

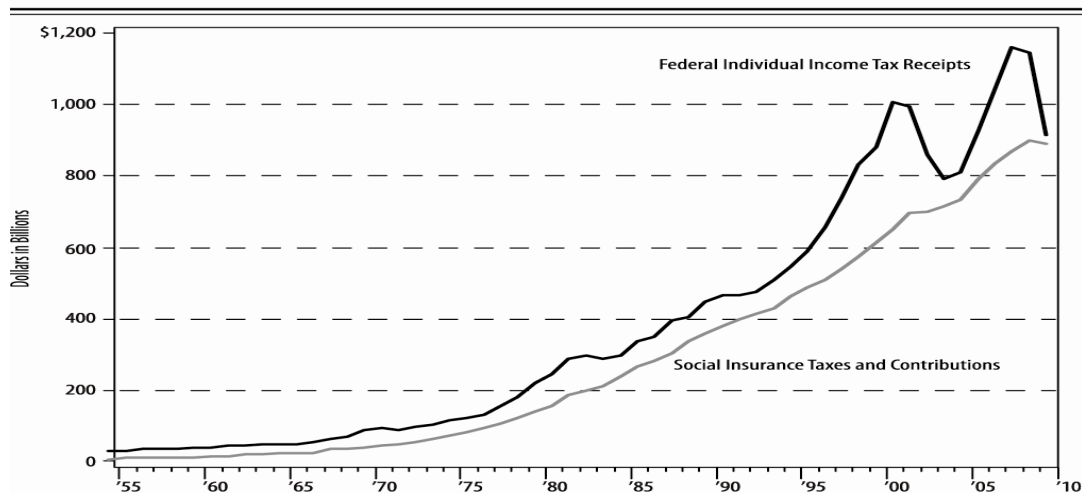
# The Week

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## Health care reform does not change our outlook

- During the past couple of weeks, our strategists within the Advisory Services Group have written several reports on various aspects of health care reform. These reports ranged from discussions of health care inflation and budget deficits to analysis of equity winners and losers as well as the impact on the dollar and the credit markets.
- After looking at the reforms from many angles, we have concluded that health care reform does not change our near term macro outlook on the economy and the markets. Health care is a large part of the economy and so is the government sector. However, many of the changes coming from the legislation will be implemented over the next few years, not immediately. Therefore, the impact of the reform will depend on how the economy and the markets are performing when the various parts of the legislation take effect.
- Looking ahead, income taxes are likely to increase in 2011 when the Bush tax cuts expire. In addition, the new health care legislation raises Medicare and Medicaid taxes on high-income earners and imposes similar taxes on unearned income from dividends, capital gains and interest. Tax increases tend to hurt the economy, assuming all other things are unchanged. But we expect the economy will not be the same a year or two from now. We believe the economy will strengthen during the next few years as it continues to heal from the financial crisis. Therefore, the negative impact from a tax increase may not be as bad in a few years as it would be if it took effect this year while the economy is still quite weak.

**Federal Individual Income Tax Receipts Versus Social Insurance Taxes and Contributions**



Sources: Office of Management and Budget; Haver Analytics

Health care reform is important, but is not the primary driver of the economy and the markets. The more important factors determining economic growth and market activity are what policymakers are doing to boost or restrain growth and where the economy is in the economic cycle. The U.S. economy is still in the early stage of the economic recovery, and policymakers are still providing excess liquidity to enhance economic growth. Therefore, we continue to focus more on the shape of the recovery and the prospects for near-term changes in monetary policy, rather than on the impact from the phased-in health care reforms over the next several years.

The financial markets also appear to be taking the health care reform in stride. The equity markets held up very well after passage of the reforms, even though many investors worried that the new legislation was a step toward socialism and increased government regulation of the economy. If this legislation had been enacted in another period, when the economy was getting weaker, rather than getting stronger, the markets may have reacted more negatively. However, investors appear to view the new health care reform as another headwind that may dampen growth, but not derail the recovery.

Looking ahead, the course of the equity markets through the rest of the year will probably be determined more by the ebb and flow of economic data and unexpected news, rather than by the passage of health care reform. As we noted in last week's commentary, the equity markets have rallied close to our equity-strategy team's year-end target range of 1175-1200 for the S&P 500. This does not mean that the market won't rally further. It just means that the market is now fairly priced to our expected earnings estimate for 2010.

This week's chart looks at the funds provided to the federal government from the two main sources of tax revenue. The largest source of funds comes from individual income tax revenues, accounting for an average 45% of government revenues during the past 10 years. The second largest source is social insurance taxes, accounting for an average 37% of government revenues during the past 10 years.

Many workers view these two taxes as income taxes. However, the government looks at them differently. When the government says that many tax payers do not pay income taxes, many of these workers still pay social insurance taxes also known as payroll taxes or FICA taxes. If health care reform requires extra taxes, beyond the payroll tax increases already scheduled for high-income workers, the government could increase payroll taxes to all workers. Or the government could increase other taxes. Additional sources of tax revenue come from corporate income taxes, accounting for an average 10.4% of government revenues during the past 10 years, and excise taxes accounting for 3.2% of revenues. Estate taxes are equal to 1.2% of government revenues, with customs fees providing another 1.0% and miscellaneous taxes adding the final 2.0%.

Finally, the federal government is studying how to reduce the deficit and could recommend other taxes after the election. These other taxes could include a national sales tax, also known as a Value Added Tax or VAT. This is a widely used tax in other countries with a large government sector. The VAT taxes consumption, not income. This could appeal to environmentalists who favor reduced consumption and conservation. Finally, there could also be a shift toward more taxation of businesses to boost the percentage of revenue from corporate income taxes. Unfortunately, higher corporate taxes might dampen job growth. The give and take on health care reminds us that there is no free lunch. If the government wants to expand programs and not increase borrowing, it needs to get money from someone first in order to increase spending elsewhere. The prospects for higher taxes in the future may affect our outlook at that time. But in the meantime, the economy is probably going to benefit more from an economic recovery this year than it will be hurt by higher taxes in a year or two.

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