Southern Capital Perspective

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HOW COULD LOWER TAX RATES AND REDUCED REGULATIONS AFFECT THE ECONOMY AND THE MARKETS?

The incoming Trump administration has promised to dramatically reduce taxes and to roll back excessive regulation. Their contention is that these actions will propel the US economy to growth rates in the 3.5% to 4.0% range. High rates of taxation on business make it harder for American companies to compete against foreign competition. It has also led to a practice called "corporate inversion" which is defined as "… the practice of relocating a corporation's legal domicile to a lower tax nation, or tax haven, usually while retaining its material operations in its higher-tax country of origin."[1] This action takes tax-paying corporations out of our country (taxed at a 35% maximum rate) and encourages them to relocate through mergers to lower tax nations like Ireland (12.5% tax rate). It is very hard for corporate managements to justify lower profitability to their shareholders when a change in location to a stable sovereign nation like Ireland may increase profitability by approximately 20%.

Excessive regulations (federal, state and local) have had a stifling effect on business activity in the United States.

According to the American Enterprise Institute (AEI)[2]:

"In a 22-industry study released in April by the Mercatus Center at George Mason University, a group of researchers found that federal regulations created an economic drag on the U.S. economy amounting to an average annual reduction in GDP growth of 0.8%" To put this into context, the U.S. economy has been growing at a rate of 2.0% to 2.4% over the last few years; therefore, a 0.8% reduction represents a 33% to 40% loss of annual economic activity.

What Can History Teach About Lower Rates of Taxation?

During the Harding and Coolidge administrations of the 1920s, income tax rates were slashed "from over 70% to less than 25%. What happened? Personal income tax revenues increased substantially during the 1920s, despite the reduction in rates. Revenues rose from $719 million in 1921 to $1,164 million in 1928, an increase of more than 61 percent."

According to then-Treasury Secretary Andrew Mellon[3]:

"The history of taxation shows that taxes which are inherently excessive are not paid. The high rates inevitably put pressure upon the taxpayer to withdraw his capital from productive business and invest it in tax-exempt securities or to find other lawful methods of avoiding the realization of taxable income. The result is that … capital is being diverted into channels which yield neither revenue to the Government nor profit to the people."

The 1920s were one of the most prosperous times in American history. There was rapid industrial growth along with advances in technology. The stock market soared as did productivity also wages grew and the result was huge profits for businesses.

During the Kennedy administration of the 1960s the top tax rate was reduced from over 90 percent to 70 percent. "What happened? Tax revenues climbed from $94 billion in 1961 to $153 billion in 1968, an increase of 62 percent (33 percent adjusting for inflation)." [4]

According to President John F. Kennedy:

"Our true choice is not between tax reduction, on the one hand, and the avoidance of large Federal deficits on the other. It is increasingly clear that no matter what party is in power, so long as our national security needs keep rising, an economy hampered by restrictive tax rates will never produce enough revenues to balance our budget just as it will never produce enough jobs or enough profits … In short, it is a paradoxical truth that tax rates are too high today and tax revenues are too low and the soundest way to raise revenues in the long run is to cut the rates now."

JFK's strategy was successful and his era, although brief, represented a dramatic turnaround for America. "… Kennedy enjoyed a nearly miraculous economic turnaround. At the time of his death in November 1963, an employment boom was beginning. Stocks were soaring, swept up in the emerging 'go-go' era on Wall Street – a time when investors were falling in love with mutual funds and conglomerates." [5]

During the Reagan administration of the 1980s, the impact of the inflation stemming from the 1970s was addressed through the tax code. The phenomenon called "bracket creep" was pushing millions of American taxpayers into higher tax brackets because of inflation even though inflation-adjusted earnings were not increasing. People were having to pay higher rates of taxation which meant that their real

(after adjusting for inflation) take-home pay was actually reduced. President Reagan introduced large tax rate reductions to remedy this situation during the 1980s. "What happened? Total tax revenues climbed by 99.4 percent during the 1980s, and the results are even more impressive when looking at what happened to personal income tax revenues. Once the economy received an unambiguous tax cut in January 1983, income tax revenues climbed dramatically, increasing by more than 54 percent by 1989 (28 percent after adjusting for inflation). [6]

According to then-U.S. Representative Jack Kemp (R-NY), one of the chief architects of the Reagan tax cuts:

At some point, additional taxes so discourage the activity being taxed, such as working or investing, that they yield less revenue rather than more."

The Reagan Record:

- "Real economic growth averaged 3.2 percent during the Reagan years versus 2.8 percent during the Ford-Carter years and 2.1 percent during the Bush-Clinton years.
- Real median family income grew by $4,000 during the Reagan period after experiencing no growth in the pre-Reagan years; it experienced a loss of almost $1,500 in the post-Reagan years.
- Interest rates, inflation, and unemployment fell faster under Reagan than they did immediately before or after his presidency." [7]

The time periods of the 1920s, 1960s and the 1980s all point to the historic success of lower rates of taxation spurring economic activity and even producing more actual revenues for the Government. The past is certainly no guarantee that the future will mirror history but the lessons of the past can be instructive as to what might be expected considering that there are multiple positive historic examples to study.

The argument regarding the effect of excessive regulations especially in the financial sector was probably best stated by Bernie Marcus, one of the co-founders of The Home Depot. In a talk to the Detroit Economic Club, he said: "America has changed drastically since he started The Home Depot – so much that he could not possibly start the successful national company today.

'We started with four stores and a dream, and a small bank believed in us enough to invest,' the 84-year old retired CEO told the luncheon crowd. 'With laws on the books like Sarbanes-Oxley and Dodd-Frank, that banker would be breaking regulations today. The next Home Depot could never get off the ground.' " [8]

The incoming Trump administration believes that it will be able to get tax reducing legislation through Congress. It is likely that it will happen because the House and Senate are in Republican hands, but not all House members and Senators that have an "R" after their names are in total agreement with President-elect Trump. This could potentially block or at least lessen the amount of the tax-cut. In regard to the roll-back of regulation, much of it can be accomplished through executive orders because it was never enacted through legislation. However, some will require legislation which once again will depend upon Congress and other parts will require fighting with the entrenched bureaucrats in the various Governmental Agencies. In summary, the opportunity for 3.5% to 4% GDP growth exists but it is by no means assured.

[1]https://en.wikipedia.org/wiki/Tax_Inverson
[2]AEI Investor's Business Daily. May 16, 2016
[3]www.heritage.org/research/reports/2003/08/the-historical-lessons-of-lower-tax-rates.
[4]*ibid*
[5]*ibid*
[6]*ibid*
[7]*ibid*
[8]https://www.jobcreatorsnetwork.com/press_releases/marcus-we-couldnt-start-home-depot-today/

Outlook

The year 2016 began with a sharp sell-off in the first quarter and the technology and healthcare sectors were hit especially hard. As the year progressed the market recovered and the election gave the market a nice boost. However, our technology and healthcare funds lagged producing a drag on performance. These funds have long track records of superior double-digit annual performance and we feel that in the future, they will return to their normal behavior. Therefore, we are staying with them because of their excellent management and historic returns.

The year 2017 has the potential to be very strong if all of the proposed pro-business changes are put into place. However, things seldom occur as forecast. Often the unforeseen event shapes the future, for better or for worse. Assuming the Trump administration gets the bulk of its tax -reduction and regulation roll-back and international trade is not too damaged in conjunction with a Federal Reserve (FED) that keeps its interest rate increases moderate then 2017 could be a positive year. There are a lot of (if's) in this outlook but on-balance it should be considered upbeat.

Happy New Year!

Your Enclosed Informational Invoice. On the enclosed invoice you will see a balance that differs slightly from the TD Ameritrade December statements. This is due to dividends in the Homestead Small Stock Fund that came in at the end of the year. ***Your accounts were actually billed slightly less than what shows on the invoice and your end-of -year balance is therefore slightly higher.*** As always, TD Ameritrade as the custodian is the official record keeper and the enclosed is for informational purposes only.

Terry E. Nager is a CFP®, CLU®, and ChFC®. He is also the President of Southern Capital Services, Inc. — a registered investment adviser. The information presented by the author and the publisher is for informational and educational purposes only. It should not be considered specific investment advice, does not take into consideration your specific situation, and does not intend to make an offer or solicitation for the sale or purchase of any securities or investment strategies. Additionally, no legal or tax advice is being offered. If legal or tax advice is needed, a qualified professional should be engaged. Investments involve risk and are not guaranteed. This newsletter contains information that might be dated and is intended only to educate and entertain. Any links or websites referred to are for informational purposes only. Website not associated with the author are unaffiliated sources of information and the author takes no responsibility for the accuracy of the information provided by these websites. Be sure to consult a qualified financial adviser and/or tax professional before implementing any strategy discussed herein.