# It’s Not the Heat, It’s the Frugality

By Editor Test *Tue, Jul 10, 2012*

*Everyone seems to agree that business has been crazy-slow this summer, thanks to election year paralysis. A bonus feature: My theory on why our monetary system functions like a bathroom sink.*

Much of the country was struck by a heat tsunami in late June and early July. Thunderstorms and tree-felling “derecho” winds accompanied 100-degree temperatures in some places. In Boulder, Co., where I was visiting, storm clouds brought lightning, which sparked fires in the mountains above town.

But the most common complaint I hear from RIJ subscribers and others around the country these days, after we exhaust the topic of heat, is that the pace of business is slow. Money is not changing hands. The multiplier effect is ineffective.

“My business is in the toilet,” a usually chipper colleague on the West Coast’s gold coast told me. “People have money, but they’re not spending it,” said someone who was trying to sell $10,000 booths for a conference in the fall. A 57-year-old hoped that his company’s recent acquiror won’t eliminate his job. A consultant said he’s just experienced the two worst months of an otherwise recession-proof career. And so it went.

Like the talking heads on CNBC after the stock exchange closes at 4 p.m. weekdays, we can always find a proximate cause for the economic doldrums du jour. The looming election and the uncertainty of its impact on taxes, regulation and federal spending happens to be my favorite scapegoat.

To paraphrase Woody Allen, in one direction lies utter devastation; in the other, total ruin. To mangle Robert Frost, it looks like our world will end either in the fire of inflation or the ice of austerity. To quote Bob Dylan: “Take your pick, Frankie boy. My loss will be your gain.”

Or, as Nachum the beggar said to the villager in *Fiddler on the Roof* who gave him only one kopeck in alms: “Just because *you* had a bad week, why should *I* suffer?”

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For annuity manufacturers, one reason to be hopeful is the possibility that contingent deferred annuities (CDAs) will sell well in the fee-based advisor channel and perhaps in the retirement plan channel. (CDAs are the subject of RIJ’s cover story this week.)

To succeed, however, the product might need a new name. As everyone knows, the word “annuity” renders most people unconscious. Earlier names for these unbundled guaranteed minimum withdrawal products (GMWB)—“synthetic annuity” and “stand-alone living benefit”—didn’t quite sing either.

But we’re probably stuck with the term CDA for a while, if only because annuity manufacturers have just spent a lot of time and legal firepower convincing a National Association of Insurance Commissioners committee that CDAs are annuities, and therefore life insurance products, and not "financial guaranty insurance" like the credit default swaps that ruined AIG during the financial crisis.

If you can think of a more melodious name than "Contingent Deferred Annuity," please e-mail your suggestion to me. If someone can come up with a plausible, pleasing substitute for CDA, I'll send him or her a fresh copy of "Someday Rich," the new John Wiley & Sons book by Tim Noonan and Matt Smith.

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Over a glass of hoppy IPA craft beer in Boulder just before the start of a stimulating Consumer Financial Decision-Making Conference in late June, I had an interesting conversation with Jeff Brown, the esteemed annuity "framing" expert from the University of Illinois. We had differing opinions about the impact of Social Security on annuity purchasing behavior.

I argued that Social Security crowds out demand for private annuities, and that the crowd-out effect helps explain the so-called "annuity puzzle." The average person, who has a $1,100 inflation-adjusted monthly income from Social Security, effectively owns a life annuity with a present value of almost $200,000, I reasoned. In other words, if someone has $200,000 in personal savings, then half of his total wealth (aside from home equity) is already annuitized via Social Security. Why should he annuitize more?

Nonsense, said the formidable Dr. Brown. He argued that, even if people have a $2,500-a-month income from Social Security, $2,500 will probably still represent a small enough percentage of their basic monthly cost-of-living that Social Security should have little or no effect on their real or perceived need for additional guaranteed income. As in so many discussions about annuities, the correct answer probably varies by individual and by income level. In the meantime, since Brown is the expert, I'll defer to his view.

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Finally, an amateur economist's note about macroeconomics: The view that federal taxes are "theft" and the corollary that the poorer half of the population should pay more in taxes (while the rich should pay less) has never seemed convincing to me. So, while hiking in Colorado earlier this year, I ignored the wild elk and the Indian paintbrush and tried to imagine an analogy that would show why those statements are wrong.

Pardon the mundane metaphor, but it occurred to me that that economy works like a bathroom sink. The water, obviously, enters through the faucet. It drains out either through the drain-hole at the bottom of the sink or (if the drain-hole is closed and the faucet stays open) through the overflow hole near the top of the sink.

Think of the water from the tap as government spending and the water in the sink as money in the economy. To keep the sink from overflowing with money (and causing inflation), the government must remove money via taxes. Uncle Sam can take taxes from people at the bottom of the economy (through the drain-hole) or from people at the top of the economy (through the overflow hole).

If the government takes money from people at the bottom of the income scale by leaving the drain-hole open, the sink certainly won’t overflow. But it won’t fill, either. To fill the economy with money but prevent inflation, you need to take the money from the people at the top of the income scale. You could, in theory, turn off the money tap (fiscal austerity) and eliminate the overflow hole and the drain (zero taxation), but the water in the sink would stagnate and (ultimately) evaporate.

Q.E.D.