



All The Emperors Are Naked

Hyperbole Alert! *Washington's latest legislation – the one extending the payroll tax cut – may be the worst piece of legislation ever passed.*

I told you to get ready for hyperbole.

It clearly isn't the most damaging piece of legislation ever passed. There are many others that were worse. But, this one little piece of legislation is the epitome of political nonsense.

It's not that Democrats and Republicans can't work together. It's because they *are* working together. Getting something done is a religion in DC. The House passed this bill by unanimous consent. Not one (1) single member objected.

Many Republicans supported the bill because they thought they would lose votes in upcoming elections if they didn't support something. Leading journalists told them so. Democrats got their payroll tax cut and extended unemployment benefits. They will call this "stimulus" and take credit for a growing economy.

But the bill, when looked at from an economic point of view makes absolutely no sense. Each of its five parts exposes a problem with Washington. Let's look at them one by one.

The Payroll Tax Cut

So many people have been erased from the income tax rolls that cutting income tax rates does nothing for them. This leaves payroll taxes as the only populist tool for politicians.

But, a 2% cut in Social Security tax rates does not boost economic output because it is not a cut in *the top marginal* tax rates. This means the government must make up any revenue loss by cutting spending (which it never does), borrowing more or raising taxes on someone else. But, taking money from one group to give to another is a zero sum game, at best.

In the year since the 2% tax cut was initiated in January 2011, and with the Fed super easy, consumption increased at an annual rate of 4.3% – unchanged from the 4.2% growth rate for all of 2010, the year prior to the cut. The tax cut did nothing. Only marginal tax rate cuts will increase growth.

Unemployment Benefits Extension

This is the one that always trips up politicians because no one wants to be on record against it. Yet, it is clear that two-year unemployment benefits have done little to create jobs. This is a European-style, Keynesian pump-primer. It has never worked in Europe, and it won't work in the US. The reason

unemployment is so high these days is because government is so big. The US needs to cut spending, not increase it.

Increased Fees on Fannie Mae and Freddie Mac

Every bill Congress passes is supposed to be "paid for" by offsetting cuts in spending, or tax hikes. This explains the two month extensions. It's cheaper to fund than a full year.

But even two month cuts need to be paid for, so Congress levied more fees on Fannie Mae and Freddie Mac. So what do fees on mortgage providers have to do with social security tax cuts? The answer is: nothing.

Social Security tax cuts should be paid for by cutting future social security benefits. If Congress was honest about this, Americans would probably not support a tax cut today for lower benefits tomorrow. It would be called eating our seed-corn. Unfortunately, we already ate it (we spend every dime Social Security brings in). So this tax cut just makes our already underfunded plan even more underfunded. Congress avoids this by putting more fees on home ownership.

But raising fees on Fannie and Freddie makes no sense. These companies are already losing money. Congress is not going to put these funds into escrow to pay for future losses...it is going to spend the money today. Future taxpayers will still be on the hook for losses. The fees also perpetuate the myth that Congress knows how to price mortgages by setting fees at the perfect level. They should be closing down Fannie and Freddie, not making them a bigger part of government.

The "Doc Fix"

Back in 1997, Congress passed a balanced budget act that was supposed to control spending, partly by holding back the growth rate of Medicare spending. Medicare payments to doctors were supposed to be held down by a formula. In the first few years, these reductions were small, but Congress avoided them anyway and by passing a "doc fix" every year, kept kicking the can down the road.

So, today, in order to comply with these cuts (which have never been allowed to happen), doctor reimbursements need to fall by a whopping 27.4%. If this were to happen, doctors who treat Medicare patients would be up in arms. No Congress-person wants that – it's not good for business.

So, Congress used this bill to push off these cuts again. It also “kicked the can” on eleven other items as well. Along with the “doc fix,” Congress also made sure cuts to ambulance and mental health add-ons, bone mass measurement, outpatient treatments, and other varied items, did not happen.

This behavior, which everyone in Washington knows happens every year, is about to go into hyper-drive. President Obama promised roughly \$500 billion of future Medicare cuts would help pay for Obamacare. These future cuts are based on formulas very similar in design to the 1997 bill. So, why would anyone believe Congress won't do the same thing all over again? When faced with the choice of cutting spending or making a constituent mad...Congress always chooses the constituents...and not the ones who pay for it all.

But it gets even worse. Every year, the Congressional Budget Office (CBO) assumes that Congress will follow through on its 1997 agreement when it scores the budget. So, the deficit forecast for the next decade assumes a cut in doctor reimbursements that everyone knows won't happen. When the budget deficit rises more than expected, everyone in Washington expresses amazement, regret and surprise and then blames it on the private sector and the rich for not paying enough taxes. Is this a messed up system or what?

The Keystone Pipeline

Republicans used this bill to force President Obama to make a decision within 60 days on the Keystone Pipeline extension. This project would have already been put in place if private businesses, and private money, were the only deciding factors. But, politicians in the US are subsidizing unprofitable solar and wind power, while holding-up and penalizing traditional, privately-funded, carbon-based fuel sources. From an economic point of view the pipeline is a no-brainer, making this the only economically sane part of this bill. But, it still highlights the broken nature of Washington.

The Worst Bill in History

Any business that ran this way would be out of business. Government, because it has so much control and power, can avoid the inevitable for a little longer. But eventually the game comes to an end. And that's exactly what is happening in Europe right now. The Welfare State has come to its logical conclusion – bankruptcy.

Spain, for example, just admitted its deficit is 8.5% of GDP, not the 6% that it was publicizing. So, it is proposing a package of tax hikes and spending cuts equal to 1.5% of GDP. This will leave the deficit at 7% of GDP, even though it had promised under new rules to get it down to 4.5%.

Governments seem unwilling to deal with issues that are relatively straight-forward. It's not hard to understand. Spending needs to be paid for by taxes, but taxes undermine

the incentives to produce and invest and push business to other countries. Eventually government spends so much that the economy cannot support it (no matter how much tax rates rise) and bond buyers go on strike. Many European countries have reached that point.

The United States is not there yet. However, it is slowly and surely approaching that day if nothing changes. Politics as usual is not working. It produces inane bills like the one described above. Every piece of the bill just passed points to a government that has run out of any self control.

Somehow it is easier to keep spending...and Congress acts like no one will ever figure it out. It links Social Security tax cuts to mortgage fees, it ignores rules that it previously agreed to and promised to follow through on, it stimulates an economy that does not need to be stimulated. It continues programs that don't work. And the entire time it is doing this it keeps telling us that without government everything would fall apart.

It's a broken system and the only common theme that runs through it is a considerable effort to get re-elected. It is becoming more clear by the day, that all the Emperors are naked...there are no more clothes.

The good news is that the electorate is waking up, the European Welfare State is failing and history suggests the US will find a way to correct its course before it's too late.