2011 3rd Quarter Stock Market Commentary

LIVING IN THE FUTURE

"Always borrow money from a pessimist.
He won't expect it back."
-Anonymous

In 1931 the Oklahoma legislature passed a statute prohibiting the manufacture, distribution, and sale of ice without a "certificate of public convenience and necessity", basically turning the manufacture of ice into a public utility. At the time, it was common for states to do this with industries deemed to serve the public interest. The resulting monopoly, known as the New State Ice Company, brought suit in 1932 against an upstart Oklahoma City businessman named E.A. Liebmann, to prevent him from competing. The district court ruled in Liebmann's favor, stating that the manufacture and sale of ice was a private business, a decision later upheld by the appeals court. Ultimately, in New State Ice Co. v. Liebmann, the case was argued in front of the United States Supreme Court, who ruled 6-2 (with Justice Cardozo abstaining) that the lower court decisions were correct, and that any law which had the effect of curtailing the common right to engage in a lawful common business, violated the due process clause of the Fourteenth Amendment.

Justice Louis D. Brandeis wrote an unusually strong dissent. Brandeis was a believer in "scientific socialism". Technological advances were leading to excess productive capacity, which in turn resulted in high unemployment. To countermand this trend, he argued that individual states should have the power to fashion laws to meet society's changing needs. He wrote "It is one of the incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory, and try novel social and economic experiments without risk to the rest of the country". Despite being on the losing side of this case, Brandeis' doctrine has been cited as precedent in dozens of cases by judges of all political persuasions.

A perfect illustration of individual states serving as a laboratory for the entire country can be found by looking at the effects of the Massachusetts Health Care Insurance Reform Law, sometimes referred to as "Romneycare". Enacted in 2006, the law mandates that nearly every state resident obtain minimum level of healthcare insurance coverage and provides free health care insurance for residents earning less than 150% of the federal poverty level who are not eligible for Mass Health (Medicaid). The law also partially subsidizes health insurance for those earning up to 300% of the federal poverty level.

The law established an independent public authority, the Commonwealth Health Insurance Connector Authority, also known as the Health Connector, which acts as an insurance broker to offer private insurance plans to residents. The reform legislation included tax penalties for failing to obtain an insurance plan. Massachusetts tax filers who failed to enroll in a health insurance plan which was deemed affordable for them lost the $219 personal exemption on their income tax. Beginning in 2008, penalties increased by monthly increments. In its basic structure, despite Mitt Romney's flailing attempts to distance himself from Obamacare, the President readily acknowledges that his health care reform legislation was modeled on that of Massachusetts.

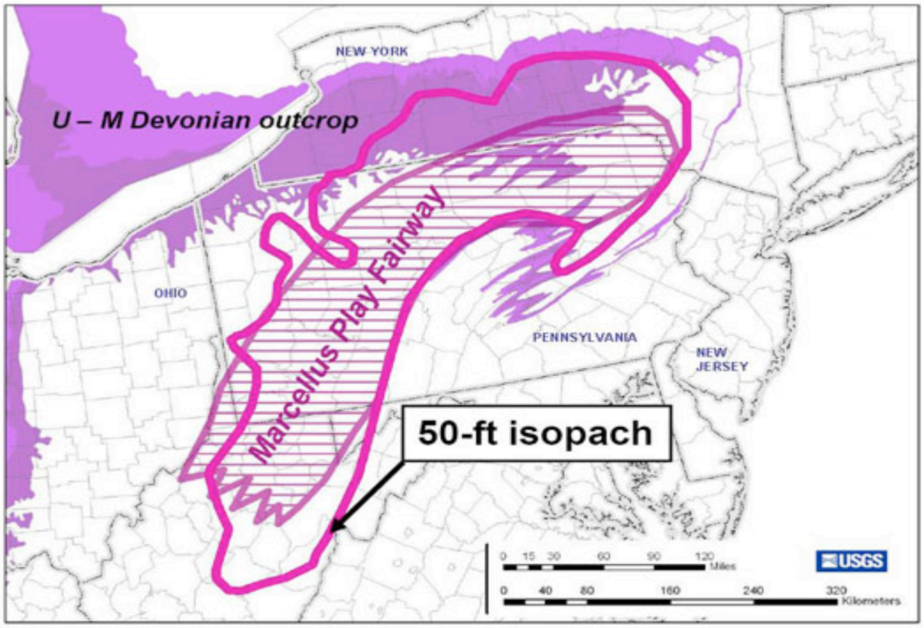
Did reform work? It depends how you measure. Prior to the law's passage, approximately 6% of the state's population was without health insurance. Enrollment has climbed steadily each year, so that today less than 2% are uninsured. With only 150,000-200,000 people not covered, the goal of universal coverage seems within reach. Unfortunately, though, the price of achieving this goal is a high one. Massachusetts now spends 33% more per capita on health care than the national average. Annual expenses on the health care initiative were $409 million more in 2010 than in 2006, even after allowing for the fact that the federal government subsidized the experiment with matching funds for an additional $409 million. Ominously, federal matching funds are not guaranteed and must be negotiated, making the state unusually vulnerable to federal expense control efforts.

The largest component of the growth in expenses has been Commonwealth Care, the heavily subsidized health insurance plan run by the Health Connector (the state agency created by the law to help residents obtain health insurance) for those meeting certain income requirements. Because of perverse incentives built into the law, smaller firms benefit by discontinuing health insurance so that their employees can be eligible for the state's subsidized program. Second, it gives employed individuals the incentive to earn less in order to qualify for state benefits. This is because the benefits are not phased out as income rises, but rather fall off a cliff as certain income thresholds are reached. This means that for certain individuals, getting a raise can result in a marginal tax rate in excess of 100%.

Given the experience of Massachusetts, perhaps the law creating Obamacare should not have been called the Healthcare Affordability Act, since it actually does nothing to make health insurance more affordable, but rather the Healthcare Universal Coverage Act, which would have been much closer to the truth.

There are numerous other experiments at the state level attempting to improve the delivery of healthcare. Maryland, for example, was granted a waiver to try to coordinate care and lower costs for Medicare, while Oregon is making an effort to determine whether Medicaid actually provides real benefits to the poor, when adjusted for the fact that provider payments are so low that access to care is severely rationed.

But health care is not the only arena in which state policy decisions can help guide federal policy. Consider the Marcellus Shale, a huge formation (65 million acres) of sedimentary rock in the Northeastern United States which holds enormous reserves of natural gas. Named after the village of Marcellus, New York, its proximity to the large population centers along the East Coast makes it an attractive area for energy development. Former Pennsylvania Governor Ed Rendell, a Democrat, and his successor, Tom Corbett, a Republican, quickly embraced the economic opportunity offered by the Marcellus. They set up a regulatory framework to encourage drilling, while monitoring the activity for safety. To date, more than 2,000 wells have been drilled, generating more than 72,000 jobs with an average wage of $73,000. In addition, there has been an estimated $5.6 billion in natural gas company purchases and $2.4 billion in indirect spending by companies along the supply chain. Thus far, drilling companies have paid more than $1 billion in state taxes, a number which is growing rapidly. In the first quarter of 2011 taxes paid were $238 million, more than was paid in all of the prior year.



Contrast this with New York, which is estimated to hold 20% of the Marcellus Shale reserves. Environmental activists have successfully convinced the legislature to impose a moratorium on drilling. Broome County, which borders Pennsylvania, commissioned a study in 2009 which estimates that its reserves could justify up to 4,000 wells, potentially generating $800 million in wages and benefits and $1.2 billion in property income from rents and royalties. With the moratorium in place, though, the population of Broome County has been in a steady decline as younger workers leave for greater economic opportunity elsewhere.

The Manhattan Institute has published a study which shows that for the state as a whole, an end to the moratorium would generate $11.4 billion in economic activity and 16,500 new jobs over the decade, based on only limited drilling, and five times those figures if the resources were more fully exploited.

Given the government's constant rhetoric that the primary imperative to get the economy growing again is to create jobs, the contrasting pathways taken by New York and Pennsylvania should help guide national energy policy – provided someone is willing to objectively look at the data.

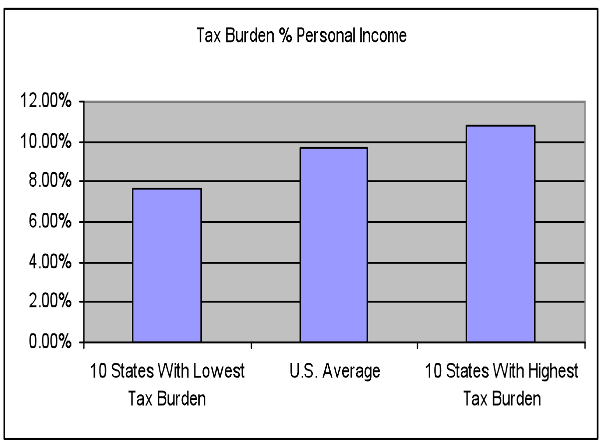
Obviously, the problem of formulating a coherent energy policy for the United States which encourages energy independence in an environmentally responsible manner, and the problem of providing health care to all Americans in a cost effective way, are two of the most vexatious that we face as a nation. But the heat generated by these issues pales when compared to the one which nearly brought the government to a complete standstill in early August. Should we attempt to bring the federal budget more into balance primarily through extensive cost cutting, or by raising taxes? Once again, states have chosen divergent paths, and their results are worth noting.

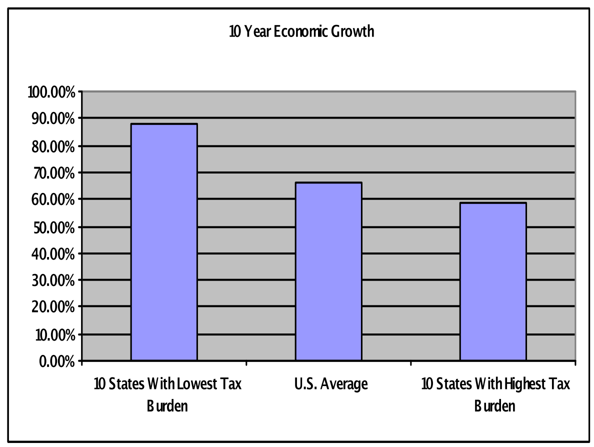
A 2009 survey of the top executives published in *Chief Executive Magazine* ranked California as having the highest quality of life in the country – hardly surprising given its proximity to both the ocean and the mountains, and a climate that permits out-door activities year-round. But that same poll also ranked it the worst state in the nation for business, while Texas consistently ranks best. While Texas suffered during the Great Recession it fared much better than the United States as a whole. Consider employment. Total jobs in Texas as of July, 2010 were 2.3% lower than in December 2007. This compares to a drop of 5.7% for the entire country. California, by contrast, lost 8.7% of its jobs. In the last year 50% of all jobs added in the entire country were added in Texas.

This pattern holds regardless of the economic measure we choose. For the ten years ending in 2009, personal income in Texas grew 67.6%, compared to 65.5% for the entire nation and 56.6% for California. Texas enjoyed 3.4% per year in-migration, while California suffered 0.8% out-migration. It seems unlikely that all these people are moving to Texas because they enjoy six straight weeks of temperatures above 100 degrees.

Every analysis shows that Texas' competitive advantage derives from a combination of relatively low taxes, low government spending and less regulation. On the tax front, Texas imposes a tax burden on personal income averaging 8.4%. The national average is 9.7%, and California is 10.5%. Total state and local spending as a percentage of private GDP has averaged roughly 17% in Texas, versus 25% in California.

The comparison in the fortunes of these two states is stunning. We can see this same pattern repeated by looking at the other states, too. In the graph shown below on the left we show the average tax burden on personal income in the ten states with the lowest burden, as well as that for the highest taxed states and the country as a whole. On the right we show the total growth in Gross State Product for these same states. Draw your own conclusion.





Sadly, the data provided by the various states serving as a laboratory for different policy choices is only useful if someone objectively analyzes the data. This appears to be a skill beyond any possessed by most of our elected representatives. In most states you need to pass a proficiency exam and obtain a license to be a hair braider or massage therapist, but you can be elected to Congress without understanding the scientific method. Albert Einstein was famously quoted as saying that "The definition of insanity is doing the same thing over and over again and expecting different results." Perhaps our elected officials should be required to demonstrate the same facility in reasoning that we require to graduate from high school.