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TRENDMACRO LIVE!

On the Coming Corporate Tax Hikes

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Funding infrastructure with corporate tax hikes isn't stimulus – it's just a hit to earnings.

We've been wondering since before Joseph R. Biden became president when the markets would start worrying about Joseph R. Biden being president (see "When Is Mr. Market Going to Start Worrying About President Biden?" July 27, 2020). Now might seem like a good time, with Biden reportedly ready to propose later *today a $2.25 trillion 8-year "infrastructure" spending program funded by a 15-year hike in corporate taxes – with another large spending bill coming soon afterward, funded by a large increase in personal taxes*. Yet Mr. Market doesn't seem to care, as of this writing, despite the S&P 500 equity risk premium being very near its narrowest since the Global Financial Crisis.

We'll have a lot to say about this as it plays out and more becomes known. *Here is our hot take.*

- *The particulars aren't important at the moment because they will change*. Among the headlines, the corporate tax rate is to rise from 21% to 28%, and a minimum 21% tax on foreign earnings is to be imposed.
- *For a hasty top-down analysis, overall, the reported price tag of $2.25 trillion implies 8.9% of 2022 S&P 500 net earnings and 5.8% in aggregate over 15 years, assuming a 6% earnings growth rate*. By comparison, the 2018 corporate tax cuts increased S&P 500 net earnings by about 12% in their first year.
- *Mr. Market might be assuming that the proposed corporate tax hikes will get watered down as they move through a divided Congress.* That happened with Trump's proposed tax cuts in 2017.
- *Or Mr. Market might be assuming that nothing will happen at all*. That's very possible, with the half-life on Biden's honeymoon ticking away day by day, given the divided Congress, and given the sense that the pandemic is no longer a transcendent emergency justifying large spending bills, especially ones that have to be paid for, or calls for taxing the rich for their pandemic "windfalls" (see "Video: What you're not hearing about the coming battle for post-pandemic tax hikes" March 29, 2021 and "Video: What you're not hearing about Janet Yellen, tax hikes, and the most important chart in economics" March 15, 2021).
- *Or maybe Mr. Market has long ago discounted corporate tax hikes, or is even a little relieved that today's proposals aren't worse* (prior versions were a lot worse – again, see "When Is Mr. Market Going

Update to strategic view

US MACRO, US STOCKS: Biden will reportedly propose an 8-year $2.25 trillion spending bill funded by raising corporate taxes over 15 years. This implies a cost to the S&P 500 of 8.9% of 2022 earnings in a quick top-down analysis. As of this writing markets are not concerned, perhaps because it has been anticipated, or perhaps because it is far from certain to be enacted in a divided Congress now that the pandemic emergency has cooled down. The S&P 500 equity risk premium is at its narrowest since the Global Financial Crisis, making stocks ripe for a long-overdue correction while this is debated and future plans for raising individual tax rates come into focus.

[Strategy dashboard]

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to Start Worrying About President Biden?”). *Maybe Mr. Market is mostly driven now by what will very likely be a booming economy this year and next almost no matter what* (see “A Boom in 2021… But What Could Make It Bust?” January 4, 2021).
- *All that said, it seems to us that this would be a good time for a long-overdue correction in US equities. When the congressional sausage factory starts to process this, there will likely be scarier versions bruited about, and who’s to say where it could end?*
- We don’t see how Mr. Market could believe that a tax-funded spending bill is a form of “stimulus” that will add more fuel to the coming boom. You can make arguments like that with debt-financed spending if there are people happy to do the necessary lending. But government spending funded by tax hikes is just a direct transfer of capital from the private sector to the public sector. There’s nothing stimulative about it. Quite the contrary.
- *Corporate taxes are simply a corporate expense*, no different than salaries or rent or insurance. When any expense goes up, all else equal net earnings go down. When earnings go down, absent a multiple expansion, equity prices go down.
- *Lower equity prices create negative wealth effects for households*, reducing the consumption of goods and services from firms and reducing their earnings further.
- *Higher corporate taxes reduce earnings growth by reducing capital investment*. Lower net earnings mean lower retained earnings, which means less capital available for capital projects. And fewer capital projects will meet necessary hurdle rates if higher taxes reduce future expected earnings from them. The riskiest will be first on the chopping block, and those are the ones that produce the big leaps in earnings growth. Diminished expected growth rates are a direct hit to multiples.
- *Transfer of retained earnings from firms to government, in the form of higher taxes, transfers decision-power from the private sector to the public sector*. Surely there are plenty of valuable “public goods” that government should invest in, and those investments have to be funded somehow. But it’s not so obvious which of those are among all the possible projects, especially when their price is understood as an opportunity cost versus what firms might have been able to do with the same capital. It’s even less obvious that the right decisions will be made by politicians whose personal agendas distort their judgments about public goods and who are largely ignorant of the opportunity costs.
- *Finally, higher taxes leave firms with less scope to compete on price (that is, to lower costs to consumers) or to remunerate their employees or hire new employees*.

Bottom line

Biden will reportedly propose an 8-year $2.25 trillion spending bill funded by raising corporate taxes over 15 years. This implies a cost to the S&P 500 of 8.9% of 2022 earnings in a quick top-down analysis. As of this writing markets are not concerned, perhaps because it has been anticipated, or perhaps because it is far from certain to be enacted in a

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