WEEKLY ECONOMIC COMMENTARY

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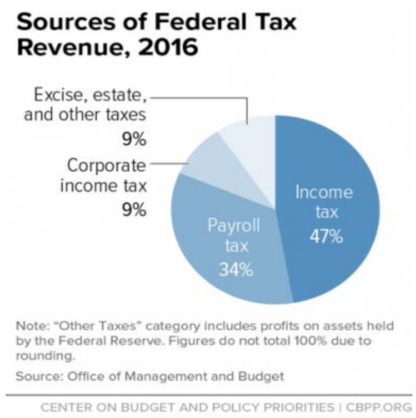
Like many young people of my generation, my first exposure to business came through the establishment of a lemonade stand on my block. It was a hot day, and street traffic was busy. Opportunity knocked.

Unfortunately, my neighbor-partners would have been right at home as panelists on *Shark Tank*. Before we sold a single cup, they were debating the relative merits of establishing a limited partnership or selling shares in the stand to the public. One young lady proposed setting up a shell company to house the enterprise. This was a bit much for a ten-year-old: I didn't know whether she was talking about Shell Oil, seashells or *conchiglie* pasta.

It wasn't until I attended business school that I fully understood why corporate form matters. Control is one consideration, and taxation is another. Large companies have entire departments dedicated to managing these elements across jurisdictions. (There are nearly 200 separate corporate tax regimes around the world.) This work has an integral impact on legal entity structures and global capital allocation.

As the U.S. Congress resumes its work this month, corporate tax reform is competing with a number of other initiatives for attention. There is broad and bipartisan consensus that the current structure of the American corporate tax system places the country at a competitive disadvantage and may actually be hindering the generation of federal revenue. Other fiscal initiatives are getting more attention, but this is one should be at the top of the list.

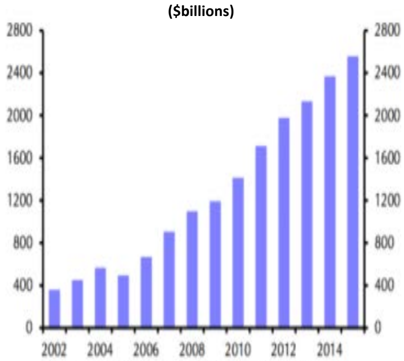


A recent report from the Congressional Budget Office confirmed that the United States has one of the highest corporate tax rates in the world. The marginal rate is 35% (39% when local taxes are included). Even after adjusting for the value of deductions, the effective tax rate on large U.S. companies is just under 19%, still high relative to other large developed countries.

Another unfriendly feature of the U.S. corporate income tax system is that it covers world-wide profits, instead of just those earned within American borders. (The United States is one of just a handful of countries that assesses in this manner.) Taxes on foreign profits only become due when earnings are repatriated; as a result, U.S. firms have left approximately $2.5 trillion in profits within their overseas affiliates.

Profits stranded overseas may have contributed to the disappointing level of U.S. investment spending during the current expansion, which may account for some of the poor productivity growth experienced since 2009.

Estimated U.S. Corporate Profits Held Overseas
($billions)



Sources – SEC Filings, Audit Analytics, Capital Economics

SELECTED INDUSTRIES	NO. OF COMPANIES	EFFECTIVE FEDERAL TAX RATE
Electric utilities (Eastern U.S.)	24	33.8%
Retail automotive	15	32.7
Trucking	33	30.9
Railroad	15	27.4
Tobacco	12	26.0
Securities brokerage	30	20.5
Banking	481	17.5
Petroleum producing	198	11.3
Medical supplies	264	11.2
Computer software/services	333	10.1
Internet	239	5.9
Drug	337	5.6
Biotechnology	121	4.5

Data compiled from documents of more than 7,000 publicly traded companies.

Source: Prof. Aswath Damodaran, New York University

The incentives in the current U.S. system generate many unintended consequences. They encourage American firms to hire and invest outside of the country, and they discourage international firms from domiciling in the United States. This suppresses hiring, innovation and the size of the corporate tax base.

The recent series of corporate inversions (where an American company merges with a foreign firm and moves the consolidated head office outside of the U.S.) further illustrates the problem. Policymakers have been watching enviously as countries including the United Kingdom, Ireland and Canada have lowered their corporate tax rates to entice firms to headquarter under their flags.

The U.S. corporate tax system has become a competitive disadvantage.

Further, the U.S. corporate tax is a form of "double taxation" (firms pay taxes on their incomes and then shareholders pay taxes on their earned dividends and capital gains). It promotes debt financing over equity financing because debt interest is deductible while dividends are not. And the tax management done by firms diverts resources from other productive alternatives.

As part of any reform, firms should be offered the opportunity to return capital currently housed overseas, potentially at a reduced tax rate. But the most recent foreign tax holiday in 2004 led mostly to increased share buybacks and special dividends instead of an expansion of capital stock. To prevent a recurrence, some legislators propose tying the repatriation to a requirement that the funds be productively invested. Longer-term, a shift from a global to a territorial tax system would prevent "stranded" profits from re-accumulating.

Simplification would almost certainly be a part of any update to the corporate tax code, and that is where opposition may arise. Many American companies take full advantage of available options to bring their effective tax rates to low levels. Reform would almost certainly increase the tax bills for some firms, and those firms (and their industry lobbyists) can be expected to push back on this basis.

Despite the many merits of corporate tax reform, the lion's share of attention in Washington has been devoted to a re-write of the personal tax code. Proposals to reduce rates and simplify returns have been debated in the Congress for several years, and the White House made this a centerpiece of its economic program.

But the financial and political calculus remains unfriendly to this effort. Keeping projected budget deficits under control while reducing individual tax rates has proven a difficult task; the administration has tried to bridge the gap between projected revenues and expenses by assuming rates of economic growth that most economists find unreasonable.

On the political front, those who stand to lose their favorite personal tax preferences will not be pleased with their elected officials, and may express their displeasure in next year's mid-term balloting. Whole economic sectors would be affected; eliminating deductions for property taxes and interest on state and local bonds could have a substantial impact on the prices of underlying assets.

Corporate tax reform will not be simple, but changing the personal code has a much higher degree of difficulty.

Corporate tax reform will not be simple, and it will not be free. But personal tax reform has a much higher degree of difficulty. It is easier to see a broadening of the revenue base in the former instance, especially if profit repatriation is initiated. And the enhancement of American competitiveness would be accretive to long-term economic growth.

The most recent corporate tax reform took place more than 30 years ago, when the world was a different place. Global firms today can shift activity and profitability to different centers more easily. A modernization of the code to account for this evolution is long overdue.

The lemonade stand closed the same day it opened. It seems that we hadn't factored production and marketing costs into our pricing, and our parents blanched at providing unlimited inventory without some guarantee of repayment. Back then, corporate tax strategy did not matter. Today, on a broader basis, it is critical.

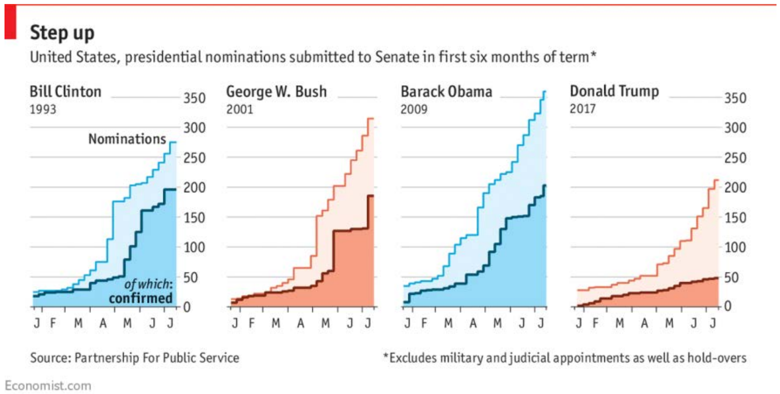
Gone Fisching

Federal Reserve Vice Chairman Stanley Fischer resigned unexpectedly this week, citing personal reasons. Fischer's term as vice chair was scheduled to expire in the middle of next year; his term as a governor of the Federal Reserve System was set to last until 2020.

Fischer joined the Fed in 2014, shortly after Janet Yellen began her term as chair. He was generally viewed as a centrist, always voting with the majority at Federal Open Market Committee (FOMC) meetings. He was not the most vocal of Fed officials, but his influence behind the scenes was thought to be formidable. Fischer is known affectionately as a central bank "whisperer," having taught Ben Bernanke, Mario Draghi and IMF Chief Economist Olivier Blanchard during his decades as a professor at MIT. (Larry Summers was also a student of his.) His tenure as the head of the Israeli central bank during the financial crisis was hailed as a great success, and his understanding of international influences on domestic monetary policy was a major asset to the Fed.

Fischer's departure will leave the Federal Reserve Board with just three remaining members, a record low. (There are supposed to be seven.) Governors do quite a bit more than simply voting on interest rates eight times per year; each is expected to help lead the range of endeavors the Fed is responsible for. A large workload is now going to be distributed among a very small group. And as vice chair, Fischer was well-positioned to cover events that Janet Yellen could not attend, and cover them well.

The Federal Reserve Board has not been at its full complement in more than ten years. Nominations have withered on the vine, waiting for confirmation hearings that are never scheduled. (One prospect, a Nobel Prize winner, was deemed unqualified by the chair of the Senate banking committee.) Things aren't getting any better; the current administration has struggled to fill senior positions in cabinet departments, hindering the formulation and execution of intelligent policy. Given the central role the Fed plays in global economic functioning, it cannot be left so severely shorthanded for long.



To date, the administration has forwarded just one nomination to join the Federal Reserve Board. The Senate banking committee is expected to vote later this week on the candidacy of Randal Quarles as vice chairman for supervision; confirmation by the full Senate should follow shortly thereafter. While names of other prospects have been floated in the press, nothing formal has followed. And the White House will soon have to make a decision on who it would propose to lead the Fed after Janet Yellen's term as chair ends next January. (Yellen can remain as a governor thereafter, if she so chooses. If she is not re-nominated, and if the Board remains short-handed, she may choose to do so.)

The number of Fed leaders has dwindled dangerously.

It is unlikely that the course of U.S. monetary policy will change much after Stanley Fischer leaves. And so far, the uncertainty surrounding the composition of the Fed has not troubled the financial markets. The Fed's construction helps sustain continuity: five regional Fed presidents will still vote at the FOMC, and Fed staff members in Washington and around the country will sustain their work in gathering intelligence, supervising banks and conducting open market operations. It is not as if the halls are completely empty, but some of the bigger offices are.

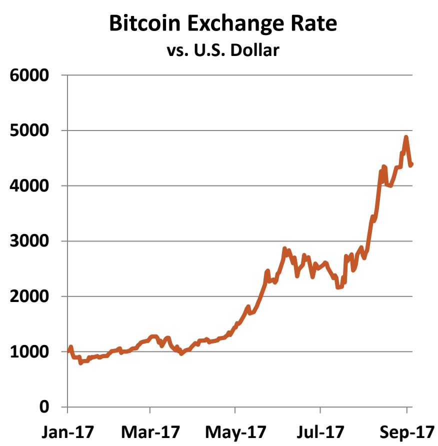
Stanley Fischer's textbook on macroeconomics instructed a generation of students, including this one. He may be transitioning away, but the power of his thinking is likely to linger.

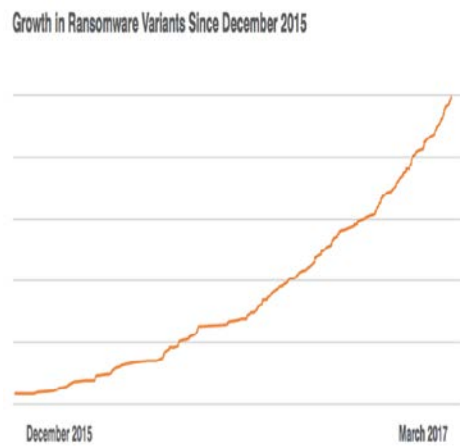
Above the Law

With the kids out of the house, my wife and I have been on a major decluttering campaign. In the process, we've found a myriad of piggy banks, none of which were very full. Either our children weren't very thrifty or they were early adopters of electronic banking.

The outermost expression of the broader trend away from cash is the rise of cryptocurrencies like Bitcoin. For those who have not been following this development, Bitcoin was the brainchild of a mysterious programmer who created the currency in 2009. His aim was to offer a medium of exchange that was impervious to what he viewed as the reckless policies of traditional central banks. Bitcoins have been gradually released via a computer network (to Bitcoin "miners"), and from there they can be bought and sold.

Bitcoin and its cousins have been back in the news recently, as their exchange rates versus the U.S. dollar have skyrocketed. Not coincidentally, the application of ransomware has been rising at similar pace.





Sources: Bloomberg, Proofpoint

It's amazing that authorities have yet to crack down on cryptocurrencies.

Because Bitcoin transactions are anonymous, the virtual currency is perfect for illicit activity and money laundering. One wonders why international law enforcement hasn't been more forceful in curtailing this kind of activity.

Recent fluctuations in the bitcoin's value have been extreme, suggesting it is not immune from speculation (or manipulation). There is nothing to stop the release of additional supply, since no central bank is managing availability in relation to economic activity. And ironically, the networks that create and store bitcoins have proven vulnerable to hacker attacks.

Perhaps I am still living in the piggy bank era, but I have trouble believing a currency created out of thin air without a central bank behind it deserves lasting respect as a store of value. We're due for a crackdown—it's just not clear who will do the cracking.

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