First Trust
Monday Morning OUTLOOK

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# Keep It Simple, Stupid (KISS)

**Brian S. Wesbury** – *Chief Economist*
**Robert Stein, CFA** – Dep. Chief *Economist*
**Strider Elass** – *Economist*

The biggest tax debate in Washington right now is not between Republicans and Democrats, but between Republicans and Republicans. Both sides of the debate seem to understand that the US tax code, particularly the fact that the US has the highest corporate tax rate of any industrialized country, is harming the competitiveness of US companies.

Both sides want to cut this tax rate and both sides want to allow for full and immediate expensing of business investment in plant and equipment. Both sides also propose to end the deduction for the interest companies pay on their (new) debts.

What they're fighting about is making the US corporate tax system "border adjustable." Some want to exempt from taxation any income generated by exports, and at the same time, no longer allow US companies to deduct the cost of imports from revenue. Like a Value-Added Tax (VAT) used in many other countries, the idea would be to promote exports. Meanwhile, it would create a level playing field between foreign and US companies trying to sell to US consumers.

Let's say the new tax rate is 20%. A Napa Valley vineyard could produce a $100 wine and pay $20 in taxes. Then, after a retailer sells that bottle for $150, the retailer pays a $10 tax on their $50 profit. Total, the IRS gets $30. If the retailer buys the $100 bottle from a French vineyard and sells it for the same $150, the retailer now pays the 20% tax rate on the *full* $150, and so sends the IRS the total tax of $30.

The retailer's revenues don't change, but its tax payments to the IRS soar while its after-tax profits plummet. In effect, a border adjustable tax forces US retailers to attempt to extract tax payments from foreign producers or US consumers. This is why retailers in the US are fighting so hard against it.

Some say retailers shouldn't care because the value of the dollar will soar as well, reducing the cost of imports. But, if this is really true, why haven't all the other countries with border adjustments in their VATs been able to take down the dollar? The theory might work on an academic chalkboard, but the value of the dollar depends on many factors. Betting on a stronger dollar to fix border adjustable tax rate problems is a HUGE gamble.

Don't get us wrong, the US should have lower tax rates. But why not just do it within the corporate tax system we already have instead of a system that's never been tried before? Trillions of dollars of decisions have been made based on the tax system we have in place today. Having the government suddenly change the "rules of the game" will create massive windfall winners and losers that may completely offset any potential positives from a change in the tax code.

Meanwhile, what if the forecast of a stronger dollar really happens? Many emerging-market companies borrow in dollars and might find it hard to repay their debts at the same time they find it tougher exporting to the US. Would the US find itself on the hook for foreign bailouts? And what about US exporters? Wouldn't a stronger dollar make it harder for Boeing to sell abroad and compete against Airbus? Would Boeing then lobby the government for looser monetary policy and a weaker dollar?

Instead, we need to keep tax reform simple. Policymakers should focus on cutting tax rates and excessive regulation (to make the US more competitive) and not get distracted by policy changes that will create big (and often arbitrary) windfall winners and losers.

| Date/Time (CST) | U.S. Economic Data | Consensus | First Trust | Actual | Previous |
|---|---|---|---|---|---|
| 2-14 / 7:30 am | PPI – Jan | +0.3% | **+0.3%** | | +0.2% |
| 7:30 am | "Core" PPI – Jan | +0.2% | **+0.2%** | | +0.1% |
| 2-15 / 7:30 am | Retail Sales – Jan | +0.1% | **+0.3%** | | +0.6% |
| 7:30 am | Retail Sales Ex-Auto – Jan | +0.4% | **+0.6%** | | +0.2% |
| 7:30 am | CPI – Jan | +0.3% | **+0.3%** | | +0.3% |
| 7:30 am | "Core" CPI – Jan | +0.2% | **+0.2%** | | +0.2% |
| 7:30 am | Empire State Mfg Survey – Feb | 6.8 | **8.0** | | 6.5 |
| 8:15 am | Industrial Production – Jan | 0.0% | **-0.1%** | | +0.8% |
| 8:15 am | Capacity Utilization – Jan | 75.4% | **75.4%** | | 75.5% |
| 9:00 am | Business Inventories – Dec | +0.4% | **+0.3%** | | +0.7% |
| 2-16 / 7:30 am | Initial Claims – Feb 11 | 245K | **244K** | | 234K |
| 7:30 am | Housing Starts – Jan | 1.226 Mil | **1.241 Mil** | | 1.226 Mil |
| 7:30 am | Philly Fed Survey – Feb | 18.0 | **22.5** | | 23.6 |