

A Special Report

December 31st, 2010

The Truth about Government Spending, Debt, and Taxes

Having just witnessed yet another “battle in the beltway” over taxes and spending, I thought it might be instructive to do a little research on the subjects. With all the partisan invective and hyperbole thrown around by the folks in Washington, it’s hard to separate fact from opinion, and I suspect it’s especially difficult for everyday Americans to relate to the sums we’re debating, because we’re talking about *trillions* of dollars.

Like most observers, I have my own *opinions* on such matters, and I’ll share some herein, but my goal in sharing these data is to allow the reader to come to his or her own conclusions. Much of what I discovered in my research I didn’t know, and hadn’t heard from our elected officials, but when one understands that our political parties are wrestling for control over *massive* amounts of money, its easy to see why some of what I’m about to share isn’t being shared by the politicians themselves.

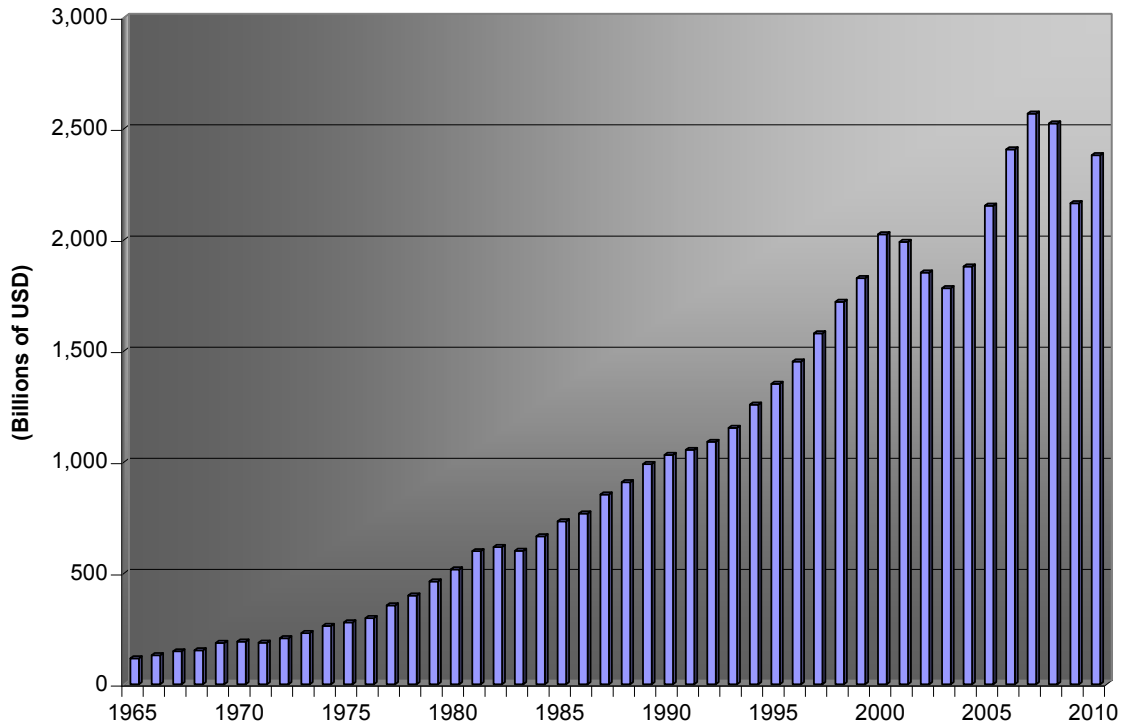
It appears to me that *both* sides, those advocating for increases in the current tax rates, and those opposing same, have some valid points. It is indeed a *fact* that overall tax revenues are *down* the past two years, owing primarily to the recession, smaller corporate profits, and higher unemployment rates. But it’s also *factual* that an increasing number of *working* Americans pay no income taxes at all, and that the current tax code is loaded with loopholes and giveaways to special interests. In my *opinion*, the equity of such a system is rightly called into question. Interestingly, both sides agree that our system of taxation is overly complex, “unfair” to some, and in need of a major overhaul. I agree, and want to share certain facts that illuminate issues that are generally and popularly misunderstood, but should be part of the public discourse leading to tax reforms.

Let me warn the reader that what follows is somewhat sobering. Hopefully, the politicians who are supposed to be representing *our* interests will stop battling one another long enough to find solutions to what is quickly going to become America’s biggest problem, runaway deficits and debt.

Fact # 1) It’s Not Just a “Revenue” Problem

The way certain politicians speak, you’d think the government was on a starvation diet. A look at the actual numbers reveals a very different story. In nominal dollar terms, revenues to the federal government have exploded *twenty-fold* since 1965. With the rare exceptions surrounding market crashes and economic recessions, the federal government takes in more money every year.

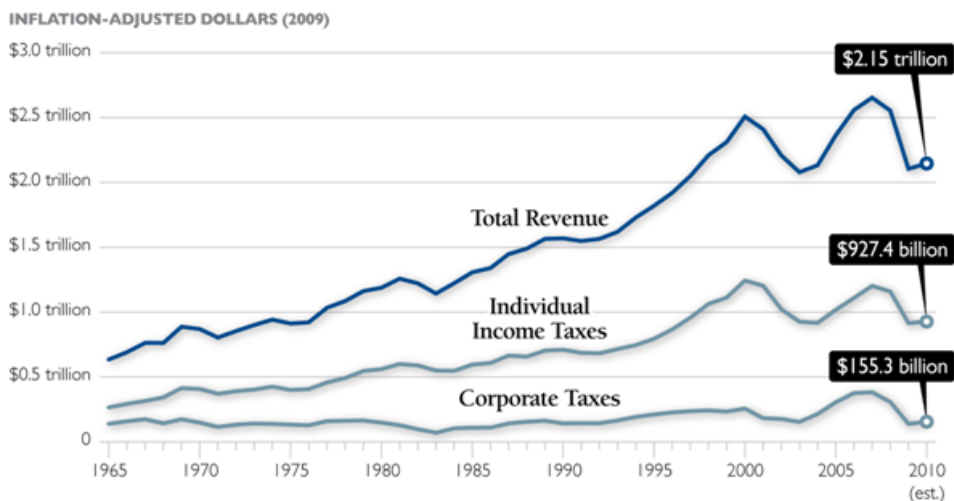
Total Federal Government Receipts



Source: Office of Management and Budget, Budget of the US Government FY 2011, Historical Tables, Table 2.1

Now everybody knows that things cost a lot more today than in 1965, but even factoring in inflation over the period, the Fed's take has more than *tripled* over the past 45 years.

Federal Government Revenues Have More Than Tripled Since 1965

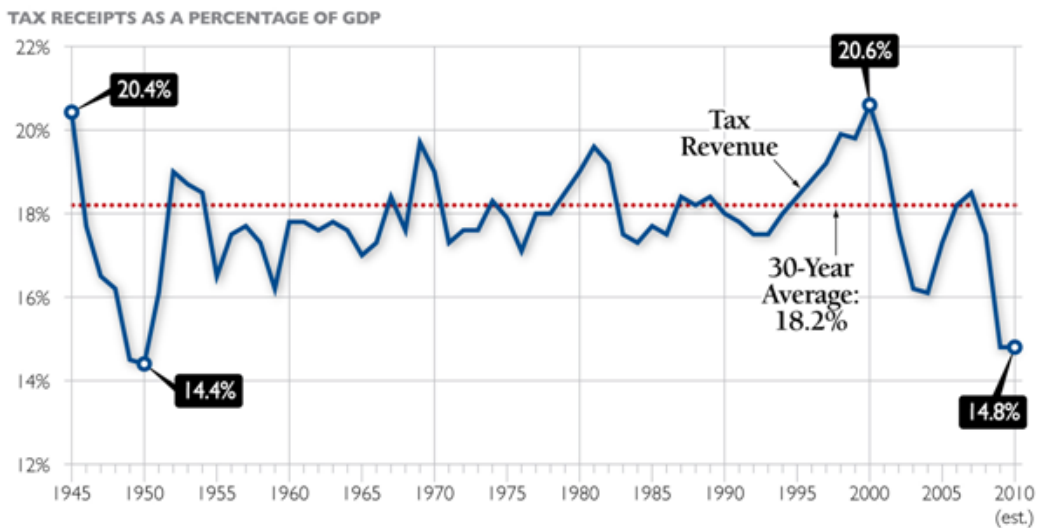


Source: White House Office of Management and Budget.

Fact # 2) While true that tax revenues have increased, the government's "share" of our economic output has been remarkably constant over time.

While the government does take in more and more revenues over time, it's also true that since World War II, the Federal government has consumed (confiscated?) a fairly constant percentage of our nation's output (as measured by its Gross Domestic Product) through taxation. With the toughest economic recession in over 70 years having placed millions of Americans in unemployment lines, the percentage the Federal government takes *has* declined the past two years. And that has a lot of "big government" proponents screaming for more....

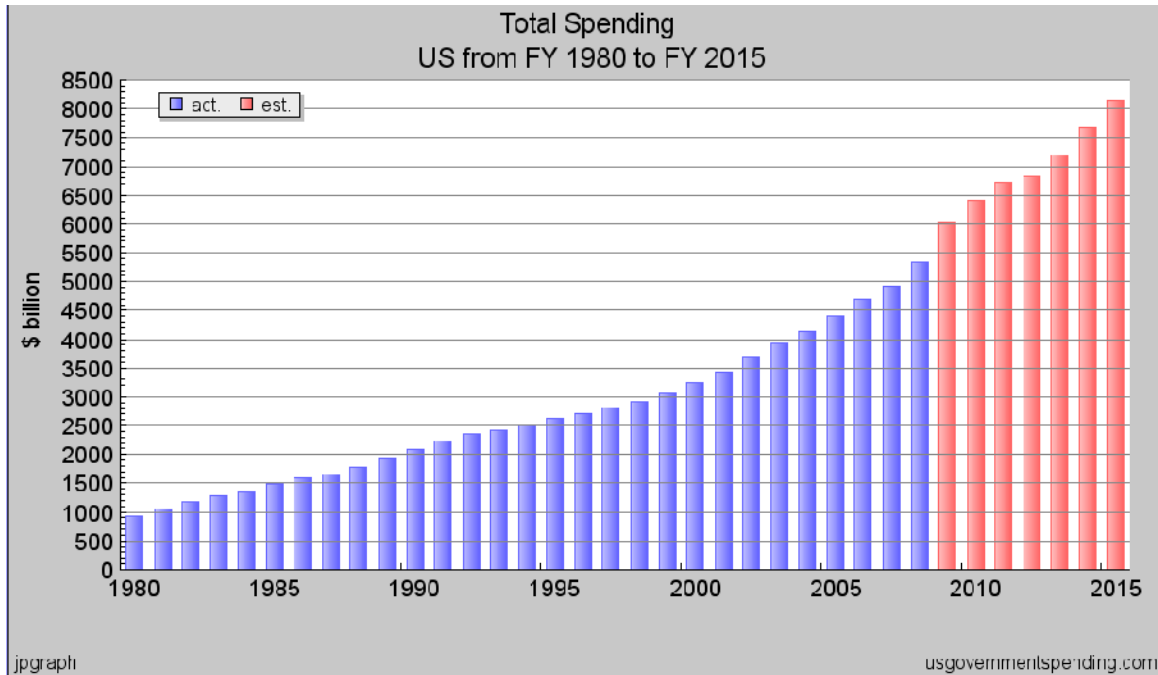
Recession Pushes Current Tax Receipts Below Historical Average



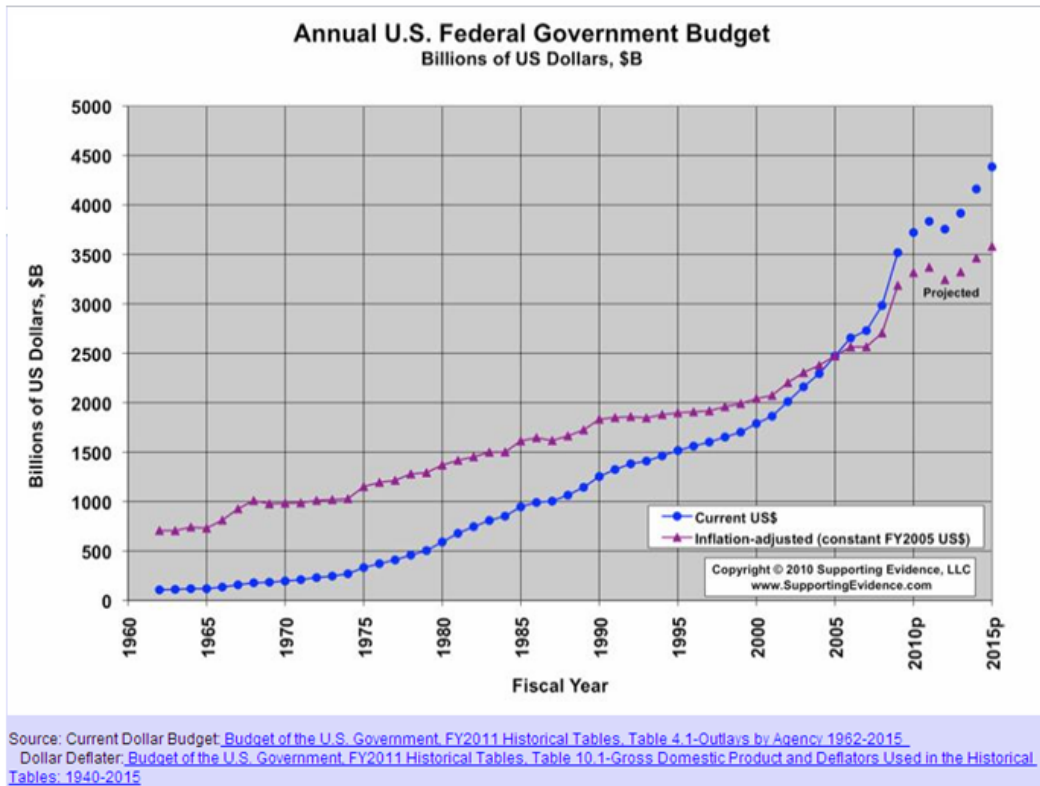
Federal Revenue Chart 5 • 2010 Budget Chart Book heritage.org

Fact # 3) Receipts may be down the past year or two, but Government Spending is rising in nominal, inflation-adjusted, and per-capita terms.

Unlike you and I, who can only spend more than we take in for a short while, the Federal, State, and Local governments, with their incredible capacities to borrow seemingly unlimited (for now) amounts of money, *can* spend more than it takes in, a *lot* more, and it *has been*, for many years now. Proponents of the "Bush Tax Cuts" (the first time they were proposed in 2001 and 2003) argued then that by constraining the tax revenues the government took in, elected representatives would be forced to sharpen their pencils and reduce government spending proportionally. Obviously, they miscalculated the level of fiscal spending discipline that exists on the Hill. The Federal, State, and Local governments in this country will spend more than \$6 Trillion (yes, with a "T") this fiscal year alone. That is more than a six-fold increase in government spending over the past thirty years, and amazingly, well more than three dollars for every two they will take in this year alone. Don't try this at home folks....



And again, before you suggest that inflation *alone* could be the cause of such an increase, the chart that follows reveals that Federal government spending has more than *doubled* over the past thirty years, even on an *inflation-adjusted* basis.

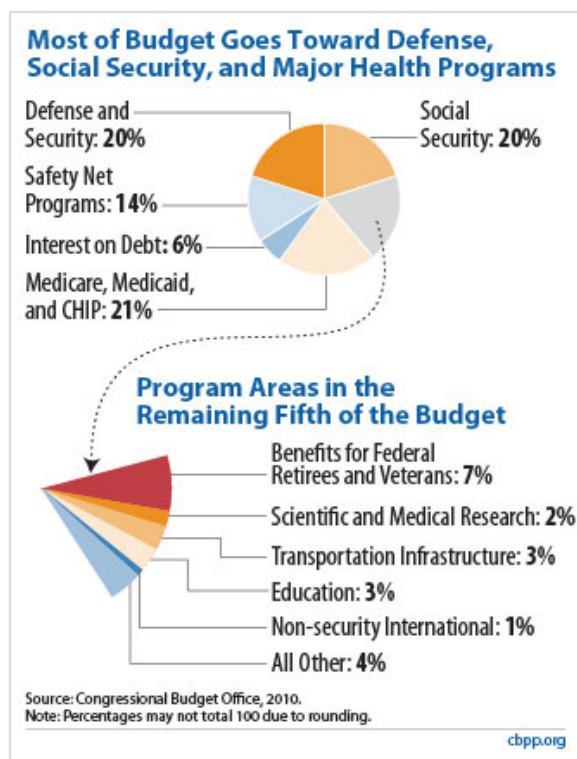


Placed in the context of the number of citizens the government serves, or *per capita government spending*, one observes that while the U.S. population has risen by approximately 35% over that period (1980 – 2010), an increase that would reasonably require a proportional increase in the need for more government services, Federal government spending has risen by an incredible 135% during the period. Let me repeat that. **Inflation-adjusted, per-capita Federal government spending has more than doubled in the last thirty years.**

While the left can rightly complain that far too many Americans live at, or below the poverty line today, the right justifiably responds that **our government is bigger today by every measure imaginable, delivering *more services to more people* than ever before, and it cannot be denied that *they have taken on more and more financial responsibility in areas it had never delivered services before.***

Fact # 4) Much of government spending is non-discretionary, leaving little room to cut.

Anyone paying even a modicum of attention to the spending debate knows by now that entitlements such as Medicare, Medicaid, and Social Security, as well as other Federally-subsidized “Safety Net” programs (i.e. Unemployment Benefits, Welfare, etc.) take a huge percentage of the government’s revenues. And if you add to those the cost of our National Defense, which one could argue is largely non-discretionary, as we live in an increasingly dangerous world, you’ve accounted for 80% of Federal government spending. The 20% that remains (i.e. “Discretionary Spending”) is really the only portion of government spending in which we have any discretion to meaningfully cut without fundamental changes to entitlements. The problem we’re facing today is that we could cut 100% of these discretionary programs, and we’d still have a *massive* deficit this year.



Fact # 5) Public (government) debt is exploding.

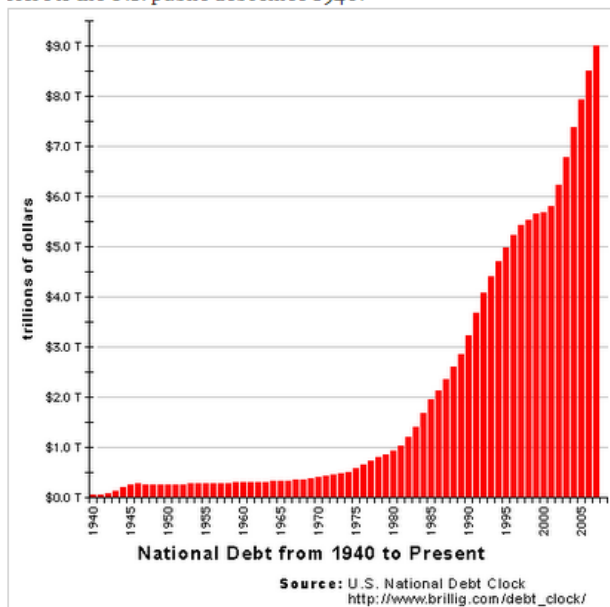
This is where the numbers get scary. The charts below tell the story. In both nominal-dollar *and* inflation-adjusted terms, the U.S. Public Debt our government has saddled us with over the past two decades defies rational explanation. Government debt is now the “can” that can no longer be “kicked down the road”. We are in the process of burying ourselves (and our children) with a debt-burden that is...well.... criminal.

Unfortunately (for us), the folks who are piling it on us actually make the laws, and its no surprise that with a simple passing of an increase in the “authorized Debt Ceiling”, which Congress regularly and routinely authorizes themselves, the thieves can simply continue to vote themselves the ability to spend far more than they take in.

The charts below are a bit dated. The outstanding U.S. Government Public Debt, which does not include the “Intra-Governmental Agency Debt” (i.e. the debt the government owes to *itself*, such as funds “borrowed” from the Social Security Trust Fund), stands today at **\$9.3 Trillion**. When one adds the Intra-Governmental Agency Debt, the U.S. Treasury’s outstanding debt, implicitly backed only by its future tax receipts, totals an unbelievable **\$13.9 Trillion**. **That’s a \$44,650 “share” of Federal government debt for every man, woman and child living in the U.S. today.** The “share” for the typical family of four now totals \$178,600, and given the virtual certainty of ongoing fiscal deficits as far as the eye can see, that debt burden, which far exceeds the average family’s annual income, will only rise. One wonders how high it can go before Moody’s rightly downgrades the U.S. Treasury’s AAA credit rating.

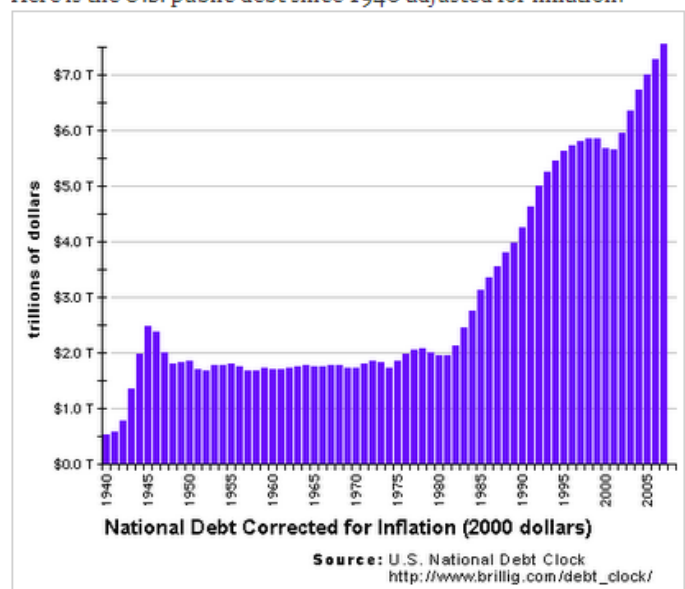
U.S. Public Debt Since 1940

Here is the U.S. public debt since 1940:



U.S. Public Debt Since 1940 - Adjusted for Inflation

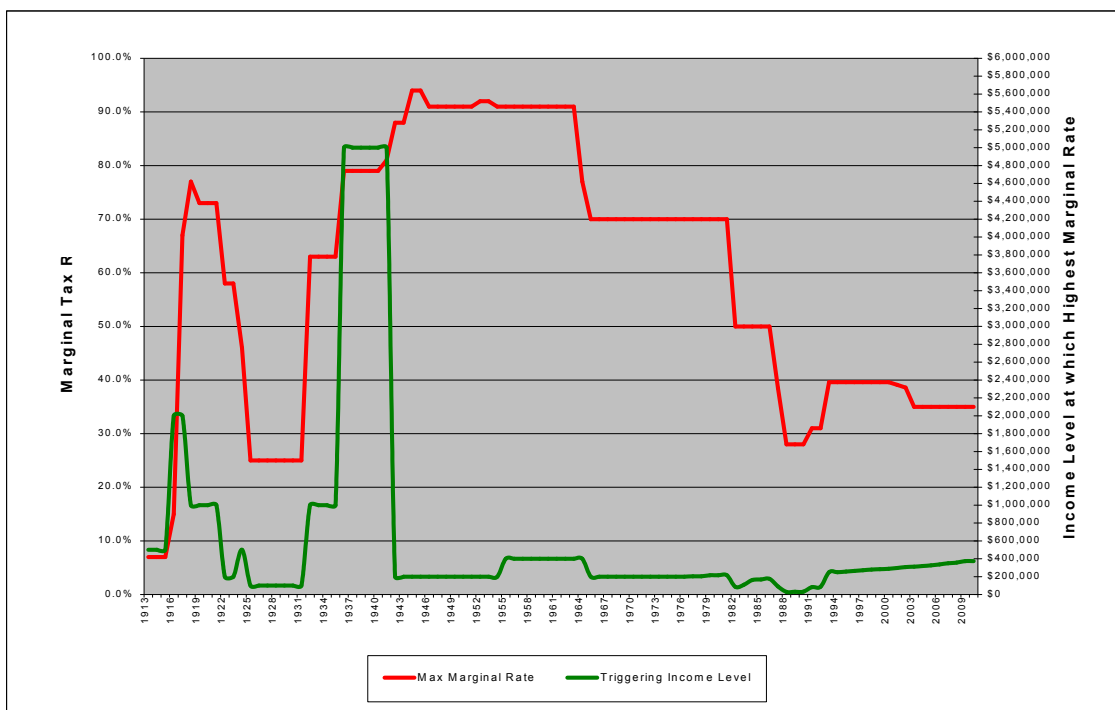
Here is the U.S. public debt since 1940 adjusted for inflation:



Fact # 6) The “wealthy” don’t pay their “fair share” of the tax burden. In fact, they pay more than their share.

Now, while politicians on both sides of the aisle have assigned blame for this debt to everyone but themselves, the biggest (and most infuriating to me) misstatement one regularly hears from the left is the statement that “*the wealthy don’t pay their fair share*” (of the tax burden).

It is true that the upper end of marginal income tax brackets today are lower than in the past. Since the permanent establishment of the personal income tax with the ratification of the Sixteenth Amendment to the Constitution in 1913, marginal income tax rates have always been “progressive” (*rising* in percentages at higher taxable income levels), but Congress has, over time, continually attempted to socially-engineer societal income levels with tax policy. The highest marginal (Federal) income tax brackets have been as low as 25% (1925 – 31), and as high as 90% (1944 – 45), and those maximum brackets have been triggered at taxable income levels as low as \$100,000, and as high as \$5 million. (It seems the definition of “wealthy” changes from time to time.)



Source: Tax Foundation: U.S. Federal Individual Income Tax Rates History, 1913-2011

Our current President has famously “defined” wealthy American couples (or at least those not “deserving” of tax relief in his opinion) as those who earn \$250,000 or more per year. Under current law, couples with taxable incomes of \$250,000 would find themselves in the 33% marginal tax bracket, and it takes taxable income of \$373,650 in 2010 to reach the highest marginal tax bracket of 35%.

One can debate the equity of a progressive tax system. One can even debate whether or not the government should be increasing its tax revenues during a fragile economic recovery. But there should be no debate at all over the question of the “share” of the tax burden the wealthy bear today. The wealthiest Americans today pay *far more* than their proportional share of income receipts. Look at the facts and decide for yourself the “fairness” of our current system’s burden on wealthy Americans.

The Tax Foundation (www.taxfoundation.org) is a nonpartisan, non-profit educational organization, founded in 1937, whose mission is simply to educate Americans on the size and distribution of the American tax burden. It provides interested observers a wealth of information on tax issues and payments, and I’d highly recommend their site to any Americans who want factual information on income tax policy without the partisan invective. I look forward every year to its analysis of our annual personal and corporate tax filings, a task it has undertaken with assistance from the Internal Revenue Service for seven decades. The most recent annual release on individual tax payments (*Summary of Latest Federal Individual Income Tax*) was posted on October 6th of this year, compiling 2008 filing data.

In reviewing the 139,960,580 individual income tax filings made that year, the Tax Foundation notes that the depth of the recession the country was experiencing that year reduced the Fed’s take from individual filers by \$84 billion, and that individual’s “effective” tax rates were at their lowest average since 2004. Their report slices and dices tax filers into percentile segments, and provides incomes and tax burdens paid by each segment.

The table below reveals some interesting data you simply won’t hear cited by the left, and strangely, you likely won’t hear them from the right either:

In 2008, Americans’ taxable incomes (by percentile earnings), their respective “shares” of the nation’s total income (as measured by Adjusted Gross Income), and their percentage of the total taxes actually paid, were as follows:

<u>Taxpayers by Percentile</u>	<u>Adj. Gross Incomes</u>	<u>Share of AGI</u>	<u>Share of Tax Paid</u>
Top 1%	> \$380,354	20.00%	38.02%
Top 5%	> \$159,619	34.72%	58.72%
Top 10%	> \$113,799	45.77%	69.94%
Top 25%	> \$67,280	67.38%	86.34%
Top 50%	> \$33,048	87.25%	97.30%
Bottom 50%	< \$33,048	12.75%	2.70%

Source: Tax Foundation: *Summary of Latest Federal Individual Tax Data*; Oct. 6, 2010

There is little mention in the public discourse that 52 million filers that year (37% of all American tax filers) used exemptions, deductions and tax credits to completely wipe out their income tax liability. Not only did they get back every dollar that the Federal government withheld from their paychecks during 2008, but some even received more back from the IRS. Interestingly, but perhaps not surprisingly, given their number (and their votes) we don't hear politicians discussing tax "fairness" when speaking about those folks.

I believe that most Americans would be shocked to learn that the wealthiest among us pay a disproportionately larger percentage of the total tax burden, especially given the rhetoric the politicians in Washington and the media use in describing their contributions. The left would have you believe that wealthy Americans are somehow maliciously avoiding payment of their tax liabilities, apparently availing themselves of "tax breaks" unknown by, or unavailable to average Americans. Serving many "wealthy" Americans professionally, I can personally confirm that this is simply not the case. Over the almost three decades of experience I have in this field, my experience has been that even as marginal brackets fell from 70% at the beginning of the Reagan administration to half that percentage today, the elimination, or limitation and/or phase-out of itemized deductions as offsets to earned income has led to wealthier Americans actually experiencing higher "effective" tax burdens today than ever before. The reader may recall the early '80's, when "tax shelter programs" were abundantly available, many of which offered 2-to-1, or 3-to-1 (or more) write-offs, providing incentives for taxpayers to invest in programs with little economic benefits other than the avoidance of tax. At that time, many exceptionally wealthy Americans did avoid income taxation. That is no longer the case, as the data I just shared proves. The creation of the Alternative Minimum Tax (AMT) system in 1970, and adjustments to their calculations since, has effectively eliminated the use of abusive tax shelters, and that is tax reform I support.

Frankly, what bothers me most about the debate over "tax fairness" we are currently observing our leaders engage in is the *tone* left-leaning politicians use when describing wealthy Americans as "millionaires and billionaires" (read between the lines, "fat cats"). They also assume all American families earning \$250,000 are millionaires (they're not), and they almost spit the words from their mouths, as if acquiring wealth could only be achieved by illicit or immoral means. And subliminally, but not too subliminally beneath the "fairness argument" they attempt to make, their tonal inference is that these fortunate few earned their incomes and wealth in less-than-honest endeavors (they didn't). Again, as I work with wealthy Americans in my practice, I can tell you that the vast majority (90% or more) of my clients came to their wealth "the old fashioned way", by earning it. They are entrepreneurs and/or professionals, who, by virtue of their hard work and risk taking, have accumulated wealth, paying income taxes all along the way, and in most cases, by employing other Americans, people who would otherwise not have gainful employment were it not for the businesses they created. As I've said, I'm fairly certain that my clients are very representative of the "wealthy" the President and his followers infer aren't paying their "fair share", and I simply beg to differ, presenting these irrefutable factual data as my argument:

The top 1% and 5% of Americans earn 20% and 34.73% of the nations' income, but pay disproportionately higher 38.02%, and 58.72% of the nation's total income tax burden.

Given this simple and stark statement of fact, there are simply no definitions of the words "fair", or "share", that could support an argument that these people are somehow not living up to their obligations. The increasing concentration of wealth in a smaller number of Americans is indisputable, and a problem for leaders to address through educational reforms, and improvements in opportunities for all Americans, but *tax policy is not the cause of that problem*. The wealthy are already disproportionately burdened by taxation, and when one adds to that argument the fact that more than a third of Americans pay no income taxes at all, I would suggest that decency, and yes, "fairness" would dictate that we not rhetorically vilify these hard-working folk **who pay more than their fair share by every nominal, per-capita, or proportional measure** one can cite.

In a capitalistic system, absolute income equality cannot be achieved, nor, in my opinion, should it be sought. I believe the history of American prosperity proves nothing if it hasn't proven that the profit motive incites innovation and risk-taking, and I would argue that a comparison of the standards of living in capitalistic economies such as ours, versus those living standards seen in socialistic or communistic systems would lead an honest observer to recognize the obvious virtues of a system that economically rewards such activities.

Let me be clear. I am not advocating a tax system that taxes everyone the same amount, regardless of income. I'm not saying that those who enjoy higher incomes (even as a result of hard work, risk-taking, or frankly, better life choices) should not pay more than the "average" American in income taxes. The "redistribution" of wealth through tax policy is necessary to a degree, and I'm all for a proportional increase in their tax burden. There can be no question that a society is best served when all its citizenry have the ability to purchase goods and services essential to human existence, and candidly, we are far from meeting that standard today. But when the burden is so disproportionately borne by such a small number of tax payers, the use of pejoratives to describe those folks, and the promotion of class warfare to disproportionately confiscate more from those few, risks the deterrence of further profit-making activities, and that would be detrimental to all Americans. I believe the push-back we've recently seen by the Tea Party to the levels of government spending and taxation would indicate that even middle-class tax payers are starting to recognize that the problems we face today have less to do with tax revenues, and who pays them, than they do with the *spending* side of the equation.

Conclusions

Perhaps the reading of the previously cited facts has led you to different conclusions about government spending and taxes than you previously held, and perhaps not. But I believe the country's fiscal mess has led us to the inevitable point at which an "adult conversation" (incoming Speaker Boehner's favorite term) about American spending priorities and obligations would be beneficial, if not absolutely necessary. For too long we've (collectively) kicked this (deficit) can down the road. That adult conversation needs to start by asking some very basic, and fundamental questions, such as:

- What are our most important national spending priorities? What must we spend on, and in which order of importance do these priorities lie?
- Assuming we have finite resources (\$\$\$) to allocate to these priorities, which current spending programs can be cut back, and yes, which can we cut out altogether?
- Where is there waste, or worse, fraud, in government spending? What other countries are benefiting from our aid, or from our military defense, and where can we cut back in these areas?
- What do we do about the impact “baby-boomers” are having (and will continue to have) on entitlements such as Social Security retirement, Medicare, and Medicaid? Can some of these programs be adjusted to account for longer life expectancies? Can some be means tested?
- On the subject of means testing, is it “fair” that those who paid the most into these systems (often including the “employer’s share for themselves and employees) should be denied the benefits they paid for, simply because they’ve accumulated wealth (after taxes) through their honest labors?
- What kind of society do we want for America’s future generations? Do we want an economic system that promotes profit-making activities, and allows those who generate them to keep as much of them as possible, or do we want a more “European” (social democracy) model that seeks to limit the “range” of incomes its citizens can earn (and keep)?
- Do we want all the government we can buy, or as little as we can afford?
- What constitutes “tax fairness”? Should we have an even more progressive tax policy than current, even for a time, where the wealthier among us would pay an even disproportionately larger percentage of the burden, or a “flatter” tax policy in which fewer Americans would pay nothing at all?
- Does it make sense to scrap the massively complex Tax Code, and start over with something flatter, fairer, and less complex?

Regardless your answers to these questions, they need to be asked, and answered, and soon. Our government’s fiscal deficits (and our total debt) have now reached levels where even the most fiscally irresponsible politician can no longer ignore the oncoming dangers. They are upon us.

As always, we welcome your comments.

-JRP

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