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“The budget should be balanced, the Treasury should be refilled, public debt should be reduced, the arrogance of officialdom should be tempered and controlled, and the assistance to foreign lands should be curtailed lest Rome become bankrupt.”

— Cicero
106-43 B.C.

On June 28, 1914 in Sarajevo, a driver made one of the most famous wrong turns in history. The car, carrying Austro-Hungarian Archduke Franz Ferdinand and his wife, stopped to turn around in front of Gavrilo Princip, a member of a Serbian terrorist organization. Princip assassinated the Archduke and his wife. Within thirty days, a chain reaction of treaties being honored led to the onset of World War I, which left approximately ten million dead. Several decades later, thirty million more lives were lost in World War II. All because of a driver's wrong turn?

I begin with this reflection not to make the almost trite reference to a “wrong turn,” though I certainly believe the United States has taken a wrong turn in managing its fiscal affairs. Rather, I want to demonstrate, in the most dramatic way possible, that complex, interconnected systems, like the system of interlocking alliances in 1916 or world's financial markets today, can erupt in dangerous, unpredictable ways.

My letter last quarter presented the U.S. fiscal situation as reported by the Congressional Budget Office (CBO), then adjusted those already scary numbers for fiscal chicanery by Congress and included state/local debt which is not included in CBO reports. The bottom line is that the U.S. fiscal situation is worse than commonly understood and is likely constraining growth within the economy. This quarter, I will examine how we got into this mess and how we might get out.

How did this Happen? An Academic View

Why does the political process favor consumption today at the expense of consumption for future generations, not to mention a smaller capital stock? Professor Barry Eichengreen of the University of California, Berkeley believes the issue lies in what economists refer to as the common pool problem. Eichengreen writes: “financing public policies from a general tax fund creates an externality: those enjoying the marginal benefit of an extra dollar spent on a project are not those bearing the marginal cost of funding it.” In short, the groups benefitting from profligate spending are not the same as those paying the bills. Not surprisingly, those benefitting from government spending are often well organized and active politically, while those paying the bills tend to be less engaged politically. In fact, government spending (federal, state and local) as a percentage of GDP, reached a post 1970 high in 2009 dipping only slightly in 2010.¹ This is an interesting theory, but it only addresses the spending side of the equation, not the revenue side. Total government revenues (federal, state and local) as a percentage of GDP are at the lowest level since 1970.²

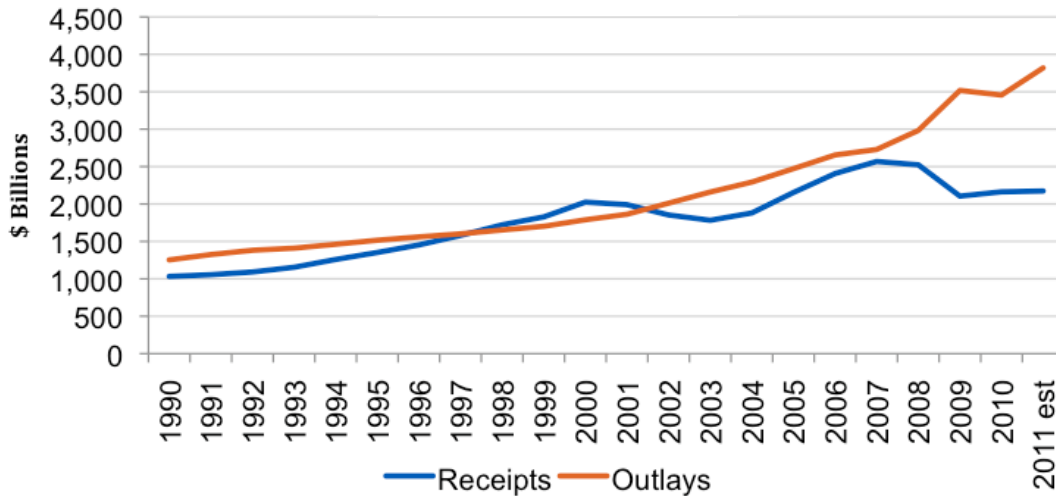
¹Public Debts: Nuts, Bolts and Worries, Barry Eichengreen, Geneva Report on the World Economy, January, 2011.

²www.usgovernmentspending.com



Perhaps the theory needs to be expanded to those benefitting disproportionately from tax cuts, as well. In any event, put the two factors of revenue and spending together and this is what happens:

Government Spending/Revenue
(Billions of Dollars)



Source: Office of Management and Budget

Why Can't We Fix This Problem?

The politics of addressing the deficit are extremely tricky, owing in part to the common pool problem and in part to the fact that, harsh as it may sound, the American people are woefully uninformed on the nature of the problem. To wit, a February 2011 Wall Street Journal/NBC news poll found that only 18% of respondents thought cuts to Medicare were necessary to "significantly reduce" the deficit; only 22% said cuts would be needed in Social Security. The same poll found that even Tea Party supporters, by a nearly 2-to-1 margin, felt that significant cuts to Social Security were "unacceptable." Further complicating the politics is the generational element: 84% of respondents 65 or older said Medicare and Social Security were "central to their financial security" while only 46% of adults under 30 responded as such.³

Are the American people right? In theory, yes. If the budget of every other category of government spending excluding Social Security, Medicare and interest were cut by nearly 61%, the federal budget would be balanced in 2010. Unfortunately, the math becomes even more difficult in the future as Medicare and Social Security grow with the aging population. I believe we can safely declare the American people misinformed about budgetary matters.

Test Your Own Budget Balancing Deftness

Are you up to the challenge of balancing the federal budget? Click on the link below for an online survey which I have reproduced from a New York Times article that lists major policy options available for closing the deficit and their attendant savings. The budget shortfall projected in 2015 is \$418 billion; in 2030 the budget shortfall rises to \$1.35 trillion and entitlement costs soar.

You have hereby been appointed as the supreme ruler. Can you solve our fiscal problems? Go to work. This will require about 10 minutes.

<http://www.zoomerang.com/Survey/WEB22DDYB7XNV5>

Were you able to, if not balance the budget, at least make a significant dent in the problem? If you are like most people, the answer is "yes." The implication seems clear: our fiscal problem is a political problem, not an economic one. Period.

³Source: Wall Street Journal 7/21/2011



What Does History Teach Us?

Nearly twenty years ago, our neighbors to the north, hit the debt wall. Canada was in crisis in 1993 when the Liberal Party, led by Prime Minister Jean Chretien and Finance Minister Paul Martin assumed power. The government's share of the economy rose to 52% from 28% in 1960; government debt was nearly 70% of GDP and interest payments consumed 35 cents of every tax dollar.⁴ With decisive action, Canada was running a budget surplus by 1998. Importantly, the ratio of spending cuts to tax increases was nearly 7-to-1.⁴

Some economists argue that spending cuts will lead, in predictable Keynesian fashion, to slower economic growth, increased unemployment, and angry voters. History does not seem to support that assertion. Besides the Canadian experience, we have had several test cases in the United States. Keynesians predicted disaster when government spending collapsed after World War II. Instead the economy boomed. More recently, the experience of the Clinton presidency contradicts doomsayers. When President Clinton took office in 1993, government spending was 22.1% of gross domestic product (GDP); when President Clinton left office in 2000 government spending as a percent of GDP had been squeezed to 18.2%. President Clinton's fiscal regime did not throw the economy into a deep slump. Indeed, the stock market boomed and confidence was high during the Clinton presidency.

Historical anecdotes aside, a comprehensive study of post-World War II fiscal consolidations in developed world economies by the National Bureau of Economic Research concluded that successful deficit reduction programs averaged \$5 to \$6 in spending cuts for every \$1 of tax hikes.⁵

Conclusions from the Last Two Letters

1. The United States fiscal situation is very serious. Official numbers understate the problem because they do not reflect fiscal chicanery and exclude state and local debt. The level of debt is likely constraining economic growth, based upon the work of Reinhart and Rogoff.
2. The United States is playing a dangerous game with financial markets. Confidence can evaporate very quickly. Consider the mini-panic that ensued when S&P downgraded U.S. debt this summer.
3. The fiscal problem is a political problem, not an economic problem. Our fiscal situation can be managed with the proper political will; Canada serves as a role model.
4. Solutions to the fiscal problem must include tax increases and spending cuts, but should heavily favor spending cuts. Keynesian fears of economic collapse caused by fiscal restraint are likely unfounded.

A handwritten signature in black ink, appearing to read "John", with a stylized flourish at the end.

John O'Connor
September 30, 2011

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⁴Source: Wall Street Journal 7/21/2011

⁵"Large Changes in Fiscal Policy: Taxes vs. Spending," Alberto F. Alesina and Silvia Ardagna, National Bureau of Economic Research, October, 2009.