying pension and health-care costs for the elderly, as well as providing medical coverage for the poor -- America's long-term budget shortfall is approximately US\$43 trillion, about four times the size of the nation's economy, and more than 20 times the federal government's annual tax revenues. And some actuaries think even that number understates the size of the problem.

To most observers, it's becoming increasingly obvious that, within the next 10 years, the U.S. government will simply not be able to borrow money fast enough to keep up with its exploding expenses. That has huge implications for everything Americans do, from funding the military to protecting the environment. The Economic Policy Institute recently projected that under the current tax regime, by 2014 all government revenue would be consumed by four areas of spending: health care for the elderly and the poor, Social Security for retirees, national defence and interest on the debt. There will be no money left for such fundamental initiatives as education, transportation or justice, which means the government would be forced into ever-escalating borrowing to pay for basic programs. Walker's department projects that, under the current tax rates, interest costs on the skyrocketing national debt would be about half of all government tax revenues by 2031. Ten years later, the cost of servicing the debt will exceed all government revenues.

Laurence Kotlikoff described this burgeoning crisis four years ago in a paper entitled "The Coming Generational Storm." Last year, he provided a dark summary of the situation in a *Fortune* magazine article. "The U.S. government is effectively bankrupt," he wrote. The available options to close the fiscal gap? Hike income taxes by 78 per cent; slash Social Security and Medicare benefits by more than half; or eliminate all other discretionary spending. "That," he concludes, "is America's menu of pain."

HOW MUCH LONGER CAN THIS SITUATION GO ON?

The United States is the world's best customer. It buys far more from foreign countries than it sells to them, resulting in a sizable trade deficit. It also spends more on public programs than it collects in tax revenues. And to pay for all these outlays, the U.S. must attract mountains of foreign capital each year, which essentially amounts to borrowing from foreign governments and investors. This is commonly referred to as the current accounts deficit -- which was running at US\$665 billion last year.

Those foreign countries don't lend out of the goodness of their hearts; for the most part they lend because the U.S. uses that money to buy goods from them and other nations. In many ways, the prosperity of the developed world, including Canada, Europe and parts of Asia, has been financed over several decades by America's rampant spending, says David Rosenberg, a Canadian who is chief North American economist for Merrill Lynch in New York. In Canada's case, by year-end this country had

sold \$8.8 billion more in goods to the U.S. than we bought from it -- despite the loonie's sharp rise against the greenback that made Canadian exports less affordable to Americans.

But foreign investors cannot go on forever supporting U.S. spending. A banker who holds your mortgage and car loan will get nervous if you keep coming back to up the limit on your credit cards, and international debt markets work in much the same way. The question becomes, how much longer will those investors be willing to lend to the U.S., especially at the current low interest rates, when the country appears to have no plan for meeting its long-term funding needs? The issue is even more pressing given the fact that the U.S. dollar has been falling for more than a year, decimating returns for those foreigners who invest in U.S. bonds.

Stephen Roach, chief economist at Morgan Stanley, is an outspoken critic of U.S. fiscal policy and has long warned that America's increasing reliance on foreign lending puts it at risk of a major economic shock. A sudden drop in the dollar could trigger, among other things, a stock market crash, a plunge in the real estate market, a deep recession, or all of the above. "There's nothing stable about America's dependence on the kindness of strangers," Roach wrote in a report last summer. "The funding of America is an accident waiting to happen."

At a recent meeting with fund managers in Boston, Roach said he believes there is a 90 per cent chance the country's rampant borrowing will eventually lead to a disaster for the economy. Others, including former U. S. treasury secretary Lawrence Summers and former president Bill Clinton, use less inflammatory language but have also warned that the size of U.S. deficits could compromise the nation's foreign policy and trade and security goals. For example, how long can Washington stick to its commitment to defend Taiwan against Chinese aggression when it borrows so heavily from China to support the American economy?

David Rosenberg scoffs at alarmists like Roach, but he does acknowledge the current fiscal path is unsustainable. He quotes economist Herbert Stein's old maxim: "Anything that cannot go on forever, will stop."

WHY SHOULD WE CARE?

History provides some harrowing examples of what happens when an economy collapses under the weight of unsustainable debt. One of the most chilling is Argentina in 2001. When the International Monetary Fund cut off its support for the country's escalating debt, the effect was catastrophic: the value of the national currency plunged, decimating the savings of millions. The resulting surge in inflation and sudden slowdown in consumer spending put thousands of businesses into bankruptcy within weeks. That, in turn, put further millions out of work and pushed one of South America's biggest economies into a punishing recession.

As unfathomable as it may seem, most economists think something like that could happen in the United States. "If foreign investors look at the long-run outlook for the federal budget and decide there is going to be a crash, you get a financial panic," Bivens explains. "Interest rates spike. That causes a huge recession. You'll have the dollar falling fast, so maybe inflation is sparked at the same time." And if interest rates spike, that

would squeeze millions of U.S. consumers who have taken out loans against the rising value of their homes in recent years. A sudden hit to the real estate market would further constrain consumers' wallets, leading to a cycle of lower spending, and deeper recession, Bivens says.

Kotlikoff outlines a frighteningly similar scenario in his book *The Coming Generational Storm*. In it, he describes America in 2030 hurting from "unprecedented" tax levels, drastic reductions to social programs, unsustainable borrowing, spiralling inflation and an explosion in tax evasion. He compares the United States in 25 years to what Russia's economy looked like at the the turn of the millennium.

When he considers the numbers, Bivens can't disagree with Kotlikoff's forecast. "You've got all the ingredients for a pretty spectacular crash that a country as rich as the U.S. should just never be even close to flirting with," he says. "Another six or seven years along this path and I think we'll really be flirting with it. It's rather insane."

And this insane behaviour is a huge problem for everyone else because of America's importance to the world economy. Literally millions of workers in Canada, the U.K., Germany, Japan and elsewhere are directly or indirectly reliant on a healthy U.S. market for their jobs. "If suddenly Americans were unable to buy those goods from those countries, the countries would have to very quickly figure out how to keep their people employed," Bivens explains. Accordingly, most economists agree that a severe downturn in the United States would drag the rest of the world down with it. "If a country as big as the U.S. gets sick, everybody's gonna get sick," says Bivens.

That is a reality Canadians don't seem to fully grasp. A recent *Maclean's*/Rogers Media poll found only 41 per cent agree that the domestic economy is closely tied to that of the U.S.; 11 per cent choose to believe the two economies are not at all interrelated. In reality, virtually every region of the country and every major industry -- forestry, energy, mining, auto manufacturing, agriculture, technology -- depends on U.S. demand for its prosperity. If American consumers are suffering under surging unemployment, spiking interest rates, collapsing housing prices and rising inflation, those same forces will inevitably spill over into Canada.

Rosenberg, for one, believes the U.S. will restructure its fiscal policy to avoid a major crash -- but even such a process of reform is sure to have negative effects on trading partners like Canada. To close its fiscal gap and reduce its need to borrow abroad, the U.S. must find ways to boost its exports while slowing imports. In other words, it must make it more difficult for other countries to sell into its market. This is what economists refer to as a "beggar thy neighbour" policy. "For the world economy, this means the free ride is over," Rosenberg says. "The days of partying on the U.S.'s fiscal Ferris wheel are over. It's done."

HOW CAN AMERICA FIX THE PROBLEM?

On Nov. 1, 2000, as George W. Bush was campaigning for the White House, he warned an audience in Minneapolis that the Democrats would lead the nation into a future of higher taxes and slower economic growth that "could mean an end to this nation's prosperity." Bush won the election

in part by portraying himself as an antidote to tax-and-spend liberals. Yet despite this bold austerity rhetoric, discretionary spending rose 23 per cent in Bush's first term. Just over four years after harping on the dangers of fiscal irresponsibility, the President is on his way to making his own warnings a reality.

Virtually every reputable independent observer who has looked at the United States budget shortfall concludes that some combination of significant tax increases and major spending cuts is unavoidable. But making those reforms happen, and closing that budget gap, will require the kind of deft touch used to dismantle a bomb. The American currency must be slowly, carefully managed lower to boost U.S. exports, but without triggering a sudden plunge in the greenback that could spark a devastating jump in inflation. Interest rates must gradually rise to ward off inflation and encourage consumers to save more of their earnings. Spending must be reined in, but not so severely that it compromises U.S. security and other public priorities. And taxes must be raised, but not so drastically that they stunt economic growth.

In many ways, the U.S. must now emulate the program that Canada instituted in the 1990s to bring its deficit spending and surging national debt under control. That was done with higher taxes, billions in spending cuts and a sharp drop in the dollar's value, combined with healthy economic growth. But south of the border the size of the challenge is much larger, the stakes are higher, and it seems clear the standard of living that millions of Americans have come to take for granted will have to change.

Walker stresses the need to make "tough decisions," and none will be tougher than tackling the runaway costs of providing health-care coverage for the elderly and the poor. Health spending in the U.S. is projected to jump 63 per cent by 2010, and to continue rising even faster after that. Most analysts agree that, at some point, the government must find a way to clamp down on those costs, yet any cuts in coverage are sure to raise an outcry from the swelling ranks of senior citizens -- a highly influential voting bloc.

Academics have proposed such reforms as a national retail sales tax, a luxury tax and a rollback of all tax cuts enacted since 2001. Others are calling for increased funding for the Internal Revenue Service to catch tax cheaters. Many insist there must be increases to Medicare premiums, as well as massive cutbacks in a wide range of social programs. But telling voters that they will have to pay more in taxes for fewer services is not an easy sell, and so far no politician has been willing to try it. In February, Bush tabled a proposed budget that would eliminate or trim back 150 government programs, but even with that, the U.S. would be racking up deficits well in excess of US\$200 billion for years to come. "They're not being serious about austerity at all," Bivens says. "They're talking about very big cuts to very small programs. They mean a lot to the people getting them, but it's pennies in the overall fiscal problem."

James Horney spent more than seven years as a staffer at the Congressional Budget Office and now does analysis for the Center on Budget and Policy Priorities, a non-partisan think tank in Washington. He says the solution to the debt problem can only emerge when both parties

in Congress and the President sit down to work out a "grand bargain" that includes concessions on both taxes and program spending, and a strategy for reassuring international lenders. "It requires a deal in which everything is on the table and everyone is at the table," Horney says. "One just hopes it will happen before some major cataclysm."

Walker shares that hope, and clings to his own sense of optimism. He says he has detected a noticeable shift in attitude just in the past few months, as legislators slowly come to grips with the inevitable financial reckoning. But he acknowledges that, so far, there is little concrete progress to show for his efforts. "The thing that is frustrating is that you can talk to people and point to things, but that's all you can do," he says. "You can lead them to water, but they have to drink. And they better start drinking fast -- and soon."

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