Trump tax plan: More fuel for the fire?

President Trump is on course to get his tax plan approved by Christmas, but who (or what) will be the big winners?

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On course for tax cuts

After days of deal-making, Saturday's 51-49 Senate vote means another major hurdle has been cleared for Donald Trump to get his first big legislative "win" of his Presidency. An initial version of The Tax Cuts and Jobs Act of 2017 had already been approved by the House back in November so now it is the job of Congress to merge the two with the aim of signing it into law before Christmas. The key differences between the two bills relate to timing, tax bands and to issues relating to health insurance for the under 65s.

What's in the Act?

The main thrust of the plan is a cut in the rate of corporation tax to 20% from 35%. There is a partial offset in that most of the business deductions and credits that can be used to reduce the effective tax rate on profits have been eliminated.

In terms of households the number of income tax brackets have been reduced from seven to four under the House plan. The lowest tax rate has actually been raised from 10% to 12%, but the majority of low income households should benefit from the doubling of the standard deduction and an increase in tax credits.

Nonetheless, Democrats argue that the overall package is regressive in that that the wealthiest households will benefit the most with the income threshold for paying the highest rate of income tax – 39.6% - more than doubling to $1 million. Repeal of the Alternative Minimum Tax and changes to estate taxes will also disproportionally benefit Americas richest. Republicans counter that the capping of property tax deductions and eliminating state and local tax deductions will be impacting the wealthiest the most.

1.4 The scale of tax cuts over the next ten years

(USD trillions)

What does it mean for the deficit?

The Joint Committee on Taxation and the Congressional Budget Office estimate that the tax cuts approved by the Senate will mean government debt increases by $1.4 trillion over the next 10 years. This is slightly less than the $1.7bn estimated under the House plan, which didn't include changes relating to healthcare provisions. Using dynamic scoring – the argument that the tax cuts are a fiscal stimulus, which will boost the size of the economy so although tax rates will be lower, tax receipts will not fall to the same degree – this drops to a cost of $1 trillion. This has to be viewed in the context of a national debt that was already expected to increase by $10 trillion by 2027, to a level of $30 trillion.

How will the economy respond?

Donald Trump has called this the Tax Cuts and Jobs Act on the basis that the cut to corporation tax (and the incentive for businesses to return the $2.6 trillion of earnings the US Treasury estimates are sat overseas) will promote investment and create jobs in America. Lower taxes on income would additionally help stimulate consumer spending. Meanwhile, the incentives to invest and the stronger economy would boost average wages in America "very conservatively" by $4000 per year. Taking it all together, the Council of Economic Advisors estimate of a 3-5% boost per year to GDP.

Unsurprisingly there is quite a bit of scepticism in Washington regarding some of the bolder claims of the Act's benefits. The Joint Committee on Taxation estimate that the combination of tax cuts will mean US GDP will be 0.8% higher each year. Others, such as the Tax Policy Centre suggest a boost of 0.7% of GDP in 2018 with weaker contributions in subsequent years – 0.4% in 2021 and 0.1% in 2026.

Scepticism seems warranted

While we acknowledge there will be a boost, coming up with a figure is very challenging and we feel more comfortable erring on the side of caution. For starters, while the tax cut for corporates is substantial we have to recognise that the effective rate that most paid was significantly lower than the 35% headline rate due to deductions and credits they could use to legitimately cut their tax bill. The effective rate has typically been estimated at 26-28% for most firms. The institute on Taxation and Economic Policy estimated[1] that of 258 large businesses it looked at the average effective tax rate was just 21.2% over the past 8 years. Moreover, the repatriation of overseas earnings will only occur at the prevailing tax rate - there won't be a special incentive. Therefore the net cashflow boost may be smaller than some commentators are factoring in.

Then we have to recognise that firms can use the money for alternative uses other than investment. These include share buybacks and special dividends, which is what occurred after the Homeland investment Act over a decade ago. Alternatively firms could use the cash to pay for investment that was going to go ahead anyway, but would have been financed by debt. As such there is no guarantee that investment will surge.

In terms of the boost from income tax cuts, the Tax policy Centre estimates that the top 1% of taxpayers would get 21% of the benefit in 2018 and 50% by 2027. While people on lower incomes would also on average see a positive impact on their finances this all suggest that the boost to consumer spending may not be great. Economic theory suggests lower income households are more likely to spend any increases in incomes and higher income households are more likely to invest the gains. So, as the plan is structured, it suggests property and equity prices may get more of the boost than consumer spending.

We also have to be cognisant of the likely reaction from the Federal Reserve. So far policy makers have reacted cautiously, but if they do feel as though the plan generates meaningful stimulus they will be more inclined to raise interest rates given the economy is already growing at 3% . We are already forecasting a December hike and three rate hikes next year.

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[1]
https://itep.org/a-comparative-analysis-tax-rates-paid-by-companies-for-and-against-the-border-adjustment-tax/

More upside risk for bond yields & equities?

So while the plan is supportive for growth prospects, we are more cautious than politicians in terms of the likely upside it provides. Instead, we see more of a near-term boost for equities (through share buybacks, dividends and wealthier individuals putting more money in) and for Treasury yields as the national debt rises more quickly and markets see greater scope for Federal Reserve interest rate increases. Moreover, there are other structural issues, such as Trump's immigration policies that could also provide an offset for growth meaning his loftier ambitions for activity are missed.

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