



Inevitabilities—One Down, More to Come

By Rob Arnott

Standard & Poor's downgrade of U.S. government debt to AA+ from AAA is a wake-up call to a public weaned on credit—both governmental and personal credit. It is time to kick the “buy today, pay tomorrow” habit and look at policy options that, no matter how painful they appear today, are far less excruciating than the consequences of not taking action. In this special note, we take a close look at government finances and entitlement programs, and what can be done now to avert a true disaster in the future.

The Downgrade

Standard & Poor's has downgraded the United States following the recent debt ceiling “debate.” The other credit agencies did not. Was Standard & Poor's out of line? We think not. Consider, for example, how the United States would stack up relative to a corporation. In “corporate” terms, the United States

- Delivers \$1.4 trillion of operating losses on \$2.2 trillion of revenues.
- Recently altered its long-term strategic plan, trimming 5% of its current spending plans over the coming 10 years—mostly in the out years.
- Carries a debt burden of \$15 trillion, amounting to more than six years of annual gross revenues. Fortunately, its lenders do not *currently* charge much interest on these loans.
- Has been generous in promising unfunded pension and post-retirement medical care to its constituents, amounting to more than 20 years of annual revenues.
- Assumes a 3% real discount rate on the unfunded obligations, when long TIPS yields—as a truer discount factor—are not even half that. If we use the TIPS yields, these unfunded obligations consume well over 30 years of “company revenues.”

A company with these characteristics, not yet in default, would be in the lowest non-default rating category available—the junkiest of the junk bonds—a C. So, why all the fuss about a downgrade to AA+? It was inevitable.

This relatively small inevitability will be followed by other, substantially more significant, inevitabilities if we don't tackle the tough issues now.¹ Any high-yield manager will tell you C-rated companies do not stay C for long. The company either gets its act together pronto or goes into default.

Deficit Reduction: Inevitable

The deficit must be reduced. It's inevitable, as status quo is unsustainable. We must, and therefore we will, have a balanced budget in 10 years. We have no choice. We do, at least for now, have choices in how to tackle the deficit. Do we reduce the deficit deliberately, or do we wait until the lenders say “no mas,” cutting up our credit cards?² Consider four alternate paths:

- Eliminate the deficit immediately by cutting 40% of all government spending, eviscerating all spending programs including entitlements, *and watch 11% of our GDP evaporate instantly*. We know that the private sector eventually steps in, so subsequent GDP growth can be quite splendid (see our *Fundamentals* from April 2011).³ But, first, we take the 11% hit. Of course, this 11% of GDP is *phony* GDP: it is pure debt-financed consumption. Still, neither party wants to be blamed for an abrupt 11% drop in GDP, no matter how impressive the subsequent recovery.
- Eliminate the deficit immediately by boosting all tax rates by about two-thirds, and hope that the economy doesn't collapse as a result. This option doesn't permit the private sector to resume its role as the primary growth engine for the economy. So any GDP hit is probably both real and lasting.⁴



- Trim the deficit from the 4% average since our last surplus in 2001 to 1% per year for 10 years.⁵ Of course, a smaller government might free the private sector to pick up the slack, so GDP growth might well be unaffected. But, under the static accounting of the Congressional Budget Office, *this approach reduces future GDP growth by 1% to 2% per year until our budget is balanced. As a result, our debt soars to about 150% of GDP.*
- Continue the game of kick the can until no lender wants to buy our debt because they know our bonds are “certificates of confiscation.”⁶ We know the consequences, from countless examples drawn from history, not to mention current examples in Zimbabwe, Greece, Ireland, Spain, and Portugal. The depression is deep and the geopolitical consequences are dangerous.

Reducing the deficit aggressively requires political courage something sadly lacking in recent weeks and in the immediate aftermath of the downgrade. But there’s a decent chance that the daunting consequences of this path may instill political courage—eventually. The evidence of Japan, Western Europe, and recent U.S. politics is not heartening. But the examples of Australia, New Zealand, and Canada all show that a sensible outcome is possible. Perhaps our electorate will step up and say “no mas” before our creditors force the issue.

Entitlement Changes: Inevitable

One of the big inevitabilities is restructuring of entitlements. The current entitlement promises cannot be honored; the resources to do so are simply unavailable, not to mention the ethical implications of saddling our children and grandchildren with obligations that we promised to ourselves, failed to fund, and failed to consult them on.

Let’s roll the clock forward 10 years. Remember, demographics won’t help us. Some 60% of the baby boom will be retired and there will be far fewer workers to support them (us).

So, what might our entitlements look like? Given the first inevitability (a balanced budget), entitlements must—and therefore will—pay their own way, with the “unfunded liability” gone, *regardless of who we elect in the next 10 years.* How do we get there? Here are some possibilities:⁷

- Eligibility at 70, not 66 or 67 for the boomers. Eventually this might be indexed to 90% of life expectancy, so we don’t have to keep fiddling with the deal.
- Social Security benefits trimmed by 20%. Perhaps this is accomplished by taxing all income earned by Social Security recipients other than their Social Security benefits at the maximum marginal rate. If a retiree’s outside income is more than about \$75K, they would presumably defer their enrollment in Social Security for as long as possible to continue to enjoy sliding marginal tax rates. By the way, such a scheme has the added benefit of eliminating the illusion of paying Social Security tax to earn Social Security benefits. In effect, Social Security will be viewed as a welfare program, not a Ponzi scheme.
- Medicare rationing. Perhaps this is accomplished by adding a lifetime limit, after which you (individually or with insurance) pay the rest. This creates cautious consumers less willing to spend their kids’ money willy-nilly.
- Medicare cost sharing. Wealthier individuals share more of the cost through a sliding scale that kicks in at a minimum net worth. Private insurance can fill the gap for those willing to pay for it.
- Merge Medicare and Medicaid. With rationing and cost sharing programs applied uniformly, there is no need for two programs.



In 10 years this is where we *must* (and therefore will) be, give or take some big uncertainty on the details. Folks who expect this will be ready for it.

Conclusion

The downgrade on Friday was the first inevitability to fall. Fortunately, a rating is, as we heard repeatedly in the award winning documentary *Inside Job*, just an “opinion,” an often lagging one at that. But there are bigger near certainties on the horizon with far more powerful implications. These inevitabilities are disconcerting, even disturbing. But, *they are inevitable*. Forewarned is forearmed.

With government sponsored post-retirement safety nets increasingly looking not so safe, the implications for U.S. retirement assets are vast. According to the Investment Company Institute, the U.S. retirement market stood at \$18 trillion at the end of the first quarter 2011, or 37% of household net worth. This pool of assets will soon be asked to do much, much more. Unfortunately, this greater load sharing comes at a time when capital markets are priced to deliver shockingly anemic returns.

But we can start planning for the burden now. We need to take better care of ourselves by mixing in an occasional salad and morning workout. We need to set aside greater amounts and start planning for sustainable distributions and post-retirement medical insurance. Pension fiduciaries need to understand that participants will increasingly view their payouts as their first and primary form of income. Advisors and financial planners need to assist their clients in accepting a greater degree of responsibility for their golden years and get “real” on likely market results between now and then. 401(k) plans need to develop cost effective one-stop accumulation (i.e., target date funds) and decumulation vehicles (i.e., managed payout funds).

It is much easier to invest successfully, not to mention plan for our future, if we accept inevitabilities, rather than rejecting them, ignoring them, or trying to imagine work-arounds. This frees us to examine the “path of least resistance”—the most likely path from where we are to where we must be—and to explore the consequences, on us, on our lives, on our future prospects, and on our investments.

Endnotes

1. “Inevitabilities” are perhaps better described as near-inevitable. The world is uncertain, and other paths may exist, though we think alternatives are unlikely and dangerous to rely upon.
2. “No Mas” literally translated from Spanish as “no more” was most infamously used during a 1980 prize fight when Roberto Duran uttered the phrase to prematurely stop his bout with Sugar Ray Leonard in the 8th round before things got out of hand. We can only hope holders of U.S. debt are more willing to take a longer beating than the former Panamanian champ!
3. “Does Unreal GDP Drive Our Policy Choices?,” *Fundamentals*, April 2011.
4. Of course, these first two options are not either–or. A blend is also possible, but, as with vast spending cuts or vast tax increases, the immediate impact on the GDP is more than any politician is likely to choose to risk.
5. A 1% deficit is reasonably harmless, even in a “new normal” of 1% to 2% real GDP growth. So, my references to a “balanced budget” would allow for deficits, as long as they’re smaller than real GDP growth.
6. In the 1960s and 1970s, as inflation ratcheted ever higher, bonds acquired this label. It is once again apt.
7. I should note that we’re acknowledging these very likely possibilities, not advocating any particular outcome.

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