# insight

July 2011

## Tax and Spend Borrow and Steal

“Annual income twenty pounds, annual expenditure nineteen shillings and six pence, result happiness. Annual income twenty pounds, annual expenditure twenty pounds and sixpence, result misery.” So said Mr. Micawber in David Copperfield.

Charles Dickens’ philosophy in 1850 still applies to individuals. Governments thought this the correct way to run their Budgets until Keynes came along and discovered some examples where this didn’t work. Until then if Governments spent more than their income it was assumed that this would lead to inflation, and that is indeed what did happen in many examples especially Germany in the 1920’s. This is the reason why in the 1930’s the British Government cut its expenditure when its income fell due to a lower tax intake due to unemployment. This had the effect of making unemployment worse.

What bemused Keynes was that sometimes when Governments spent money that it did not have, it did not lead to inflation. Those sometimes were when there was so much slack in the economy that spending money just took up the slack. In the 1940’s the United States spent huge amounts on building armaments which led to an increased standard of living without inflation. The reason was that there was so much slack in the economy.

It is Keynes’ theories that now make up the policies of nearly all western economies, overspending when unemployment looks bad, and then gathering more monies in when the economy does better. That is balancing the budgets over time. The trick is knowing when to stop spending. The trouble is that Governments like spending money as it buys them votes. The last Labour Government promised to balance the books over a period of time. Their trouble was that the time got longer and longer, and they left office without having done so.

Governments borrow money so that they can spend it. This is fine provided it will be repaid. Sometimes it doesn’t get repaid. This is called a default. British Governments have never defaulted, unless you go back to 1642, and then technically it was the King (Charles), not Parliament.

The United States has also never defaulted, but their constitution is such that the Government needs the support of Congress when re-negotiating loans. Currently the Republicans are making it difficult for Obama; hence some uncertainty in the markets, but this should resolve itself by August.

Other Governments *have* defaulted on their Loans. Czarist Government Loans weren’t going to be honoured by Lenin and his successors. In 2001, Argentina froze personal bank accounts, and eventually allowed those who held U.S.Dollars to exchange these only for Argentine Pesos at a quarter of their previous exchange rate, thus pocketing the difference. This seems like stealing to me. What will happen in Greece? Will they finally say they can’t pay back, and many Governments and foreign banks as well as Greek banks will lose fortunes?

The Roberts Partnership

80 Mosley Street
Manchester
M2 3FX

T. 0161 238 7474
W. www.robpar.co.uk

A cynic might also examine inflation. After all, money halves in real value every 10 years at 7.5% inflation. Thus unless a net after tax rate of return is not greater than inflation, the Government is paying back less than it has borrowed. Probably it can be considered stealing only if the Government intends to have that high rate of inflation.

What is happening in Britain now?

The Government owes a lot of money. It has to reduce its expenditure or raise taxes or both. If not then inflation will occur, and it may not be able to borrow monies because of a lack of trust that the economy will come under control. This is what is happening in Greece now. The fact that the reduction in expenditure has to occur is not denied by the Opposition, it is only a question of timing. Ed Balls especially states that the Coalition Government is doing it too quickly and will lead to serious unemployment. So far it's not looking like he is correct.

How does all this affect the Stock Markets?

If we could just rely upon UK economics, then it is likely that two years from now we will be in a better state. As stock markets tend to look two years ahead, then the current state of the stock market looks fair value. In the U.S. the current funding problem will be resolved, and when that uncertainty is taken out, it should be less volatile. The overhanging problem however is Greece and other Euro countries, and this uncertainty will dominate European stock markets so that volatility is likely to remain. That does not mean to say however that all European markets are very risky at this point. Great opportunities lie in the more northern European countries, and indeed international companies.

As always, diversification is required, and companies with likely rising dividends very attractive.

**Rants 1& 2.**

1. Chief Executives of Footsie companies get paid too much. The average is about £3.4 million a year. The average income of all UK male employees is £28,000 a year. Last year Chief Executives' pay rose by 32%. Average pay increases for all employees was some 3%. The pay of Chief Executives has little relation to the increase in value to others. Why does it happen? They are rewarded by their remuneration committees. In the process many backs are scratched. Can it be stopped? Only possibly by shareholders replacing the remuneration committees.

The Roberts Partnership

80 Mosley Street
Manchester
M2 3FX

Does it matter?

If a very small number in a society benefit substantially, even though the vast majority are not poor in the absolute sense, a sense of injustice can arise, and gross disparities may well lead to social upheavals. Unnecessary scare-mongering? History would suggest not.

2. Capital Gains Tax has never been a sensible tax, but it is even less so now. It produces little revenue for the Treasury and is exceptionally complex even for employees of HMRC to fathom. To that cost should be added all the record keeping required by individuals, and the time and cost spent by them and their advisers on the computations and advice considered when decision making takes place. It is a desperately bad tax from an economic point of view because it encourages holding onto a bad investment which may have done well in the past but is not doing so now. CGT has always been a political football. Its rates are now 28% and 18%, the rate depending on an individual's marginal rate of income tax. Importantly there is now no allowance for inflation or the length of time an asset is held. Thus even though an asset has stayed the same in real value terms, it will be taxed when sold. Really the tax is now a wealth tax but administered in a cack handed way as it is only paid when the asset is sold, and avoided altogether on death.

   Introducing a sort of allowance for inflation may be in the Coalition's aims, but it is well down the agenda, and unfortunately abolishing the tax would be the equivalent of political euthanasia.

**Prediction**

For about 25 years now I have read or heard of predictions to cut higher rate tax relief on pensions. I never thought this particularly likely because of the practical difficulty of making this fair vis-à-vis those in non contributory pension schemes. However the Treasury's actuaries have thought up a scheme of revenue extraction to do with the new rules regarding paying too much into a pension scheme for such members and no doubt they could think up some whizzo scheme for taking something out of the pension fund relating to the higher rate tax relief.

Recent rumours that George Osborne has been looking at this again have been denied by the Treasury. It is however a very attractive benefit for higher rate taxpayers who have earned income, and for all you earners making hay whilst the sun shines could be a good motto to follow.

The next three months could be interesting, but make sure that you have a good holiday,

With best wishes for the summer

**Andrew Roberts**