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First Trust

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Monday Morning Outlook

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Framework for More Government

Government leaders from advanced economies around the world will meet this week in Pittsburgh, PA to have a gabfest about the direction of economic policy. At present, the G-20 is working on finalizing what they call a "Framework for Sustainable and Balanced Growth."

This agreement does not have the force of law. It is not a treaty and the US Congress will never vote on it. What it does tell us is the direction in which policymakers think the US, China, and Europe should head.

As Bob Davis and Stephen Fidler of the Wall Street Journal put it in today's paper, "If implemented, the framework would involve measures such as the U.S. saving more and cutting its budget deficit, China relying less on exports, and Europe making structural changes to boost business investment."

For Europe, these proposals – to make it a better place to invest, including more labor-market flexibility – sounds like something we could sign onto.

For China, the goal is to get their consumers to spend a larger share of their incomes. Done right, by shrinking subsidies for exporters, it's a good idea. What we fear, however, is that policymakers really favor a larger social safety net, which will reduce the incentive for China's workers to save for their own retirements.

For the US, the idea of saving more and cutting the budget deficit sounds innocuous at first. Given the events of the past two years, who among us doesn't wish they had saved a larger share of their incomes earlier this decade? And, all else equal, most of us want the government to reduce the budget deficit.

But the document does not talk about the US government cutting spending, and everything we know about the direction of health care policy is that spending will be moving upward. This leaves tax hikes as the way policymakers are thinking the US needs to close the yawning budget gap. And there is a tax hike out there that would kill two birds with one stone, that would raise government revenue while at the same time give workers more of a reason to save their money rather than spend it. It's called the value-added tax, or VAT for short.

The VAT, which originated in France in the 1950s, is advertised as a consumption tax and is in place in at least 88 countries around the world. Every European country has a VAT (some as high as 25%) and many have wanted to see it installed in the US.

The key problem with the VAT is that once implemented, the rate always goes higher and this leads to even more government spending.

There are three reasons this happens. First, The VAT is hidden from the people who ultimately pay it. Consumers do not see the tax cost of what they buy – it is added into the price of a product. Second, the tax is very efficient and hard to avoid. It gathers revenues easily. Third, the VAT starts off as a low flat-rate tax.

We have no problem with a low flat-rate tax when it's transparent – when the people who pay it are aware they're paying it. But if it's hidden, the extraordinary efficiency of the tax will generate too much revenue too easily for politicians to just leave things the way they are. The temptation will be enormous to add-on more government programs and just lift the tax a point here and then another point there. This is a recipe for slower growth and higher unemployment.

These policy changes would help balance world growth by holding back the US economy and boosting growth elsewhere. What the US government wants to sign onto is a way to grow the government under the auspices of "saving" the world. No thanks.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-21 / 9:00 am	Leading Indicators - Aug	+0.7%	**+0.7%**	+0.6%	+0.6%
9-24 / 7:30 am	Initial Claims - Sep 19	550K	**550K**		545K
9:00 am	Existing Home Sales - Aug	5.350 Mil	**5.260 Mil**		5.240 Mil
9-25 / 7:30 am	Durable Goods - Aug	+0.5%	**+0.5%**		+5.1%
7:30 am	Durable Goods (Ex-Trans) - Aug	+1.0%	**+1.5%**		+1.1%
8:45 am	U. Mich. Consumer Sentiment	70.5	**71.0**		70.2
9:00 am	New Home Sales - Aug	0.441 Mil	**0.447 Mil**		0.443 Mil