Building a better working world

How US tax reform affects consumer demand across sectors

US tax reform is already affecting post-tax income of households across the nation, although the direction and magnitude vary widely across income brackets, states and filing status. CFOs and CMOs must understand how these tax changes may affect their companies' target audiences' spending patterns, quantify this impact on different parts of their business and adjust their operations accordingly.

Herein we outline the impact of US fiscal reform across various types of consumers and provide some considerations about how companies can capture market growth. We also touch upon where consumer demand may arise and how companies can mitigate the risk where demand may fall as consumers adjust their budgeting decisions.

Mapping the tax reform impact on US consumer income and spending

The Tax Cuts and Jobs Act in effect since 1 January 2018 has already impacted the paychecks of families in the United States.

Some of the most impactful measures in the law related to individual income tax are:

- A modification of the income levels of tax brackets and a reduction of tax rates across brackets
- A near doubling of the standard deduction, which more filers are likely to utilize under the new law
- A $10,000 cap on the state and local taxes (SALT) deduction, mostly selected by high-income households filing in high-tax states

While most US households will see a net increase in post-tax income, a small portion of households will see their tax bill go up. Due to the SALT cap, these households, whose net income will decline, are generally high-income and file in high-income or property tax states (e.g., California, Connecticut, Illinois, Massachusetts, New York, New Jersey and Washington, DC)

It is well-known that a change in consumers' income will directly impact spending decisions across industries. The extent of the impact, however, will vary across both consumer segments and product categories. For instance, as suggested by US saving rates across different income categories,[1] higher-income households

[1] *Report on the Economic Well-Being of US Households in 2015, Board of Governors of the Federal Reserve System, May 2016*

have higher savings rates and so are more likely to allocate an income increase to savings rather than spending. Other populations may fully spend that extra cash or use it to pay off debt. The products and services that consumers will likely shift spending toward or away from also vary across demographic characteristics.[2] Low-income households are more likely to spend an income increase on small discretionary items, including food or entertainment. High-income households negatively impacted by the reform are likely to cut back on discretionary durables or tourism and leisure expenses.

Figure 1 below provides examples of post-tax income changes in absolute and relative terms across different categories of taxpayers based on their income level and geographies. Specifically, it highlights the variance of the impact across different population segments, which also tend to make different budgeting decisions.

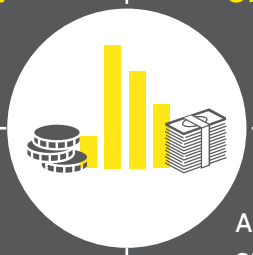
Figure 1: Winners and losers of the tax reform

Adjusted gross income: $800k
Married filing jointly, three children
Itemized deduction in 2016: $125k
High-tax state

Change in after-tax income:
-$7.8k (-1.0%)

Adjusted gross income: $75k
Single filer, no children
Standard deduction in 2016
High-tax state

Change in after-tax income:
+$1.8k (+2.4%)



Adjusted gross income: $2.0m
Married filing jointly: two children
Itemized deduction in 2016: $220k
Low-tax state

Change in after-tax income:
+$23.5k (+1.2%)

Adjusted gross income: $52k
Single filer, two children
Standard deduction in 2016
Low-tax state

Change in after-tax income:
+$1.9k (+3.6%)

Source: Tax Foundation: 2018 Tax Reform Calculator

The complexity of predicting consumers' budgeting decisions

Not only will the tax reform shift income and budgeting decisions across different populations in different ways, the impact will also vary across categories of consumer products and services.

So how can companies systematically quantify the impact of US tax reform on their consumers' spending decisions?

In order to anticipate how demand will shift, businesses should classify products in their portfolio considering two factors:

- The income elasticity of demand for the product
- The degree to which demand for the product is concentrated in populations likely to see their income affected by the tax law

When determining demand income elasticity, consumer goods can be divided into three categories:

- **Inferior goods:** demand for these goods decreases as income rises, allowing consumers to switch to higher-quality substitutes. Margarine is an example of an inferior good.
- **Necessity goods:** their demand rises with income, but growth is lower than that of income. Most consumer staples fall under this category.
- **Superior goods:** demand for these goods increases more than proportionally as income rises. Luxury goods are examples of superior goods.

[2] *Bureau of Labor Statistics, Consumer Expenditure Survey 2016*

Figure 2 provides an overview of products and industries that we expect to be most impacted by the reform based on their demand elasticity and the degree to which demand is concentrated in groups most likely to be affected by the tax law. Products expected to see the largest increase in demand are above the line. Those expected to be most negatively impacted are below the line.

Figure 2: Impact assessment by product

How companies should prepare for demand shifts

As US households start to adjust their budgets following tax reform, CFOs and CMOs should evaluate whether their industry, portions of their product portfolios or specific customer segments are particularly affected. And they should consider taking the following initiatives:

- **Supply chain:** adjust production, inventory management and distribution strategy to accommodate the new levels of demand
- **Marketing:** reassess the marketing strategies in place to either engage customers likely to cut their spending or attract new customer segments; provide customer relationship management capabilities, including identification of income-related purchasing behavior changes and identification of customer segments by level of income elasticity
- **Merchandising and assortment of products and services offered:** reassess product offering and assortments locally based on expected shifts in local demand across customer segments
- **Pricing and promotion or discounts:** review pricing and incentive strategy in light of shifts in demand across customer segments to either maintain customers likely to switch to different categories of products or attract new customers; anticipate increases in incentive budget for additional market support
- **Investment and strategic actions:** assess whether the business should target new customer segments, understand how those segments compare to the current customer base and assess whether the current product portfolio meets the new demand
- **Innovation pipeline:** review current product innovation strategies and anticipate innovation in products and services to meet that demand

Taking the appropriate actions requires a thorough understanding of the economic impact of the tax reform on different populations and of consumers' spending behaviors across different categories of products and services. Ernst & Young LLP can assess these implications and provide actionable recommendations in preparation for that demand shift.

Contacts

Daniel Kahn, PhD
Principal
Transaction Advisory Services
Ernst & Young LLP
daniel.kahn@ey.com
+1 202 327 6695

Louise Keely, PhD
Principal
Transaction Advisory Services
Ernst & Young LLP
louise.c.keely@ey.com
+1 312 879 2994

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