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In case of bankruptcy . . .

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If you knew the U.S. government was going bankrupt primarily because of spending on Social Security and Medicare, and the only solutions were the following, which one would you pick?

(1) Doubling individual and corporate income tax rates.

(2) Immediately cutting Social Security and Medicare benefits by two-thirds.

(3) Immediately cutting all federal discretionary spending (including defense) by 143 percent.

(4) Reforming Social Security and Medicare by moving from the current defined benefit plans to a program of individual investment accounts, like the current 401(k) and Medical Savings Account (MSA) plans.

Many leading economists of the political right and left have concluded the U.S. government will not be able to pay its creditors, including its current and future retirees, the full value of promised benefits, unless current policies are radically changed. (Most recently, Professor Laurence J. Kotlikoff in a paper for the Federal Reserve Bank of St. Louis, and Lawrence A. Hunter, former chief of staff for the Joint Economic Committee in a paper for the Institute of Policy Innovation, using different models, each concluded the U.S. is on its way to bankruptcy. The above alternative solutions were taken from these papers.)

Simply, government spending, in particular Social Security and Medicare, is growing faster than real economic growth. Obviously, it is a mathematical truism that this trend cannot continue indefinitely -- and when something cannot continue forever, it will not.

When governments go bankrupt, they pay off their debts by running the printing presses, which results in high inflation and perhaps hyperinflation. Under the condition of bankruptcy/hyperinflation, everyone gets poorer, including both workers and retirees. Argentina is a good example of a country that has been going through bouts of bankruptcy. A century ago, it had the world's third-highest per capita income and was on par with the U.S. But Argentina now ranks about No. 70 in the world with a per capita income of only around $13,000 per year as contrasted with the U.S. and Ireland with per capita incomes of about $41,000 yearly.

Increasing the tax rates by the magnitude necessary would make U.S. tax rates even higher than most European nations, and lead to economic stagnation, or worse. The French, Germans and Italians are trying the high tax rate route, and it is not working. Cutting current Social Security and Medicare benefits would not be fair to those who are retired, or near retirement, and cutting other government spending by the necessary amount would not be politically acceptable.

When the AARP folks, or most Democrats and many Republicans in Congress, tell you the Social Security and Medicare problems can be solved by minor tweaks, they are either ignorant or lying. Most AARP members are at retirement age. If you look at the AARP position on Social Security and Medicare reform, you can only conclude these people don't really care about their grandchildren.

Fortunately, if Congress acts quickly, there is a relatively painless way out, which will avoid the U.S. going the way of Argentina (and France). It involves both tax and entitlement reforms. Tax reform means either moving to a sales tax or flat tax system in which taxes on capital are removed. Such reform will increase both capital and labor, thus increasing productivity growth. Entitlement reform means moving from the current pay-as-you-go defined *benefit* systems for Social Security and Medicare to defined *contribution* systems with individual retirement and medical accounts, as most private companies have been forced to do.

The transition to individual accounts will entail some transition costs that can be covered through some temporary increase in government borrowing and/or sales of government assets such as federal land (the federal government owns more than 40 percent of the land in the U.S.).

Serious and responsible people both right and left understand the national debate over the defined contribution plans should be about the size and the extent of government versus individual control. This debate is not happening -- to the necessary degree to get reform -- because most Americans still do not understand the magnitude of the problem (as shown by the polls). There is also no need to reduce the real promised benefits to current and near-retirees -- but only if Congress acts soon.

The Bush administration made a strategic mistake by failing to educate the American people to the nature and extent of the problem before launching its partial solution. Given the irresponsibility and the inability of much of the political class and media to explain the real problem and lead the country to the solution, private parties will have to do it. The only salvation is for well motivated individuals to invest the time and resources to do the necessary educational effort -- or in a few decades the U.S. will look like Argentina.

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