

By Christopher E. Grant

Washington is Fooling Nobody

“You can fool some of the people all of the time, and all of the people some of the time, but you cannot fool all of the people all of the time.” Abraham Lincoln (attributed)

The latest chapter in the on-going Federal Budget Deficit/National Debt saga provided round-the-clock media theatrics as the political kingpins from both sides of the aisle repeatedly traipsed back and forth between the halls of Congress and their “negotiating sessions” at the White House, stopping only long enough to step eagerly before the waiting microphones to reassure their respective constituencies that they were, as promised, winning the budget battle. **With less than an hour to go before the midnight Federal Government “shutdown” deadline, a budget deal, boasting some \$38 billion in “cuts” was struck.** A week later, the final fiscal 2011 budget resolution (which began back on October 1, 2010) was passed by the House by a vote of 260-167 and by the Senate by a vote of 81-19.

Battling over 1% of 1%?

In honor of Paul Harvey, here is the “rest of the story.” **The much ballyhooed budget compromise that was hailed as historic for carving \$38 billion will, according to the non-partisan Congressional Budget Office, shave a mere \$352 million from this year’s spending.** The CBO analysis concluded that about half of the reductions are for future years, and nearly half of the rest are phantom cuts. As reported by the Washington Post (far from a conservative shell), “the analysts found that \$13 billion to \$18 billion of the cuts involve money that existed only on paper and was unlikely to be tapped in the next decade.” In fact, the Post’s own review of the 459-page budget uncovered what they deemed “accounting alchemy” since, in at least 98 cases, Congress took back unused IOUs while still terming them cuts. **Bottom line: our self-congratulating politicians were actually able to cut .01% from the \$3.83 trillion 2011 Fiscal Year Federal Budget or .023% of this year’s projected \$1.56 trillion (yes, with a “T”) budget deficit.**

The Deficit Commission: A Brief History

Because some readers may see this evaluation as overly harsh, let’s rewind just a few months and briefly review the findings and recommendations of The National Commission on Fiscal Responsibility and Reform entitled “The Moment of Truth.” Co-Chaired by Erskine Bowles, former chief of staff for President Bill Clinton, and Alan Simpson, the #2 Republican in the Senate for a decade, **the bi-partisan, 18-member Commission selected by President Obama was given a mandate to issue a voted-upon recommendation by December 1, 2010.** The theory was that at least 14 of the 18 members would approve a plan, which Congress could then vote on.

In setting the stage, the report’s opening section entitled “The Looming Fiscal Crisis” begins, **“Our nation is on an unsustainable fiscal path” and concludes, “Continued inaction is not a viable option, and not an acceptable course for a responsible government.”** The report then sets out a proposed plan of action. Because of the importance and urgency of these issues, and since so few people are either aware of the Commission’s existence or familiar with its proposals, we feel it is appropriate to restate the summary of the six component strategy:

1. **Discretionary Spending Cuts:** Enact tough discretionary spending caps to force budget discipline in Congress. Include enforcement mechanisms to give the limits real teeth. Make significant cuts in both security and non-security spending by cutting low-priority programs and streamlining government operations. Offer over \$50 billion in immediate cuts to lead by example, and provide \$200 billion in illustrative 2015 savings.

2. **Comprehensive Tax Reform:** Sharply reduce rates, broaden the base, simplify the tax code, and reduce the deficit by reducing the many “tax expenditures” – another name for spending through the tax code. Reform corporate taxes to make America more competitive, and cap revenue to avoid excessive taxation.
3. **Health Care Cost Containment:** Replace the phantom savings from scheduled Medicare reimbursement cuts that will never materialize, and from a new long-term care program that is unsustainable with real, common-sense reforms to physician payments, cost-sharing, malpractice law, prescription drug costs, government-subsidized medical education, and other sources. Institute additional long-term measures to bring down spending growth.
4. **Mandatory Savings:** Cut agriculture subsidies and modernize military and civil service retirement systems, while reforming student loan programs and putting the Pension Benefit Guarantee Corporation on a sustainable path.
5. **Social Security Reforms to Ensure Long-Term Solvency and Reduce Poverty:** Ensure sustainable solvency for the next 75 years while reducing poverty among seniors. Reform Social Security for its own sake, and not for deficit reduction.
6. **Process Changes:** Reform the budget process to ensure the debt remains on a stable path, spending stays under control, inflation is measured accurately, and taxpayer dollars go where they belong.

Taken as a whole, the plan was designed to:

- Achieve nearly \$4 trillion in deficit reduction through 2020, more than any effort in the nation’s history.
- Reduce the deficit to 2.3% of GDP by 2015 (2.4% excluding Social Security reform), exceeding President’s goal of primary balance (about 3% of GDP).

- Sharply reduce tax rates, abolish the AMT (Alternative Minimum Tax), and cut backdoor spending in the tax code.
- Cap revenue at 21% of GDP and get spending below 22% and eventually to 21%.
- Ensure lasting Social Security solvency, prevent the projected 22% cuts to come in 2037, reduce elderly poverty, and distribute the burden fairly.
- Stabilize debt by 2014 and reduce debt to 60% of GDP by 2023 and 40% by 2035.

Spending Cuts and Taxes Surely You Jest

Predictably, the big stumbling blocks in the plan were either spending or tax related. Democrats like Rep. Jan Schawkowski of Illinois opposed the plan because they couldn’t fathom any big cuts in Social Security or Medicare. Republican Congressional members like Rep. Jeb Hensarling of Texas were opposed because it contained some tax increases, or the elimination of tax breaks that could be construed or defined as tax increases. Last we checked, the solution to a budget deficit requires an increase in revenue, a decrease in expenditures or, most likely, some of both. **Unfortunately, this plan, like most controversial legislative measures that involve cutting spending and/or raising taxes was DOA, failing to garner the necessary 14 votes.** The report’s subtitle, “The Moment of Truth” couldn’t have been more apropos.

Ryan v. Obama Politics as Usual

Fast forward to today and we’re virtually back to square one. Facing off are the latest proposals in the form of Rep. Paul Ryan’s (R, WI, Chairman of the House Budget Committee) budget resolution for fiscal 2012 (already passed by the Republican controlled House of Representatives) labeled the “Path to Prosperity” countered by President Obama’s outline response set forth in his April 13, George Washington University speech.

While the Ryan plan appears more aggressive, claiming a deficit reduction of \$6.2 trillion over 10 years vs. the President's more "modest" \$4 trillion reduction over 12 years, the approaches are more notable in their reflection of the philosophical chasm between their methods. Comparing or contrasting the details at this point would be a waste of time since they will undoubtedly be championed or challenged by their respective advocates or opponents over the coming weeks and months. **Suffice to say that the Ryan plan includes the repeal of the Obama health care plan and the Obama plan includes repeal of the "Bush" tax cuts for "millionaires and billionaires." Don't hold your breath in anticipation of an "adult conversation."**

Dueling Disappointments

Blurred by the upcoming partisan debate will be the fact that **between 2012 and 2021, federal government spending still rises 34% under Ryan and 55% under Obama.** And even the more "austere" Ryan plan doesn't balance the budget until sometime between 2030 and 2040, racking up some \$5.7 trillion in new debt over the next decade – more than \$14 trillion by the time the budget is "balanced."

How about entitlements where there is overwhelming agreement that the current path is unsustainable?

Social Security Reform – Pass

First, Social Security. Ryan provides no specific changes, instead proposing a budget mechanism to force Congress to take action on the program. "Force Congress to take action?" Now there's a confidence builder. The Obama solution – nada.

Medicare/Medicaid At Least a Starting Point

Second, Medicare and Medicaid. The Obama approach would "build" on the healthcare law reforms "which will reduce our deficit by \$1 trillion." Notes: The \$1 trillion claim is the Democrats' own estimate over a 20-year period. In contrast, **the bi-partisan Deficit Commission report states that health spending projections under the new law**

"count on large phantom savings" and the reform law's new long-term care program is "unsustainable." Not a ringing endorsement. The Ryan approach turns Medicaid into a block grant system and Medicare into a "premium support" voucher system. **Maybe a viable approach for much needed healthcare reform; but the "big savings" still occur beyond 10 years** when the system is slated to be fully implemented.

I Can't Be Out of Money I Still Have Checks

But what's the rush? The government's checkbook still has a balance equal to roughly one month's bills before requiring a new credit limit in the form of a bump-up of the current \$14.3 trillion debt ceiling. **Not to worry, though. Congress will certainly resolve this minor detail – as soon as they reconvene from their 2-week recess on May 1st.** Once again, there will be the requisite finger pointing, pontificating, and hand wringing, concluding with a claim of victory by both sides. And, after this momentary diversion, on we'll go to the really important battle over the 2012 budget.

No Fooling Us Twice

The purpose of this diatribe is to assure our clients and readers that we are not among those fooled by the fiscal theatrics being performed in Washington, nor should they be. **The debt/deficit issue is serious and the federal government's response, delay or failure to act will have consequences.** As Bill Gross of Pimco warns in his January 2011 Investment Outlook, *Off With Our Heads!*, "The problem is that politicians and citizens alike have no clear vision of the costs of a seemingly perpetual trillion dollar annual deficit. As long as the stock market pulsates upward and job growth continues, there is an abiding conviction that all is well and that 'old normal' norms have returned. Not likely."

Comparing the U.S. response to "Euroland or the United Kingdom, which appear to have gone on an extreme fiscal diet," Gross sees **the "American answer to a bulging waistline as always 'mañana.'** Debt commission recommendations are tossed in

the trashcan, tea party election rhetoric eventually focuses on miniscule and merely symbolic earmarks, and both Democrats and Republicans congratulate each other on their ability to reach a bipartisan agreement for the good of the nation.”

The Bond Vigilantes Are Returning

The investment implications of mindless U.S. deficit spending are also numerous, perhaps **the most evident of which is the attempted forcing of investors into “risk assets.”** With the Federal Reserve holding short-term interest rates at near-zero in order to minimize the interest cost on the burgeoning federal deficit, **the real, after-tax/after-inflation return on fixed income securities (the historical mainstay of retirees) is struggling to stay on the positive side of the ledger.** While the cost of gas, food and medical care soar, the puny 3.35% yield on a 10-year U.S. Treasury bond is hardly attractive. **In fact, so unattractive are Treasury yields that Gross and his Pimco team have eliminated all Treasuries from their \$140 billion Total Return Bond fund, the largest bond mutual fund in the world. A bold indictment from the #1 bond manager.**

Joining the growing chorus of the concerned is Standard & Poor’s Ratings Services who, on April 18th, revised its outlook on the long-term credit rating of the U.S. sovereign to negative from stable. While affirming its ‘AAA’ long-term rating, it fired off the following warning:

“We believe there is a material risk that U.S. policymakers might not reach an agreement on how to address medium and long-term budgetary challenges by 2013; if an agreement is not reached and meaningful implementation is not begun by then, this would in our view render the U.S. fiscal profile meaningfully weaker than that of peer ‘AAA’ sovereigns.”

The Time for Action and Accountability

Concluding, we join in the commission’s Preamble to the “Moment of Truth” report:

“We believe neither party can fix this problem on its own, and both parties have a responsibility to do their part. The American people are a long way ahead of the political system in recognizing that now is the time to act. We believe that far from penalizing their leaders for making the tough choices, **Americans will punish politicians for backing down – and well they should. . . After all the talk about debt and deficits, it is long past time for America’s leaders to put up or shut up. The era of debt denial is over, and there can be no turning back.”**

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