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Can a Tax Rewrite Boost Tax *Collections*?

Efforts to rewrite the federal income tax code have held center stage this fall in D.C. You'll note that we use the term "rewrite" rather than "reform," recognizing that definitions of reform vary widely by political association and philosophy.

At this writing, neither the particulars nor the passage of final legislation are certain. Instead, we turn to an assessment of the *current* tax code's performance in gathering revenue to fund the level of federal spending we appear to demand.

The accompanying table provides basic context and perhaps an antidote to politicians' propensity to exaggerate. It sorts and smoothes federal revenues and outlays over the past five decades, shown as percentages of the overall economy (gross domestic product, or GDP). To bring the discussion current, it also shows the results for fiscal 2017, which closed September 30th.

Notably, the smallest average shortfall (deficit) was for the decade 1998-2007 at just 0.8% of GDP. The largest average deficit, 5.2%, was for the latest decade, 2008-2017. The financial crisis and recession early in that decade had a big impact. For both fiscal 2009 and 2010, federal receipts shrank to just 14.6% of GDP, while outlays surged to 24.4% and 23.4%, respectively.

The 2017 numbers show a return to relative normalcy. But at 3.5% of GDP, the deficit is stuck above the economy's growth rate, and overall tax collections have stagnated.

Economic expansions typically grow tax revenues *at least* as fast as the underlying economy. From 2010 to 2015, federal revenue rebounded a cumulative 50%, reaching 18.2% of GDP in 2015. However, starting in 2013, several provisions raised rates on upper income taxpayers.

Tax legislation and economic conditions have a lagged effect on the amount of tax actually collected. In the wake of personal income tax hikes, and despite a multi-year run of good employment numbers, *cumulative* growth in federal revenue for the last two fiscal years was a mere 2%.

Individual income taxes may have been affected by taxpayers adjusting to higher rates, perhaps by rearranging compensation and portfolios away from straight taxable income and toward tax-exempt municipal securities, tax-deferred retirement plans, leveraged real estate, and other capital gains assets. For that trailing two-year period individual income tax collections grew less than 3%.

A bigger effect has shown up on *corporate* taxes. Those collections actually fell 14% over the past two years despite rising profits. If there is a glimmer of bipartisanship on taxes, it may be the idea that the corporate tax system has become uncompetitive, incentivizing companies to locate, or at least book more of their profits, *outside* the U.S. Even politicians can grasp the concept that 20% of *something* is more than 35% of nothing.

It's often said that a tax system should raise the requisite revenue without unduly distorting economic activity. Objectively, the numbers suggest we could do better on that score, but tax legislation is rarely an exercise in objectivity. ■

Federal Taxes & Spending: Past Patterns and Realities

Fiscal Years by Decade	Individual Income Tax	Payroll Tax	Corporate Income Tax	Other Receipts	Total Receipts	Total Outlays
	----- *10-yr. averages as percentage of Gross Domestic Product (GDP)* -----					
1968-1977	7.9%	4.6%	2.8%	1.9%	17.4%	19.3%
1978-1987	8.3	5.9	1.8	1.8	17.8	21.4
1988-1997	7.9	6.4	1.9	1.4	17.6	20.5
1998-2007	8.2	6.3	1.9	1.4	17.8	18.6
2008-2017	7.6	5.9	1.6	1.3	16.4	21.7
Fiscal 2017	*8.3*	*6.1*	*1.6*	*1.4*	*17.4*	*20.9*

Source: *Congressional Budget Office*

The Nobel Prize for Helping Us Help Ourselves

There are countless theories on the forces that drive financial markets. But in the end, market movements are the cumulative effect of the *behavior* of all participants – those who know a little, those who know a lot, those who control billions, and those just saving for a comfortable retirement. So it seemed fitting that the reputed "Father of Behavioral Finance," Dr. Richard Thaler, would receive the 2017 Nobel Memorial Prize in Economic Sciences.

If you've worked for an employer that automatically directs a portion of your pay into your 401(k) account, you've felt the long arm of Dr. Thaler's research. If we were all perfectly rational economic beings, we would proactively defer as much as we could reasonably afford into those accounts. The tax benefits are compelling, and achieving retirement security is no small challenge.

It's now widely recognized that 401(k) participation and savings rates rise notably when employees are *automatically opted in* rather

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OPEC Striving for a Delicate Balance

It has been three eventful years since the *Quarterly* featured profound changes in global oil markets sparked by a renaissance in U.S. production (Winter 2014: "A New Oil Paradigm Shuffles the Deck"). At that juncture, we noted that OPEC's decision to sustain high production levels looked like "a high stakes game of chicken." Their transparent strategy was to see if low prices would pressure U.S. producers to curtail their higher cost production.

Lower prices did have some of the intended effect. The meager three-year returns for Natural Resources funds in the accompanying table reflect the impact on the financial performance of energy-related companies. However, low prices are tough on OPEC countries too, so this past year saw the cartel shift to a strategy of coordinated production *restraint*, led by Saudi Arabia.

That strategy, a perkier global economy, and a handful of supply disruptions appear to have propelled a solid six-month comeback for oil prices from around $45 to better than $60 per barrel. On cue, Natural Resources mutual funds have bounced back, and energy stocks got a fresh pop when OPEC confirmed plans to continue those production constraints through 2018

OPEC will be watching U.S. active rig counts and production numbers to see if their success at supporting the price of oil prompts a renewed supply surge from these shores. U.S. onshore oil production peaked in early 2015 at 7.6 million barrels per day, but had fallen to 6.5 million by the end of 2016. Drilling rigs directed to oil dropped to just 330 in mid 2016 but had risen to 750 by this past September. Actual production is rising again.

OPEC faces a delicate balancing act with conflicting pressures. For most member nations, oil is a nationalized asset. Development and production costs may be low, but those governments need more oil *revenue* to support other spending. It is estimated that Saudi Arabia, with some of the lowest production costs, still needs oil at $78 per barrel to balance its overall fiscal picture.

In their latest quarterly market update, global energy specialists at Guinness Atkinson raised projections for growth in global oil demand while citing signs of less growth potential for U.S. production and more confidence in OPEC discipline.

Guinness Atkinson suggests that Saudi Arabia, through OPEC, targets a "reasonable (affordable) world oil bill" as a percentage of world gross domestic product (GDP). Over the past ten years, that total tab averaged 4.2% of world GDP, compared

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Behavioral Finance in the *Present* Tense

When it comes to the findings of behavioral finance research (related article on page 1), it's tempting to attribute common investing miscues to inexperience. But it seems that even the most sophisticated professionals are not immune. The *Wall Street Journal* recently provided supporting evidence with a review of this past year's market prognostications by 17 of the industry's largest brokerage firms.

A year ago, nearly all of those firms' market strategists were predicting a lackluster 2017 for stocks. Their average target for the Standard & Poor's 500 Index's 2017 close was 2343, just 4.6% above its 2016 close of 2239. Predictions ranged from a low of 2275 to a high of 2450.

At this writing, the S&P stands at 2630, representing a 17.5% rise on the year, not counting dividends. The Dow Jones Industrial Average and NASDAQ have risen 22.4% and 25.6% respectively. Stocks could slip before year-end, but it would take a pretty deep dive over that handful of trading days to approach those original projections. Even that wouldn't offer complete redemption, as 13 of the 17 firms subsequently raised their year-end targets for the S&P to an average of 2537. Better late than never, apparently.

Seeing safety in numbers is one of our more enduring behavioral quirks. We're also inclined to see current trends going on indefinitely. Forecasts for 2018 may display those same behavioral tendencies. However, markets tend to frustrate groupthink, and trends are bound to turn, at least for a while. ■

Investment Performance Review	**TOTAL RETURN *** (dividends and capital gains reinvested)			
Selected Mutual Fund Categories *	**--- Annualized through Dec. 5, 2017 ---**			
	1 yr.	***3 yr.***	***5 yr.***	***10 yr.***
Large-Cap Stocks (Blend)	21.1 %	8.9 %	14.2 %	7.5 %
Mid-Cap Stocks (Blend)	15.0	7.7	13.5	7.6
Small-Cap Stocks (Blend) †	16.0	9.4	13.6	8.3
Foreign Stocks (Large Blend) †	24.5	5.8	7.4	1.4
Diversified Emerging Markets †	30.1	5.4	4.2	1.1
Specialty Natural Resources †	10.7	2.6	2.5	0.4
Specialty Real Estate †	9.0	5.3	9.1	6.1
Cons. Allocation (30-50% Equity)	9.9	4.1	5.7	4.6
Long-Term Bond	9.0	4.6	4.0	6.0
World Bond †	6.8	1.9	0.9	3.4
High Yield Taxable Bond †	7.8	4.6	4.9	6.5
Long-Term Municipal Bond	6.8	3.1	2.6	4.1

* Source: Morningstar. **Past performance is NOT indicative of future results.**

† Small-cap stocks, high-yield (lower rated) bonds, and sector-specific funds may exhibit greater price volatility than the stocks of larger, established companies and/or more broadly diversified funds. Securities of companies based outside the U.S. may be affected by currency fluctuation and/or greater political or social instability.

Testing Times for Retailers, As Always

'Tis the holiday shopping season, and recent readings on the economy and consumer confidence have been among the strongest in years. Retailers should be rejoicing, right? And yet, for much of the year the prevailing narrative has been on the revolution in e-commerce and the pressures on traditional "brick-and-mortar" retailers and high-profile consumer brands.

Analysts at Capital Group also site relatively weak wage growth, greater consumer price consciousness since the Great Recession, and less brand loyalty among critical millennial consumers. Discount retailers appear to have fared better than high-end vendors and brands. And some subsectors such as large home improvement centers and auto parts stores have been less vulnerable to erosion from e-commerce.

Nevertheless, major retailers are looking to deal aggressively with excess capacity and overhead, often closing or repurposing underperforming locations. The effects have spilled over into commercial real estate, especially retail malls. And the supermarket sector was shaken by Amazon's acquisition of Whole Foods earlier this year.

All that said, the retail world's *sturm und drang* may be a bit overdone. Economists at BCA Research recently conducted a detailed search for statistical evidence of a meaningful e-commerce effect on retail prices, profit margins, etc. Without re-crunching all the data here, their key conclusions were as follows.

• E-commerce affects about 4% of the goods and services factored into the Consumer Price Index.

• Most of the past decade's disinflation has been in areas unaffected by e-commerce, including energy, food, and owner's equivalent residential rent.

• Online retail's operating cost advantages are overstated, while weak productivity growth and high profit margins challenge the idea that e-commerce has delivered a significant supply-side benefit.

• Online pricing appears subject to frictions similar to traditional outlets, and some measures of online prices have mirrored the CPI.

BCA Research also notes that e-commerce is by no means the first revolution in retail and may prove to be less disinflationary than the rise of the "big box" stores a generation ago. After a yearlong struggle for many retail stocks, the sector has seen a strong bounce in recent weeks. As always, it is difference of opinion that makes a market. ■

Those HSAs Are HOT, and Why Not?

A lot of ink has been spilled comparing Traditional and Roth IRAs. The discussion turns on the value of an up-front tax deduction versus the promise of tax-free withdrawals in retirement. But what if you could have both? More taxpayers are seizing on that prospect with Health Savings Accounts (HSA).

The creation of HSAs was a sidebar in the 2003 legislation that established Medicare's prescription drug benefit. HSAs must be used with high-deductible health insurance policies that meet certain requirements. Initially, contribution limits were low, and the accounts were slow to catch on.

Today many more taxpayers are in high-deductible health plans that qualify them to contribute to an HSA. Annual contribution limits have grown to 2017's maximum of $3,400 for an individual and $6,750 for a family, plus a $1,000 catch-up for those over age 55.

HSA contributions are deductible regardless of income level and whether one itemizes deductions. Investment earnings in the account are not taxed on a current basis, and withdrawals to cover qualifying medical expenses are tax-free.

What retiree doesn't expect to have such expenses, given Medicare deductibles, Part B premiums, and other uninsured medical costs? If one can't find any such expenses, withdrawals from an HSA after age 65 can be spent on anything and simply be taxed like withdrawals from a traditional IRA.

Not surprisingly, this supplemental retirement vehicle is catching on. Total HSA assets grew 22% in 2016, and the Fidelity organization recently reported a 50% year-over-year increase in HSA openings.

As with an IRA, a 2017 HSA contributions can be made up to next spring's tax filing deadline. But reimbursements from the account are only tax-free if used for medical expenses incurred *after* the account is established. The first step is to check your health plan's HSA eligibility. Then your investment professional can help you explore HSA custodians and the mechanics of putting contributions to work. ■

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to 3.2% for the past 20 years and 2.8% over 30 years. In 2016, at about $45 per barrel, the world's oil bill was just 2.1% of GDP. Looking out a couple years, a world oil bill of 3% of GDP would imply an average price in the $70-75 range.

Of course, there is no "right" price for oil. It is a fluid function of supply and demand with both sides of that equation subject to a host of variables including advances in energy and transportation technology, the rise of renewables, and the politics of climate change. Correlation between economic growth and oil demand growth has been strong. But in more mature industrialized nations, demand remains below 2007 pre-recession peak levels, while emerging nations have seen demand hitting new highs year by year.

The International Energy Agency estimates current global demand at 98.2 million barrels per day, up from 96.7 million a year ago. We certainly have seen advances for alternatives, but it looks like oil will be a key part of the energy mix for some time to come. ■

Even a *Stopped* Clock Is Right Twice a Day

Maybe you've seen the online National Debt Clock spinning merrily along at *www.usdebtclock.org*. Its iconic predecessor, a longstanding billboard maintained by the Durst Corporation near New York city's Times Square, recently spent six months in the repair shop. Durst spent $160,000 on a new digital display and wiring while retaining the sign's admittedly "dated" look.

After all, it's really about the numbers, which also could use some illumination. For example, the *Wall Street Journal* noted that while the Clock was in the shop, the debt grew by $687 billion. But how could that be? The Congressional Budget Office (CBO) reported a $666 billion deficit for *all* of fiscal 2017, while the repairs only took *half* a year.

That discrepancy mirrors some confusion on the *total* debt number. The Clock shows nearly $20.6 trillion, while CBO reports $16 trillion in debt held by the public. That spread mostly relates to the *balances* in the Social Security and Medicare trust funds. Those balances are simply a historical tracking of amounts by which those programs' dedicated revenues have exceeded program outlays, plus accrued interest.

Nevertheless, by law the trust funds are counted as federal *debt* with respect to staying under the statutory debt ceiling. Something to keep in mind the next time *that* circus comes to town. ■

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The Nobel Prize...

than having to make an affirmative election. A recent survey from Alight Solutions found that 33% of companies now automatically default workers into deferring an average of 6% of pay into their 401(k) accounts. Alright reports that 37% of employers still use a 3% default rate, but that was the standard for more than half of employers as recently as 2009.

Getting us all to join the party by default is a start. The other key is to nudge us to save more. Employers have long used offers to match employee contributions up to some percentage of pay. As indicated above, many plan sponsors have raised the default deferral percentage for their automatic enrollees. Plans also are instituting automatic *escalation*: periodic increases in the percentage of pay deferred into an employee's retirement account.

This is all optional of course. Employers don't have to do any of the above, and employees can opt out. Dr. Thaler built his Nobel *bona fides* exploring the financial foibles of us mere mortals. Overcoming our natural inertia in saving for retirement is just one of the more salient effects of behavioral finance insights. Now, if they could just make us smarter healthcare consumers. ■

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