In the News

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No lightening of economic burdens apparent

By Paul Orfalea and Lance Helfert
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Last year, Federal Reserve Chairman Ben Bernanke said we have five choices: raise taxes; reduce spending on non-entitlement programs such as defense; reduce spending on entitlement programs such as Medicare and Social Security; increase budget deficits; or employ some combination of these.

Speaking to the Washington Economic Club on Oct. 4, Bernanke warned of the significant demographic change altering the country's economic make-up: the nation is aging, and adequate preparation for the coming demographic transition may well involve significant adjustments in our patterns of consumption, work effort and saving.

"Ultimately, the extent of these adjustments depends on how we choose, either explicitly or implicitly, to distribute the economic burdens of the aging of our population across generations," he said.

These economic burdens include elder-care costs, retirement costs, rising healthcare costs, and reductions in overall economic output and consumption. Bernanke raises both the issue of generational fairness, wondering how much of the burden will fall on our children and their children, and the issue of economic efficiency, what is the best way to manage our collective finances?

Such economic concerns weigh more heavily each day as the topics of income inequality and immigration get more media attention. As a result, many pundits and politicians have been banging the drum of economic populism, offering a disturbingly narrow range of solutions.

Boomers will remember that Bob Dylan sang "you don't need a weatherman to know which way the wind blows." For boomer investors, the wind is blowing toward higher, possibly much higher, taxes. We cannot make predictions, but we must consider the possibilities and their potential effects on our investment strategies.

Elder care

A New York Times headline in December read: "Elder-Care Costs Deplete Savings of a Generation." However, it might be more accurate to say that elder-care costs are draining the resources of two generations and possibly more. The paper reported that more than 15 million adult children care for their aging parents, "a responsibility that often includes paying for all or part of their housing, medical supplies and incidental expenses. Many costs are out of pocket and largely unnoticed: clothing, home repair, a cellular telephone."

Increasingly, elder-care expenses come out of children's own retirement savings. On Jan. 18, Bernanke spoke to the Senate Budget Committee of a "vicious cycle" as 76 million baby boomers qualify for Medicare and Social Security benefits and the cost of those benefits widens budget deficits, increasing the debt payments on those deficits.

As the boomers grow older and their parents experience unprecedented longevity, the market grows for medical equipment, pharmaceuticals and consumer healthcare goods. This should bode well for a company like Johnson and Johnson, which competes in all three areas. Still, investors and consumers must wonder who will pay for all this, and how much will they pay.

Will the boomers go bust?

Barely a week goes by without a major publication noting that baby boomers have not saved enough for retirement. While some lay the blame on selfish and wasteful consumption or the lack of fiscal discipline, economist and former Labor Secretary Robert Reich saw things differently in his April 5, 2006, blog entry titled "Why American Nest Eggs are Shrinking."

The answer is that most Americans don't save because they can't save. Despite the surge in corporate profits, the median wage (half of Americans earning more, half earning less) has gone nowhere. In fact, if you figure in the effects of inflation, you find that most peoples' wages and benefits have been dropping. Add in the soaring costs of healthcare and fuel, and the picture is even worse. Americans aren't saving — they're going into debt — for the simple reason they're earning less and have to spend more.

Many people confuse the stock market with the economy, and until recently the stock market had been celebrating a bull run, despite enormous increases in the cost of oil, healthcare, and groceries.

However, as their debts mount and their buying power shrinks, people will stop asking how the Dow is doing.

Expedient solutions

Let us again consider the choices offered by Bernanke:

1. Reduce spending on entitlement programs. Social Security and Medicare are always campaign issues, but rarely legislative issues. As 70-80 million baby boomers qualify for benefits, the political cost of touching the so-called "third rail" of politics only increases. Reducing expenditures on entitlement programs, therefore, seems unlikely.

2. Reduce spending on non-entitlement programs. Since Sept. 11, 2001, a candidate recommending cuts to non-entitlement spending, which is mostly defense, would face considerable challenges getting elected. Thus, non-entitlement spending cuts of consequence are politically risky.

3. Increase the budget deficits. This is more than an option; it's been the de facto standard in recent years, and one wonders how long this can go on. But increasing deficits may be little more than a deferred tax increase, depending on the economy's long-term performance. However, the idea of balancing the budget always seems to find political traction in an election year, so increasing the deficit — as an overt policy choice — seems unlikely.

4. Raise taxes. Populist pundits and lawmakers have been calling for increases in marginal tax rates, higher ceilings on earnings subject to social security taxes, and higher capital gains taxes. Short term, this choice could slow the economy as people lock up huge sums of capital to avoid taxation. Long term, this could result in higher interest rates, lighting the fuse on America's debt bomb. Despite the fact that tax increase "fixes" have never solved our problems for long, their expediency gives them an edge in Washington.

Bernanke suggested that some combination of higher taxes, reduced spending and deficit management could solve the problems caused by our coming demographic shift, but that would require the sort of level-headed, compromise-based, thoughtful and practical problem-solving approach that does not fit easily on a bumper sticker. In other words, it is a hard sell, politically speaking.

What's the alternative?

Although John Edwards does so most overtly, all of the current Democratic presidential candidates strike populist chords on the subjects of healthcare and trade, and several Republican candidates have joined the chorus. It has become quite fashionable to pit "the people versus the powerful," as Al Gore put it, on the topics of tax fairness, education and energy policy.

The oratory is stirring and sometimes compelling, but every proposal carries unintended or underestimated consequences: how will our foreign allies respond to increased protectionism? Will middle class financial insecurity express itself in anti-immigration policy? Are populist proposals inflationary? Will higher capital gains taxes reduce liquidity, and will reduced liquidity slow innovation?

As we have seen with the recent subprime mortgage fiasco, anything can happen. In hindsight, everything seems predictable, but only uncertainty is truly certain. A capital gains and marginal rate tax hike might not solve the nation's financial woes, but it must be considered as a possible outcome of the growing populist political movement.

This is why entrepreneurial investors accept uncertainty as part of their investment strategy: quality companies and tax-efficient portfolio management will serve one well, come what may.

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