Who Picks Up the Bill? Part 1

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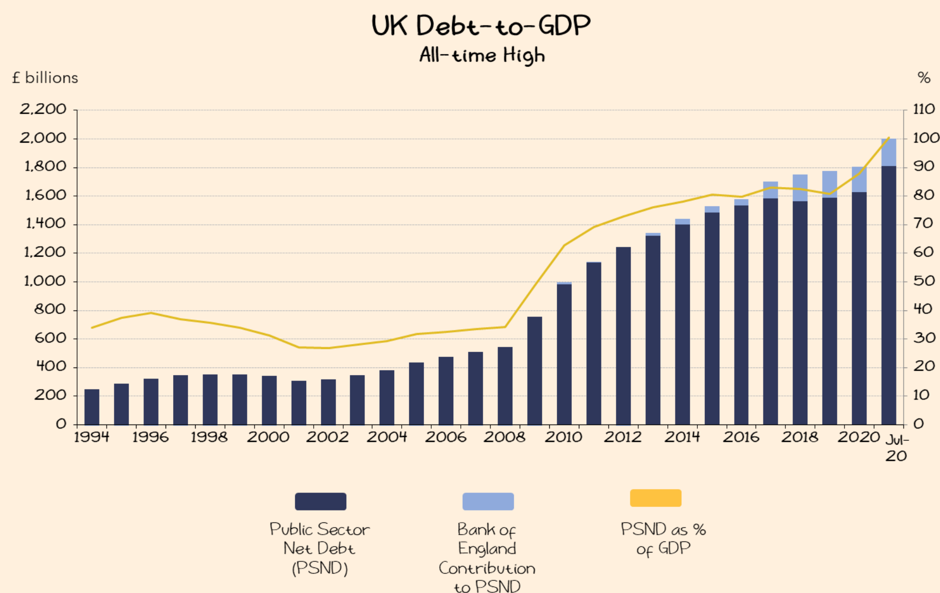
Key Takeaways:

- Given the recent $20 trillion of stimulus sponsored by governments and Central Banks all over the world to keep the global economy afloat amidst the COVID pandemic, we asked ourselves who and especially how are we going to pay for this spending regime.
- Austerity measures, which target a decrease in government spending and an increase in taxation, are unlikely to be enough to cover the current level of spending.
- Expect the theme of taxation to become politicized, especially going into the US elections.

Unconstrained Expenditure

The former Federal Reserve Chairman Janet Yellen recently published an op-ed in the New York Times with Joe Biden's former chief economist, Jared Bernstein, titled "The Senate is on Vacation While Americans Starve", calling for immediate action to avoid a catastrophic increase in US unemployment. The US Senate is hotly debating **another economic bailout package** that ranges through a vast party-political spread from $1 trillion to $3 trillion of additional fiscal expenditure. Across the Atlantic, Germany is extending its furlough scheme until the end of 2021, at a potential cost of €30 billion according to The Times newspaper, joining many other European countries along the path of extended assistance. In the UK, the current furlough scheme runs out in October. The UK's debt-to-GDP ratio has surged back through the 100% level, an indicator that has already taken place in US ($26.6 trillion debt to ~$20 trillion of re-forecasted GDP).



As summer ends, the lines between targeted support and semi-permanent subsidy are becoming blurred.

Who's paying for all of this?

COVID-19 was an unexpected shock to the global system, but the economic fault lines that opened up during the heavy-handed lockdowns had existed from long before the pandemic struck, something that we've addressed a length in the past. Central banks had been undertaking Quantitative Easing (QE) for the best part of a decade, and financial easing was not a question of support, but rather of economic survival even before the pandemic. Currently, with the monumental efforts from governments and central banks (i.e. debt issued and money printed, respectively) in order to offset the burden of COVID, we can't help but ask ourselves: Who is going to pay for all this support? And how?

Above all, what is the risk that we're all underestimating how much all this support will cost to our future generations?

Two routes: Austerity (& Taxation) or Expenditure

Independently of where you come from, it is highly likely that your home country is currently raising a large amount of debt to support its economy during these troubled times. How are they paying this debt back? We highlight two potential routes: Austerity (including Taxation) and Expenditure.

***Austerity (& Taxation)* could be considered a route of 'pain', whilst *Expenditure* a route of 'pleasure'. One would attempt to cleanse the system today by spending less and raising taxes, whilst the other holds onto the notion that we may be able 'print our way to prosperity'. These policies can, however, be complimentary and implemented simultaneously.**

Austerity is tangible, as we've all experienced taxes and, at some point in time, tightened our purse strings in order to make ends meet. *Austerity* is frowned upon by politicians, given that no one wants to run for office whilst telling their potential voters that they will be taxed more, and that the government will spend less.

Expenditure is the alternative, where instead of decreasing our expenses, we use the money printing power of Central Banks to finance government debts, thus allowing them to actually increase spending (this is called budget deficit financing) rather than decrease it. The *Expenditure* route is based on the idea that we do not need to cleanse as we can just keep on printing more money to finance our deficit. And if, and when, inflation occurs, it will help erase the nominal level of debt. Budget deficit financing, also called Modern Monetary Theory (MMT), is far more conceptual than *Austerity*, although it has some history from the 1970's when inflation reached double digits. Today's MMT is an old policy repackaged for a modern crisis in which we are the guinea pigs.

In this piece, we'll only focus on *Austerity & Taxation*, and we'll assess if it's a viable option to finance the current (COVID induced) spending regime (the short answer is NO). Next month, we'll focus on the *Expenditure* side of things (including MMT).

Balancing Spending and Revenue

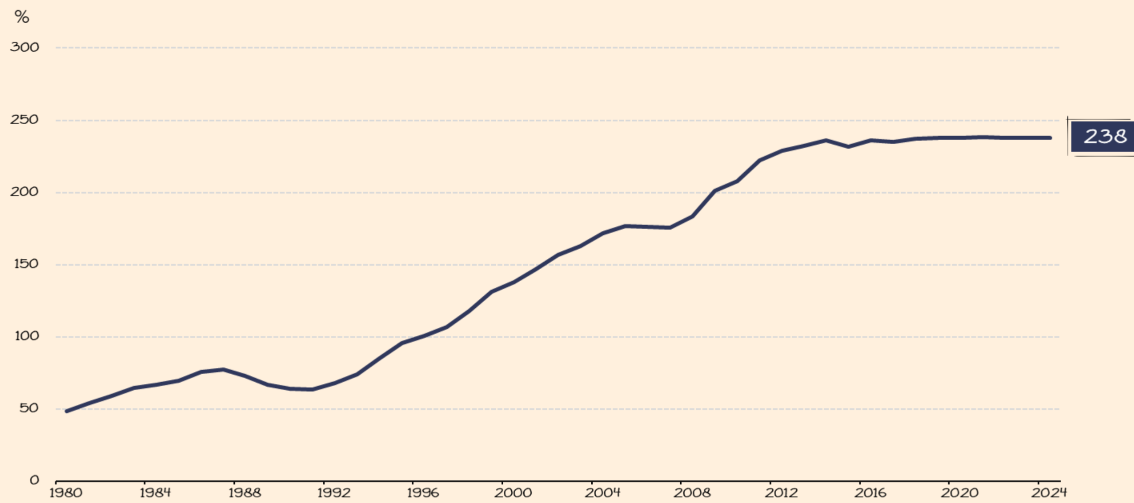
Throughout history, governments have overstretched themselves by building up huge budget deficits, where government spending exceeds revenue. Ideally, governments 'should' save during the good times, building up a revenue buffer, and spend these reserves during the bad times, but that rarely happens. With that, governments have different options to balance the books.

Governments will initially prefer to cover the shortfall between spending and revenue via borrowing in the debt markets given that borrowing is less "politically costly" than trying to run a balanced budget, but once interest payments on debt can no longer be covered by income, the threat of default begins to rise. Despite numerous well-known serial defaulters (Argentina and Greece both have a rich history), most governments still see default as the absolute last resort. (Go read our 'Debts, Deficits, and Future Financing' piece here to get an idea of where the US stands, as it's probably closer than you might think).

At what point do levels of debt become unsustainable? There are no specific rules, but there are multiple factors at play. Is the debt internal (denominated in local currency) or external (e.g. Emerging Market debt denominated in US dollars)? Is it held by long term domestic savers or opportunistic foreign investors? What is the maturity of the debt? What is the yield on the debt and what is the inflation rate?

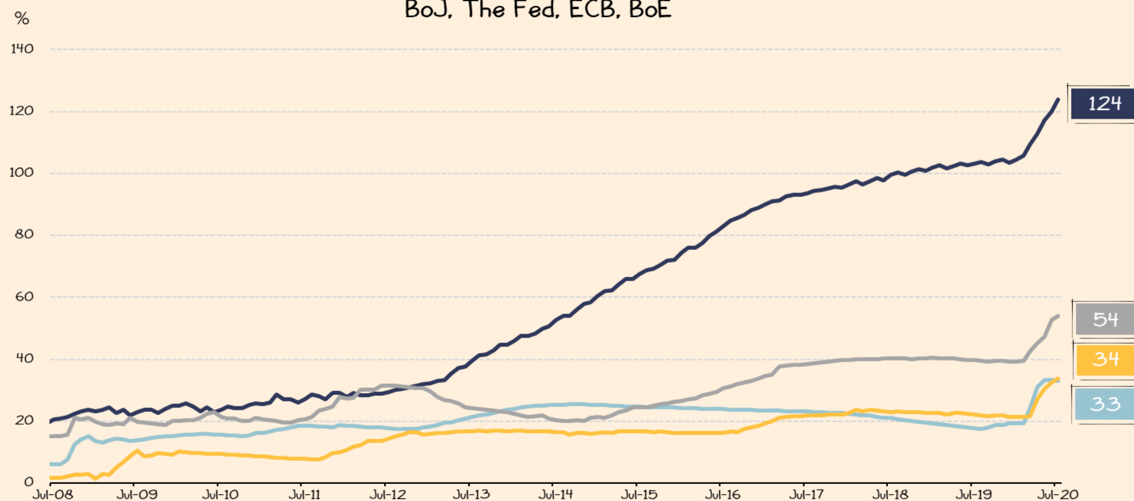
Carmen Reinhart and Kenneth Rogoff attempted to identify a tipping point in the book 'This Time is Different: Eight Centuries of Financial Folly' (2009). Despite some adverse publicity around one of their calculations, **their research still points to a government debt-to-GDP ratio that, above 90%, would be at a level which increases default risk**. But it varies wildly for different economies.

Japan is perhaps the clearest example of how an excessive debt-to-GDP ratio can be carried to levels that would have caused a default in many other countries. Japan's debt-to-GDP ratio has been in excess of 100% since the mid 1990's and above 200% for a decade.

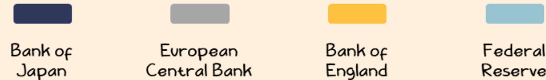


Source: Bloomberg, The Lykeion

Despite the excessive level of debt, the expectation of a Japanese default has been an investor's graveyard for years. The debt is mainly held in domestic hands and the Bank of Japan has been buying the debt via an ongoing QE program that has, so far, failed to create any form of serious inflation. **Their balance sheet-to-GDP ratio is the world's highest, but inflation remains tame.**



Source: Bloomberg, The Lykeion



For most countries, however, rising debt-to-GDP ratios are a sign of economic weakness. Rising debt and rising deficits risk a ratings downgrade to a country's sovereign debt, exacerbating the problem

because once the downgrade happens, interest payments will increase even more (especially if revenues eventually fail to cover the interest payments on debt, so that more debt has to be issued to cover these payments), creating a vicious downward spiral.

When more debt is no longer an option to finance the gap between government spending and revenue, that's when Austerity kicks in. **Austerity is a combination of reduced spending and/or increased taxation to try and balance out the books.**

The 'logical' remedy for a country that has been partying too hard for too long would be to reign in the spending and collect extra revenues via higher taxes (or engineer higher revenues to tax via stimulating growth).

Unfortunately, the last couple of decades have seen many developed market economies increase their debt levels during the times of plenty, rather than building-up their emergency funds for use during recessions. Therefore, when an economic slowdown occurs, funds have already been depleted and governments are starting off with a deficit, meaning that the need for Austerity is compounded by the lack of government savings.

Government finances in the US, UK and much of Southern Europe were already in a perilous state pre-COVID. So, given that we've not built any emergency funds when the economy was running hot, how will we support the economy during these rainy days? Where and how can we cut spending or increase government's revenue?

The Rules of Austerity: Spending Cuts

The COVID-crisis was particularly devasting for the poorest sections of many country's populations. Cutting healthcare expenditure is, therefore, a non-starter – it would be a certain vote loser. Lockdowns have also had a disproportionately negative effect on children who have experienced severe disruptions to their education. Education is another area that will be considered sacrosanct. Expenditure on infrastructure is also unlikely to be cut given its tangibility and visibility to the voter. In fact, most countries are anticipating increasing their fiscal expenditure to help kick-start growth.

Spending cuts, if they materialize, will have to be specifically targeted. In the UK, **defense is the only major line item in which the government can conceivably cut spending without creating a voter revolt** (although time is on the UK government's side because the next election is not due until 2024). But cutting its armored tank fleet is merely a footnote when compared to the current fiscal bill. In the US, the defense budget could also be a prime target for spending cuts. It totaled $730 billion in 2019 and is way ahead of all other country's equivalent budgets. China comes in at a distant second place, spending $261 billion last year, about 35% of the US level. You may have, however, already spotted the problem. The total expenditure of $730 billion is still dwarfed by the size of the fiscal packages announced so far this year.

Bank of America analyst Michael Hartnett has noted that globally, there has been over $12 trillion of fiscal support and $8 trillion of monetary support. The total of $20 trillion equates to about 20% of global GDP.

"You have to sort of pinch yourself sometimes to sort of realize that it's actually happening" (Michael Hartnett).

On March 27th, the US announced a $2.2 trillion package and then on April 21st a further $484 billion package including aid for small business. Even if the US industrial-military complex agreed to a 25% cut in the defense budget (it won't), a spending cut of around $180 billion is hardly going to touch the sides of this fiscal chasm. **It would take over 14 years of 25% cuts to the military budget just to repay the additional fiscal burden that has accrued so far this year.** This is before any further expenditure is agreed, as it surely will be in the coming months.

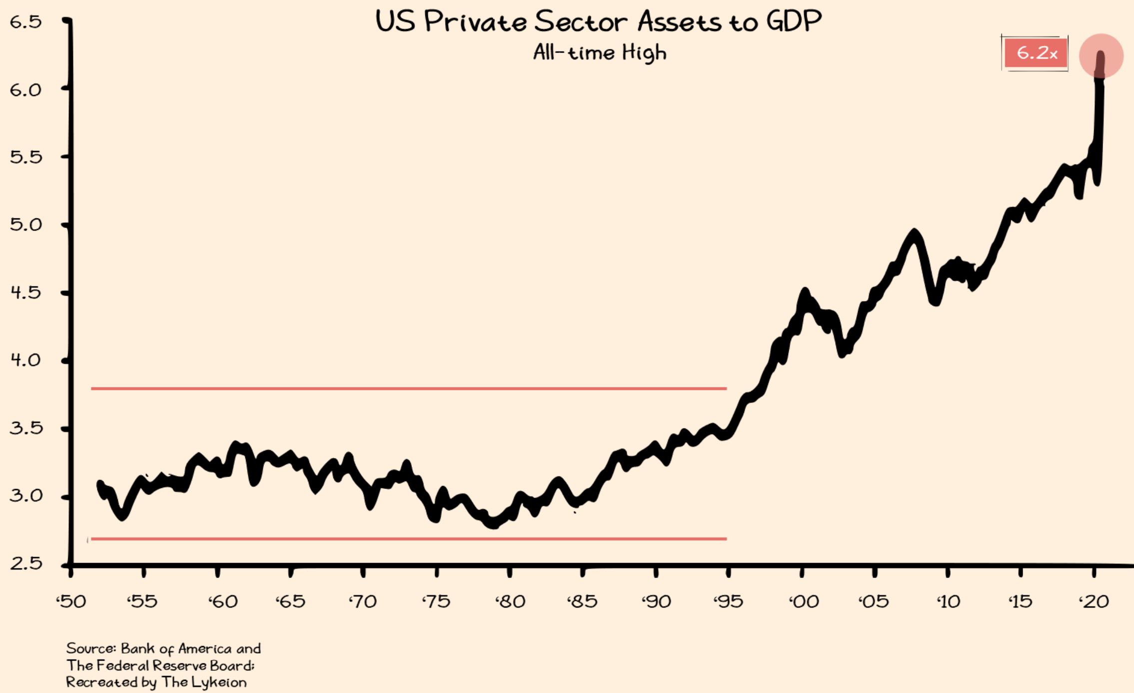
So far, the fiscal expenditure has been toward support, not stimulus, for the economy. There has not yet been any fiscal expenditure that has targeted new growth.

Therefore, austerity measures that are focused on spending cuts alone are highly unlikely to gain momentum because of populist opposition. And even if they could be implemented, they would have very limited impact, simply because the size of the global spending spree is so vast.

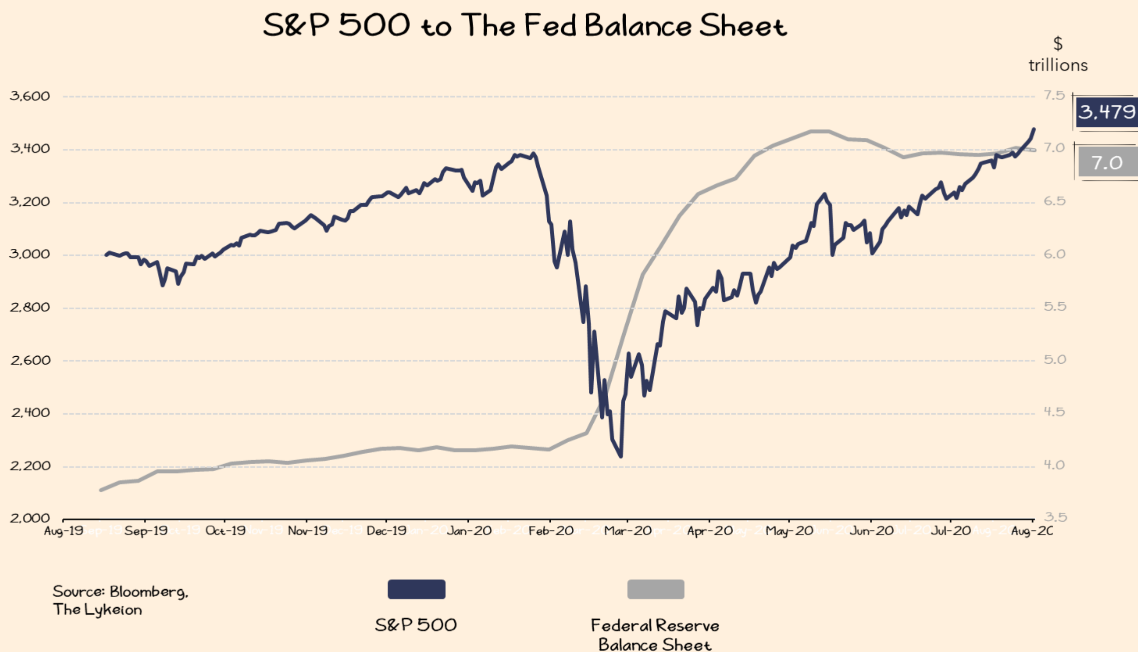
It seems that, given the amount of non-negotiable spending areas in the budget and how little impact those cuts would really have, the only way for the government to decrease the budget deficit is by increasing revenue rather than cutting spending. Paradoxically, this means that, for revenue to increase, government spending needs to increase as well. But we'll cover more of that next month.

The Rules of Austerity: Taxation

Whilst the populist movement maybe in opposition to spending cuts, it is largely in favor of targeted taxation as means to help reduce public debt burdens. **Inequality is at the highest level since the 1920's.** Bank of America's Hartnett shows that the ratio of private sector financial assets as a percentage of GDP has skyrocketed to 6.2X during the COVID crisis. The speed and scale of the move is impressive.



US billionaires have added $637 billion to their wealth during the crisis, according to Business Insider. Whilst this is partly attributable to the concentration and acceleration effects of technology, it is equally plausible that the $3 trillion of balance sheet expansion by the Fed in 2020 has worked its way into the equity market, which ends up widening the wealth gap as the wealthiest 10% of US households own 84% of all the equity market.



The size and scale of the economic bust we just experienced would normally be commensurate with a 50% decline in the equity market and a slow burning recovery in prices. Not this time though.

S&P 500 During Prior Two Recessions

Source: Bloomberg,
The Lykeion

This inequality is therefore a prime target for unusual or one-off tax measures, which are being openly discussed in many parts of the world. But what are the different tax opportunities being considered?

Support, Stimulus, Revenue

Before we review the opportunities for tax hikes, we first must recognize that many countries have initiated tax cuts or tax deferrals in order to support their economies. The OECD set out a three-phase framework for navigating the crisis: support, stimulus and revenue.

The support phase was all about keeping jobs and keeping businesses open so that when a recovery comes, businesses can quickly return to the new normal. Governments have stood in the shoes of employers by waiving a variety of tax costs to provide relief on a cash flow basis. In the UK, for instance, the government cut Value Added Tax (VAT) to stimulate spending and Stamp Duty (the UK's tax on house purchases) to help rejuvenate the housing market. The 'new normal', however, is turning out to be a very different beast from the 'old normal'. Businesses have realized that they can still be efficient with fewer employees and employees have realized that they can still be efficient from home, thus depriving urban centers of the footfall on which many businesses thrive.

Short-term tax benefits are at risk of becoming a long-term burden for government finances. Most governments are still in the support phase and are now having to think about conducting the stimulus and revenue phase simultaneously, which will clearly create conflicts as one aims at supporting economic growth (i.e. increased government spending) and the other at balancing the budget deficit (i.e. decreased government spending).

Reversing Tax Breaks

Before governments consider increasing taxes, they may first need to consider reversing the emergency tax cuts of the crisis period. But, if these cuts were implemented to stimulate demand, their reversal will have the opposite effect. Twice during the last decade Japan has increased (rather than reversed) its sales tax. On both occasions, consumption plummeted, and GDP went into negative territory. Whilst it's not apples to apples, it's at least a warning sign.

Windfall Taxes

Are there businesses out there which have made significant profits as a result of the crisis? Technology and online shopping appear to be clear winners and have been rewarded by astonishing outperformance. The ratio of the tech heavy NASDAQ100 versus the broad-based banking sector highlights this exceptional divergence.

NASDAQ100 to Banking Sector (BKX)

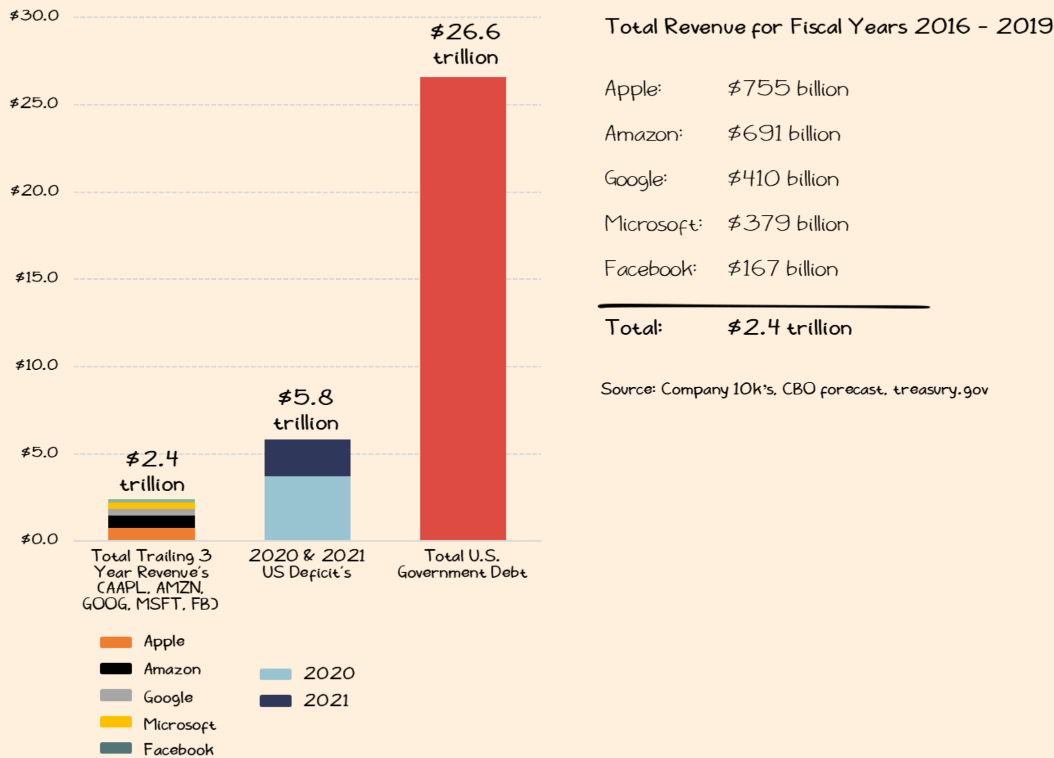
Source: Bloomberg, The Lykeion

It is, however, only a small number of stocks that are driving this performance. The top five stocks of the S&P500 in 2020 (Microsoft, Apple, Amazon, Google and Facebook) account for over 23% of the index. During the dot-com peak of 2000, the top five (Microsoft, GE, Cisco, Intel and Walmart) accounted for 18%. **Revenues for a few stocks have surged, but profitability has lagged as even these companies have incurred extra costs in order to cope with the crisis. Profits across the S&P500 have flatlined for 5 years, dipping aggressively in 2020 even as the index has surged to all-time highs.**

The astonishing outperformance of a few equities and the huge wealth increases for their founders have made the tech giants a popular target for a windfall tax. The EU has tabled the idea of a digital tax in order to recoup some of the €500 billion of emergency funds that were agreed in July, including non-refundable grants that many perceive as the first steps toward debt mutualization. For context, debt mutualization is the sharing or transfer of risk. In the case of the EU, that would currently entail the transfer of debt obligations from economies with weak public balance sheets to those with stronger finances, such as German (though currently this still remains a distant possibility).

A windfall tax is, however, extremely difficult to implement. Geographical considerations require a coordinated response by governments with divergent views and political aims. The US is currently unwilling to impose these sorts of taxes on the tech behemoths that spend considerable amounts of cash lobbying in Washington. Even within a specific jurisdiction, such as the EU, it is difficult to reach a consensus, as witnessed by the recent discord over Ireland's beneficial treatment of tech firms which stands at odds with broader European consensus. Without international cooperation, corporates will simply move their operations from one beneficial jurisdiction to another, with their teams of highly paid international lawyers always one step ahead of the respective governments.

Windfall taxes seem like a good idea and can be implemented on domestic or national champions (e.g. the UK's oil sector in 1997). Today's corporate winners are easy to identify - they are a very select bunch of international names, mostly headquartered in the US. But even there, the revenue potential is a drop in the bucket when compared to the size of the fiscal overhang. **Taxing 100% of the big five's revenue over the last three years is still less than half of what the next two years projected fiscal deficits will run…and compared to the total US government debt, well…**



Income and Wealth Taxes

General income tax increases are a non-starter in the current political, economic and social environment, except for the very highest earners. Income inequality had already been politicized prior to the COVID crisis. The uber wealthy are a clear target, but the uber wealthy are also the most mobile.

In August, a group of Californian law makers tabled the idea of a wealth tax that could hit in excess of 30,000 residents with a 0.4% tax on net worth. The idea would be to raise an estimated $7.5 billion for the state.

It seems like a simple idea, but it would be hideously difficult to implement. How do you value a person's net worth? Does the calculation take into consideration only the assets held within the state, or does it include those that are held in other regions? The wealthy are, of course, the most mobile and could simply relocate before a tax is imposed. This is precisely the reason why New York Governor Cuomo claims he has no intention of imposing one. He needs to encourage his resident's back from the Hamptons, rather than encourage them and their spending power to stay put by the beach.

US left-wing firebrand Bernie Sanders has already mooted a "Make Billionaires Pay Act" that would impose a one-off **60% tax on the gains made by billionaires since March 18th**, according to CNBC. This would raise a considerable sum, potentially $440 billion. Imposed at the national level, it would avoid some of the mobility issues that could derail a state-imposed wealth tax like the one proposed by

California. Being one-off in nature, it may discourage the sort of exile that followed the UK's flirtation with a 99% tax in the 1970's that saw many of the super-wealthy relocate overseas, thus reducing rather than increasing the tax take.

Once again, however, $440 billion is not going to move the dial on a deficit that is expanding at the rate of trillions rather than billions. Wealth taxes can quickly appear vindictive, rather than advantageous.

UK's proposal as an example

Underlining the scale of the problem and the different tools that each country possess, was the outline changes revealed in the UK's press on August 30th. They included changes to both capital gains and corporation tax. Corporation tax could rise from 19% to 24% (would still remain one of the lowest in Europe), but would further hit cash strapped businesses. **It was under fire within 24 hours of the press release.**

Perhaps less controversial is the plan to increase the capital gains tax rate from a flat rate of 28%, to come in line with income tax (which reaches 40% and 45% for higher UK earners). This would impact capital gains on second homes, but not primary dwellings and it would also hit families who live off dividend income rather than salaries. In addition, pension tax relief will also be reduced in order to claw back revenues. **The gains could total £30 billion per year, which once again doesn't really move the needle. For context, the UK's outstanding government debt has soared above £2 trillion.**

Growth through tax cuts

Many economists insist that the most efficient way to balance the books is through generating additional revenue via the economic growth that has been stimulated by tax cuts, rather than increasing taxes. Tax cuts encourage investment, which in turn leads to revenue growth. Revenue growth in the private sector increases the base from which taxes can be collected and has been the surest way to reduce deficits over recent decades. Taxable income rises when economic growth increases.

"More taxes will hurt the recovery, damage the job improvement potential, and reduce investment in the economy. More taxes mean less growth and no deficit improvement". (Daniel Lacalle, author of "Freedom or Equality: The Key to Prosperity Through Social Capitalism").

The most likely reason for tax hikes is that it would be a vote winner in the current environment. It will be a key battleground for votes in the US November Election battle. Democrat Party candidate Joe Biden has announced significant tax increases.

Simplifying complex tax codes such as those in the US and UK may help reduce government expenditure on tax collection, but the savings are trivial, insufficient to even dent the spiraling costs of the COVID-crisis. Capital is dynamic. **Extremely high taxes constitute a one-off transfer of wealth, but then discourages the generation of future wealth, killing the creation of capital.** Most tax regimes are a long-term equilibrium that have evolved over years of changing governments and leadership styles residing somewhere near the center ground of political thinking. Inertia is part of their nature and the sort of radical changes that would be needed to raise meaningful levels of revenue will

be unpalatable to all but the most radicalized voters (as the UK proved in its most recent election, when it wholeheartedly rejected an extreme left candidate from the Labour Party, handing a landslide victory to the Conservatives). As Daniel Lacalle sad, "A wealth tax in the United States would make no visible reduction in the existing deficit, let alone finance the trillions in entitlement spending that Biden has announced."

There are very few countries that are ready for this type of change. Change on this scale will require widespread rejection of the status quo and that in turn will probably require a series of full election cycles to arrive at that point. **This is why the 'radical' alternatives such as Modern Monetary Theory and the engineering of higher levels of inflation through 'infinite quantitative easing' and 'infinite fiscal spending' are starting to gain momentum and replace the austerity measures that were commonplace in the wake of the great financial crash. They seem to be the only real alternative that governments have to balance spending and revenue.**

It will be on these untested ideas of extreme fiscal and monetary engineering that we'll focus on in the next Macro edition of The Lykeion.