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Company stock price reactions to the 2016 election shock: Trump, taxes, and trade[☆]

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ABSTRACT

Donald Trump's surprise election shifted expectations: corporate taxes would be lower and trade policies more restrictive. *Relative* stock prices responded appropriately. High-tax firms and those with large deferred tax liabilities (DTLs) gained; those with significant deferred tax assets from net operating loss carryforwards (NOL DTAs) lost. Domestically focused companies fared better than internationally oriented firms. A price contribution analysis shows that easily assessed consequences (DTLs, NOL DTAs, tax rates) were priced faster than more complex issues (net DTLs, foreign exposure). In sum, the analysis demonstrates that expectations about tax rates greatly impact firm values.

1. Introduction

The election of Donald J. Trump as the 45th President of the United States of America on November 8, 2016 surprised most observers. The election's unexpected outcome (on the morning of Election Day, Trump's chances were 17% on Betfair and 28% on FiveThirtyEight) combined with the wide policy differences between the two candidates led to substantial reactions on financial markets. Large price moves were recorded across asset classes, including stocks, bonds, and exchange rates.

This paper focuses on the response of stock prices to the election in the short- and in the longer run.

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Assessing the relative winners and losers among companies from the election is interesting, given the sizable differences in the policies the two candidates favored in several economically important areas. One major difference, a prime focus of this paper, lay in expected corporate tax policy changes. While dividend taxes have changed frequently, leading to a large literature on the effects of dividend taxes on stock prices (reviewed in Graham, 2003; and Hanlon and Heitzman, 2010), the last major US federal corporate tax reform dates back to 1986. Thus, although corporate finance theory suggests a first-order effect of corporate taxes on firm value, it has not been possible recently to study the actual pricing of federal tax changes. The 2016 Presidential election provides a unique opportunity to conduct such an analysis because it is rare in developed economies to have the combination of such a surprising outcome and such a difference in tax policies between the candidates.[1] We take advantage of these two characteristics of the event to investigate first the impact of taxes on firm value, and second the efficiency of stock price responses to potentially dramatic changes in both the corporate tax rate and other important features of the tax system.

The 2016 Presidential election has unique advantages and disadvantages compared to events analyzed in other papers examining stock price responses to changes or expectations about changes in tax policy. In such events, such as the 2003 Dividend Tax Cut (Auerbach and Hassett, 2006, 2007; Amromin et al. 2008), the proposed policy change is usually known with some precision and little else is involved during the event window; these are advantages. A typical disadvantage is that the surprise of the event is low since the probability of the policy passing is generally reasonably high. Moreover, the outcome if it does not pass is unknown, as a modified policy may be adopted if the initial proposal fails. These advantages and disadvantages are reversed in the case of the 2016 election. Trump's election affected expectations about many things besides corporate tax policy, a disadvantage, and as we discuss below, the specific tax policy that would ultimately be implemented, if any, was uncertain. However, the election surprise was large, an advantage, and the alternative policy—maintenance relatively close to the status quo for corporate taxes under a Clinton presidency with a Republican majority in the House—was reasonably clear.

Many policies, and in particular tax policies, require Congressional approval. Thus, rather than Trump's election per se, it is probably the fact that Republicans controlled both the Presidency and Congress after the election that led investors to expect substantial corporate tax reform to be much more likely than under alternative election outcomes. Either a Clinton presidency and/or a Democratic majority in the Senate would probably have produced gridlock, similar to the 2010–2016 period, making major policy changes unlikely. Nevertheless, it is important to keep in mind that there were two Republican corporate tax plans going into the election—one from the Trump campaign, and one from the House Republicans—and that they differed on a number of dimensions. While the tax reform that will ultimately be implemented, if any, will undoubtedly differ significantly from both plans, these two plans constitute the preponderance of information on possible tax reform options that was available to investors at the time of the election and thereafter. The one-page description of the Administration's intended plan on April 26, 2017 (The White House, 2017) provided an update. That intended plan incorporated important elements from both the Trump-campaign plan and the House Republicans' plan. It is therefore useful to summarize those plans' main elements to guide the analysis conducted in this paper.

Among the noteworthy elements of Trump's campaign plan (Trump, 2016) are: (i) a reduction in the statutory corporate income tax rate to 15% from the current 35%; (ii) a one-time deemed repatriation of corporate cash held overseas at a 10% tax rate, followed by an end to the deferral of taxes on corporate income earned abroad (with the current combination of worldwide taxation and foreign tax credits being maintained);[2] and (iii) an election available to firms engaged in manufacturing in the US to immediately expense (rather than depreciate) capital investment. However, firms that elected expensing would not be allowed to deduct interest expenses.

The House Republicans' tax plan (Republicans, 2016) contained the following elements: (i) a reduction in the statutory corporate income tax rate to 20%; (ii) immediate expensing of business investments in both tangible and intangible assets (with the exclusion of land); (iii) the elimination of deductibility of net interest expense (although interest expense would be deductible against interest income); (iv) the addition of an interest factor to net operating loss (NOL) carryforward balances that compensates for inflation and a real return on capital, associated with a removal of NOL carrybacks, and the introduction of an annual limitation on NOL utilization equal to 90% of pre-NOL taxable income; (v) the introduction of border adjustments that exempt exports and tax imports; (vi) a switch to a territorial taxation system;[3] and (vii) the taxation of accumulated foreign earnings at a rate of 8.75% if held in cash or cash equivalents and at 3.5% otherwise

[1] There is a large general literature on the effect of elections on financial markets. For example, Niederhoffer et al. (1970) consider Dow Jones Industrial Average responses to elections and nominating conventions. Snowberg et al. (2007) document a positive short-term aggregate market reaction to surprise Republican presidencies. Moreover, a substantial literature studies the stock market development during Democratic and Republican administrations over the longer run. For example, Santa-Clara and Valkanov (2003) document a "presidential premium" (especially for large-cap stocks) during Democratic presidencies. Knight (2007) studies stock prices of 70 politically sensitive firms and election odds in a prediction market in the run-up to the Bush/Gore election of 2000.

[2] Under the tax regime in effect at the time of the election, firms are taxed on worldwide income but that tax can (with a few exceptions) be deferred until the foreign subsidiaries distribute the monies back to their US parent. When repatriating foreign profits, firms get a credit for the foreign taxes paid on that income. The end of deferral was mentioned in the original version of the Trump campaign tax plan (Trump, 2015) but not discussed in his revised plan (Trump, 2016); however, since the revised plan did not mention a switch to territorial taxation, it appears to be reasonable to assume that the worldwide taxation/foreign tax credit system would be maintained.

[3] Under a territorial taxation system, dividends received from foreign subsidiaries are exempted from US taxation.

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