Coming Fiscal Horror Show

BY STANLEY DRUCKENMILLER

America is "eating its seed corn" at the expense of future investment.

For the last forty years, American exceptionalism and innovation have been on display. America led the personal computing revolution, the development of the internet, the move to mobile and cloud, the blockchain, and we are leading in generative artificial intelligence. Indeed, the cover story of *The Economist* recently, "Riding High," documented the astonishing success of American capitalism over the last thirty years.

But continued delay in addressing the U.S. fiscal gap threatens a future of America not "riding high" but rather sinking into malaise and decay. Failure on the fiscal front will embolden autocracies in places like China and Russia, and tragically risk a lack of wealth to make sufficient investments to address existential crises like climate change, not to mention programs for the least well-off.

If nothing changes, pensions tomorrow will be a fraction of what they are today, and the government won't be able to pay for more than half of Americans' health care bills. In twenty to thirty years, there will be fewer young workers, many more seniors in need of support, with the starting point as the highest national debt in our history. Future seniors who believe they will have as comfortable a retirement as the current seniors do should think

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again. If young people believe that we will have the resources to fight climate change, think again. The numbers don't add up.

Here are some facts. The share of fiscal spending going to seniors has been growing dramatically since the 1960s when Medicaid and Medicare joined Social Security as federal entitlements. Today we spend six times more per senior than per child in the United States. Think Social Security versus education. Almost 60 percent of all our tax revenues are spent on seniors, and this trend is only starting. As Figure 1 shows, the gray boom is just getting under way. In ten years, spending on seniors will take 70 percent of all taxes. Effectively, with entitlements compounding away, everything else is squeezed.

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In this context, the fiscal recklessness of the last decade has been like watching a horror movie unfold. During the last decade, U.S. debt grew from $15 trillion to $31 trillion today, a level of indebtedness only comparable to that after World War II. And debt does not account for what the government has promised to pay for Social Security and Medicare. It actually assumes these payments will be zero. In the 1950s, this "off-the-book" debt was small because baby boomers were just being born. So actual debt was a reasonable measure of the country's indebtedness. Not anymore. There are credible estimates that if you assume the government will pay the same to seniors in the future as it is paying today, the present value of that debt approaches $200 trillion. That's trillion with a "T."

What makes the last ten years particularly horrific is that the United States has had some golden opportunities to reduce the fiscal gap ahead of the demographic storm that is coming. After World War I and World War II, the United States quickly repaid its debt by raising taxes and restricting spending. Contrast that with today. After the 2008 Great Financial Crisis but pre-covid (see Figure 2), when the economy boomed in 2018 and the unemployment rate hit a fifty-year low, and even under a Republican administration, the deficit could not go lower than 5 percent of GDP. And then post-covid, America had a booming economy where tax revenues were augmented by high inflation, nominal growth of over 10 percent, a tax revenue windfall from capital gains due to the tech boom, all with 3.5 percent unemployment. So, one may reasonably ask, how much bigger was the surplus relative to that during the tech boom in the late 1990s? Incredibly, the United States ran a *deficit* of over $1 trillion. Never in history has a booming economy produced a worse fiscal result. Never. Expect this trend to continue absent radical policy changes.

The entitlement arithmetic just doesn't work. Imagine asking yourself how much taxes need to be raised today to maintain the current magnitude of safety nets into the future. Economists call this a "fiscal gap" measure. Today that measure is 7.7 percent of GDP, up from 7.2 percent ten years ago. (See Figure 3.) This is equivalent to a 40 percent increase in all Federal taxes collected, or an immediate and permanent cut of 35 percent in federal spending. These are dreadful alternatives and still they are probably being underestimated. Faced by this magnitude of tax increases, investment would inevitably falter and growth would decline, making it almost impossible to maintain the size of current safety nets.

How ironic that France, with a fiscal gap of 2.3 percent, is already raising its retirement age to make it fairer to future generations. Meanwhile, in the United States, the only thing that Hillary Clinton, Joe Biden, and Donald Trump can agree on is that entitlements should never be touched. And waiting only makes the problem worse as

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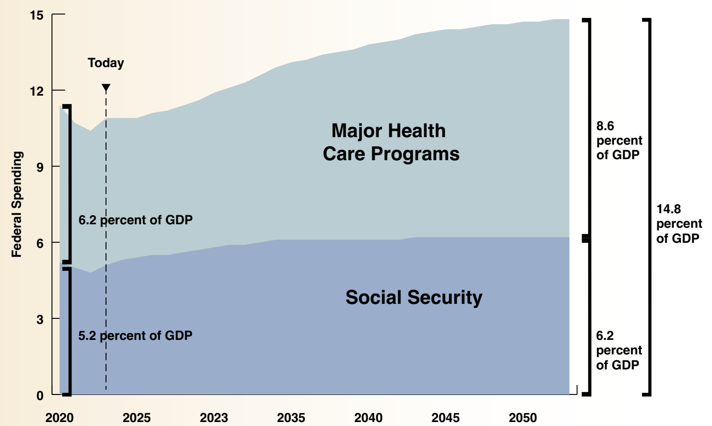
interest payments keep building (see Figure 4). For example, with interest rates at 5 percent, interest payments every year would be as big as the entire covid relief of 2020. As the chart shows, interest payments rise from 8 percent of outlays to 27 percent by 2050. This is a nightmare for future economic growth, investment and productivity, and, of course you, the future taxpayer.

It is time that Washington policymakers let go of the false pretense that cutting entitlements is a choice. It is not. Either they cut entitlements today or they will have to cut them much more tomorrow.

But there's more to the ugly story. Around fifteen years ago, the Federal Reserve simultaneously decided to start courting with asset bubbles. Then-Fed Chair Ben Bernanke embarked on QE2, another round of rapid expansion of the Fed's balance sheet. The chair feared a period like the 1930s and wanted to buy insurance to avoid deflation by not only keeping policy rates at zero but also by reducing long-term interest rates. At that time, Bernanke assured everyone this would be a temporary measure. He said, "Monetization would require a permanent increase in the money supply to pay the government's bills through money creation. What we're doing here is a temporary measure that will be reversed so that at the end of this process, the money supply will be normalized, the Fed's balance sheet will be normalized, and there will be no permanent increase, either in money outstanding or in the Fed's balance sheet."

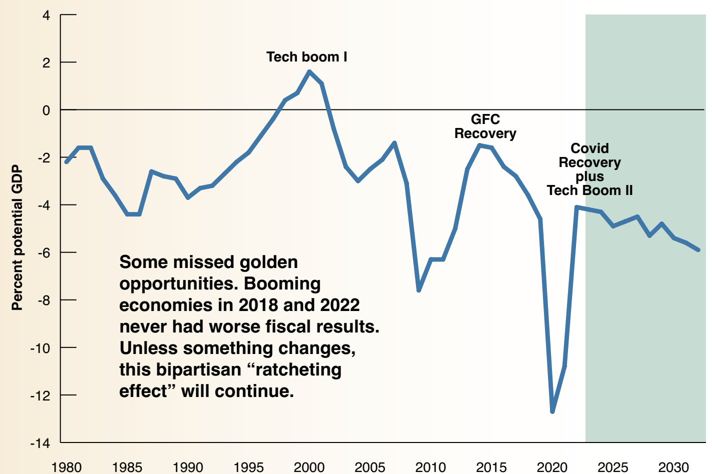
Since then, and despite these confident words and several periods of strong growth with very high inflation, the Fed never felt the need to meaningfully reduce its balance

Figure 1 The Coming Demographic Storm



Sources: Congressional Budget Office, June 2023, *Long-Term Budget Outlook.*

Figure 2 U.S. Cyclically Adjusted Fiscal Balance



Source: Congressional Budget Office.

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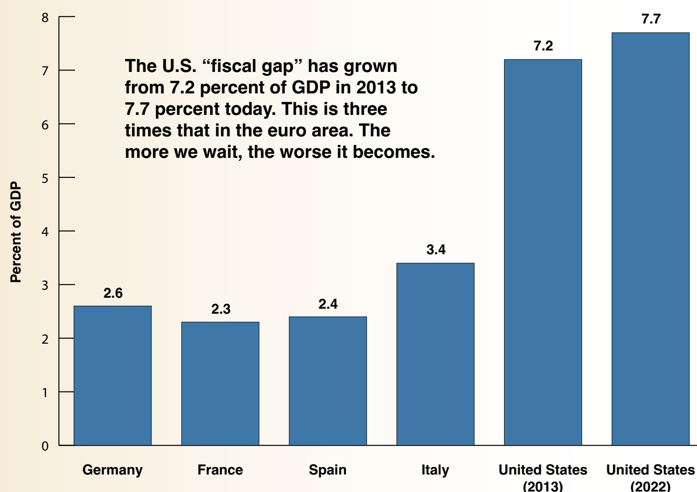
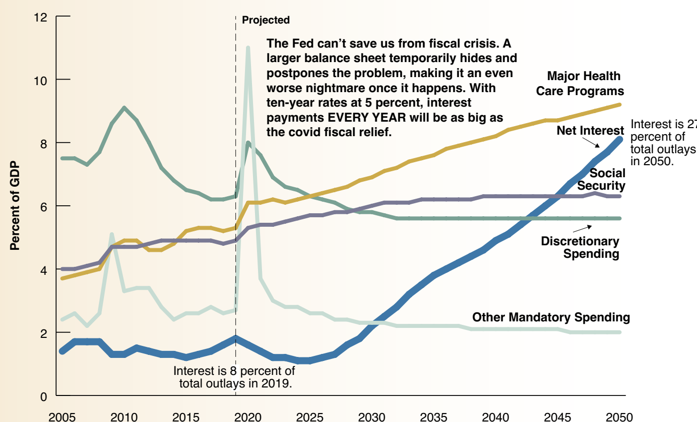
Figure 3 Required Structural Deficit Adjustment



Source: European Commission.

Figure 4 Federal Spending



Source: Congressional Budget Office, *Long-Term Budget Outlook,* September 2020.

sheet. The balance sheet of the Fed today stands at just below $9 trillion, or ten times as large as before the financial crisis. This Fed policy has enabled risky behavior from investors, banks, and the government. It has driven unprecedented bubbles in both breadth and magnitude—the tech frenzy, the crypto craze, SPACs, the search for yield by investors and also by regional banks. While it has truly been an "everything bubble," nothing symbolized the Fed's predicament more than Dogecoin, which started as a joke and reached a market cap of $80 billion. Central banks should be in the business of balancing rather than fueling asset prices and risky behavior.

Some of the costs of the Fed's policies are already becoming apparent. Inflation has become part of American family dinner conversations. So have bank runs. Unfortunately, by still owning a large amount of government debt, the Fed continues to create the illusion that it can help with our fiscal problems. Consider what took place in the spring of 2021. It was obvious then that the economy was not only avoiding a deep hole, but already booming, with an inflation problem brewing. Bizarrely, the Fed kept its foot on the gas and Congress kept spending. Congress spent another $3 trillion bringing its covid total to $5 trillion, with the Fed financing over 60 percent of all issuance. Chair Jay Powell's Fed acted as a great enabler for these fiscal excesses. Had it not been for one Senator, Joe Manchin (D-WV), Congress would have spent another $3 trillion.

The entitlement arithmetic just doesn't work.

In an attempt to correct the biggest mistake in Fed history, the Fed in the last year has raised rates 500 basis points. Better late than never. Still, at the first signs of trouble, the Fed recently in just four days undid most of the small progress it had made in reducing its balance sheet. This asymmetric Fed response is what feeds the lack of serious structural action in Washington from both sides of the aisle. It allows the Biden administration and Congress to avoid having to address our long-term fiscal dilemmas. It helps the Republican House talk a tight budget while leaving entitlements off the table even though we all know that there is simply not enough revenue left to meaningfully reduce spending. It allows the Biden administration to suggest the need to increase the rate of spending and label the Republicans' already timid proposal as "wacko." It is hard to overstate the myopic absurdity of the predicament Washington policymakers have created. They are consuming our "seed corn" at the expense of future investment and growth. ◆