Letter 32

Towards a global increase in corporate taxes.
What are the implications for the markets?

"If you don't take change by the hand, it will take you by the throat" Churchill.

Let us listen to Churchill. Around the world, democracies are weakened by the shift of the middle class towards populist parties, populism is threatening. This is due to the stagnation of middle-class incomes over the last thirty years, rising inequality and a lack of state resources to invest in education, health and public infrastructure. This is one of the consequences of the tax cuts and budgetary revenue of the last decades.

In the United States, compulsory levies accounted for 31.5% of GDP in 2000, while in 2019 it accounted for 28%. Not only were Trump's tax cut of 35% to 21% not financed, the budget deficit in 2019, making up of 4.6% of GDP, was the highest seen at the top of the cycle. Yet, companies preferred share buybacks or dividend increases to increased investment, and so neither economic growth nor productivity was stimulated.

The corporate tax rate was, as ***Saez and Zucman***, two French economists close to the Democratic Party, pointed out in their book ***"The Triumph of Injustice"***, 52% in 1960, still more than 40% at the end of the 70s, but 40 years later, it is below 25%.

For a long period of time, multinational firms have taken advantage of optimization schemes in "tax havens" and recently, 60% of their profits were made in these countries, compared to 30% in the year 2000. The five major digital companies have paid $220 billion in taxes over the past decade, which is equivalent to 16% of their pre-tax profit.

The situation is evolving. On the one hand, after the search for undeclared accounts, the OECD has for several years been focusing on corporate tax, a more lucrative subject. On the other hand, in the face of the crisis and the worsening of public debts, companies understand the need to participate in the effort to reduce inequality and help economies emerge from the crisis.

***I. The financial dimension of globalization*:**

Globalization has three main components: trade, with the reduction or even the abolition of tariffs; economic, with the relocation of production sites to countries that can offer lower wage costs and, above all, to new hubs of consumption growth such as China; and financial.

The financial dimension is essential: states are sometimes, destabilized by the free movement of capital; often, faced with the mobility of companies; frequently, exposed to the exodus of qualified individuals, so they have lowered corporate and income tax to keep company headquarters and qualified workers in their territories. They have compensated with higher consumption-related taxes, but such a measure exacerbates inequality.

We have also observed the implementation of tax optimization schemes. Small countries such as Ireland and the Netherlands have been able to offer low tax rates, 12.5% for the former and tax rulings for the latter. An ***OECD study*** conducted a few years ago pointed out that tax optimization costs between 4%

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T: +41 22 518 85 85 | www.sing-alliance.com

and 10% of global corporate tax revenue, or between $100 billion and $240 billion annually.

Donald Trump lowered the corporate tax rate by 14 points from 35% to 21%. This significant decrease had little impact on profit and investment ultimately, as the majority of companies did not pay taxes at the face rate and benefitted from depreciation or deductions opportunities. The effective rate was about 27%. The impact on the results of the S&P500 companies was estimated at 10%.

***II. The adjustments sought to address the excess of globalization* :**

- ***OECD recommendations* :**

In 2015, the OECD presented the "Base Erosion and Profit Shifting" project with two objectives – the fight against the transfer of profits in the world and the fight against the erosion of the tax base. Open to the 36 members of the OECD, this negotiation has been extended to more than 110 states, including China. In the meantime, the U.S. Congress is passing the measures proposed by Biden to press for taxation on GAFAM's turnover. The European Commission is considering a 3% tax but has not been able to obtain the necessary unanimity due to the lack of approval from Germany, Ireland and the Scandinavian countries.

Certainly, the turnover tax is unsatisfactory because it is not based on the profitability of companies. Nevertheless, it has allowed, for example, France to tax companies with a turnover exceeding €750 million on the basis of 2018 results and to recover a third of the billion in lost revenue in 2019. Since then, Italy, Spain and Austria have implemented a similar tax and, outside the EU, the United Kingdom and India are doing the same.

- ***The Biden plan* :**

The idea of greater fiscal justice, promoted by OECD and taken up by Biden, has two facets: on the one hand, to ensure that a minimum tax rate is met; on the other hand, to impose tax on the digital giants in countries where they make profits.

Biden would like to raise the corporate tax to 28%, but given the narrow majority and the reluctance of moderate Democratic senators like John Manchin, a 25% rate seems more likely.

In an effort to put an end to tax optimization and the use of tax havens, Biden wants to impose a minimum rate of 21% on overseas subsidiaries of companies making more than $20 billion in profits. Trump had already taken a step in this direction earlier with a 10.5% tax on the revenue of U.S. companies abroad. If a country maintains a tax rate below 21%, the United States will take the difference. Wharton estimates that the tax increase would bring in an additional $1 trillion in revenue over the next 10 years.

This measure was inspired by the proposal of ***Saez and Zucman***, in their book ***"The Triumph of Injustice"***, where they explained that each country must become the gendarme of its multinationals. If Apple pays 2% in Jersey, the U.S. could collect the missing 19%. Such an approach would not violate any international treaty and would not require the cooperation of tax havens. With such a measure, U.S. companies would face an increase in their tax bill by about $100 billion. G20 countries must agree to apply a minimum rate of 25% to multinational companies.

Conclusion* : *"The Dangers of Infectious Greed" Greenspan

Biden takes this warning from Greenspan, former Chairman of the Fed, seriously and intends to put an end to tax competition. The plan to increase corporate tax is one example of the shift from

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"Reaganomics" or Thatcherism to a new era of regulation and less tax competition, and an era of relocation and reaffirmation of power. And this development calls for 8 remarks:

- ***A desire to reaffirm the power of the United* States :**

The technological revolution has contributed to the rapid development of Asia but also to the deindustrialization of the West. In 1970, as ***Milanovic*** reminds us in ***"Capitalism, Alone",*** the West produced 56% of world GDP, while Asia including Japan contributed 19%. Today, these proportions have changed to 37% and 43% respectively.

Joe Biden's quest for uniform taxation of multinationals around the world is part of a desire to reinforce American pre-eminence, to repatriate activities, and to remove some of the incentives for relocation.

Without pushing the paradox, we can argue that Trump and Biden shared a common goal, to strengthen the attractiveness of America, and a similar observation, globalization has intensified deindustrialization and it has prompted offshoring to take advantage of an attractive tax system.

The convergence ends there because the solutions are opposite. Trump lowered corporate tax from 35% to 21%, and thus revenue fell from $365 billion in 2015 to $160 billion in 2018. But the results are bleak: tax cuts have not increased investment, labor supply, growth or operating margin, and capital repatriation has been disappointing. The country is losing out because under the Trump presidency, federal tax revenue has fallen to 16% of GDP, the lowest level since 1945. There is therefore an inability to finance the Welfare State, infrastructure and education – all of which are key factors for success in the medium term.

So, Biden is taking a different path by raising taxes and, in order not to penalize America, aiming for harmonization and a global minimum rate. Biden's plan intends to increase U.S. tax revenue and as a result signal the end of the rivalry between countries for tax competitiveness.

- ***A strengthening of the role of the* state :**

Tyler Cowen has shown that prosperity is not contradictory to a state with broad prerogatives, including on the social front, provided that it remains agile and efficient, and does not encroach on individual freedoms. It is through collective investment in education, health and other public services that the most developed countries have become rich. With Biden's infrastructure plan and its financing, the U.S. needs to empower itself to reduce the chronic budget deficits of the Trump era while reinvesting in education and social services to improve social cohesion. Democracies, if they are to survive, must have the means to fight against global warming and the impoverishment of the middle class.

- ***A brake on the substitution of capital for labor* :**

To fight for a uniformity of tax rates is to go beyond the problem of capital mobility, it is to make the search for tax optimization obsolete. At a time of robotization and concerns about future employment, the search for a harmonization of corporate tax is, for the United States and for the major European countries, a means of encouraging the relocation of activities and thus creation of domestic jobs.

- ***A step before anti-trust measures* ?**

Regardless of taxation, GAFAM risk to face the wrath of the administration against the abuse of its dominant position, but this will be analysed in a future Letter.

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- ***A timely moment*** **?**

This tax increase, at a time of strong recovery in corporate earnings, could be easily absorbed. Britain will also increase its corporate tax from 19% to 23%. However, the increase should be considered in the context of pressure on margins due to higher commodities, transport and components costs.

Assuming a tax rate of 25%, a country like France that has a tax rate of 31% can continue to lower it. Traditionally, large countries often have rates above 25% and will hardly be affected. Instead, the losers will be the small countries like Malta, Cyprus, Luxembourg, the Netherlands... those who are willing to make their territories more attractive with low corporate tax rates such as the 9% in Hungary, 10% in Bulgaria, 12.5% in Ireland, and 13.5% in Switzerland.

- ***Low budgetary impact*** **:**

To temper the optimism of tax supporters, it should be noted that the increase in corporate tax will hardly reduce the budget deficits that are expected to be between 8% and 15% of GDP this year. In OECD countries, corporate tax revenue accounts for only 3% of GDP, a small percentage compared to public spending. In the United States, it was 8% of GDP in the 1960s, 2% of GDP on the eve of Trump's election, and 1% when he left. The increase in the U.S. rate and the setting of a minimum rate are expected to increase revenue by $150 billion per year, which is minimal compared to the budget deficit of $3.1 trillion in 2020.

- ***A step before a possible harmonization of income tax*** **?**

If the virtuous path to initiate deleveraging is that of an economic growth rate higher than the cost of debt, the governments might be tempted to go further in increasing tax, once the worst of the crisis has passed. This is because the revenue resulting from an increase in corporate tax will be marginal compared to the mass of debt. Thus, the idea, supported by ***Piketty in "Capital and Ideology"***, of a harmonization of income and wealth tax of the most privileged has been raised. Biden is considering an increase in income tax for people earning more than $400,000 a year because the share of income held by the wealthiest 1% in the U.S. is 20% versus 11% in Europe. Other countries could follow suit. The minimum wage is another topic of consideration for Biden’s team. In the 1950s, the United States had the highest minimum wage in the world, in 1970 it was $10/hour in today’s $ terms, and in 2019, the real level was only $7.20. Thus, Biden, while without success for now, would like to raise it to $15/hour. According to Piketty, the gap between the average income of the richest 10% and the poorest 50% is 8x in Europe, 19x in the USA, 35x in South Africa or the Middle East.

- ***A stock market impact*** **:**

Let us end with the most important aspect for our investment strategy. The sectors most affected by an increase in corporate taxes will be technology and pharmaceuticals as their effective rates are between 10% and 15%. Conversely, the consumer and value sectors such as energy, manufacturing, finance and materials, which were recently boosted on the stock exchange, will be less affected because their domestic tax rates are often in line with the official rate and their subsidiaries are not located in tax havens. In other words, their stock market success could continue.

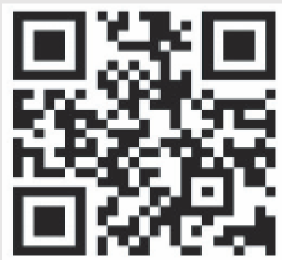
Geneva, 20th April 2021

Bruno Desgardins

SINGALLIANCE
SingAlliance (Switzerland) SA | 16bis rue de Lausanne 1201 Genève Switzerland
T: +41 22 518 85 85 | www.sing-alliance.com

Bruno Desgardins
CIO
Switzerland

SingAlliance (Switzerland) SA
16bis rue de Lausanne
1201 Geneve
Switzerland
T: +41 22 518 85 85
E: info.switzerland@sing-alliance.com



SingAlliance Pte Ltd
20 McCallum Street
#18-01 Tokio Marine Centre
Singapore 069046
T: +65 6303 5050
E: info@sing-alliance.com

SingAlliance (Hong Kong) Ltd
1205, 12/F Bank of America Tower
12 Harcourt Road, Central
Hong Kong
T: +852 3611 7790
E: info.hongkong@sing-alliance.com

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