Tax Reform, An Opportunity
By Peter Scholtz
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The recent Tax Reform Legislation seems to have continued the wide divide in Washington in terms of whether it is good or bad policy. Lower middle-class earners generally will get a modest tax cut, whereas upper class earners (incomes exceeding $400k) may actually be getting a tax increase, depending on their unique circumstances. If you have a million-dollar mortgage, and you live in a high tax state, your taxes will actually rise due to the effect of losing many deductions. Those same earners with low deductions living in a low or no income tax state are likely beneficiaries. Overall, it's a mixed bag for the individual tax payer, but the change in the corporate tax rate is anything but subtle and an undeniable positive for the economy.

For the past twenty odd years, the corporate tax rate around the world has been in steady decline. With globalization, countries have competed for international companies whose identities have become blurred with respect to what nation they are associated with. Corporations around the world have changed their domicile seeking lower tax rates while the United States has been the lone holdout on high corporate rates. In addition, the United States had a unique law that requires corporations to pay the U.S. government the difference in the tax rates between the host country and the U.S. rate. At a 35% U.S. rate, a company doing business in a 25% tax rate country is required to pay the 10-percentage point difference to the U.S. government. These earnings had deferred tax status so long as the money remained overseas. It has been estimated that up to two trillion dollars in U.S. corporate profits remained overseas to the benefit of the host country. The new tax law taxes all of this money at a one-time 15% rate, regardless of whether the money stays abroad, so it is now flowing back to the United States.

In understanding its effects, it is important to understand corporate behavior with respect to tax changes. A company, especially a large sophisticated one, decides where to invest and what investments to make, based on their estimated returns on a project. Let's say the company is looking at a project that generates $1,000,000 in yearly pretax profits for 10 years and requires an initial $4,500,000 capital outlay. This domestically based firm pays 40% of that in taxes, 35% Federal and the rest state and local. It earns $550,000 annually after tax. This project represents a return on their invested money of a little over 5%. If their tax rate is reduced to 21% Federal, plus state and local of 5%, their tax rate is now 26% and their net profit on the project is $740,000 annually, raising the return to over 10%. This might make the difference in their decision. Many marginal projects will now become viable with a lower tax rate. This increases investment activity and expansion, and GDP growth. There are many large domestic companies that have been paying the full tax rate and although they are very profitable with lots of investment opportunities, they have been constrained

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in their expansion plans by paying out a large amount of cash flow in taxes. More after-tax cash flow enables them to grow at a faster rate. There are many U.S. centric retailers, grocers, and service companies like regional banks that have paid the top rate.

Additionally, large international companies have now seen their project analysis tilt towards investing in the United States versus other countries. Although the United States gets it share of foreign investment due to our educated work force and stable political climate, this tax change is a game changer for Asian and European companies looking to locate facilities overseas. Expect more foreign investment over time.

Many have argued that the tax change is a non-event since our effective rate has been well below 30%. A lot of the low effective rate has been a result of our large multi-nationals keeping their low-taxed profits outside of the country. Not only will this now change, bringing this capital back to the United States, but companies like GE will pay more. GE has had a very low rate by investing in tax credit projects. With a high potential tax rate, these tax credit projects had a high return. A lower tax rate reduces the amount of taxes saved and the value of the project, so with tax reform you get less economic distortions due to playing these “tax games”. We have had a wide divergence in tax rates paid, so there are many companies that will benefit.

The bottom line is that this is a sea change tilting the investment opportunities in the United States for the better. It will definitely increase economic growth. Already, firms have announced pay raises and bonuses for lower paid individuals, numbering over a million people. Not all this is altruistic since the labor market is getting quite tight and if investment opportunities are opening up, you better keep your trained labor.

The timing of the tax reform, however, is pretty bad. This is an economic stimulus during the strongest period of growth in this cycle in an economy with less slack. Tax Reform legislation was desperately needed in 2009, but instead the government mandated additional health care costs, especially on small businesses. In spite of such a deep recession, we crawled out of it and have not had a single year with GDP growth over 3% since the bottom. Contrasting that with the tax cuts in the early 1980’s, a similar deep recession that witnessed 9% growth in the first quarter of 1983. Global growth is currently very strong and synchronized for the first time in a long time. Fiscal policy should at this time be more benign, however, this **Corporate Tax Reform was so needed** that it is a blessing to get it done at any time.

Besides new investment projects, where will this money go? Cisco Systems has announced that it will return most of it to shareholders since they don’t have investment opportunities that require more capital than they are generating. They are a very mature company. Shareholders in turn will reinvest the money in companies that can use it. Walmart has announced wage increases, and many retailers and restaurants seem to be investing in people. Read, higher wages. Still, highly competitive businesses such as retailers and banks will probably see a lot of these “tax savings” competed away over time as the price of goods and services will be lower than otherwise. Consumers will be the big beneficiaries here. Indeed, one may argue that all corporate behavior hinges on adequate after-tax returns and so inevitably, it is the customer that pays the tax since higher prices are needed to cover tax costs. Much of this corporate tax reduction will therefore flow through to the public in areas of intense competition.

The remaining question is what does this do to the Federal Deficit? Firstly, it is important to understand the deficit. In recent decades, the amount of spending in government transfer programs such as Social Security and Medicare has ballooned (see entitlement picture). These projections are without tax reform and without a recession, at a point in the cycle where deficits should be the lowest. The number of new benefits in Social Security and especially Medicare have increased significantly over the decades and are being compounded by demographics. Social Security was originally indexed to inflation plus a number giving recipients real increases every year. Individual Medicare benefits have increased faster than inflation, in addition to new, added benefits such as the Part D drug benefit. Social Security and Medicare tax rates are now over 15% of a middle-income worker's salary when including the Employer's portion. It was in the low single digits in the 1960's. Transfer Payments are now over half of the Federal budget and clearly the rapidly growing expense elephant in the room. Social Security has its roots in Germany when the government cut a deal with labor such that if you lived beyond the current life expectancy, you received an annual payment. The life expectancy at the time was 65 years old. You can see why this is a problem (see budget forecast from 2014). The percentage of population on this increasing list of benefits is growing. Increasing spending elsewhere like defense, walls on the Mexican border and even good infrastructure projects aggravates this problem.

The U.S. economy has an interesting fact regarding tax rates. Ever since the income tax has become a meaningful amount, the amount of taxes collected by the Federal Government has been very stable as a percent of GDP – roughly 17% to 20%. This is referred to as Houser's Law. Envision a tax rate from zero to one hundred percent. At the extremes, no taxes are collected. Income taxed at a very low rate generates little receipts and no one will draw a salary at a very high rate either. One could owe more than 100% of earnings, depending on state laws. This reasonably steady 17% to 20% tax collection is despite the fact that marginal tax rates have come down substantially over the decades (see picture). If this is the case, changes in tax rates do not affect changes in tax receipts as a percent of the economy nearly as much as believed. They do affect economic behavior.

Witness the state of Connecticut, with the highest per-capita income in the country as an example of how tax rates don't fix budget problems. There was no state income tax in 1985 and now Connecticut is one of the highest tax states in the United States; in all kinds of taxes. They most certainly have the highest taxes per capita collected. Do they have a large budget surplus? The state has never had a worse fiscal situation. UBS and GE are leaving. Wealthy retired individuals are leaving to become Florida residents. There are 13 years of inventory of large estates on the market. Connecticut has had one positive growth year in the economy in the last five. Connecticut must compete with other states for people, but countries compete for large corporations. It is not quite the same, but similar.

If, at the Federal level, tax rates do not dramatically change tax receipts as a percent of GDP, then it begs a question. Should not tax policy be designed to maximize GDP to maximize tax receipts? Many years ago at a conference I asked Jack Kemp, the ex-professional quarterback and Congressman, “has anyone in Washington been studying what the optimal tax rates should be for growth and tax receipts?” He gave me a confused answer. I have recently seen some studies on optimal rates, but the results and methods are very controversial. Common sense would tell you it should probably be somewhat low to stimulate economic growth, but not so low you can’t achieve the 17-20% tax receipt range. You will not solve the deficit with tax policy as shown by Connecticut, it must be solved by addressing and constraining government spending, limiting it to less than 20% of GDP. The 1980’s and 1990’s witnessed rapid GDP growth and a slowly decreasing Federal deficit, not as a result of changes in tax policy or dramatic spending cuts. The two larger deficit periods you see in the picture, early 1980’s and 1990, are due to recessions. Tax policy stayed largely unchanged and the Federal government slowed the growth in spending to a level slower than the growth in the economy. The last three years of the 1990’s saw GDP growth exceeding 4% all three years. The budget ended in surplus.

We have a major budget problem today that will result in a day of reckoning that will be very painful. My fear is that we will attempt to solve it the way Connecticut has, and with similar results. Lowering the corporate tax rate, eliminating the U.S. disadvantage and economic distortions, is the best policy we have passed in decades. It generates growth in GDP and growth in government tax receipts. Any poor timing, or undesired consequences, will be dwarfed by the positive effects of this change. Over time, over-spending can only be solved by lower spending. Maximizing growth maximizes growth in government tax revenue. We still have a major budget challenge, but if economic growth can accelerate, and we show some discipline by restraining the growth in government spending, we can address our long-term problems.