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Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

This week, a fair number of people have asked me if I watched the President's State of the Union address on Tuesday. Given I am prone to bloviate about the economy and the markets, you might think I am interested in politics. However, I unintentionally missed the President's speech, although I probably wouldn't have tuned in even if I had remembered to do so. It completely slipped my mind.

Frankly, politics, or at least what currently passes for politics, bores me. The reason is simple: both political parties basically want the same thing. They just have different ways of going about it, and tend to focus more on the means than the ends. Put another way, the two political parties seem to be far more process oriented than results.

To that end, I once heard a comedian or pundit say something along the lines of: "If the Democrats proposed a law requiring Americans to jump off a 2,000 foot cliff, the Republicans would counter with one mandating a 1,000 foot jump." Never mind the end result is disastrous no matter what way you go about it.

I suppose I classify myself as a capitalist more than either a Republican or a Democrat. Yes, I think that fair. It seems to me, you satisfy a lot of societal ills by making the society wealthier. Depending on your worldview, that statement is either crass or obvious. However, you can look at the wealthier, developed economies in the world, and compare their societal inequities with countries like Sierra Leone, Haiti, Afghanistan, Laos, and others. Would I rather debate things like a 'living, minimum wage' or access to clean drinking water and basic sanitation?

As our nation has become wealthier, we have been able to address a lot of problems, many of which have plagued mankind since the dawn of time. But, make no mistake about it, it is because we are wealthy that we have been able to do so, and not the other way around. Why? Because it takes resources to make meaningful change, and I am not just talking about in the government's coffers. I am talking about throughout the economy.

Therefore, in my opinion, any regulation or wrinkle to the tax code which inhibits our ability to generate wealth in an efficient manner is a step in the wrong direction in solving our societal problems. Any initiative, no matter how well-intentioned, which inhibits the free flow of capital, to its highest and best use, is anathema to just about everything we want and need as a society and economy. You see, people tend to be more charitably inclined when they have more money in their pockets.

As a result, any proposal from either party which complicates the tax code even more or throws another layer of whatever on it is a bad idea. The goal should be efficiency and transparency. Granted, some folks and some companies would really come unglued if Washington made any meaningful changes to the tax code, as virtually everyone benefits from some deduction here and credit over there. However, we all secretly know simplifying the thing would be in the economy's best interest, but everyone has a dog, no matter how small, in the fight….making it a political hot potato and non-starter.

With this said, if the goal is to increase wealth in the country, the Congress should seriously consider one of two options, because doing both wouldn't get anywhere. The first is slashing corporate taxes and closing any loopholes the two parties can agree upon. This is low-hanging fruit. Why?

Inside this issue:

The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital... the ease or difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential for growth in the economy.
John F. Kennedy

Something to Think About Cont.

Well, because, when all is said and done, corporate profits drive stock prices. Period. As such, if corporate America had higher earnings, everyone that has a 401K would benefit tremendously. Here is the math, and I will use our friends here in town, Regions Financial Corporation, as an example.

For fiscal year 2014, Regions reported an income tax expense of $457 million. It had fully diluted Earnings Per Share of $0.79 last year, with approximately 1,376,500,000 shares of common stock outstanding. It is currently trading at $9.09/share, as I type this morning, which would equate into a trailing Price/Earnings multiple of 11.51x….using these numbers.

Now, if corporate income taxes were to suddenly vanish, that would mean up to an additional 33.2¢ in Earnings Per Share. This would take that from $0.79 to $1.12, potentially. If we assume the same Price/Earnings multiple, 11.51x, the share price would vault from $9.09 to $12.89. In absolute terms, that doesn't sound like much, but multiple it by 1,376,500,000 shares, and you get an increase in RF's market capitalization of roughly $5.2 billion, with a B.

So, by foregoing the $457 million in income taxes, we create $5.2 billion in wealth. Hmm. If you are so inclined to do the math across the board, for all publicly traded companies, the resulting increase in market capitalization would be literally in the trillions of dollars. I might be horribly naïve, but I would imagine that would have a very beneficial impact on people's charitable inclinations and mindset.

Basically, it all comes down to a multiplier effect. For every $1 Washington takes in corporate income taxes, we give up, as a society, $18.27 in wealth (using the current trailing 12-month Price/Earnings multiple on the S&P 500) due to the fact investors pay UP for each $1 a company makes. This is funny money, and I don't see how Washington can turn $1 into $18.27….if it could, no one would complain about paying taxes.

Can you think of a quicker way to increase 401K balances, which would cause middle-class wealth to soar?

As for capital gains taxes, let me riddle you this one: what is a better driver of capital gains taxes? 1) stock market returns, or; 2) capital gains tax rates? If you guessed #1, you win the prize. In fact, it would appear capital gains taxes actually go UP as a percentage of GDP when capital gains tax rates go DOWN or in the year before they go UP. However, make no two ways about it: a higher stock market leads to higher capital gains, and that shouldn't come as any surprise.

Please follow this URL for the supporting data for my comments in the previous paragraph: http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=161

But why is this so? The answer is obvious. If you have a low cost basis stock, you would be far more inclined to listen to or find other investments if you only had to pay a 15% tax as opposed to a 28% tax, which the President proposed in his State of the Union address for high income earners. Never mind capital gains taxes as percent of GDP went down the last time Washington raised the rate to 28% (from 20%) during the Reagan years in 1987. To that end, capital gains taxes collected, in absolute terms, didn't get back to pre-hike, 1986, levels until 1996….obviously, 10 years later.

These are just the numbers, and you can see the table on the website. Further, this is what the Congressional Budget Office had to say about the 1987 capital gains tax increase in a white paper dated 1988 (How Capital Gains Tax Rates Affect Revenues: The Historical Evidence):

> A number of statistical studies have provided strong evidence that realizations of capital gains decline when tax rates on gains are increased. The estimated size of this response of capital gains realizations, however, differs greatly among studies. The responses estimated in some studies have been used to support a claim that the 1986 act reduced revenue from capital gains taxes when it increased the tax rates, and that lowering the maximum tax rate on long-term gains to15 percent would increase revenue. The estimates in other research suggest an opposite conclusion. Moreover, all of these studies have used methodologies that are open to criticism.
>
> This study provides new evidence on the relationship between realizations of long-term capital gains and tax rates on capital gains, based on statistical analysis of data for the years 1954 through 1985.The statistical results offer additional support for the view that higher t x rates do lower realizations of capital gains.

Something to Think About Cont.

> As a result, increases in tax rates on capital gains produce much less revenue than they would if taxpayers' behavior were unaffected.

Please bear in mind, this was released in 1988 (granted it is a little dated), when the Democrats controlled both houses of the Congress and rock star Reagan was in the White House. If you look at the data from the URL I gave, you can conclude on your own that not much has changed since 1988.

Therefore, you can reasonably intuit Washington could actually have a revenue neutral policy of both cutting corporate taxes and the capital gains tax rate, to some degree. In the process, capital flexibility and household wealth would increase. That should be the goal, and the only thing left should or would be the two sides duking it out on the process and the formulas.

But who is actually preaching this type of stuff? Particularly in a way which makes sense to John Doe? I would submit no one is. Why? Because it doesn't make a lot of sense IF you don't bother to do the math to any degree. Frankly, it isn't necessarily intuitive. You mean we increase household wealth and tax receipts if we cut corporate taxes and the capital gains tax rate? Come on, man. You have been drinking the Kool-Aid far too long.

Drinking Kool-Aid is a lot more fun than doing spreadsheets, math, and doing google searches only to come to a conclusion anyone in Washington, of either party, could have if only they had bothered to determine the GOAL first and the process a distant second. Instead, we get long speeches and curious rebuttals...all of it scrubbed, pre-scripted, and vetted to ensure it plays with the appropriate party faithful. In the end, that is why I don't much care for politics, and why I forgot, literally, to watch the State of the Union address.

So, let me leave you with what I submitted to the Montgomery Advertiser for inclusion in this Sunday's edition. I feel it dovetails nicely here. Have a great weekend.

> **In his State of the Union address, President Obama announced his plan to make a community college education free for all those who maintain a certain grade point average. He would fund this with increased capital gains taxes on the wealthy. While this doesn't have a chance of passing Congress, is it a good idea economically speaking?**
>
> You are right, the President's plan doesn't stand a chance on Capitol Hill. However, it makes for good political theater, and, at worst, it will get people thinking about improving educational opportunities in our country. So, bully for him on his vision, but would it actually work?
>
> I will save the in-depth discussion on increased capital gains taxes for another day, and leave you with this: anything which inhibits the free flow of capital in the economy is not a good idea. Further, if the increase in the capital gains tax from 15% to 23.8% for top earners hasn't reduced income inequality in the country, I am not certain why another increase would magically work.
>
> Now, making community college free for everyone sounds like a great idea. Who would actually be against that? After all, that would make American workers that much better educated, and, therefore, more productive. That would be good for the economy, right?
>
> Where the rubber meets the road, theory and reality aren't always one and the same. I believe this is one of those times.
>
> After all my years in business, I have found one thing to be generally true: higher degrees and good grades usually reflect a worker's drive to succeed, as opposed to actually being the recipe for success. To that end, I have met motivated, creative workers who never went to college who have had great careers, and made a lot of money. Conversely, I have met any number of people who have fumbled, bumbled, and stumbled into a degree, and haven't amounted to much in the business world.
>
> In essence, having a degree isn't a prerequisite for success, nor does not having one doom someone to failure. However, it is tempting and easy to look at the data and conclude the degree is the reason for the success, as opposed to digging deeper to realize the degree is usually a byproduct of the worker's drive to succeed.

Something to Think About Cont.

As such, I would submit focusing on improving K-12 across the country is far more important than picking up the tab for community college. Why? Because it is much easier to instill motivation in a young person, who should be an academic sponge, than trying to do so after they are already an adult.

Yes, some people figure out the way the world works when they are in their 20s and 30s, and suddenly get their act together. When I was 22, my parents probably would have said I was one of them. However, I was also very fortunate to have had a strong K-12 base off which to build, one which my parents, my school system, and my community helped build.

So, I suppose Hilary Clinton was kind of right when she wrote "It Takes a Village." It does take a society to demand quality primary education, and reward positive behavior, from stem to stern. The sooner we can do a better job on these things in the lives of our children, the better.

If we can do our part on that, they will take care of the community college degree themselves.

I guess what I am saying is this: if our goal is to have an even wealthier country, we had better figure out a better way to work together towards that common goal.

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