DEBT AND TAXES

U.S. Treasury yields rose this week after the U.S. Treasury Department estimated that they would borrow a record $2.99 trillion in the second quarter this year, more than five times as much as quarterly borrowing during the height of the 2008-09 financial crisis. As part of the upcoming auctions, they also indicated that there will be a ramp up of issuance of longer-dated securities, including a new 20-year bond issue of $20 billion that was much larger than Wall Street analysts were expecting.

It should come as no surprise that in fiscal year 2020, the federal government will likely run the biggest budget deficit as a share of GDP since World War II. Between increased federal spending and reduced tax revenue due to sluggish economic activity, the Congressional Budget Office predicts a record deficit of $3.8 trillion this year. Federal debt is expected to exceed GDP by the end of 2020 and rise to 108% of GDP in 2021.

Without a doubt, the short-term need to limit the economic fallout of the pandemic must outweigh fears of a future reckoning over out-of-control debt. With that, once the economy is stabilized and public health is secure, difficult choices will likely be necessary, one of which we believe will have to include higher tax rates.

After the Great Depression in 1939, federal tax collections as a share of GDP were just 7.0% according to the U.S. Treasury. Then, the lowest marginal income tax bracket was 4% on income up to $4,000 (about $73,000 in today's dollars), and the highest bracket was 79% for income over $5 million (about $92 million in today's dollars). Within a few years, the need for war financing grew considerably, and Congress raised taxes significantly to help pay for the war. By 1944, the lowest marginal income tax bracket was up to 23% on income up to $2,000 ($30,000 in today's dollars), and the top marginal income tax bracket was 94% on income over $200,000 (about $3 million in today's dollars). These changes also led to much more widespread payment of federal income taxes. In 1939, less than eight million households filed income tax returns with the federal government. Just five years later this number had grown to more than 47 million.

It is hard to imagine when a World War II-style tax hike policy response will ever be palatable, especially under the current political regime. But it would be naïve not to consider higher tax rates as a likely future reality. In the years to come, we predict conversations may emerge over the need for a national sales tax, an increase in higher marginal tax brackets, capital gains tax hikes, or a repeal of the current high level of estate tax exclusions. We might also see a proposal to pull the ceiling off the wage base of Social Security and tax higher levels of income to fund this pool of benefits. Certainly, we can hope that strong rebounding growth in nominal GDP shrinks the debt ratio, perhaps fueled by a surge in post-COVID labor productivity (Zoom, anyone?). Perennially low interest rates will also help as interest expense will remain low, and Fed policy accommodation is largely a given these days (though bond market vigilantes will have to continue to cooperate). Counterbalancing the support of growth and low rates is the reality that the Treasury was already facing increased spending as a percentage of GDP in the years ahead as the population ages. Now, the needs of our aging population demographic will also be layered with the legacy of this costly but absolutely necessary crisis response. But someone, someday, will ultimately have to pay the price.

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MORTGAGE RATES: STICKY ON THE DOWN SIDE

The Federal Reserve took steps in March to keep money flowing through the mortgage financing system. The actions, including two rate cuts, were part of the central bank's broader efforts to protect the economy from more damage from the COVID-19 pandemic. Is it time for you to consider a refinance, or a social distance property purchase?

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