

The Kiplinger Letter

FORECASTS FOR MANAGEMENT DECISIONMAKING

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Dear Client:

Washington, April 22, 2005

Bush's tax advisers want big changes to the income tax code, both for individuals and for companies. The nine-member panel charged by Bush with recommending changes has until July 31 to report. But members already know that tweaking won't be enough.

TAXES

The panel will offer several options, giving Bush plenty of political cover and letting him put his own stamp on a plan.

All the options will stress simplicity, allowing for fewer deductions and tax brackets.

All would tax investment income less.

And all would end or revamp the alternative minimum tax, the AMT, which has become an unintended tax increase for many in the middle class.

The commission will also recommend some kind of consumption tax, probably a national sales tax, to raise much-needed additional revenue.

Other likely recommendations: Make recent tax cuts permanent, eliminate the estate tax, reduce deductions for state and local taxes and expand the current Earned Income Tax Credit for the working poor.

Bush will work hard to win approval for the plan. By fall, he'll have shifted his efforts from revamping Social Security to taxes. He'll see tax reform as his best shot for a domestic policy legacy.

But overhauling the system means choosing winners and losers. Fierce lobbying will slow action. Change will take time...probably years.

The catalyst that may help Bush get the job done: The AMT. It's almost a flat tax, with only two brackets. The first \$175,000 of AMT income is taxed at 26%, with a 28% rate for all income over that. Couples get a \$58,000 exemption, but many regular deductions are nixed, including state taxes, some medical and most miscellaneous expenses. Mortgage interest is restricted, and there are no personal exemptions.

The AMT's reach will zoom if nothing's done. Because its brackets and exemptions aren't indexed to inflation, more people get hit each year. The tax will ensnare 11.6 million households in 2006, up from 3.4 million this year. By 2010, it'll nab half of taxpayers making \$75,000-\$100,000.

2001 and 2003 rate cuts add to the problem, lowering tax liability of middle-incomers under the regular schedule until the AMT kicks in.

Lawmakers have to tackle the AMT...not this year, but soon. If they don't kill it, they'll at least index brackets and exemptions.

When they do, odds of a sales tax may go up. Just indexing would forgo hundreds of billions in federal tax revenue. That money will have to be made up somewhere or deficits will soar out of control.

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**THE
ECONOMY**

There's no need to worry about a revival of stagflation, despite accelerating inflation and weak economic gains for March. That combo hobbled the economy in the 1970s, when double-digit inflation led the Federal Reserve to boost interest rates despite a lagging economy.

Inflation IS picking up, but not alarmingly. We still see the CPI, the Consumer Price Index, actually slowing this year to 2.8% from 3.3% last year. However, the closely watched core CPI, which excludes energy and food prices, is likely to creep from 2% last year to 2.2% this year.

The economy is downshifting, not sputtering. Growth of about 3.5% is still the best bet, led by a solid business sector. The silver lining to modest inflation is that it means more firms are raising their prices, boosting profits and increasing funds available for hiring and investing.

The Fed will tread a narrow path between tempering inflation and sustaining the economy. It'll continue a series of gradual rate hikes, with another quarter-point increase in May, the eighth in 11 months.

Corporate profits will continue to fuel mergers and acquisitions. Companies on the prowl have plenty of cash on hand and won't be deterred by a sluggish stock market, which would slow deals paid for with stocks.

All told, deals worth \$1 trillion will be inked this year. That's up from \$830 billion last year and nearly double 2003's total, but well below the \$1.7 trillion in 2000...the apex of the dot-com boom.

Leading sectors in merger mania will include energy, cable TV, tech (led by software), telecommunications, health care and retailing.

SELLING

Major credit card firms are raising transaction fees by 5% to 25%. Most retailers won't get any advance notice of the increases. They'll just appear on bills from Visa and MasterCard, which say the hike is necessary to cover antifraud measures and higher processing costs.

Hardest hit will be small retailers...gift shops, florists, beauty salons, etc. They pay higher transaction fees than big chains and can't pass the added burden on to customers through higher prices. Many are already squeezed by competition from Wal-Mart, Target and others.

Remedies are few. Stores could increase the minimum purchase for charges, but that could turn off consumers who dislike using cash.

New types of businesses will buoy franchising. Sales volume will hit \$1.4 trillion by decade's end, up from \$900 billion in 2005. And no longer will franchising be dominated by hotels and restaurants. As baby boomers age, there will be more opportunities for niche services, including elder care, home repairs, wine classes and home-cooked meals.

Merchants will be liable for rebate lapses by product vendors. The Federal Trade Commission ruled that CompUSA had to honor rebates on QPS products it sold, even though QPS was the one that was negligent.

The crackdown on rebate fraud follows a surge in complaints about unpaid rebates. They rose 20% last year after doubling in 2003.

Testing new e-commerce sales pitches is a lot easier now.

A system from SiteSpect lets marketers try out their sales ideas without the hassle and cost of reprogramming. The system allows tests to be added to Web pages, which can be easily restored after the test. Retailers can experiment with bigger photos, more-detailed descriptions and instant discounts to see which help improve sales and which don't.



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VETERANS

Over 1 million U.S. troops have served in Iraq and Afghanistan. They and their families will give the vets' lobby added clout, pressing Congress for more health care benefits, civilian job security and tuition payments...all in the face of a severe budget crunch.

How returnees are treated will likely be an election issue in 2006. Lawmakers will outbid one another to show their support.

Some congressional action is already getting under way.

Bush backs a Senate bill to provide traumatic-injury insurance for family members forced to quit jobs to care for injured veterans.

Democrats are focusing on an overhaul of the GI Bill to fully cover vets' college costs and provide better health benefits.

But there will be limits to Congress' newfound generosity. Lawmakers won't provide tax relief for companies that make up the gap between military pay and civilian pay for employees called to duty.

Some states will help. N.M. is paying life insurance premiums for its troops. Okla. and Wash. will likely follow suit. Similar plans are pending in over 30 other states but face stiff budget constraints.

TRADE

Congress is arming for a trade war with China to help U.S. firms hurt by Beijing's currency policies. China fixes the yuan at 8.3 to the dollar, rather than letting it float. At that rate, the yuan is undervalued by 15% to 40%, making it harder for U.S. firms to compete.

Companies will find it easier to seek protection from imports under a bill likely to pass by August. It would add currency manipulation to the list of illegal subsidies that can trigger U.S. retaliation. Some lawmakers want to be tougher and give China a six-month deadline to revalue the yuan, but Congress probably won't want to go that far.

Russia's promise as a lucrative market is fading fast.

U.S. direct investment in the country, about \$430 million, is minor. But U.S. businesses had expected it to increase rapidly in coming years.

More shenanigans in the oil sector will spook foreign investors. President Vladimir Putin is following up on his manhandling of Yukos, Russia's top oil producer, by slapping a huge tax bill on TNK-BP, 50% owned by the U.K.'s BP. Putin had claimed Yukos was a unique case. The Kremlin also is blocking foreign firms from taking majority ownership in most oil projects, potentially crippling a crucial economic sector.

DOMESTIC SECURITY

State spending on homeland security is going up in a big way. Some \$5 billion in federal grants now clogged in the pipeline will soon be cleared for use, with \$5.2 billion more coming in 2006.

States will lean heavily on private firms for help in four areas:
First responders. Secure and compatible communications systems, protective gear and warning sensors for chemical and biological weapons and mobile medical equipment are among the top priorities in most states.

Seaports. Cargo ports, which haven't had much attention so far, will get mobile X-ray machines, motion sensors and new video technology.

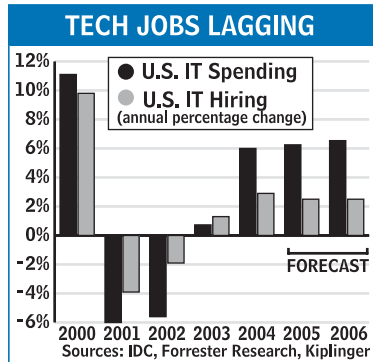
Infrastructure. Key bridges, highways, subways and train tunnels will be reinforced and equipped with motion sensors and video cameras.

Chemical and nuclear plants. States will use their grant money to help private plants beef up security against air or ground attacks.



TECH

Jobs for IT workers will be relatively scarce the next few years, even with robust business spending on technology. Hiring is slow in part because of mergers in the telecom and software industries



and the caution that businesses are showing about the economy. They're contracting work out for new projects instead of adding staff.

IT hiring probably won't take off until 2008, when a new generation of more-secure computers hits the market, kicking purchases by businesses and consumers into higher gear. The spread of fiber-optic lines and wireless Web access will also fuel buying and create new jobs.

IT skills most in demand: Network designers, security specialists, Windows administrators and software engineers. There's also a need for people experienced in remote network access.

Offshoring will remain a minor factor in the slow IT job growth. Only about 110,000 jobs have been shifted to India and other nations.

That's because there are problems that keep offshoring in check. Security risks are greater. Transportation, electricity and lodging are often inadequate. And turnover is high, making recruitment difficult.

Tired of spending Saturdays washing windows or mowing the lawn?

Get yourself a robot to help do your chores. Within two years, robots will be able to clean the windows on the outside, cut the grass, rake leaves, grind yard debris into mulch and clear snow from driveways.

By 2010, robotic aides will help even with complex chores, responding to verbal commands to move around household furniture, assist elderly people out of a bathtub or cook dinner from scratch. By then, iRobot, Evolution Robotics and others will be selling robots to help with housework for about \$500, with \$5 billion in annual sales.

A boon for weary commuters: Better Web-based traffic reports.

BeatTheTraffic.com uses data from traffic sensors to help drivers plan rush-hour trips. For \$19.95 a year, users log on and check routes before leaving or sign up for text-message alerts on their cell phones. BeatTheTraffic.com currently serves 17 metro areas on the West Coast plus Phoenix, Chicago, Minneapolis, Milwaukee, Atlanta and Anchorage.

BUSINESS & POLITICS

More companies will enlist workers to achieve political goals, encouraging them to be grassroots lobbyists on important issues. They'll also let workers know how an election might affect business.

Over 1000 firms are already doing it, taking a page from unions, which engage in similar efforts. Most of the companies use Web sites to educate workers on business issues and help them contact members of Congress. The companies also post profiles of political candidates.

Employers can get help setting up and running their Web sites from the Business Industry Political Action Committee at www.bipac.org.

Yours very truly,

Knight Kiplinger
THE KIPLINGER WASHINGTON EDITORS

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