

Macro Comment

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No simple solution to the deficit problem

The U.S. government hit the debt ceiling this week. However, the Treasury Department announced that it can manage expenditures and financing until early August without defaulting on its debt. Raising the debt ceiling is only one step in a much larger discussion of how to control the deficit. Unfortunately, there are not simple solutions to reducing government borrowing.

I have a plaque on the wall of my office which is a replica of the one left on the moon in July 1969 by the Apollo 11 astronauts. It says "Here men from the planet earth first set foot on the moon ... We came in peace for all mankind". In hindsight, a more realistic statement in light of today's deficit problem may have been "We came because we could afford to." Now our country cannot afford to do everything that we might like to do because many years of deficit spending have caused debt levels to rise to a very high level. Consequently, our financial situation requires difficult choices.

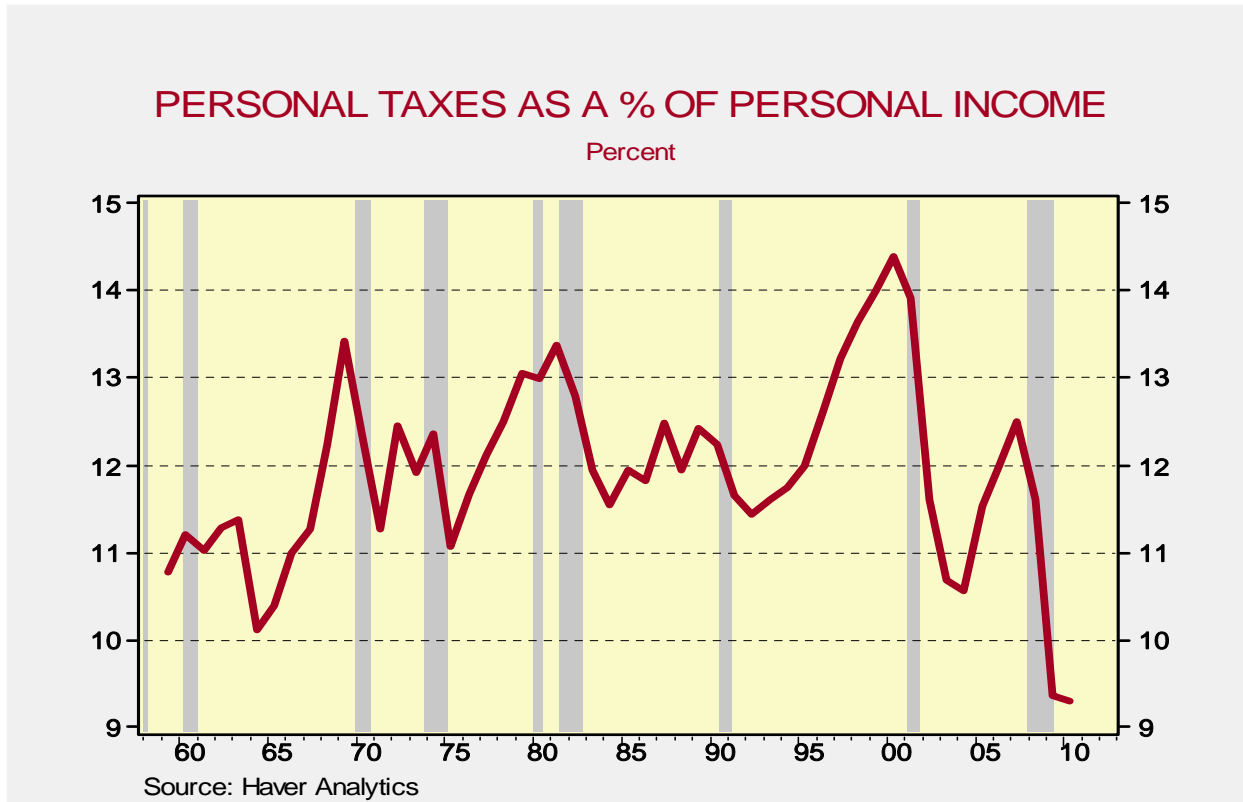
The debate over the debt ceiling centers on the best approach to handle government spending and taxes. The Administration would like a clean deficit ceiling increase with no strings attached. Republican Congressional leaders would like the bill increasing the debt ceiling to contain significant spending cuts to reduce the deficit. At this point, it looks like the debate and fiscal maneuvering will go down to the wire.

Between now and early August, the Treasury department will do several things that it has done in the past to avoid increasing expenditures and issuing more debt. First, the U.S. government has stopped issuing State and Local Government Treasury securities. These are U.S. government bonds that state and local governments buy as investments when refunding municipal debt. The government will also not issue new debt to replace maturing bonds in the federal employee retirement fund, holding that money as cash instead. Finally, the government will also temporarily delay re-investing maturing federal government debt in the federal employees' retirement money market fund. These steps will reduce some forms of government debt currently outstanding, allowing the government to issue other new debt and not go over the debt ceiling.

We expect Congress to pass the debt ceiling in early August. However, if we are wrong and Congress fails to raise the debt ceiling as needed, the financial markets could react very negatively, with government bonds dropping in price, the dollar declining and equities suffering too. However, such a reaction would probably force Congress to vote again. But failure to pass the debt ceiling the first time could damage to the status of U.S. debt in international markets. This would be a high cost to pay for political advantage in the next election.

Looking further down the road, passing the debt ceiling will not solve the deficit problem; it will just create a little breathing room. Congress must still decide how much to cut spending and/or increase taxes in order to reduce the deficit. The Republicans would like to reduce the deficit through spending cuts. The Administration would like to raise taxes. Both sides argue that the opponent's proposal would hurt the economy.

A bi-partisan group of six Congressional leaders have been working to find a compromise to the deficit problem. Such a compromise would include both spending cuts and tax increases, making it difficult for some members of both parties to accept. Unfortunately, even this gang of six could not reach a compromise. Republican Senator Tom Coburn dropped out of the talks this week over differences in entitlement spending cuts. As a result, a compromise solution to deficit reduction looks less likely this year. Nevertheless, we believe deficit reduction will eventually include some tax increases as well as spending cuts. The big question is Can the U.S. economy withstand an increase in taxes? The answer is yes a year or two from now, if the economy continues to expand as we anticipate.



This week's chart shows the history of the personal taxes paid by all Americans as a percent of personal income earned. This shows the tax burden for the economy as a whole, not individual tax rates. The chart reveals several important facts that may influence the ultimate decision on potential tax increases.

First, at the end of last year, taxes as a percent of personal income were at the lowest level going back to 1959. Total personal taxes paid equaled only 9.3% of total personal income in 2010. This was well below the 50-year average of just under 12%. Thus taxes could increase modestly and not rise to an above-average rate. The economy could weather such a tax increase, but growth would probably be restrained. Tax increases are likely to include the expiration of the Bush era tax rates at the end of 2012 and the expiration of the one-year payroll tax cut at the end of this year. Of course, there could be other tax increases too.

Second, the chart shows that taxes paid usually drop during a recession (the shaded years) because fewer people are working and paying taxes and more people are getting income (transfer payments) through government

assistance. Third, tax payments tend to rise as the economy expands, in part because more people are working and paying taxes but also because tax rates are more likely to be increased when the economy is healthy.

So how did tax payments as a percent of income get so low? The chart shows that taxes paid as a percent of income were far above average and at a record high in 2000. Of course, that was when the government was running a surplus. During the recession of 2001 and the weak economy that followed the 9/11 terrorist attacks, the Bush administration cut taxes twice, once in 2001 and again in 2003. These lower tax rates reduced the tax burden to a slightly below-average rate and helped the economy stabilize during the uncertainty that followed the terrorist attacks. The second drop in taxes paid as a percent of income

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occurred during the recession and financial crisis of 2008-09. Once again, tax cuts were part of the fiscal stimulus that helped the economy recover from the recession.

Looking ahead, as the economy heals from the wounds of the latest recession, Congress is likely to consider tax increases as part of any compromise to reduce the deficit. Congress would probably lean toward more spending cuts if tax

payments were already above average. However, that is not the case. With taxes paid below the long-term average, any agreement by Democrats to cut spending is likely to include an agreement by Republicans to accept a tax increase. Obviously, this will not be easy. There are no simple solutions to the deficit problem. The United States can no longer afford big government and low taxes at the same time. Both parties will need to make difficult choices on spending and taxes going forward.

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