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2020 Vision

Janet Novack 11.17.08, 12:00 AM ET

Prepare yourself: No matter what the politicians promise, long term, the government is going to grab more of your money.

If you make more than \$250,000 you are perhaps fretting about how much the bailout and the fiscal stimulus will cost and how much you will pay for them. Tune out these dark thoughts. There is something much bigger to think about: the rising cost of government over the next 15 years. This should be on the minds not just of the upper class, who already pay half of the income tax, but of the vast middle class. If we define the larger group as those in families with incomes between \$25,000 and \$250,000, we're talking about three-fourths of the country. The government is destined to extract a pound of flesh from the middle class because this is where the money is; there simply aren't enough millionaires around to pay for everything. The pain will take the form of both taxation and broken promises.

Here's what sober budget analysts (from both parties) see when they focus on 2020 and beyond: The well-off will pay higher federal taxes, for sure. But ordinary folks will pay more, too. They will pay as tax burdens diffuse into the costs of things they buy. They will likely pay more for fuel and electricity, as the costs of carbon permits and renewable-fuels mandates get built in. They may be asked to pay a European-style value-added tax. And they will pay on the other side of the ledger: Their retirement benefits will get clipped.

The federal government will get bigger, but not big enough to keep all the promises Washington has made. So the normal age to receive Social Security retirement benefits, already rising in steps to 67 for those born in 1960 or later, will increase further, perhaps to 69. High earners will pay more in and get less back in retirement. Call it a "tax" or call it "means testing"—it's government, and it will make you poorer.

Meanwhile, the need to contain Medicare costs and to cover the uninsured will also result in the better-off paying more, either through taxes, insurance premiums or both. "Whether we call it premiums or whether we call it taxes, it's going to be income related," says John Rother, executive vice president of policy and strategy for the AARP, the 40-million-member old folks' lobby.

You may be thinking: This is politically impossible! When Congress tried to raise Medicare premiums in 1989, didn't a gang of old people chase Congressman Dan Rostenkowski in Chicago? And force a repeal?

Look again at legislative history. In 2003 a House-Senate conference committee negotiating the expansion of Medicare to cover prescription drugs slipped in a provision mandating income-related Medicare premiums. In 2009, when those premiums are fully phased in, the wealthiest seniors will be charged \$7,400 a year per couple for the same outpatient and doctor-visit coverage other seniors will get for just \$2,310.

These changes aren't dependent on the results of the election or the final tab for the financial markets mess, although both will affect how this all plays out. Instead, the grim predictions are driven by the aging of the baby boomers, the relentless growth in health care costs and decisions politicians have made—or shirked—over decades.

During the last 50 years federal government revenues have averaged 18% of U.S. gross domestic product. But if the growth in health care costs isn't slowed, and Congress doesn't renege on its promises, by 2050 the federal government's costs for the Big Three entitlement programs—Medicare, Medicaid and Social Security—will exceed 18% of GDP, leaving nothing for defense, homeland security or anything else (including paying interest on the federal debt). Either taxes go up, or benefits get taken away, or both.

"What's unique at this point, relative to all the nation's history, is that the long-term budget is in permanent imbalance," says economist C. Eugene Steuerle, a Ford, Carter and Reagan Administration Treasury official who's now vice president of billionaire Peter G. Peterson's new antideficit foundation.

As of mid-October the federal debt stood at \$10.5 trillion, with \$6.2 trillion of that held by public investors here and abroad. (The rest is mostly the U.S. Treasury owing money to another federal agency or fund, like the Social Security Trust Fund.) Alarming, to be sure. But not compared with the estimated \$41 trillion net present cost of unfunded Medicare and Social Security benefits—that is, benefits in excess of the revenues that under present law will be available to pay them.

When will the politicians get serious about fixing this? Hard to say. The financial crisis might give them an excuse for further delay, making the necessary tax hikes and benefit cuts, when they do come, even more brutal. "It's like saving for retirement. The earlier you do it, the less you have to put away each year," says Clint Stretch, managing principal of tax policy at Deloitte Tax.

On the other hand, the government's new guarantees for trillions in private debt and a trillion-dollar federal deficit for fiscal 2009 could both hasten the day of reckoning—if foreigners who have been buying up most new Treasury debt become concerned about the U.S. government's long-term fiscal prospects and put their money elsewhere.

The resulting federal debt crisis might force tough political choices that seem unthinkable today. "People will do on day two of a crisis things they'd never do on day one," observes Mark Weinberger, who was the Treasury's top tax official when the Bush tax cuts went through and is now global vice chair of tax at Ernst & Young. "Who would have thought a Republican Administration would nationalize Fannie Mae and Freddie Mac?"

Taxes

With the 2001 and 2003 tax cuts expiring at the end of 2010, Democrats, including Senator Barack Obama, are itching to push marginal income tax rates for couples earning \$250,000 or more back up to their level at the end of the Clinton Administration; the current 33% and 35% ordinary income tax rates would revert to 36% and 39.6%, while the current top 15% capital gains rate would go to 20%. Two sneaky provisions—one limiting itemized deductions for the better-off and the other denying them personal exemptions—would also make a comeback, pushing the true top rate to 40.8%.

Yet politicians of all stripes are vowing to preserve the tax cuts for the middle class and add to them, too. Already, 38% of households pay no income tax (or get a net cash transfusion from the earned income tax credit). Obama's proposals would increase the no-pay share to 48%, while transferring an additional \$650 billion over ten years to families who don't owe income taxes, through new or expanded "refundable" credits for such items as child care costs, college, mortgage payments and retirement savings, the Urban-Brookings Tax Policy Center estimates. That's a giveaway of 80% of what Obama would save by raising taxes on the wealthy.

A Democratic Congress will try to wring more from those at the top in other ways. Say, by attacking "loopholes" and tax evasion. A new analysis of IRS data shows that those earning \$200,000 to \$1 million underreport their taxable incomes by an average of 20%, compared with 8% underreporting by those earning \$50,000 to \$100,000.

But the country can't pay its growing bills simply by squeezing the rich; there aren't enough of them, and the pressures of world competition will stop marginal rates from going back over 50%, let alone to the 70% in place before President Ronald Reagan took office, Weinberger says. Nor can the politicians shift the load to the corporate income tax. Our 35% federal corporate income tax rate is already the second highest among the developed nations.

"Internationalization puts constraints on what you can do with tax policy that have not always been there. That's most obvious with corporate income tax, but with individual taxes, too," says MIT economics professor James Poterba, president of the National Bureau of Economic Research and a member of a tax commission President George W. Bush created and then ignored.

So the pols are in a box. They've gotten a huge chunk of the electorate accustomed to paying little or no income tax. But they need to raise money from middle-class folks to pay benefits to the middle class, as well as to the less well-off. That's where some sort of consumption tax would come in—on carbon or, more likely, on everything. The U.S. is the only industrialized country without a VAT—essentially a sales tax, applied at each level of production to value added at that level. Economists generally agree that the tax (even though invented by the French) is less destructive to economic growth than higher personal or corporate income taxes or higher payroll taxes.

"A VAT has got to happen. We're at a point where the traditional money-raising options are not going to work," says Yale law professor Michael J. Graetz, who was a Treasury official during the Administration of President George H.W. Bush and has

been pushing a plan to use proceeds from a VAT to reduce corporate income taxes and exempt families earning less than \$100,000 from the income tax. A VAT encourages personal savings, which the U.S. needs more of. Plus, it forces retirees to help pay for their government benefits. Says Graetz: "You tax the elderly and you tax the coupon clippers. But no politician is going to say that out loud."

To be sure, a VAT faces tremendous hurdles. Two decades ago economist Lawrence H. Summers, who later became President Clinton's Treasury Secretary and is now an Obama adviser, famously observed that the U.S. hadn't adopted a VAT because "liberals think it's regressive and conservatives think it's a money machine." The country might get a VAT, he went on, when liberals realized it was a money machine and conservatives figured out it was regressive.

Now liberals are coming to the view that a VAT wouldn't be regressive (that is, hard on the poor) if the proceeds were used to fund universal health care. Last year Summers and Jason Furman, now director of economic policy for the Obama campaign, made exactly that point in a "strategy paper" called "Achieving Progressive Tax Reform in an Increasingly Global Economy."

Given all that, what should you do? Those who are now in and likely to remain in the top income brackets should plan for higher tax rates—and think hard before they defer income. "It's misleading to talk to people about the benefits of deferral without explaining they're deferring into a black hole," says Robert Gordon, president of Twenty-First Securities. But, Gordon adds, don't rush to sell stock because you think the capital gains rate is going up. If a gains tax hike is in the offing, you'll have time to sell. No gains increase has ever been made retroactive—Congress has an incentive to give you notice, since the extra selling in advance of a rate increase goes to revenues.

If you're well paid, but not rich, you might be wise to opt for a traditional 401(k) (which comes out of pretax dollars) over a Roth 401(k) (aftertax dollars). Roths make sense for people who expect their tax rates to be higher in retirement or want to leave their account to their children. Middle-class and upper-middle-class savers who will need to use the money themselves and expect to be taxed at lower rates in retirement—plausible if they are moving from California to Nevada—are usually better off with a pretax retirement account.

Social Security

By 2041 the government will be able to pay only three-fourths of promised benefits with the current Social Security tax, which is 12.4% of the first \$106,800 in wages during 2009. (The cost is ostensibly split between worker and employer.) Looked at another way, to fund all the benefits promised for the next 75 years, the Social Security tax would have to be raised immediately by 1.7% of payroll.

Compared with Medicare, Social Security is easy to fix, so long as the politicians are willing to fiddle with both benefits and taxes. Obama has said he won't support benefits cuts or increases in the retirement age. Instead, his advisers have suggested imposing a 2% to 4% payroll tax on salaries greater than \$250,000. Yet that would cover only a fraction of the shortfall.

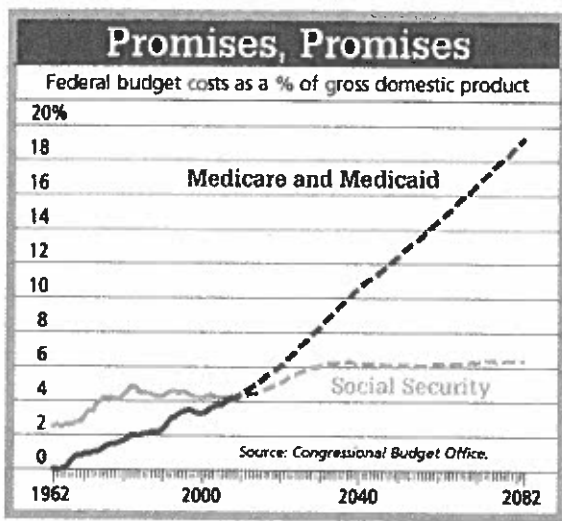
The AARP's Rother offers a more pragmatic view. A final deal, he says, will likely include a phased-in increase in the retirement age; a change in the way the consumer price index is calculated (that would lead to slightly smaller benefits increases for retirees each year); and somewhat higher payroll taxes and lower benefits for the well paid. This is hardly revolutionary. Social Security benefits are already skewed by income, so that low-wage workers get a high return on their savings and high-wage workers get a rotten return.

Congressmen have touched this third rail and lived. Over the years they have increased the retirement age slowly from 65 to 67, raised payroll taxes, delayed a cost of living increase and made as much as 85% of the once tax-exempt benefit checks taxable.

If you're 55 or older now, you shouldn't have to worry about reduced initial benefits, since any changes will be phased in slowly if the AARP has anything to say about it. "But anyone who is more than ten years away from retirement [at the time of a rewrite of the law] can reasonably expect to have their benefits adjusted," Rother says, adding that a delayed benefits cut is not only fairer but "politically expedient, because people younger than that aren't thinking that much about retirement."

So plan on working longer and getting less. Also, no matter when you stop work, consider delaying taking your Social Security benefits until you're 70—the "delayed retirement" credits you earn should make up for some of the benefits Uncle Sam will be taking away. Some advisers are suggesting that high-earning, self-employed folks (who pay both the employer and employee side of the tax) form S corporations so they can treat more of their income as profits, subject to income but not payroll tax, and less of it as salary. Former senator John Edwards did this when he was a trial lawyer, to duck Medicare taxes, whose marginal rate on high earners went from 0% to 2.9% in a 1993 tax law.

But Bernard S. Kent, a tax adviser at Telemus Capital Partners in Southfield, Mich., tells his clients that unless they're making more than a million, the hassle and thousands a year in extra fees involved with an S corp aren't worth it. Anyway, any extension of the Social Security tax to a higher income level is likely to be accompanied by an attempt to squelch the S corp strategy. Existing S corps probably won't be grandfathered.



Medical Insurance

The details are hard to predict, but the general drift is inevitable. Medicare will likely evolve toward coverage of the whole population but with restrictions on what's covered. Patients who want to pick their own specialists or demand the latest drug for restless leg syndrome will have to pay extra. "It's basically what the Europeans are evolving into—an adequate health care system for everybody, and if you want to pay more you can supplement on top of that. Most people in Medicare pay more to supplement the benefit," says Rother. Another point analysts agree on is that the well-off are likely to pay more; even a flat-rate VAT used to finance universal health coverage would cost big-spenders more. As noted, there is already a progressive tax built into Medicare premiums.

Another likely outcome is that the present income tax exclusion for employer-financed health care will be capped. (The exclusion is worth \$200 billion a year.) Senator Obama, to be sure, got much mileage out of saying that Senator John McCain would tax this benefit. But this honey pot is too big to go untouched forever.

Add it all up. Your taxes are going up, your benefits down. There's nothing to do but save more, spend less and work longer. You're already doing this to put your kids through college. Now you'll be doing it to pay for your own bacon.

Read Forbes Editor William Baldwin's Side Lines On This Story.

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