THE LINNEMAN LETTER

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Dealing With The Budget Deficit

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The U.S. has experienced three distinct post-Korean War federal budgetary eras. From 1954-1973, the federal government ran surpluses in four years, spending an average of 16% of GDP while collecting an average of 15.8% of GDP, for an annual average federal deficit of a mere 0.2%. During this period, real federal spending rose by 67%, while real GDP grew by 68%. The budget deficits of this scale may or may not have been the best economic policy, but annual deficits of 0.2% of GDP were economically sustainable given average annual real GDP growth of 4%. During this era, political debate was about 50-100 bps of GDP more in spending or less in taxes, and eliminating "waste, fraud and abuse" could believably result in balanced budgets.

Beginning in 1974, a major shift occurred in social policies, particularly with respect to retirees. The result was the steady expansion of federal entitlement spending, which pushed federal spending to an annual average of 20.7% of GDP from 1974-2007. This 470-bp increase in federal spending as a percentage of GDP was only partially matched by a 270-bp increase in federal revenues as a percent of GDP, which averaged 18.2% of GDP per annum. As a result, the federal budget generated surpluses in only three years during this era, as the average annual federal deficit rose to 2.5% of GDP. Real federal spending rose by 152%, while real GDP rose by 175%. Given that real GDP grew by a compound annual average of 3.1%, these deficits may or may not have been good policy, but they were (barely) sustainable, as economic growth slightly exceeded deficit growth. During this era, political debate continued to focus on 50-100 bps of GDP in additional spending or reduced taxes. And while eliminating "waste, fraud and abuse" might not have balanced the federal budget, it would have made dramatic progress toward this goal.

Since 2008 we have a whole new ballgame, with the federal government spending an annual average of 23.5% of GDP, while collecting an annual average of just 15.7% of GDP. That is, spending rose by 280 bps of GDP while receipts fell by 250 bps of GDP. The result is an annual average federal budget deficit of 7.8%, while the compound annual rate of GDP growth has been a mere 0.7%. This may be good or bad policy, but it is clearly unsustainable policy. In fact, it is far beyond sustainable.

Since real estate serves the economy, it is impossible for the government to reallocate 6-8% of GDP without an impact on the real estate business. As a result, D.C. politics really matter to the real

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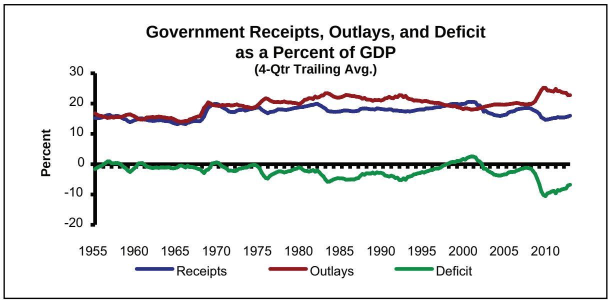
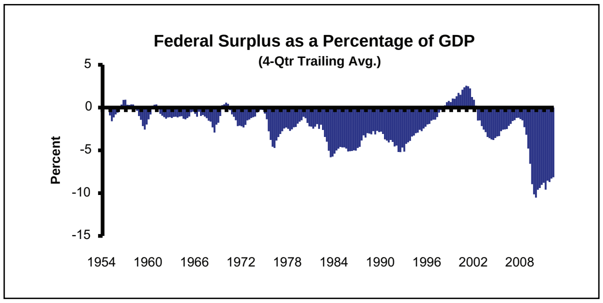
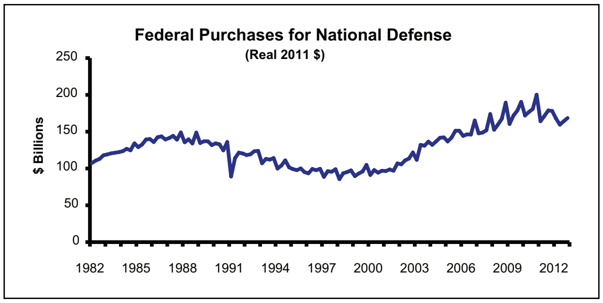
estate industry for the first time since abusive tax allowances were eliminated from the tax code in the 1980s. Everyone in real estate is impacted by Dodd-Frank, because its pronouncements for the financial sector disproportionately impact the capital-intensive real estate industry. Everyone in real estate is affected by ObamaCare's impact on labor costs. And everyone in real estate will be impacted by the response of economic growth to the steps taken to reduce unsustainable deficits, as well as by who is gored in this vicious political process.



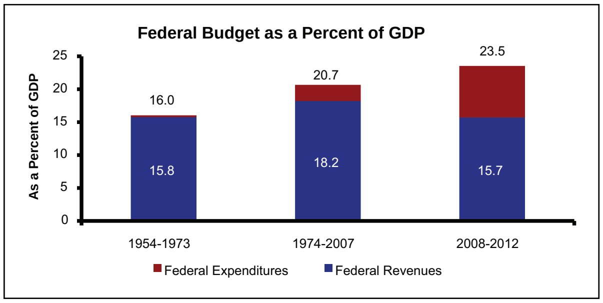
The drop in the federal revenue share of GDP largely reflects the increased cyclical volatility in federal income associated with an ever increasing reliance on the highest-income households to pay the bulk of income taxes. The top percentile household incomes are disproportionately cyclical. As the effective zero-income tax bracket has risen to envelop 50% of the population, the pro-cyclicality of federal revenues has grown, underscoring a flawed tax structure over the business cycle. This pro-cyclical revenue pattern is dangerous, as in good times the additional tax proceeds are inevitably spent, while in bad times the spending remains even as revenues plummet.



The current unsustainable federal deficit also reflects a decrease in Federal Insurance Contributions Act (FICA) tax proceeds, as employment fell by 8.9 million jobs, combined with stunning increases in federal handouts. These handouts went to select banks, auto companies, insurers, unemployed workers, homeowners, etc. in ways that have been well documented. Handouts also went to an increasing number of recently disabled workers. Currently at 8.8 million, the number of Americans receiving disability benefits has doubled since 1995, costing taxpayers \$260 billion per year. By 2011, 38 million working age households (42% of all such households) received benefits from at least one federal entitlement program. This means that "we" are subsidizing almost half of "us."



In short, we are a rich society that feels entitled to live well beyond its means. The result of all this is that over the past five years, real federal spending rose by 15.6%, versus a 2.5% increase in real GDP. The budget deficits of the current era mean that we can no longer afford political debates about 50-100 bps of GDP in taxes or spending. We must fundamentally re-examine the benefits we are awarding and how we pay for them. It is the simple truth that taxes as a percent of GDP will have to rise, while spending as a percent of GDP must fall such that the gap is less than 2% of GDP. This must occur in order for the deficit to be sustainable. And the extent of the necessary reforms will only grow as Boomers retire.



Everything, including entitlement promises beyond our means, must be on the table, and soon. In a world where entitlements and interest payments on federal debt represent about 65% of the \$3.7 trillion in annual federal spending, we simply cannot achieve (and maintain) a sustainable budget deficit by eliminating "waste, fraud and abuse."

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And do not be fooled by the recent narrowing of the deficit. This almost exclusively reflects the spike in revenues associated with the one-time shift in income from 2013 to 2012, in anticipation of higher tax rates in 2013.

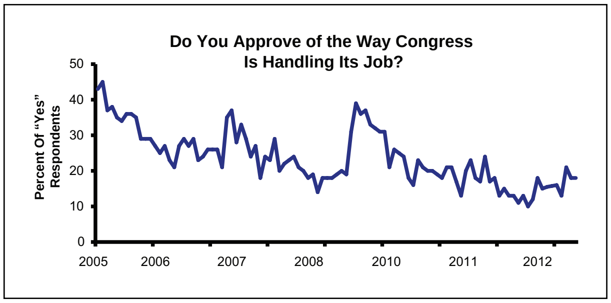
The homeowner interest deduction looms large in any discussion of tax reform. If it is not eliminated, then every other special exemption is open to protection. Yet we doubt that the mortgage interest deduction will be eliminated, as it is too widely used, particularly in regions like New York and California, where home prices are far above national norms. Not only do about 40% of all U.S. households have mortgages, but reduced home prices would adversely impact the wealth of about 65% of U.S. households. This seems like too much political headwind. The likely outcome is a phased-in capping of interest deductions. But even this is tricky politically, due to the concentration of high-valued homes in key coastal (and very Blue) states.

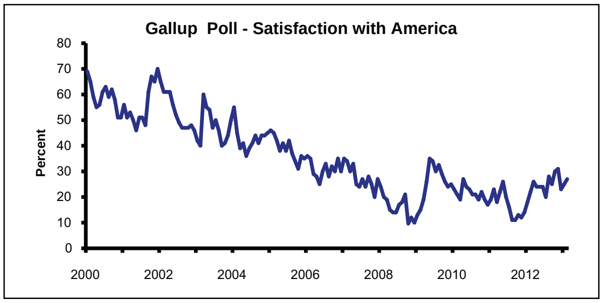
Sequestration is small potatoes. It is a mere $43 billion cut on $3.7 trillion in federal spending. This roughly 1.5% reduction in federal spending directly increases taxpayer wealth via reduced future tax liabilities, which, in turn, increase consumer and business spending. To put the sequestered amount in context, in 2013 the improvement in housing starts will add $45-60 billion to GDP.

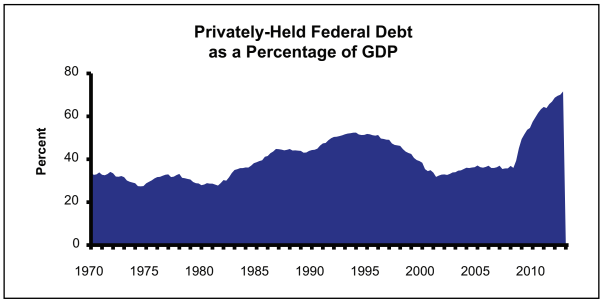
We have added $7.3 trillion in net federal debt in the past five years, an amount that is growing at more than $1 trillion per year (on $15.8 trillion of GDP). Outstanding net federal debt is $11.9 trillion. And even after sequestration, real federal spending will still be 5.7% higher in 2013 than in 2012. Our question is, "What budget cut?"

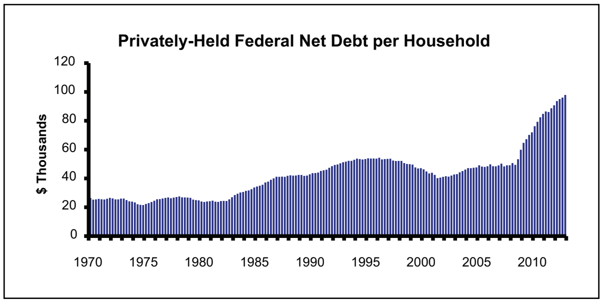
Compared to the employment downsizing in construction (15.2%), housing (17.0%), and manufacturing (10.4%), which occurred in 2009 as private enterprises bled, the mere 3.5% reduction in federal employment during the past two years, as the government bleeds, is absurd. The anti-austerity backlash triggered even by such small cuts vividly demonstrates why big deficits are hard to reduce. Beneficiaries understandably fight reductions to their benefits, even if they only recently received these benefits. Once the smoke is out, it is very difficult to put it back in the bottle. This is why large and unsustainable federal deficits throughout history, and around the world, have generally been inflated away. Inflation is taxation without legislation. But inflation is also a tax that robs purchasing power (in non-neutral ways), as surely as taxes do.

The Keynesian support of deficit spending is based on the concept of insufficient aggregate demand. Government spending is assumed not to be duplicative of private activity, and therefore will have no offsetting reduction in private spending. The idea is that more government spending is assumed to be as efficient as existing government spending and also as efficient as private spending and investment. However, it is highly unlikely that incremental government









spending is as productive as either in-place government spending or private spending. First, it seems reasonable to suspect a diminishing marginal productivity of government spending. That is, the government is already spending on the most socially productive things (police, courts, jails, highways, etc.), and incremental government spending is rarely as productive as private spending and investment. After all, people know better what they want than do many layers of bureaucracy.

If one believes that government needs to stimulate aggregate demand, a far more effective way to do this would be to have the Fed make a loan to every business and consumer (pro rata to their contribution to GDP in order to assure economic neutrality), subject to the condition that they must incrementally invest and consume the full amount of this loan. This is the true “Friedman helicopter” monetary infusion. These private decision makers could then decide how to most effectively deploy this “manna from the Fed.” Surely this would provide a greater stimulus to aggregate demand than politically decided and bureaucratically administered federal spending.

Recently it has been shown that Reinhart and Rogoff greatly overstated the decline in real GDP growth that occurs when federal debt-to-GDP ratios exceed 90%. But lost in this discussion is the fact that the data indicate that GDP growth diminishes as this ratio increases, even at low ratios, refuting the Keynesian notion that deficits fuel economic growth. The reason is obvious: today’s deficits mean that more of the current economy is being used (i.e. consumed) by the relatively unproductive government sector at the expense of the private sector, which will incur future tax burdens. This negative arbitrage is why the growth rates of Mao’s China, the USSR, and North Korea are all far less than that of the U.S. It is also why Western Europe’s growth rate has long been lower than the U.S. growth rate. And it is why the U.S. growth rate over the past five years lags behind long-term U.S. growth rates.

It is interesting how politicians suddenly are saying that some cuts in government spending are more economically impactful than others. That is, not all government spending is equal. We have been a lonely voice saying that the Keynesian notion of simply increasing any form of government spending (“G”) in order to foster growth is nonsense. That is, it is spending on what and not how much that matters to the well-being of society. Now Keynesians suddenly seem to agree. A small victory!