

Debt and Taxes—A Tipping Point?

It is tax time. The Tax Foundation calculates that tax freedom day for wage earners this year is April 9. This means that Americans will have spent the first one hundred days of 2010 working just to pay their taxes. Taxes are important in lots of different ways. Some include: financing government programs; paying down or at least servicing government debt; legislators, who believe the electorate needs help, use taxes as incentives or disincentives for particular types of behavior (e.g., a proposed soft drink tax to stop kids from a friendly pepper upper); redistributing capital among different income groups, etc.

Taxes are tied at the hip to debt and importantly to each of our belief systems. People are built differently with diverse ways of looking at the world. If you look at a flower arrangement, what do you see? Some see pretty colors and beauty, smell a lovely fragrance, think of romance. Others see cost, wonder how long the flowers will last, smell stinky flower water, etc. Different minds see the same opposites in taxes and debt.

Some of us see needs, programs that will help others, and solving problems. Others see living beyond our means, debts our children will have to pay, the threat to the principle of self-reliance, a huge takeover by the Federal government of important segments of our national economy, etc.

Mixed into debt and taxes is the long history of politicians buying votes. It happens everywhere, but in the U.S. it started in the early days of the Republic when politicians corralled votes with whiskey. In our more sophisticated times they try to think up programs voting blocks want. Roman senators played the same game eventually to excess and the destruction of their empire. An honest question is, has the U.S. gone too far? We each have our own opinions and that is what makes politics interesting.

Economists have tried to gauge the impact of taxes and debt on economic health. Some believe tax rates above a certain level curtail economic activity. If taxes are so high that the incremental income from being a surgeon versus a postman is narrow, why grind in school and work hard, long hours to get a minimal economic advantage? High taxes also encourage the underground economy that pays no taxes, a particular problem in California. The Los Angeles Times has reported that in L.A. County (10.2 million people) forty percent of all workers work for cash and do not pay taxes. We have been forcefully reminded in the recent economic downturn of the poisonous impact of debt and leverage. High debt causes problems.

The adverse effects of high taxes and debt are easily visible at the state level. When rates get too high, people move out and businesses shut down or transfer to lower cost venues (Nevada loves California politicians). Tax receipts decline and then state governments are forced to shrink. High tax states like California, New York, and Michigan all are in this ugly tax/debt downward spiral.

The traditional 1950's household operating custom was to spend no more than the cash on hand. One of our employees remembers a "movement for improvement" regime from this period. The mother wanted a dishwasher and all family spare change had to go into a jar until enough cash was raised to make the purchase. Importantly, everyone in the family contributed and felt pride

and a sense of ownership when the new machine was finally acquired. Governments and politicians have not learned this lesson. They have a long history of spending beyond their means. We may have finally spent to the point of crisis on this issue.

The U.S. now has a national debt of over \$12 trillion and it is growing rapidly. There are estimates that if you include off-balance sheet Federal liabilities (for example debts of Government Sponsored Enterprises like Fannie Mae or Freddie Mac) the total U.S. debt amounts to an impossible \$54 trillion. Total U.S. government debt numbers for the first three months of calendar 2010 are now out. See the government web site www.cbo.gov or the time clock on www.brillig.com/debt_clock. The deficit for this short period was \$326 billion. That amount is \$1,000 for every resident, man, woman, child, legal or illegal. In the eyes of many, the last three generations, with the help of the Federal Reserve and legislators of both parties, have mortgaged the country's future.

What are the solutions to our crushing debt burden: 1) curb government expenditures, 2) increase taxes, 3) inflate out of debt, 4) grow the labor force, 5) cut the current account deficit. So far voters do not appear willing to make the necessary sacrifices. Cutting our living standards and economizing would mean continued high unemployment, a squeeze on profits, and lower government tax receipts. Instead, the Federal government will for sure turn to higher tax rates on corporations and the wealthy. Debt is the current consumption of future earnings and that is the path we are on. We are joined in this daisy chain by most of the developed western countries.

Fewer and fewer people have to pay Federal taxes and more and more Americans are dependent on government handouts. Recent IRS data for 2008 reports that a record 52 million Americans, 36% of all tax return filers, had no income tax liability because of credits and deductions enacted in the past fifteen years. The Tax Policy Center projects that this percentage will increase to 47% in 2009. The tax code has always had exemptions to protect the poorest Americans from paying income taxes, but the new credits, such as the Child tax credit, Making Work Pay credit, and the First Time Homebuyer credit, are now exempting more and more middle-class families.

The Tax Foundation says that in 2004, 60% of households in the U.S. received more in benefits and services from the government than they paid in taxes. Spending hikes recently enacted by Congress are expected to raise this to over 70%. In simple terms, this means a record number of tax filers are disconnected from the cost of government. This is a dangerous trend. It attacks the traditional American pride in self-reliance. It creates a bias toward more spending and against keeping tax rates low since the burden is increasingly borne by those at the high end of the income scale. These people tend to be the entrepreneurs, risk takers, and small businesses that create most of the jobs.

The rich pay the vast majority of taxes and clearly more are coming. The top one percent of income earners now pays more tax than the bottom ninety-five percent. In 2007, this top one percent paid about forty percent of all Federal taxes. The top five percent paid about sixty percent of all Federal income taxes, and the top ten percent paid over seventy percent. It worries many that a majority of citizens do not pay taxes and have no skin in the game.

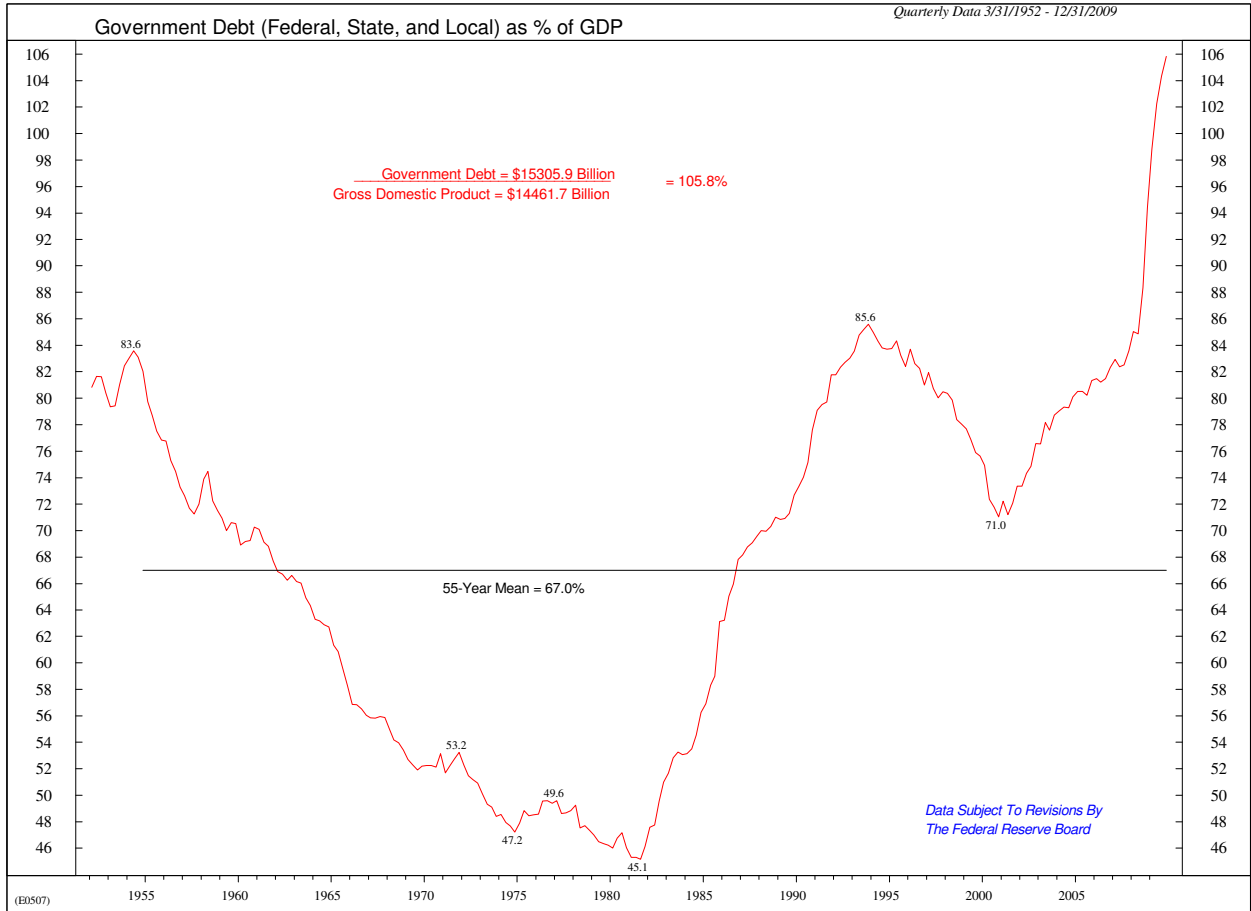
Tax sensitivity is an important ingredient for good performance in managing individual portfolios. It is little appreciated and not understood by many. People always focus on gross percentage performance or high hard-dollar returns, not net after-tax results. Try explaining the difference between taxable versus tax-free income, the advantage of taking tax losses to offset realized capital gains (and to a limited extent current income), and the benefit of holding on to a low-cost currently underperforming stock that has good long-term prospects, in order to avoid paying a large current capital gain tax.

Taxes change incentives. For example, low taxes on dividends encourage companies to pay out cash whereas high taxes encourage them to reward shareholders by buying back shares. Which is your preference? Does the latter practice impact balance sheets? Low capital gain rates encourage intelligent use of capital. People are more willing to sell low-cost holdings in declining industries and reinvest in ones with better prospects. This tends to lower capital costs for areas of growth, which is good for the economy overall. High capital gain rates tend to keep capital locked in to more dormant industries and reduce available money to finance growth.

Given the massive growth of debt in our economy, higher taxes seem inevitable. The Bush tax reductions enacted in 2001 and 2003 will expire beginning in 2011 and revert to their previous levels. Long-term capital gains will go from the current 15% to 20%, and the maximum ordinary tax on income will increase from 35% to 39.6%. Unless Congress acts, the tax on dividend income will increase dramatically from 15% to 39.6% (most believe Congress will limit the increase to 20%). Higher taxes are also expected in such areas as Medicare, estate and gift taxes, etc. Tax planning is a nightmare because Congress constantly changes rates depending on the enthusiasms and perceived needs of the day.

We all want our government to work efficiently and for our collective benefit. Differing views on debt and taxes are natural and constructive. As things now stand, the following are truths: 1) debt is high, 2) massive Federal programs that have recently been enacted will exponentially add to debt, 3) unemployment is high, 4) economic growth is tepid, 5) taxes on the wealthy and small businesses will soon rise. Investors and citizens have to decide if current conditions will: 1) foster a strong economy and needed job growth, 2) cause wage earners to work hard and focus on savings versus consumption, 3) promote self-reliance and encourage each of us to live within our means and not depend on government largess.

Depending on how you think about it, have these problems/opportunities been factored into current stock prices? The truth is that only the Shadow knows. Covington is confident America has a bright long-term future. Americans have a long history of facing problems and solving them. It usually takes a crisis to get our act together. Short-term actions on debt and taxes are important and need to be constructive. Bond yields are the vigilantes in the background and will eventually make politicians do what is right. In simple terms, this means that if interest rates rise significantly on government debt, it would have catastrophic implications. We will watch carefully and hope good sense prevails.



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