Economics

Macro news

US TAX REFORM LEGISLATION OBSERVATIONS

*The tax reform legislation will have larger positive impacts on economic performance—including business investment, employment, and wages—than the consensus and the Federal Reserve currently forecast.

*Is the legislation good or bad? A glass-half-full assessment is that the legislation is a step forward from the current arcane tax system, particularly the sweeping changes in corporate taxes and the simplification of individual taxes; a glass-half-empty assessment focuses on the legislation's weaknesses compared to earlier "blueprints" for tax reform, its sunsetting of key provisions, higher deficit projections, and the initial incidence of legislation—the initial distribution by income bracket—without consideration of the economic responses to the policy changes.

*The incidence of the legislation—the distribution of tax cuts and increases—must start with the initial incidence and also consider the impacts of the economic responses to the policy changes, including impacts on employment and wages.

*Key wildcards—what businesses do with freed up assets that have been "confined" overseas, the tax benefits for the 5 million+ pass-through businesses, and the implications for wages—are potential sources of upside surprises to the economy.

* *The significant economic momentum of 2017 and historically elevated business and consumer confidence form a critically important basis for assessing how the tax legislation will affect the economic and financial landscape.* This supports the view of upside surprises. However, worries about "overheating" are overstated: aggregate demand will pick up, but increased investment and efficiencies will lift productive capacity. Look for wages to accelerate and inflation to rise moderately, but not to worrisome levels.

The Positives

Aligning U.S. corporate tax policy with most other industrialized nations by reducing the marginal tax rate on income to 21% from 35%, a touch below the median marginal rate of other OECD nations, and moving toward a "territorial" tax treatment of international income, are cornerstones of the tax reform. This will greatly diminish the "erosion" of U.S.-headquartered companies—but not completely eliminate "inversions" by U.S. companies that may still seek lower taxes in the lowest tax nations—and will provide financial incentives that will encourage some U.S. companies to rely more on domestic production rather than overseas production. Various media reports of "retaliation" by foreign nations should be relegated into the "silly and ignore" file. Paring back the deductibility of corporate interest costs is a positive step—the legislation should have gone further and completely phased out the deductibility of corporate interest costs in order to move the tax treatment of debt and equity financing to an even playing field.

The simplification of individual income taxes through folding the personal exemptions into the near doubling of the standard deduction—thereby reducing the number of taxpayers who itemize—and broadening the tax base while trimming back or eliminating various deductions, exemptions, credits, etc., is a step forward. Like other government subsidies, taking away such deductions is painful, even though there is little economic rationale for them in the first place. Remember, the goal of taxes is to generate tax receipts to finance government spending without distorting economic performance. In this light, capping the deductibility of state and local taxes makes

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sense—and, in fact, repealing this deduction has been under consideration for decades. Ditto the provision that reduces the cap on the deductibility of mortgage interest and repealing the deductibility of mortgage interest on second homes are steps in the right direction. The U.S. is one of the few industrialized nations that allow mortgage deductibility—many nations that do not allow the mortgage deduction enjoy higher homeownership. One common theme in U.S. housing finance is that the government's subsidies of housing work primarily through encouraging reliance on debt (and providing the largest subsidies to higher income taxpayers). Despite the howls of the housing industry, the policy changes in this legislation are a plus.

The Negatives

From the glass-half-empty view, the political process took its toll on the earlier vision of tax reform. The final legislation involves some key reform provisions but also includes many other policy changes that increase government deficits, do not add to productive capacity and sustainable improvement in economic performance and add unnecessary complications.
While the legislation maintained some of the original intent of earlier "blueprints" for reform, some of the key provisions either didn't make it through the politically-charged legislative processes or they were diluted. Most notably, the demise of the border adjustment tax (BAT) in response to heavy industry lobbying forced a policy construction rethink that resulted in a less-than-perfect move toward a territorial tax treatment of corporate income earned overseas and led to a political agreement that allowed the tax legislation to add $1.5 trillion to projected deficits. The BAT would have been a cleaner approach that would have encouraged production back to the U.S. and would have been a major revenue gainer. A lot of its financial burdens would have been born by overseas companies. Without that revenue source, the tax legislation included a grab-bag of base broadening provisions, some of which have been the sources of the largest public opposition.

In this ninth year of economic expansion with building momentum, an increase in deficit spending is inappropriate. Keep in mind, the highly visible $1.5 trillion increase in deficits is an estimate over a 10-year budget period, based on certain assumptions. Actual budget outcomes may differ, depending on future economic conditions. The most important lasting issue is whether stronger growth will be sustained.

In terms of simplicity—a goal of tax reform—the sunsetting of a number of policy changes in order to fit within budget constraints adds uncertainty to the outlook for future tax policy. This is undesirable: predictable policy is always better. Our hunch is that some of provisions scheduled to sunset—like the full expensing of new investment (scheduled to phase out after 2022)—will be extended, but the sunset provision nevertheless adds unnecessary uncertainty. Other provisions that sunset are so far off they will not affect economic decisions in 2018–2019.

Economic Responses: The Wildcards

Our summary assessment is that the legislation will add to current economic momentum and lift growth. Our forecast of 2.9% real GDP growth in 2018 and 2.7% in 2019 is well above consensus estimates (see "U.S. 2018 and 2019 growth projections revised up on tax reform[eqr.berenberg.de]", December 4, 2017). It is also above the Fed's forecast of 2.5% in 2018 (Q4/Q4) and 2.1% in 2019. Moreover, we project corporate profits to rise faster than GDP, particularly after-tax profits. The reduced taxes on capital, higher after-tax rates of return on investment, and efficiencies generated by the reforms of the corporate tax system will provide a moderate boost to sustainable potential growth. In addition, fiscal stimulus will add temporarily to growth in 2018–2019.

Our above-consensus forecast reflects the anticipated positive economic responses to the key reform provisions in the tax legislation plus the mounting benefits of the easing of burdensome regulations in an array of industries that are leading to more efficient production processes and heightened confidence. Many macroeconomic models (like the Fed's FRB-US) are underestimating how changes in the regulatory and tax policies are influencing economic outcomes because they estimate the impact of fiscal policy changes based primarily on the magnitude of the change in budget deficits while understating the positive efficiencies gained from reforms, and they do not fully capture how changes in the regulatory environment influence economic activity.

We emphasize the strong economic momentum and high levels of confidence will enhance the responses to the tax legislation (see Table 1). Momentum has been building in consumer spending and business investment, and levels of confidence are extraordinarily high. Consumer confidence has been lifted by sustained employment gains and low unemployment, and rising household net worth, reflecting appreciation in the stock market and home values. Business confidence has been buoyed by the thrust toward deregulation—the reduction of burdensome regulations in a number of industries. This is *reflected clearly in business surveys.*

Three wildcards add to the potential economic impacts of the tax legislation:

**The release of accumulated corporate assets that have been held overseas;*
**How the corporate tax cuts will affect wages; and*
**The impact of the lower taxes on the 5 million+ pass-through companies.*

Some portion of the estimated $2.5 trillion in cash and noncash assets U.S. businesses have accumulated overseas will remain overseas to fund ongoing operations, but freeing up these assets will allow businesses to put the additional resources to work and flow into the economy. The lower taxes on new and existing capital and the very low interest rates will encourage business expansion and investment. Employment and wages should also lift. In addition, businesses will increase dividend distributions and stock buybacks. History shows that businesses respond to changes in tax policy. In 2004, a reduction in taxes on dividends led to an immediate one-time $300 billion increase in corporate dividend distributions, and the widely anticipated tax increases in January 2013 led to nearly $400 billion in dividend distributions (see Chart 2). Stock buybacks have remained at high levels in recent years. The flexibility provided by the tax legislation may generate a pickup (see Chart 3).

If dividend and stock distributions rise by $500 billion—a relative small portion of the repatriated cash and noncash assets—this would add 3% to personal income. *Elevated consumer confidence suggests some portion of this would be spent, which could add significantly to consumption and GDP.*

Importantly, the move toward territorial tax treatment of overseas income reduces a tax penalty on U.S. multinational corporations and the flexibility it provides is expected to increase production and distribution efficiencies.

The flow-through of corporate activities and profits to individuals has always been a controversial topic—keep in mind that individuals own and work at corporations. The wage compensation share of national income has drifted down and, in recent years, wage gains have remained modest despite the rate of unemployment falling below its natural rate. *Amid high and rising corporate profits and cash flows, a sizeable (but difficult to measure) portion of the rise in after-tax profits will go toward higher wage compensation.* This may involve one-time bonuses or increases in base wages. Several large firms have already announced increases in worker compensation; we expect more to follow. This will increase disposable incomes and purchasing power.

There are over 5 million pass-through businesses—partnerships, proprietorships, and Subchapter S corporations--and the latest National Federal of Independent Businesses (NFIB) survey provides a very buoyant expectation of small business responses to the tax reform. Overall, the NFIB survey recorded its second highest confidence survey of all time—the highest was in Spring 1983—and two-thirds of respondents said they planned to increase capital spending in response to tax reform, and nearly one-half said they would increase employment. Let's see if these survey results are realized.
As we have noted in prior research, of the roughly 17 million in U.S. motor vehicle sales annually, nearly one-half are purchased by corporations, including many pass-throughs (see "U.S. vehicle sales driven by business purchases[eqr.berenberg.de]", February 16, 2017). Such purchases are recording as business investment rather than consumption.

We emphasize that pass-through businesses play a large and critical role in the economy—

as producers, employers, and essential components of supply chains of larger corporations. They are major beneficiaries of the tax legislation, and their responses bear close attention.

Observation on the Distribution of Benefits and Costs

The incidence of the tax legislation—the distribution of benefits and costs by income level—is much more complex that the initial distributional estimates that get so much attention from the media. The distributional effects must take into account the responses and economic impacts of the tax policy changes, including the impacts on employment, wages, and productivity. Those impacts are more difficult to estimate but important nevertheless.

Table 1: Key US business and consumer sentiment indexes

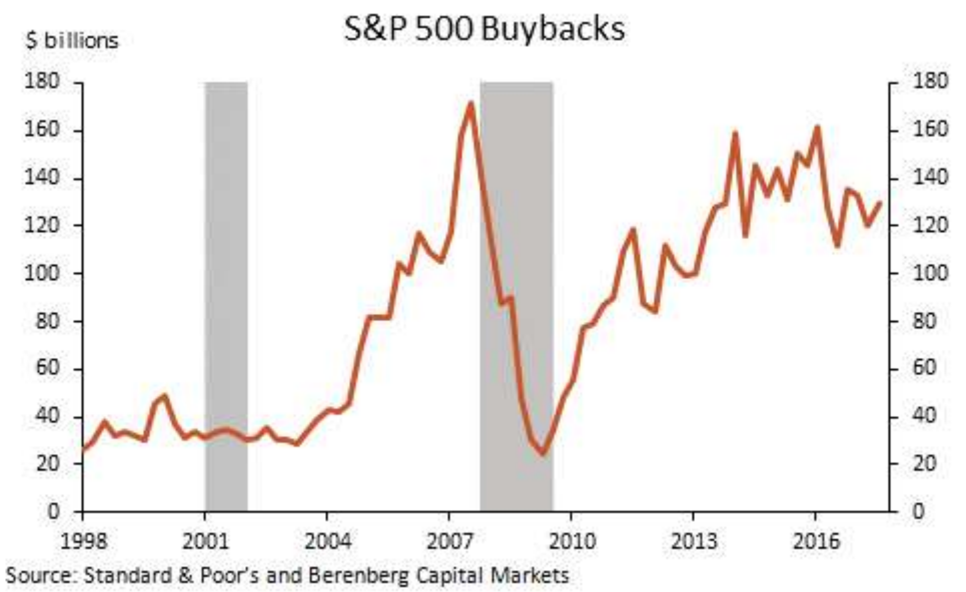
(Index)	Nov-17	Nov-17 Percentile*	Change from Jan-Oct-17 avg.	Change from Nov-16
Texas mfg	54.5	76	0.5	4.1
Empire State mfg+	55.3	81	0.8	8.0
Philly Fed mfg+	57.4	94	0.2	3.1
Richmond Fed mfg	30.0	100	16.2	24.0
Kansas City Fed mfg	58.1	93	1.3	10.0
ISM mfg	58.2	79	0.9	4.7
ISM non-mfg	57.4	80	0.4	1.2
NFIB Small Business Optimisim	107.5	100	2.9	9.1
Home Builders housing market index+	74.0	98	7.1	11.0
U Mich consumer+	96.8	84	0.1	3.0
Conference Board consumer	129.5	93	10.1	20.1

*Note: *Percentile of the November value of indicators relative to history of each respective series. +As of December 2017.*
Source: Institute for Supply Management, Federal Reserve Banks of Philadelphia, New York, Kansas City, Richmond and Dallas, National Federation of Independent Business, National Association of Home Builders, University of Michigan, The Conference Board, and Berenberg Capital Markets

Chart 2: Personal Dividend Income

Source: Monthly data. Source: Bureau of Economic Analysis and Haver Analytics

Chart 3: S&P 500 Buybacks



Source: Quarterly data. Source: Standard & Poor's and Berenberg Capital Markets

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