LPL RESEARCH
WEEKLY ECONOMIC COMMENTARY

April 17 2017

CORPORATE TAX REFORM TAKES CENTER STAGE

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KEY TAKEAWAYS

Corporate tax reform has taken center stage as the headline policy issue.

A rough estimate of median expectations is that tax reform passes by the end of 2017 with a top marginal corporate tax rate of 25%.

Timely passage may decrease policy uncertainty, helping to turn improved confidence into increased economic activity.

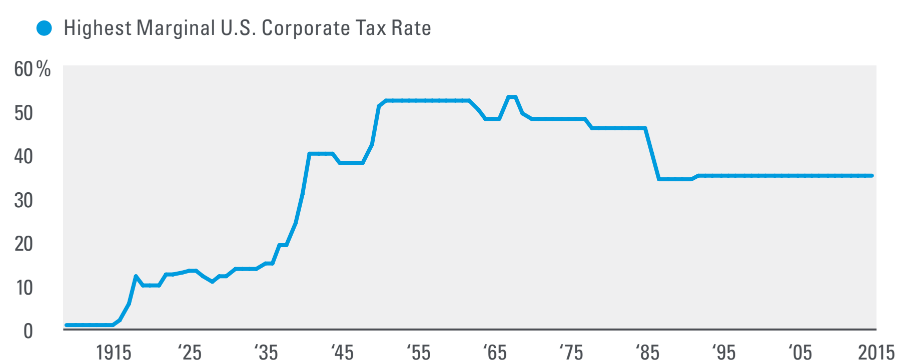
Over the next few weeks, analysis of the Trump administration's first 100 days will increasingly dominate the news cycle (April 29 is day 100). From a policy perspective, all of the action (or lack thereof) will take place over the rest of 2017 and into 2018, which is a more realistic time frame for implementing major agenda items. During that time, corporate tax reform will likely take center stage.

When it comes to progress on corporate tax reform, financial markets and the economy may respond differently. For markets, a fair amount of upside has likely been priced in, perhaps leaving more downside than upside potential. From an economic perspective, downside and upside may be more evenly balanced. Judging from the high levels of divergence between business and consumer confidence and hard economic data, policy uncertainty may continue to delay major spending decisions by individuals and businesses. Further clarity on tax reform may improve the transfer of increased confidence to economic activity. This week, we provide an overview on progress, expectations, and potential economic impact of corporate tax reform.

BY THE NUMBERS

While the U.S. has had a top statutory corporate tax rate of 35% since 1993 [Figure 1], the highest current level among developed economies according to the Organisation for Economic Co-operation and Development (OECD) data, any company that actually pays 35% should hire a new team of accountants. The average effective rate in the U.S. is near 24%, consistent with other

1 THE U.S. HAS HAD A STATUTORY CORPORATE TAX RATE OF 35% SINCE 1993



Source: LPL Research, Tax Policy Center 04/17/17 developed economies. For Fortune 500 firms, that number comes down closer to 21%, suggesting tax reform would likely be more beneficial to small and mid-cap firms.

Regarding corporate tax reform, two questions will dominate all others: When? and What's the rate? Expectations for when center on year end. Passage in 2017 would be considered a success at this point. Passage in 2018, however, would not necessarily be considered a failure if there were clear progress and a solid chance of success. If we moved into the new year and passage still looked like a coin toss or party wrangling was pushing expectations into the summer 2018, both markets and businesses would likely be disappointed. While a delay until the start of 2018 would be late compared with passage of key tax legislation in prior administrations [Figure 2], the more complicated task of comprehensive reform justifies a longer timeline.

The headline number that will get the most attention when it comes to expectations will be the new top marginal corporate tax rate. We're at 35% now. The number Republicans have been eyeing is 20%, although President Trump's initial proposal was 15%. 20% is a politically attractive target, a nice round number meaningfully lower than 35%. In fact, at 20%, you can practically say that you cut the rate in half. On the other hand, 30% would feel like relatively little progress. So expectations have settled at around 25%. From a Republican perspective, anything higher than 25% would probably be considered at least a modest disappointment; anything below 25% a modest success.

2 THERE'S TYPICALLY A SIX-MONTH DELAY FROM TAKING OFFICE TO FISCAL LEGISLATION

President	Action	Date Passed	Months Into New Term
Kennedy	Spending Increases	Jun '61	5
Nixon	Tax Cut	Dec '69	11
Ford	Tax Cut	Mar '75	7
Reagan	Tax Cut	Aug '81	7
Clinton	Tax Increase	Aug '93	7
George W. Bush	Tax Cut	Jun '01	5
Obama	Tax Cut and Spending Increases	Feb '09	1
		Average:	6 Months

Source: LPL Research 04/17/17

WHAT ARE THE POLITICS?

The president may try to build a coalition that includes centrist Democrats by tying a tax package to infrastructure spending. The more ideological wing of either party in a two-party system is often more powerful as opposition than in building coalitions. Move out toward the ideological wing when advancing legislation and there are not additional positions further out that can get drawn in. Move toward the center and there starts to be some political pull on centrists from the opposition party, and even some pull on the opposition party core. The power of the ideological wing, by contrast, is its ability to portray itself as a litmus test for the party faithful.

We've already seen this effect play out in the attempt to repeal and replace the Affordable Care Act (ACA, "Obamacare") and the ire the Republican Party's Freedom Caucus drew from the president. Although opposition to the ACA has become, in ways, the top single-issue test of anti-Democrat animus since its passage, there is not much at stake district by district. The tax code, however, is a lobbyist's delight, and major reform could have considerable district-by-district impact, creating opportunities for deal making. The Republicans hold majorities in both houses of Congress and with good party discipline could advance their agenda without help from Democrats. But tax policy can make odd coalitions, because shared interest in defending an industry prominent in a district or state's constituency can lead to unusual political partnerships.

ECONOMIC BENEFITS

From an economic perspective, the immediate direct benefit from reforming the corporate tax code may be modest. There are two basic arguments for the economic impact of tax reform. First, the massive system put into place to manage the tax system (tax accountants, tax lawyers, auditors, agencies, regulators) is very inefficient. But it's unlikely that proposed legislation will simplify the tax code enough to cancel these costs. It may even create short-term inefficiencies as the massive tax machine adjusts to the new rules. The greater impact would come from the ability of businesses to more effectively and efficiently allocate resources than the government can.

It's important to keep in mind that all the tax plans under current consideration are structured to be revenue neutral. That is, tax reform is not supposed to reduce the net taxes collected. If that's true, taxes can be lowered only if there are offsets. Some potential offsets may include repatriation of profits held abroad at a special rate (although this would be a one timer) and "dynamic scoring," where some assumptions about a stronger economy, and therefore increased profits and taxes, are allowed to be built in to the projections.

Depending on how tax reform is structured, it may also provide some secondary benefits. One of the most important: allowing companies to expense capital investments more quickly, or possibly entirely, in the year they are bought. Usually the expense from these types of long-lasting capital purchases has to be spread out over several years. Such a change may encourage investment and in turn boost productivity, which has been lackluster during the current expansion. Macroeconomics aside, reforming the tax code will certainly benefit the businesses that pay lower taxes.

BAT?

The border adjustment tax (BAT), an intriguing theoretical idea that turns the corporate income tax into what has been called a destination cash-flow tax, may be dead on arrival. BAT is a tax system based on where goods and services are consumed. Therefore, exports, which are consumed abroad, would not be taxed but imports would be. Domestic production consumed at home would be taxed as it already is. The added wrinkle is that domestic expenses are counted against profits but overseas expenses are not. Companies that produce domestically for foreign consumption—think complex machines for export still manufactured in the U.S., like airplanes—would be the winners. The big losers? Companies that manufacture inexpensive goods abroad for sale in the U.S.—think retailers.

The theory behind the BAT is that the tax would increase the value of the dollar, offsetting the advantage to exporters (and the disadvantage to importers) caused by the tax, but whether that theory would work in practice is unknown. If that theory were to prove correct, then the main result of a BAT (in addition to a stronger dollar) would be to eliminate any incentives for companies to relocate abroad, since the tax code would be indifferent to where a company is based. The greatest damage would be any area of the global economy hurt by a strong dollar that gets no offset from the tax system, for example, foreign entities that borrow in dollars or producers of commodities that are priced in dollars.

Although theoretically attractive, the BAT has several problems when it comes to the practical business of making law. One disadvantage is the complexity it may add to the tax system. A BAT will have many winners and losers and there will be strong efforts by lawmakers and lobbyists to write exceptions into to the law to protect constituencies. The BAT may also violate World Trade Organization (WTO) rules.

DON'T GET DRAWN IN BY POLITICAL THEATER

There's an old saying about taxes that goes something like, "Taxation is the art of getting in the most possible plucking with the least possible clucking." The point of this old saw is that tax policy is as much about perception as it is about policy or principles. As the debate about corporate tax reform proceeds, enjoy the political theater but keep in mind the basic principles. Passage by the end of 2017 at a 25% top corporate marginal tax rate is the breakeven in terms of perception. Promoting investment would be a positive. Genuine simplification would be as well, but government isn't very good at simplification once the lobbyists get involved. And finally, for discussion another day, while the goal is to be revenue neutral, the calculation of what revenue neutral means will be highly complex and is unlikely to be 100% correct, creating possible risk to the national debt if the dynamic scoring proves to be too optimistic. ■

RES 5851 0417 | Tracking #1-600102 (Exp. 04/18)