First Trust
Monday Morning OUTLOOK

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Tax Cuts on the Horizon

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The one key reason for being bullish on equities the past several years has been valuation. Stocks are cheap based on profits and interest rates.

However, one additional reason to be bullish is that tax policy is very likely to improve after the next presidential election. For very different reasons, the election of either a Republican candidate or Hillary Clinton should generate tax cuts.

It's easy to see why the election of a Republican would lead to tax cuts. One of the few issues on which the vast majority of Republican voters agree is that tax rates matter and lower tax rates generate more economic growth. Almost all of the major candidates have a plan, or at least an inclination, to cut tax rates, particularly those that stifle economic growth the most, such as on corporate profits and income from investment.

At present, companies pay a base federal tax rate of 35% on corporate profits. Combined with an average state tax rate of about 4%, the US rate is the highest for any advanced country in the world.

Then shareholders pay an additional layer of tax when those after-tax profits generate dividends or capital gains. That second layer of tax can be as high as 20% for the highest earners (23.8% including a surtax created by Obamacare). In addition, companies that invest in plant and equipment have to take years to depreciate those costs instead of expensing them for tax purposes the year they make them.

Marco Rubio would cut the corporate tax rate to 25% and completely eliminate the second layer of taxes applied when shareholders earn dividends and capital gains. He'd also let companies fully expense business investments the year they make them. Chris Christie would cut the corporate rate to 25% as well, although he'd maintain a second layer of tax on capital gains and dividends, instead cutting tax rates deeper than Rubio on high income workers.

Rand Paul would replace the corporate profits tax with a European-style 14.5% valued added tax and move to full expensing of capital purchases, eliminating depreciation. Meanwhile, shareholders would pay that same 14.5% rate on capital gains and dividends. That would bring the effective tax rate on corporate profits to 27%, essentially the same as Rubio's 25%.

(Here's the math on Paul's plan: under a VAT, labor income and capital income both pay 14.5% at the corporate level, leaving 85.5% to shareholders, who pay a 14.5% rate on that remaining 85.5% when they earn dividends or gains. That leaves 73% of the original profit, which means the effective tax rate is 27%.)

Ben Carson and Ted Cruz have said they'd like to see a flat tax of some sort. Scott Walker hasn't issued any particulars yet, but we're confident he will propose a tax plan that's very aggressively pro-growth as well.

In the end, with Republicans in Congress chomping at the bit to cut taxes the past several years, whomever the Republicans nominate, including Jeb Bush, is likely to run on tax cuts to boost economic growth.

But even a Democrat could deliver pro-growth tax cuts. If a center-left Democrat wins the next election (in contrast to far-left candidates and potential candidates like Bernie Sanders or Elizabeth Warren), one of the first things her Keynesian economic advisers will privately say is that the economic recovery is "long in the tooth" and that the odds of a recession before a re-election battle in 2020 are pretty high. (<u>We</u> may disagree with that analysis, but it's how <u>they</u> think that matters.)

As a result, we think Hillary Clinton would look for ways to compromise with Republicans and cut taxes out of political self-interest, to try to prolong the expansion past re-election. Just last week, Clinton said she'd like to "reform capital gains taxes to reward longer-term investment." Meanwhile, many big-dollar Democratic donors know the US corporate rate is too high and there's ample room to reform the system by cutting the 35% tax rate on profits if a Democratic president is so inclined,…even if the inclination is guided by electoral politics rather than free market philosophy.

Nothing in politics is guaranteed. But if you look carefully, and don't let your personal politics interfere with your analysis, you should start to see better tax policies looming out on the horizon. Just another reason the bull market has further to run.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
7-22 / 9:00 am	Existing Home Sales – Jun	5.400 Mil	**5.420 Mil**		5.350 Mil
7-23 / 7:30 am	Initial Claims Jul 18	280K	**281K**		281K
9:00 am	Leading Indicators – Jun	+0.3%	**+0.1%**		+0.7%
7-24 / 9:00 am	New Home Sales – Jun	0.548 Mil	**0.548 Mil**		0.546 Mil