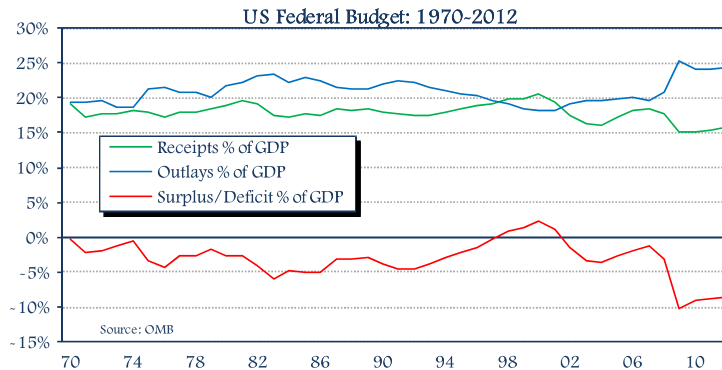
SEPTEMBER 2012

INVESTMENT UPDATE

Despite the pomp and pageantry associated with the Republican and Democratic Conventions over the past couple of weeks, voters may not be feeling quite as ebullient as the politicians—and for good reason: We aren't being told the truth.

Saying what you think you need to say in order to get elected is nothing new; that's what politicians do. But this is becoming an increasingly dangerous game. We are fast approaching the point in this country that we can no longer sweep our fiscal problems under the rug. In fact, to torture the analogy, the rug isn't even big enough to cover all the dirt that's under there already.

The facts are indisputable. The US has racked up $16 trillion in unpaid bills, and according to the Congressional Budget Office (CBO) we will add an additional $1.2 trillion this year. These deficits will only get worse in the coming years unless dramatic steps are taken, as the aging of the US population places additional strain on costly Social Security and medical benefits.



What's more, we're not even close to balancing our current budget—that $1.2 trillion shortfall in the 2012 budget is the gap between the estimated $2.2 trillion in revenues and $3.7 trillion in expenditures. In other words, we are only generating 69% of the revenue we need to pay off all our bills for just 2012. And that, to be frank, is pitiful.

To put the imbalance in perspective, we offer the chart on this page, which shows historical federal receipts and expenditures since 1970, expressed as a percentage of US GDP, along with the corresponding annual surplus/deficit. You'll have to look carefully to find the surpluses; we've had only four years out of the past 40 when we've spent less than we've taken in: 1998-2001. The fiscal situation has deteriorated significantly since then, including a huge nosedive once the recession began in 2007, with annual budget deficits of 5-10% over the past four years.

When politicians talk about what should be done to fix this mess, it always seems to come down to a binary solution: "We need to cut spending!" or "We need to raise taxes!" while always targeting an unsympathetic group or policy. But even a cursory glance at the chart on this page shows that we need both—we need to reduce the amount of expenditures that our government makes, and we need to find ways to increase the revenues that we're taking in. Doing just one or the other means that draconian cuts or draconian tax increases must be instituted to make up the difference.

Let's take taxes first. Clearly, we are not taking in enough revenues to pay for our current expenditures. Part of the problem comes from the current economic environment; with millions of Americans either unemployed or under-employed, payroll tax revenues have fallen off sharply during the recession and, at barely 15% of US GDP, receipts are woefully inadequate to cover the cost of operating this country. But a closer look shows that even when the economy was booming in 2005-2007, we "maxed out" at revenues of just 18% of GDP. And therein lies the problem: Our current tax structure is unable to generate sufficient revenue to balance the budget, even with dramatic spending cuts.

When they were instituted in 2001, the so-called "Bush tax cuts" seemed like an OK idea; we were running a budget surplus, the economy was humming along, and we had a "peace dividend," as we scaled back military spending after the fall of the Iron Curtain. The intention was to return money to taxpayers rather than have the government pay down its debts. And while the tragic events of September 11 certainly forced us to ramp up our military spending, even in 2001 we should have known that we had demographic changes headed our way that would require larger outlays in the future. These tax rates should never have been thought of as "permanent."

It's considered political suicide to propose raising taxes; once lowered, it's hard to take tax cuts back. Unfortunately, that's where we stand today. Somebody in a senior leadership position is going to have to "man-up" and tell the truth about tax rates. George HW Bush did it, Clinton did it, heck, even Ronald Reagan raised taxes a couple of times. But neither President Obama nor Governor Romney seem willing to propose a real solution.

Let's look at the candidates' tax policy recommendations. Obama will raise the marginal tax rate on the top two brackets from 33% and 35%, to 36% and 39.6%, respectively, eliminate some deductions for these high-income earners, index alternative minimum tax parameters to the rate of inflation, elimi-

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nate certain corporate tax breaks (e.g., fossil fuel preferences, certain insurance and banking taxes), and tax "carried income" as ordinary income. Obama's plan extends most other provisions of the Bush tax cuts indefinitely.

According to the Brookings Institute, Obama's tax proposals will raise an additional $1.7 trillion in revenue over the next ten years compared to "current policy" ("current policy" assumes the Bush tax cuts remain essentially intact indefinitely). If, on the other hand, all the Bush tax cuts were allowed to expire at year-end 2012, and no other changes were made, the US would take in a total of $4.5 trillion in additional revenue over the next decade. In other words, Obama is looking to claw back approximately 38% of the revenue that would be collected if the Bush tax cuts expired in their entirety.

The details of Governor Romney's plans are much less complete—it would be unusual, after all, for a candidate to have a line-by-line budget proposal. But he has laid out certain principals for what a Romney tax code might look like. Unfortunately, his proposals don't quite add up. He has said that he wants to cut individual tax rates by 20% across the board, while remaining "revenue neutral." But the only way that could be done would be to sharply cut or eliminate deductions like the home mortgage interest deduction, charitable contributions, or business interest deductions (all three total about $250 billion annually). It's not likely these could be eliminated—each comes with powerful interest groups that will fight for the continuation of current policy, and all are widely popular and—some would argue—vital to help boost a recovering economy (particularly the home mortgage interest deduction). And, more to the point, Romney's promise of a "revenue neutral" tax policy is, as we've seen, simply not good enough.

Yet we cannot "tax our way" out of our budget problems; according to a study by The Urban Institute, without spending cuts, just getting the budget deficit down to 3% of GDP in 10 years would require that personal tax rates rise across the board by more than 1/3 (e.g., those in the 28% bracket would see their marginal rate rise to 38.4%). Alternatively, if we tried to place the entire burden on just the top two brackets, those rates would have to rise from 33% and 35%, to 72% and 77%, respectively. And that still won't balance the budget; it will only get us to within 3% of balancing it in a decade.

Still, we have to face up to the facts: The demographic changes here in the US over the coming decades—an aging population with rising healthcare costs and falling savings—mean that we will see huge funding costs for programs designed to support retired folks. According to the bi-partisan budgetary watchdog Concord Coalition, the population of those aged 65 and older will increase by almost 80% by 2035, while the working population will rise by just 12%. Neither tax hikes nor spending cuts alone will solve our problems. We need to focus on both.

Just as with taxes, there are no easy solutions when it comes to finding programs to be cut. We are being lied to when politicians claim that budgets can be balanced by "eliminating waste;" if was that simple, we would never have had our first budget deficit. Discretionary spending (the items that Congress approves on an annual basis, and which includes the defense budget), while Washington's favorite whipping boy, represents only 18% of the federal budget. Equally important, discretionary spending is not a major source of future expense growth in most projections. As the Concord Coalition points out, "fixating on cuts in domestic discretionary spending alone is a smoke-screen" for not taking real action.

Yes, the real source of federal spending today, and the main source in the growth of future spending, is "non-discretionary"—the social, retirement and medical programs that provide payments and benefits to those who are deemed eligible. There can be no hope of fiscal reform, or anything approaching a balanced budget, without taking these programs on. Worse, the more we pile up debt to pay for these underfunded programs, the larger our interest expense becomes; the CBO's projections estimate that interest on our debt will become the biggest line item in the US budget, at nearly 6% of GDP, by the middle of this century. In less than two decades, they project that, without needed changes, annual non-discretionary spending, including interest costs, will reach 20% of US GDP. In other words, 100% of that magic 20% of GDP from tax revenues will go just to non-discretionary items. That will leave us with nothing for the military, nothing for roads and bridges, no education, no medical research, no payments to the states. And these projections are somewhat optimistic; if medical costs continue to grow at current rates, non-discretionary spending alone rises to 27% of GDP by mid-century.

We've harped on it before and we will continue to do so: Nearly two years ago, the Simpson-Bowles commission provided the blueprint for how to fix US fiscal policy, and both parties did their best to distance themselves from the commission's findings, to the detriment of our country's finances. Their recommendations are as clear today as they were then: All items must be "on the table" for discussion; failing to tackle our biggest spending programs increases the pressure to raise taxes further or completely gut smaller programs. Since neither party has the numbers or the credibility to force its agenda through, each will have to work across the aisle. But there is good news; again, quoting the Concord Coalition: *"Substantial and credible long-term deficit-reduction plans would build public confidence in US fiscal policy that would help the recovery."*

We agree completely. What's holding our country back, as much as anything at the present time, is lack of confidence and clarity on future US fiscal policy: What will my taxes be? What kind of future medical and retirement benefits am I likely to get? Can I afford to hire new employees? Naturally, recent surveys show strong opposition to raising taxes on the middle class (90% opposed) and reducing Social Security benefits (85% opposed); yet more than 90% of Americans answered "yes" to the statement, "I am willing to do my part to reduce the national debt, as long as other people do theirs."

We're ready. Are the politicians?