

Why We Plan

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Introduction

Even for those who have tried to take a media holiday, it is nearly impossible to get away from the histrionics and demagoguery surrounding the current debt ceiling debate (given the tone of the discussions, calling it a “debate” is far too kind).

The media are in a tizzy, delighting in their ability to use scare tactics on their unsuspecting audience once again. They gleefully play clip after clip suggesting that the U.S. is on the brink of defaulting on its debt. Please forgive the grammar, but ***it ain't gonna happen!***

We render that opinion regardless of whether or not the debt ceiling is actually raised in a timely manner. Rather, it is a simple fact. That is the perspective we hope to leave you with in this installment of Why We Plan.

Default - What is It?

The media and various politicians throw around the risk of default as if it is not only a possibility, but a distinct probability. Moreover, the ratings agencies, in an effort to become relevant once again, have gotten involved by threatening to lower the AAA rating of the U.S. (for reference, these are the same agencies that could not figure out that pools of sub-prime mortgages – or loans to people with minimal assets or income – might be at risk of default).

If you understand what it takes to default, you will understand that the likelihood of the U.S. defaulting on its debts is slim, to say the least.

According to the Merriam-Webster dictionary, default is defined as a “failure to pay financial debts”. Those of us who have ever borrowed money understand that the payment of a debt has two components: the payment of interest and the repayment of principal. It is a fairly simple concept.

Without going into the exact numbers, the U.S. takes in over \$2 trillion in tax receipts per year. The interest on our current debt is about 10% of that. Since we are taking in something on the order of 10x

more money than we need to pay interest on our loans, we have plenty of money to repay that portion of our debt, so it does not seem as if we are risk of being unable to pay our interest.

What about the principal? Many of you out there are probably thinking that if we do not raise the debt ceiling, there's no way we can pay back principal in a timely manner. However, that's not a true assumption. Let's assume that the U.S. has to repay \$100 million in 3-month Treasury bills. All we would have to do is issue \$100 million in new 3-month Treasury bills, for example, to repay the old ones. The amount of debt outstanding is unchanged – in other words, there is no impact on the debt ceiling. We are simply rolling over our loan, something businesses do on a daily basis as a regular part of business.

So, the likelihood of default is absurdly low. The Treasury department has sufficient funds to make our interest payments and the flexibility to repay principal, as needed. The Secretary of the Treasury would either need to proactively decide not to pay the debt or would need to be instructed not to pay it for there to be a problem. Fortunately, neither option is politically expedient.

Spending - The Real Problem

So, if default is not really the issue, what's the big deal? Over the course of the last few years, government spending has gone from about 18% of GDP to 25% of GDP. This has been done under the guidance of both parties, so nobody in Washington is blameless. This is a problem because the more resources devoted to government spending, the more the private sector gets crowded out. Historically – in both our economy and others worldwide – the higher the percentage of the economy devoted to the government, the higher the unemployment rate and the slower the economic growth.

In the U.S., four years ago the federal budget was \$2.7 trillion. Today it's over \$3.8 trillion. The reality is that we are spending far more than we are taking in. In fact, it has been estimated that this year we need to borrow 40 cents of every dollar that we spend. If we do not increase the debt ceiling, spending needs to be decreased because we will not be able to borrow to finance any additional spending.

Recent reports have suggested that something on the order of \$2 trillion in spending cuts – *over 10 years* - is on the table (although, that number has seemingly drifted lower over the course of the last few days). While that seems like a big number, and this is supposed to be the result of serious, contentious negotiations, consider these tidbits:

- Over the next 10 years, it has been estimated that we are going to have deficits totaling around \$7 trillion. So, \$2 Trillion in cuts doesn't even reduce our projected deficits by 1/3.
- The Office of Management and Budget is forecasting total spending of about \$46 trillion over the next 10 years. Cutting out \$2 trillion during that period is a reduction of less than 5%. And all of the talk is about sacrifice?
- Consider this example: The federal government would be like a family spending \$60,000 per year offering to cut its budget by about \$3,000 – or only \$250/month. It might mean a little sacrifice, but then again, it might not. It all depends on how the money is being spent.

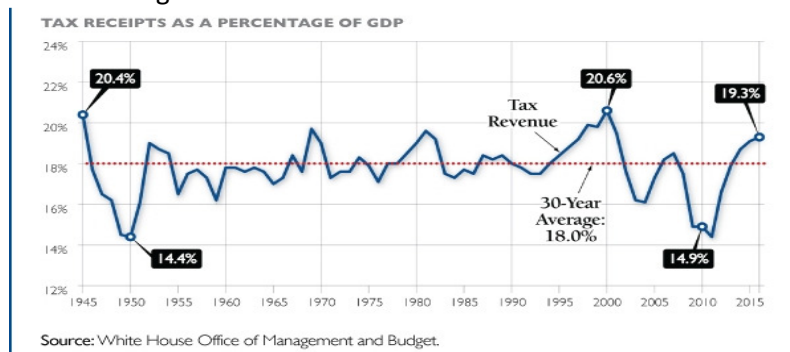
- Once again, our federal government's budget this year is for some \$3.8 trillion of spending. Four years ago they spent a "mere" \$2.7 trillion. Increasing spending by 40% in four years and then considering cutting 5% of spending hardly seems like the result of the "tough" negotiations we've been hearing about. Let's revisit our hypothetical family from above. We already assumed that they are currently spending \$60,000. However, if they were like the government, they were only spending \$43,000 four years ago! Now they're bragging about being able to possibly cut \$3,000 from their budget?

The only times we have had budget surpluses in the past was when spending was less than 18% of GDP. Once again, we are currently at 25%. It is time to get our house in order. As shown above, cutting \$2 trillion does not really get us to where we need to be, but at least it is a step in the right direction and sets the tone.

Tax Increases - Not a Solution

Of course, many people feel that in addition to cutting spending, we should raise taxes. There are a few reasons why tax increases will likely be ineffective in dealing with our situation.

First, take a look at the following chart:



As you can see, from 1945 until now, tax receipts have generally bounced between 15% and 20% (with temporary outliers), and have averaged about 18% (for reference, this chart was prepared by others based on information from the OMB). The amazing thing is that during the period of time shown, tax rates have varied dramatically. *Regardless of the tax rates, however, the collections as a percent of GDP have remained relatively static.* So, those that expect increased tax rates to bring in increased revenues may be missing something.

There are a few other tidbits to be taken from the chart. If you look at our recent history, you'll see an outlier to the upside in 2000. That was a time when the economy was booming and the free market was working well. Fast forward to current times when we have an outlier to the downside. We all know how things have been the last few years with unemployment. As you can see, there was a similar dip following the recession in the early 2000's – of course, the dip was not quite as deep, but neither was the recession. Now, look at the forecasts going forward. The assumption, presumably under current tax rates, is that revenues will not only increase to the average, but will go beyond that once again. *So, by doing nothing, we are still forecasted to get increased revenues as the economy continues to recover.*

There is one final point. Recall in the section discussing spending above that we mentioned that the only times we have had surpluses was when government spending has been under 18% of GDP? Now

you know why. When tax receipts, which have averaged 18% of GDP exceed spending, we have a surplus.

So history shows us that regardless of tax rates, tax receipts tend to be confined to a relatively narrow band. However, there are a couple other items worth considering (examples courtesy of First Trust Advisors):

- The Administration has contended that the “millionaires and billionaires” should pay more. Without going into how class warfare is anathema to American history, let’s think about that point. Let’s assume that instead of the top tax rate being 35%, we raised it to 100%. In other words, all income over a certain level would be taken by the government. Let’s also assume that people did not change their behavior (which is admittedly a very silly supposition). Under this scenario, the government would generate under \$400 billion of additional revenue. Based on our current spending, that would support us for about 5-6 weeks. So, making the “rich” pay more does not really seem like a viable strategy.
- Now, assume that we identify the richest families in the U.S. – the ultra-rich – and simply *confiscate* all of their assets. What if we simply took all of the assets from the families on the *Forbes* 400 list of the richest Americans. If we did this, the government would take in approximately \$1.4 trillion – enough to cover spending for about 4 months. Of course, this can only be done once since the richest would no longer have any assets. Even this approach does not work too well.

The bottom line is that tax revenues are likely to increase as the economy improves. Changing tax policy might make sense for other reasons (i.e., simplifying the tax code), but it is not going to address our current problem. Once again, our current problem is spending.

What Happens Next?

The good thing is that the likelihood of default is slim. The bad thing is that there may still be an impasse and an agreement on raising the debt ceiling may not be reached in a timely manner. So what happens then?

We have been through this before. Back in late 1995/early 1996, the government was forced to shut down for almost 30 days as a result of a similar situation. Government workers were furloughed, and there was a rough patch. However, following this, the politicians realized that things were serious and they had to act. Good times followed. Government spending was actually cut. During the 4 years following the shutdown, real GDP grew by about 4% per year and the stock market was up over 20% per year. Government shrunk, profits grew – people were happy.

If something similar happens again, there will likely be short-term turmoil in the markets. You might recall what happened when TARP (the bank bailout) was not passed the first time – the stock markets sank. Of course, they rebounded when a deal was announced a few days later. The key is to remember that if something happens, it is a short-term phenomenon based on government incompetence. It is not in the best interests of our government or individual politicians to prolong this situation, so it will ultimately be resolved. Either way, the great companies in the US and the world, the companies you own in your portfolio, will likely continue along their path of making money.

If there is not agreement, some may panic and sell which could exacerbate a downward move in the markets, though given that many already panicked out at much lower prices a few years ago and from all statistical data appear to be still on the sidelines, any downward move could be muted. Of course, those that panic will probably miss out on the strong up move when a deal is announced shortly thereafter, thereby locking in losses and missing out on gains (and future gains on those gains) forever.

Knowledgeable investors with well-defined portfolios and ample cash reserves will have no reason to sell and can sit by comfortably waiting for the government to get its act straight. For our investors, that is one of the reasons behind baskets 1 (current year spending) and 2 (intermediate term spending). You don't need to touch your longer-term investments for years, so short-term crises like this (should it happen) do not require action (other than rebalancing, perhaps, which will allow you to buy low).

Wrapping It Up

The bottom line is that it is time to ignore the demagoguery coming out of Washington and start relying on logic and historical perspective. We have a spending problem in the country that needs to be addressed. If history is a guide, increasing tax rates will do nothing as overall tax revenues will likely remain constant. So, our only meaningful choice is to cut spending.

The issue of default is seemingly a non-issue unless a proactive decision is made to actually default. We have sufficient revenues to pay our interest and ample flexibility to roll over debt to repay principal as it comes due indefinitely.

Regardless of the above, if the two sides cannot get their act together, there may be a temporary government shutdown and short-term market moves to the downside. Once again, using history as a guide, these moves will ultimately reverse – possibly very quickly – as our politicians finally get it and put the country back on the right path. If you have a sound plan (as all our clients should), this will likely be a short-term phenomenon that does not require action *unless your individual circumstances and/or goals have changed* (in which case, call). If they haven't, you should not be fooled into making a long-term change to your portfolio based on short-term actions dictated by politics.

Feel free to pass this along to friends or colleagues that might find the perspective useful. As always, we are here to help and provide a little common sense perspective. Feel free to call or write with any thoughts.