

BEFORE THE NEXT CRISIS

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February 4, 2019*

These should be the best of times. World poverty is at a record low, and world incomes are at a record high. People in most countries have never had greater economic opportunity and prosperity, yet a great disquiet is unsettling many around the globe.

Global net government debt is at a record high and growing. The great curse of democracies is that the people demand that their political representatives give them more “free stuff” in terms of healthcare, retirement and poverty protections, etc. Yet tax rates in many countries are already above the long-run maximizing rate. Responsible fiscal policies are evaporating country by country.

Populations are aging throughout the world, resulting in an increasing percentage of elderly who must be cared for by a shrinking proportion of working-age populations. Many are growing increasingly pessimistic about the debt/demographic dilemma.

Monetary policy seems to have hit a wall. During the Great Recession, major central banks greatly increased their holdings of government securities, without developing a coherent plan for unwinding what they had done. Traditional monetary policy is now dead!

I recently received a note from a colleague who is one of the best economists that I know and who has held a number of high-level government positions. He observed: “The entire system has become so illogical, so convoluted and built by repeated applications of flawed government policies attempting to solve previous problems created by government efforts to correct still earlier problems it created ad infinitum, that economic theory offers no explanations/predictions inside the limits.”

The only thing that is clear is that the present situation cannot continue forever. One can only speculate how it will end – a general collapse, a rolling readjustment (as has happened in Greece) country by country, or a wake-up in some key countries whereby some courageous and knowledgeable leaders are elected to effect the necessary fiscal changes.

In this issue, Dennis Richardson observes that the “Fed seems to be in a desperate race toward normalization before a downturn in the economy arrives so that it has some tools to help fight the recession. The Fed’s conundrum is whether it can achieve normalization without causing the economic downturn for which it is trying to prepare.” Richardson presents a brief history of how the Fed got where it is, and then reviews the various alternative actions the Fed can now take, including doing nothing.

The policy dilemma that U.S. policy makers are facing is modest compared to what the Japanese officials now confront. Orphe Pierre Divounguy gives what can only be characterized as a depressing overview of the Japanese situation. “For the past decade, Japan’s population has been declining. This decline has been driven by decades of extremely low fertility rates and a recent uptick in the number of deaths among the oldest population in the world.”

The working-age population is now declining, while entitlement spending on an aging population is increasing. The debt burden is already at world record highs, and any further increase in taxes will only slow growth even more, reducing real tax revenues and making the situation worse. Old-age pensions and entitlements need to be reduced, but this is a political non-starter as the young correctly understand that if the state is not taking care of their parents and grandparents, they will have to – resulting in a reduction of their living standards.

The Japanese situation is only a forerunner of what many of the world’s advanced economies are facing. Parts of Europe are now suffering from negative population growth, and it is only a matter of time before Europe as a whole and eventually even North America have a declining population. More dependent old people and few workers will lead in one way or another to falling living standards – with no obvious way out – other than increasing birth rates and cutting entitlements.

Various schemes by governments to increase birth rates, such as tax credits for children, have not shown great success where they have been tried. One of the ironies is that as pay between men and women increasingly reaches parity, the opportunity costs for a woman to drop out of the work force to have children

greatly increases – and a tax credit to fully offset this cost is likely to be so high as to undermine what is increasingly becoming a shrinking tax base.

To avoid cutting pensions, governments could do more to reduce or even eliminate other government programs, but each of these also has its own political constituency, which will resist any reductions – the education, medical, infrastructure and defense spending lobbies are not going to wither and go home without a fight.

A major target of those seeking to obtain more revenue for governments are “greedy” rich people and corporations, particularly those who shop the globe for tax advantageous reasons. Many of those in governments seeking to “get the rich” fail to distinguish between the negative effects of an increase in the tax on capital and one on consumption, leading to many unnecessarily destructive taxes.

As government tax officials have become more and more aggressive in their pursuit of tax avoiders and evaders, the personal and financial risk for taxpayers with “offshore accounts” has grown. Tax lawyer, Dan Mastromarco, describes the dangers and hoops that people seeking to close their accounts and otherwise avoid risk needs to go through in order to protect themselves. Part of the problem is that some of the rule changes are retroactive, so people who operated in good faith at some time in the past now find themselves liable for actions which seemed perfectly legal at the time. An even greater problem is the number of governments and their administrative organizations who now claim the right to demand data and forms from those who have financial accounts in more than one jurisdiction. The complexity has grown to the point where it is nearly impossible for any one person to know all of the things he or she may be required to do or all of the potential liabilities they may face.

And oh, by the way, your death may not absolve your heirs for being responsible for some of your tax and other alleged financial sins.

The good news is, as I noted in the first sentence, that the world is getting more prosperous, despite the best efforts of many of those in government to throttle success. History shows that many insolvable problems are indeed solved by very clever people – so do not despair and applaud the clever.

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