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MACROCOSM

Tax Reform: The Sausage Factory Moment

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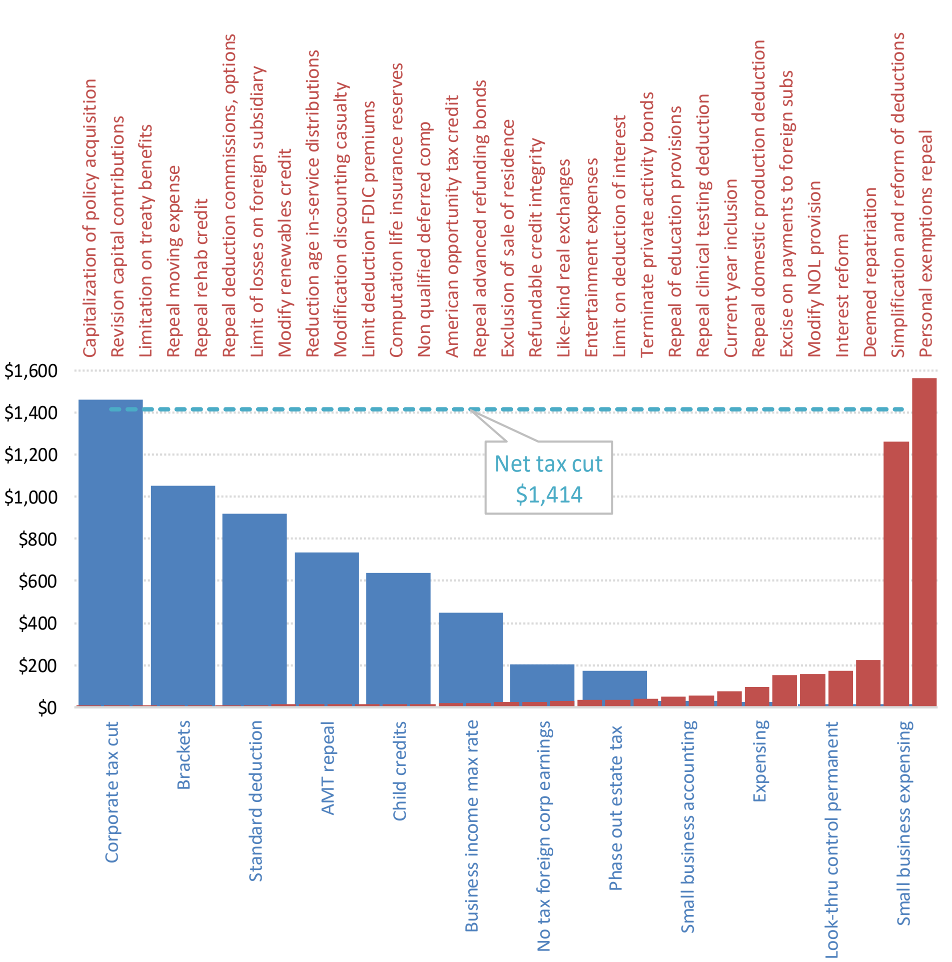
The conventional wisdom moves from "tax cuts can't happen" to "tax cuts won't matter."

The GOP's tax reform bill – the Tax Cuts and Jobs Act – is 429 pages of complexities and gimmicks, including both tax cuts and tax hikes. Just the summary is 82 pages. *The biggest single cut is lowering the corporate tax rate to 20%*, which statically scores at $1.462 trillion over ten years. The entire bill scores at $1.414 trillion. So one would not be entirely wrong to say that *the hundreds of other provisions just cancel each other out*, and function as mere window dressing (please see the chart below).

TCJA tax cuts and tax increases 2018-2027, provisions >$5 bil, static score



Source: Joint Tax Committee, TrendMacro calculations

Update to strategic view

US MACRO, US STOCKS: The House legislative text for tax reform is moving the conventional wisdom away from "tax cuts will never happen" to "tax cuts won't matter." We continue to believe they will both happen and matter. Markets might take this moment to get lost in the messy details, which could trigger a long-overdue buyable dip. The centerpiece of the proposed bill is the cut in the corporate tax rate from 35% to 20%, a statically scored tax cut of about 10% of 2018 S&P 500 earnings, and $1.462 trillion over ten years. All the other hundreds of provisions effectively cancel out. The loss of the SALT deduction means that some higher earners in large blue states face an effective tax hike, but we continue to expect it will get bargained away in the Senate. There are problematic provisions, especially the "deemed repatriation" wealth tax on retained foreign earnings. A BAT-like excise tax on affiliate payments is already being amended away.

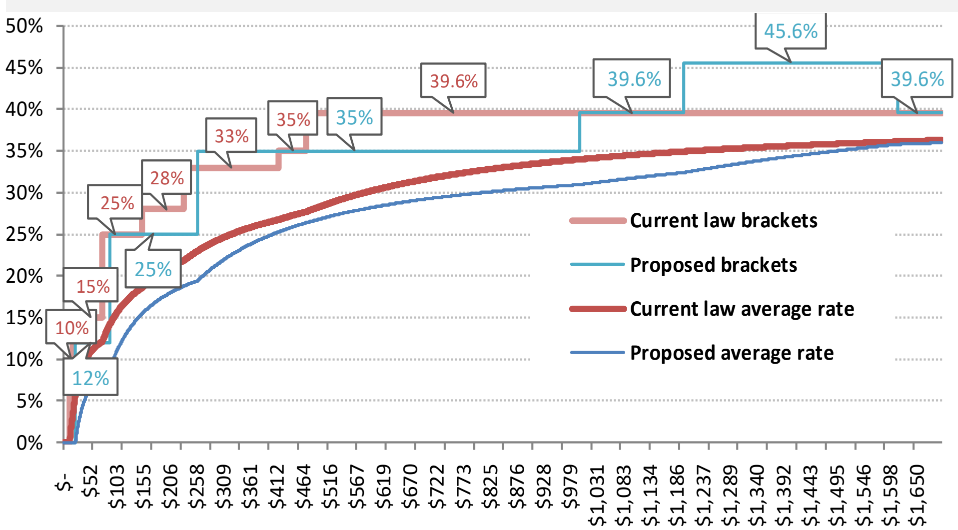
[Strategy dashboard]

Markets don't seem disappointed since TCJA – it's being pronounced "tick-ja" in Washington – was revealed Thursday morning. It's just one more case of stocks marching to new highs as, one painful step at a time – each step believed by the consensus to face some insurmountable obstacle – the prospects for tax cuts have gotten increasingly real, just as we predicted they would (see "Tax Cuts Start to Get Real" September 28, 2017). There are many more steps – a mark-up, a vote in the House Ways and Means Committee, a vote in the full House, a Senate bill that could be quite different, then to conference and to President Donald J. Trump's desk – and the consensus will be writing TCJA's obituary every step of the way. *Could it all blow up? Of course it could, but we don't think it will – and there's still more pessimism than optimism about it, so there's still an asymmetrical upside surprise potential in stocks.*

In the meantime, this is the sausage factory moment. This is where we get to see all the messy complexity, the inevitable trade-offs economic and political, the inspirations and the errors, and fact that this will produce both winners and losers. *Negotiating all these internals is where all the political risk lies. And this is where markets form their first impressions of what tax reform will really look like, so this is a likely moment for stocks to give us a buyable dip. Already, the conventional wisdom is changing from "tax cuts are impossible" to "tax cuts won't matter." So the trick is to not let what you see in the factory ruin your taste for sweet delicious sausage.*

- And who can help but look first to determine how one's self will make out? And then who can help but let personal bias shape how they evaluate the whole package and its impact on the overall economy and the markets?
- Looking just at the proposed headline tax brackets, the biggest gains come for taxpayers (assuming married, filing jointly) with adjusted gross income of about $300,000 – and for those with AGI of about $1 million (please see the chart below).

Individual tax rates by AGI Married filing jointly. Includes standard deduction. Ignores changes for itemized deductions, AMT, business income.



Source: House Ways and Means Committee, TrendMacro calculations

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- *Because the bill preserves the present top bracket of 39.6%, as AGI rises, the proposed average tax rate converges with that under current law.*
- *But the headline tax rates don't even begin to tell the whole story. There are many important internals.*
- *The proposed maximum rate on "business income" derived through interests in pass-through entities delivers a greater tax cut, for some taxpayers, than implied by the headline rates.* The proposed maximum rate is 25%, which a taxpayer would be able to claim on 30% of business income. The 30/70 blended rate works out to 35.22% for the highest earners at the margin.
- It is likely that lower corporate tax rates, and the elimination of penalties on repatriating profits earned overseas, will lead to special dividends, larger regular dividend payouts and more share buy-backs. *For the taxable individuals receiving them, these payouts would be taxed at the favorable dividend and capital gains rates, increasing gross income while, at the same time, lowering the average effective tax rate.*
- *Cutting the other way, there would be an effective tax hike for many high-income taxpayers, because of the proposed elimination of the deduction for state and local taxes (SALT).*
- The cost of losing the SALT deduction depends what state you live in (obviously, the hardest-hit are wealthy high-tax states – California, New York, New Jersey, Connecticut and Massachusetts – while Texas and Florida are mostly unscathed).
- And it depends on whether a given taxpayer had been subject to the Alternative Minimum Tax, which already took away the SALT deduction anyway. AMT is eliminated in the proposed bill, which could confer offsetting advantages.
- *Because the states hardest-hit by the elimination of the SALT deduction are all Democratic strongholds, we have long said that it will be a powerful bargaining chip in the end-game in the Senate.* We continue to expect that it will be dealt away in exchange for enough Democratic votes to overcome a filibuster, allowing tax reform to be permanent – by pulling it out of the filibuster-proof "budget reconciliation" process that requires it to be temporary (see "Trump's Tax Cut Nuclear Option" May 1, 2017).
- Democrats have had to be mostly silent about eliminating the SALT deduction until now, because they don't wish to make self-interested arguments about preserving the prerogatives of the wealthiest blue-staters. Now that it's coming down to the wire, they're reduced to protesting that the SALT deduction benefits the "middle class," a claim that even the *New York Times* and the *Washington Post* have had to acknowledge is false. *Even if untrue, it's about the only thing Democrats at the Ways and Means mark-up this week can talk about. These populist claims made now, however ridiculous, will make it politically acceptable later for Senate Democrats to compromise with the GOP.*
- GOP congresspersons in blue states are protesting too, arguing that the SALT deduction is the only thing that spares their constituents from excessive taxation imposed by local Democrats. *This, too, clears the way for compromise by giving the GOP cover*

for accepting higher statically scored deficits from preserving the SALT deduction.

- *Looking at the individual side of the proposed bill on its own – and assuming the preservation of the SALT deduction – we see it as a legitimate pro-growth tax cut with some strong elements of true reform.*
- To be sure, eliminating the SALT deduction would have been very strong reform. But bracket simplification, removal of various targeted deductions, expansion of the standard deduction that will allow up to 95% of taxpayers to no longer bother to itemize, and the elimination of the AMT and the estate tax are strong reforms, too.
- *There are troubling elements that cut the other way, too.*
- The claw-back of the tax benefit of the new 12% bracket on AGI's above $1.2 million effectively creates a 45.6% "bubble bracket" – between $1.2 million and about $1.64 million. It's been called a "stealth bracket" because it is not declared to be a bracket at all. But in terms of the marginal disincentives faced by taxpayers in the "bubble," it functions exactly like a bracket (so we include it in the chart on the second page).
- The proposed increased refundable child credits do nothing to improve incentives – at least not incentives to work and invest, although we concede they may improve the incentive to have children, which we suppose isn't the most anti-growth idea we've ever heard.

As we said at the very beginning, the main event here is on the corporate side. *The best part of this bill is cutting the corporate tax rate to 20%. Again, the static score for this alone is a $1.462 trillion tax cut over ten years. In some sense if would be economically ideal if this were all the bill did.* But that would be too simple. In politics, complexity functions as a Trojan horse, allowing simple things to sneak in, when they couldn't have made it on their own.

- There are lots of provisions for corporations in the bill – some tax cuts, such as accelerated capital expensing, some tax hikes, such as limits on the deductibility of interest payments. But there are four big ones that matter.
- *Cutting the top corporate tax rate from 35% – the highest among the major economies – to 20% – below the average of the major economies – is a pure win.* No trade-offs. All winners, no losers. The lowest of low-hanging fruit. If there's a tax cut that "pays for itself," this is it. We've said as much over and over, since we first started talking about Trump's focus on it when he was still a candidate in the primaries (see "Sympathy for the Donald" March 2, 2016).
- Taken on its own, capping the corporate tax rate at 20% would increase next year's S&P 500 after-tax earnings by about 10%.
- Again, higher after-tax earnings will allow corporations to pay higher dividends and do bigger share buybacks. They would also allow corporations to hire more workers, and banks to make more loans. That would lead to higher investment and consumption everywhere in the economy. And *that* would help young not-yet-

profitable companies – who get no tax break, because they have no profits to tax – to benefit by selling more goods and services.

- Next other countries will realize that, to compete, they have to cut their own corporate tax rates (France just did). It will be protectionism in reverse – a race-to-the-top to see who can be the most globally competitive, by being the nation that most liberates its corporate sector.
- To put it in the lingo of traditional macro-economic analysis, cutting the corporate tax rate has a "multiplier." And in defiance of conventional economic wisdom, that multiplier is subject not to diminishing returns, but rather to increasing returns, as a more rapidly expanding economy calls forth unpredictable innovations (see "Global Bull Market: Still Not Loved and Still Not Over" October 16, 2017).
- *The bill also eliminates US taxation on foreign earnings, which is an additional corporate tax cut of $205 billion over ten years. This is another strong pro-growth reform, eliminating the US's perverse claim on domestic firms' global earnings.*
- *Unfortunately, cutting the other direction, the bill imposes a one-time tax on accumulated foreign earnings from 1986 – 12% on cash, and 5% on other capital. It doesn't matter whether or not the earnings are repatriated – they are "deemed repatriated" – so this functions as a wealth tax.*
- A 12% rate is far lower than the 35% rate that a corporation may have borne if it had repatriated the earnings in prior years. It's even lower than the 20% rate that would been borne for earnings repatriated in the future, under new lower corporate rate. But it's a lot higher than the 0% rate that would have been borne if the corporation wished to leave the earnings where they are (indeed, those earnings may now be at work not as stranded savings, but rather as legitimate components of the capital structure of foreign operations – so they should never come back). But that option is not available because, again, the earnings are "deemed repatriated" whether or not they actually are.
- *The static score for this provision is $223 billion – but this would not be a devastating one-time hit to earnings next year. Corporations would be allowed to pay it over eight years.* And it would be approximately financed by the $205 billion in tax cuts earned by the elimination of US taxation on foreign earnings going forward.
- So it can be seen as a trade-off. But there will be some corporations who will have to pay the wealth-tax on past earnings who don't have offsetting future earnings. And once this wealth tax is collected, that's forever – while the elimination of taxes on foreign earnings may only be temporary, especially if it has to be enacted in the Senate under "reconciliation."
- *We are also concerned by the proposed 20% "excise tax on outbound related-party payments." Corporations could avoid the 20% excise tax on the gross payment by subjecting the related party to a 20% tax on its profits from this "effectively connected income."* As originally proposed, this provision scored as a $155 billion tax hike over ten years.

- *But opponents complained that this was a mini version of the protectionist border adjustment tax (BAT) concept* that, thankfully, fell by the wayside as tax reform was negotiated over the summer between the GOP House and other stakeholders (see "Drop the BAT and Run" July 31, 2017).
- That's a little unfair, as it is not imposed on all imports. It is intended to focus on abusive payments to foreign subsidiaries – payments that would be tax deductible in the US, and either lightly taxed or not taxed at all at their foreign destination. But like a BAT, the excise tax may run afoul of international tax treaties, and may be construed as a tariff under World Trade Organization rules.
- A risk going forward is that the well-intentioned effort to strip this bill of the "deemed repatriation" wealth-tax and the mini-BAT excise tax will, under the strictures of static scoring, require offsetting reductions or phase-ins of the pro-growth parts. That would be a bad trade-off, and we think it would be better to leave things as they are.
- Already, on Monday, House Ways and Means Committee Kevin Brady introduced, and the Committee approved, an amendment that includes a significant reduction to the excise tax. It loses $148 billion of its originally anticipated statically scored revenue. That and other small changes put the entire bill $74 billion over its $1.5 trillion budget. So at least within the rules of the game as it's now being played, something else is going to have to be adjusted to find some revenue.
- The key flaw of static scoring is that it assumes away taxpayers' reaction functions – the "multiplier" that we discussed earlier. We are confident that corporations can find ways to reduce the statically scored harm of the wealth tax and the mini-BAT. At the same time, we are confident that the 20% corporate rate will pay for itself – which means that the statically scored value of this tax cut will in fact be far greater, because it will be calculated on a higher base of earnings not currently contemplated.

Bottom line

The House legislative text for tax reform is moving the conventional wisdom away from "tax cuts will never happen" to "tax cuts won't matter." We continue to believe they will both happen and matter. Markets might take this moment to get lost in the messy details, which could trigger a long-overdue buyable dip. The centerpiece of the proposed bill is the cut in the corporate tax rate from 35% to 20%, a statically scored tax cut of about 10% of 2018 S&P 500 earnings, and $1.462 trillion over ten years. All the other hundreds of provisions effectively cancel out. The loss of the SALT deduction means that some higher earners in large blue states face an effective tax hike, but we continue to expect it will get bargained away in the Senate. There are problematic provisions, especially the "deemed repatriation" wealth tax on retained foreign earnings. A BAT-like excise tax on affiliate payments is already being amended away.