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"Inflation is Taxation Without Legislation"

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This quotation is from one of the greatest economists of the modern era, Milton Friedman. He was associated with the Chicago School of Economics and won the Nobel prize in 1976. Friedman was an expert on inflation. He said, "Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output." This is the situation that the U.S. is facing today.

The evidence of inflation is showing up everywhere. The following excerpt from Forbes points out the impact on natural gas prices that has occurred and is ongoing. *"The situation is most alarming in natural gas, which many consumers rely on to power and heat their homes. At over $5 per million Btu, benchmark Henry Hub natural gas prices are more than twice as high as a year ago, at an annualized rate equal to a $109 billion increase to consumers. The Energy Information Administration (EIA) reports that working natural gas stocks are 17 percent lower than a year ago and 7 percent below the five-year average.*

"Gas shortages in Europe and Asia are drawing more U.S. gas abroad as exports of liquefied natural gas (LNG), exacerbating market tightness here despite America's vast gas reserves." It can be argued that governmental policy limiting the domestic production of oil and gas has added to the inflation in energy cost.

This excerpt from the Washington Post gives some insight into the problem of inflating food costs. *"Food producers have struggled with shortages, bottlenecks, and transportation, weather and labor woes, all of which have caused food prices to rise. The end is not in sight, inflation at the wholesale level climbed 8.3 percent last month from August 2020, the Labor Department reported Friday, the biggest annual gain since the department started calculating the number in 2010. Those prices are passed on to consumers: Meat, poultry, fish and eggs are up 5.9 percent over last year, and up 15.7 percent from prices in August 2019 before the pandemic."*

Inflation is clearly with us in the here and now. Chairman Powell of the Federal Reserve (Fed) still maintains that it will prove to be transitory (temporary) and we hope so, but we need to understand the effects of inflation, specifically how it functions as a hidden tax. We will look at three different aspects of how it serves as a tax.

First, the most direct example is the pay raise that seems to be but is not. A median income taxpayer earning around $60,000 per year gets a 5% cost-of-living pay raise ($3,000). In a 5% inflationary environment, the taxpayer will actually lose purchasing power. Of the $3,000 that is intended to make up for the loss of purchasing power, only $2,400 goes to the taxpayer and $600 goes to the federal and state governments, assuming the wage earner is in approximately the 20% marginal tax bracket.

This is a cruel hoax on the taxpayer because he/she thinks they are getting a raise to at least keep up with rising expenses, when only the politicians are benefitting without the political damage of having to raise taxes. The perpetrator of the inflation scourge is the government itself and the central bank (the Fed). Remember, inflation is too much money chasing too few goods – the Fed is the creator of the money, and the government spends it excessively. However, ironically for their misdeeds, the politicians benefit, and the people suffer.

The second example functions like a tax but is not literally a tax. It is the increase in cost of almost every good or service. Going back to our first example, if our taxpayer had not been fortunate enough to receive a cost-of-living raise, then the $60,000 income would have lost $3,000 in buying power with nothing to offset it. A 5% loss to a moderate- or low-income individual would produce a significant reduction in standard of living. This is the explanation for the label of "cruel tax" applied to inflation. Warren Buffett, one of the world's richest investors, is credited with calling inflation a "cruel tax on people."

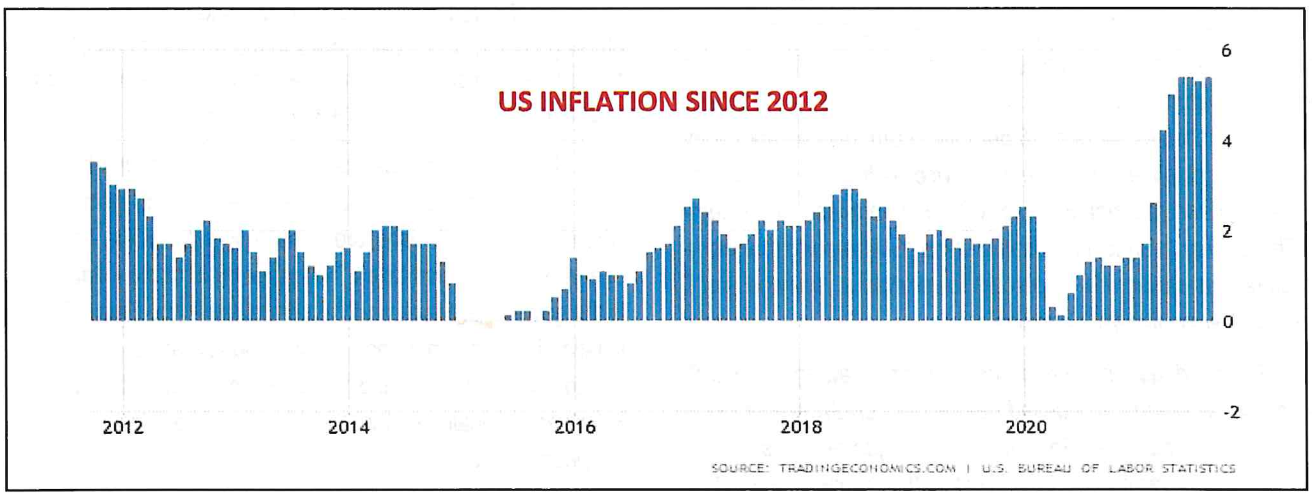
This cruelty comes down disproportionately hard on the lower economic segments of American society. The following excerpt from CNN illustrates the impact. *"It's also important to keep in mind what these households are spending on. Families earning $30,000* *to $70,000, pre-tax, spend one-third to one-quarter of their annual after-tax income on food, utilities and rent, according to my calculations using data from the BLS survey. For families making $15,000 to $30,000, the share jumps to 47%, and for families making less than $15,000, it reaches an outsized 116%. Families making more than the median, by comparison, spend between about 7% and 19% of their after-tax income on such necessities."* It seems that the claim that no one with less than $400,000 income experiencing a tax increase is not valid.

The third aspect of the inflation and taxation dynamic deals with corporate taxation. The thinking among many politicians is: it's okay to spend the money and then raise taxes on the corporations because that won't hurt the voters, and nobody really likes the corporations. The fallacy in that line of thinking is that spending all that money is inflationary and that corporations don't really pay taxes. People do. An excerpt from National Review explains it clearly:

"... corporations do not pay any corporate tax – individuals do. That is because companies pass on their costs. Some of the tax is paid by consumers, who pay higher prices. Company employees pay some of the tax through lower wages. And investors' retirement accounts pay some of the tax through lower returns.

"So, while it might be good politics to stick it to big corporations – or at least to posture that way in front of voters and television cameras – a corporate tax-rate hike would not accomplish its intended goal. Instead, taxes are paid by individuals who then get less for their money, receive smaller paychecks, and have a harder time saving for retirement."

The first two examples illustrated that inflation truly is "taxation without legislation." This is the reason politicians resort to this tactic because it goes into effect without fanfare or scrutiny. However, the facts eventually come out, but by that time the damage has already begun. Recently, it was revealed that the average American household was paying an extra $175 per month for food, fuel and housing. The last example is the politicians use of subterfuge by saying that they are going to tax corporations to pay for all the extra spending, but that is not true, and the "cruel tax" falls on the individual taxpayer, especially hard hit are those who can least afford it.



OUTLOOK

The last part of the third quarter of 2021 may be the beginning of a stock market correction. The quarter started off strong but the last couple of weeks experienced a pullback. The total retreat has only been about 5%, which is less than the average 10% correction, but it is unclear if it is over or just pausing, as are most things in this extraordinary period that we are living through. Historically, September is the weakest month of the year for equities and often the market hits its low in October and then rallies into the end of the year. Will this year follow the traditional pattern or not?

The last quarter of the year and extending into 2022 will be heavily influenced by what is going on in Washington DC. The level of taxation, regulation and government spending will play a major role in the market performance. These issues are being fought over as this letter is being written. We do not know the outcome yet, so we are, for the most part, holding our present positions but continuing to gradually build our inflation hedges at the rate of one-half percent per month (as outlined in a previous newsletter). Our plan is to continue on this track until we see some evidence that the inflation is actually "transitory". As always, things can change and the unforeseen event can happen that will require altering our game plan.