The Absolute Return Letter
November 2009

Time to Cut Taxes?

"The only thing worse than rescuing the system would have been not to do so."

\- Martin Wolf

Welcome to the third letter in our four letter series about major trends defining the future of the world we live in. I kicked off back in September with a piece on energy supplies and last month I took a closer look at the demographic outlook. This month my focus will be on government and why our leaders need to think outside the box to solve the crisis we find ourselves in. I have found this topic particularly difficult to handle – probably because I am somewhat outside of my comfort zone. I sincerely hope you enjoy it anyway.

Let me introduce the main characters: First, the banks which are veering out of control (again!). Next, our central bankers and regulators who are doing a better job than broadly perceived; however, they lack the political support to tackle a financial system which thrives on excesses. And, just to complete the picture, we are up against a political system which is institutionally corrupt and politicians who are hopelessly narrow-minded and unable to look beyond the next election.

Corporate Announcement

We are delighted to announce the launch of **Quartet Capital Partners LLP**, a new private client wealth management business which we have established in partnership with Colin McInnes, a former director of Berry Asset Management PLC.

For a long time it has been our desire to develop a more traditional wealth management business, and we believe we have found the right partner in Colin. If you like the Absolute Return Letter and are looking for somebody to manage your wealth, you should have a word with Colin, as the macro themes highlighted in this letter will be reflected in the asset allocation at Quartet Capital.

Quartet Capital provides innovative investment solutions for private clients across the globe. It seeks to adopt a different approach to wealth management compared to many of its peers. Rather than trying to shoehorn clients into someone else's investment model, it custom builds the investment offering around them. Clients are treated as individuals, both in terms of the personal attention they receive as well as the investment solutions Quartet Capital proposes. Each client's requirements are different, and so each portfolio will differ from others, although the same investment themes run through the portfolios the firm manages.

Portfolios are invested on a multi-asset basis taking inspiration from the approach adopted by the highly successful Yale and Harvard University Endowments. Studies have shown that, over the longer term, asset allocation decisions contribute the majority of a portfolio's performance. It is on both strategic and tactical asset allocation that Quartet Capital primarily focuses and where the firm's expertise lies.

All assets are externally held at top custodians and banks and Quartet Capital is authorised and regulated by the Financial Services Authority in the UK.

For further information please contact:

Nick Rees:
+44 20 8939 2903
nrees@arpllp.com

Colin McInnes:
+44 20 8939 2920
cgm@quartetcapitalpartners.com

Authorised and Regulated by the Financial Services Authority.
Registered in England, Partnership Number OC303480.
Pine Copse, Whitmoor Common, Worplesdon, Surrey, GU3 3RP

Less means more

Since the early 1980s, we (or at least those of us living in an Anglo-Saxon country) have lived in a world where less has carried the meaning of more. Reagan and Thatcher both genuinely believed in small government. Fundamentally, they shared the view that people respond to economic incentives, but it was not only about tax. The public sectors in both countries were slimmed down and much red tape removed. Even the City of London underwent drastic transformation - the so-called Big Bang. The economy reacted favourably in both countries and stock markets began a journey which lasted more than two decades and delivered the most powerful bull market of all times.

But, as we all know now, it ended in tears. Like children in a candy shop, we couldn't control ourselves. Greed took over and whatever control mechanisms there were in place failed miserably when we needed them the most. It is therefore perfectly understandable that both regulators and politicians want more control. I just wish that our elected leaders would put their self-interest to the side for once and do what is right for the country. Unfortunately, that is about as likely as the sun not rising tomorrow morning.

Too big to fail or...?

Central to the discussion is the role of our banks. Are some banks really too big to fail or are they just too politically connected to fail? Following last year's near Armageddon, most banks desperately need fresh capital and our monetary authorities - with plenty of encouragement from our Government – have created an environment which has handed banks a license to print money. In a budget constrained world, such a policy was always considered a more palatable way to re-finance the banking sector than the alternative – pumping more hard earned tax payer money into the banking system. So far so good.

Unfortunately, little seems to have been learned from the excesses of recent years. As we have seen time and again, easy money leads to carelessness, paving the way for future bubbles, and why should it be any different this time? A system where profits are privatised and losses socialised is destined to fail. It is the old moral hazard argument all over again and it encourages extreme risk taking. It is nevertheless the system which is being practised all over the world at the moment. And if politicians believe they can solve the problem by capping bonuses, they are less intelligent than even I thought.

In a recent article in the Financial Times, Willem Buiter made some interesting observations on this subject:

"Will things be different during the next boom/bubble? The next credit and asset market boom will generate massive profits and generous tax revenues. The same phalanx of lobbyists will again descend on regulators, legislators and members of the executive branch of government. New and exciting financial instruments - superprime lifegages perhaps - will be demonstrated by highly paid hirelings from academia to have unprecedented potential for diversifying, sharing and extinguishing risk. It will be different from every other boom in the past. It will be a truly sustainable euphoria - a high for humanity. And the regulators/supervisors will be convinced, seduced, intimidated or co-opted."[1]

Bank of England Governor Mervyn King recognises the problem:

---

1 http://blogs.ft.com/maverecon/2009/10/after-subverting-bank-insolvency-our-leaders-are-now-about-to-make-a-mess-of-liquidity/

"It is important that banks in receipt of public support are not encouraged to try to earn their way out of that support by resuming the very activities that got them into trouble."[2]

As a possible solution, King has proposed a re-introduction of the rules which used to be in place, prohibiting retail and investment banking activities under the same roof. For speaking his mind, he was publicly reprimanded by the Prime Minister, who deemed such a policy response "simplistic and out-of-date". Perhaps I should mention that banks are amongst the largest contributors to the political parties in this country. So much for integrity.

It is time to move on

A friend of mine attended an investment conference recently, where one of the speakers was the CEO of a world famous investment bank. When the talk turned to bonuses, the CEO stated flatly that "it is time to move on" (no prizes for guessing which bank). Perhaps it is time to move on, but not in the direction he wants to go. When US tax payers were forced to cough up $185 billion last year to save AIG which in turn saved an entire industry bar Lehman Brothers, the man on the street would be forgiven for expecting a touch more humility and sensitivity from those running our banks.

I am not for one second arguing that bonuses should be regulated. It is simply the wrong way to address the problem. But society is faced with a much broader problem when bankers carry on living in their ivory towers whilst the canyon between them and the rest of society grows bigger and bigger. *"Take risks and you will be amply rewarded; fail and the tax payer will bail you out"* is about the only lesson they seem to have learned from the past two years. The solution? Force banks to take less risk. It is absurd that many of our banks are still levered 30, 40 and some even 50 times. With less risk, their profits in good times will be much lower (and their losses in bad times correspondingly smaller), and the reduced profits will automatically drive down bonuses.

Here in the UK, two banks (Royal Bank of Scotland and Lloyds Banking Group) are being forced to break up their businesses. *If you are too big to fail, you are too big to exist*, seems to be the philosophy. However, the government deserves little or no credit for that decision. It is in fact the EU Commission which is forcing the government to take this draconian step. Who said nothing good comes out of Brussels? It is a much more constructive move than the pathetic focus on bonuses, but it doesn't address the basic problem – banks must reduce their gearing.

The Laffer curve

Regulating banks more effectively is only half the story, though. As already alluded to, governments all over the world are faced with rising debt, threatening to bankrupt many countries. Several political leaders have already stated publicly that taxes will have to rise, but is that really the appropriate policy response to a dire fiscal outlook? Let's turn our attention to the so-called Laffer curve[3]. The Laffer curve simply states that there is always a revenue optimal tax rate. The Laffer curve does not provide any evidence as to what that tax rate actually is. As illustrated in chart 1 below, not surprisingly, when the tax rate is zero, the tax revenue is also zero; likewise when the tax rate is 100%. Somewhere in between, the optimal tax rate is to be found. The obvious implication of this relationship is that, over and above a certain point, the tax revenue falls once the tax rate is increased.

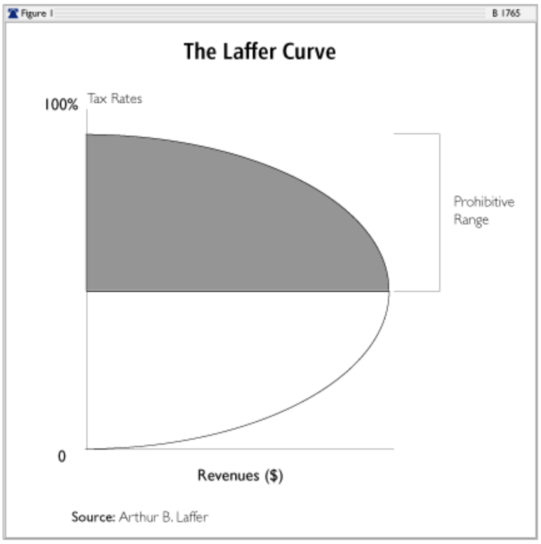
---

2 *http://www.ft.com/cms/s/0/97e0f540-bda9-11de-9f6a-00144feab49a.html*

3 *Named after Arthur Laffer, who was a member of Ronald Reagan's Economic Policy Advisory Board during Reagan's two terms as US President.*

Behind the relationship between the tax rate and tax revenues lies the simple notion that a change in the tax rate has an arithmetic as well as an economic effect on tax revenues. The arithmetic effect of a tax hike is always positive whilst the economic effect is always negative due to the effect it has on output, employment, consumption, etc. In other words, the two effects *always* move in opposite directions.

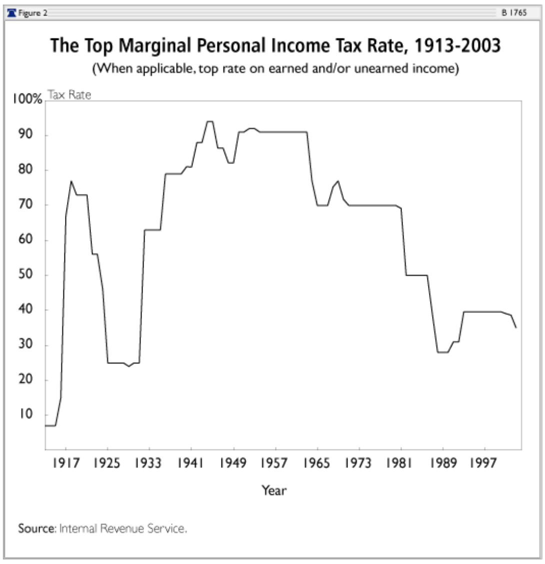
Chart 1: The Laffer Curve



Source: http://www.heritage.org/research/taxes/bg1765.cfm

It was this basic idea which drove President Reagan to lower tax rates in 1981, yet he was by no means the first US president to do so. In the early 1920s Presidents Harding (1921-23) and Coolidge (1923-29) had reduced the top rate from a whopping 77% to 25% and, in the early 1960s, President Kennedy had also introduced massive tax cuts. The top rate had peaked at 94% (!) by the end of World War II and he brought it down to 70% (see chart 2).

Chart 2: US Marginal Tax Rates



Source: http://www.heritage.org/research/taxes/bg1765.cfm

Compelling evidence

So how did these tax cuts actually affect tax revenues and overall economic growth? The evidence is quite compelling (see table 1 below). During the four years prior to 1925 (the year in which the 1920s tax cuts were fully implemented, US tax revenues declined by 9.2% per year. In the following four years, tax revenues rose 0.1% per annum. The Kennedy experience was equally convincing. In the four years prior to the 1965 tax cuts, tax revenues rose by 2.6% per annum. In the following four years, revenues rose by 9.0% per year. Finally, in the Reagan years, tax revenues declined by an annual rate of 2.6% during the four years leading up to 1983, whilst revenues grew by 3.5% annually during the subsequent four year period[4].

Table 1: US Tax Revenues around Major Income Tax Cuts

President	Year	4 Yrs Prior	4 Yrs After
Harding-Coolidge	1925	-9.2%	+0.1%
Kennedy	1965	+2.6%	+9.0%
Reagan	1983	-2.6%	+3.5%

Source: http://www.heritage.org/research/taxes/bg1765.cfm.
All numbers are inflation-adjusted.

Furthermore, in all three instances, economic growth accelerated following the tax cuts. For example, between 1978 and 1982, US GDP growth averaged 0.9% per year in real terms. Between 1983 and 1986, the economy grew by 4.8% in real terms, so the case in favour of tax cuts appears to be pretty compelling.

Other factors to be considered

It is not always one-way traffic, though. In his first term as President, Clinton actually increased taxes in 1993 and what followed? One of the biggest economic booms of all times. Other factors impact tax revenues as well. In the case of Clinton, he presided over an economy which benefited immensely from globalisation and an IT boom, the likes of which had never been seen before.

Here in Europe, total tax revenue as a % of GDP is, on average, much higher than it is in the United States (chart 3). Whilst European growth rates have, admittedly, been modestly below US growth rates in recent years, there is no evidence to suggest that the higher tax rates have done significant damage to European growth. If that were the case, Denmark and Sweden should suffer the lowest growth rates amongst developed nations. In fact, the two Scandinavian countries have enjoyed comparatively high economic growth in recent years.

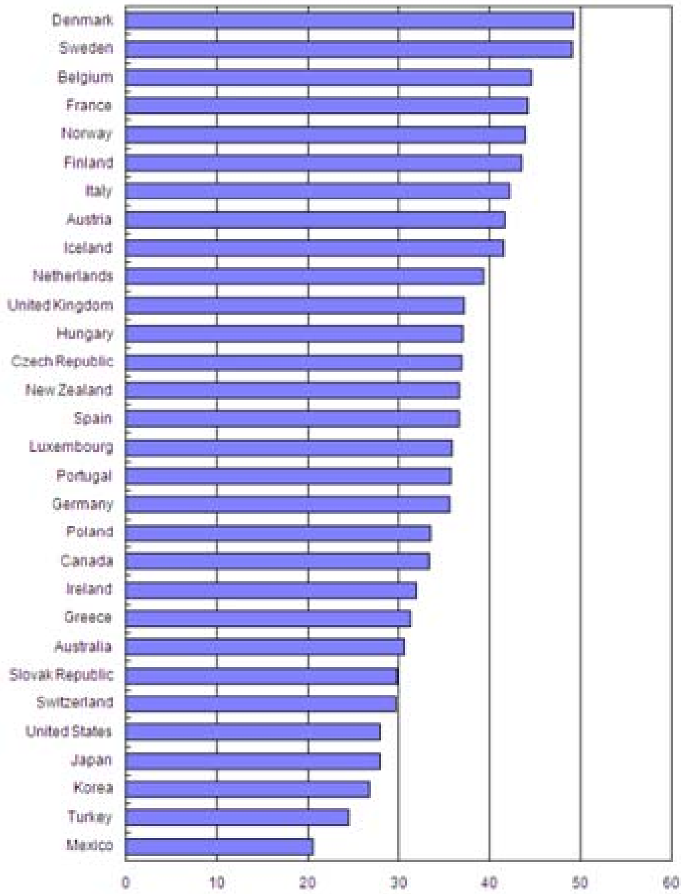
Also, corporate earnings have been as strong here in Europe as is the case in the US, and European stock markets have actually vastly outperformed the US market in recent years. So it is hard to drive the argument that lower taxes always lead to higher economic growth and stronger stock market performance. However, it is noteworthy that, in the United States, 3 major income tax cut programmes have been implemented in the last 100 years. In each and every case, tax revenues have grown, GDP growth has accelerated and there has been significant job creation. Can you ask for any more than that?

The canary in the coal mine?

One thing is sure, though. Given the rapidly rising public debt all over the OECD area, economic growth must be secured at any price. Anything else will be devastating longer term. Japan stands out as the black sheep with public debt-to-GDP reaching 218% this year. Japan has tried many things to drag itself out of the quicksand but to no avail.

[4] *Source: http://www.heritage.org/research/taxes/bg1765.cfm*

Chart 3: Total Tax Revenues as % of GDP (2006)



Source: OECD

Its stimulus programme has been very Keynesian with a multiple of public spending projects over the past couple of decades, most of which have been a terrible waste. Now, 20 years later, Japan is falling into the precise trap our economic adviser Woody Brock is warning so vehemently about. GDP growth is slow or non-existent. Debt continues to grow rapidly and sticky deflation makes an already difficult situation almost impossible to deal with.

So far, Japan has just about gotten away with it because they have had easy and cheap access to credit. But what will happen if (when) that changes? It is no longer inconceivable that Japan will default on its sovereign debt at some point over the next decade. Ambrose Evans-Pritchard has written an excellent piece in the Daily Telegraph recently about Japan's predicament, which you can read here.

Woody Brock did a study earlier this year where he pointed out the danger of allowing public debt to grow much faster than GDP for an extended period of time. As is evident from chart 4, should the United States (or any other nation for that matter) fall into that trap, the implications could be very dire indeed. Think Zimbabwe. Therefore, given the large escalation of public debt, policy makers should aggressively pursue a pro-growth policy. Anything else could have fatal consequences.

Chart 4: US Federal Debt Outlook

8% Federal Debt Growth Scenario

		Debt Growing @ 8% and GDP @				
		-1%	1%	2%	3%	4%
2010	Debt (trillions)	$12	$12	$12	$12	$12
	GDP (trillions)	$14	$14	$14	$14	$14
	Debt ÷ GDP	**0.9**	**0.9**	**0.9**	**0.9**	**0.9**
2015	Debt (trillions)	$18	$18	$18	$18	$18
	GDP (trillions)	$13	$15	$15	$16	$17
	Debt ÷ GDP	**1.3**	**1.2**	**1.1**	**1.1**	**1.0**
2025	Debt (trillions)	$38	$38	$38	$38	$38
	GDP (trillions)	$12	$16	$19	$22	$25
	Debt ÷ GDP	**3.2**	**2.3**	**2.0**	**1.7**	**1.5**
2035	Debt (trillions)	$82	$82	$82	$82	$82
	GDP (trillions)	$11	$18	$23	$29	$37
	Debt ÷ GDP	**7.5**	**4.6**	**3.6**	**2.8**	**2.2**
2045	Debt (trillions)	$177	$177	$177	$177	$177
	GDP (trillions)	$10	$20	$28	$39	$55
	Debt ÷ GDP	**18.0**	**8.9**	**6.3**	**4.5**	**3.2**

Source: www.sedinc.com

Cut income taxes!

Empirical evidence suggests that recessions destroy tax revenues; tax cuts don't. And increased tax revenues are precisely what we need to solve our fiscal crisis. It is therefore tempting to argue that now is the time for a reduction in income tax rates. Unfortunately, and true to form, our politicians will most likely do exactly the opposite. And the Swiss will be laughing all the way to the bank as more and more disenchanted people in this country flee Britain and Gordon Brown's strait jacket to start a new life in Switzerland.

Niels C. Jensen

Absolute Return Partners

Absolute Return Partners LLP is a London based private partnership. We provide independent asset management and investment advisory services globally to institutional as well as private investors, charities, foundations and trusts.

We are a company with a simple mission – delivering superior risk-adjusted returns to our clients. We believe that we can achieve this through a disciplined risk management approach and an investment process based on our open architecture platform.

Our focus is strictly on absolute returns. We use a diversified range of both traditional and alternative asset classes when creating portfolios for our clients.

We have eliminated all conflicts of interest with our transparent business model and we offer flexible solutions, tailored to match specific needs.

We are authorised and regulated by the Financial Services Authority.

Visit www.arpllp.com to learn more about us.

Absolute Return Letter Contributors

Niels C. Jensen	njensen@arpllp.com	tel. +44 20 8939 2901
Jan Vilhelmsen	jvilhelmsen@arpllp.com	tel. +44 20 8939 2902
Nick Rees	nrees@arpllp.com	tel. +44 20 8939 2903
Tricia Ward	tward@arpllp.com	tel: +44 20 8939 2906