



March 1, 2006

Investment strategy and recommendations
for the U.S. fixed income market

Special Report

U.S. AGING TIME BOMB: WHEN WILL IT BLOW UP TREASURYS?

The following *Special Report* was written by our Washington Editor, Dr. Rudolph Penner. Dr. Penner is currently a resident scholar with the Urban Institute, a nonpartisan public policy research organization in Washington. He has been a pre-eminent and influential analyst of budget policy for the past two decades. He was also director of the Congressional Budget Office during the mid-1980s.

Dr. Penner analyses the Bush Administration's 2007 Budget, and reviews the long-term outlook for fiscal policy and the budget balance. The short-run budget outlook is fairly benign. The 2006 deficit will be much lower than the Administration's estimate of \$423 billion. Fiscal policy will have a roughly neutral impact on real GDP growth this year, and could be slightly contractionary in FY2007.

The good news is that the budget deficit is likely to decline as a percent of GDP for the next few years, even if the President's tax cuts are made permanent. The bad news is that little progress will be made on reforming entitlements, which are set to explode in the next decade as the population ages. Congress is unlikely to tamper with Social Security and Medicare until it is forced to do so by voters or financial markets. It may take a riot in the bond market before politicians act.

The aging time bomb is ticking. Nonetheless, the bond market is sanguine at the moment, and a declining deficit/GDP ratio in the next few years reduces the risk that a riot point will erupt in the near term. Thus, we do not think that bond investors should position for a major increase in fiscal risk premiums within a one or two-year investment horizon.

If, as is often said, a country's budget is a comprehensive statement of a nation's priorities, it is clear that the American people dearly love the elderly. The total amount spent on Social Security, Medicare, Supplemental Security Income, as well as civil service, military, and veterans' retirement and disability programs will equal over \$1 trillion in 2006 – about 57 percent of total Federal spending outside of defense and interest.¹ And this does not count the substantial amounts spent on the elderly within the Medicaid program or the smaller amounts spent within welfare programs, such as food stamps.

¹ The \$1 trillion includes amounts spent on the disabled, but elderly recipients are dominant.

By comparison, about \$500 billion will be spent on defense. Indeed, it is a secular decline in defense relative to GDP that has mainly financed the expansion of Social Security and Medicare (**Chart 1**). Means-tested programs targeted on the poor spend roughly one-third the amount spent on programs for the elderly and disabled that are not means tested.²

² Supplemental Security Income, a program focused on poor elderly and disabled is not included in this calculation. It should be noted that a significant portion of the spending on Social Security and Medicare goes to the poor even though they are not targeted by the programs.

CHART 1
Defense Makes Way For Entitlements

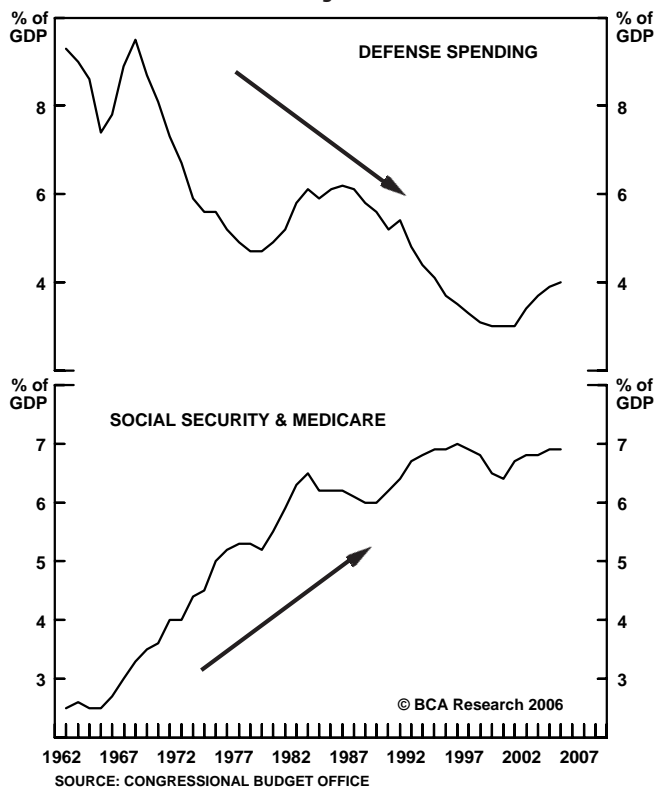
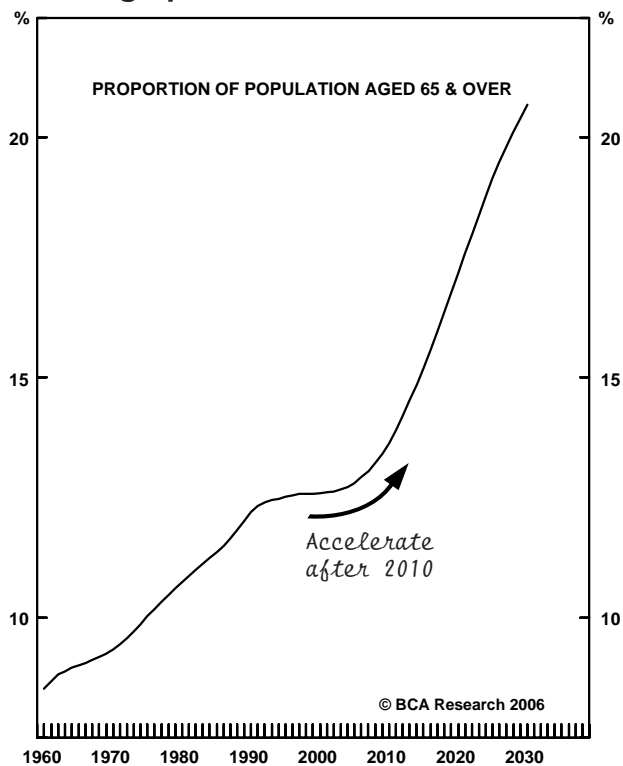


CHART 2
Demographic Disaster Looms



As is well-known, the elderly population will begin to soar over the next decade because of aging baby boomers and increasing longevity. Also, the per capita cost of providing the elderly and disabled with health care can be expected to continue to grow faster than per capita income (Chart 2). As is also well-known, this means that the programs for the elderly are not sustainable in their current form.

This problem does not seem to make much of an impression on either Congress or Wall Street. The latter is important, because the financial community represents one of the few constituencies that could scare Congress into fiscal discipline.

A recent auction of 30-year U.S. Treasury bonds went very well, yielding lower interest rates than expected. It is, at least, interesting to note that in 2036 when these bonds mature, reasonable projections of the financial implications of current policy imply that the U.S. public debt will exceed 200 percent of GDP. The buyers of these bonds must assume either that they

will be able to sell them before anyone begins to worry about this budget trajectory, or that the trajectory will eventually be made sustainable by fundamental programmatic reforms.

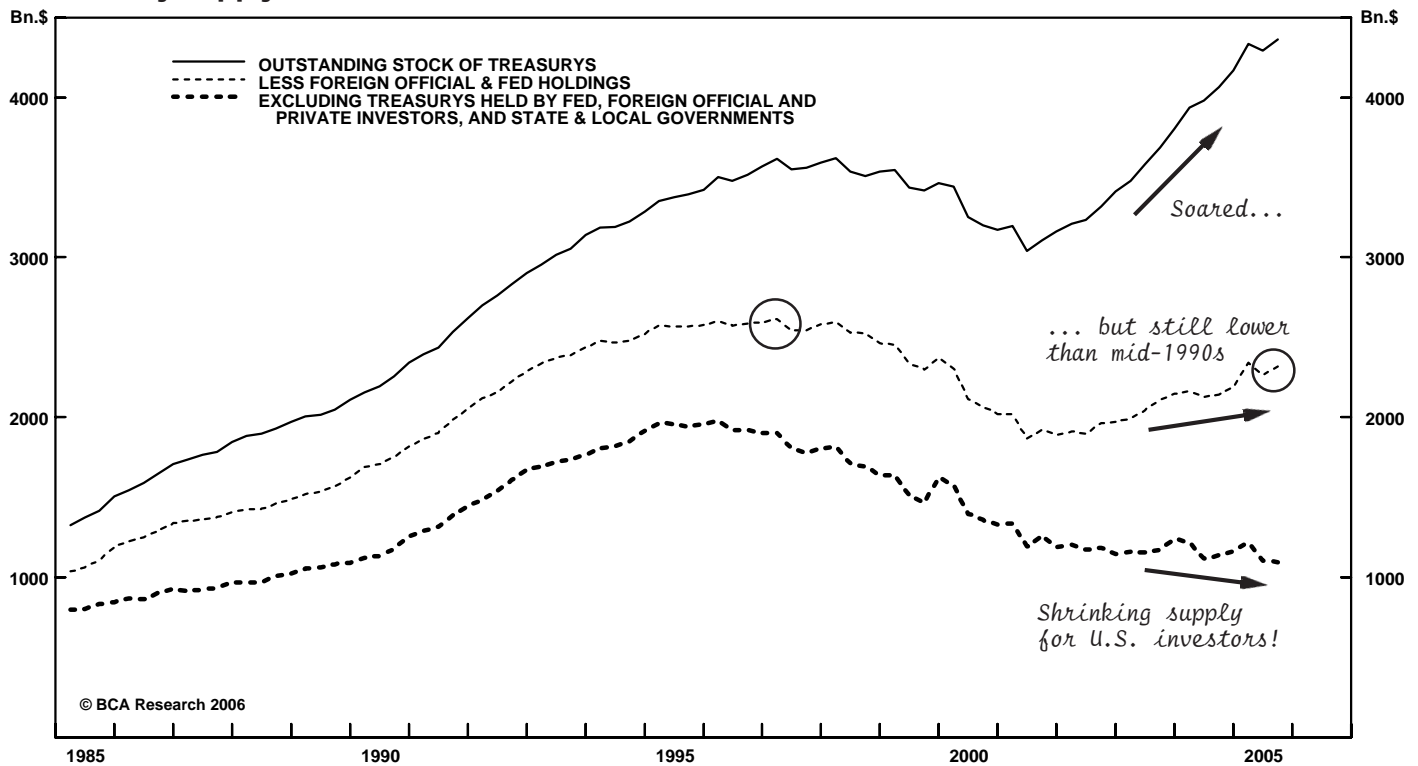
Financial Markets Will Have To Riot

Given Congress' current mood, it is extremely difficult to envision significant reforms unless they are prompted by a financial crisis. When might such a crisis occur? It is difficult to say, because financial markets are so fickle in their attitude toward fiscal policy. They went into some turmoil when Jimmy Carter put out a budget in January of 1980 that had a deficit of \$16 billion. A short time later, they accepted Reagan's deficits of more than \$200 billion with total equanimity.

The bond market would likely have priced in a significant fiscal risk premium by now, if it were not for Treasury purchases by foreign central banks.

Chart 3 shows that the outstanding stock of

CHART 3
Treasury Supply



Treasuries has surged to over \$4 trillion. However, the stock available to the private sector (i.e. after Fed and foreign central bank purchases have been excluded) has risen much more slowly and amounts to a little over \$2 trillion. Foreign demand helps to explain why real yields have stayed so low in the face of the budget blowout.

One can identify certain crucial events that may attract attention and provoke a Wall Street reaction. The first baby boomer applies for Social Security in 2008, and qualifies for Medicare in 2011. Entitlement spending starts to rise much faster than GDP by 2013. Later in the decade, the cash flow of the Social Security trust fund turns negative. Some time in the mid-2020s, the public debt passes 100 percent of the GDP.

The rating agencies will play an important role in the reaction of financial markets. At what point do they choose to downgrade the U.S. government debt? In my view, they have sufficient reason to do it now. But they hesitate, because that action would be so

traumatic, and they still hold out hope for reform. Financial markets will likely react before the rating agencies make any moves. The 2008 Presidential election could be a turning point if reform is not seriously debated. Nonetheless, there is a good chance that financial markets will ignore the deficit until well into the next decade, when the rising proportion of retirees begins to accelerate.

The Bush Budget And The Elderly

The President made a terrible error early in his presidency by supporting a new Medicare prescription drug program that greatly worsens the budget trajectory – without demanding any significant Medicare cost savings in return. More recently, his track record is better. Last year he offered proposals for a fundamental redesign of Social Security. There were significant problems with his design, but that was almost irrelevant to the subsequent debate. His opponents were able to sink the whole notion of reform without having to offer alternative proposals. It is now generally agreed that

the Social Security debate is dead for a good long time.

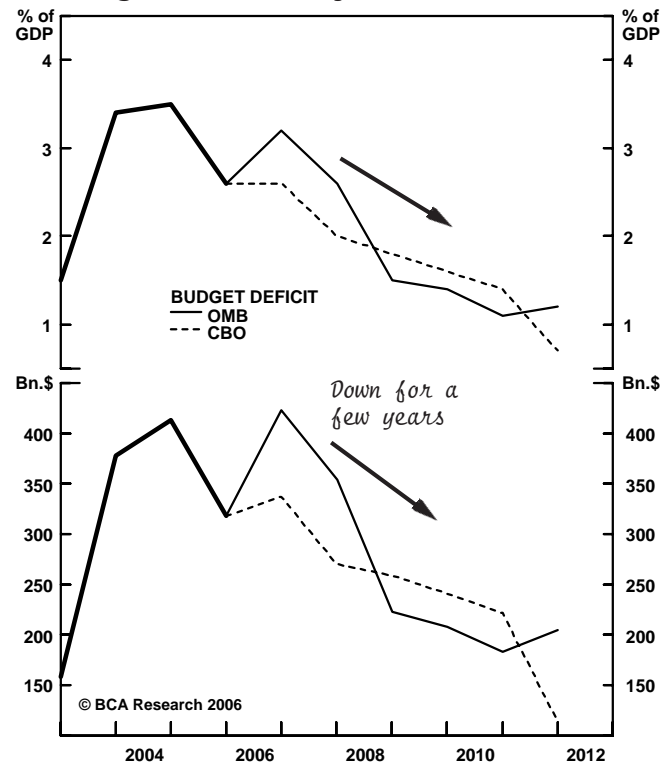
In this year's budget for FY2007, the president repeats his Social Security proposal and begins to nibble at the much more serious Medicare problem. He has suggested cuts in payments to the doctors and hospitals who provide health care and increases to the Medicare premiums paid by the more affluent. He has also recommended a further automatic cut in provider payments when dedicated revenues can no longer finance as much as 55 percent of the cost of the program. Providers will strongly resist any reduction in their fees and they are busily organizing to oppose these reforms. The political unpopularity of Medicare reform represent one of many reasons why so many observers believe that this budget is "dead on arrival."

It is again probable that the President's proposal will sink without a trace, without his opponents having to propose any alternatives. If Democrats perceive that they have gained in the 2006 election by just saying "no," and Republicans perceive that they lost support because of the President's proposals, it will be a very long time before Congress returns to the long-term budget problem, unless it is forced to by financial markets.

The Deficit In The Short Run

The most curious feature of the President's recent budget is an estimate that the fiscal 2006 deficit will soar to \$423 billion, or \$105 billion above the 2005 level (**Chart 4**). Budget deficits are sufficiently volatile that one has to be careful about saying that this is impossible, but it sure seems implausible. The fiscal year is more than four months old and the deficit through January is \$15 billion below that of 2005. It is true that the growth of revenues will slow significantly during the rest of the fiscal year and that the spending pace will accelerate because of the prescription drug program, but the deterioration in the last two thirds of the fiscal year

CHART 4
Budget Picture Okay For A Few Years



would have to be extreme to reach the Administration's deficit estimate.

The Congressional Budget Office (CBO), making reasonable policy assumptions, estimates a 2006 deficit of \$355 billion, fully \$68 billion lower than the Administration's estimate (**Chart 4**). If policies were not changed, their deficit estimate would be \$337 billion, but they expect a substantial increase in spending on Iraq and Afghanistan as well as some relief from the alternative minimum tax. Fiscal policy was slightly restrictive in 2005, as measured by the change in the standardized budget deficit. The fiscal thrust in 2006 is hard to read. The initiation of the prescription drug program will push spending upward and will be counted in naive measures of fiscal thrust, but much of this will be a substitute for private spending on drugs. Will individuals spend their drug savings on other things or will they put it in a bank account? There is no major change in tax policy, although the standardized deficit will make the continued surge in individual income receipts appear restrictive. It is more accurate to think of that increase in the tax burden as

providing a built-in stabilizer. Then, it is reasonable to conclude that fiscal policy will be approximately neutral in 2006, whatever is shown by the cyclically-adjusted deficit when it is computed in a few weeks. In 2007, fiscal policy will be very slightly restrictive, if war spending starts to trend down and Congress is as restrained on domestic spending as the President would like it to be.

One of the bigger uncertainties in the budget outlook for the next few years involves the path of corporate tax revenues. They constituted only 13 percent of total revenues in 2005, but they are extremely volatile. They rose 47 percent in 2005, largely because of temporary tax changes, and CBO estimates that they will rise 8 to 9 percent in 2005. After that, CBO assumes that they remain essentially constant in nominal terms through 2010. This reflects CBO's pessimistic outlook for corporate book profits. If CBO is right about profits, it will be bad for the budget and probably even worse for equity markets. They expect a 1.2 percent profit increase in calendar 2006 and a decline in 2007 that will not be reversed until 2009.

The main question is whether the corporate profit share of GDP will revert to its historical mean and if it does, how quickly will that occur? CBO has the profit share reaching its historical mean in 2013. The *Bank Credit Analyst*³ is more optimistic, projecting 5 percent annual growth in operating profits over the next decade. The Wall Street consensus is even more optimistic for the near term, where the consensus of bottom-up analysts is calling for a 12% increase in earnings over the next year. Part of CBO's short-run pessimism is related to pension law at the time they did their analysis. Then-current law required large increases in contributions to defined benefit pension plans. New pension law should correct this problem.

Because of pension reform and a more rapid growth of underlying profits, I think it is reasonable to be somewhat more optimistic about corporate tax revenues than the CBO estimates. In the CBO outlook, the wage share of the GDP does not go up as

fast as the profit share falls, implying that less of the GDP is taxable. This is because of an assumed rapid rise in untaxed benefits, like health insurance, and some increase in depreciation. Even if the wage share rose as fast the profit share decline, it would not be good for revenues, because wages are taxed at a very much lower rate than profits.

Individual tax revenues grew 15 percent in 2005. CBO expects the growth to slow to 8.2 percent in 2006. The actual result will depend crucially on the fortunes of the very rich. The top 1 percent of adjusted gross income⁴ earners will probably account for more than one-third of individual income tax revenues in 2006. Reports of record bonuses on Wall Street may be an indicator that the rich have been doing quite well recently and this could expand income tax revenues beyond the CBO estimate.

With a little more optimism regarding corporate and individual income tax revenues, and a slowdown in the Katrina spending rate, it is relatively easy to create scenarios in which the 2006 deficit is actually lower than 2005's \$318 billion. Certainly, something less than CBO's \$355 billion seems more likely than a greater amount, and there is almost no chance that the deficit will be as high as the Administration's \$423 billion.

The Administration seems to be in a pattern of forecasting deficits very conservatively in the short run. They overestimated the 2005 deficit by \$109 billion three months after the fiscal year began and the 2004 deficit by \$107 billion. Their motives are not clear. It is true that exaggerated estimates early in the year means that they can claim great improvement as the year progresses, but projecting high deficits makes it more difficult to pass an extension of their tax cuts. It also undercuts the credibility of any budget projection.

That credibility is very low to begin with, given the large mistakes in recent years. Economists forecast

³ *The Bank Credit Analyst*, February 2006.

⁴ Adjusted gross income (AGI) is income adjusted for such things as contributions to retirement accounts and moving expenses. Exemptions and various itemized deductions, or a standard deduction is subtracted from AGI to compute taxable income.

deficits for several years in advance just before a sizeable surplus emerged in 1998. Then, such large surpluses were forecast into the future that we worried about running out of government debt. That problem was solved very quickly as we again sank into deficits. It makes it hard to get people to believe that we face huge deficits in the long run when we make such large errors in the deficit forecast for the very short run. Unfortunately, the long-run outlook numbers are so overwhelming that they could be much better than currently forecast and still leave a major problem.

The Administration projects a deficit of \$354 billion in 2007, but that does not include all the expected war spending. CBO estimates a current policy deficit of \$270 billion (**Chart 4**). Making reasonable assumptions about war spending and changes in tax policy, including restraining the spread of the alternative minimum tax, would bring the CBO estimate into the \$350 to \$360 billion range. If I am right that the 2006 deficit will come in lower than either the Administration or CBO is now forecasting, the 2007 deficit should be lower as well. But I would not expect much improvement over the 2006 outcome in absolute terms, *although the deficit should decline as a percent of GDP for the next few years, even if the President's tax cuts are made permanent*. That, of course, assumes that there is no recession.

While many, including some Europeans, refer to the Administration's short-run fiscal policy as being irresponsible, it is worth noting that the United States is very likely to keep its deficit below the Maastricht limit of 3 percent of GDP. In other words, we are doing better than some who actually signed the treaty. The real irresponsibility does not involve the short run. It is doing nothing about the long run. Congress has to take much of the blame for this, and I include both Republican and Democratic members.

Extending The Tax Cuts

The President's budget again asks that the tax cuts of 2001 and 2003 be made permanent. That would require 60 votes in the Senate and that is not plausible. So-called reconciliation procedures can be

used to pass tax cuts with a simple majority, but the cuts cannot extend beyond the time horizon used for the Congressional Budget Resolution (BR), that is to say, the resolution in which Congress stipulates targets for total spending, revenues and the deficit. This year the proposed BR is likely to use a time horizon of 5 years. That implies that the tax cuts could be extended through 2011, but that outcome is unlikely for a number of reasons.

First, the reconciliation procedures for fiscal 2006 do not allow for a sufficient revenue loss to both counter an increase in the alternative minimum tax and to extend the 15 percent rate on dividends and capital gains more than one year beyond the expiration date at the end of 2008. Congress may decide not to do even that much, though recent votes in the House and Senate recommend it. In order to act to extend the lower rates for more than a year, Congress will first have to pass a budget for 2007 and many observers think that this will be difficult. If Congress cannot pass a budget, they cannot use reconciliation procedures. Second, even if they pass a budget, it is not clear that there are 50 votes for extending the tax cuts for more than a very short period. Republican moderates will be reluctant to back the President in the face of large deficits, especially if his approval rating remains in the low forties.

The 2006 election becomes crucial to the long-run future of the 15 percent rate on dividends and capital gains, to the future of the rate cuts of 2001 and to the estate tax. If one examines particularly vulnerable Republican Senators, it is probably not important whether Chafee wins in Rhode Island. He is the most liberal Republican Senator and votes against tax cuts fairly consistently. But if the highly conservative Senator Santorum loses in Pennsylvania and the more moderate, but tax cutting, Senator DeWine loses in Ohio, the long-run future of the 15 percent rate will be in severe jeopardy, because Republicans could lose even more seats or because several Republican Senators who have been ambivalent about tax policy may decide not to vote in favor of an extension.

The individual income tax rate cuts passed in 2001 expire in 2010 and the estate tax would be revived in 2011 under current law. That means that the elections of both 2006 and 2008 become very important to the future of these tax policies. The top bracket rate, now 35 percent, is most contentious. It could again go slightly above 39 percent, depending on whether a Democrat wins the presidency and which party controls the houses of Congress. I find it hard to believe that even a Democratic Congress would eliminate the 2001 tax rate cuts that favor the middle class, or reduce the generous tax credits benefiting the poor. However, the top rate would likely rise if Democrats prevail.

Whatever happens in the elections, it is likely that there will be some compromise on the future of the estate tax, if only because current law – which requires that heirs inherit the decedent's cost basis in assets – is so complex as to verge on the unworkable. One might see a basic exemption as high as \$5 million (\$10 million for couples), and a top rate as low as 25 percent.

The President's budget provides some temporary relief from the Alternative Minimum Tax (AMT), but nothing specific is proposed for the long run. Congress will probably continue to muddle along, providing some relief year by year, but not preventing more and more taxpayers from being afflicted. It is unfortunate that the recommendations of last year's presidential panel on tax reform disappeared without a trace. Their report is superb. But they recommended financing the elimination of the AMT with limits on mortgage interest and health insurance deductions, and this is seen as being so politically implausible that the report was barely discussed.



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Conclusions

It is likely that the President's proposals for reforming Medicare will suffer the same fate as last year's proposals for reforming Social Security. Consequently, the long-run budget problem will be allowed to fester for the foreseeable future absent a financial crisis. The short-run budget outlook is much better than the long-run outlook, and the 2006 deficit will almost certainly be lower than the Administration's estimate of \$423 billion. It may even be less than CBO's most recent estimate of \$355 billion.

The fate of the temporary tax cuts passed in 2001 and 2003 will depend crucially on the next two elections, since it seems unlikely that they will be extended this year. Unless there is a remarkable recovery in Republican election prospects, the 15 percent rate on dividends and capital gains is in jeopardy, as is the top income tax rate of 35 percent. Rate cuts in the lower brackets and the tax credits for the poor should endure, however. There is likely to be a compromise on the estate tax that allows for a much larger exemption and lower rates than existed in 2000. Congress will continue to muddle through on the Alternative Minimum Tax, but they may not be sufficiently generous to prevent many more people from being afflicted by this strange and oppressive tax.

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