October 26th ,2017

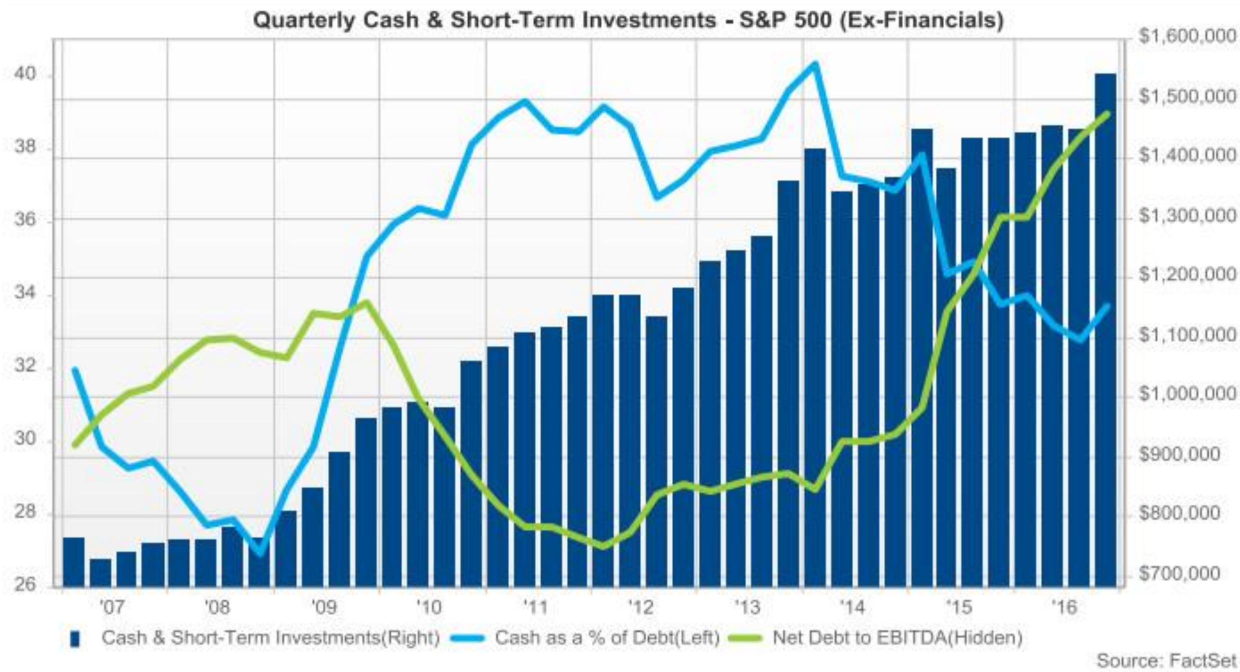
Manhattan Atlantic Capital

The Relationship between US Corporate Tax Cuts and House Hold Wages

Often what frames corporate culture is the way in which employees are monetarily incentivized. Let us review the material impact of pending US corporate tax cuts on the employee behavior with an emphasis on C- level employees.

Trump's proposal to cut US corporate taxes from 35% to 20% is expected, according to the chief of the White House Council of Economic Advisers (CEA), to, on average, boost US family wages between $4000 to $9000. The CEA used Switzerland and Ireland as case studies, an arrayed sample that lends itself to countries with somewhat subtle pronouncements as tax havens. It seems that the CEA deliberately bypassed more comparable countries to the US as data may show that there is no significant correlation between corporate tax cuts and real wage increases.

Adherents of the CEA model also assume that plant and equipment on company balance sheets do not depreciate. I presume that their logic holds for intangible assets such as patents and good will. Both tangible and intangible assets depreciate with time. General Accepted Accounting Principles (GAAP), authoritative accounting principles set by policy boards, stipulates that companies must expense depreciation from both tangible and intangible assets. Further, the CEA model assumes that US corporations do not engage in debt financing. At the writing of this piece, the S&P U.S. High Yield Corporate Bond Index is trading at $102.5. Three years back from October 25th, 2017, the S&P U.S. High Yield Corporate Bond Index price increased by 0.55%, but this trend masks a February 2016 price trough of $85.07 and an October 19, 2017 price peak of $102.68. Bond prices have an inverse relationship with their yields. Hence, higher corporate bond prices yield lower yields. An Aaa US bond yield, as of yesterday, provided a yield of 3.63%. This incentivizes US corporates, in the absence of growing aggregate demand, to borrow at 3.63% and to make equity investments that return 19.53% per year, the year on year return of the S&P 500 back a year from yesterday, and pocket the spread by building cash and cash equivalents on their balance sheets. There is evidence displaying corporations pocketing of the spread between debt and equity return instead of using their newfound cash to build factories or to invest in research and development. See figure below.



The chart displays cash and equivalents (short term investments which, to some degree, represent gains from debt and equity spreads) that increased from $770b in early 2007 to $1.54t at the end of the third quarter of 2016. Mid 2011 to mid 2016 displays a steep rise of net debt to EBITDA, suggesting the increased use of debt financing.

In some cases C-level executive compensation is linked to upward trending return on equity, net income divided by shareholder equity or assets minus liabilities. By increasing debt and its accompanying interest expense which is tax deductible, a CEO could provide her firm a higher return on equity without the need to increase earnings.

Tax cuts also incentize C level executives to engage in share buy backs. After all, many C-level executives have stock options and so buying back the corporations stocks make them scarcer than they would otherwise be and by extension increase earnings per share. With downward pressure on interest rates from the Fed, corporations could borrow money to buy their own shares and by extension increase their share price without investing in factories. In November 2016, Goldman Sachs estimated that S&P 500 companies will "spend $780 billion on buybacks — a new record." Corporate Tax cuts will only encourage further share buy backs.

Any newly minted MBA student could build a Net Present Value (NPV) model which assesses the returns from a new project such as building a factory or opening a new super market while netting the accompanying costs. The NPV model subtracts tax from the income statement, but it adds it back to the cash flow from operations because tax is not a function of a company's operations. The model focuses on discounting future cash flows back to present value so that the sponsors of the project could ascertain the current value of the project while accounting for future value. A terminal value is also added to the value of the project and this has no bearing on tax. Tax does not veto a new project, but future cash flow, driven by aggregate demand, does. Low interest rates accorded by the Fed to corporates are tax cuts by another name. Observe what people do to know what they think.