Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

TRENDMACRO LIVE!

On Trump's Tax Cut Proposal

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Donald Luskin

The supply-side vision he campaigned on. No details, but at least it's the end of the beginning.

The good news is that just a week after the media had declared it impossibly problematic and indefinitely delayed, *the Trump administration just released its tax policy vision – and it looks a lot like the simple, elegant pro-growth vision that Trump campaigned on all along – a plan of which we said a year ago "pro-growth supply-siders" would "crawl across broken glass to get"* (see "Sympathy for the Donald" March 2, 2016). And we're delighted to say that, as we expected, the GOP House's border adjustment tax is nowhere to be seen (see "Trump Gives the BAT the Boot" April 17, 2017).

The bad news is that it's only a simple one-page position paper – with less detail, actually, than the original campaign proposal. It commits to spending the month of May in "listening sessions with stakeholders to receive their input." So this only marks the end of the beginning of the tax-cutting process.

- This started to emerge in vague public statements by Trump as early as last Friday, and he tweeted about it with more clarity on Saturday. We think that, more than the French primary election (see "On the French Presidential Primary" April 24, 2017), this is responsible for the global risk-on rally that, as of this writing, has not quite ended the first "Trump Correction," with US stocks within basis points of surpassing their March all-time highs (see "A Trump Correction at Last?" March 3, 2017).
- *Objectively the vision announced today is "phenomenal." But we have to say we have a subjective sense of let-down that it's still all quite vague, and it wouldn't surprise us one bit if markets showed some disappointment.*
- *And we need to think through the politics of the fact that Trump himself didn't appear at today's roll-out press briefing, leaving it to Treasury Secretary Steve Mnuchin and National Economics Council Director Gary Cohn.*
- In a nutshell, the top corporate rate would be lowered from 35% to 15%, and this would apply to businesses organized as pass-throughs such as S-corporations and LLCs. In today's press conference, Mnuchin said steps would be taken to assure that this doesn't lead to abuses by creating new pass-through entities to shelter personal income.
- The only protectionist element in the proposal is a one-time tax on corporate cash held overseas, whether or not it is repatriated – which

Update to strategic view

US MACRO: The Trump administration announced tax cut proposals, which are substantially identical to his campaign platform. It's only a one page position paper, promising that May would be spent in "listening sessions" with stakeholders." We think the excitement in the run-up to today's announcement is responsible, more than the French election, for the big risk-on move in global markets. Now we wouldn't be surprised if markets showed some disappointment at the vagueness of it all. The border adjustment tax is gone, and the only protectionist feature is a one-time tax on corporate cash held overseas, whether or not repatriated. The administration has actively pre-sold tax cuts as pro-growth stimulus, and capable of "paying for themselves." We think the math is credible. For the GOP, deficit-phobia can be set aside, and for Democrats – especially the ten Senators facing re-election in 2018 in rust-belt high-unemployment states carried by Trump, it will be difficult to vote against anything positioned as stimulus.

[Strategy dashboard]

was the single alarming feature of Trump's original proposal in the campaign (see "Trumped!" December 14, 2015). Mnuchin said today that the rate of this tax has not yet been set (it was proposed at 10% in the campaign). That said, at the same time, the proposal would end the present regime of attempting to tax overseas income.

- The personal tax code would be simplified from seven brackets to three brackets: 10%, 25% and 35%, with no clarity of the adjusted gross income levels at which these rates would kick in. There would be a $24,000 standard deduction for couples filing jointly, and all deductions other than mortgage interest and charitable contributions would be eliminated – including state and local taxes.
- The 3.8% surcharge for top earners on capital gains and dividend income would be eliminated, presumably leaving the top rate at 20%.
- The estate tax and the alternative minimum tax would be eliminated.

Much of the media hand-wringing about the difficulty of enacting tax cuts like these has been that they would be blocked by GOP deficit-phobes in Congress. We think lip-service will be paid to seeming fiscal rectitude, but this will not be a big barrier to enactment.

- *Trump's surrogates over the last two weeks have ably prepared the ground by laying out a cogent and committed supply-side case, positioning the tax cut proposal as pro-growth stimulus that transcends fiscal concerns.*
- Early last week Mnuchin said, "Economic growth is our number one priority. The difference between 1.8 per cent GDP and 3 per cent GDP compounding is staggering… There could be as much as close to $2tn difference in revenues under different growth scenarios... We believe in dynamic scoring." Later last week he said, "The plan will pay for itself with growth."
- Office of Management and Budget Director Mick Mulvaney – a former congressman who co-founded the supposedly deficit-phobic Freedom Caucus – said last week, "…we're not starting off saying, 'How do we do something that's deficit-neutral?' We're starting off saying, 'How do we get economic growth?'" Earlier last week he had said, "It's a go-big or go-home type of attitude."
- Key congressmen seem to be on board. Over the weekend following the withdrawal of the House vote on the American Health Care Act, Freedom Caucus chair Mark Meadows said that on tax cuts he sees "a lot of flexibility in terms of some of my contacts and conservatives …tax reform and lowering taxes, you know, will create and generate more income."
- Senate Finance Committee Chair Orrin Hatch (R-UT) said yesterday, "I'm open to getting this country moving." As to bearing deficits to do it, he added, "I'm not so sure we have to go that route, but if we do, I can live with it." It probably wasn't natural for him to make this concession. *But we think Trump's long dalliance with the border adjustment tax, which was never part of his original tax logic, was his way of softening up the fiscal hawks by showing that deficits were a lesser evil than embedding protectionism in the deep-tissue of the tax code.*

Contact TrendMacro

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Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

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- As to the House champions of the BAT, after the AHCA fiasco, we don't think Speaker Paul Ryan's (R-WI) insistence will be very vigorous (see "Does AHCA Kill Tax Reform?") March 27, 2017). He said yesterday, "We're in agreement on 80 percent and on the 20 percent we're in the same ballpark." We think it's no more than a sad coincidence that 20% is the proposed level of his border adjustment tax.
- Ways and Means Committee Chair Kevin Brady (R-TX) reportedly will "press ahead with the import tax, not merely because it would make up for lost revenue but because it would protect American jobs." We doubt he'll press very hard or get very far ahead.
- As to Democrats in Congress, the going-in assumption has to be that they will be unified in their opposition to today's proposed tax cuts. If so, then they will have to pass the Senate under "budget reconciliation," in which case if they are "scored" as causing a deficit in the budget-window, they would have to automatically expire at some point, likely 10 years out.
- Mnuchin is taking a strong posture, acting like he'd be willing to proceed without Democratic support. He said this morning, "If we have" tax cuts "for 10 years, that's better than nothing."
- *And with the elimination of all personal deductions other than mortgage interest and charitable contributions, presumably there deduction for state and local taxes – which would tend to hit high-tax blue states hardest. We have no doubt this will be heavily negotiated and might even work as a hostage that the GOP could release in exchange for Democratic votes.*
- Be that as it may, there are ten Democrats in the Senate who face re-election in 2018 in states carried by Trump in 2016. If the GOP stays reasonably unified and continues to portray the tax cuts as a form of pro-growth stimulus, *who's to say that enough Democrats would not come on board to overcome a filibuster, and make the tax cuts permanent?*
- *If three Democrats could vote for Supreme Court nominee Neil Gorsuch – Heidi Heitkamp (ND), Joe Manchin III (WV) and Joe Donnelly (IN), all up in 2018 – all it takes is five more.*

We think it's credible to think that tax cuts can indeed "pay for themselves."

- We had to laugh last night when the staunchly anti-Trump anti-tax-cut *New York Times* inadvertently made the case. A *Times* story cited a study by the Tax Foundation, claiming it found that to "make up for…losses" from a 15% corporate tax rate, "the economy would have to become 5 times larger." Soon the *Times* story had to be corrected – the Tax Foundation found "It would have to become 5 percent larger, not five times larger."
- This doesn't seem like too much to ask for over a 10-year budget window. And it sounds even more credible when the Tax Foundation study expresses the same thing in per annum terms – only 0.9%. Add that to the Congressional Budget Office's baseline growth assumption of only 1.9% per annum over 10 years – is it too hard to believe that cutting the corporate tax rate from the highest in the

world to close to the lowest in the world couldn't get growth up to a still sub-normal 2.8%? We think not.

- *Here's the logic in a simplified, rounded and stylized form – exclusively considering the cut in the top corporate rate*. *The corporate income tax presently takes 2% of GDP*. *If that were halved by a rate cut, then the rest of the economy would have to grow 1% more to make up the difference. It seems to us that's an easy lift.*
- Soon the complex dynamic scoring models of the Congressional Budget Office, the Joint Tax Committee and various private organizations will deliver their verdicts on Trump's plan. *We expect the models will generally be too conservative – that is, they will underestimate the degree to which the proposed tax cuts will "pay for themselves."*
- Dynamic scoring models, like all econometric models, make many overt and hidden assumptions about how taxes affect economic activity. And it may be especially important now how these models judge the initial conditions on which Trump's proposals will act. Most critical, they will likely look at today's seemingly low unemployment rate of 4.5% and assume that the economy is already at full employment, without much room to grow. We believe fervently that the headline unemployment rate fails to count as many as 8.4 million unemployed persons, many of whom could be drawn back into the labor force if growth conditions were to improve (see "The Demographics Myth" March 20, 2017).
- This brings us back to the question of Democratic support. We could argue that Trump got elected because he remembered those 8.4 million unemployed who'd been forgotten by Democrats. Those ten Democratic Senators facing re-election in 2018 in Trump-states – in which a significant number of that 8.4 million probably lives – won't forget them now.

Bottom line

The Trump administration announced tax cut proposals, which are substantially identical to his campaign platform. It's only a one page position paper, promising that May would be spent in "listening sessions" with stakeholders." We think the excitement in the run-up to today's announcement is responsible, more than the French election, for the big risk-on move in global markets. Now we wouldn't be surprised if markets showed some disappointment at the vagueness of it all. The border adjustment tax is gone, and the only protectionist feature is a one-time tax on corporate cash held overseas, whether or not repatriated. The administration has actively pre-sold tax cuts as pro-growth stimulus, and capable of "paying for themselves." We think the math is credible. For the GOP, deficit-phobia can be set aside, and for Democrats – especially the ten Senators facing re-election in 2018 in rust-belt high-unemployment states carried by Trump, it will be difficult to vote against anything positioned as stimulus.