Tax Reform? ETFs Potentially in Play

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The stock market is up after Trump's election as "animal spirits" were initially aroused with the promises of a repeal and replacement of Obamacare, a tax reduction, a large infrastructure program, and a lighter regulatory burden. Since the health care bill appeared likely to fail and was pulled, the market ebullience has faded. It now appears, the focus of the Trump administration would naturally shift toward lowering tax rates although there is still talk of trying to resuscitate the health care effort and finish it before changes would be instituted in the tax area.

President Trump also said "Right now, American companies are taxed at one of the highest rates anywhere in the world". The United States historically has had a consistently steady but very high corporate tax rate despite the pattern of other countries which have dramatically lowered their rates over the past 10 years, thus the widening of the competitive disadvantage.

As can be seen in the chart above from Cornerstone Macro, the United States currently has a combined rate of 39% consisting of a 35% federal tax rate plus the average tax rate amongst the states while others in the OECD have a rate of only 25%, which is 14 points or about 35% lower on a stated basis. The United States, with its corporate tax rate at 39%, now has the HIGHEST corporate tax rate amongst the 35 member countries of the OECD or amongst the G20. Widening the lens, the US corporate tax rate amounts to the 3rd highest amongst 188 countries in the world. Only the United Arab Emirates and Puerto Rico have higher rates than our country.

President Trump campaigned on a promise of a 15% corporate tax rate while the House in its "Better Way Forward" program has proposed a 20% rate. We believe either end of the numbers would be a welcome change given where the USA rate of 39% stands in the world today.

As the debate heats up on taxes, people will take sides on whether to evaluate tax reform on a "static" or "dynamic" basis. Those who favor a static approach will cite budget concerns and will want dollar for dollar offsets to "pay for" the tax cut because they don't factor in any changes in behavior, nor do they factor in any change coming from the impact of faster growth that would result from the reduction in rates. Those who favor *dynamic* scoring have a number of terrific examples of programs to examine that worked very well where corporate tax rates were sharply reduced while "collected" taxes rose.

The first observation one would make from the table above is how small the percentage of collected corporate taxes are relative to GDP. That is because so much of the collected taxes come from individuals, from payroll taxes, from entities like sole proprietorships and from trusts.

The chart below comes from the Congressional Budget Office and shows the mix of tax revenues in the United States since 1945 and the diminishing contribution of corporate income taxes.

Canada is a good example of a country that has dropped its corporate tax rate and increased its revenues. In Canada's case, their corporate tax rate was close to 50% in 1982 and they have since steadily dropped their rate all the way down to 15% … without a corresponding erosion in collected corporate tax revenues.

Ireland may be the "all-time" example of higher collected revenues from lower corporate tax levies. The country was collecting only 1.5% in corporate taxes as a percent of GDP in 1982 when the tax rate was 50%, but with a rate of 12.5%, Ireland's collected corporate taxes now amount to 2.7% on a GDP base that is 11.6 times larger.

In the U.S., small and mid-sized companies comprise 99% of all firms, employ around half of the country's workforce, and account for more than 60% to 70% of the job growth in our country. When President Reagan took office, he lowered the top marginal bracket from 70% to 28%. The Cato Institute developed some numbers based on the report, "Statistics of Income (SOI)" from the IRS.

The Cato team looked at the income earners over $200,000. As can be seen in the table below, the number of "rich" filers back in 1980 totaled 116,757. Those filers had taxable income of $36.2 Billion and paid taxes of $19.0 Billion, which works out to a melded tax rate of 48.9%. Fast forward to 1988 when the top marginal rate was 28%, the number of filers who earned over $200,000 rose 6.2 times to 723,697. The 1988 "rich" filers reported taxable income of $353 Billion of income, up 9.8 times from 1980 and paid taxes of $99.7 Billion, up 5.3 fold from 1980.

Even if the impact from a higher population base with a better economy and some inflation were aggregated, those factors would only contribute a theoretical gain of around 50% – not the realized experience of a <u>five fold increase in collected taxes</u>.

We believe there will be a budget deal. We suspect the possibilities are that (i) a 50% probability that the House plan is passed close to its current form which cuts taxes, reduces the number of individual tax brackets, broadens the base, and reforms the code, or (ii) a 30% probability that the Trump plan gets pushed through which would cut rates to 15%, or (iii) a 20% probability that a tax plan is instituted that only tweaks the code, lowers rates only slightly, and doesn't impact the deficit much.

If a deal does get approved, we believe smaller companies will benefit more than larger ones, as they will receive a greater post-tax bump in profits. Accordingly, small cap ETFs such as the IWM (iShares Russell 2000 ETF) or IWC (iShares Micro-Cap ETF) may warrant a closer look.