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US Policy Pulse

Untangling Election-Year Tax-Policy Threads

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In this report, we discuss potential changes to tax policy as a result of the 2024 general election.

Key Insights:

- The 2024 election will have significant tax-policy implications, as much of the Tax Cuts and Jobs Act (TCJA) expires at the end of 2025.
- Individual, corporate and capital gains tax rates are just some of the tax-related items that could potentially be altered following either Democratic or Republican electoral success.
- Since 1928, higher corporate, income and capital gains tax rates have not translated to stronger or weaker economic or equity-market results on a concurrent-period correlation basis.
- While Vice President Harris' and former-President Trump's tax-policy agendas have yet to be finalized, it is likely that Harris will use President Biden's 2025 budget proposal as a baseline for her own proposals and that Trump will seek to permanently extend select TCJA components.
- Debt and deficit pressures will weigh on both parties, though geopolitical, economic and partisan spending priorities may induce elevated future fiscal spending.
- If current budget trajectories persist, net interest outlays could account for 59% of the federal deficit—the highest since the Great Financial Crisis—with the total deficit rising to 6.9% of GDP by 2034.
- Our expectation for higher-for-longer debt and deficits implies that taxes are likely to rise. Tax-advantaged products may help mitigate tax exposure, improve tax efficiency and maximize net gains.

The 2024 general election cycle has been full of surprises, with recent media coverage largely focused on who is running. Now that both the Republican and Democratic presidential and vice presidential nominees have been selected, scrutiny is likely to turn to candidate platforms and policy nuances. The general election results will have numerous policy consequences, including an outsize impact on tax planning in the US, as the new Congress will be tasked with reforming the tax code given the sunsetting of many TCJA provisions at year-end 2025.

The process of developing tax policy is multifaceted, with many moving pieces. As we discuss the current iteration of Democratic and Republican proposals, we remind investors that they are still in their formative stages, with many of the line items subject to critical legislative debate and revision. Investors will likely gain a clearer picture of taxation methods and magnitude as we approach November, with final legislation passing at the end of 2025, to be enacted in 2026. That said, an understanding of the relationship between potential tax-code changes, the economy and the markets may guide individuals as they consider post-election investment strategies.

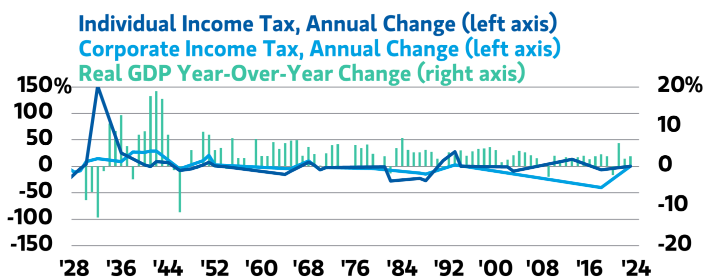
This discussion will detail key aspects of both Republican and Democratic tax plans, as well as tax-mitigation strategies for investors. However, it is critical that individuals seeking tax guidance consult a trusted tax advisor, as no part of this report is intended to provide, or be used for the purposes of, tax advice.

Tax Policy and the Economy

First, we look at changes to marginal and statutory tax policy, where we have found little correlation with economic indicators. It is important to note that coincident economic data may present limitations based on the complications of the US tax code, geopolitical influences and outlier events. Distinct trends arise when isolating the highest marginal individual income tax rate, the top statutory corporate income tax rate and the capital gains tax rate.

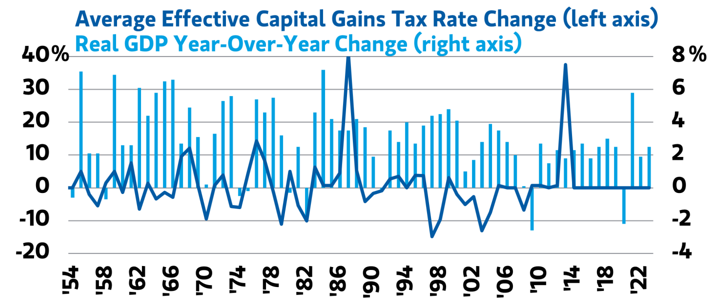
We found evidence of a weak relationship between GDP growth and changes to individual and corporate income-tax rates since 1928, as well as to capital gains tax rates since 1954. Correlation coefficients for all three were below 0.26 and above -0.26, with 1.0 indicating perfect correlation and 0.5 or more considered a statistically significant correlation (see Exhibits 1 and 2). The weak relationship is critical to note, as changes to capital gains taxes are currently the subject of public scrutiny, and the data suggests that a high capital gains rate should not hamper economic performance. We found a similar trend when analyzing the relationship of individual income tax, corporate income tax and capital gains tax rates with the Consumer Price Index (CPI).

Exhibit 1: Income Taxes and Changes to GDP Are Weakly Correlated



Note: Individual and corporate income taxes reflect highest marginal and statutory rates, respectively.
Source: US Treasury, Internal Revenue Service, Haver, Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Dec. 31, 2023

Exhibit 2: Capital Gains Tax and US GDP Growth Have No Correlation

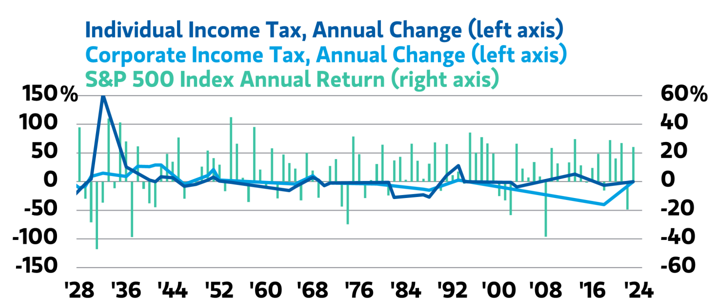


Note: Capital gains tax rate represents annual percent change.
Source: US Treasury, Internal Revenue Service, Haver, Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Dec. 31, 2023

Tax Policy and the Markets

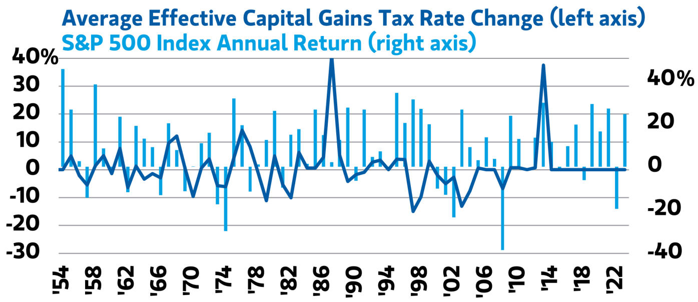
Changes to marginal individual and statutory corporate income taxes and effective capital gains tax policy have little correlation with equity market performance. Notably, our base case observation that market performance is more strongly correlated with the business cycle than with political party also appears to apply in the context of tax-policy changes. As with the economy, the S&P 500 Index has been weakly correlated with individual income and corporate taxes since 1928 and with capital gains taxes since 1954. All three have exhibited correlation coefficients of less than 0.2 and more than -0.2. Additionally, while the stock market's correlations with corporate income taxes and capital gains taxes have been directionally positive, and individual income taxes have been negatively correlated with stocks, all three correlations are statistically insignificant. We encourage investors to consider this dynamic when developing their expectations for future market performance. In short, a higher tax burden does not translate directly to negative or positive equity returns (see Exhibits 3 and 4).

Exhibit 3: Income Taxes Have Not Been Strongly Correlated With Stock Performance



Note: Individual and corporate income taxes reflect highest marginal and statutory rates, respectively.
Source: US Treasury, Internal Revenue Service, Haver, Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Dec. 31, 2023

Exhibit 4: Capital Gains Tax Changes Have Had Little Impact on Stock Market Returns



Note: Capital gains tax rate represents annual percent change.
Source: US Treasury, Internal Revenue Service, Haver, Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Dec. 31, 2023

Party Tax-Policy Positions

When considering the future of tax policy, it is important to acknowledge that information regarding both Harris' and Trump's tax platforms has yet to be fully disclosed. For example, GOP congressional leaders have signaled a desire to extend the TCJA in full, and it is likely that Trump would seek to make many of the 2017 provisions permanent, while also considering additional and/or deeper tax cuts. In contrast, President Biden's 2025 budget proposal is largely seen as a blueprint for Harris if she becomes president. That said, the full scope of Harris' agenda remains unknown, and her plans are likely to diverge from the 2025 budget proposal as she refines her own platform. While we are still seeking clarity, it is valuable to review party and candidate platforms, as investors may gain insights regarding potential tax consequences.

Notably, policy changes are typically more moderate than campaign promises, and a divided legislature often further tempers outcomes. An election outcome leading to a unified House of Representatives and Senate, however, could result in higher taxes, while a split legislature would likely mean more modest changes. Without factoring in potential legislative offsets or other changes, it is estimated that a full TCJA extension would add $5 trillion to the US deficit over 10 years. The Biden budget also serves as a tax-policy wish list, with Democrats seeking to raise taxes on the highest earners, while also increasing spending. In practice, however, the worst-case scenario rarely materializes, and deficit growth, tax cuts and hikes tend to be lower than initial projections. In Exhibit 5, we detail known tax-policy-change proposals from Republicans and Democrats, including policies announced on the campaign trail by both Trump and Harris. They highlight the fluid nature of current partisan tax frameworks as we near the election, showcasing the variability of fiscal policy and budget outcomes. For example, current Republican and Democratic proposals, respectively, are expected to add approximately $1.7 trillion and $560 billion to the deficit over 10 years.

The many TCJA provisions set to expire in 2025 will have consequences mostly for individual investors. Should certain provisions not be extended, individual income tax rates could rise—rolling back the top marginal income tax rate from 37.0% to 39.6%—and estate tax exemptions could be cut in half. However, Democrats and Republicans alike have an interest in keeping certain taxes low. According to the Institute on Taxation and Economic Policy, a complete expiration of the TCJA could result in tax increases for approximately 86% of Americans. This supports our belief that regardless of election outcomes, Congress will forcefully address the issue of which provisions will be extended and which will lapse. Should the Democrats win both chambers of Congress, however, new tax initiatives aimed at the wealthiest taxpayers could reenter the political discourse. These include, but are not limited to, an increase in the capital gains tax and reconsideration of higher marginal income tax rates. In contrast, if Republicans take both legislative chambers in a sweep, a move to maintain the TCJA's higher alternative minimum tax exemption and phase-out amounts, along with maintaining the estate and gift tax exemption amounts at $10 million per individual (indexed to inflation), and doubling the estate tax exemptions, could reduce taxpayer liability.

The expiration of much of the TCJA also means that corporate tax changes could be on the table. For example, Democrats may seek to increase the corporate income tax rate from 21% to as high as 28% and to raise taxes on active pass-through income. According to an April 2021 Morgan Stanley & Co. Research report, raising the corporate income tax to 28% could lead to a 6% decline in earnings for the S&P 500 Index. However, a split House and Senate could prompt a more modest increase to 25%, which could cause earnings to decline by a more manageable 4%. Republicans have proposed reducing the corporate income tax rate from 21% to as low as 15% and may seek to revive the 100% depreciation bonus. Significant cuts to the corporate income tax rate would likely increase earnings and be positively viewed by investors. While the tax debate could drive volatility in equity markets in the near term, we believe any direct impact on earnings would likely be manageable.

Exhibit 5: Party-Specific Tax-Policy Priorities Are Likely To Change

TRUMP: CLOSER TO ORIGINAL TCJA

Policy Item	10-Year Cost ($B)
Tax Increases*	
Extend SALT cap, limit utilization of current SALT workarounds	$190
Phase down green energy tax credits early	$253
Repeal personal exemption deduction	$1,700
Retain itemized deduction limits, including home mortgage interest deduction cap	$200
Tax large private university endowments**	TBD
Total Offsets	**~$3,433**
Cuts and Exemptions: Individual	
Expand standard deduction and individual rate cuts for three years	($1,676)
Child Tax Credit (CTC) enhancement extension	($700)
Increase AMT exemption for most taxpayers	($750)
Double estate tax exemption; expand opportunity zones	($247)
Extend 20% pass-through deduction for qualified business income	($608)
No tax on tips**	TBD
Reduce Social Security distribution tax**	TBD
Cuts and Exemptions: Corporate	
Lower corporate tax rate from 21% to 20% or 15%	($96)
Reinstate R&D expensing over five years; delay tighter limit on interest deductibility	($336)
Revive 100% bonus depreciation	($344)
Keep GILTI, FDII cuts	($394)
Total Cost of Tax Extensions	**($5,151)**
Total Deficit	**-$1,718**

HARRIS: CLOSER TO BIDEN FY25 PROPOSAL

Policy Item	10-Year Cost ($B)
Tax Increases	
Raise buyback tax from 1% to 4%	$80
Raise corporate tax from 21% to 23% or 28%	$200
Make the limit on excess business losses for pass-through firms permanent	$69
Section 265 changes and world interest limitation	$180.60
Raise the additional Medicare tax from 0.9% to 2.1% for >$400k earners	$245.50
Raise the net investment income tax rate from 3.8% to 5%	$116.50
Expand net investment income tax base to active pass-through income	$249.50
Tax cap gains >$1m at 39.6%; tax unrealized cap gains >$5m at death	TBD
Total Offsets	**$1,141**
Cuts and Exemptions: Individual	
Reinstate expanded ARP CTC and full CTC refundability	($334)
Make the expanded ARP earned income tax credit permanent	($164)
Individual rates: extend cuts for <$400k earners and raise to 39.6% for >$400k earners	($520)
No tax on tips**	(TBD)
Cuts and Exemptions: Corporate	
Reinstate R&D expensing over five years; delay tighter limit on interest deductibility	($336)
Revive 100% bonus depreciation	($344)
Total Cost of Tax Extensions	**($1,698)**
Total Deficit	**-$558**

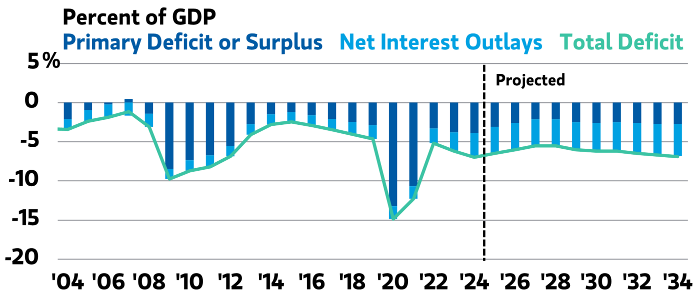
*Does not include all provisions. **Unofficial candidate policy proposal. Note: TCJA = Tax Cuts and Jobs Act | SALT = State and Local Tax deduction | AMT = Alternative Minimum Tax | GILTI = Global Intangible Low-Taxed Income | FDII = Foreign-Derived Intangible Income | ARP = American Rescue Plan
Source: Tax Foundation, Morgan Stanley & Co. Research, Morgan Stanley Wealth Management Global Investment Office as of Aug. 13, 2024

Tax Policy and the Federal Deficit

Federal debt and deficits are also likely to play a role as legislators negotiate provisions for a final tax bill, and attempts to rightsize the budget may be challenging. While current election projections for 2024 point to a split congressional outcome, it is unlikely that Congress will cut the deficit significantly in 2025, as balancing different political priorities has proved difficult in recent years. Republican legislators, for example, are likely to push for lower taxes while cutting spending, but if corresponding spending cuts are not deep enough, deficit spending will persist. Democratic members, in contrast, may seek to increase taxes while boosting spending. If spending outpaces revenue gains, federal deficit growth will be difficult to tame. That said, adjustments to fiscal policy could slowly reduce the deficit if revenues and expenditures are structured to produce a surplus over time.

While deficit reduction and responsible budgeting will be at the center of political discourse, fiscal spending is likely to remain elevated due to geopolitical factors and other partisan spending priorities. Budget growth is likely to keep federal deficits higher for longer. If the current trajectory persists, net interest outlays could make up 59% of the federal deficit—the highest since the Great Financial Crisis—with the total deficit rising to 6.9% of GDP, by 2034 (see Exhibit 6). Although the partisan makeup of Congress will significantly impact the outcome, federal debt and deficits will pressure both parties to consider the balance between revenues and expenditures.

Exhibit 6: Net Interest Outlays Could Account for Nearly Two-Thirds of the Federal Deficit



Source: Congressional Budget Office, Morgan Stanley Wealth Management Global Investment Office as of June 18, 2024

Investor Tax-Mitigation Strategies

Our expectation for higher-for-longer debt and deficits implies that taxes are likely to rise in the future, as the propensity to increase spending and/or extend major tax cuts fosters notable budget imbalances over time. While coincident data indicates low correlation of tax changes with both annual GDP growth and equity market performance, tax increases and decreases may alter investor behavior. According to a February 2021 study in The Quarterly Review of Economics and Finance, when investors anticipated a capital gains tax increase, trading volume of long-term "portfolio winners" has increased by 86%, while volume for "portfolio losers" has declined by 68%. Furthermore, a December 2021 Princeton University study found that, while investors had an inelastic response to a 5% capital gains tax increase, a much larger tax increase could cause misallocation of capital, resulting in a lock-in effect, or a reduction in investment activity. Importantly, changes to individual and corporate income taxes, as well as to capital gains tax rates, are likely to spur greater interest in tax-advantaged products and accounts, as investors seek to manage tax exposure (see Exhibit 7).

Exhibit 7: Tax-Advantaged Products, Securities and Accounts May Help Mitigate Policy Risks

Tax-Advantaged Securities and Products	Tax-Advantaged Accounts
Municipal Bonds	Individual Retirement Accounts (IRA)
US Treasuries	Employer Sponsored Retirement Accounts
Tax-Advantaged Preferreds	Coverdell ESA
Tax-Exempt Mutual Funds	Health Savings Accounts
Tax-Deferred Annuities	Flexible Spending Accounts
Tax-Efficient Funds	529 Plans

Source: Morgan Stanley Wealth Management Global Investment Office as of Aug. 13, 2024

Should tax policy-related risks materialize, investors may potentially offset or mitigate the effects of tax hikes via tax-advantaged products, securities and accounts, some of which are designed to improve tax efficiency and maximize net gains. For example, municipal bonds may be appropriate for clients that qualify for the asset class's triple-tax-exempt status, while other types of investment vehicles may be employed to achieve different tax-related goals. Furthermore, tax-advantaged accounts may provide either pre-tax or post-tax benefits, as exemplified by IRA and 401(k) accounts. Other investing strategies could include the use of tax-loss harvesting and tax-efficient indexing. We encourage investors to contact their Morgan Stanley Financial Advisor for more information on tax-advantaged investing strategies and to seek guidance from a trusted tax professional.

Investment Conclusion

Formulating tax policy is challenging, with a multitude of stakeholders and external forces shaping the outcome. The 2024 general election is likely to have lasting consequences for the development of tax policy, especially given much of the TCJA's expiration at year-end 2025. The expiration creates an opportunity for future lawmakers to shape tax policy for years to come. Importantly, we have found that investor concerns regarding tax policy frequently do not align with the rate of change in economic growth and stock market performance. For example, individual and corporate income tax changes, along with capital gains tax changes, have little correlation with markets and the economy.

While candidate tax-policy platforms are still in the formative stages, we highlight that both increases and decreases to certain tax items could have lasting impacts not just on individuals and corporations but on federal debt and deficits. A sustained federal budget imbalance could mean that taxes are likely to increase over the long run, regardless of who is in office. That said, we encourage investors to consider potential tax changes carefully, as regime change may spur a greater interest in tax-advantaged investing.

Disclosure Section

Index Definitions

For index, indicator and survey definitions referenced in this report please visit the following:

https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

Glossary

Nominal Gross Domestic Product (GDP) is the GDP of the country measured at current market prices and not adjusted for inflation or deflation.

Real Gross Domestic Product (GDP) is the GDP of the country measured at current market prices and adjusted for inflation or deflation.

Risk Considerations

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

Investing in foreign markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks. **Investing in currency** involves additional special risks such as credit, interest rate fluctuations, derivative investment risk, and domestic and foreign inflation rates, which can be volatile and may be less liquid than other securities and more sensitive to the effect of varied economic conditions. In addition, international investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with **emerging markets and frontier markets**, since these countries may have relatively unstable governments and less established markets and economies.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Treasury Inflation Protection Securities' (TIPS) coupon payments and underlying principal are automatically increased to compensate for inflation by tracking the consumer price index (CPI). While the real rate of return is guaranteed, TIPS tend to offer a low return. Because the return of TIPS is linked to inflation, TIPS may significantly underperform versus conventional U.S. Treasuries in times of low inflation.

Interest on **municipal bonds** is generally exempt from federal income tax; however, some bonds may be subject to the alternative minimum tax (AMT). Also, municipal bonds acquired in the secondary market at a discount may be subject to the market discount tax provisions, and therefore could give rise to taxable income. Typically, state tax-exemption applies if securities are issued within one's state of residence and, if applicable, local tax-exemption applies if securities are issued within one's city of residence. The tax-exempt status of municipal securities may be changed by legislative process, which could affect their value and marketability.

The majority of $25 and $1000 par **preferred securities** are "callable" meaning that the issuer may retire the securities at specific prices and dates prior to maturity. Interest/dividend payments on certain preferred issues may be deferred by the issuer for periods of up to 5 to 10 years, depending on the particular issue. The investor would still have income tax liability even though payments would not have been received. Price quoted is per $25 or $1,000 share, unless otherwise specified. Current yield is calculated by multiplying the coupon by par value divided by the market price.

IRS rules stipulate that if a security is sold by an investor at a **tax loss**, the tax loss will not be currently usable if the investor has acquired (or has entered into a contract or option on) the same or substantially identical securities 30 days before or after the sale that generated the loss. This so-called "wash sale" rule is applied with respect to all of the investor's transactions across all accounts.

Growth investing does not guarantee a profit or eliminate risk. The stocks of these companies can have relatively high valuations. Because of these high valuations, an investment in a growth stock can be more risky than an investment in a company with more modest growth expectations.

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