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MACROCOSM

Delayed Gratification for Corporate Tax Cuts

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Donald Luskin

Phasing-in a corporate tax cut in 2019 makes CAPEX a better deal than if the rate were zero.

Step by reportedly impossible step, President Donald J. Trump's tax cuts move toward the finish line, just as we've said all along (see "On Trump's Tax Cut Proposal" April 26, 2017). The conventional wisdom continues to throw up arguments why they still won't get enacted. We still say they will (see "Tax Reform: The Sausage Factory Moment" November 8, 2017).

- In the end-game, the House and Senate versions will have to be blended. And there will have to be a showdown with Democrats over the repeal of the deduction for state and local taxes, which could change everything at the last moment (see "Trump's Tax Cut Nuclear Option" May 1, 2017).
- For now, we think the Senate version is more like how things will turn out. It's built to pass with minimum controversy. It discards a number of the reforms in the House bill – such as reducing the mortgage interest deduction and eliminating the medical expense deduction. It adds lots of little special-interest giveaways. And it uses lots of timing gimmicks – phase-ins and sunsets – that make the statically scored budget-impact of the bill appear smaller.
- In client conversations this week, we've heard a lot of concern about one particular timing gimmick – *keeping the present 35% top rate for 2018, and not moving to 20% until 2019. The fear is that companies will defer economic activity to 2019, causing earnings to fall and growth to slow in 2018.*
- This is a legitimate question, and we will address it. But we disagree with commentators who are now saying that delaying the 20% corporate rate till 2019 will cause a recession in 2018. Some base this on what we think is a false history lesson – that the phase-ins of the Reagan tax cuts of August 1981 caused the 1981-1982 recession (we thank Paul Volcker for that one, not tax cuts). We'll grant that a phase-in may not be optimal – although in a larger sense it may be, if it enables the whole bill to be enacted. Either way it's not going to cause a recession in 2018.
- For one thing, all the tax cuts for *individuals* will be effective for all of 2018. So whatever we might fear companies will do while they wait for lower rates in 2019, to cause a recession it would have to be bad enough to overcome the stimulative effects of lower rates on individuals (including the stimulative effects on companies resulting from the stimulative effects on individuals).

Update to strategic view

US MACRO, US STOCKS: Tax cuts march on, while the conventional wisdom still says they won't happen. We still say they will. Clients are concerned by the potential delay of the 20% corporate tax rate in 2019. We don't see this as harming forward after-tax earnings estimates, or stock prices, nor can competitive firms afford to suspend activity for the sake of income-shifting. It is highly complementary with the provision for immediate expensing of capital investments, raising their internal rate of return by allowing them to be deducted under a high tax rate, and then their fruit taxed under a low tax rate. This should lead to a boom in capital investment, the deficiency of which has been a signature of the age of "secular stagnation."

[Strategy dashboard]

- But even if we stipulate that it won't cause a recession, that's not to say that a delay till 2019 won't have distortive effects that could possibly be harmful in various ways.
- *We see five potential channels for distortive effects, and we're not worried about any of them. In fact, one of them is very pro-growth.*
- **THE GAME-THE-SYSTEM CHANNEL** This is the "it will cause a recession" argument. Yes, companies will try move as much taxable income as they can from 2018 to 2019, if they know that their tax rate will be lower in 2019. But a company's tax books aren't the same as their GAAP books. Let them play their games on their tax books if that lowers their tax bill. Lowering their tax bill is pro-growth.
- But it's not feasible to suspend very much real economic activity in 2018 and then take it up again in 2019, and expect that you can somehow capture two years of activity in one year, and with a lower tax rate. In a competitive economy, most economic activity, if foregone, cannot be recaptured next year at a lower tax rate – because there's a competitor who captured it last year by not foregoing it.
- **THE CAPITAL MARKETS CHANNEL** In whatever year the cut to 20% takes effect, it will instantly increase after-tax corporate earnings. That will have some combination of two salutary effects on stock prices – at any given multiple it will drive prices higher, or at any given price it will drive multiples lower. Which effect will dominate depends on how much of a surprise the tax cut is, and at this point we still think there would be a considerable element of surprise (though not as much as there would have been several months ago – see "Tax Cuts Start to Get Real" September 28, 2017).
- Be that as it may, *we think that stock prices are far-forward looking, and so long as the tax rate is known with certainty to be lower in the coming year and for years thereafter, there won't be much of a penalty on a one-year delay.*
- **THE DEMAND-SIDE CHANNEL** The 20% rate, by driving after-tax earnings higher, means there will be an increment that can be distributed to stakeholders through higher employee compensation, higher dividends, special dividends, and share buybacks. Whether people spend the money, save the money, or invest the money, it's all good.
- Better to have such a thing sooner rather than later. But versus the *status quo ante*, delaying it a year isn't a harm – it's just a deferred opportunity. And it's like a lottery-win: it's just an endowment, and it doesn't have any incentive effects on the winners to work harder.
- **THE SUPPLY-SIDE CHANNEL** A lower rate applied to corporate earnings already in place is only a windfall endowment. That rate applied to incremental earnings in the future is the incentive to build, to expand, to invest – to capture new after-tax earnings that didn't pencil out as worthwhile under the old higher rate. *With the 35% corporate rate the highest in the world, rendering US business globally uncompetitive, we see this incentive effect on the supply side as the most powerful mechanism by which tax cuts lead to growth.*

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- But it takes time to design and implement plans to pursue new earnings opportunities. *We don't think a 35% tax rate in 2018 will keep companies from investing immediately so that they can harvest the fruit of that investment in 2019 at a 20% tax rate. In fact, in one way it will encourage it, because that investment will turn out to be the best way to game the system and shift net income into future years.*
- Which brings us to **THE CAPEX CHANNEL.** The investments companies make in 2018, which they expect to harvest at lower tax rates in 2019 and beyond, are themselves tax deductible in 2018 at the 35% rate. And all the more so under the "immediate expensing" provision in both the House and the Senate bills. For tax purposes, companies will no longer have to depreciate long-lived capital investments – they can take the whole expense against taxable earnings in the first year – and it takes effect in 2018.
- *That's a powerful double incentive to make capital investments immediately – you get to write the whole thing off this year at a high tax rate, and then the profits earned from it next year, and forever after, will be taxed a low rate.*
- *With a 35% tax rate in the year the capital investment is made, and a 20% tax rate when the investment bears fruit, the internal rate of return of any successful capital investment will be higher than if the tax rate dropped to 20% immediately.*
- *Indeed, it will be higher than if the corporate tax rate were zero* (please see the table below).

Internal rates of return of $1 CAPEX: immediate expensing and 25% return over ten years

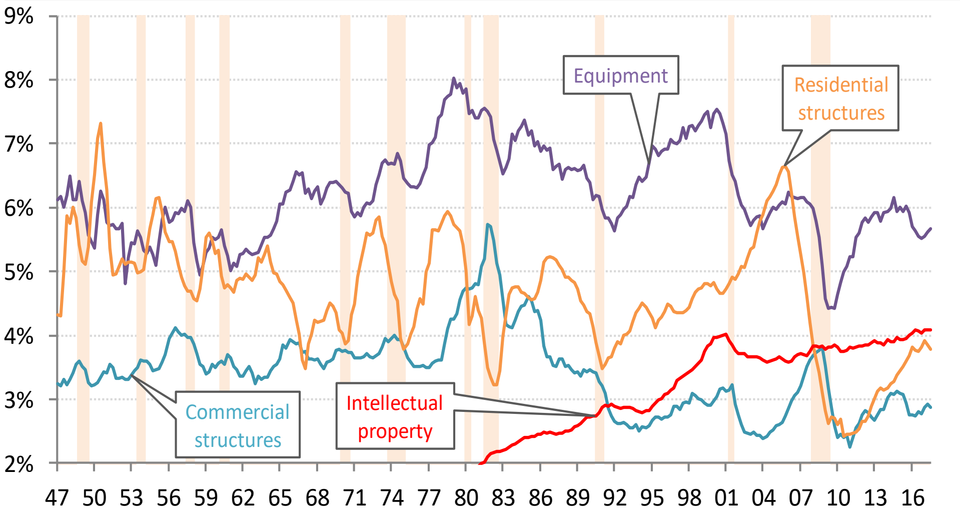
Year	0	1	2	3	4	5	6	7	8	9	10	IRR
Pre-tax cash flow	$ (1.00)	$ 0.25	$ 0.25	$ 0.25	$ 0.25	$ 0.25	$ 0.25	$ 0.25	$ 0.25	$ 0.25	$ 0.25	
Tax rate	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	
After-tax cash flow	$ (1.00)	$ 0.25	$ 0.25	$ 0.25	$ 0.25	$ 0.25	$ 0.25	$ 0.25	$ 0.25	$ 0.25	$ 0.25	21%
Tax rate	**20%**	20%	20%	20%	20%	20%	20%	20%	20%	20%	20%	
After-tax cash flow	$ (0.80)	$ 0.20	$ 0.20	$ 0.20	$ 0.20	$ 0.20	$ 0.20	$ 0.20	$ 0.20	$ 0.20	$ 0.20	21%
Tax rate	**35%**	20%	20%	20%	20%	20%	20%	20%	20%	20%	20%	
After-tax cash flow	$ (0.65)	$ 0.20	$ 0.20	$ 0.20	$ 0.20	$ 0.20	$ 0.20	$ 0.20	$ 0.20	$ 0.20	$ 0.20	28%

Source: TrendMacro calculations

- We think the supply-side incentive effects of lowering the corporate tax rates are the most important for growth. Responding to these incentives requires capital investment. The combination of immediate expensing and a one-year phase-in of the 20% tax rate is itself an additional and complementary incentive.
- And at this particular moment in history, there is a case to be made that creating incentives for capital investment is exactly the kind of stimulus the economy most needs.

- Investment in residential structures – housing – famously fell off a high cliff in the Great Recession, and has only partially recovered. But fixed investment of all kinds has been in a secular bear market at least since 2001 – when we believe the era of "secular stagnation" started (please see the chart below from "Data Insights: GDP" October 27, 2017).

Fixed investment as a share of gross domestic product



Source: BEA, TrendMacro calculations

- One typical explanation for this is demographics. Maybe it has been a factor looking backward. But looking forward, US demographics are changing from "deficit" to "dividend" (see "The Demographics Myth" March 20, 2017).
- Another typical explanation is to point to record-low productivity growth. But we see low productivity as a synonym for secular stagnation, not a cause of it. But if we want to know why productivity is so low, isn't the decline in fixed investment the first place we should look? It's practically axiomatic that capital investment is required for productivity growth.
- So what's required for capital investments? Animal spirits are a pre-requisite. We think they're on the rise (see "Sympathy for the Donald" March 2, 2016). And now it seems we're putting in place tax policy that encourages capital investment, too.
- *Great surges of growth are always most likely in sectors that have long been deficient, and suddenly face a catalyst for catch-up. This looks to us like one of those times. We could be on the verge of a capital investment boom.*

Bottom line

Tax cuts march on, while the conventional wisdom still says they won't happen. We still say they will. Clients are concerned by the potential delay of the 20% corporate tax rate in 2019. We don't see this as harming forward after-tax earnings estimates, or stock prices, nor can competitive firms afford to suspend activity for the sake of income-shifting. It is highly complementary with the provision for immediate expensing of capital investments, raising their internal rate of return by allowing them to be deducted under a high tax rate, and then their fruit taxed under a low tax rate. This should lead to a boom in capital investment, the deficiency of which has been a signature of the age of "secular stagnation."