SIGNATUREFD

FAIRY TALES, PLOT TWISTS AND THE UNTOLD STORY:

THE FUTURE OF THE U.S. ECONOMY

A SIGNATUREFD WHITEPAPER

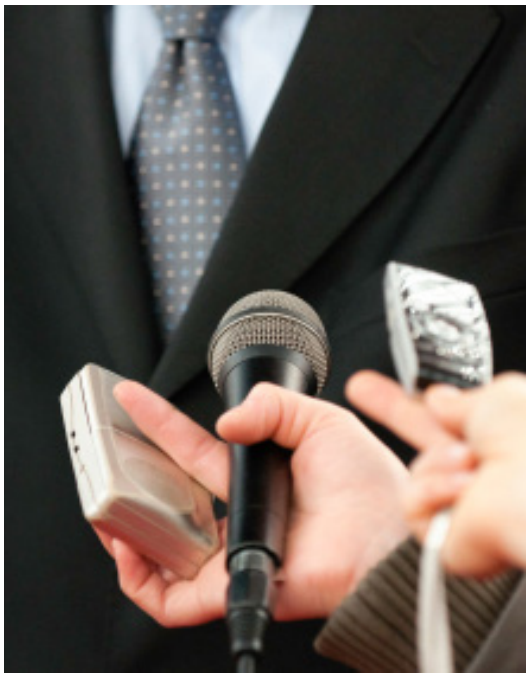
abstract

As we look forward to one of the most significant presidential elections in recent memory, both major political parties have been spinning fairy tales about the real solutions that will address our challenges and get our economy back on track. While we firmly believe that America is poised for another period of innovation-led growth, that future is not guaranteed, especially if voters and political leaders continue to ignore reality. As a country, we face major challenges as well as great opportunities, and how we respond to both will determine the long-term direction of the United States. Though the immediate future remains uncertain, we are optimists over the long run, and believe that by embracing some major policy changes today, the U.S. will be well-positioned for a renewed period of prosperity and success.

Recent global economic and political events have felt like a work of fiction, with more twists and turns than an Agatha Christie mystery. Unfortunately, we cannot flip ahead to the last page of the book to see the ending. With that in mind, we will use the fifth part of our "Economic Outlook" white paper series to make some general observations about recent events—the presidential campaign and central bank actions—and then turn our attention to the good news about our economy and the future of our country.

In regular meetings with clients and peers, we are continually confronted with a negative bias and legitimate fear about the future. Though we are pragmatic and realistic, we also learned long ago that it never pays to be permanently negative on the United States, or, for that matter, the global move toward capitalism. The bulk of this paper will focus on what we call the "untold story," or the coming period of growth and advancement in the U.S. economy.

As we have discussed in earlier white papers, economic rebalancing requires time. Debt repayment happens slowly and is the major cause of our moderate and uneven recovery. The issue of poor confidence, however, which we have



BOTH THE OBAMA AND ROMNEY CAMPAIGNS HAVE PUT OUT PLANS AND MADE PROMISES THAT CONTINUE ON THE PATH OF UNSUSTAINABILITY.

also identified as a key reason for the current climate, is driven by national direction and leadership by policymakers and business leaders. On this point, we are as disappointed as our readers. We will be watching for progress on 10 key policy issues (which we discuss in more detail later in the white paper). We recognize that in our political system change can't happen immediately. Nonetheless, forward momentum is a must. The markets and the economy will key off progress as well. Once they are assured problems are being resolved then confidence will increase.

Finally, we've included an in-depth discussion of our specific policy recommendations. Many of you will disagree with some of our ideas, but we hope after setting the stage in our previous four white papers that we have earned some credibility with our readers. We certainly don't wish to imply that our answers are the best option in every case, and we welcome debate and discussion on each of these issues. Above all, we want to see an open, honest and forward-looking conversation about what needs to be done to get America back on track.

FAIRY TALES

A month ago, it looked like the election could turn into a debate over ideas—a true discussion about the direction of our country. As we enter the final month of the campaign, our hopes for that conversation have been dashed. The ongoing campaign by sound-bites shows no signs of changing. This is unfortunate, because both the Obama and Romney campaigns have put out plans and made promises that continue on the path of unsustainability.

In *Capitalism 4.0: The Birth of a New Economy in the Aftermath of Crisis*, Anatole Kaletsky draws parallels between our current situation and early periods of crisis in which capitalism and the political system adapted. He argues that the period from the New Deal through the 1970s represented capitalism version 2.0, when it was generally believed that the government was the solution to most problems. By the late 1970s, this system was coming apart and capitalism version 3.0 was ushered in with the philosophies of Ronald Reagan and Margaret Thatcher. By 2007, these philosophies had been taken to their extreme. There was a general belief that the markets could do no wrong, which was widely held in the Greenspan Fed and the George W. Bush administration.

FOR NOW, THE BATTLE-LINES SEEM DRAWN... NEITHER PARTY IS TELLING THE VOTER THAT SIGNIFICANT SHIFTS ARE COMING AND THAT IF WE DON'T ADDRESS OUR PROBLEMS SOON, THE MARKETS WILL FORCE CHANGE.

Our frustration with the current presidential campaign is that neither party is laying out a framework for the idea of capitalism 4.0. The President continues to believe that a return to the policies of capitalism 2.0 will solve our problems. On the other hand, Mitt Romney seems to suggest that the government should have no part in the economy and that a return to even stronger forms of supply-side economics will solve our ills. According to Kaletsky, "The most distinctive feature of capitalism's next era will be a recognition that governments and market can both be wrong and that sometimes their errors can be fatal."[1] Neither party seems willing to accept this new understanding of the future of capitalism.

We ended our last paper with the suggestion that we need neither a big government nor a weak government, as the two parties seem to advocate, but a strong and flexible small government. We struggle with the recent wave of philosophical purism advocated by both parties when history shows they each have a tendency to act contrary to expectations when incentives exist. For example, Ronald Reagan passed the largest expansion of the now controversial Earned Income Tax Credit in 1986, saying that the changes were a "sweeping victory for fairness."[2] Bill Clinton earned acclaim from both parties for signing the Republican-led Personal Responsibility and Work Opportunity Act. Although some question that law's impact, many economists believe it helped to lower welfare and poverty rates in the late 1990s.[3] Finally, George W. Bush pushed through one of the largest unfunded benefits program in a generation, The Medicare Modernization Act of 2003, which was projected to cost the federal government at least $500 billion over a decade.

One can draw a few observations from these historical actions. First, there is clear precedent for compromise and bi-partisan action from both parties. Second, presidents can often support and push through legislation that is seemingly at odds with their party's core philosophy. Finally, as we recently heard someone say, "the trouble with today's political debate is that it is not so much about a debate about *what is said* as it is *who says it*."

For now the battle lines seem drawn. Democrats want you to believe that we can solve all our problems by continuing to expand the social safety net, which can be paid for by the top 1%. Alternatively, Republicans passionately explain that by immediately dropping both corporate and individual tax rates and only slightly modifying discretionary spending we can put growth back on solid footing. They argue that more meaningful adjustments to entitlements and taxes will be needed, but those can be dealt with later. Former Senator Alan Simpson has a word for these types of political promises: bunk. We will be somewhat more polite and call them fairy tales. So far, neither party is telling the voter that significant shifts are coming and that if we don't address our problems soon, the markets will force change. As we discuss in more detail below, changes are still manageable. For now, however, the advice that the first thing to do to get yourself out of a hole is to stop digging seems appropriate.

PLOT TWISTS

We supported TARP and the significant easing that the Federal Reserve undertook in 2008 and early 2009. We even backed assistance for the automotive industry (though the departure from traditional bankruptcy procedures with regard to bond holders set a poor precedent) and the idea of a major stimulus plan in early 2009. These views may not square with some readers, but we would argue that, from a macroeconomic standpoint, they were all necessary. When an economy is faced with a debt crisis, the initial reaction of the entire private sector (both households and companies) is to save, effectively paying down debt or stashing cash under the proverbial mattress. Only two outcomes are possible when this happens: The economy will shrink by the net amount of savings, or the government steps in and fills the hole. In our opinion, given the challenges with reversing a negative feedback loop and the huge cost to society of declining growth, the government solution is the best of two bad options.

THE LONGER PEOPLE ARE UNEMPLOYED, THE HARDER IT WILL BE TO GET THEM BACK INTO THE WORK FORCE WHEN JOBS DO BECOME AVAILABLE.

While we have supported government intervention in the past, we are now worried that things have begun to move too far in that direction. The Federal Reserve has essentially promised permanent low rates, unleashing in the last month what many are calling Quantitative Easing Unlimited (QE∞). In this program, the Fed plans to buy $40 billion of mostly mortgage-backed securities. The QE program will be adjusted as needed, "If the outlook for the labor market does not improve substantially."[4] We can hardly blame the Fed for this action, since its legal obligation is to manage the economy toward a dual mandate: full employment and price stability (i.e., low inflation). Currently, inflation is below the Fed's long-term target and employment is clearly lagging. In this context, one could almost fault the Fed for not doing more. However, there are self-acknowledged costs to these bold actions.

As we read further into this book of fiction, we should be prepared to encounter several more plot twists. The reason our concern is growing is that the sheer force of the recent actions is unprecedented. Moreover, the Fed's policy action is a "blunt tool," meaning it can help the situation but may also cause a lot of collateral damage. The more effective way to address persistent unemployment would be through targeted government programs that encourage hiring and working, or through stimulating areas of the economy that are poised for growth, such as the energy industry.

In our opinion, part of the Fed's goal is to compensate for the government's inadequate attempts to address these problems. The Fed certainly fears a high level of embedded unemployment versus cyclical unemployment tied to the economic downturn. The longer people are unemployed, the harder it will be to get them back into the work force when jobs do become available. A permanently high level of unemployment creates all types of problems, including slower growth and higher inflation.

AS THE FED'S PRESENCE IN THE MARKET CONTINUES, NEW AND DANGEROUS BUBBLES MAY FORM.

Therefore, we can understand the Fed's aggressive action, but are also aware that this is not the optimal solution and that it may cause long-term ramifications. The Fed is employing a technique that economists call "financial repression." In its broadest sense, financial repression is a form of market manipulation that alters the outcome of private sector saving decisions.[5] Currently, this is being done by artificially holding down interest rates and pushing investors into taking on more risk. Because of an ongoing lack of confidence in the economy, private investors would like to hold the safest securities possible (generally the government bonds of stable countries). By holding the yields on these instruments lower than they would be otherwise, central banks induce investors to look at other alternatives, likely bidding up the value of those investments.

The concept of financial repression has been around a long time and was used rather successfully after World War II. Then, however, it was done in concert with overall government policies. At present, we are most concerned that low interest rates will not motivate legislators to address the necessary long-term budget changes. Second, as the Fed's presence in the market continues, new and dangerous bubbles may form. We already see a very strong push toward income-producing assets, and in some parts of the market we have seen evidence of prices beyond what a normal risk-averse investor would be willing to pay.

THE UNTOLD STORY

Clearly, we aren't fans of how policymakers are currently doing their jobs. The Fed is doing too much and the President and Congress are doing too little. Despite this confusion weighing on the economy, we are beginning to see the green shoots of real future growth. Anatole Kaletsky wrote that, "The traumatic events of 2007–09 will neither destroy nor diminish the fundamental human urges that have always powered the capitalist system—ambition, initiative, individualism, the competitive spirit. These natural human qualities will instead be redirected and reenergized to create a new version of capitalism that will ultimately be even more successful and productive than the system it replaced."[6] We fundamentally agree with this assessment.

The untold story is that our economy is evolving much faster than most others around the world and the industries that are likely to drive the next generation of growth are becoming visible. We see a future that is based on evolution in the traditional areas, such as manufacturing and energy, as well as revolutionary changes in the fields of medicine and technology.

MANUFACTURING RENAISSANCE AND DOMESTIC ENERGY

After peaking in the 1970s, U.S. manufacturing has been in a long, slow decline. The cost structure of production in the United States became prohibitively high and labor disputes and the oil crisis in the late 1970s pushed industry over the edge. Over the following 40 years, manufacturing went first to places like Mexico and eventually to China, where cheap labor was available due to economic reforms. Today, most of these trends are reversing and the U.S. has regained an advantage when it comes to manufacturing.

Three big factors are driving this manufacturing renaissance: labor costs, North American energy and global rebalancing. Chinese manufacturing growth exploded over the last decade, especially after the country joined the World Trade Organization (WTO) in 2001. China enjoyed an advantage over the rest of the world due to its huge supply of relatively cheap labor. Because of recent wage price increases, however, this advantage is deteriorating. According to the Boston Consulting Group, "Within five years, the total cost of production for many products will be only about 10 to 15 percent less in [China]," and after factoring in shipping, inventory and other costs, "the cost gap between sourcing in China and manufacturing in the U.S. will be minimal."[7]

The second driver of a manufacturing renaissance is the abundance of energy, notably natural gas, which has been made available by new hydraulic fracturing technologies. (See our recent white paper, "Harnessing the Power of Natural Gas," for a review of this technology and its potential benefits and risks.) According to research provider BCA, "For natural gas consumption, low prices and abundant supply should boost demand from electricity generation, petrochemical manufacturing, and [natural-gas-powered] vehicles."[8] Although energy production and refining represent a relatively

small part of the U.S. economy, the indirect benefits of lower energy costs are significant. For many industries, especially chemicals and certain types of metals processing, energy is the largest cost. According to GaveKal, production uses four basic inputs, land, labor, commodities and capital, and over the last 15 years, we've seen a huge arbitrage in labor costs due to China's emergence as a major economic power. However, with this cost equalized and with capital a global market, the advantage goes to the U.S. for reasonable land prices and cheap energy. GaveKal asks, "If one were to build a new chemical plant or a new factory today, where would one deploy capital? Five years ago, the answer would have been China for this is where the cheap labor was. Today, the answer is the U.S. for this is where the cheap energy will be found."[9]

FEW DEVELOPMENTS WILL COMPARE TO WHAT IS COMING IN INFORMATION TECHNOLOGY AND MEDICINE.

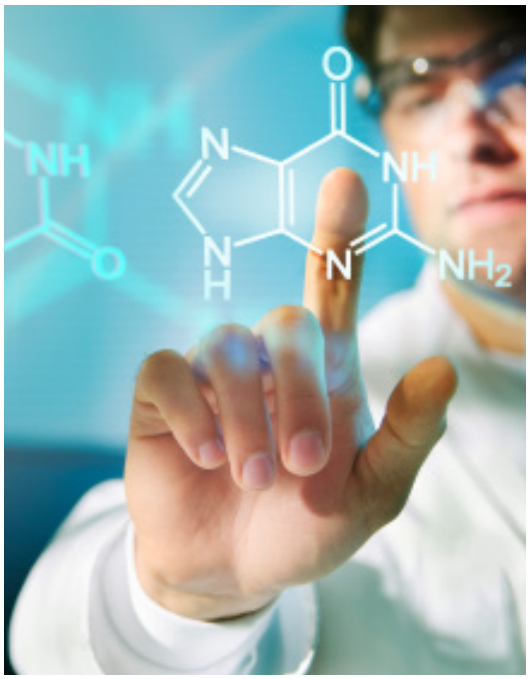
The final driver of the resurgence in U.S. manufacturing is the natural rebalancing of an economy that became highly uneven during the last 20 years. The symbiotic relationship between China and the U.S. was the biggest example of this imbalance, but a very similar relationship was emerging between Germany and many of the peripheral European countries. Coming out of the 2008/2009 crisis, it is now clear that these imbalances will not return to their prior levels, and in reality are reversing.

In the past, the U.S. purchased goods from China and the money from these sales was recycled into U.S. financial instruments, especially Treasury and mortgage bonds. This practice peaked along with the financial crisis and is now waning. As more production returns to the U.S. and China pushes its economy toward domestic consumption, the trade and capital deficits between the two countries will continue to decline. The trend toward U.S. energy production will also reduce the amount of capital sent offshore to purchase oil. In fact, some economists believe that we can essentially balance our trade with the rest of the world within a decade. The last piece of this rebalancing is the pent-up demand for many domestically produced items. In a recent report on manufacturing from Ned Davis Research, the author wrote that, "We believe... that vehicles, housing, and energy, three important industries, have made secular turns, which will...bode well for U.S. manufacturing for years to come."[10]

UNIMAGINABLE ADVANCES IN TECHNOLOGY AND MEDICINE

While the more traditional fields of goods manufacturing and energy production will see positive evolution and benefits from modern technology, few developments will compare to what is coming in information technology and medicine.

Though we are over 40 years into age of microprocessors, we are only 10 or 15 years into the age of the Internet, social media and mobile technology. The rate of advancement, known as Moore's Law, (which says that computer speed tends to double every two years) has not changed, even though the microprocessor revolution is 40 years old. For example, the 1971 Intel 4004 chip



had 2,300 transistors, while the latest 2011 version had 2.6 billion.[11] Another significant trend is cost declines in storage. In six years, the cost of storage has declined over 90%, and the cost of one gigabit of storage plunged from $100,000 in 1980 to just five cents today.[12] Finally, the move toward mobile technology is just beginning. As Nancy Gibbs writes in *Time* magazine, the newest users of Apple IOS or Google Android smartphones hold in their hands "more computing power than Apollo 11 when it landed on the moon."[13]

According to Paul David, it took nearly 40 years for American businesses to fully appreciate and adjust production methodologies after the invention of the electric motor.[14] Is today's technology adoption any faster? We would argue that although the advances of the past 30 or 40 years are amazing, we may just be on the cusp of the major advances in productivity that these technologies make possible.

If the changes in technology are impressive, then the gains that could lie ahead in medicine are truly mind boggling. Much of the recent advancement in medicine is happening because of genome sequencing. It was just 10 years ago that the first full sequencing of a human genome was completed. At the time, the cost was in the billions of dollars and the process took several years to complete. In just the last decade, technology has advanced to the point that a full genome sequencing can be completed by a single laboratory technician for just $4,000.[15] Due to these huge advancements, MD Anderson Cancer Hospital in Houston recently announced a $3 billion initiative to significantly reduce the number of deaths and improve the quality of life for patients with eight common forms of cancer.[16] The mortality rate among cancer patients has already dropped by 21% for men and 12% for women over the last 20 years.[17] And the *Financial Times* reports that even as the incidence of cancer rises with aging population, projections from Cancer Research UK indicate a 17% drop in the rate of cancer deaths by 2030.[18]

Additional advances are being made in cell technology. A recent article in *The Wall Street Journal* discussed medical advances that are at the intersection of two of the most fascinating current technologies—cell incubation and 3D printing. A California-based company is working on technology that will use 3D printing technology to grow living cells such as blood vessels, cartilage and muscle for use in surgery. Researchers project this technology would allow us to grow entire organs, eliminating the need for transplant donors.[19]

Though we are hardly medical experts, we believe we are on the verge of quantum leaps in our understanding of many major diseases and treatment programs, eventually leading to higher life expectancy. This could have dramatic consequences for the markets. Not only does health care remain a large and growing component of our overall economy, but because life spans will be longer than current demographic expectations, economic growth should also be higher than anticipated (all else being equal). Longer life expectancy will create additional challenges for entitlement programs, but on balance, it is a positive development for the economy.

EDUCATING OUR YOUTH IS A 15- TO 20-YEAR INVESTMENT. CHANGES MADE TODAY WON'T BEAR ECONOMIC FRUIT FOR NEARLY TWO DECADES.

OUR POLICY CHANGE WISH LIST

We have discussed some of the possibilities for economic growth, many of which are at odds with the market's current negative tone. In fact, some well-known economists have even speculated that we are at the beginning of what some call "the end of growth." In a recent paper, Dr. Robert Gordon concluded that the world may be entering a period similar to the one from 1300 to 1750 when there was virtually zero growth and standards of living were essentially stagnant.[20] It would appear to us that recent technological advances still haven't been fully adopted and will likely provide for significant advances in the human experience for several years to come. But these improvements will only happen in an environment that is conducive to cultivating and maximizing the benefits that come from these technologies.

With that in mind, we have created a top-10 list of policy changes that we think would benefit our economy and the country in general. The degree to which we can address these issues will determine the course of events over the next 20 years. The list begins with our top priorities.

1. **REFORM EDUCATION.** This is the most vital area of concern. We truly can't understand how an antiquated system that fails our kids doesn't garner more attention from politicians or the electorate. Perhaps the problems are so deep they seem impossible to fix. Maybe the cycle of politics doesn't provide any incentive to tackle projects that get measured in decades rather than years or quarters. Whatever the reason, we must modernize and equalize our education system be to be globally competitive. The needed reforms needed are significant, and the necessary changes will take many years to work their way through the system. Educating our youth is a 15- to 20-year investment. Changes made today won't bear economic fruit for nearly two decades.

   Reforming education isn't about spending more money. According to Andreas Schleicher, head of analysis at PISA, "only about 10% of the variation in pupil performance has anything to do with money."[21] In a study using 2006 data, the Department of Education found that the U.S. spends $9,145 per pupil while South Korea, New Zealand, Ireland and Japan (all of which have schools ranking higher than the U.S.) spend between $6,000 to $8,000.[22] In our opinion, the key areas of concern are subjects for academic focus, school choice and oversight, and better tracking of students for post-secondary education.
   In regard to subject focus, we're alarmed that society and the business community have almost fully converted to a technology-based environment but most classrooms have limited available technology. With the resources at our fingertips via the Internet, a concentration on math, science, logic and problem-solving skills, along with advanced

technology training, should make up the core of educational curricula. In a recent white paper on the skills gap in the United States, Steve Leuthold shared a story about a dinner meeting between President Obama and Steve Jobs. The President, referring to the manufacture of Apple products, asked Mr. Jobs, "Why can't that work come back home?" Jobs responded that the "U.S. doesn't have enough people trained at the mid-level skills needed."[23]

A CONCENTRATION ON MATH, SCIENCE, LOGIC AND PROBLEM-SOLVING SKILLS SHOULD MAKE UP THE CORE OF EDUCATIONAL CURRICULA.

The primary argument for public support of education is to make it an equal process, where students would receive comparable education and thus training for full participation in our economic system without regard to geography, socio-economic or cultural differences. Generally, our system has not lived up to these ideals. We would argue that a shift away from federal oversight to local decision making would put control back in the hands of those who are best able determine the right approach for their own community.

Finally, we believe that compared to other countries, our system is not effective at helping students choose paths for post-secondary education. The push toward traditional four-year college education has ignored less expensive and more targeted programs in technical and vocational education. Better guidance and planning for a career path and the development of efficient and appropriate post-secondary education is desperately needed. One example of a successful program is at the Dunwoody College of Technology in Minneapolis, which has partnered with local businesses to provide the most up-to-date and needed educational programs in a technical school environment. With 90% of 2011 graduates employed in their field of study at average starting wages of $32,000 to $40,000, the program appears to be a success. The entire unemployment rate from the college was under 5% and most graduates received multiple job offers.[24]

2. **ENCOURAGE SAVINGS.** As a general rule, household savings have been trending higher in recent years after bottoming out in the 2008 financial crisis. The encouragement of debt (see policy recommendation #7 below) and the incentives for spending over savings are built into our current system. Last year, Federal Reserve Chairman Ben Bernanke suggested that we should increase "incentives to work and save, by encouraging investments in the skills of our workforce, by stimulating private capital formation, by promoting research and development, and by providing necessary public infrastructure."[25]

As part of tax reform, additional incentives for savings should be encouraged, such as permanently setting tax rates on dividends and capital gains at low levels, equalizing tax treatment for debt and equity financing by corporations, and simplifying the confusing mess of various tax-incentivized savings vehicles [e.g., IRAs, Roth IRAs, 401(k)s, 403(b)s and SEPs]. Moreover, the current policies of extremely low interest rates

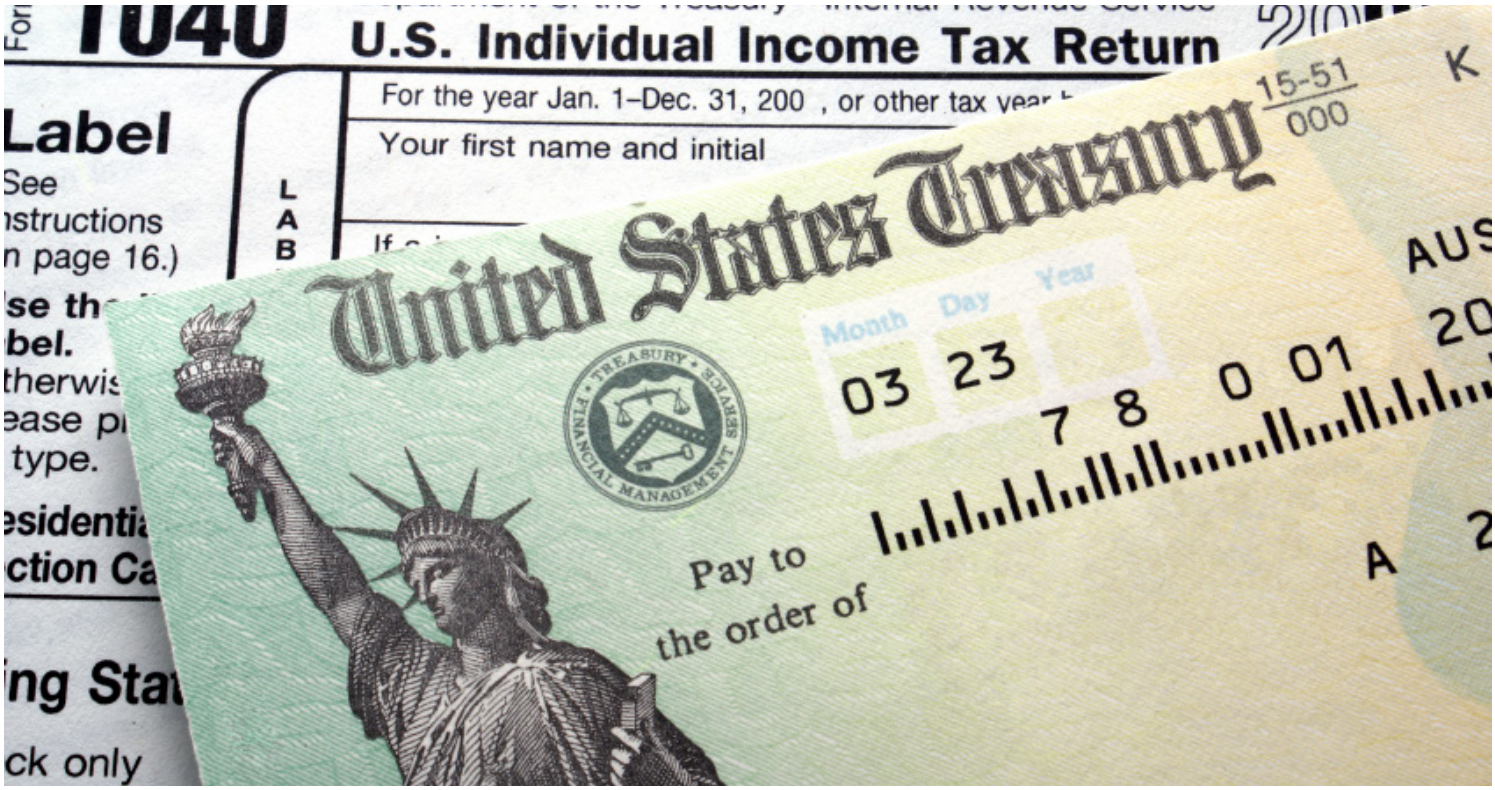
50% OR MORE OF CORPORATE CASH IS CURRENTLY STRANDED IN FOREIGN COUNTRIES BECAUSE OF THE OUTDATED U.S. TAX SYSTEM.

are detrimental and discouraging to savers. We are not advocating quick changes to the Federal Reserve's low-interest-rate policies, but by bearing a bigger share of the responsibility, fiscal policy makers could help reduce the need for unconventional Fed action, thereby allowing interest rates to be normalized sooner. The bottom line is that via both cultural changes and economic policy shifts, households should be encouraged to save a much more significant share of their income than they currently do.

3. **PROMOTE INNOVATION AND INVESTMENT.** Education and capital have become the two source materials for economic advancement. Innovation and investment are the twin engines that convert these two materials into economic growth. Corporate America is seemingly in great health, but this has come at the cost of investment in future productivity. Today, companies are flush with cash, but they have tended to hoard rather than invest in new employees, new capital investments or in distributing to shareholders via dividends.

One major change that is needed is corporate tax reform addressing the significant amount of capital earned by U.S.-based multinational companies. We have seen estimates that 50% or more of corporate cash is currently stranded in foreign countries because of the outdated U.S. tax system that heavily penalizes companies for bringing these funds back on-shore.

Additionally, economic uncertainty is likely stifling corporate action. With dozens of significant tax and regulatory actions set to expire over the next few quarters, long-term planning as part of significant capital investment becomes very tough. According to a recent study, the unemployment rate may be as much as 2% higher than it would be if economic uncertainty were not at current levels.[26] If there was less uncertainty, unemployment might be closer to 6% than 8%.



Finally, regulations have risen dramatically over recent years, creating inefficiencies. A recent study by the Competitive Enterprise Institute estimates that "private sector spending on regulatory compliance is as much as $1.8 trillion per year. When this is added to official government spending of nearly $4 trillion, the government consumes as much as 40% of total GDP."[27] We are not advocating a return to *laissez-faire* policy, as the recent financial crisis showed the limitations of such an approach. We do, however, advocate a significant study of the effectiveness of regulation. Ultimately, we'd like to see a streamlined government that is able to focus on areas where its assistance is most needed.

4. **TAXES.** Certainly, this is a huge area of focus in the Presidential election, especially with the looming "fiscal cliff." As we mentioned above, we feel that both parties are glossing over the real issues and painting a fairy tale picture of the facts. In reality, our problems are structural and have been perpetuated by both parties in recent decades.

First, spending is too high, but most citizens have yet to face the reality that entitlement reform is the *only* area of spending where we can really change things. We touch on this issue in the next section, but for now we will just emphasize a point we made in our third whitepaper: 70% of all future spending is due to just three things—Medicare, Social Security and Medicaid. Without changes to these programs, we have no hope of significantly changing our country's fiscal situation.

Second, taxes are too low. We aren't saying that rates are too low, but that after all deductions and credits, households and corporations, on average, are not paying enough in taxes. Our proposed solution is to lower marginal rates across the board, dramatically curtail itemized deductions and special interest tax incentives, and broaden the tax base with new forms of taxation, such as a national sales or value-added tax (VAT) and significantly higher energy taxes.

Removing most tax deductions would create the potential for economic volatility and should be done in phases as marginal rates decline. In our opinion, incentives for earning income would be enhanced with lower marginal income tax rates and this would offset any areas affected by the loss of deductions. We would support maintaining the tax on both capital gains and dividends at a rate lower than earned income, but somewhat higher than 15%. Though politically unpopular, eliminating most deductions would limit federal involvement in the economy and also encourage

ELIMINATING MOST DEDUCTIONS WOULD LIMIT FEDERAL INVOLVEMENT IN THE ECONOMY AND ALSO ENCOURAGE SAVING.

saving and investing over spending. Two areas we would advocate leaving as tax-preferential would be deductions for retirement savings and charitable giving. As detailed in the Simpson-Bowles plan to reduce our country's deficit, "Tax reform must reduce the size and number of tax expenditures and lower marginal tax rates for individuals and corporations, thereby simplifying the code, improving fairness, reducing the tax gap and spurring economic growth."[28]

Finally, in addition to individual tax reform, we believe corporate tax reform is needed. We already mentioned the tax incentives not to repatriate monies earned off-shore. We also believe that equalization of tax treatment for corporate interest expense and dividend payments would encourage more equity financing and less debt at the corporate level. All these changes, along with reduced marginal rates, would put our system in a more globally competitive position.

5. **ENTITLEMENTS REFORM.** We discussed these issues in much more detail in our third white paper, "Word of the Year: Unsustainable." Our key message in that white paper was that the path we are on is not sustainable. With the wave of baby boom retirees and medical costs that are rising faster than overall economic growth (due both to inefficiencies and advancing technology), the pace of growth in these programs must come down or we will go broke. We calculated that the promises of the government totaled between 1.6 and 2 times the revenue that was likely to meet the obligations.

   In examining the details of the programs, we determined that Social Security was a relatively "easy" fix. By gradually raising the retirement age to 70 and moderating the overall growth of the program to inflation less 0.5%, the program would move back into balance. The Medicare and Medicaid challenges are much more daunting, primarily because expenses are growing faster and these programs do not have as much attached revenue. In fact, Medicaid is one of the fastest growing expenses in the budget and is essentially an unfunded program. Multiple solutions will be needed to tackle these programs' financial challenges, but some combination of private market price setting, means testing or discretionary medicine limitations, end-of-life cost reductions, and reduction of fraud and abuse are all necessary. In the case of Medicaid, more significant involvement of state governments rather than federal oversight would likely increase efficiencies.

   Entitlements are the most controversial issue confronting politicians today, but we believe that the electorate is ready for a major debate on this subject. Intuitively, people recognize that current spending is not sustainable. They also agree that the programs are generally good for Americans. Thus, voters are likely to reward forward-thinking and sound leadership on the matter of entitlements. As the Simpson-Bowles plan says, "We need to implement policies today to ensure that future generations

have retirement security, affordable health care, and financial freedom. To do that, we must make Social Security solvent and sound, reduce the long-term growth of health care spending, and tackle the nation's overwhelming debt burden."[29]

6. **ENERGY POLICY.** This was the central topic of our recent white paper, "Harnessing the Power of Natural Gas."[30] In that paper, we highlighted the fact that oil has historically cost between 6 and 12 times that of natural gas based on the energy produced by each fuel. However, due to technological advances in natural gas production, it has more recently been trading at 25 to 50 times the cost of oil. As a result, the natural gas industry is booming as the consequences of abundant and globally competitive costs of energy are recognized. The longer the price differential stays high, the more the necessary infrastructure will be added and the higher the level of adoption that will take place. This is happening in multiple ways—manufacturing investments, electricity production conversions and fleet vehicle changes.

   The key results of this game-changing energy technology, in our opinion, are three-fold. First, a U.S. manufacturing renaissance due to the natural advantages of locating new facilities in the U.S. Second, additional jobs created in the U.S. A recent study by global information company IHS shows that up to 9% of all job creation in the U.S. in 2011 was related to shale energy.[31] Finally, relying on our own sources of energy could reduce spending on military operations in the Middle East.

   In that white paper, we also discussed in detail the long-term benefits of new shale energy technology as well as the associated concerns and risks. As with other forms of fossil fuel energies, it is not the long-term superior solution that renewable energy will be. But it will take time for green technologies to be viable on a mass scale and economically efficient. We would support higher energy taxes to help bridge the gap toward renewable energy and as a way of capturing the environmental and military costs associated with our dependence on oil. At a high level, we don't believe that either party has fully supported the potential of near-term fossil fuel advantages or the long-term need and expense of shifting to renewables. A much more thoughtful and robust plan for this critical industry is needed.

7. **REMOVE INCENTIVES FOR DEBT.** We mentioned earlier, we need to encourage savings and reduce incentives to finance investment with debt. As we described in detail in the first installment of this white paper series, the current crisis has much to do with debt accumulation. Total debt in the U.S. economy peaked at more than 3.9 times the size of the overall economy in 2007 and has subsequently declined to 3.5 times the overall economy. We believe that total debt-to-GDP ratio will need to drop closer to three to one before the next cycle of maximum growth can begin.

THE ECONOMIC ARGUMENT FOR BROADER IMMIGRATION ACCEPTANCE IS SOLID.

Why is debt so critical? Debt has to be serviced out of income, which is why the comparison to overall GDP is relevant. With interest rates at record lows, it is not likely that debt service costs will be going down (as rates rise it will cost more to service the debt). Thus, the trend toward lower debts will likely continue. As we discussed in that first white paper, the good news is that the process of reducing private sector debt is fairly advanced, in our opinion. Much of the remaining decline in debt will fall on the public sector, especially the federal government.

If we are in a period of long-term decline of outstanding debt, we believe it would make sense for government incentive structures to encourage this healthy trend. The tax code is littered with incentives to finance with debt over equity capital. First, the biggest individual tax break is for mortgage interest deduction. We would support a complete elimination or major curtailment of this deduction in favor of a credit or other non-debt specific mechanism for first-time home buyers. The second major incentive in the code relates to corporate financing—interest on debt is deductible at the corporate level while payment of dividends is not. Moreover, many companies are encouraged to buy back stock as a way of returning capital to investors rather than paying dividends because of a single layer of taxation on this use of cash. We fully believe that companies should be allowed to manage their own balance sheets, but we also believe that the tax code shouldn't provide incentives for one form of financing over another.

8. **REFORM IMMIGRATION.** Immigration is a delicate subject in political circles, and we have limited expertise in the geopolitical or public safety aspects of the debate. In addition, this is not a new issue for our country; immigration has been a contentious topic since before the Constitution was signed. With that said, the economic argument for broader immigration acceptance is solid. First, a growing population adds to economic growth. The real rate of growth in any economy is generally going to converge with the rate of growth in the labor force and the level of productivity. One of the core problems in Japan and much of Europe is that low levels of fertility, lack of immigration and inflexible labor rules have restrained key inputs to growth. Last year, a study by Ned Davis Research found that the U.S. comes out as one of the biggest winners, when reviewing all of the fully developed economies on the demographic and productivity figures.[32]

Immigration is also critical in entrepreneurial companies, especially in the technology and engineering fields. One study by Vivek Wadhwa found that "there was at least one immigrant key founder in 25.3% of all engineering and technology companies established in the U.S. between 1995 and 2005...creating just under 450,000 jobs."[33]

9. **BREAK UP THE BANKS.** Our second white paper, "The Crisis of Confidence," focused extensively on consequences of the recent financial meltdown. Curiously, few perpetrators of the crisis have been tried, convicted and sentenced. This is unique compared to many previous crises, and one likely result is a perception among the investing public that the true problems have not been resolved. If they lack confidence in the health and sustainability of the financial system, investors and corporations are likely to proceed with caution. We believe that until the government is seen as a capable, strong and fair arbiter of business and economic rules that confidence will remain low. Yet it is difficult to see how new regulation is possible given the sheer size and scale of many financial companies.

MANY OF OUR SUPPOSED CHALLENGES ARE NOT A RESULT OF OUR WEAKNESS, BUT THE RISING STRENGTH OF OTHER NATIONS.

In a recent interview, Sandy Weill (the man most directly responsible for creating the financial powerhouse Citigroup) called for the largest banks to be broken up. The core of his message was about protecting taxpayers' money. He advocated separating the depositary banks from investment houses. The deposit institutions would have transparency, regulation and modest enough leverage to protect the taxpayers and the deposit holders. Investment banks would be allowed to take on more risk, but would be required to provide transparency and mark-to-market pricing on holdings each night and post collateral. In Weill's view, these would be the only steps that could possibly rebuild the financial industry's reputation.[34]

10. **PRIVATIZE MORTGAGE MARKET.** Our final wish-list item would be the move to a privately-led mortgage market, supported by federal guarantees. It is somewhat ironic that Americans often criticize Europeans for government involvement in the economy, because in many sectors, including education, housing and healthcare, we have some of the highest levels of government intervention. While much of the financial crisis was caused by private sector mortgage lending, plenty of the blame resides with the tailwind of federal incentives and lack of regulation that pushed these sectors into even riskier lending. It would appear that both parties are now advocating a slow unwinding of Fannie Mae and Freddie Mac, the government-sponsored enterprises that are at the heart of the U.S. mortgage market, and today still account for about 90% of mortgages underwritten.

We believe a more sound system would require the private sector to provide the capital to fund the mortgage market. To balance the private sector, underwriting criteria should be standardized and strengthened, while federal guarantee fees to protect investors should be applied to most mortgages (using size cutoffs that vary by geography). The guarantee fees would allow the government to act in a counter-cyclical manner, increasing costs when markets are frothy and reducing them when markets are down. To balance the fears of agency risk, the mortgage underwriters would be required to hold a material portion of the loans they underwrite on their books, with no access to insurance if those loans ultimately go bad.

A BRIGHT FUTURE AHEAD

We recognize that it is fantasy to expect all of our policy suggestions to become reality. That said, we anxiously await progress on any of them, while also anticipating that all of these areas will be hotly contested and debated over the coming decade. In the end, the American electorate must guide our representatives and force the necessary change.

Imitation is the sincerest form of flattery, and many of our supposed challenges are not a result of our weakness, but the rising strength of other nations. After the Second World War, America was the dominant force in all aspects of the global economy. But in the past 30 years, others have copied our formula and have raised the bar. Each time America has been challenged, we have risen to the occasion. This will happen again. Though our journey across the valley is frustratingly slow, we are starting to see the faint images of another period of prosperity and growth on the mountaintops rising in front of us. This new era will be driven by a return to American manufacturing, energy abundance, and huge advances in medicine and mobile technology. With the proper decisions and leadership over the next decade, we have faith that we will rebuild confidence in the American Dream. As the election draws near, we hope every citizen will take the time to study the issues, make decisions that they believe are correct and exercise their right to vote. God bless our great nation in this important season.

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