Trump’s tax battle still has a long way to go

President Trump delivered more detail on US tax plans, but as with healthcare, nothing is guaranteed to pass

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Some fresh numbers - but low on in-depth detail

President Trump and leading members of the Republican party have unveiled their long-awaited plans to overhaul the US tax system. However, the details are somewhat light. Taxes will be cut for both individuals and corporates, but we don't know where offsetting savings will come from to prevent a huge increase in the deficit.

> *Making proposals is one thing, getting Congress to agree is another*

For individuals, the proposals are that the seven income tax brackets are reduced to three – 12%, 25% and 35%. However, it allows Congress to introduce a fourth, top tax rate, for high earners should it choose – the current top tax rate is 39.6%. The estate tax and alternative minimum tax would also be eliminated. At this stage, it looks as though higher income households and the wealthy have most to gain from these proposals.

For businesses, corporation tax would be cut from 35% to 20% together with the ability to immediately write-off capital spending for five years, possibly more - taxes for unincorporated businesses will be cut to 25%. Significantly, there will also be a one-off tax cut on repatriated foreign earnings. These have been stockpiled (due to high US tax rates deterring bringing them back to the US) with various estimates suggesting around $2.6-trillion of earnings currently sit offshore. If we see a sizeable proportion brought to the US it could boost investment spending (and potentially productivity) and/or incomes if special dividends are paid out. The dollar impact may be relatively limited given surveys suggest much of the holdings are already in dollars or dollar-denominated assets held overseas.

Making proposals is one thing - getting Congress agreement is another

However, we have to remember that making proposals is one thing, getting Congress to agree is another. These plans will be debated for many weeks and could get significantly amended. We already know that Washington is deeply divided and that significant compromise will likely be needed.

The nonpartisan Committee for a Responsible Federal Budget has suggested the cost of this plan would amount to around $2.2 trillion. To mitigate the impact on the budget there have been indications there will be some offsetting revenue-raising initiatives, but there is a lack of clarity about who will actually end up paying and how much they will pay. It seems as though the most likely source will be through ending state and local tax deductions and perhaps reducing deductions for interest payments. As more details gradually emerge we are likely to see opposition increase. Consequently, getting enough votes to approve these reforms could be tricky.

As a backup plan, Administration officials suggest that they are prepared to use "dynamic scoring"[1] in order to help facilitate a revenue-neutral budget projection for the next ten years. This would mean the tax reforms could pass with a simple majority in the Senate rather than the 60 seat threshold typically required. This would obviously make legislation easier to pass, but it still may take longer than the president would like.

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[1] This process, which is not universally supported, assumes that lower taxes boost growth, which prompts stronger tax revenue growth in the future

Bottom line

Market hopes surrounding President Trump's proposals for a massive fiscal stimulus (tax cuts and infrastructure investment) have gradually faded since his inauguration. However, these tax policy development could help to nudge expectations back in a more positive direction. While we suspect there will be some watering down, any tax cuts that put more money in the pockets of households and businesses are likely to be seen as a boost for the economy.

There are questions over how many people will meaningfully benefit and it does risks a wider fiscal deficit and higher government debt levels. Nonetheless, with Fed Chair Janet Yellen earlier in the week setting out the case for tighter monetary policy, successful implementation of tax changes will likely push financial markets into pricing in a greater chance of rate hikes.

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