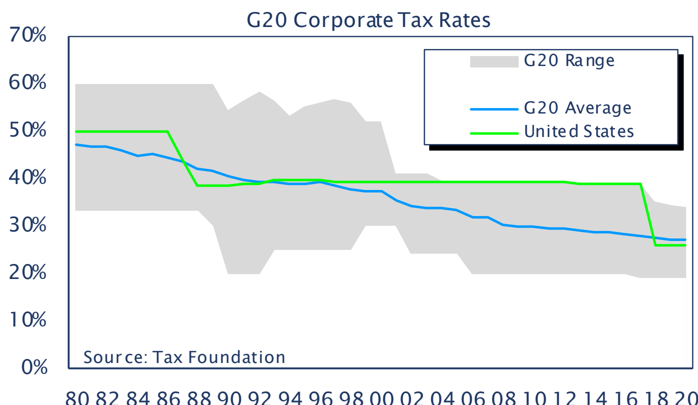
INVESTMENT UPDATE

Ex-Fed Chair and current Treasury Secretary Janet Yellen has been busy this month, having just spent a few days in London with her Group of Seven (G7) colleagues. One of the big topics at this year's summit was taxes, a particularly critical subject given the massive expenses—and fiscal deficits—that the world's largest developed economies are racking up as policymakers continue to battle the effects of COVID.

Yellen's primary message to the group was that there has been a "race to the bottom" among major economies in continually lowering their domestic corporate income tax rates, as sovereign governments try to attract foreign companies to relocate to their shores. As the chart on this page demonstrates, falling corporate tax rates are not just a recent phenomenon; they've been dropping for at least 40 years. The chart also shows that, after a long time holding the line, the US made a significant cut to our own corporate tax rate in 2017, where it moved towards the middle of the range for the broader Group of 20 (G20) countries (note that for the US, the tax rate includes an imputed average state tax).



The proposal that the G7 agreed to, at least in principle, sets a minimum corporate tax rate of 15% for member countries. You may have already noticed that this 15% rate is below that of every G20 (not to mention G7) member country. Why set a rate below where everyone is currently? For one reason, there are countries outside of the G20, like Ireland, Lithuania, and Latvia, which currently have corporate income tax rates at or below 15%; drawing a formal line in the sand helps to set a minimum acceptable limit for any member country thinking about moving lower.

There are additional benefits to the agreement, including the proposed elimination of the complicated and unpopular system of digital services taxes imposed by European countries, which the Biden administration believes unfairly singles out US tech companies. Digital services taxes would be replaced by a minimum 15% tax on the largest multinational firms which have an operating profit margin of at least 10%. The Biden administration believes the taxes from these large global companies will generate $500 billion in additional tax revenue to the US Treasury over the next decade.

Some would say these proposals and agreements are largely symbolic, but they are best seen as part of a much larger effort by the US to shore up its finances, as we are simply not generating sufficient tax revenue to pay for the services the federal government provides. This was already a big problem pre-COVID, but as we'll see, events over the past year have made the job far more daunting.

As the chart on the next page shows, federal spending as a percent of US GDP has been steadily rising over the past seventy years. In the 1960s and 70s, social programs were ramped up, as was defense spending, including the cost of the Vietnam War. Throughout the 1980s and 90s, outlays dropped back below the 20% of GDP level, as some social programs were trimmed, while interest expense on federal debt came down as interest rates declined. Meanwhile, receipts (i.e., tax revenues) remained fairly steady from the 1950s through the 1990s, averaging around 17% of GDP, with ups and downs linked closely to the health and growth of the US economy, as one would expect.

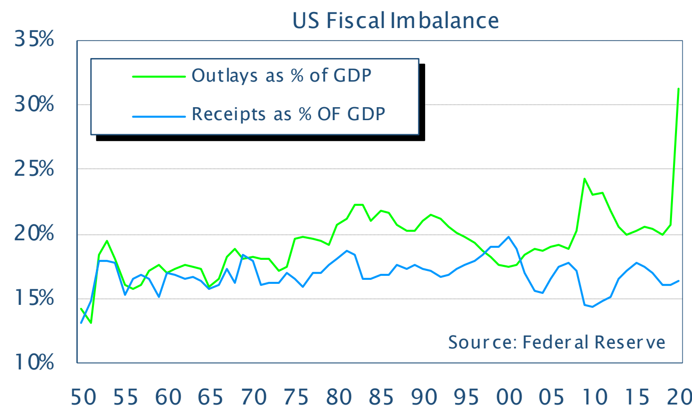
By the late 90s, Cold War defense spending was cut back, while tax revenues grew (Democrats pushed through a rare tax rate hike), to the point that the US budget came back into a surplus for a couple of years. Defense spending ramped back up post-9/11, and cuts in marginal tax rates led to a drop in revenue and a return to big deficits. This pattern was repeated again in the wake of the financial crisis, when the budget deficit rose to 10% of US GDP, the highest since World War II, and again last year, when deficit spending skyrocketed as extended benefits to households and businesses reached levels unseen in modern US history.

Today, total federal debt stands at 125% of US GDP. That's double what it was prior to the financial crisis, and above the critical 100% level, a degree of indebtedness which has trig-

gered austerity measures in both developed and less-developed economies in the recent past. Few would argue that the impact of COVID on the US economy demanded a strong fiscal response to offset the 30+ million jobs lost last year. Extended benefits helped to keep families' cupboards stocked, and provided a sense of security for those who could not work. But the cost of these programs has had a huge negative impact on our fiscal balance, and will have to be repaid over time.

With all this in mind, and considering that the US is not exactly an outlier among other Western economies in running big fiscal deficits over the past few years, it's perfectly understandable that Biden and the G7/G20 are desperate to, at the very least, hold the line on tax rates. And clearly, we should expect to see the end of emergency/extended benefits in the coming months as folks return to work and life begins to resemble something closer to normal than what we've lived through over the past 15 months. But simply holding the line on corporate taxes is not going to close the gap between outlays and receipts.

The simple fact of the matter is that we are moving further away from, and not closer to, a balanced federal budget. The chart on this page clearly shows that even during periods of solid economic growth, when businesses and households are making money, tax receipts as a percent of GDP haven't come in above 18% in 20 years, and have been on a downward trend since G.W. Bush lowered tax rates early in his first term. The recent highs in tax receipts were in 2015 and 2016, after Obama raised the top marginal tax rates. Even though the economy grew strongly in 2017-2019, tax receipts dropped due to Trump's corporate and household tax cuts.



Meanwhile, during this same 20-year period, spending has been on an irregularly rising trend. Now the Biden administration is pushing for massive increases in federal spending over the next decade—up to $4 trillion in new spending—including $2 trillion in infrastructure spending, $950 billion in education and family support programs, and approximately $500 billion each in additional defense spending and non-discretionary spending. Depending on which side of the aisle you're sitting, these plans are either vital for the future of America, or pork-barrel politics at its worst.

We are politically agnostic, but are sympathetic to those who ask, "How will we pay for these programs?" If you're thinking "higher taxes," you'd be correct. After the 2018 tax cut, we noted that the reductions in corporate taxes, in particular, would probably get reversed by the next Democratic administration, so there's no surprise here. But an increase in the statutory corporate tax rate (from 21% to 28%) is just the beginning. Other notable changes include the aforementioned 15% minimum tax rate on book income of over $2 billion; a doubling of the global intangible low-tax minimum tax to 21%, along with new taxes on foreign fossil fuel income (and elimination of fossil fuel tax preferences in favor of various clean energy tax credits); limits on deductions for interest expense; and removal of deductions for offshoring jobs.

On the individual tax front, there are fewer changes, the main ones being an increase in the top income tax bracket from 37% to 39.6% (for families making more than roughly $500,000); the elimination of favorable treatment for long-term capital gains, which will be taxed as ordinary income for those with adjusted gross income above $1 million; elimination of preferential treatment of carried interest and the imposition of a 3.8% net investment income tax on incomes above $400,000, even for "pass-through" business income; and various increases on estate taxes.

The non-partisan Tax Foundation analyzed the Biden budget proposals, and calculated that these changes would increase corporate tax revenue by approximately $1.7 trillion over ten years and individual tax revenue by $660 billion over the same period. But there are tax credits in the budget as well, for expanded child and dependent care, which will reduce tax receipts by around $1 trillion over the next decade. They did not calculate the impact of increased tax enforcement that the budget claims will boost revenue by $718 billion in ten years, as there is no standard methodology for these types of calculations.

If you're doing the math in your head, you'll find that the numbers do not get us closer to the goal of a balanced budget, but instead will increase the deficit by anywhere from $1 to $3 trillion over the next decade, even if we include the revenue increases for enhanced enforcement by the IRS. The Tax Foundation also estimated that these changes on net will impact the US economy by reducing GDP by approximately 1% per year, and will result in job losses of 165,000 over the decade.

Obviously, these figures will change if the spending plans are cut back (which looks likely); but even a scaled-down proposal won't get us much closer to closing the budget gap. Tough decisions on spending programs and tax policies will be necessary for that to happen, and there seems to be little political will, on either side of the aisle, to make that happen.