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Summer Commentary 2005

The Markets and Economy

The stock market has moved within a fairly narrow range so far this year, hovering around a zero percent return. Investors are focusing on rising energy prices, the U.S. current account deficit (trade with other nations) and higher interest rates. Through all the bad news, including the recent horrific events in London, stocks have not done too badly, as the comparative environment remains favorable for growth investing.

During the first six months of 2005, the Standard & Poor's Index of Blue Chip Stocks lost -1.70% versus the Rikoon Carret portfolios return of -.68%. Over the last twelve months, the Federal Reserve has raised interest rates eight times. Its goal of achieving a neutral stance in terms of stimulating or constraining the economy has still not been achieved. The markets, in fact, have shrugged off the Fed's policy as long term interest rates are now lower than they were last year. In the international stock area, the Rikoon Carret portfolios gained 3.2% during the first six months while the Dow Jones World Index, excluding U.S. stocks, declined -1.5%.

Inflation is looming on the horizon. Labor costs are creeping up and businesses are now raising prices in response to higher materials costs. This has not seemed to slow down U.S. consumer spending or consumer confidence which continues to rise. Americans seem to be buoyed by slightly rising personal incomes and jobless claims are falling as well so far this year. Overall, U.S. manufacturing is showing signs of strength and even though the economy worldwide is slowing, the environment remains relatively favorable for business.

This is not to say that we are expecting a bull market in either stocks or bonds. It is fascinating to note that U.S. bonds have actually outperformed U.S. stocks this year while rates have moved up. It defies conventional wisdom. The Rikoon Carret taxable bond portfolios gained 1.27% versus the market's increase of .95% while our tax-free portfolios gained 1.6% versus a .74% return for the short term municipal bond market index.

The NASDAQ technology index was down -5.45% during the first six months of 2005 and the Dow Jones Industrial average of thirty stocks was down -4.7%. Energy and consumer stocks are the two areas which have been supporting the market. Companies are increasing dividends at a healthy rate in order to take advantage of the new tax laws, which excludes 85% of qualified dividends from tax. In the face of slowing economic growth, companies have squirreled away cash and decreased their exposure to borrowing.

Some companies are even increasing their spending on technology which may provide a base for technology stocks to move upward sometime in the not too distant future.

Expectations are that the Federal Reserve will continue to raise rates at a "measured pace" up to 4.25%. However, given the attractiveness of the U.S. securities markets to foreign individuals and governments, mortgage rates might actually fall from current levels. All of this money flow into the U.S. has fueled rampant gains in many real estate markets around the country.

Gold has languished in the $410 to $445/ounce range. Prices for many of the basic commodities used in industrial processes have continued to go up, albeit more slowly in 2004, due to the slowing of China and the remainder of the Far East.

In the next commentary, I will be discussing real estate at length. Many people have come to regard it as a "sure-fire" way to grow their assets, but here at Rikoon Carret, we believe in investing in long term growth with only those assets that can be picked up at reasonable prices. This is certainly not the case in many real estate markets today.

The U.S. Tax System

Now that it is summer, many of us feel a special sense of relief in that another tax season has passed and we can look forward to the next three seasons where, if our determination is strong, we can ignore the revenue collection arm of the federal government.

Having reviewed many tax returns in detail over the last several months, I believe it is appropriate to take a long hard look at our country's tax program. It is important to face the unpleasant fact that our system has run amok. My intent is to provide readers of this commentary with some substantive food for thought.

No one doubts that our tax system is incredibly dysfunctional. Even government bureaucrats and policy makers bemoan the complexity of the current system. In a letter recently brought to my attention by a client, the IRS apologetically stated that even though the instructions for filling in a certain section of the tax return read one way, (and it took five pages of small, single print directions to guide the interested taxpayer through the maze), there was a small paragraph at the end of the letter stating that a small group of tax lawyers had determined that the actual effect of the now current tax law was the exact opposite of what they had just explained in the instructions.

The IRS offered an apology, a tacit admission that their own interpretation, based on common sense and the ability to read English, was wrong and they proceeded to shrug their shoulders at the complexity with which we as taxpayers must cope. It seemed to me that they were well aware of the implausibility that normal people can comply with the system and that it has gone beyond their control as well. There is, in fact, no one in control.

There are still a few brave souls who do their own tax returns. Those who use a computer program have to trust the program to know the intricate interaction of various rules, and these taxpayers are forced to blindly accept computer modeling of different solutions. Doing federal tax returns on one's own, without a computer program, if you have anything other than W2 reported wages, interest or dividends, is a daunting task.

There are regular calls in Congress for tax simplification. No politician is against it. Why has there been no action? One easy answer to this is the fact that special interest groups from all parts of the spectrum have ingratiated themselves and their pet ideas into the tax code. Every few years, there is an act of Congress that is generally called tax "simplification" but all it does is add volumes of further detail to the code of law and rulings that one must puzzle through to know what the law means.

Who is served by this complexity? Even though our tax system serves as a full employment act for people in the accounting field, most accountants I know bemoan the fact that their jobs have become so overly complex as to be absurd. As a result, most Americans have moved further and further away from understanding how we got here and why must our government work in this way.

In 1861, the first U.S. federal income tax was put into place. It taxed income from $800 to $10,000 at the then onerous rate of 3%. Amounts over $10,000 were taxed at 5%. Eight hundred dollars per year of annual income in 1861 is roughly equivalent to $25,000 today. There were no exemptions, no deductions, no depletion, no depreciation, and no charitable contributions. It was made simple so that citizens could understand what they were paying, and in fact, everyone paid their share though not very cheerfully.

These first taxes were put in place to pay for the Civil War, which was partially fought so that the United States could become a unified country and not just an amalgamation of individual states, loosely subscribing to a proclamation on paper of indivisible rights and liberties for all. Though there was scattered resistance, the general U.S. population did not object to the imposition of taxes for very long, and the government was able, in 1864, to raise the tax rate on incomes over $10,000 from 5% to 10%! The U.S. also had to borrow money to fund the Civil War. People are generally willing to pay taxes (and buy low returning bonds) in times of wars and emergencies. Perhaps this is one reason why we are told that there is now and will be forever in the future a perpetual war (like on terrorism).

In the 1860's, there were also substantial consumption taxes. Most revenue came in the form of what we now call "sin" taxes. The tax on liquor was $2.50 a gallon. This was roughly ten times the actual cost of the whiskey itself, so that a 25 cent bottle of spirits had an additional $2.50 tacked onto it, yielding a total cost of $2.75. All forms of transportation were taxed as was every form of advertising.

Today, most taxes get paid as deductions from payrolls. Consider how much of your and your loved ones' paychecks get siphoned off each year by various government agencies.

Everyone, even people earning the minimum wage, pays over a thousand dollars a year under a system that is neither fair nor simple.

In theory, people who make more money are supposed to pay in not only more money but at a higher percentage rate. In fact, with the availability of a myriad of tax deductions, business depletion, depreciation, travel and entertainment expenses, personal deductions and tax avoidance schemes, there are considerable numbers of very wealthy Americans who still pay less in tax than working people. This is just flat out wrong and it undermines our republic.

Every year, ideologues who profess to believe whole heartedly in "free" markets suggest that a "flat" tax is appropriate for America. For example, they suggest that everyone might pay 20% on all income. Under this scenario, lower income people would pay the same percentage as high income people. This would negate whatever measure of fairness exists in what we now have, which are "progressive" tax tables. Higher income taxpayers do pay high rates on some of their inflows, the portion called "taxable income", up to 36.5%. Low income workers generally pay around 10 to 15%. This is one of the few redeeming characteristic of the current tax code.

Unfortunately, our current tax system promotes weird business and personal decisions. It actually discourages conservative types of savings by taxing interest at high levels and, it serves to promulgate America's high consumption patterns by giving many types of tax breaks for taking on debt. These are contributing factors in our nation's shameful international deficit, whereby we eventually will end up handing over some, if not much, of our future economic clout to other world powers.

If we can simplify the tax code and take it out of our lives as factors in our decision making, individuals and businesses will then look towards the future in a more rational, clear headed way. My basic proposition is for a "progressive flat" tax, where people can earn up to a certain amount of money and pay no tax at all. Consider what would happen if the first $20,000 in earned income per person, in every household, was totally exempt from taxation.

A family of four people would be able to earn up to $80,000 with no tax while a single person with $100,000 would start to pay tax on amounts over $20,000. While the $20,000 per person noted here is arbitrary and would need to be refined, the concept is to levy no tax on the amount needed to support a reasonable lifestyle in today's dollars, increasing that amount in the future with a realistic appraisal of inflation.

What ever the amount finally determined to be totally exempted from tax per individual, people earning over that amount, say, $80,000 for a family of four, would pay a moderate amount, perhaps 10% on all income above their base level, up to twice their base or $160,000. They might then pay 20% on all income from twice their base level to four times base level or from $160,000 to $320,000. To continue the analogy, a rate of 30% would be levied on income from four to eight times base, $320,000 to $640,000, and then above $640,000, the progressive flat tax could be set at a rate of 40%, to cover income up to sixteen times base. At that point, the rate would cap out at 50% on all income above $1,280,000. A family of one person would start to pay tax on lower amounts of income because their natural consumption level ought to be far lower than a family of four.

The important point here is that with some kind of progressive flat tax, and the numbers suggested above are just beginning points to start the discussion, there would be no need to tax any kind of long term capital gain. Our nation would clearly experience a boom in long term investment, including real estate, agriculture, as well as stocks and bonds, as investors learned to pay attention to real world opportunities and not just trying to tweak themselves around the tax laws. There would also be a boom in entrepreneurial activity if there was no tax on capital gains with a concurrent increase in employment opportunities.

In order to simplify the tax code, make up for lost revenue due to the extinction of the capital gains tax, and to insure that people not investing in the future but living off the fat of the land are paying their fair share of taxes, there would be no reason to allow for any deductions, be they depletion, depreciation, mortgage interest, entertainment, travel, professional expenses, medical expense, etc. This would mean that business ventures would have to make sense from a production of useful goods and services point of view, that politicians would have no need to pander to special interests, and ordinary people would then be able to see rewards for thinking of future generations.

All of these suggestions would vastly simplify our tax code, promote long term savings and remove the government's influence on our personal decisions. I am ready for some brave soul to propose implementing broad consumption taxes that would pay for making our country a better place to live, work and play. Under a "progressive" flat tax, many working people would pay less than they do under the current tax code and it is possible that even wealthy Americans, if they invested in increasing the productive capacity of America, might also pay less tax. Where then, would our budgetary shortfalls be made up? It is my belief that certain consumer taxes could make up the difference.

Consumption taxes are much like the gross receipts tax we have here in New Mexico. They are collected when a consumer buys something from a business. There is a way to impose consumption taxes in a "progressive" fashion. For example, if there was no sales tax on items under $1,000, many people would not pay any consumption taxes at all, thereby stretching low wage earner's dollars. If items retailing between $1,000 and $5,000 had a 5% tax levied on them, and products selling from $5,000 to $10,000 had a 10% tax, and so on, our government's coffers might be replenished even as we promote saving and investment.

To continue the illustration above, if items selling from $10,000 to $30,000 had a 15% tax, and goods from $30,000 to $100,000 had a 20% tax, most of this tax revenue would come out of the pockets of wealthy consumers. A 30% tax could be levied on consumer purchases over $100,000 (excluding real estate). People saving for the future would be rewarded by making all long term investment gains, those held for ten years or more, totally free of tax. These numbers are presented to stimulate discussion and are not suggestions to set taxes at certain rates. Consumer tax proceeds could be used instead of the higher income and payroll taxes that are on their way if Social Security and Medicare are to survive for the next generation.

Real estate taxes are the funding source in many communities for public works, most notably, education. Many communities, especially those considered to have a high quality of life, have seen an influx of outsiders who have bid up the price of local properties. This has forced some low income residents to sell their homes because of increases in real estate taxes.

Real estate speculation often results in unwelcome demographic effects due to the financial expulsion of traditional residents. I propose that revaluations for real estate taxation purposes only be done at the time of a sale and that large increases in real estate taxes only take place after a sale, as a kind of ongoing transaction fee. This would mean that stable families and individuals could enjoy the taxation level they are used to. This would promote stability in neighborhoods. People who speculate in land or houses generally have weak ties to the local community. It seems appropriate to tax their speculative efforts more heavily.

As funds have moved from the stock and bond markets into real estate, wildly escalating prices have increased pressure on local people to leave their communities. Under my proposal, there would be no tax increases on persons who live in and hold onto their real estate property for the long term. To make up any lost ground due to the fundamental changes in our income and real estate taxation system, we could also agree as a society that meaningful "sin" taxes on gambling, alcohol and cigarettes are needed to help fund public education, health, transportation and the environment. How about consumption taxes on luxury TVs, expensive furniture, vacations, jewelry, precious metals, art work, wine and cigars?

Another suggestion is to have new kinds of pooled resource taxes on service providers. In Minnesota, there is a tax on all medical receipts by doctors which is used to fund a pool of money to pay for medical care for the poor. A similar kind of tax could be levied on legal and investment services. I am only half joking. The important concept is that these funds not be used for specific programs, but rather the money should go into the general tax revenue accounts to make up for any reduction in tax receipts that might come about as a result of the progressive flat tax and revised real estate tax systems described above.

There is one possible action that we, as taxpayers could take, to bring attention to our deep felt dissatisfaction with the complexity and insaneness of the present tax system. Since the government is required to check over our tax returns once we file, to see if we made any mistakes, what if many of us sent in our tax payment dollars without filling in the forms? As law abiding citizens, we could provide all the required information but, as a sign of frustration, just not fill in the confusing forms.

In effect, we would be asking the government, since they created the forms and instructions, to figure out our tax returns for us. They kind of do this now anyway, as anyone who has received a notice of tax underpayment knows. It would give the government a dose of its own medicine and if enough people took this course of action which is simple, legal and a potentially effective way of promoting change, it might force the IRS themselves to become advocates for real reform just to get rid of their headache!

We need a system that is understandable, easy to comply with, and progressive. It should encourage long term thinking and saving and discourage unnecessary consumption.

Personnel News

Juliana, her husband David and her mother, spent 10 days on the Peruvian Amazon in a small ship. The boat, which was fashioned after the Rubber Barons boats, held only 20 passengers plus crew. Her favorite part of the day was when she would go up on the observation deck around 5:00 AM, have a cup of coffee and watch the macaws and parrots fly overhead. What a way to start the day!

Jeff Sand has been playing guitar and vocals, pro bono, around Santa Fe and can be seen occasionally at the El Castillo Retirement Center and Open Hands community. Jeff's specialty is popular music from the '30's and '40's which is a favorite with the residents at these facilities.

Rob's extra curricular sport activities during the last several months were the Smoky Mountain Adventure Race during the first week of April. A freak snowstorm at 5,000 feet dumped 18" of snow and packed 70mph winds, along with -20 degree temperatures, so the race was called off halfway through even though Rob was ready to go on. Undeterred, Rob participated in an orienteering meet in Los Alamos as well as the first ever adventure race held in New Mexico. The Quest for Fire, held in and around Angel Fire Mountain, was a twelve hour race in which his team took second place. So as not to give the impression that he's any expert, in an earlier weekend adventure race in Asheville, Rob and his co-ed team turned their canoe over twice in the cold and dirty French Broad River. Suffice it to say that Rob continues to look for other potential teammates after that experience! This summer, Rob will be competing in Las Vegas, New Mexico at the end of July and then is taking time off for family until a 40 hour adventure race in October and then in November, he'll attempt an Ironman competition in Panama City, Florida.

Calendar of Client Teas

Santa Fe: July 28, September 15, October 27, and December 8.
Asheville, North Carolina: August 25 and November 10.

The teas begin at 3 p.m. and go until 4:30 p.m. and are held at our offices at 510 Don Gaspar, Santa Fe and our new Asheville office at 196 Pearson Dr.