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Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

Last night, I watched the Vice Presidential debate until I couldn't take it any longer. If that was a debate, I don't know what an argument is. While I understand Joe Biden's desire to be assertive, and even aggressive, at one point during the proceedings, a scene from "This is Spinal Tap" came to mine: "This one goes to eleven."

Certainly, members of either party will applaud their candidate's performance, and deride their opponent's; however, I wonder what the truly undecided felt watching last night. Frankly, I can't imagine last night did much of anything for either ticket, which, after last week's Presidential debate, could be sort of a victory for the Administration, I suppose.

With that said, the debate of tax policy caught my attention, and I wasn't real pleased with what either man had to say on the matter. It seems as though tax policy exists solely to "feed the machine," regardless of consequences. While that might elicit more than a few "duhs," I was struck by how neither candidate had what I would consider to be a coherent tax plan to stimulate growth.

Take the proposed increase in taxes on the arbitrarily defined "wealthy." This gets a lot of press, which is unfortunate, because solely increasing taxes on the Top 1% won't have a real effect on reducing the overall level of public indebtedness moving forward. Why? Because budget projections are about as useful as pro forma financial statements.

They are, at best, a guess, and, at worst, a mechanism to distort future expectations. So, when the public and debate moderators ask for 'specifics' regarding tax policy what the two parties will give them are nothing more than a stab in the dark supported by some math generated by someone who is also taking a stab in the dark.

As Ned Ryerson, aka Needle Nose Ned and Ned the Head, from the movie "Groundhog Day" might say: "You know I've got friends of mine who live and die by the actuarial tables and I say, "Hey! it's all one big crap shoot any hoo." Indeed. After all, if you could look into the future with perfect clarity, you wouldn't be in a debate with anyone, now would you? Whew.

While we never know for certain what the tax receipt impact of tax policy changes will ultimately be, we do know tax receipts tend to go up when economic activity goes up. As such, any effective tax policy will be one which encourages economic growth, as opposed to targeting tax receipts, if that makes sense.

Basically, a rising tide lifts all boats. Would you rather have 10 out of 100 OR 15 out of 200?

Despite centuries of economic growth to the contrary, many people, including today's politicians, tend to look at economics as a "zero sum" game; that it doesn't have the potential to get exponentially larger. There is no other way of defending today's complicated tax code, and proposals to increase taxes on a small segment of society. It is confusion over relativity and absolutism.

Which is more important when you are trying to balance the books? Some might argue the former, but I think greater emphasis should be on the latter….by far. If someone is productive and clever enough to earn $8 million per year, do you ratchet up the tax on the $8 million, or do you do every-

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If we open a quarrel between past and present, we shall find that we have lost the future.

Winston Churchill

thing in your power to encourage them to make $10 million? Again, do you want 10% of 100 or 7.5% of 200? I would opt for 7.5%, but our politicians are more preoccupied with the 10% number out of a sense of perceived fairness. There is no serious economic or balancing the budget argument you can make with proposed tax increases at this time, seriously. Our primary budget woes are on the spending side, and due to sluggish economic growth.

Can you increase economic activity by raising taxes? That is the real question, and it depends.

While our economic pie has unlimited potential, it can be constrained, if you accept the private sector is a better generator of wealth than the government. It is all due to discretionary income, what the economy has, in aggregate, to spend and invest. As you can imagine, more discretionary income is preferable to less.

Now, IF the increases in tax receipts are greater than the rate of increase in economic activity, discretionary income in the economy will go down. That makes sense: the higher the level of tax collections, the lower the amount the consumer has to spend. So, if the goal is to collect more money from the people who "can afford" to pay it, you have to increase tax rates at a rate less than the increase in their discretionary income in order to consistently increase tax revenue over an extended period of time.

In essence, it is far preferable to have a growing pie. How do you do it?

At the end of 2Q 2012, the growth in year over year (12 month), inflation adjusted disposable income in the US was 1.3%. The average increase going back to 1960 is 3.3%. So, currently, disposable income in the United States is growing significantly less than the historical average, significantly. As a result, tax receipts as a percent of GDP has remained less than the desired 20% for an extended period of time. Therefore, you can make a coherent argument our problems with tax collection in the country have far less to do with a small percentage of people making an obscene amount of money than they do with the economy, as a whole, simply not producing enough disposable income.

In short, something is broken, and do you fix it by increasing tax rates OR by producing more disposable income? This is where I will become counterintuitive.

In nominal terms, unadjusted for inflation, what has been the biggest drag on personal income, and therefore disposable income and even tax receipts? The kneejerk reaction is the weak labor markets, right? I mean that makes sense, as we all know about the woes in the employment numbers. However, this would be an incorrect response, as 'wage & salary disbursements' in the United States are actually higher NOW than they were before the financial panic and ensuing recession. Isn't that hard to believe? In fact, this measure, this subset, of personal income was at an all-time high, in nominal terms, as of its last reading in August 2012. Frankly, that doesn't compute.

So, why is disposable income barely inching along, and has, in fact, slowed its rate of growth since 2009? Slowed it considerably? Whether you realize it or not, you already the answer.

In August 2008, estimated annual 'personal interest income' in the United States was $1.422 trillion. Thanks to the recession, and the Fed's attempts to spur economic growth, we all know interest rates have plummeted since that time. As a result, 'personal interest income' in the US was an estimated annualized $986.6 billion this past August. That is a difference of close to $450 billion! That is a lot of money.

Tax just that difference at existing ordinary income tax rates, and Washington will easily, and I mean it ain't even close, collect more in taxes over the next 10 years than they would taxing the richest of the rich an additional 4.6% on the highest marginal tax bracket.

When you consider deposits on the books at commercial banks in the US are up almost $2 trillion since that time, good grief, what a difference in personal income we would have IF only interest rates were higher! The mind boggles when you think about the multiplier effect of an additional $450 billion suddenly appearing in the economy, doesn't it? Heck, that is the equivalent of 9 million $50K/year jobs! 9 million middle class jobs!

But….but….but don't low interest rates stimulate borrowing & lending, and therefore job creation and economic activity? Ordinarily and intuitively, I would say yes. However, since loans & leases in bank credit on the books of commercial banks in the United States have only grown roughly $200 billion over the last 4 years, which is virtually a standstill,

Something to Think About, *cont.*

you could argue low interest rates are actually ironic at this point in time: banks aren't lending money and folks have less money to spend. As a result, there is less economic activity than there would be ordinarily, meaning less demand for borrowing…..and it goes on and on. What's more, these low interest rates haven't even fueled multiple expansion in the stock markets. So, it is the worst of all possible worlds!

Now, and this is where I will be completely counterintuitive, would it make sense to question whether low interest rates are actually good for the economy? Particularly when they are this low? Do they actually curtail economic growth, at some point? Hmm. Is there some magic point, some point on the yield curve which maximizes economic activity? Sort of like the famed Laffer Curve when it comes to tax collection? If you go too high, it throttles activity. However, if you go too low, the same thing happens.

Of course, the flipside of this argument, if you want to call it that, is an increase in deposit rates would lead to an increase in borrowing rates, and more than likely a flattening of the yield curve. This would compress corporate profitability, particularly in the financial sector as it continues to repair its collective capital base. Obviously, that is a bad thing, even a horrible thing, and would more than likely compress economic activity. Further, an increase in interest rates would increase Washington's debt service, which would likely cause our overall level of indebtedness to grow. Whew. It seems you can't win for losing some times, and this might be one of those times.

However, where the rubber meets the road, expecting low interest rates, in and of themselves, to spark economic activity might be analogous to waiting on the Easter Bunny. After all, if our own experience didn't suggest as much, perhaps Japan's experience over the last two decades might drive the point home. After all, the Bank of Japan has kept interest as low or lower than ours, and Tokyo has funded a myriad of government works projects, all to virtually no avail. Why?

Well, contrary to popular thought, when rich people and societies run out of money, or see their incomes fall, they tend to become more focused on preserving what they have left, as opposed to taking the necessary risks to make more. Does that make sense? When in doubt, hunker down and hang around.

As such, in an increasingly risk averse and deleveraging private sector, the accompanying low interest rates will actually have a negative impact on household wealth, as income which would have gone to the consumer ends up as corporate profit. If companies employ this capital in ways other than expanding domestic capacity and jobs, the economy feels very little impact. If multiple valuations on stocks don't increase significantly, very real end wealth is actually created, which is clearly an ironic conclusion...and counterintuitive.

So, I am struggling with this: what can we do to spur household disposable income? I don't think increasing marginal tax rates is an effective tool, almost by definition, with our overall rate of economic growth. However, I wonder IF a telegraphed, orchestrated increase of deposit rates might work. This is incredibly contrary to everything I have ever learned or heard, but the nation is grasping at straws here, and I know another two years of basically declining 'personal interest income' isn't going to help matters terribly much.

In the end, I am not sure exactly what either political party's real end game is; however, judging from the arguments I head last night, I am pretty certain they both have not too dissimilar paths to reach a similar end. Will they work? Well, if we define 2011 and 2012 as work, we will do just fine. If we want something more, we might want to explore counter-intuitive and 'out of the box' methods of expanding household income to get out of this mess.

Important Economic Releases

Release	Survey	Actual	Prior	Comments
Initial Jobless Claims	339K	370K	369K	This was a very light week for economic releases. However, a couple of the ones we did have were surprisingly good.
Trade Balance (Aug)	-$44.2B	-$43.8B	-$42.5B	
Producer Price Index (Sep)	1.1%	0.8%	1.7%	
Univ of Michigan Confidence (Oct P)	83.1	78.0	78.3	

Tables & Data Points

STOCKS	Dow Industrials	S&P 500	NASDAQ	Russell 2000	Nikkei 225 (¥)	DJ STOXX 50 (€) Price
12/31/10	11,577.51	1,257.64	2,652.87	783.65	10,228.92	2,792.82
12/31/11	12,217.56	1,257.60	2,605.15	740.92	8,455.35	2,216.55
9/20/12	13,596.93	1,460.26	3,175.96	851.51	9,086.98	2,553.03
9/27/12	13,485.97	1,447.15	3,136.60	843.54	8,949.87	2,506.06
10/4/12	13,575.36	1,461.40	3,149.46	844.65	8,824.59	2,485.75
10/11/12	13,326.39	1,432.84	3,049.42	829.78	8,546.78	2,487.08

BONDS	3-Mo UST	6-Mo UST	2-Yr. UST	5-Yr. UST	10-Yr. UST	30-Year UST
12/31/10	0.13	0.19	0.60	2.01	3.30	4.34
12/31/11	0.01	0.06	0.24	0.83	1.88	2.90
9/20/12	0.11	0.14	0.26	0.69	1.77	2.95
9/27/12	0.09	0.13	0.25	0.65	1.66	2.84
10/4/12	0.10	0.14	0.24	0.63	1.67	2.89
10/11/12	0.10	0.15	0.26	0.66	1.67	2.85

OTHER	Prime	Fed Funds	3-Month LIBOR	Gold/troy oz.	Oil—WIT/brl.	$/Euro	JPY/$	$/GBP	CAD/$
12/31/10	3.25	0.25	0.30	1,421.40	91.38	1.337	81.19	1.559	0.994
12/31/11	3.25	0.25	0.58	1,566.80	98.83	1.296	76.99	1.551	1.017
9/20/12	3.25	0.25	0.37	1,767.80	91.87	1.297	78.24	1.622	0.977
9/27/12	3.25	0.25	0.36	1,777.60	91.85	1.291	77.60	1.624	0.981
10/4/12	3.25	0.25	0.35	1,794.10	91.71	1.302	78.48	1.619	0.980
10/11/12	3.25	0.25	0.34	1,768.80	92.07	1.293	78.35	1.605	0.979

Disclosure