YANNI PARTNERS

DELIVERING THE PROMISE

MEASURING UP

Volume 17 | Number 3 | Summer 2005

President Bush's Economic Agenda

IN THIS ISSUE

Examining the President's economic agenda.

Six months into his second term, President Bush has already set an ambitious economic agenda. Four broad-based economic reforms top his list of priorities: reigning in government spending, restructuring institutions fundamental to American society, passing legislation that promotes economic growth, and controlling future energy costs.

In this issue of *Measuring Up*, Yanni Partners will examine the President's economic agenda, including his specific proposals. We will also discuss the likely impacts that these proposed reforms will have on the capital markets as well as clients' portfolios.

Reigning in Government Spending

As a first step toward his campaign goal of halving the Federal budget deficit by 2009 and controlling government spending, President Bush earlier this year sent to Congress for approval a $2.57 trillion spending plan that makes the broadest domestic spending cuts since the Reagan era.[1] Under the proposed 2006 spending plan, 13 of the 24 major Federal agencies will receive less money than received under the 2005 plan. The Department of Housing and Urban Development will experience the largest drop in funding, with cuts nearing $4 billion, which is an 11.5% cut from 2005. In addition, cuts to the Departments of Agriculture, Education, and Justice will total $3.6 billion.[2] Specifically, the budget outlines capping farm subsidies at $250,000 annually, down from $360,000 currently; consolidating 18 community development programs and placing them under control of the Department of Commerce to reduce redundancy; and reducing the Community Oriented Policing Services (COPS).[3] Overall, the proposed 2006 budget eliminates or substantially reduces 150 programs that are not succeeding, duplicating existing efforts, or not fulfilling an existing priority.

Conversely, the Department of Defense budget will increase by $19.3 billion (a 4.8% rise from 2005) to $419.3 billion, and homeland defense programs will see a 3% budget increase. Based on this spending plan, the President has emphasized protecting Americans at home and abroad. A new program aims to secure chemical plants, ports, and public transit systems against possible attack.[4]

[1] McKinnon, John D. and Jackie Calmes, "A 'Lean Budget' From Bush Cuts Mainly at Home," *The Wall Street Journal*, February 8, 2005.

[2] Office of Management and Budget, "Overview of the President's 2006 Budget."

[3] McKinnon, John D. and Jackie Calmes, "A 'Lean Budget' From Bush Cuts Mainly at Home."

[4] McKinnon, John D. and Jackie Calmes, "A 'Lean Budget' From Bush Cuts Mainly at Home."

In all, outlays are expected to rise to $2.57 trillion from $2.48 trillion during 2005, while receipts are expected to increase to $2.18 trillion in 2006 from $2.05 trillion in 2005. Assuming these figures hold, the deficit would drop to $390 billion during 2006 from an expected 2005 deficit of $430 billion.[5]

Social Security and Tax Reform

The second aspect of the President's economic plan is to address the institutions that are fundamental to American society, including the Social Security and tax systems.

As featured in a previous issue of *Measuring Up* (Winter 2005), Social Security in its current form is unsustainable. By 2018, the Social Security Administration will pay more in benefits than it receives in taxes, and by 2042 the Social Security Trust Fund will be completely exhausted.[6] Currently, 40 million seniors receive Social Security benefits; this number is expected to rise to 72 million within the next 15 years. Retirees, living longer and collecting more benefits, combined with fewer workers paying into the System relative to the number of retirees, will soon put a severe financial strain on Social Security.[7]

Retirees, living longer and collecting more benefits, combined with fewer workers paying into the System relative to the number of retirees, will soon put a severe financial strain on Social Security.

In light of this problem, President Bush has proposed a significant overhaul of Social Security. His solution encompasses three related goals: 1) future generations should receive benefits equal to or greater than current retirees, 2) Social Security benefits should grow faster for those in lower tax brackets, who rely primarily on Social Security for their retirement income, and 3) workers should have the option of investing a portion of their Social Security taxes in a portfolio of diversified mutual funds through personal retirement accounts.[8] In order to pay higher benefits and keep the System solvent, the President has proposed cutting benefits for those workers in higher tax brackets and issuing new Treasury securities. Raising taxes is not an option; President Bush feels that higher taxes will stifle economic growth. Critics of the President's plan note that the proposal will force big reductions of middle class benefits in order to pay larger benefits to lower-income retirees.[9] In addition, issuing a substantial amount of Treasury securities may force interest rates higher.

President Bush has also made a commitment to reform the Federal Tax system during his second term, but has not yet proposed any specific plans. Ultimately, he wants to reduce taxation of private savings, preserve the deductions on mortgage payments and charitable contributions, and reduce the complexity of the tax code.[10] It is estimated that $330 billion in taxes goes unpaid annually; reducing the complexity of the system aims to give taxpayers a clearer picture of their true tax bill.[11] The President has recommended to Congress to make permanent the current tax cuts, which are due to expire in 2011. The tax cuts, originally enacted in 2001, helped ease the country out of recession. Making the cuts permanent will continue to spur economic growth and productivity increases, according to President Bush.

However, critics claim that making the tax cuts of 2001 permanent is unsustainable over the long-term. Requisite spending cuts and/or tax increases in other areas to compensate for lower federal tax revenue will merely shift resources from low-income households to high-income households. In addition to the proposed tax plan, the President aims to cut the budget deficit by 2009. Making the tax cuts permanent in 2011 (when they are set to expire) would incur a substantial cost during that year and thereafter. Aiming to reduce the budget deficit by half by 2009 ignores a major cost two years later.[12]

[5] Office of Management and Budget, www.whitehouse.gov/omb

[6] *Measuring Up*, Volume 17, Number 1

[7] Bush, President George W., "Press Conference of the President," April 28, 2005.

[8] Bush, President George W., "Press Conference of the President," April 28, 2005.

[9] McKinnon, John D. and Jackie Calmes, "Bush Spells Out his Overhaul Plan for Social Security," *The Wall Street Journal*, April 29, 2005.

[10] Niskanen, William, "Bush's Economic Agenda Deserves Support," Cato Institute, May 4, 2005.

[11] Bush, President George W., "Press Conference of the President," April 28, 2005.

[12] Gale, William G. and Peter R. Orszag, "Bush Administration Tax Policy: Summary and Outlook," The Brookings Institution, *Tax Notes*, November 29, 2004.

Promoting Economic Growth

The third pillar of President Bush's economic agenda, which is to pass legislation to promote economic growth, echoes the tax plan outlined earlier. The tax cuts of 2001 apply to small businesses as well as individuals, and making the cuts permanent will encourage job growth and spur innovation.[13] Along that same line, the President plans to address rising health care costs, especially for small businesses. Smaller companies cannot gain the same economies of scale with regard to health care premiums that are available to large corporations. President Bush hopes to pass legislation that would allow smaller companies to pool their accounts, thus receiving the same cost savings as the larger companies.[14]

Perhaps the most far-reaching aspect of this pillar is to pass the Central American Free Trade Agreement (CAFTA). Modeled after the North American Free Trade Agreement (NAFTA), CAFTA would eliminate, over the next 10-20 years, all tariffs on U.S. manufactured and farm products to Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, and Nicaragua. Supporters of the trade agreement, including President Bush, argue that 80% of Central American products already enter the United States duty-free. CAFTA would level the playing field by making nearly 80% of American exports duty-free as well. U.S. exports to Central America total $15 billion annually; this amount could rise by $4 billion and add 25,000 U.S. jobs once the agreement is approved. Opponents of the plan argue that CAFTA, in its current form, will put small-scale farmers in Central America out of business as low-cost U.S. exports flood the market. Conversely, the U.S. sugar industry contends that Central American sugar imports may drive down prices in the already oversupplied U.S. market.[15]

Controlling Energy Costs

The final aspect of the President's second-term economic agenda is to control future energy costs. Rising energy costs act as a tax on consumers and businesses, limiting economic growth. But as the world economy expands, the demand for energy and oil in particular, rises, thus driving up prices. While U.S. energy consumption has risen considerably over the past few decades, domestic energy production has lagged. Therefore, the United States must increasingly rely on foreign energy production. Given the political turmoil in many oil exporting nations as well as lofty current energy prices, reducing U.S. dependence on foreign energy production, particularly oil, has become one of President Bush's overriding goals. The President's plan to make the U.S. more energy self-sufficient has four aspects: 1) utilize technological advances to use energy more efficiently, 2) find innovative and environmentally-friendly ways to make the most of current U.S. energy reserves including oil, gas, coal, and nuclear power, 3) develop new sources of energy, such as hydrogen, ethanol, and biodiesel fuel, and 4) help emerging economies, especially China and India, become more efficient energy consumers and help reduce global demand for fossil fuels. One specific initiative the President recently proposed is to open a small portion, approximately 2,000 acres out of 19 million acres, of the Alaskan Natural Wildlife Reserve (ANWR) to explore for oil and gas deposits.[16] Though the benefits of uncovering oil and natural gas deposits in the ANWR may be great, any drilling or disruption to the area is sure to cause protest from environmental groups.

The tax cuts of 2001 apply to small businesses as well as individuals, and making the cuts permanent will encourage job growth and spur innovation.

Effects on Capital Markets and Portfolios

President Bush's second-term agenda focuses heavily on preserving and growing the current economic expansion. Cutting the deficit in half within the next four years, making permanent his

13 Bush, President George W., "Speech: President Discusses Economy, Budget at the Detroit Economic Club," February 8, 2005.

14 Bush, President George W., "Speech: President Discusses Economy, Budget at the Detroit Economic Club."

15 Associated Press, "Opponents Seek to Derail CAFTA Deal," *The New York Times*, May 31, 2005.

16 Bush, President George W., "Press Conference of the President," April 28, 2005.

Measuring Up

Yanni Partners
310 Grant Street, Suite 3000
Pittsburgh, PA 15219-2302

2001 tax breaks, ratifying CAFTA, and reducing the United States' reliance on foreign oil all should help spur economic growth.

By controlling government spending and eventually cutting the budget deficit, the government reduces the need to issue Treasury securities to make up the funding shortfall. This may keep interest rates and inflation pressures lower, thus maintaining economic growth. Making the tax cuts permanent would also encourage growth. Individual taxpayers and small businesses would keep a larger portion of their earnings and could either spend or save this extra amount, thus driving the economy forward.

As mentioned earlier, ratifying CAFTA would immediately make nearly 80% of U.S. exports to Central America duty-free, increasing exports to the region by perhaps 25%. This will open access to the region for the U.S. computer services, tourism, financial services, telecommunications, and entertainment industries.[17] However, industries in which Central American companies have a competitive advantage, such as sugar production, may undercut the prices of American companies. While some U.S. producers may lose revenue, the added competition will force existing companies to become more efficient. Overall, CAFTA should foster economic growth not only in the U.S., but in Central America as well.

[17] Associated Press, "Arguments for and Against CAFTA," *The New York Times,* May 31, 2005.

Finally, President Bush's energy plan aims to reduce America's dependence on foreign energy, and oil in particular. If it succeeds, the U.S. will become more self-sufficient over the long-term. New energy-producing companies and industries will emerge, and oil will become less valuable. However, this is a long-term plan; over the short-term, little will change. In short, higher energy costs will still act to slow economic growth.

Overall, President Bush's economic agenda is likely to have a positive effect on the equity markets, as interest rates, inflation, and taxes all remain lower. Generally these effects drive stock prices higher. Additionally, opening new markets to U.S. goods and services will likewise encourage growth in exporting companies. However, a lack of any significant short-term solutions to the energy problem will continue to stifle growth within the broad equity market. In the fixed income market, continued lower interest rates and low inflation will serve to cap the potential returns on bond portfolios. If energy prices continue to rise, the fixed income market might rebound as investors become wary of an economic slowdown. Currently, it is difficult, if not impossible, to ascertain the probable effects of the President's economic agenda on clients' portfolios. Yanni Partners will continue to monitor significant economic developments, and suggest any portfolio shifts that may be warranted due to changing conditions.

Yanni Partners provides a full range of consulting services vital to the management of various portfolios. Our ultimate goal is to offer a basis for improved investment monitoring and performance.

Yanni Partners, Inc. is registered as an investment advisor with the Securities Exchange Commission.

If you have any questions or comments concerning *Measuring Up*, please contact: Lisa M. Marcotullio,
Director of Operations **Phone:** 412.232.1000 **Email:** marcotullio@yannipartners.com **Web:** www.yannipartners.com