

Mitchell's Musings 9-29-14: The Forgotten Unfunded Liability

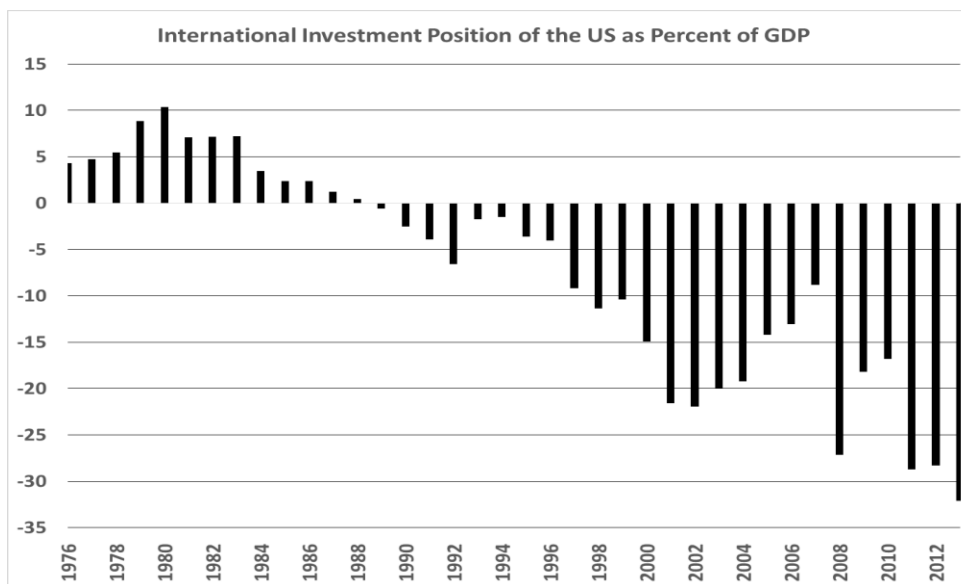
Daniel J.B. Mitchell

In recent years, there has been much discussion of unfunded liability. Usually, the targets of this concern are pension and social insurance programs such as Social Security, Medicare, and various state and local public pension plans. The concern is that even if these plans have assets in them at the moment, the projections are that the eventual liabilities exceed those assets and coming generations, therefore, will have to come up with the money to cover obligations that represent labor services in the past.

From time to time, I have had fun calculating the unfunded liabilities of the Pentagon (we are committed to national defense "forever" but we don't have assets on hand today to pay for that future commitment). I have even calculated the similar unfunded liability of my hometown Santa Monica's police department. (As in the Pentagon case, the city is committed to provide police protection to all inhabitants "forever" but there are no assets set aside today to pay for that commitment.) Suffice it to say, you get very big numbers, numbers sufficient to scare your average congressional representative or Santa Monica city council member.

There is a difference, however, between pension unfunded liabilities and future service liabilities. In the former case, we seek to have assets accumulated in the past that pay for past service, even though the actual payments are received by employees at some point in the future. In the case of promised future services (Pentagon, Santa Monica police), future taxpayers will have to pay only for services which they will benefit from in the future. In the underfunded pension case, future taxpayers are paying for the services provided for, but not paid for, by past taxpayers.

In short, according to the idea of matching services and paying for services over time, it is a Bad Thing to have people in the future pay for the consumption of folks in the past. So let's see if there is anywhere to be found an unfunded liability in which folks in the future must somehow pay for things in the past, apart from Social Security, Medicare, and public pensions.



As can be seen on the chart on the previous page, when you consider the US as a whole, you find that since 1980, we have tended to accumulate international assets (claims on the world) more slowly than we have accumulated liabilities. Whereas before the 1980s, our international liabilities generally grew more slowly than our international assets, afterwards, the reverse trend developed. Of course, there were periods of fluctuation in which the trend generalization did not hold, thanks to such things as movements in exchange rates. But the underlying trend is evident from the chart. In 1980, we had assets > liabilities of roughly 10% of GDP, we now have assets < liabilities of about one third of GDP. In the former period, we could in theory have “paid off” our gross international debt by selling assets and still had 10% of GDP in assets left over. Now, if we tried to “pay off” our gross liabilities, we would come up short after asset sales by about a third of GDP. That’s a lot.

Unless you think that we can go on increasing our net debt to the world forever (so there never will be a point where future folks will be paying for past consumption, you might be concerned by this forgotten unfunded liability now that you know. Of course, there is a comeback. Maybe our net borrowing has been directed toward accumulating capital assets which someday, somehow will produce the needed pay back. A visit to your local retail electronics store should disabuse you of the notion that the increase in debt is all going into capital goods. Flat screen TVs, iPhones, sure seem like consumption goods. Go to your local toy store and look at the country of origin of the products you find there. Sure seems like consumption goods there, too.

For that matter, go to your local Toyota, Kia, Volkswagen, Mercedes, or BMW dealer. We can argue over what exactly is a capital good. But your car, in the end, is more consumption than investment in the sense that it is unlikely to generate resources for the US to repay our net foreign debt.¹

When pensions are underfunded, their trustees often create a plan to achieve full funding over a period of time. Essentially, what is involved is first paying into the fund the “normal” cost of the plan (the amount that covers the incremental liability generated each year) and then setting up a schedule to amortize (pay off over time) the accumulated past unfunded liability. The analog to the normal cost in the case of net foreign debt is (roughly) the net export balance. If the US from now on kept its net export balance to zero, the unfunded liability would cease to increase since we would be paying for current consumption from the world (imports) with sales to the world (exports). But moving to a zero balance of net exports would not pay off the accumulated past debt. To do that, we would need to run a net export *surplus*. The bigger the surplus, the faster we would retire net debt.

Our net export balance seems to be around -\$500 billion per annum. Our net debt is roughly 10 times that amount. (The figures vary from year to year.) So to pay off the net debt in ten years, we would have to run a net export surplus of around +\$500 billion per annum. So the total “swing” from the current deficit situation to the 10-year payoff plan would be about a trillion dollars. In effect, the swing would be a stimulus of about 5-6% of GDP, with a fair amount coming from added manufacturing production.

¹Yes, I know; in principle if I buy a Toyota instead of a Ford, you could say that I freed up US capacity to turn out that hypothetical capital good which will someday pay off that debt. There are a lot of formerly employed auto workers who might not have experienced it quite that way.

There are ways to make it happen. All that is needed is for the folks who are so upset about the unfunded liability of programs such as Social Security to become equally concerned about the hidden unfunded liability embedded in international commerce.