RENEWING THE AMERICAN DREAM:

TURNING THE DIALS FROM RIGGED TO RIGHT

FOX RIVER PARTNERS

2018

"The subjects of every state ought to contribute towards the support of the government, as nearly as possible in proportion to their respective abilities. The expense of government to the individuals of a great nation is like the expense of management to the joint tenants of a great estate, who are all obliged to contribute in proportion to their respective interests in the estate."

–Adam Smith

The Wealth of the Nations

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EXECUTIVE SUMMARY

We represent a group of concerned market practitioners and business leaders, who understand the economic grievances of the middle and working classes to be the major driver of social and political instability in the United States. **Our concern is that, if unaddressed, these injustices will further accelerate instability and threaten the long-term growth, and viability of the U.S. economy.**

Among our cohort of business leaders is Joe Ritchie, founder of **Fox River Partners**. According to BusinessWeek, "Ritchie is widely acknowledged to be one of the sharpest minds in the options business." Joe and Fox River Partners' analysis has discovered that **a small group of American individuals and corporations have manipulated the tax system, creating unfair advantages and unsustainable capital concentration that dampens competition, decreases consumer demand, slows economic growth and reduces economic mobility for all Americans.**

Calling this concentration "negative stability by design," we believe that if these structural issues are not addressed, the economy and the political order are at risk of further deterioration and collapse. These trends are too similar to previous periods of history when unfair tax polices led to wealth over-concentration, economic injustices, popular unrest and, ultimately, to violent revolutions such as 2nd century B.C. Rome, colonial America under the royal British governors, France under the *Ancient Régime* in the late 18th century, and Tsarist Russia during the late 19th and early 20th century.

Given this dire reality and the current policy focus on tax reform in Washington D.C., we propose pragmatic tax policy prescriptions to address this problem while understanding there are other critical policy choices (monetary, government spending, deficits, education, anti-trust, etc.) that need to be made to address these grievances, improve economic mobility and return vibrant, stable growth to the U.S. economy. **We believe it can be done. It has been done before. US policy makers can turn the dials of U.S. tax policy to grow the "enterprise value" of the American economy and restore the American Dream for all Americans.**

I. THE ECONOMIC ROOTS OF SOCIAL UNREST: THE DYING AMERICAN DREAM

Violence at presidential campaigns rallies. Rising radicalism. Growing social and political unrest.

In recent years, America has entered a new season of increasing political instability. In fact, the *Institute for Peace and Economics*, in their *2017 Global Peace Index*, has found that while the world has become a slightly safer place over the past year, the United States has become less peaceful. Out of all the countries in the study, the U.S. experienced the greatest decline in peace, falling 11 places to 114th most-peaceful country out of the 161 in the index. In a separate study of 178 countries across the globe, called the *Fragile States Index*, the United States was the nation with the 13th highest deterioration of stability in 2016**. The leading cause for this decline: <u>group grievances causing social unrest</u>.**

What is the core grievance? "**The failure of the economy to deliver real progress to middle-class and working-class Americans over the past 15 years is the most fundamental source of public anger and disaffection in the US,**" says William Galston, an expert in governance studies at the Brookings Institution think tank.

In 2016, after 16 years of both the Bush and the Obama Administrations, average middle class incomes are still lower then they were in 2000. Yet, in that same period incomes have skyrocketed for the elite of America. Something is fundamentally wrong.

At the most basic level, **the social contract between average Americans and the governing elite has been undermined. Equality of opportunity and economic mobility, both hallmarks of the American experience, are shrinking for the broad majority of Americans.** Now this anger is being directed at 'establishment' politicians on both the Left and the Right.

Revisiting the principles inherent in this social contract, the Founding Fathers of America had a vision of freedom and opportunity for every citizen, regardless of title, birth or background. Further articulated by James Truslow Adams in 1931, this vision came to be known as "The American Dream". Adams aptly described this as a "dream of a land in which life should be better and richer and fuller for every man, with opportunity for each according to his ability or achievement." This dream of our founders became a reality as millions of immigrants arrived

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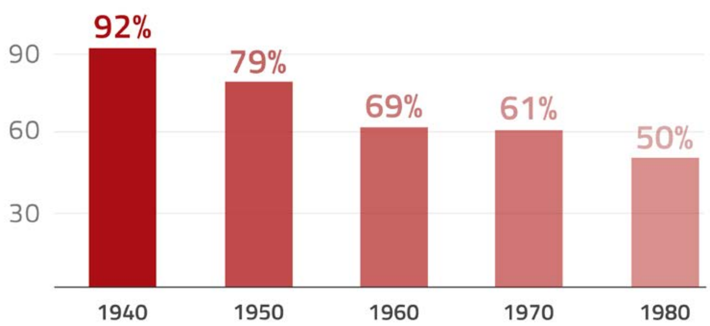
on American shores with little more than the hope of a better life for themselves and their children. But as upward mobility continues its steady descent, this dream is more and more becoming a fantasy.

IT'S GETTING HARDER FOR AMERICANS TO GET AHEAD

Percent of children born in a year that earn more than their parents did



Source: Equality of Opportunity Project

Let's look at the facts. For Americans born in 1940, there is a 92% chance of being better off than their parents. Yet, for Americans born in 1980, they only have a 50% chance of being better off than their parents. Americans went from full confidence in a future of opportunity to a 50/50 chance, the luck of the draw.

The American Dream is dying for the average American. In deeper analysis, when looking at the aggregate financial data, the economic trajectory of the middle class American is not looking good:

- **Wealth** – The average middle class family has nearly $15,000 less in total wealth then they did 20 years ago. This is a 12% decrease compared to the elite in America who saw their wealth almost double during that same time period.

- **Income** – Over the last 30 years, labor productivity has gone up 80% while wages, when adjusted for inflation, have only increased 8%. The average American has an income of $51,939. The average worker had wage growth of 22 % between 1979 and 1999 but just 2% from 1999 to 2009.

- **Personal Debt** –The average American has $90,000 in personal debt and $160,000 in home mortgage debt. Debt payments are beginning to exceed income for many Americans.

What does this mean for markets and economic growth? **The working and middle class of America are, from an economic perspective, the beating heart of our economy and the largest group of consumers in the United States. Right now, with these financial burdens, they can't breathe. With highly leveraged balance sheets and stagnant incomes, consumers' options for**

increasing debt to consume goods and services are running out. These demand side issues create growth challenges and increase the likelihood of frequent boom bust cycles.

II. MORE FUEL ON THE FIRE: A TALE OF TWO ECONOMIES

What compounds the problem of diminishing incomes and wealth for average Americans is **that at the same time these Americans' fates have changed for the worse, the elite in our society have thrived financially. This experience, an additional grievance, only amplifies the sense that economic opportunity and mobility are decreasing for working and middle class Americans.**

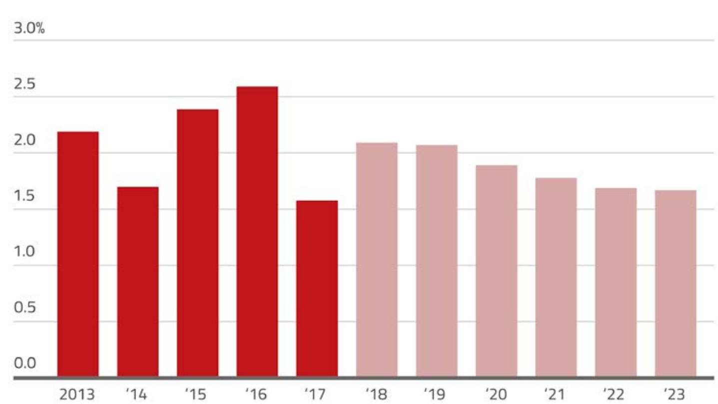
Historically, income concentration dropped dramatically following both World Wars and was roughly unchanged for the next few decades. It started climbing again in 1975, reaching pre-World War I levels by 2000. U.S. income inequality has now reached levels not seen since 1928. In both cases, a similar pattern was in evidence--a boom in the financial sector, over-leveraged lower-income households, a massive, systemic financial crash--and the two worst economic slumps in U.S. history, the Great Depression and Great Recession, followed.

According to *Morgan Stanley*, after the Great Recession, household income growth was much more rapid at the higher end of the income scale than at the middle and lower end. After-tax average income soared 15.1% for the top 1% from 2009 to 2010--but grew by less than 1% for the bottom 90% over the same time period, and fell for many income groups.

Standard and Poor's Rating Agency (S&P) stated clearly that **runaway economic inequality is harming U.S. economic growth by excluding large parts of the population from its cumulative benefits**. According to their research, **higher levels of economic inequality are increasing political pressures, discouraging trade, investment, and hiring**. These factors contributed to the S&P lowering of the US growth rating over the next decade. Growth in 2016 was a tepid 1.6%. Even more

DIMMING OUTLOOK

The IMF expects the U.S. economy will cool absent government stimulus, tax code overhauls, and other major economic policy changes. GDP growth rate;



Source: IMF

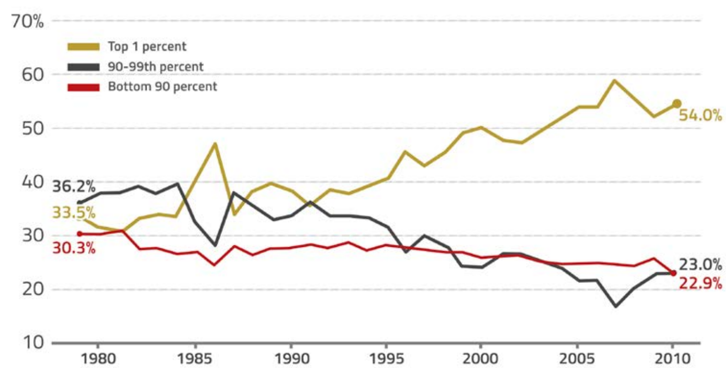
disappointing, the International Monetary Fund **decreased US GDP growth projections to 1.7% over the next five years if no policy changes are made.**

III. THE SOURCE OF DIVERGENT, TEPID GROWTH: WEALTH CONCENTRATION

What is driving income inequality and this divergent recovery? To understand this trend, you have to look closer at wealth inequality. From 1983 to 2013, while wealth decreased for average Americans by 12%, **the elite almost doubled their wealth. As capital concentrated, so did income from this wealth concentrate**.

INCREASING SHARE OF INCOME FROM WEALTH CLAIMED BY THE 1%

Concentration of capital incomes, by income group, 1979–2010



Source: Economic Policy Institute

Below is a snapshot of the concentration of capital:

- **Individuals** - 20 Americans have the same wealth as half the US population (152 million people).
- **Financial** - The five biggest U.S. banks now control half of the industry's $15 trillion in assets. Thirty years ago, the financial sector claimed around a tenth of U.S. corporate profits. Today, it's almost 30 percent.
- **Corporate** - In 1994, the top 100 American companies made up one-third of the country's gross domestic product (GDP). Today, these giant corporations account for almost half of the American GDP.
- **Cash** – According to Blackrock Inc., **global investors are hoarding over $70 trillion cash**. Given that American investors account for a large portion of this group, **there is a significant pool of concentrated, idle capital not at play in the market**.

In the free market, this type of concentration can lead to substantial leverage, political power and unfair advantages for a few players. **Like massive giants fighting miniscule dwarves, concentration creates an unfair power dynamic in the market. Because of this dynamic, a majority of Americans are becoming like the losing players in the popular board game of Monopoly, unmotivated to play the game any longer as one player has taken all the property. They know the system is rigged against them. The result: decreasing competition, innovation, and entrepreneurship.** *The Kauffman Foundation* reports that the percentage of adults owning a business has been declining since the 1990s, when the foundation first began to track that number. A study by the *Brookings Institution* found that the start-up rate (the number of new companies as a percentage of all firms) has fallen by nearly half since 1978.

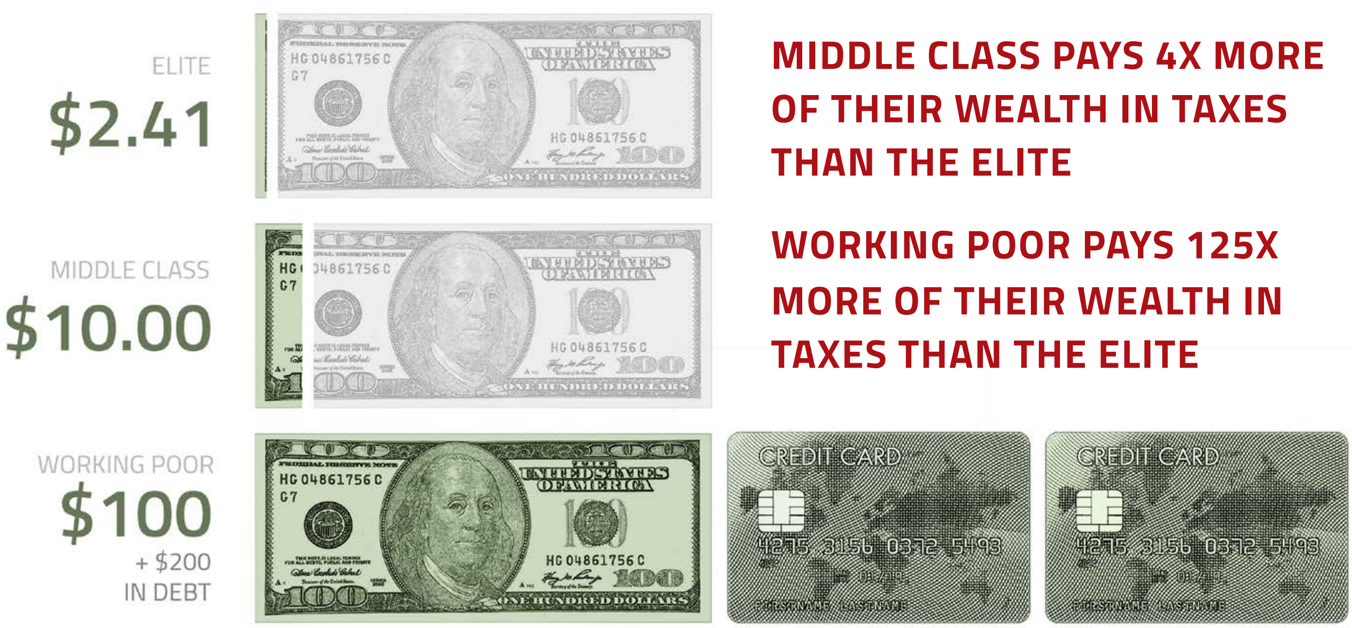
IV. AMERICAN CAPITALISM HAS DIALS

While most Americans understand the power of the "Invisible Hand" of market forces and self-interest that generates supply and demand, they are sometimes unaware that **American capitalism has dials** that can be adjusted to moderate how we support the necessary laws and regulations that frame the free market, making it a suitable and effective place of exchange. These dials include monetary policy, trade policy, financial regulations, and investments in public goods like education and infrastructure. Our system of laws and regulations provide the foundation for access to and fair play within a free market. The free market relies on the rule of law, national security, the protection of private property, and the general welfare of citizens. The American governance system was designed to be a limited government that managed these necessary activities on behalf of the people.

Adam Smith, the founder of modern capitalism, spoke about one of the dials: tax policy. In his seminal book, *The Wealth of Nations*, he wrote, "The subjects of every state ought to contribute towards the support of the government, as nearly as possible in proportion to their respective abilities. The expense of government to the individuals of a great nation is like the expense of management to the joint tenants of a great estate, who are all obliged to contribute in proportion to their respective interests in the estate." His key point: **the contribution to the expenses of managing our nation must be proportional to each person and family's respective economic interests in the nation and <u>their ability to pay</u>**. Proportional contribution is necessary to support a prosperous economy and free society.

V. THE TAX DIALS: DISTRIBUTING WEALTH TO THE TOP

Most Americans assume the current tax system follows this capitalist principle of fair contribution. This is flat wrong. This is because most reporting in the media focuses on just federal income taxes In looking at all taxes paid, including taxes on property, consumption and income, at all levels of government, it's precisely the opposite. <u>The lower your ability to pay is, the higher your relative taxes</u>. The graph below is built on the Fox River Partner analysis of wealth data for each tax income bracket, comparing this data to total taxes paid (income, property, sales) by each of these brackets at federal, state and local levels. **The complete picture uncovered is worse than previously imagined. This does not look like a fair tax system that supports a prosperous economy.**



TOTAL TAX DOLLARS PAID (INCOME, PROPERTY, SALES AT ALL LEVELS OF GOVERNMENT) BY EACH BRACKET FOR EVERY 100 DOLLARS OF WEALTH

For over 30 years, advocates of "trickle down" economics argued that lower taxes on the elite would increase growth, increase savings and investment and boost productivity (i.e. increases the economic pie). **In reality, this famous moniker was only half true: growth has slowly trickled but only up toward the top of the economy.** Congress' own non-partisan research group, the *Congressional Research Service*, conducted a 65-year study of changes to the tax structure and found the following:

> "Throughout the late 1940s and 1950s, the top marginal rate was typically above 90%; today it is 35%. Additionally, the top capital gains tax rate was 25% in the 1950s. Today it is 15%. The real GDP growth rate averaged 4.2% and real per capita GDP increased annually by 2.4% in the 1950s. In the 2000s, the average real GDP growth rate was 1.7% and real per capita GDP increased annually by less than 1%...Analysis of such data suggests **the reduction in the top tax rates have had little association with savings, investment, and productivity growth. However, the top tax rate reductions appear to be associated with increasing concentration of income at the top of the income distribution.**"

Specifically, there are various ways that tax policies contribute to wealth concentration.

- **Capital gains income is taxed lower than work income** – Unearned income of a physical or financial asset is taxed at a lower level than working income. This incentivizes capital accumulation over work.

- **Property taxes are regressive and a majority of elite property is not taxed** – A majority of elite property is in financial capital vs. working poor & middle class capital is primarily in their houses. Property taxes disproportionately affect working and middle class owners.

- Offshoring of $1.2 trillion in personal wealth shelters elite American property from $35 billion in taxes.

- **Consumption taxes are regressive** – Sales taxes have a higher impact on working and middle class consumers. Elite consumption is incentivized by tax breaks for luxury business goods – airplanes, yachts, etc.

- **Corporate welfare benefits the capital owners of large corporations over the owners of small businesses capital.** According to *The Sunlight Foundation*, **200 of America's most**

politically active corporations spent a combined $5.8 billion on federal lobbying and campaign contributions. What they gave pales compared to what those same corporations received: **$4.4 trillion in federal business and support.**

- **A complex set of tax rules benefit wealthy asset owners:**
    - using 'collars' to avoid paying capital gains taxes
    - using 'wash sales' to time the recognition of capital income
    - using derivatives to convert ordinary income to capital gains or convert capital losses to ordinary losses
    - using derivatives to avoid constructive ownership rules for partnership interests
    - using 'basket options' to convert short-term gains into long-term gains

The bottom line: the dials have been turned to benefit a small group of American individuals and corporations creating unfair advantages and unsustainable capital concentration that decreases competition, consumer demand and economic growth.

VI. THE RULES OF THE GAME THAT GROW ENTERPRISE VALUE

Fundamentally, this concentration is putting the economy at risk. The working and middle classes are the heart of the U.S. economy. Concentration clogs the economic arteries. If the blood does not circulate to the heart, the body dies. Working and middle class segments make up 60% of total households and account for 40% of consumer spending. If their incomes continue to flat-line while personal debt increases, this will continue to impact long-term consumer demand. And the reverse is true. **Unlike tax breaks for the wealthy, money in the hands of the working and middle classes goes immediately into the bloodstream of the economy by creating increased demand for products and services.**

In fact, an empirical study conducted by the *University of Chicago* and published in the *National Bureau of Economic Research* found that **1% of GDP tax cut for the bottom 90% results in roughly 3 percentage points of GDP growth over a two-year period. The same 1% of GDP**

tax cut for the top 10% had no statistical impact on growth. Another groundbreaking study by a group of economists at the IMF found that a **10% decrease in inequality (a change in the Gini coefficient to 0.37 from 0.40) increases the expected length of a growth spell by 50%.**

Ultimately, business leaders know that if we slice the tax pie in a fair manner that increases economic mobility, the entire economic pie grows.

To explain this by analogy, the American economy could return to being more like the National Football League (NFL). The NFL is the most popular sports league in North America, has a $63 billion value and has more total value than all NBA and MLB teams combined. What is the key to this growth and success? The rules of the NFL Draft: the lowest performing team gets the first round draft pick. We see in this example that **by writing the rules to help lower performing teams improve, the NFL enterprise value of the entire league grows and the games are more interesting to watch. This strategy is the secret to the NFL and used to be the secret to America's economic success.**

VII. TURN THE DIALS TO REIGNITE ECONOMIC MOBILITY

What can we do? We have to **rewrite the rules to get the opportunity unstuck from the top and return equality of opportunity and economic mobility for all Americans. We need to change the system to make it fair again. If we make the tax rates fair for all Americans, we can increase excitement to play in the game and participate in the economy.**

Our team of market practitioners has a plan with the following recommendations:

1. **Enact the Growth Accelerant Tax – a one time tax of 1.5% on the property, "the ability to pay", of top 1% and use these funds to provide a $10, 000 tax credit for every family in the bottom 50%.** Improving the balance sheets of average Americans will immediately increase consumer demand and will impact the stock market and grow everyone's investment assets beyond what was taxed.

2. **Stop picking winners and losers & end hundreds of billions in corporate welfare.** Giving Americans hard earned cash to big corporations just ends up in the hands of wealthy individuals and does not stimulate growth. It has already been established that these corporations have enough cash on hand and do not need additional government handouts.

3. Lower middle and working class income tax rates to the same as capital gains tax rates for the elite. There is no rational reason to treat income from human capital, physical capital, and financial capital differently. A middle class worker should not be paying a higher tax rate on his job income than an investor making income on his capital assets. According to the CBO, **this action would provide hundreds of billions to use either to fund tax credits for the working and middle class or reduce deficit spending. To those that say raising capital gains taxes will hurt growth, there is no established relationship between raising capital gains taxes and reduced growth.**

4. **Encourage Education & Training through a simplified Earned Personal Tax Credit** that provides cash for "personal" maintenance costs (healthcare, job training, etc.) for "human capital" similar to match corporations get to exclude for "physical capital" like facility and machinery maintenance. With increasing globalization, automation and the increased use of artificial intelligence in the workplace, we need Americans to have advanced technical expertise to thrive in the next economy.

5. **Streamline & simplify tax code and eliminate complex set of tax deductions and rules that unfairly benefit wealthy asset holders.** Complexity only benefits those with access to expensive attorneys, wealth managers and high-paid accountants. The more complex the tax code, the more opportunities for abuse and unfair advantages to wealthy individuals and corporations.

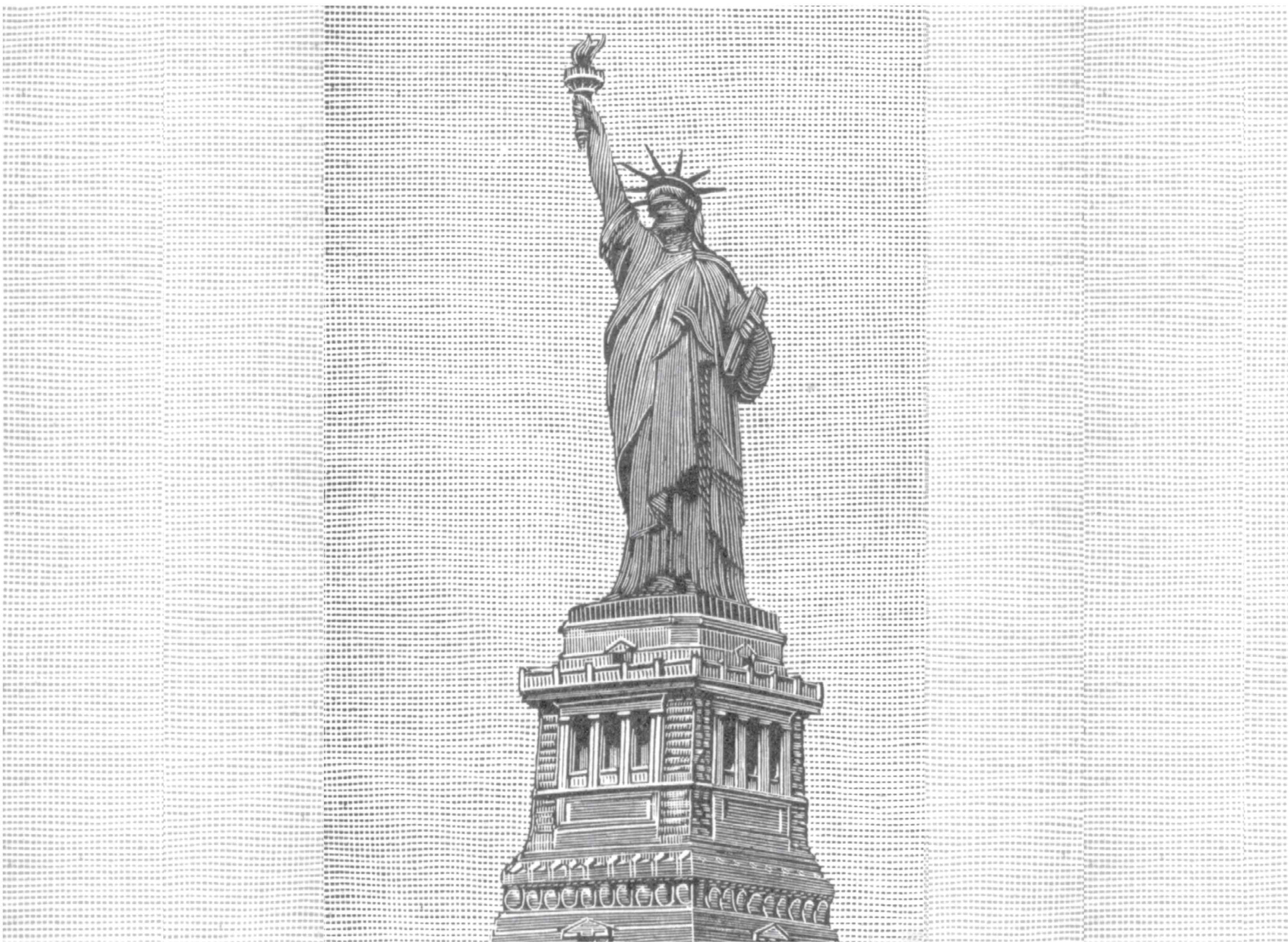
With these actions, **we can end the distribution of the working and middle classes hard earned money to the elite of America, stimulate demand for products and services, and get our economy growing again.**

VIII. A RETURN TO GROWTH & OPPORTUNITY FOR ALL AMERICANS

America can return to being a nation of freedom, opportunity and prosperity for all. We have done this before and we can do it again. **We can return to the dynamic growth and mobility of the 1950s and 1960s America.** We once again can be a country that gives everyone a fair chance to get "in the game" of the economy and compete. Returning to the S&P analysis:

> **"From a consumer perspective, benefits [from reducing economic inequality] would extend across income levels, boosting purchasing power among those in the middle and lower levels of the pay scale--while the richest Americans would enjoy increased spending power in a sustained economic expansion."**

Everyone will benefit. To do this, Congress needs to move beyond right and left and take action now to reform the U.S. tax system to make it work for all of us. We need to create disincentives for the elite to hoard and we need to create incentives for average Americans to take risks, retrain themselves and compete in the marketplace. **Let's renew the dream for all Americans.**



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