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INSIDE STORY

A Taxing Debate!

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A Taxing Debate!

"Let me tell you how it will be; there's one for you, nineteen for me – 'cause I'm the taxman, yeah the taxman. …If you drive a car, I'll tax the street; if you sit I'll tax the seat; if you get cold, I'll tax the heat; if you walk, I'll tax your feet… 'Cause I'm the taxman, yeah I'm the taxman." ~The Beatles

In this issue, we wrap up our series on politics and economics with discussion of an issue on everyone's mind right now: Should we raise taxes? Those on the right argue this would be harmful to the economy at a time when the economy is already weak. Those on the left say we need to raise taxes to fight the deficit. Who is correct?

Last quarter, I talked about how economic advisers to administrations tend to be economists first and political advisers second. I do not believe that it is a coincidence that while President Obama has drawn a line in the sand saying that the Bush tax cuts must go away for top income earners, two of his top economic advisers have done just that – gone away. First, Christina Romer resigned her post as Chairman of the Council of Economic Advisors. Her resignation was coincidently well-timed with the publication of a research paper she co-authored with her husband in which Romer stated there is empirical evidence that "tax increases appear to have a very large, sustained, and highly significant negative impact on output." Not exactly what her then-boss wanted to hear as he campaigns to raise taxes. Romer is now home once again, teaching at the University of California at Berkeley.

After Romer's departure, White House National Economic Council Director Larry Summers announced he would leave the administration to rejoin the faculty at Harvard where his colleagues, Alberto Alesina and Silvia Ardagna, recently published another paper stating that the empirical evidence suggests "…that tax cuts are more expansionary than spending increases in the cases of a fiscal stimulus. Based upon these correlations we would argue that the current stimulus package in the U.S. is too much tilted in the direction of spending rather than tax cuts. **For fiscal adjustments, we show that spending cuts are much more effective than tax increases in stabilizing the debt and avoiding economic downturns. In fact, we uncover several episodes in which spending cuts adopted to reduce deficits have been associated with economic expansions rather than recessions."**

Seeing reports like these published by faculty at traditionally liberal institutions such as Harvard and Berkeley brings hope that we may be getting back to a day of higher political discourse. In my youth today's debate over taxes would have been carried forth by people like Daniel Patrick Moynihan on the left and William F. Buckley on the right, while today we get Michael Moore and Glen Beck. We might all agree this is an astonishing decline in the level of national discourse.

"Everyone," Moynihan liked to say, "is entitled to his own opinion, but not to his own facts." The fact is raising taxes will be harmful to the economy and will be less effective in lowering the deficit than spending cuts. To raise the level of discourse on this issue, we might try to understand why tax rate increases are harmful to the economy, and in fact do not always produce more tax revenue, and why tax rate decreases are helpful to the economy and often actually increase tax revenues.

Taxes represent a cost to consumers and businesses alike, and revenue to the government. In my opinion, one of the best ways to think of taxes is to think of them as the price of a product or service. Let's say that we are a retailer like Wal-Mart, we'll call ourselves IC-Mart. The prices we put on our products are costs to our customers and revenue to us, just like taxes for the government. If we are going to open our store we have to decide what price to put on our various products. Our goal of course is the same goal of any store, to maximize our long-term profits, so how do we set the prices?

If we set the prices very high, we will make a lot of money on each item and have a very high profit margin. However, if they are too high, no one will be willing to buy from us and although we have a high profit margin, we will have low volume and not make much money, or potentially lose money. We could set our prices very low, in which case we could

attract a lot of customers and have a really high volume of sales, but we would have a very low profit margin on each sale, and potentially lose money once again. The trick is finding the right price where you maximize the combination of profit margin with volume. If our prices are too high, then lowering them will actually increase our revenues and total profits. On the other hand, if our prices are too low, then increasing them may make sense.

These same forces impact tax rates and revenues. The idea that simply raising the tax rate will increase revenues, or that lowering the rate decreases revenues, is just plain wrong. However, it is also oversimplified to think that you can just lower taxes and always get more revenue. Taxes work like prices and the effect of raising or lowering them will depend largely on what the current level of taxes are and what the current economic environment is like.

One of the common arguments on the left today is that Clinton raised taxes and the 1990s were a great economic success. Therefore raising taxes this time won't hurt the economy. This would be funny if it were not so dangerous. In fairness this argument ranks up there with some in the Bush administration who argued that deficits didn't matter because Reagan had big deficits and the economy did great in the 1980s. Both arguments are evidence of the less-thoughtful Moore-Beck era of political discourse and would have been immediately dismissed by the more thoughtful Moynihan-Buckley era.

The fact is that looking at total economic activity during a short period of time does not show the exact impact Clinton's tax increases had, or for that matter the impact of Reagan's tax cuts. In order to know for certain, one would need to have the ability to go back in time and create an alternative reality where opposite policies were enacted, and see the difference. The 1980s saw not only a decrease in tax rates but also a reduction in regulation and the collapse of the Soviet Union, all of which contributed to economic prosperity in the U.S. The 1990s were defined economically by a period of unprecedented world peace and the dawning of the internet age, and these factors alone were going to raise the economy regardless of tax policy. Reagan lowered taxes from a rate as high as 70%, while Clinton raised taxes modestly from relatively low rates. All of these factors must be considered. Economic theory, reason, and common sense tell us that taxes should be thought of as a necessary evil. As such they should be kept as low as possible. Do tax rates need to go up today? Will raising taxes in these uncertain economic times be catastrophic?

The answers to those questions are not nearly as clear as our political pundits wish to make you think. There is no doubt the government is going to need more revenue in order to dig out of the hole it has dug, but higher tax rates don't always equal more revenue. Remember, taxes work like prices. You are probably thinking, 'but Chuck, I don't have to buy things in your store, but I do have to pay taxes.' That is true

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REVIEW *of* ECONOMY

A slow slog but no double dip. To many, it seems as if the recession has never ended, but GDP growth was positive for the 2nd quarter coming in at 1.7% and is expected to be 1.9% for the third quarter. This is growth, but it certainly does not feel like it, especially when America is used to bouncing back so robustly from economic downturns of the past.

Unemployment remains a big issue, up since last quarter to 9.6%, and this number still understates the true unemployment number which is most likely well into double digits. Policy leaders in Washington continue to do everything in their power to destroy the job market.

Congress recessed without even proposing a budget for 2011, and without addressing what tax rates will be next year. This irresponsible behavior just magnifies the uncertainty in the minds of business leaders and will continue to hamper the economic recovery. +

REVIEW *of* MARKET

After the correction in the 2nd quarter, markets bounced back in the 3rd quarter. The S&P 500 was up 11.29%. This is not surprising as the selloff in the 2nd quarter had been over done. Although the economic data remains weak, corporate earnings remained stronger than expected and the market reacted positively.

After a brief rally in the 2nd quarter, treasuries resumed their lowly status in the bond world as high-yield once again led the way. At least we got to write something different for one quarter.

International snapped back as we thought is would, with the MSCI EAFE up 16.53%. Europe's economic issues remain but valuations are attractive. Emerging markets were the best place to be as the MSCI EM index was up 18.16%. +

MARKET *forecast*

Nothing has really happened to change our forecast. We are sticking with our 12% forecast for the S&P 500 which seems less crazy than it did three months ago. We still like domestic over developed international, although we did reduce the amount of our underweight due to attractive valuations.

The long-term emerging markets story remains in tact, so we are maintaining our overweight. We have removed our overweight to small caps as the lackluster recovery benefits stronger, larger companies.

We continue to be concerned about the bond market. Treasuries seem like a trap right now. Corporate and high yield bonds are looking fully valued. We proceed with caution in what is supposed to be the safe areas of the market. +

» *Continued –*

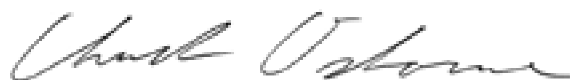
for most of us, but the wealthier you are, the less true it becomes. The "rich" have a great deal of control over how much money they make. The majority of the rich are business owners, and they can decide how much they want to work to grow their business. If growing their business means paying more in taxes but not really taking more money home, then they are likely to spend more time on the golf course and less in the office. In addition, not all taxes are created equal. The capital gains tax, for example, is a largely voluntary tax which one can avoid paying by simply refusing to sell the asset that has appreciated in value. The rich get much of their money from investment income, including capital gains.

Don't just take my word for it, look at the facts. The Bush tax cuts have been criticized for helping only the rich and in part, if not single-handedly, causing the much-discussed income gap. However, two years after the Bush tax cuts, tax revenues from people making more than $1 million a year were up 80%, from $132 billion to $236 billion. The Treasury Department estimates that without the Bush tax cuts, the top 1% of income earners would pay 31% of all taxes and the top 10% would be paying 63%. With the tax cuts, the top 1% actually pay 37% of all tax revenue and the top 10% pay 68%.

There is indeed a concerning income gap: the top 1% makes 19% of the income in America and the top 10% make 44%. I would contend that this is a symptom and not a cause of the growing cultural gap in our country, but that is a subject for another day. The fact is the Bush tax cuts actually caused tax receipts to be more progressive than they were before. This is true because unlike the rich, those who live paycheck-to-paycheck don't have any control over how much tax they actually pay. It is this reason that increasing the tax burden on the rich ultimately ends up being a tax increase to the middle class, because it is only the middle class that has the combination of enough money to tax but not enough to play the game and avoid taxation. When taxes go up, the rich avoid them and the middle class ends up carrying more of the burden.

This is the theory of why raising taxes is not a good solution for narrowing the deficit, and the research of Alesina and Ardagna shows that this holds true in the real world. However it does not leave us with the answer to our second question, Will the tax increases be catastrophic? I don't think so. They will be harmful, but probably not to the extent of being catastrophic, at least not from an equity investment point of view. I say this because I believe the tax increases are currently priced in the market. The looming tax increases are a big reason economic activity is so slow right now. If the Bush cuts are made permanent or at least extended for five years or more, I think you will see a big up tick in the market and the economy. It would surprise me if there was a big negative reaction to the cuts lapsing.

In the long run, I would side with Winston Churchill who once said, "We contend that for a nation to try to tax itself into prosperity is like a man standing in a bucket and trying to lift himself up by the handle." Raising taxes will not get us out of the mess we have created. The only way out is to grow our way out, but that requires growth friendly policies from our government. That will require a massive change in direction.



Chuck Osborne, CFA, *Managing Director*