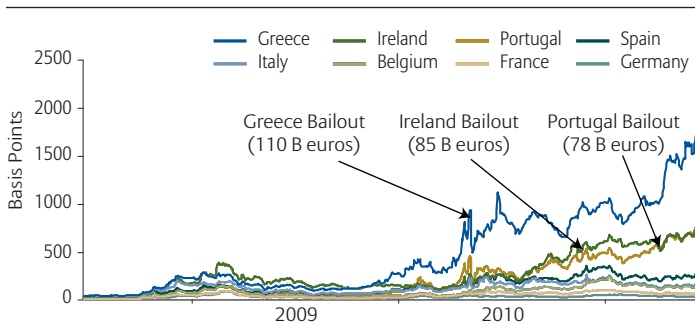


# The Fiscal Future of America

by Greg A. Meier, June 2011

The Great Recession punched gaping holes in public finances worldwide. Governments with questionable accounts are gasping as improprieties come to light. More than a year after Greece ignited Europe's sovereign crisis, the odds on a developed world debt default remain dangerously high.

## Credit Default Swap Spreads (5-Year)



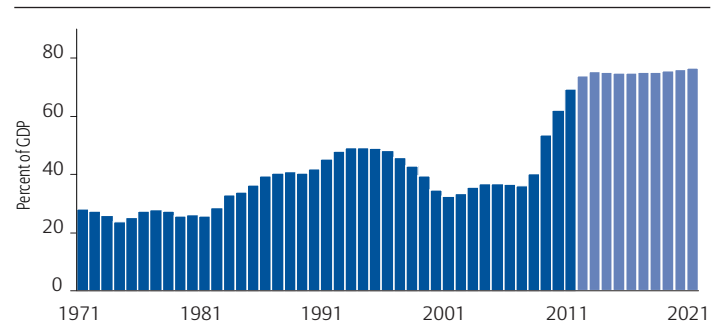
As of 20-Jun-11. Source: FactSet; Allianz Global Investors Capital. See additional disclosure.

For the United States, the 2009, 2010 and 2011 federal deficits will be the largest in post-war history. Rarely in surplus before the crisis, Washington is on course to overspend by an additional \$7 trillion over the next ten years. In 2021, if present policies are unchanged, net federal debt outstanding will equal 77% of GDP, more than double 2007 levels. (Please see chart titled Federal Debt Outstanding.)

Interest payments will triple, approaching \$800 billion per year. And, these 'baseline' estimates from the non partisan, publicly funded Congressional Budget Office (CBO) are probably conservative. They anticipate a benign economic landscape and relatively mild increases in government borrowing rates.

Critically, they assume fiscal tightening will occur on schedule at the end of 2011 and 2012 as 'temporary' easing programs expire. If Congress extends tax relief, as it frequently does, CBO figures indicate the U.S. will still be grappling with a 7% budget shortfall ten years from now. (Please see chart titled Federal Revenues and Outlays.)

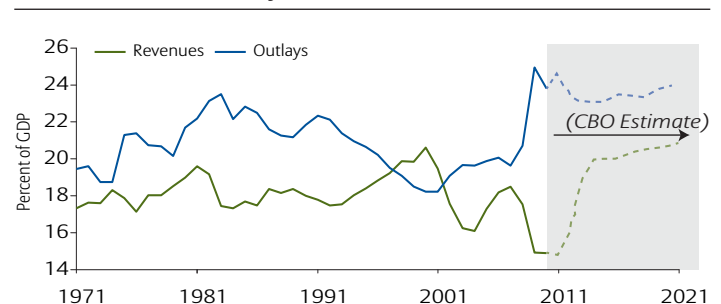
## Federal Debt Outstanding (Net)



As of Jan-11. Source: Congressional Budget Office; Allianz Global Investors Capital. See additional disclosure.

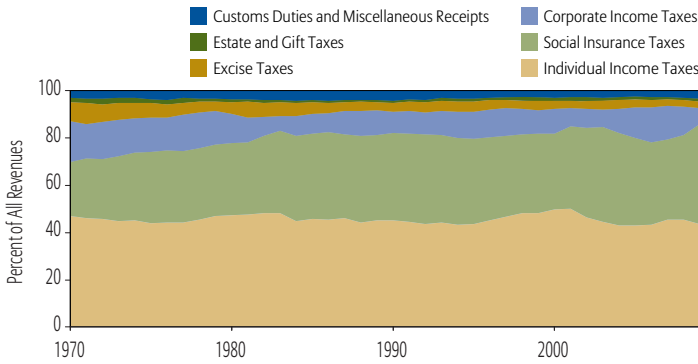
Endless deficits result in stagnation and ruin. There will be calls for tax hikes. This won't suffice. The federal government would need to expand money collected from businesses by nearly 80% to cover baseline estimates on the 2011-2021 budget gap. (Please see chart titled Federal Revenue Sources.)

## Federal Revenues and Outlays



As of Jan-11. Source: Congressional Budget Office; Allianz Global Investors Capital. See additional disclosure.

### Federal Revenue Sources



As of Jan-11. Source: Congressional Budget Office; Allianz Global Investors Capital. See additional disclosure.

Approximating such an increase would cripple an economy already burdened with the second-highest corporate tax rate in the industrialized world (39%). (Please see table titled Global Corporate Tax Rates.)

### Global Corporate Tax Rates

Country	Adjusted Central Government Corporate Tax Rate	Sub-Central Government Corporate Tax Rate	Combined Corporate Tax Rate
Ireland	12.5		12.5
Poland	19		19
Slovak Republic	19		19
Czech Republic	19		19
Hungary	19		19
Korea	22	2.2	24.2
United Kingdom	26		26
Canada	16.5	11.1	27.6
Australia	30		30
Germany	15.8	14.4	30.2
France	34.4		34.4
United States	32.7	6.4	39.2
Japan	28.0	11.6	39.5

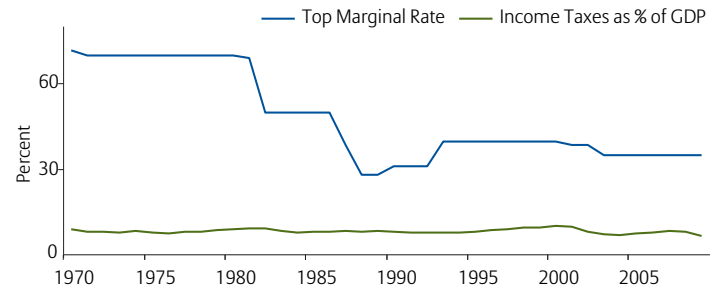
As of 1-Jan-11. Source: Organisation for Economic Co-operation and Development; Allianz Global Investors Capital. See additional disclosure.

Even modest rate hikes will drive companies, jobs and associated tax revenues abroad. The economic damage wrought by trying to plug America's fiscal hole with corporate dollars would likely blot out any benefit.

From a personal tax standpoint, the options are equally grim. Proponents of higher income taxes will note current levels are low by historical standards. This is true. Since 1913, the top rate in the U.S. has averaged about 60%. In 2011, top earners will pay 35%. But even a rise to 39.6%, which would have occurred this year if the Bush tax cuts had been allowed to expire, would have a limited impact.

Over the past forty-one years, the maximum marginal rate in the U.S. has ebbed and flowed from a high of 72% in 1970 to a low of 28% in 1988-89. However, the government take from income taxes hasn't shifted substantially as either a percent of U.S. GDP (6%-10%) or federal revenues (43%-50%). (Please see chart titled Personal Income Tax Policy.) Faced with higher taxes, people adjust their behavior. A singular focus on collecting more from individuals will not solve Washington's problem.

### Personal Income Tax Policy

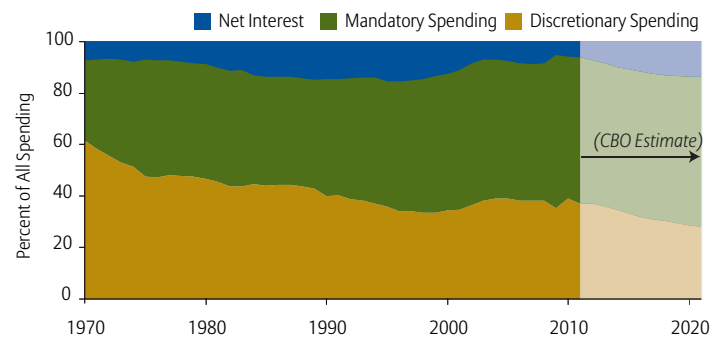


As of Jan-11. Source: Tax Policy Center; Congressional Budget Office; Allianz Global Investors Capital. See additional disclosure.

The U.S. government must reduce spending. So-called 'discretionary' outlays are a common first choice for cuts. But here, the easy money is gone. Discretionary spending, which includes funds for critical programs like education, transportation and the military, collapsed from 61% of the federal budget in 1970 to 39% last year.

Under the current plan, this slice of the pie is already scheduled to shrink further, touching 28% by 2021, the lowest level in at least a half century. (Please see chart titled Federal Expenditure Categories.)

### Federal Expenditure Categories



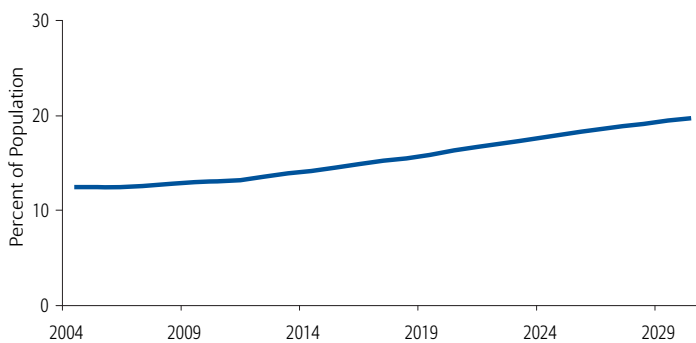
As of Jan-11. Source: Congressional Budget Office; Allianz Global Investors Capital. See additional disclosure.

The remainder of the federal budget is consumed by three things: interest payments on the federal debt, health care costs and retirement costs. If Washington's books are to be brought back into balance, it is very likely lawmakers will be forced to reform entitlements.

This won't be popular. Attempts at reform in Europe have been marked by street protests, nationwide strikes and political upheaval. Governments administering cutbacks have been voted from office in Ireland and Portugal. Spain may be next. For America, the issue of entitlements is complicated by the fact many programs are already badly underfunded.

Today, Social Security, the core U.S. public retirement account, still has positive cash flow. But by 2014, as a groundswell of 'baby boomers' exit the workforce and draw down savings resources, the fund will begin paying out more than it brings in. (Please see chart titled Persons Aged 65 and Older.)

#### Persons Aged 65 and Older



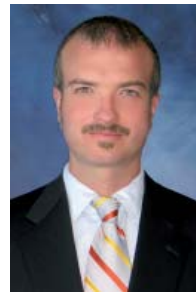
As of 10-Jun-11. Source: U.S. Census Bureau; Congressional Budget Office; Allianz Global Investors Capital. See additional disclosure

By 2037, this demographic transformation will exhaust Social Security's reserves. Revenue paid into the fund will only cover 75% of retiree benefit payouts. These projections from the Social Security Administration are disquieting. They also understate the scale of the challenges ahead, as they predate tax holiday legislation passed by Congress in December. The "Tax Hike Prevention Act of 2010" slashed payments into Social Security by an additional \$112 billion this year.

Europe's debt crisis should serve as a hard warning on the need for pre-emptive action. When imbalances are left unresolved, markets force discipline. In July 2010, the CBO published a brief titled *Federal Debt and the Risk of a Fiscal Crisis*. The conclusion: unsupportable debt levels in the U.S. could result in an "abrupt" drop in investor confidence and a "sharp" rise in interest rates. Acknowledging the problem is a good first step.

Meanwhile, Europe's policymakers continue to sweat through the difficult process of reining in government. From the periphery to the core, austerity is a regional priority. Great Britain is leading the charge, chopping back spending at the fastest pace in half a century. Germany, France, Spain, Italy, Ireland and Portugal are implementing deep cuts as well. For many Europeans, the official retirement age is set to rise. These measures are painful. In the future they should bear fruit, putting Europe ahead of the United States on budget and governance.

What significance does this hold for individuals? For one, tax hikes tend to dampen investment returns. And a government focused on debt reduction and austerity may have fewer countercyclical options when the next economic downturn hits. Asset price volatility could remain uncomfortably high. Individuals considering retirement may be forced to rely more on personal savings than they expect. Entitlements should not be viewed as guarantees. We are all poorer than we may think.



**Greg A. Meier, Financial Writer**

Greg Meier produces market commentary, outlooks and research for Allianz Global Investors Capital.

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