

Can Capitalism continue to co-exist in the American Democracy?

What relevance does this basic question have for your personal portfolio? Please read on for some fundamental questions which are being raised. We start with a short historical perspective.

Our newsletter last quarter examined the manner in which debt has been transferred from individuals and corporations to government balance sheets. The extreme volatility we have experienced in this year's markets—stocks, bonds, commodities, and national currencies can be directly attributed to the debt filled balance sheets of individuals and nations. Greece and Ireland are insolvent. Not far behind are the finances of Spain, Italy, Portugal and then of Great Britain and the United States. Masses of people in these countries are experiencing personal insolvency.

When the individual accumulates more debt than he has assets he must find the wherewithal elsewhere to pay or barter for his livelihood. His alternative is starvation. Nations have interceded for their citizens to provide solutions. Originally, the solution was imprisonment or deportation and the social stigma that attached. In more modern times nations have become more humane. One avenue for modern day solution is represented by the social programs—in this country, unemployment, social security, Medicare, Medicaid, housing and other welfare programs. Another avenue in this country is available through the courts with bankruptcy petitions—the process has become easier and easier.

Living standards throughout the Western nations have improved dramatically. Our early citizens were not guaranteed a public education. Early in our national history there was serious contention whether the federal government should pay for our road system. Thus, when we hear people state that this federal program or another is unconstitutional what they really are saying is that the implicit powers of the federal government enunciated by prior court decision are insufficient to empower the federal action sought. Interpreting law in this manner is the court's practice of stare decisis. It has provided a reasoned, steady, predictable evolution of the law.

The power and scope of our federal government has exploded from the time of the first Roosevelt. We did not have a federal income tax until 1913. With that new revenue source came the birth of an expanding federal treasury. That treasury has become increasingly more attractive to both the well meaning and graft seeking politician, to the businessman and citizen of this country and of the world. It has enabled the revenue source for government expansion into domestic social and regulatory programs and international involvements never before contemplated.

In 1913, this country had become the pre-eminent capitalist nation of the world. Yet as a military power we were just entering the world stage. We might well have remained so, not involved with the conflict of World War One.

Almost as an after thought to that involvement, Woodrow Wilson introduced the rationale that we were making the world safe for Democracy. Historians have suggested that our involvement resulted in international tensions and the intellectual foundation for many of our later foreign policy involvements both before and after The Second World War. Those involvements from foreign aid to foreign battles have been expensive and not always successful.

At home, the depression of the thirties was in part caused by our World War One involvement. To relieve the plight of so many of our countrymen being out of work and in financial difficulty, domestic social and regulatory programs were introduced such as those of the Work Progress Administration, wages and hours legislation, social security, farmer's subsidies. Each of these can be seen as an extension of the democratic process of government, bettering the condition of the common man, leveling the social playing field. The funding came from the tax payer. The benefit went to the worker and the unemployed, the able and the disabled, the ones willing to contribute by their work product to the national well being and the ones unwilling. Some commentators suggest there is benefit in providing a safety while others see disadvantage to the initiative and industry of those able yet without motivation receiving the beneficence of contributing members of our society. The latter commentators now contend that conditions had been set in place for our people to look increasingly to the federal government to provide for the individual's wants.

Immediately after World War II, resulting from both social and defense expenditures we had a national debt equally large in relation to our economy as that we encounter today. The debt was not a problem. Our men and women still had strong work and ethical standards they valued and held sacred not only their own but other people's contract and property rights. Business and the markets flourished. Soon America produced nearly two thirds of the world's work product. Its people pulled together, valued their jobs, took pride in being Americans and in contributing to the welfare of their country. America and Americans grew wealthy.

But wealth tends to corrupt. So it did. As the nation's wealth increased, so did the individual's desire for a better standard of living. Immediately following the war, Americans borrowed only to purchase their home or perhaps a new car by 1960, the credit card was standard. Vendor financed purchases were mortgaging the futures of the American consumer. They were now purchasing refrigerators, washing machines, and TV's with someone else's money, i.e. on credit. Americans opted for self betterment as the nation's needs increasingly took second place. Mass media broadcasts increasingly sounded ads for the ever increasing necessities for achieving a better way of life, a higher living standard. Special interest groups were employing the mass media to broadcast their strident and divergent views no matter how discordant.

In his 1961 inaugural address John Kennedy had to caution "Ask not what your country can do for you. Ask what you can do for your country". Neither voters nor office holders heeded this admonition. Change was occurring and had occurred in our culture, values, politics and could be evidenced in our court decisions. For earlier generations debt was a condition to be avoided, sometimes even viewed as immoral. Now elements of our society had come to view the creditor and not the debtor as being the one to receive society's sanctions.

Previously unemployment and government provided social benefit programs implied a condition of financial failure and were to be avoided. Now, in some circumstances, people were openly seeking job loss and the accompanying unemployment benefit.

To continue in office, politicians paid no heed to increasing the public debt, with the two primary beneficiaries being social legislation and the Department of Defense. Constituents whose jobs depended on government spending for personal or business improvement, who benefited from new school or business construction or increases in health and pension payments and protections or simply were granted a tax reduction might all favor the office holder with their vote. One school of jurisprudence maintains that courts are mere extensions of the legislature, have the duty of promoting the popular will and the voice of the majority. This is in diametric contradiction to the position taken in the Federalist Papers that warned against the “tyranny of the majority”. Today the mass media has come to “color” the news so as not to offend those office holders who might otherwise benefit their news organizations.

Government leaders and academicians both liberal and conservative have repeatedly stated that, unless radically and quickly curtailed, this debt accumulation is **the most dangerous issue** facing our nation. Although not focused upon with this writing, the issue is equally if not more distressing at the state level. One has only to consult the 1950 writings of Herbert Philbrick or those of the late eighties and early nineties by Robert Bork to understand how long developing, and how pervasive is the problem and how little the educational system from grade school through the university has dealt with it. Little comparative effort has been expended to acquaint the student with the dismal science, economics.

As reported by Wikipedia, the gross public debt of the United States as of July 5, 2010 was \$13.182 trillion dollars which approximates 90% of our gross domestic product. It is anticipated to rise above 100% of gross domestic product in 2012. {These figures do not include significant of the undertakings to guarantee and support the GSEs, Fannie Mae and Freddie Mac.) Gross domestic product is the final value of all goods and services produced within the country in its fiscal year. Because of the interest costs necessary to sustain the public debt it becomes more and more difficult to sustain. Already we are witnessing instances where the federal government is selling off portions of its accumulated wealth (land and natural resources) to carry its obligations. Debt owed to a foreign competitor has the further disadvantage of weakening our competitive bargaining power and in time can weaken our ability as a nation to defend ourselves.

Balancing the finances of a nation is not that different from balancing the finances of an individual. A careful assessment must be made of what is available to be taken in as revenue just as a careful assessment is required to determine what can be expended. There are obvious differences. For the government office holders {charged with the duty of determining who will receive government benefit and who will pay the attendant tax} attention may be diverted from the business of government to the office holder’s personal business of maintaining government office. Thus, the decisions become political; making the issue of whose candidate holds office an essential element in determining what government programs thrive and what citizens pay.

As to the citizens, a recent issue of the Economist magazine found that collectively our consumer citizens had accumulated personal debt of 2.81 trillion dollars with the average household's debt exceeding \$120,000. Making things worse, almost ten percent of our workers are officially listed as unemployed. Reliable non governmental sources report the unemployed figure as more than 17%.

Government regulations targeting minimum wage, retirement and health benefits, working conditions, environmental issues and various other issues have raised the cost of doing business. This places industries at competitive disadvantage when attempting to sell their product or service in either the domestic or the international market. In turn, it has the effect of reducing available jobs as there is no market for what is produced. Debt and unemployment reduce the ability of the domestic consumer to pay for goods and services due to his accumulated debt or unemployed status. The foreign worker, laboring for less pay and benefits, produces a more competitive product than that able to be produced domestically. The foreign worker, be he legal or illegal, is willing to work for less when he goes to work in this country. These circumstances restrict profits taxable to our government. With fewer contributions to the domestic treasury, the function of contributing to the federal fisc falls to fewer and fewer contributing individuals. Their incentive is arguably reduced as they look to support those to whom they do not feel an obligation.

With fewer tax contributors and more dependant for support under today's reduced qualification standards, less will be available to distribute. Already this fact is being widely recognized. Serious proposals are advanced to means base any payments to be made from social security, to reduce government salaries and retirement benefits. Public employees are threatened to be laid off. National defense program expenditures have been cut, perhaps not as might be expected by withdrawals of manpower from Iraq and Afghanistan. Cuts have come in technology programs for the defense of Europe and of this country and for administering the work of other government agencies. In the recent past when evaluating a company's stock for acquisition in your portfolio, we have often inquired relative to the necessity of that company's product to government needs and the needs of the individual. Budgetary constraints are placing a new meaning on what is necessary to each of these consumer groups.

For the taxpayer who represents a diminishing percentage of the American electorate, the signs are ominous. Due to a procedural provision in the 2001 tax law, the provisions enacted in that year expire as of January 1, 2011 and with that expiration come increases in the tax rates, the capital gains tax, the tax on dividends and a bevy of other tax increases. The administration has indicated that, as to the tax rates, it wishes to exclude taxpayers making less than \$250,000 annually from the increase. But, depending on the taxpayer's individual situation, the overall tax imposition will increase as will various impositions such as use taxes.

The subject of tax increase is never popular in an election year. Consequently Congress made it very clear that its membership did not want to address the income tax issue prior to elections.

Very early in 2010 the President appointed a Commission. Its revenue proposals will be presented for up or down vote to Congress on December 1. Precedent for such Presidential action is not available. The Constitution calls for revenue bills to be initiated in the House of Representatives.

But politics governed the day in 2009 as Congress allowed the estate tax to lapse without taking any action. As a consequence, tax professionals have been faced with guessing what the estate tax provisions will be for 2010, an issue that has yet to be clarified. Obviously, the country requires clarification for the estate tax and cannot afford a similar period of uncertainty to develop regarding its biggest single source of revenue, the income tax. Rumored to be included in the Commission's recommendations is a new Value Added Tax that will impact transfers of both goods and services. A value added tax could initiate a new tax system for the country with revenue raising possibilities equal to those of the income tax.

For the businessman, particularly the small businessman, conditions may seem threatening. A typical small business entrepreneur often sacrifices early security to put hard work, ingenuity and capital into what he starts as a struggling business venture. His hoped for reward comes from the after tax accumulation he hopes to obtain eventually for himself and his family. The administration's tax program if enacted may greatly reduce the reward he hopes to build. Additionally, the capital he may need to borrow to build his business has become scarce due to increased loan requirements resulting from the capital implosion of 2008. Business can thrive in an economy where government is stable, the law is predictable, where taxes and labor costs are affordable, where the imposition of government regulation is even handed and acceptable and where there is adequate demand for the enterprise's goods and services. Each of these conditions has been adversely affected within the last several years.

What's worse, a stereotype of the businessman has been created in the mind of the public and has become a target for the law to correct. There have been many examples to which the public can legitimately point. It's the stereotype of the top executive who has bent or broken the law to the citizenry's extreme disadvantage. It's the rich, uncaring, manipulator who has now been caught. In the public's rush to punish the stereotype, it may do away with the legal provisions that have served to build our innovative and creative enterprise system. It may stifle our nation's most important source of wealth and with it our most important source of future national revenue.

The individual investor faces a new set of critical issues. As with the business, the individual must assess his needs and objectives using updated standards of measurement. What are those needs and objectives and how are they to be prioritized? What is available to the individual to meet those needs and objectives? Will his revenue sources remain the same? Has he come to rely on government originated cash flows such as social security or pension income? Is he among the fortunate whose income from these sources will not be reduced? What will be his future tax obligations and how will they be met?

He must be particularly aware that even his after tax and after benefit assessments will not remain constant. That's because the government has added so substantially to the money supply that future cost will escalate very substantially. How will this affect the flow of income needed presently and what is the accumulation that must be built for future consumption?

Having assessed this basic cash flow calculation, the individual investor may now be prepared to address where investment money is to be placed.

For the financial planner, his occupation has become complicated. This is not primarily a result of the codification and expansion of his obligations by the new Financial Regulatory Act. The debt accumulations of government and the individual have resulted in market precipices in each of the generic markets: cash, bonds, stocks, commodities and real estate. A precipice may bring on volatility which we have experienced. Many businesses have closed and individuals declared bankruptcy. Supply lines and operational plans have been disrupted. A government deeply in debt has infused the banking system with paper money. Its hope is that the banks to which much of the stimulus was distributed will reignite the business cycle by initiating loans and thus disburse the new paper to those areas of the economy where needed. But, having been once burned with defaulted loans, the banks have sought to protect themselves. They have raised lending standards. People have continued out of work as potential employers have remained short of cash with which to hire. The paper has yet to be circulated in a manner that avoids the possibility of recession. The timing of investment is critical for, once the specter of depression has past, the large amount of new money issued is predicted to result in inflation. For the financial planner, forecasting the actions of government has become critical to forecasting the financial future of companies targeted for investment.

The planner must be constantly aware of government issues of finance. Large segments of the private sector have been moved to direct federal control as for example, in the automobile, financial and health industries. The Government Accounting Office, Congressional Budget Office, the Office of Management and Budget, and the United States Treasury have all warned of the long term financing challenges facing the government. "This is because expenditures related to entitlement programs such as Medicare, Medicaid and social security are growing faster than the economy overall..."

"These agencies have indicated that under current law, sometime between 2030 and 2040, mandatory spending (primarily social security, Medicare, Medicaid and interest on the federal debt) will exceed tax revenue. In other words, all discretionary spending (e.g. defense, homeland security, law enforcement, education, etc) will require borrowing and related deficit spending. These agencies have used terms such as "unsustainable" and "train wreck" to describe such a future" This quote from Wikipedia was written prior to the passage of the Administration's new health law.

The financial planner sees 2010 as a pivotal business, tax, and investment planning year. With the prospect of higher taxes for business and the individual imminent, what should taxable income be this year? What amount does the individual determine to roll from his taxable IRA into a Roth IRA and at what risk to a possible later second tax imposition? How does an individual best utilize the present provisions of the gift tax to move assets from one taxable entity to another?

What tax and financial risks are to be anticipated from initiating or continuing a business or investment venture presently? We were promised change with the election of the new administration. This may well be the year for alert individuals to focus on the national transition in revenue flows taking place.

With 2010 a pivotal year for tax and investment planning, what is to be anticipated from the years following 2010? Ideological political battle lines have been drawn between those favoring an increase in the democratic leveling process and those favoring the retention of a modified capitalism.

Those favoring the increase in democratic process will be significantly assisted in the election process as the remaining stimulus money; over 1.25 trillion dollars will be applied to stimulate this fall's economy. This may temporarily mask our financial problems. Much will be determined by the national elections to be held in November and in 2012.

Since 1913, the trend of elections has seen a dramatic acceleration of the leveling process, the democratic process. The evidence is there from regulations to improve working conditions to hours and pay, from income and transfer tax impositions to environmental regulation, from Medicare and Medicaid, to social security and ERISA. The trend has been to mitigate and eliminate many of the major flaws of the capitalist system, the inequalities of race, sex, and national origins. Obviously, many remain. But, now, the issue is presented whether the capitalist system as so refined should continue. Despite capitalism's many flaws, it has served us well and been the model for economies around the world. It has the advantage of advancing the best products for the individual into a competitive marketplace rather than the collective product as chosen by one overseer.

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