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MACROCOSM

Tax Cuts in the Jaws of Victory

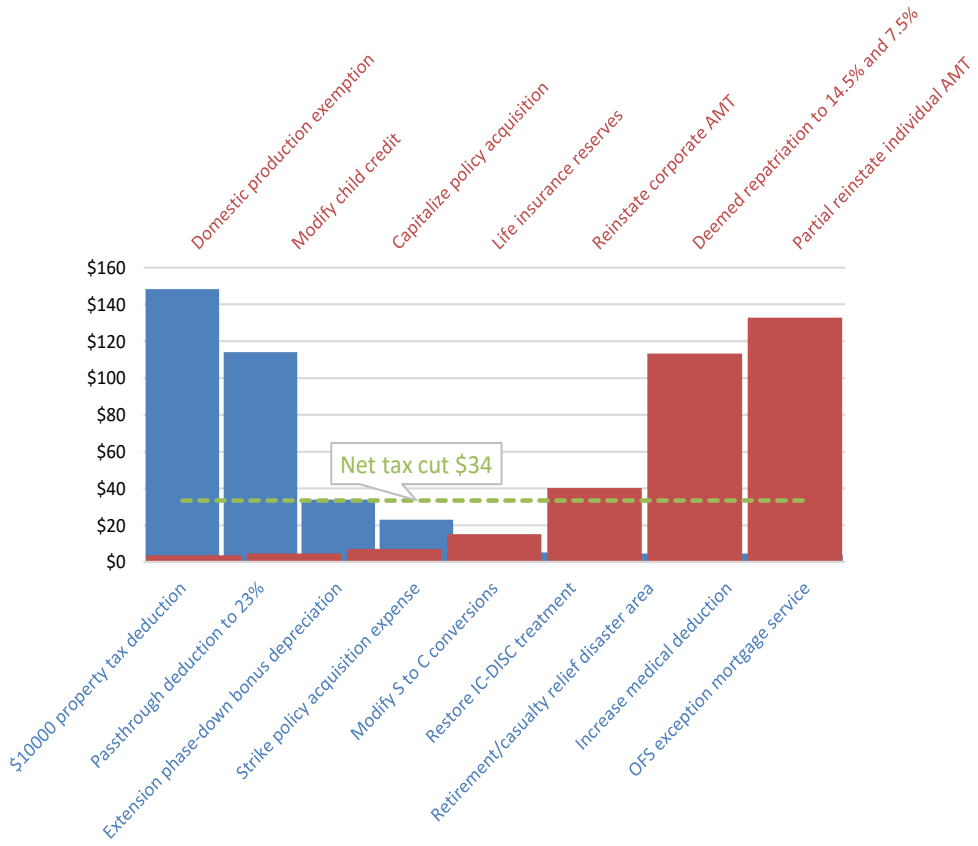
Monday, December 4, 2017

Donald Luskin

If the GOP Congress will take yes for an answer, major pro-growth policy can be enacted.

Declared "in limbo" Tuesday morning and facing a "cascade of problems" on Thursday evening, the Senate passed the Tax Cuts and Jobs Act early Saturday morning. *Last-minute changes* – *hand-written into the bill as it was being voted* – *add $34 billion in net tax cuts*, *statically scored* *(please see the chart below), bringing the net tax cut to $1.448 trillion.* Now the consensus pessimistic narrative moves on to what a "tough sell" the Senate bill will be in the House, and how a House/Senate conference to resolve differences will have to work at the same time as "a government shutdown looms" after funding authority runs out this week.

TCJA senate modifications: tax cuts and tax increases versus prior bill
2018-2027, provisions >$3 bil change, static score



Source: Joint Tax Committee, TrendMacro calculations

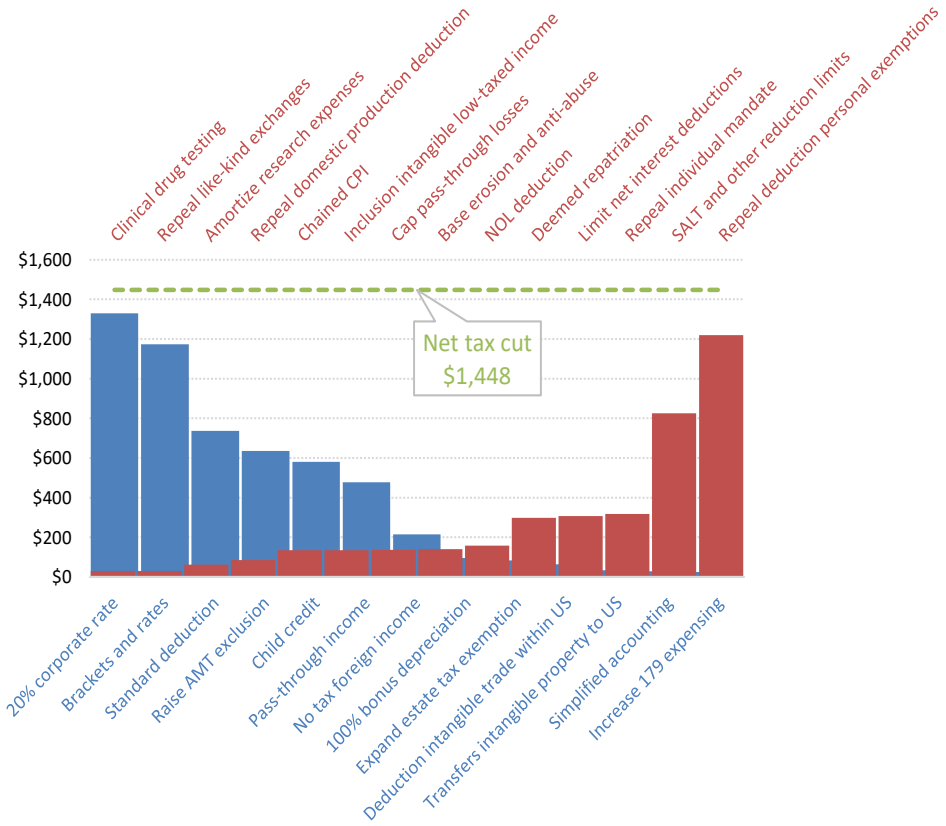
Update to strategic view

US MACRO, US STOCKS: The Tax Cuts and Jobs Act passes the Senate with last-minute modifications, preserving the pro-growth centerpiece from the House's version: cutting the corporate tax rate to 20%. From here there are both easy and hard legislative paths, and it is unknown what the GOP will do – but we remain confident that tax cuts will be enacted this year. Markets are now expecting it too, so there may not be much more upside when it happens, maybe even a "sell on the news" reaction, producing a buyable dip. Trump may have opened the door to a last-minute negotiation with Democrats that would preserve the state and local tax deduction. That would be an upside surprise in the short-term. Longer-term, markets are not adequately anticipating the pro-growth power of the supply-side incentive effects of cutting business tax rates.

[Strategy dashboard]

- For all the pessimism, the number of remaining hurdles is small enough so that surely markets are finally discounting a high probability that a bill will be enacted into law – as we have, all along (see, for instance, "Does AHCA Kill Tax Reform?" March 27, 2017).
- *So if a bill is enacted shortly, we don't see why there would be a great deal of immediate upside for markets – maybe even a short-term "sell on the news" reaction. Everything feels a little stretched to us anyway – but admittedly that's a purely intuitive observation.*
- *But would very likely be a buyable dip. Looking more than a few days and weeks ahead, we see lots of upside – because we don't think the consensus fully appreciates with growth potential in the very messy conglomeration of tax cuts and tax hikes that is emerging* (see the chart below, and "Tax Reform: The Sausage Factory Moment" November 8, 2017).
- *All that said, it's not a done deal. If it falls apart at this point, there would be some downside. There didn't used to be, when markets expected nothing* (see "Drop the BAT and Run" July 31, 2017).
- The path forward looks this this. The simplest thing would be for the House to pass the Senate's bill – and we're done. Or the House could make some changes – to be sure, the hurried

TCJA senate bill as enacted: major tax cuts and tax increases
2018-2027, provisions >$25 bil, static score



Source: Joint Tax Committee, TrendMacro calculations

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[About us]

Recommended Reading

Spatial variability of tight oil well productivity and the impact of technology
J.B.Montgomery and F.M.O'Sullivan
Applied Energy
December 1, 2017

Eight Heresies of Monetary Policy
John Cochrane
The Grumpy Economist
November 29, 2017

[Reading home]

Senate bill could use a little clean-up of various unintended consequences. And the Senate could pass *that* bill – and we're done (provided it meets the Senate's rules for "budget reconciliation," so that the bill can be passed with as few as 50 GOP votes, without a Democratic filibuster). These are the minimax solutions.

- Absent one of those, a conference committee would have to work out a compromise between Senate and House versions, and assuming it could do so, *that* would have to be voted in *both* chambers. That would be a riskier maximax solution.
- *In our view, the only really important part of these unnecessarily complex bills is the reduction of the corporate tax rate to 20% -- which is in common between the Senate and House bills* (again, see "Tax Reform: The Sausage Factory Moment" November 8, 2017). *We have that bird in our hand. Why risk upsetting the whole thing – or for that matter, risk having to trade away the best part of the whole thing?*
- Trump reportedly said Saturday, speaking of the 20% corporate tax rate, "It could be 22 when it all comes out, but it could also be 20. We'll see what ultimately comes out." Who's to say what to make of one of Trump's off-hand remarks? Media accounts are positioning it as Trump impulsively snatching defeat from the jaws of victory – mere hours after he was hailed as an effective and disciplined shuttle-diplomat in the Senate's difficult passage of signature legislation.
- Maybe it means nothing at all. Just more Trump talking. *Or perhaps it's an invitation for a final phase of negotiation – risky, to be sure, but with a high payoff – in which Democrats are brought into the process, contributing enough votes in the Senate to pass a cloture motion (that is, to avoid a filibuster), in exchange for preserving the deductibility of state and local taxes (SALT).* This is something we've been expecting all along, and have been surprised not to have seen more hints that it was coming (see "Trump's Tax Cut Nuclear Option" May 1, 2017).
- We believe that the SALT deduction is distortive an inequitable, but eliminating it is effectively a tax-hike. So if to preserve it we have to compromise the most pro-growth part of the bill – the 20% corporate tax rate – we'd just as soon lose it. The potential magic here is to use Democratic votes to bust out of the straightjacket of false trade-offs imposed by the deficit ceiling contained in the Senate's reconciliation instructions – with that gone, we could keep the 20% rate and the SALT deduction at the same time.
- That's the dream. That's the ultimate bill. *Markets are not thinking about this possibility at all, and there would be a great deal of upside coming out of a positive surprise like this.*
- But we continue to believe that either the House or Senate version, as they stand right now, would be very pro-growth – much more so than the consensus understands.
- The key growth element contained in the 20% corporate tax rate operates through what we've called the "supply-side channel" – the removal of a tax-barrier that has prohibited otherwise productive economic activity, liberating that activity to take place,

expanding the opportunity set for the whole economy (see "Delayed Gratification for Corporate Tax Cuts" November 20, 2017).

- Lowering marginal tax rates for pass-through business entities – the provisions for which were sharply improved in the last-minute Senate modifications (again, see the chart on the first page) – operates the same way in the non-corporate sphere.
- The last-minute Senate modifications made some corporate tax provisions worse – especially the "deemed repatriation" tax on cash held overseas, raising the toll from 10% as originally provided, to 14.5% (again, see the chart on the first page). But this doesn't interfere with the incentives for expansion offered by the reduction of the top marginal rate to 20%. Rather, it subtracts from the windfall gains arising from taxing pre-existing activities at 20% rather than 35% – what we have called the "demand-side channel" (again, see "Delayed Gratification for Corporate Tax Cuts"). Such a windfall amounts to a transfer payment from the Treasury to corporate shareholders, which is fine as far as it goes because we'd rather shareholders have the money than the Treasury. But there are no incentives for growth in such a transfer, so having it be offset is of little consequence to our outlook.
- The only provision that would be worth any compromise on the 20% corporate tax rate would be the limitation on the deductibility of interest expense to 30% of EBITDA (House version) or EBIT (Senate version). Rather than withdrawing a barrier to new business activity, this imposes one, to the extent that the 30% limit is not compensated by the new 20% tax on profits.
- Of all the provisions in play, this is the only one that strikes us as being potentially systemic – because it could make existing highly-leveraged entities uneconomic, especially the ones that are already not yet producing taxable profits, imperiling their ability to service their debt.

Bottom line

The Tax Cuts and Jobs Act passes the Senate with last-minute modifications, preserving the pro-growth centerpiece from the House's version: cutting the corporate tax rate to 20%. From here there are both easy and hard legislative paths, and it is unknown what the GOP will do – but we remain confident that tax cuts will be enacted this year. Markets are now expecting it too, so there may not be much more upside when it happens, maybe even a "sell on the news" reaction, producing a buyable dip. Trump may have opened the door to a last-minute negotiation with Democrats that would preserve the state and local tax deduction. That would be an upside surprise in the short-term. Longer-term, markets are not adequately anticipating the pro-growth power of the supply-side incentive effects of cutting business tax rates.