Trumponomics Part 2, Tax Reform

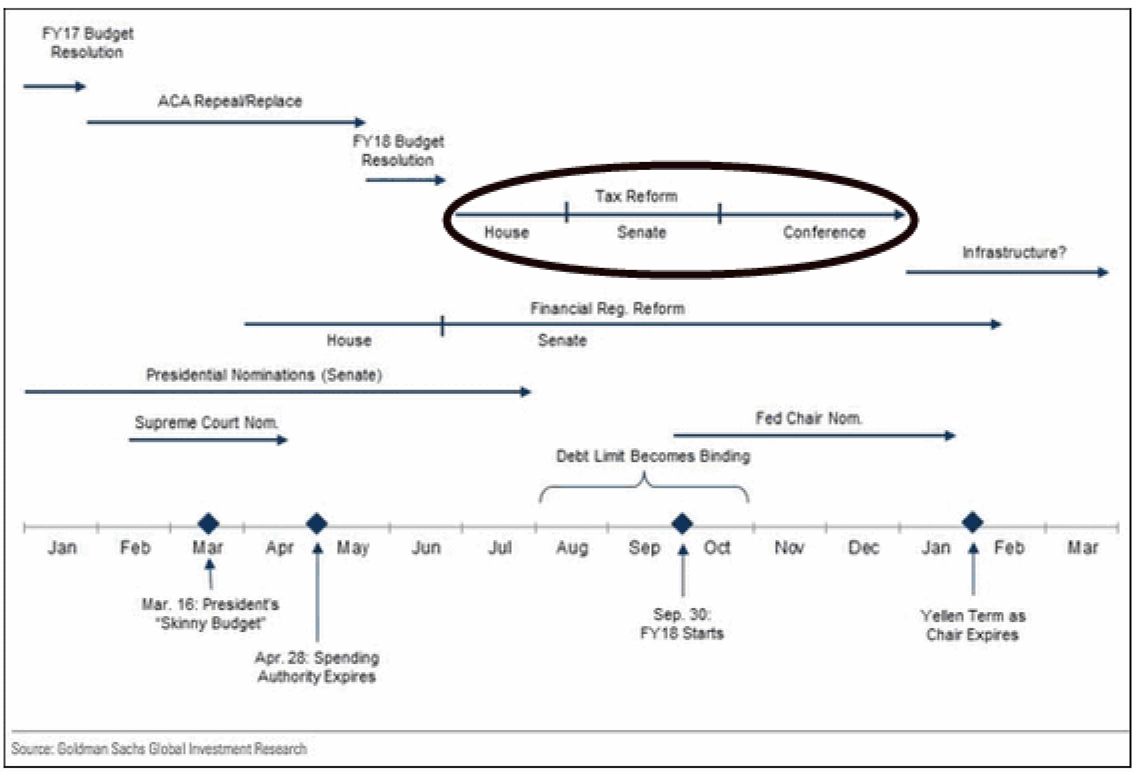
Trumponomics Part 2 will analyze President Trump's tax proposals. We don't know what will be passed or when.

One of the main economic efforts of the Trump Administration is tax reform, and it could include:

- Lower taxes for individuals
- Lower taxes for corporations
- Lower taxes for corporate overseas profits if brought back to the U.S.

Remember, the idea to lower taxes is to stimulate the economy for higher growth that will create more high paying jobs. Bottom line, will tax cuts create millions of high paying jobs? I will answer this question at the end of this report.

Below is the timeline for the Trump Administration's agenda:



Source: Goldman Sachs, @joshdigga

The above timeline is already being pushed forward. In early February, President Trump stated "I'll release a phenomenal in terms of tax in 2-3 weeks." The stock market rallied on the news. A few weeks later, Secretary of the Treasury Steven Mnuchin said he expected the tax plan to be ready around August. Recently Speaker of the House Paul Ryan stated the tax plan would probably be out early 2018.

Then, Presidential candidate Donald Trump's repeatedly said he would "cut the hell out of taxes". Paul Ryan wants tax cuts revenue neutral, in other words tax cuts should not increase our deficits.

I was around when the last major tax reform plan was passed in 1986. The Reagan Administration passed the Economic Recovery Act of 1981 and the act did have tax cuts. But real tax reform did not pass until 1986.

We must remember that our economy and world is much more complicated and bigger than in 1986. Also, the country and politics is much more polarized than it was in the 1980s.

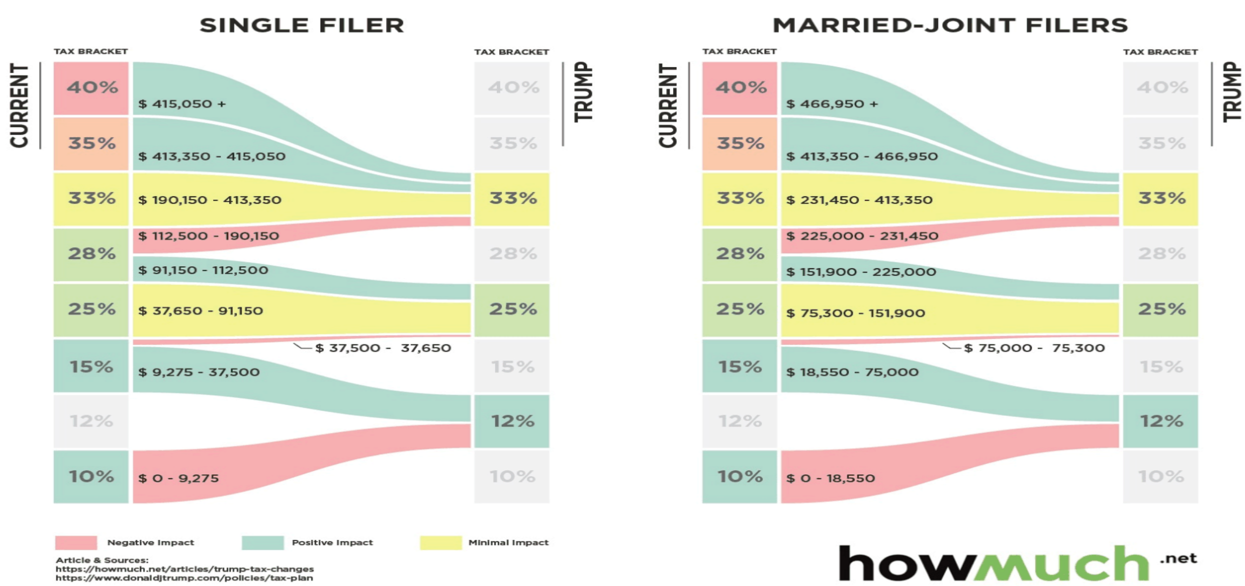
Most of us realize it will take time to devise a plan, get consensus and then pass. I remember in the 1980s there were lots of articles and plans issued about tax cuts. I wasted a lot of time reading all the proposals, and they were different than what was passed. I've learned not to read and analyze every proposal, but focus on what is passed.

I will do the same in this report. I will look at the big picture of taxes and the economy, and I won't focus on the details on many of the proposals.

Individual/Household Tax Cuts

Middle-class tax cuts are a top priority for President Trump.

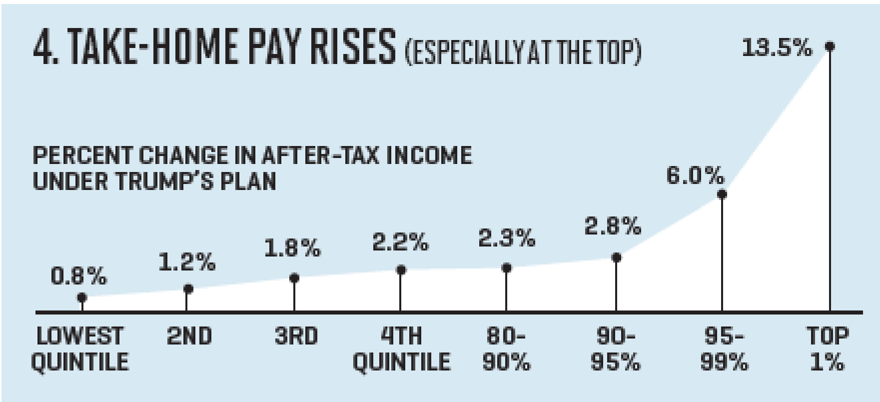
Below is one of the proposed tax plans from the Trump Administration:



Source: howmuch.net

President Trump’s tax plan is essentially to have only 3 tax brackets compared to the current 8.

Below is a chart that shows the tax benefit for the different income groups in the U.S.:



Source: Fortune Magazine

Lower income households will get the least amount of tax relief compared to the top income households.

During the elections and after President Trump stated he would provide “massive” tax cuts to the middle class. According to the chart above, the “massive” cuts will be a little over 2%.

Why do higher income households get higher tax breaks than lower income households? Below is a table that shows taxes and government transfers for each average household income group:

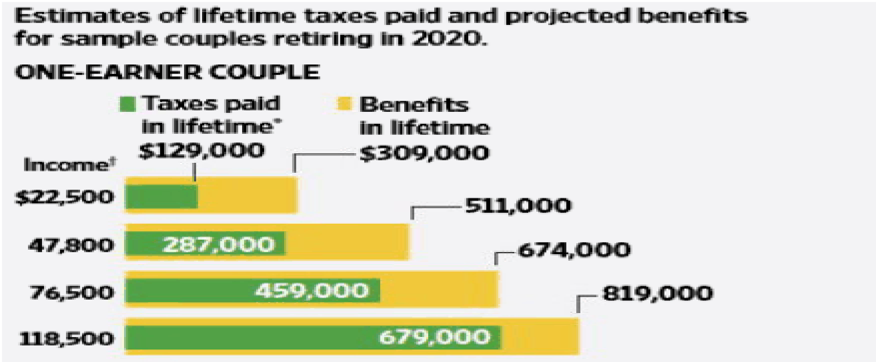
AVERAGE HOUSEHOLD INCOME & TAXES BY QUINTILE

Category	Lowest	Second	Third	Fourth	Highest
Market Income	$15,800	$31,300	$53,000	$88,700	$253,000
Gov’t Transfers	9,600	16,200	16,700	15,000	12,000
Federal Taxes	-800	-4,000	-8,900	-17,600	-69,700
Adjusted Income	24,500	43,400	60,800	86,100	195,300

Note: Numbers may not add up to totals because of rounding.
Sources: Congressional Budget Office, Evercore Wealth Management

Lower income households do get government transfers that help them with the high cost of living while wages have been stagnant.

Another way to understand why the tax cuts are a lot lower for lower and middle class income groups is explained by the chart below:



Source: BusinessWeek

When most people pay their taxes, the majority of their taxes are for their social security and Medicare benefits. Again, as the above chart shows, their benefits are much larger than the taxes they paid in. In other words, the taxes that most people pay, they will get back in Social Security and Medicare, and then some. Especially if you have a long life, and health issues at the end of life.

The lowest income group will be paying $129,000 in taxes, but get about $309,000 in benefits in their lifetime, more than twice the amount they paid in taxes. We must remember that if your income is only $22,500, your economic life is difficult, and many of your choices (having a family, housing, transportation, food) are very limited.

Because lower income tax payers get more benefits, the amount of tax cuts they could receive is limited.

Because high income tax payers pay more in taxes (according to the table above the previous chart, the highest tax bracket, on average pays about $70,000), the government could theoretically afford to give them more tax cuts. Also, my last report on Trumponomics explained that tax cuts when our deficits and debts are so large, is a bad idea. I do explain later in this report that the economic benefits (multiplier effect) is not helpful. Click here to review the report. The deficit, and debt explanation is in the first section. Compounding the problem is the mass retirement of baby boomers who are collecting Social Security and Medicare benefits.

Will providing tax relief to high income consumers help the U.S. economy? What will they do with the increased income? Most likely they will 1. Put it in their brokerage account 2. Pay down debt 3. Buy a luxury car (probably German or Japanese) 4. Buy new wardrobe (probably French or Italian designers) 5. Buy American goods. Will tax breaks for the rich help the U.S. economy - probably not.

Democrats say they will oppose net tax cuts and will resist proposals that mostly benefit high-income households. Also, it will not look good for Republicans in the mid-term elections if the biggest tax cuts go to the rich.

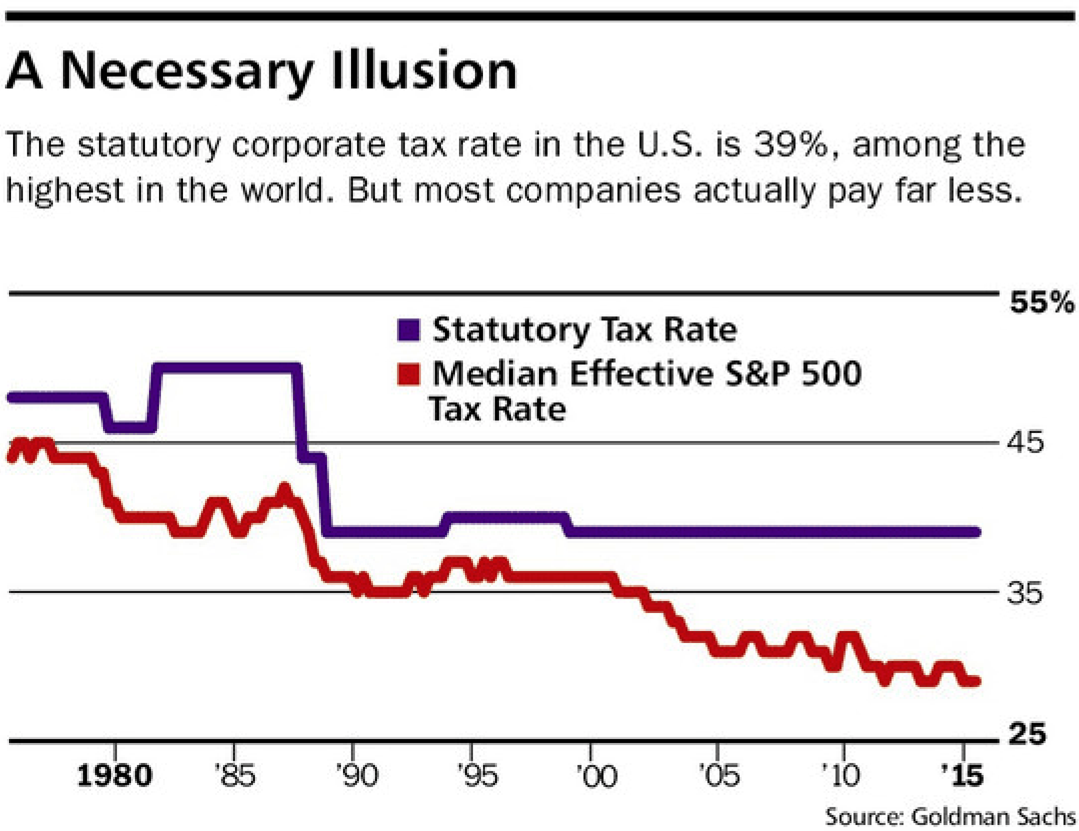
Corporate Tax Reform

Lowering Corporate tax rates

I have not read President Trump's *Art of the Deal,* but according to the financial media, President Trump will ask for the moon understanding that he probably won't get it, but it's a starting point for negotiations.

The President's starting point is to bring down corporate tax rates to 15%, from a top rate of about 35%. Most analysts believe that 20% to 22% would be more realistic. Still, a 20% decrease could help many companies financial performance.

Even though the top tax rate is 35%, most corporations don't pay that because of the many tax deductions they get. Below is a chart that shows the effective tax rates of the S & P 500:



According to the above chart, median effective tax rate for S & P 500 companies is about 27%. An 8% decrease (35% tax rate minus 27% tax rate) would not be a big drop in the corporate tax rate.

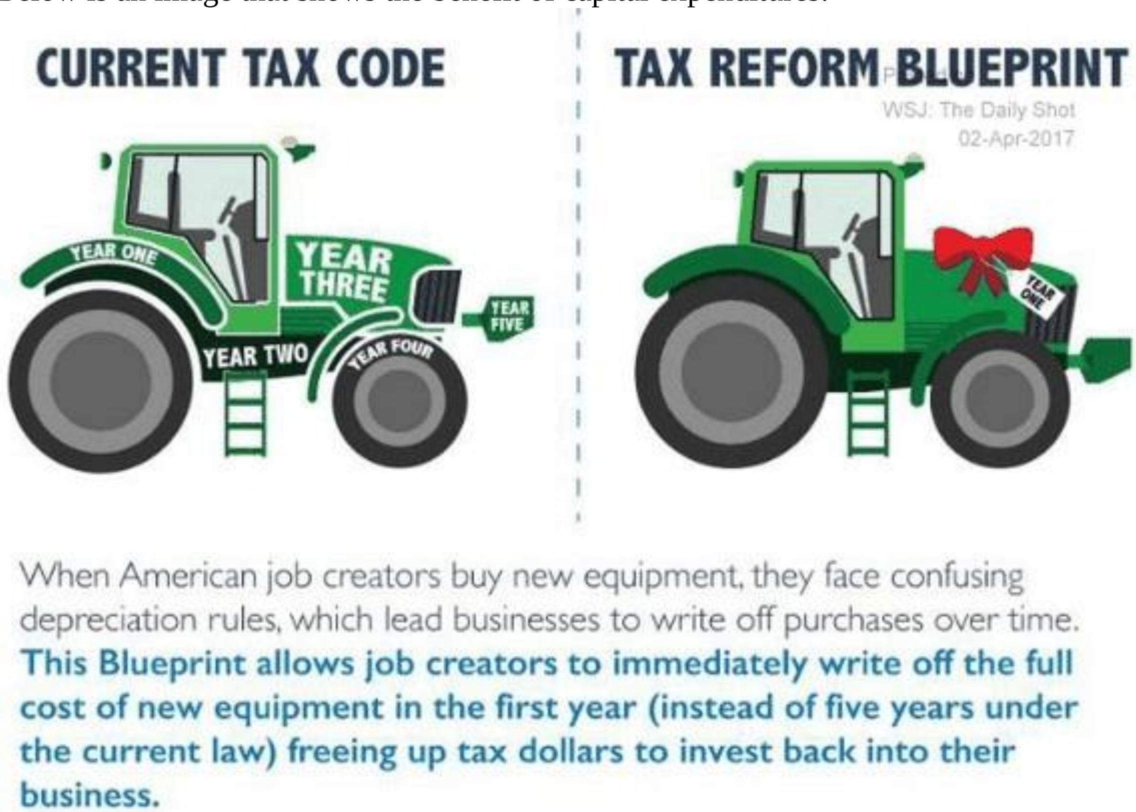
To get taxes down for corporations, it is being discussed that corporations may have to give up some of their tax breaks. Most corporations want lower taxes, but they aren't willing to give up their many tax breaks, deductions. This is true for individuals also.

Lower taxes could increase the coffers of U.S. companies. Lower taxes could also help corporate earnings in the short-term, but the increased cash flow change would only be good for the first year. Longer-term, corporations and individuals would like lower taxes as it helps their bottom line.

Capital Expenditures Tax Breaks

Tax breaks for capital spending has been tried many times in the past, and it is effective – in the short-run. Businesses will take advantage of the tax breaks by buying big ticket business items (hardware, software, equipment, vehicles….).

Below is an image that shows the benefit of capital expenditures:



Source: WSJ

Normally, businesses can write off a capital expense over the life of the asset. Let’s say the tractor above cost $75,000, and it has a useful life of seven years. The business would be able to write off about $10,714 per year. If the capital expenditures tax proposal is passed, then a business would be able to write off the $75,000 the first year, a much bigger expense to lower their taxes.

The company would have more money in their coffers because they would pay lower taxes, but their earnings would be lower because of the bigger expense.

Border Adjustment Tax (BAT)

The BAT is very controversial, and there are probably more negatives than positives.

Briefly, there would be an agreed upon tax, let's say 20%, on imports, and tax breaks worth a similar amount on exports.

The positives would be to discourage and increase the price of imports and encourage exports. If we had an increase in exports and a decrease in imports, jobs could come back or be created.

The other advantage would be an increase in tax revenues. The BAT is a tax proposal by Paul Ryan and he believes it would make tax cuts neutral. He thinks the taxes on imports could be close to $100 million a year and could pay for other tax cuts and some infrastructure spending.

The negatives are being voiced from major retailers like Walmart. They believe that they would have to raise prices as most of the products they sell are imported. Raising prices will probably hurt their top and bottom lines.

The higher prices would be partly paid by consumers and some retailers won't be able to pass on all of their increased costs. The higher prices would probably hit lower and middle income households more. Some believe a strong dollar would occur with the BAT, and the stronger dollar could make imported goods less expensive. A stronger dollar, and higher import prices could be a wash.

Our trading partners like Mexico, China, and Japan could retaliate by increasing tariffs on imported goods from the U.S.

Most economists, analysts believe that BAT would hurt the consumer, especially lower and middle-income families, and therefore it probably won't be included in corporate tax reform.

Profit Maximization and Repatriation of Overseas Profits

Corporations with overseas profits are taxed at corporate tax rates if they are brought back to the U.S. These profits are already taxed at the countries where they are made, in most cases. Because of the potential for double taxation, many U.S. companies leave their profits overseas. It is estimated that overseas profits add up to over $2 trillion.

To bring back all these profits/cash, a tax proposal would tax overseas profits at a much lower rate, 10% is being suggested.

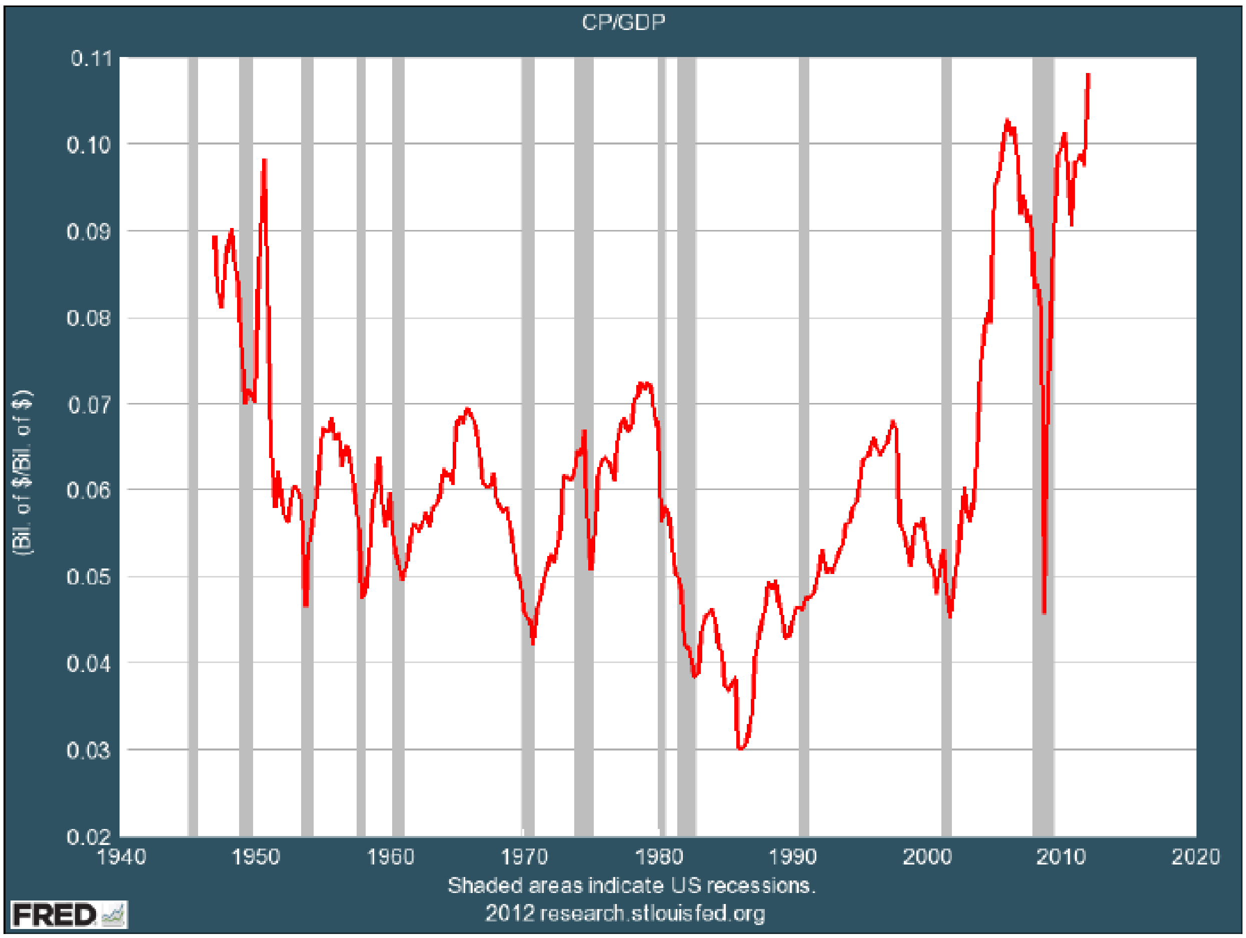
Repatriation was utilized in 2004, so it would probably be included in President Trump's tax reform.

The tax revenue from repatriation could help pay for other tax cuts and infrastructure and military spending.

What will corporations do with the tax breaks? We do have data on this, but before we review, let's talk about the priorities of most public corporations.

When I went to graduate business school, we were taught in almost every class (accounting, finance, management, strategy) that the goal of every business, business executive, and employee was to maximize shareholder wealth. This is what drives every strategy and effort of management. This has not changed at most business schools and most businesses.

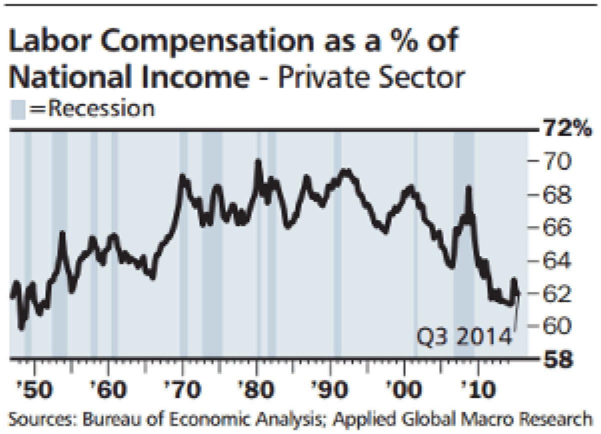
Corporate America has done a great job of maximizing profits:



Source: Federal Reserve Economic Data (FRED), St. Louis Fed.

As the chart shows, corporate profits are at historic highs.

Unfortunately, those profits aren't shared by their workers:



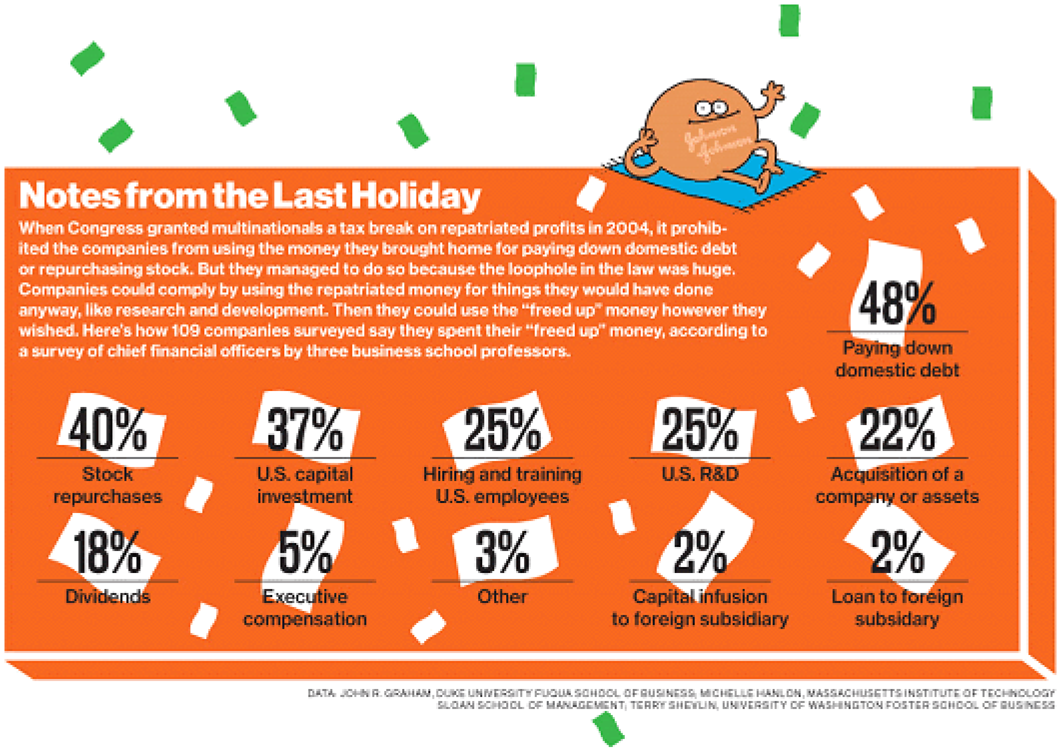
As the chart shows, corporate profits aren't shared with employees as they have in the past.

How would management maximize shareholder wealth with repatriated profits? Expenditures would probably include:

- Stock buyback programs
- Decrease debt
- Capital expenditures
- Research and development
- Dividend increases
- Mergers and acquisitions to move into new markets/products
- Increase hiring and training

Notice that hiring is not a top priority (job creation is a priority of the Trump Administration).

Below is an image from BusinessWeek that shows where repatriated profits went during the last tax holiday in 2004.



Source: BusinessWeek

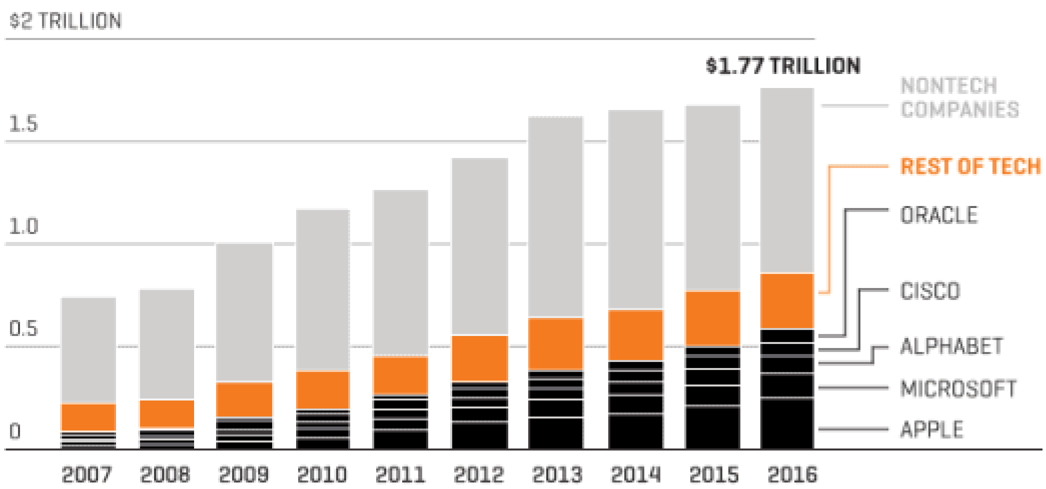
During the 2004 tax holiday, paying down debt was the number one use of the tax break. Hiring was number four. Notice there was not a mention of raises for employees, some money was used for executive compensation.

Tax provisions are being made to make sure that the repatriated money would be used to help workers and the economy. There were restrictions in the 2004 tax holiday, but companies were able to work around the restrictions, as they are likely to do this time around.

The real question is – will corporations forget their profit maximization focus, and will they then hire more workers and give more raises to their employees and not just to executives. If the President could convince corporations to hire more people and give more raises, this could help President Trump meet his jobs mandate.

I doubt that corporations will change. If you have owned stocks for a long period of time you have probably received letters from law firms regarding class action suits regarding company management who did not make decisions that were in the best interests of its shareholders. Company management and board members have a legal responsibility to make decisions that are in the best interests of shareholders. Corporate management and board members do not have a legal responsibility to maximize worker wealth, or increase payrolls, unfortunately.

Much of the overseas profits are from technology companies:



Source: Moody's Investors Service, 2016 projected data

These technology companies are domiciled in Seattle or the bay area of San Francisco, so repatriation would probably help the economies in these area. President Trump wants to help the people that elected him (Ohio, Michigan, Wisconsin, and Pennsylvania, North Carolina, Florida), and probably not Seattle and the San Francisco Bay area of California.

Also, not all of the repatriation will come back because the cash is needed to fund operations in the countries they do business in.

One of the main problems with President Trump's economic plans is his focus on manufacturing. Our economy is much more diverse than manufacturing. Our economy essentially has about 10 sectors:

U.S. SECTORS
BASIC MATERIALS
CONSUMER GOODS
CONSUMER SERVICES
FINANCIALS
HEALTH CARE
INDUSTRIALS
OIL & GAS
TECHNOLOGY
TELECOMMUNICATIONS
UTILITIES

Source: Barron's

Each major sector has many industries, there are about 150 industries. We have the most diverse economy in the world.

The consumer is about 70% of the U.S. economy, so the largest sector is consumer services and consumer goods. Here is a list of the many industries in the consumer services sector:

CONSUMER SERVICE INDUSTRIES		
Media	Home Improvement Rtlrs	Food Retailers & Whlslrs
Brdcst & Entertainment	Specialized Consumer Svcs	General Retailers
Media Agencies	Specialty Retailers	Apparel Retailers
Publishing	Travel & Leisure	Broadline Retailers
Retail	Airlines	Restaurants & Bars
Food & Drug Retailers	Gambling	Travel & Tourism
Drug Retailers	Hotels	Recreational Svcs

Source: Barron's

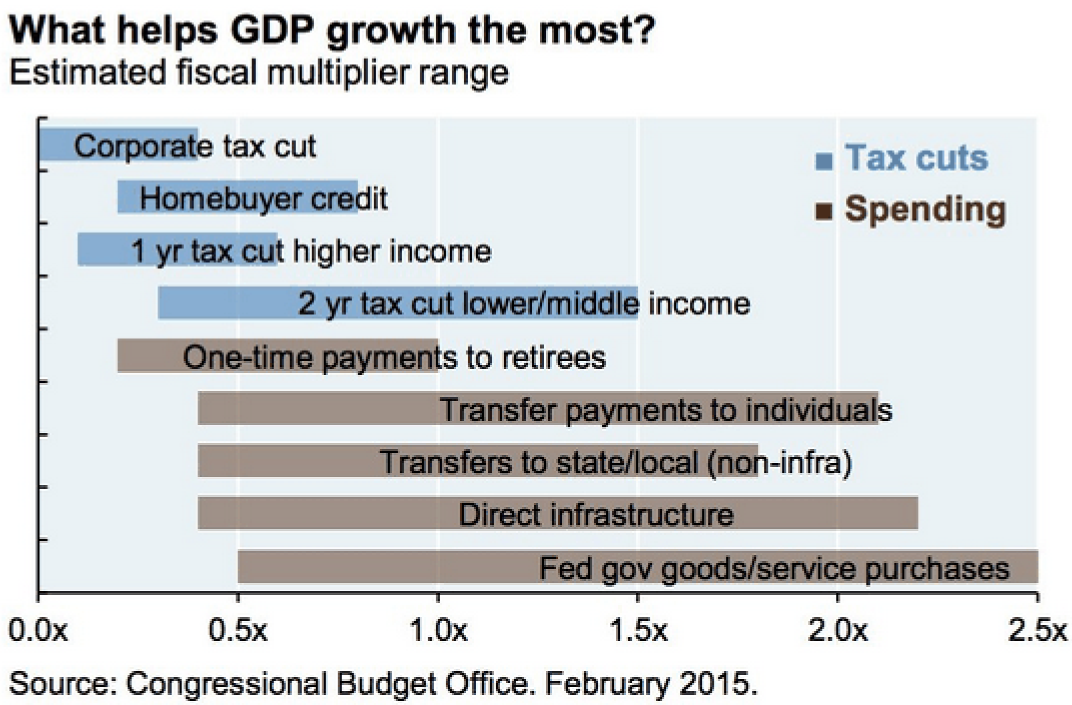
There are millions of job openings, but many applicants don't have the skills or don't live in areas where the jobs are. President Trump needs to focus on the other areas of the economy, and not just manufacturing. He also needs to develop plans to help close the skills gap of workers for the jobs of today and in the future. He could also consider programs to help families move to areas in the country where the jobs are. This would need coordination between education, businesses and the government. Many countries do coordinate and cooperate among these three important entities.

Multiplier Effect

Will corporate and individual tax breaks help the economy? In my Trumponomics Part 1 report I did write:

"Think tanks like the Heritage Foundation and the American Enterprise Institute greatly influence Republican economic thinking, and they are married to cutting taxes (supply-side-economics), free markets and global free trade. The policies they promote are ideological and have proven overtime not to work in the real world."

Here is a chart that shows that tax cuts don't have the multiplier effect that could help the economy more significantly:



A multiplier effect is basically how many times a dollar recycles/multiplies in an economy.

As the chart shows, tax cuts have a low multiplier effect.

Notice that transfer payments and infrastructure and government spending have higher multiplier effects.

I will write more about infrastructure proposals in my next Trumponomics report.

Summary & Conclusion

- As I wrote about in Trumponomics Part 1, tax cuts with growing deficits and debts is a bad idea at this time. Making the situations worse are baby boomers retiring in large numbers. They're collecting Social Security and applying for and using Medicare. Again, tax cuts are not a good idea at this point.

- President Trump's tax reform will probably include tax reform for individuals and households, corporations and lower tax rates for repatriation of corporate overseas profits.

- We don't know what will be passed or when.

- Individual taxes brackets will probably be reduced from eight to three. There will also be tax cuts, but the biggest tax cuts will be for upper income households.

- Corporate tax reform could include lower taxes that could go from an effective tax rate of about 27% to about 20%. Capital expenditure tax breaks are part of tax reform, and these could help the economy in the short-run. A BAT is favored by Paul Ryan and some republicans because it could make tax reform revenue neutral. Most analysts and some republicans believe BAT will not become law because it could cause higher prices for consumers.

- Most corporations will probably not do a lot of hiring or give raises to its workers. They are not legally required to, but they do have a legal responsibility to its shareholders, owners.

- The multiplier effect of lower taxes to high-income taxpayers and corporations are low, and probably won't do much to improve economic growth, but more importantly, they won't create millions of high paying jobs.

- Tax reform would mostly help high-income tax households and shareholders of corporations.