

MY SOLUTION TO THE DEBT CRISIS: COMPOUND INTEREST - THE EIGHTH WONDER OF THE WORLD (*THE MONEY MARATHON - AUGUST 2011*)

The debt crisis has been avoided, at least for a while, based on a last-minute deal agreed to by both parties. However, the underlining issue, our federal debt, remains a major issue. So, I have a long term solution to the problem.

First, what is the problem? The problem is we have a ballooning national debt of \$14.3 trillion that is 100% of our Gross Domestic Product. The debt has exploded by \$4 trillion in the last three years and is projected to grow with another \$8 to \$10 trillion expected in deficits by 2021, clearly unsustainable amounts. Even worse, unfunded liabilities of Social Security and Medicare are over \$60 trillion. That means that the expense is growing much faster than the revenue. By my calculation, the national debt is \$47,000 per person or \$120,000 per household in the United States. If every individual wrote a check today for \$47,000 payable to the government today (\$200,000 for a family of four), we would clear off the national debt totally - at least for now. This is probably not going to happen.

If you look back historically, you will see that we didn't get here overnight. We have been overpromising and overspending for decades, and certainly much more recently. According to the Wall Street Journal (*The Road to a Downgrade-July 28,2011*), entitlements and benefit payments (Social Security, Medicare, Medicaid, food stamps, unemployment insurance and others are now 66% of our budget, up from 28% in 1965. Over time, politicians have promised more and more benefits that were unaffordable for the long term. As one example, Medicaid in inflation adjusted dollars cost \$4 billion in 1966 and now cost \$243 billion (an apples to apples comparison). While these programs have been expanding the number of people not paying any federal income taxes has increased dramatically. Since 1986 the percentage of people not paying any federal income tax has increased from 18% to 51% today.

What can be the results of this debt issue? Again, according to the Wall Street Journal (*The Debt Ceiling and the Pursuit of Happiness* written by Arthur Brooks, July 25, 2011), there are two possible outcomes. One outcome is that with a huge increase in taxes on the very few, paying to support a growing majority that is "completely invested in the welfare state" that "at some very high level of taxation and government spending " the situation stabilizes-"(think Sweden)". The other possible outcome is that the welfare state collapses under its own weight, creditors lose confidence in our debt and our currency and stop lending us money and we basically go broke (think Greece).

According to Brooks, we need to explain the need to solve our debt issue and other issues with the growth of our economy by explaining to the public why these issues are important in terms of what is important to us as Americans, like "self realization, meritocratic fairness, and the promise of a better future." Questions of lower taxes for entrepreneurs, economic growth, and entitlement reform have to

be explained in terms of our belief in “earned success”, increasing “individual opportunity” and because “it’s wrong to steal from our children.”

With that background, here is my solution to the debt crisis. As many of you know, I have spent many years talking to students and young adults about the importance of saving early in life and the power of compound interest. That passion for this subject prompted my first book, *“Making a Million with Only \$2000-Every Young Person Can Do It.”* In the book, I show how small amounts of money can compound to huge amounts using the power of compound interest. Albert Einstein purported to have said that compound interest was the most important mathematical concept he ever learned. This is the guy who came up with $E=MC^2$ and special and general relativity. The point is that compounding of money can work very powerfully for you or even against you - like now. Simply, here is how we stop it from working against us. According to the figures from the budget office, in 2011, our revenues are projected to be \$2.173 trillion dollars and our expenses are projected to be \$3.818 trillion for a deficit of \$1.645 trillion. The government has projected a budget for the next five years through 2016. Based on increasing revenue each year when the economy recovers, and the expectation of taking off the Bush tax cuts in a couple of years, they project revenue of \$3.819 trillion in 2016. Their numbers still show a huge deficit in 2016 with expenses rising to \$4.467 trillion in 2016 which would still mean a substantial deficit. If instead of lowering expenses, we froze expenses at current levels while revenues grew according to income projections (a compounding of revenue so to speak without compounding expenses) we could balance the budget in 5 years. Now this sounds easy, and really it is, but it would mean that budgets, departments and entitlements would be frozen at current levels. So if a person received a \$2000 monthly Social Security check it would not increase for that period of time. However, it wouldn’t decrease or be eliminated either. Basically, this solution uses compounding of revenue while freezing the compounding of expenses for a few years to balance the budget.

This solution is a simple solution, but not the best solution. The best solution would be for the government to do what many business do and cost justify each department each year in somewhat of a zero based budget. A department that was cost inefficient would be eliminated or reduced based on a periodic evaluation. Entitlements would be made financially sound by adjusting their annual rate of increase with some tweaking. With Social Security, a slight increase in the age of payout, a full taxation of the benefits for the wealthy, and changing the indexing to inflation rather than wage increases would make it solvent for the long run. Medicaid payments from the government could be turned over to each State in a lump sum annually which would also lower the rate of increase. Medicare would be the most difficult because it most likely requires a change in structure that lowers the rate of increase.

The key to both solutions is to lower the rate of increase of expenses so that compounding working against us slows. The good news from all of this is that the country is finally having serious discussion on our national debt. We are recognizing that in the long run how our country manages its finances is not much different from how an individual manages his own personal finances.

[Remember every investor's situation is unique and it is important to review your specific situation with a financial professional.]

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