The CONTRARIAN'S view

DEBT OVERHANG

January 17, 1993

If you've been subscribing to The Contrarian's View for any length of time, you know that I have not been very cheerful.... OK, let's be honest, I've been downright gloomy.... about economic prospects for the next two years. I've suggested that we are at a major turning point in interest rates.... that they are about to embark on a multi-year rise; inflation will return, probably virulently; that a major bear market in stocks lies directly ahead.... probably a "granddaddy" bear market, like that of 1973-74, in which investors bail out of mutual funds en masse, and the portfolio managers dump stocks wholesale to meet redemptions; and that the chances of a financial "accident" occurring in the next two years are as great as they've been since 1929. Why, you might rightfully ask, am I so pessimistic when stocks have been making new highs, the economy appears to be recovering, interest rates are as low as they've been in twenty years, and inflation appears to be under control?

My answer lies in the fact that for almost thirty years our federal government has consistently spent more than it has raised in taxes and fees, with some of the difference being made up with printing-press money, but with most of the difference being borrowed. Now the federal debt is so large, and the interest being paid on it so burdensome, that eventually the Feds will run out of options to keep the government running.... except to monetize the debt (hyperinflation), raise taxes sharply (kills the economy), or default on the debt (also kills the economy).... or (perish the thought!), cut way back on spending, especially on "entitlements" benefits.

It was Lyndon Johnson who started the process back in the 1960s by promising us both "guns and butter".... waging both an expensive war in Vietnam, and launching "Great Society" entitlement programs. But it is only since the early 1970s, when Congress took away Richard Nixon's ability to "impound" (not spend) funds.... the closest thing we had to a presidential line-item-veto of the budget.... that spending and borrowing really went out of control. From 1974 to 1981, the annual budget deficit averaged about 8% of the accumulated federal debt. In the middle years of Ronald Reagan's presidency, during the "supply-side" silliness that prevailed the time, it bulged, peaking at 15% of the federal debt in 1983. In the past seven years the annual budget deficit has "settled down" to about 7% of the accumulated national debt.

Well, that sounds pretty good.... budget deficits are only 7% of the debt and maybe are declining..... seems like we're gaining control of the situation.... until you realize what this really means: The federal debt is growing at a compound annual rate of 7% AFTER adjusting for inflation.... in real (inflation-adjusted) terms, this means the debt, and the interest paid on it, will double every ten years.

Meanwhile, if historical trends persist, the economy will continue to grow at 3% per year, which has been the average long-term growth rate for the U.S. This 4% gap between real growth of the economy and the real (unreal?) growth of our national debt,

annually compounded, if left unchecked will eventually render our government incapabable of meeting its obligations (in other words, bankrupt). In the table that follows, I've assumed what I consider to be an optimistic scenario: The economy continues to grow at a 3% pace, and federal revenues keep abreast.... that is, taxes are neither increased or cut; interest rates remain low, so the national debt continues to compound at only a 7% rate (the gap between growth of federal income and debt stays constant at 4%); and no new budget-busting entitlement programs (such as a national health-care system) are voted in. All dollar figures shown are adjusted for inflation, and are in billions of 1992 dollars:

	Federal Debt	Annual Deficit	Federal Income	Deficit As % of Income
FY1992	$ 4,135	$ 290	$ 1,075	27%
1993	4,425	310	1,107	28%
1994	4,735	332	1,140	29%
1995	5,067	355	1,174	30%
1996	5,422	380	1,209	31%
1997	5,802	406	1,246	33%
1998	6,208	435	1,283	34%
1999	6,643	465	1,322	35%
2000	7,108	498	1,361	37%

Coincidentally, in 1992 the interest paid on the federal debt was almost the same as the budget deficit: $290 billion. In other words, if there were no federal debt, the budget would have been in balance. Also coincidentally, the federal government is currently paying about 7% interest (on average) on its debt, the same as the debt-compounding rate. If both these trends persisted (unlikely, but I hypothesize it to make a point), by the year 2000 the interest paid on the debt would be almost half a trillion 1992 dollars.

The revenues raised from the individual income tax (the Form 1040 you fill out every spring) in fiscal year 1992 were about 45% of the total federal income, so about 60% of what people paid in taxes went just to pay interest on the national debt. If this table is an accurate projection of the future, and if individual income taxes continue at 45% of federal income, then in the year 2000 82% of all individual income taxes raised will go to pay interest on the national debt.

I say that the figures in the previous table are optimistic because they don't allow any margin for error. Suppose the economy doesn't grow at a 3% long-term rate, but the debt drag lowers the growth rate to 1% or 2%, with the trend punctuated by frequent recessions. Suppose the government per-versely raises income tax rates so high that revenues actually lag economic growth because so many people avoid (or evade) paying taxes at the higher rates. And most probably, suppose interest rates don't remain at current levels (lowest in twenty years!), but the government's need to borrow forces them higher. In the following table I've projected only one of these possibilities.... rising interest rates.... as it is the most likely to occur, and in my opinion, will occur. I've assumed nothing drastic here; just a gentle, half-percent per year rise in interest rates.... and as a consequence, a half-percent-per-year increase in the ratio of the annual deficit to the accumulated debt, for four years, until the annual deficit "stabilizes" at 9% of accumulated debt, which is the average since the early 1970s.

As in the previous table, all dollar figures are inflation-adjusted in billions of 1992 dollars:

	Federal Debt	Deficit As %/Debt	Annual Deficit	Federal Income	Deficit As % of Income
FY1992	$ 4,135	7.0%	$ 290	$ 1,075	27%
1993	4,425	7.5%	332	1,107	30%
1994	4,757	8.0%	381	1,140	33%
1995	5,138	8.5%	437	1,174	37%
1996	5,575	9.0%	502	1,209	42%
1997	6,077	9.0%	547	1,246	44%
1998	6,624	9.0%	596	1,283	46%
1999	7,220	9.0%	650	1,322	49%
2000	7,870	9.0%	708	1,361	52%

Under this scenario, which I feel is more realistic than the deficit-as-a-constant-7%-of-debt figures given in the first table, by the year 2000 116% of individual income taxes will be used to pay interest on the national debt.... in other words, ALL individual income taxes raised, plus ALL corporate and excise taxes (about 12% of federal income, if 1992 ratios prevail), plus 4% of

Socal Security payroll taxes. I doubt we would ever reach this level and still have a stable, low-inflation economy.... something must give first. Other countries which previously have travelled the route to bankruptcy we are now following fell apart when their deficits exceeded about half their revenues, so the year 2000 marks the "danger point" for us if we don't change course. To bring the situation to a more personal level, assume you have take-home pay of $50,000 per year, and you carry a $290,000 variable-rate mortgage on your home on which you make interest-only annual payments of $20,300 at a very favorable rate of 7%..... and the principal need never be repaid; you can always roll it over. Now, no banker in her right mind would write you a mortgage with these terms, because the bank would soon be out of business; but for the sake of the example, I'll assume you found a stupid bank. Your struggling existence depends on low interest rates; should your mortgage-loan rate rise to, say, 11%, your interest pay-ments would be $31,800, or almost two-thirds your income. That doesn't leave very much for your day-to-day living expenses. But this is the situation our government might well face only eight years from now.

You can see that the government has an enormous incentive to keep interest rates low, and especially to bring down long-term interest rates.... because the lower the rate of interest it pays on its debt, the more debt can be carried without apparent pain. We think of Federal Reserve chairman Alan Greenspan as an "inflation fighter"; but I think his actions are more a response to the government's financing needs in the absence of sound fiscal policy.... especially his forcing short-term interest rates to artificially-low levels, so the government could quickly refinance much of the debt coming due at cheap rates. After all, if he were able bring the government's overall debt-financing cost down from 7% to 5% (without killing off the economy in the process), which would lower the "gap" from 4% to 2% in the first table above, it might buy the government another decade of time to get its affairs in order. And the last thing we can afford is a robust economic recovery, as the financing needs of business in competition with government would quickly drive interest rates (and the deficit) higher.... otherwise, why does the Fed talk of further monetary tightening as soon as the economy shows the slightest inkling of recovering from its present comatose state? Orwell's 1984 has truly arrived; less is more.

I would surmise that Greenspan has decided that if the country is going to spend itself into bankruptcy, we should go bankrupt honestly rather than by the hyperinflation route. (Go directly to jail; do not pass GO; do not print $200 trillion.) But current efforts to keep interest rates artificially low create an unstable condition, because excessive borrowing and spending ultimately always lead to higher interest rates, both nominal and real. The longer rates are kept low, the more quickly they will rise when finally torn free, feeding on themselves (because the government MUST pay interest or default) in an interest-rate spiral. So, my second table above may also be overly optimistic because it assumes only a gradual rise in interest rates, and assumes nothing else goes wrong.... no recessions, not getting sucked up into any more expensive wars (even while Saddam Hussein continues to be a problem, and Iran prepares to dominate the Muslim mideast), no acceleration in the deficit-to-debt ratio beyond 9%.

In real life we have Bill Clinton about to charge off in the wrong direction on his white steed Infrastructure. One of the proposals under consideration is to loosen bank restrictions to free up $89 billion more in business lending. This is $89 billion that won't be lent back to the government, thereby enlarging the deficit by that amount. The resulting stimulus in the M2 money supply should awaken businesses and their borrowing needs enough for interest rates to nudge upward about 1% IF

the government weren't a heavy borrower. But in today's economy direct government borrowing, plus government-gauaranteed and government-supported borrowing, accounts for about 85% of all monies borrowed (the private sector has the other 15%), giving about a 3:1 "multiplier" effect.... so short-term interest rates could quickly climb about 3% on very modest stimulus, in spite of the Fed's desire to keep them low. Also, if I remember correctly, loose bank regulations and insufficient reserves are what led to the taxpayer bailout of the savings and loans; the current problem with banks is not that capital-reserve requirements are too high, but that the regulators were first, too late, then, too heavyhanded, in disposing of the assets of marginal instutions, and probably put many banks out of business that shouldn't have been and thoroughly frightened the rest.

If Sir Bill unleashes his bank-lending stimulus, plus a modest "economic recovery" spending program, plus new public spending on high-tech "infrastructure", plus who-knows-how-much on health-care "reform", public and private borrowing needs could easily spike interest rates upward in a relatively short time.... like, double within two years. Then the "danger point" year would advance to 1996 or 1997; the economy would be under severe strain by 1995; and the stock market, which frequently leads long-term low points by about two years, would begin to discount the trouble in.... you guessed it!.... 1993.

Additionally, the federal government's current "official" $4.135 trillion debt figure somewhat understates the true size of the debt. An additional trillion dollars has been borrowed from Social Security "trust" funds and replaced with nonmarketable Treasury securities.... essentially, government IOUs.... and spent. The federal government also guarantees an additional $3 trillion in "nongovernment" debt, such as federally-assisted home mortgages, student loans, and so forth, some portion of which will certainly run into repayment difficulties when interest rates rise.

I still haven't figured out what worthwhile things the government has done with all of the money it has borrowed. Lyndon Johnson wasted a wad on the Vietnam war; the government's "war on poverty" seems to have created a permanent welfare class, complete with drug subculture.... which has led to another costly and ineffective "war on drugs"; and a bundle has been soaked up by expensive and destructive regulation, such as the energy price controls of the late 1970s. Perhaps the only effort where we've gotten a good return on the money spent was Ronald Reagan's "star wars" effort to bankrupt the former Soviet Union in a technological arms race. This was spectacularly successful, but we have become so impoverished in the effort that we now can't afford to send money to Russia to help vault it into the capitalist "new era". (Most financial aid to eastern Europe is being provided by Germany, which will reap the benefits in the next century.)

I also haven't figured out why nobody in Washington appears to be paying any serious attention to the debt overhang problem. Maybe Congress is so used to exempting itself from laws it passes for us peons to observe, that it believes it is also above the laws of nature. But the mathematics of compounding is immutable: Unless we change course soon, there is no question but that our government will be bankrupt; we can only argue when. Maybe the politicians figure they won't be around when the s--t hits the fan; by then, it will be somebody else's problem. Maybe the economics of deficit spending is so depressing they close their eyes and pretend the problem isn't there, hoping it will go away. At least the American electorate isn't as easily fooled; a fifth of the voters last November felt that continuing massive deficits were so damaging to the nation's future that they voted for Ross Perot for president, in spite of his eccentricities.

(Want to place any bets that good ol' Ross will be back again in 1996, stronger than ever?)

I also haven't figured out why we all voted for the turkeys who have done this bad thing to us. There is no free lunch; why did we let ourselves be fooled into thinking there was?

I see three possible outcomes as we continue on our present course. The first, which I think is the least likely, is a "credit meltdown" occurring in the late 1990s.... 1996 or 1997, most probably. As we enter the middle 1990s, with President Clinton's and Congress' welfare spending and higher marginal tax rates, the economy is stagnant or in recession, interest rates are climbing sharply and the deficit is careening out of control. Interest paid on the debt now consumes 93% of the government's revenues, and the government borrows to continue providing services, the cost of which is now 161% of revenues. The national debt is now at 110% of gross domestic product and compounding at the rate of 14% per year, and foreign lenders are getting very nervous, because they doubt that the U.S. can continue to make interest payments on this overwhelming debt.... a default appears inevitable. One sunny spring morning in 1996, a European central banker announces that his country will no longer support the dollar, which had been steadily declining on world currency-exchange markets for months. This is the signal the world hoped against hope would never come.... the U.S. is bankrupt.... and panic ensues. In three hours computer-generated futures selling drives the dollar 40% lower on foreign exchanges, and with it the prices of Treasury securities, before the markets are shut down by regulators.

Next day, several major money-center banks find that insolvency threatens as they struggle to repay overnight loans to foreign lenders who are clamoring for their cash.... in their own currencies, not in dollars. Quickly, the banks begin calling in domestic loans for cash to buy foreign currencies before the dollar plummets further in value. By midafternoon the President has imposed an emergency freeze on all domestic loan calls, and has directed the Federal Reserve to provide to foreign central banks whatever funds are needed to cover foreign loan redemptions (through their banks, not ours). U.S. stock and bond markets fail to open because the crush of sell orders has driven projected prices well below what would be permitted by the trading "collars". The public, sensing danger, causes a run on ATM machines as they withdraw cash up to their maximum daily limits; by 2 PM all banks have disabled their ATM systems, but most of the machines were already out of cash anyway. By 4 PM, when the President directs all banks to close their doors for the day virtually every bank in the country is insolvent on paper.

The rest of the week sees a bank holiday, and stock, bond and commodities markets remain closed. But on foreign markets, which have reopened, Treasury securities trade at 10% to 30% of their pre-panic prices. The following Monday, the banks reopen and customers wanting cash are paid in "scrip" (bank paper), which can be redeemed for cash as soon as government printing presses can crank out enough to meet demand. Checks will not be honored; all use of credit cards is prohibited.

This is the worst of the crisis; but in the ensuing weeks, as the liquidation of assets behind callable loans begins, prices drop sharply, and the country rapidly slides into depression......

I say that this outcome is the least likely because it does not include any monetizing of the deficit/debt my the Federal Reserve; the path to bankruptcy ends in sudden panic with the Fed still hanging tight. I think it is much more realistic to assume that when the immovable compounding of debt overwhelms the intransigence of the Federal Reserve, the Fed will blink. After

all, the mathematics of compound interest cannot be changed; the only alternative is default, but people (even Greenspan) can be replaced.

So a more likely outcome is that a large chunk of the debt will be inflated away, leading to an inflation-induced boom preceding a deflationary collapse. It is spring of 1995; for two years the economy has been struggling along under the weight of steadily-increasing interest rates. The Fed has been trying to steer a middle course, printing enough money to keep the economy above water, but not so much that inflation gets out of hand. But now M2 is growing at a rate greater than the 9.5% per year Fed upper target, and a strange kind of inflation is underway; the values of assets continue to decline in real terms, as they have been since 1989.... houses and commercial real estate, businesses, farmland, natural resources (except precious metals, which are holding up quite well after a 1992 bear-market bottom).... but the cost of food, manufactured goods (especially those made mostly overseas) and services is escalating way beyond the ability of most people's incomes to keep up. Stocks have been in a bear market for two-plus years, as corporate profits have vanished in the increasingly inflationary environment; people are instead buying coins, jewelry, antiques, art.... any kind of collectible that looks like it will appreciate faster than inflation. The $900 billion annual deficit is now more than half the government's intake of $1.7 trillion; and because entitlements are indexed to inflation, and because investors expect higher inflation ahead, the government is paying 16.3% interest on 20-year bonds, causing the deficit to spiral out of control.

The dollar has been sinking on foreign-exchange markets for almost two years now.... since mid-1993.... and it has recently been able to maintain parity with the deutschemark ($1 = DM 1) only through massive intervention by the Bundesbank (the German central bank). On a fine day in May (at least, the weather is fine!), as the Treasury's quarterly bond-refunding is getting underway, the head of Germany's central bank, speaking for the entire European community of nations, states that Germany will no longer support the dollar until the United States puts its fiscal affairs in order. The dollar quickly collapses on the world's exchanges to DM 0.72, and suddenly, there are no buyers for the Treasury bonds. Well, the Treasury can't call off the auction because the government MUST roll over the debt coming due, or default; but the only bids coming in are from the Japanese at a yield equivalent of 24%.... so in steps the Federal Reserve, and it buys the entire remaining Treasury offering (about 85% of it) at par for its own account.

This action is clear for all to see; the Federal Reserve has changed its policy, and will now monetize all Treasury debt that cannot be auctioned in the open market at "reasonable" rates of interest. In New York, the bond market tanks, but stocks take off like a bolt, rising 15% the next day alone, and 32% for the week. Inflation is now official (rather than unspoken) government policy; the name of the game for survival is to borrow, and pay back with cheaper dollars. The economy picks up, for awhile, as entire empires are built by new entrepreneurs on borrowed money; although the quality of goods manufactured and productivity decline, and crime rises, as people devote an increasing amount of time and energy trying to stay ahead of inflation.... now at 8% per month, and still rising.... instead of making an honest living.

By the summer of 1996 inflation is running at 30% per month, and the creditors of America.... largely middle-class savers and retirees on pensions.... have been wiped out by the inflation. They now swell the welfare rolls, as the government is the only source of income that keeps pace with the price increases. Tax collections have broken down; lawlessness is prevalent, and people are prisoners in their homes at

night. But there is hope; the voters are furious, and in the fall elections Ross Perot's America First party captures 93% of the seats in Congress and Perot himself is elected president virtually by acclamation. In early 1997 the Perot government freezes government spending at current levels, drastically cuts welfare benefits and throws most recipients off the dole, and issues new dollars, backed by Fort Knox gold and interchangeable with newly-minted gold and silver coins and convertible for a brief period at $N1 for 1200 old dollars. The old Treasury debt is replaced with new notes, also at a 1-for-1200 ratio, whose interest is payable either in new dollars or (to foreign holders) in gold bullion.

Inflation stops dead in its tracks, and the economy stabilizes at a depressed level, but the damage has been done. The middle-class savers, especially retirees, were wiped out, while the people living on borrowed money ultimately came through OK (at least, better than most everybody else). The United States enters the 21st century as a maligned, discredited banana republic: The world's only remaining superpower has died......

You will note that in both of these hypothetical outcomes I have projected, the end comes rather quickly, and this is an important point. How, you may well ask, can I project such chaos when at the moment things appear to be quite normal, and look like they will continue that way indefinitely? By way of analogy, let me offer up the recent history of IBM. IBM has been having difficulty maintaining market share for several years, but in spite of periodic restructurings it seemed that the company would continue to be profitable and that the dividend was safe; after all, IBM's corporate managers are among the best in the world, and it appeared to all they knew how to adjust to change. Then in the fall of 1992, IBM said its computer mainframe markets were collapsing, which is exactly what happened to the stock; it cratered. And why? Because it became clear to all (especially to the analysts, who were caught flatfooted) that IBM management had lost control of IBM's destiny, and whatever it had been doing to regain control to date was wrong, or was insufficient. But the ILLUSION of being firmly in control had kept the stock afloat until the illusion was shattered.

And that's the way it is with our federal government.... The president, Federal Reserve, Treasury and even Congress offer the ILLUSION of being in control of the economy when in reality they are rapidly losing control.... indeed, have lost control.... of the situation; only the illusion remains. The illusion is supported by the bond rating services, which continue to insist U.S. debt is top-quality when, if any private entity had the current debt overhang of the U.S. government, its bonds would long ago have been downgraded to junk status. (The government's greatest asset is the ability to tax its unwilling subjects; but even this capability has limitations.) Furthermore, the private economy relies on this illusion to stay healthy and continue on course; does anybody doubt that if it were suddenly apparent to everybody that the government is bankrupt, that a large part of private debt would also suddenly become uncollectible? It need not be a foreign central banker that shatters the illusion.... the shock could come from any source, but once the illusion is shattered, the markets, the economy.... and very possibly, the government.... would quickly unravel. This is why I have said that during the next two years, while the debt overhang becomes ever larger, we are highly vulnerable to a financial "accident".

Apocalyptic though this may seem, there is plenty of evidence that our economy is having trouble coping with the debt overhang, if we would only choose to open our eyes and see it. The oil depression of the 1980s (following the "recycling of petrodollars"); the savings-and-loan bailout; the riots in Los Angeles (the system is NOT working for some minorities); the commer-

cial real-estate depression and scattered insurance-company failures; the leveraged-buyout and junk-bond busts; Congress' creation, then repeal of catastrophic-illness insurance for the elderly..... these are not signs of an economy that is humming along smoothly, but of one that threatens to come apart at the seams; and certainly, of an economy which cannot absorb any more social-welfare programs.

Now, having offered up two possible outcomes to the debt crisis, let me say.... I don't think either one is how things are going to turn out. To understand why, we need to look at the other side.... who owns the government debt. Although too much debt is bad, the interest the government pays on it doesn't just disappear into the ether, never to be seen again; somebody is collecting that interest, and saving or spending it. About 15% of U.S. government debt is owned by foreigners; the rest is held domestically. Although statistics are hard to come by, I think we can safely say a good chunk of the debt is held by banks as supposedly-"riskless" reserves (in lieu of being lent to customers); another good chunk is held by the public, mostly as E and EE savings bonds; but I would say the largest chunk is held by state and local governments and insurance companies as reserves for pensions and retirement annuities, and by individuals in IRAs, 401(k) and similar tax-deferred retirement plans.

We also need to look at where the government spends its money: About 52% of the budget for fiscal year 1992 was spent on "entitlements"; this percentage creeps up a little bit each year, as this is the fastest-growing part of the budget (after interest paid on the debt). Now "entitlements" includes things like aid to welfare mothers, farm price supports, food stamps and the like, but the largest part is paid out as Social Security, Medicare and Medicaid benefits.... "welfare" for the middle class. At our behest, the government has promised us that it will "take care" of us.... all of us.... at least at some minimal level, in our golden years.

When Social Security was first implemented, it was a welfare program (although it certainly wasn't advertised as such at the time). Life expectancy was much less, and lucky was the person who lived long enough to collect full benefits at the government-mandated age 65. The program had 30 workers paying in for every person collecting benefits, and "premiums" (taxes) were 2% or less of each employee's pay. Social Security certainly saved many an elderly widow from being shipped off to the local poorhouse (which was the alternative available at the time), but a useful retirement plan it wasn't.

With the passage of time, life expectancy increased, and what was originally a welfare program mutated into a middle-class entitlement program, with many retirees collecting benefits for 20 years or more. The addition of Medicare and Medicaid in the 1960s met another real need.... to keep the elderly from descending into poverty from high medical expenses.... or to keep elderly folks from dying just because they couldn't afford medical care. As for many well-intentioned government programs, technology has raised the ante, because through the miracles of modern medicine people can overcome all sorts of "aging" diseases and live to ripe old ages.... at high cost.

In the "old" days, before the government "safety nets" for the aged were in place, people were expected to provide for their own retirement, or die while still working. If your resources ran out, you moved in with the kids, and they supported you 'til you died. Rarely was there anything left for the kids when you passed on.... more likely, they were financially (and emotionally) drained from caring for you in your final years. Only folks who had no close relatives still living wound up in the poorhouses.

Today we not only have "entitlement"

programs.... Social Security and Medicare.... whose benefits are (mostly) distributed without regard to financial need (i.e., everybody collects), but many families find that the government support systems actually encourage elderly parents to shed assets to their kids, then live on Social Security, Medicare/Medicaid and food stamps (with a little under-the-table help from the children) until it's time to be shipped off to the nursing home - at government expense.

So not only do we have, maybe, a third of our retirement income promised to us by the politicians, but many baby-boomers will find.... indeed, are plan-ning on... their parents leaving them good-sized estates at death. Not all elderly folks are well-off, of course, but as a class the retired are no longer poorer than most Americans.... they are better off.

In effect, the government is bankrupting the country (and indirectly, all of us) to support the largely-comfortable lives of current retirees, and to ensure even more comfortable retirements for the baby-boomers. (When Bill Clinton talks about "controlling" health-care costs, he's not referring to your company health-insurance plan, where presumably you have several competing choices and you can choose the benefits according to what you are willing to pay. What he really means is that the money the government is shelling out in medical care for the poor and elderly is busting the budget, and he means to bring it under control by fixing prices rather than explicitly cutting benefits.) This is especially so for the upper-middle-class, which has the means to take advantage of tax-deferred savings programs, such as IRAs and 401(k)s, to supplement the government programs.

If the government is not to go bankrupt, it needs to at least reach a "steady-state" growth rate of the national debt.... it should grow at a real rate of no more than 3% per year, to match the growth of the economy. That would still leave quite a debt overhang and interest bill to pay, but at least the problem wouldn't get worse. To close the 4% gap, it will have to go where the money is.... not to workers, because to increase their taxes would kill off the economy.... but to retirees and retirement plans, where there is a lot of money piled up, and where benefits are (from the government's point of view) much too generous at others' expense.

One step would be to raise sharply the age you must reach before you can collect Social Security and Medicare benefits, say to age 70.... which would keep people working longer and, ultimately, collecting less before death. That might solve the problem of how to pay the retiring baby-boomers their Social Security from the trillion-dollar "trust" fund surplus that really isn't there; but it doesn't solve the current cash-flow problem. For this, the government must turn to the incomes of present-day retireees to steal the money it needs.... and I think there are several ways it could do this.

The easiest.... and I think, the most likely.... would be to steal away your money at death, by sharply lowering the estate-tax exemption and by raising estate taxes (probably by eliminating the capital-gains forgiveness that occurs at death). Dead people don't vote; and this would certainly cut down on the massive transfer of wealth to the baby-boomers that otherwise will occur over the next two decades. (It provides a strong incentive for the elderly to give away their accumulated wealth while they're still alive.... which might not be such a bad thing, because the parents can enjoy seeing their children and grandchildren benefit from their largesse. I never did understand why some people hang onto every last nickel until they die, never knowing how their offspring benefit from their estates, and in some cases passing on their estates when the recipients are themselves too old or in too poor health to enjoy them to the fullest.)

We might also see substantial changes in laws affecting insurance.... an imputed "appreciation" portion of term and whole-life insurance could be made taxable at death; and the use of various kinds of insurance to pass on assets tax-free at death could be severely curtailed. Again, the government collects more when you die.... the only recourse you have is: Don't die! (Just kidding, folks.... last time I checked, death was still inevitable.)

Even these changes wouldn't be enough to solve the problem.... eventually, Congress would have to restrict Social Security benefits to current recipients. The most obvious way would be to make Social Security benefits fully taxable (just as all other retirement benefits are, the politicians will tell you). Currently, recipients between ages 65 and 72 lose $1 of Social Security payments for each $2 of earned income above a threshold; this could be extended to ALL kinds of income (including tax-exempt bond interest), not just wages and salaries. And finally, if the government perceives that you have done too well on your own, it could simply cut off all Social Security payments to retirees above a certain income level, and/or apply a "supertax" to private pension benefits. If the Social Security outlays could (through taxation) effectively be cut in half, "saving" the government about $200 billion in 1992 dollars, that would go a long way toward reducing the deficit; it should certainly close that 4% gap.

Because the Social Security system is a political "sacred cow", you can be sure the politicians won't do much until the country is at the brink of a crisis so plain to see that even they cannot ignore it. But given the choice between bankrupting the government and triggering a depression too horrible to imagine, or breaking its retirement "promise", I have no doubt that it's the promise that will go. Isn't this unfair, when you've been planning your life around a promise that will no longer be kept? Sure it is, but politicians are always making and breaking promises.... they even break them with retroactive legislation.... so it's completely in character for them. And even though it will be grossly unfair and it will be a bitter pill to swallow, we will swallow it, becase the alternatives are worse: We can accept having the government steal part of our retirement away in taxes, or have all of our savings wiped out in a hyperinflation or the value of our assets demolished in a vicious deflation. All choices make us poorer; which is the least painful?

Once the government's retirement promise is broken, the Social Security system will lose its middle-class support and will revert to its original function as a welfare system. The middle class, cheated out of much of its retirement benefits, will probably insist that Congress spread the pain around a little, so other welfare payments, especially to those who are not poor.... farm-price supports, for example, or funding for public radio and TV, or research grants, or maybe even food stamps.... will also be eliminated. As we enter shell-shocked into the 21st century, realizing that the party is finally over, a new Congress with a new sense of fiscal responsibility might actually start running budget surpluses and retiring some of that debt overhang.... and the country might not become a banana republic after all.

What does this mean for you, especially if you are a baby-boomer? First, I think you should expect to pay somewhat higher taxes as a worker.... mostly coming through the back door, as a reduction or elimination of income-tax deductions, or as an implied increase in income.... making health-care benefits taxable, for example. I think you should expect to fully fund your own retirement (don't expect to get any Social Security benefits), especially if you want to retire earlier than the government would like you to; and I think you should expect your retirement income to be fully taxable (beyond what you paid in), maybe in a tax superbracket. And if your parents are get-

ting along in years, ask for your money now.

There is a fourth possible outcome that I have not previously mentioned, because the chances of it happening range between zero, zilch and none: Congress sharply and immediately cuts spending, especially in entitlement programs, without raising taxes; in fact, it cuts the capital-gains tax to bring in more revenue.... and balances the budget. Fat chance, right?

Now I think it becomes clear why I am not too cheerful about the stock market's prospects during the next two years. Congress will, I think, take us right to the brink before doing something about the debt overhang.... hopefully, it will be in time.... and I think stocks will spend the next two years discounting the approaching crisis, and will be especially vulnerable to bad news because the economy's ability to absorb any unexpected shocks will be much reduced. The brightest outlook for stocks.... that of hyperinflation.... would bring us a roaring bull market in 1995, as people shed cash and bonds for anything with tangible value; the other outlooks call for subpar performance until..... one way or another..... government spending is finally brought under control. I feel at least a small part of your assets should be in precious-metals stocks.... highly-leveraged vehicles, such as the warrants of Atlas or Amax, or the long-term LEAPs of ASA, Homestake, or Placer Dome will do, as the cash outlay is small, but they will soar in value should a financial crisis strike and will provide excellent "insurance" for your portfolio in a time of distress.

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P.S. Have a Happy New Year.