Economics

Macro news

# STATUS OF US TAX AND FISCAL REFORM PROPOSALS

*Last week I met with numerous Congressional leaders--several Members of Congress plus senior staffers who are integral to developing the tax and fiscal reform proposals and navigating them through the legislative process.* In general, I am left with the impression that tax and fiscal reforms will be enacted in 2017, but similar to all tax reform legislation, the process will be contentious and bumpy and there will be modifications to the proposals. Between now and when the proposal is signed into law, there will be reports of its failures and speculation that it will not pass. That's typical of policy reform. While modifications are likely to be required to achieve enactment, it's way too early in the process for any to be proposed. Based on our assessment that enactment of fiscal reforms are highly probable, even with modifications, we maintain our above-consensus economic growth forecasts. See "US: stronger growth, higher rates, more uncertainty", November 30, 2016, and "Critical current issues facing the US in 2017", January 4, 2016.

1) The key policymakers acknowledge that 2017 offers the best chance to enact tax and economic reform, and delay may postpone indefinitely the prospects for reform. Congressional leaders are still aiming to enact reforms in August 2017. Based on the history of legislative processes and political realities that means the House Ways and Means Committee--the tax-writing Committee in Congress--must pass a bill by May. The Senate needs at least several months to deliberate and modify such comprehensive legislation. All parties involved in both the House and Senate acknowledge that while the legislative process is moving along, there are certain to be bumps along the road to passage. There will be numerous times in coming months when the fiscal reform legislation looks like it is going off the rails, followed by indications that the process is back on track.

2) Congressional leaders who are navigating the reform proposals through the legislative process have looped in The White House and the Treasury. Thus, while the Ways and Means Committee works on the various details of the legislation with the Senate Finance Committee (SFC), the House and Senate Budget Committees (HBC and SBC) and other involved parties, the Administration is fully informed and debating the issues. The White House and Treasury agree that at this time it would be inappropriate to propose an alternative policy.

3) *The word I get from several sources is* ***"there may be room on the budget."*** This clearly suggests that contrary to common perception, deficit neutrality is not a binding constraint, at least somehow measured. A top Congressional policymaker put it this way: *the overall package will be a tax cut in static terms, but will reduce the budget deficit based on dynamic budget scorekeeping.* This implies that the fiscal package will widen the deficit in a budget scorekeeping procedure that does not reflect any macroeconomic feedbacks from the proposed legislation, but will reduce the deficit when scorekeeping incorporates the macroeconomic impacts of the pending legislation.

   A few notes: Congress's Joint Committee on Taxation (JCT) is charged with conducting the budget scorekeeping on pending tax legislation; when legislation involves spending as well as tax changes, the Congressional Budget Office (CBO) conducts the scorekeeping. In static scorekeeping, the

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Mickey D. Levy
Chief Economist US, Americas and Asia
+1 646 445 4842
mickey.levy@berenberg-us.com

budget and underlying economic forecasts reflect the microeconomic effects of proposed legislation, while in dynamic scorekeeping, both microeconomic and macroeconomic effects are captured. It is widely expected that the Administration's estimated economic responses to the reform legislation will be significantly larger than the economic responses projected by the CBO. That will translate into larger estimated deficit projections by the CBO than the Administration. The CBO will submit its budget scorekeeping to the HBC and SBC which will then negotiate the pending legislation in Congress and with the Administration. Subsequent negotiations will be formed and constrained by the estimated budget implications of specific proposals and how they may be modified.

Most likely, proponents of the legislation will use a procedure called "reconciliation" that enables budget-related pending legislation to be approved by simple plurality (rather than a 60% majority) and disallow filibustering (this process was established by the Budget Control Act of 1974 and like most other budgeting provisions, its use has been broadened since then). Also, Congress will have to deal with the Byrd Rule (adopted in 1985), which stipulates that the reconciliation process can be used only if the fiscal legislation is deficit neutral after the projection period (10 years) ends; if the dynamic scorekeeping projections of the fiscal legislation result in higher deficits following the tenth year after enactment, then the fiscal legislation would be modified to "sunset"--expire--at 10 years. This is how the 2001 tax cuts were enacted--they expired in 2011 (remember the "fiscal cliff"?). If all of this sounds crazy, it simply reflects the arcane nature of the Congressional budgetary process. (This description short-circuited some of the detail).

4) *The fiscal reform will not be confined to corporate tax reform. Personal income taxes will be changed, most likely with lower taxes on middle and lower-middle income households and lower rates but base broadening of higher income tax filers that will result in no net reductions in their effective rates.* Note that with all of the attention drawn to corporate tax reform, little attention has been paid to the individual income tax changes--particularly those that will provide tax relief to middle and lower-middle income households. *Note that the corporate tax cuts (and expensing of new investment) and individual tax changes will benefit all Subchapter S and pass-throughs* (this may involve lower rates for higher income households but base-broadening in a way that benefits S Corporations and pass-throughs but not high income individuals). The tax benefits to smaller and medium sized businesses--the sources of economic expansion and job creation--is a primary objective of the tax reformers.

5) *Presently, the Congressional managers of the tax and fiscal reform are promoting the proposal as a complete package and do not have any immediate thoughts of modifying specific provisions of the proposal, such as the highly visible border adjustment (BA) or phasing out business deductibility of interest expenses.* They currently believe that modifying the provisions *now* would upset the balance of the total package (in particular, the border adjustment is a major source of tax receipt to the Treasury needed to offset or partially offset the other provisions of the legislation) and may subject the proposal to legal issues. This latter concern applies to the border adjustment: the Congressional Republican leadership's blueprint for tax reform ("A Better Way – Our Vision For A Confident America – Tax," GOP, June 24, 2016) argues that shifting the corporate tax system to a cash flow basis from an income basis makes the border adjustment compatible with the World Trade Organization's (WTO's) by-laws.

   In reality, modifications seem likely for enactment. There are political and economic winners and losers within Washington and industry. Large US retailers are lobbying aggressively against the BA. Whether estimates of the impacts of this legislation are right or wrong (or right or wrong but overstated), loud voices are heard. (Note: the incidence of the BA depends on what happens to the US dollar and US product demand…to the extent the dollar rises, US importers pay less for the imported goods so foreign suppliers and their workers bear the burden of the costs; *to the extent US domestic demand strengthens with faster growth of consumer spending and business investment, then US companies will enjoy faster top-line revenue growth and will gain some pricing power* ***that will enable them to maintain their margins…****many analysts and importing companies miss this latter point.*) But as noted above, it's too early in the process to expect alternatives to the BA or the overall fiscal reforms to be proposed.

6) A big uncertainty is how reform of the Affordable Care Act (ACA) fits into all this. While many Congressional leaders would like to consider and agree upon an appropriate reform of the ACA prior to tackling tax reform, resolving ACA is difficult, and the sequencing of the ACA reform and fiscal legislation is a big uncertainty in Washington. In the meantime, the tax and fiscal committees in Congress keep working and moving ahead on the tax proposal.

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# Contacts: BCM

www.berenberg.com
e-mail US: firstname.lastname@berenberg-us.com

JOH. BERENBERG, GOSSLER & CO. KG

Internet www.berenberg.com E-mail: firstname.lastname@berenberg.com

## EQUITY RESEARCH

AEROSPACE & DEFENCE
Andrew Gollan +44 20 3207 7891
Charlotte Keyworth +44 20 3753 3013
Ross Law +44 20 3465 2692

AUTOMOTIVES
Adam Hull +44 20 3465 2749
Paul Kratz +44 20 3465 2678

BANKS
Adam Barrass +44 20 3207 7923
James Chappell +44 20 3207 7844
Andrew Lowe +44 20 3465 2743
Andreas Markou (EM) +44 20 3753 3022
Eoin Mullany +44 20 3207 7854
Peter Richardson +44 20 3465 2681
Jonathan Sharpe +44 20 3753 3031

BEVERAGES
Javier Gonzalez Lastra +44 20 3465 2719
Batuhan Karabekir (EM) +44 20 3465 2631
Adam Mizrahi +44 20 3465 2653

BUSINESS SERVICES, LEISURE & TRANSPORT
Roberta Ciaccia +44 20 3207 7805
Najet El Kassir +44 20 3207 7836
Stuart Gordon +44 20 3207 7858
Josh Puddle +44 20 3207 7881
Julia Winarso +44 20 3465 2627

CAPITAL GOODS
Sebastian Kuenne +44 20 3207 7856
Philippe Lorrain +44 20 3207 7823
Rizk Maidi +44 20 3207 7806
Horace Tam +44 20 3465 2726
Simon Toennessen +44 20 3207 7819

CHEMICALS
Sebastian Bray +44 20 3753 3011
Andrew Heap +44 20 3207 7918

CONSTRUCTION
Lush Mahendrarajah +44 20 3207 7896
Robert Muir +44 20 3207 7860
Olivia Peters +44 20 3465 2646

ENERGY
Yuriy Kukhtanych (EM) +44 20 3465 2675

FOOD MANUFACTURING AND H&PC
Rosie Edwards +44 20 3207 7880
Yordana Mavrodieva +44 20 3207 7817
Fintan Ryan +44 20 3465 2748
James Targett +44 20 3207 7873

FOOD RETAIL
Batuhan Karabekir (EM) +44 20 3465 2631

GENERAL MID CAP - EU
Gunnar Cohrs +44 20 3207 7894
Martin Comtesse +44 20 3207 7878
Flavien Hias +44 20 3465 2693
Aymeric Lang +44 20 3753 3037
Anna Patrice +44 20 3207 7863
Benjamin Pfannes-Varrow +44 20 3465 2620
Simona Sarli +44 20 3207 7834
Julia Scheufler +44 20 3753 3016

GENERAL MID CAP - UK
Robert Chantry +44 20 3207 7861
Sam England +44 20 3465 2687
Ned Hammond +44 20 3753 3017
Benjamin May +44 20 3465 2667
Owen Shirley +44 20 3465 2731

GENERAL RETAIL
Conrad Bartos +44 20 3753 3053
Michelle Wilson +44 20 3465 2663

HEALTHCARE
Scott Bardo +44 20 3207 7869
Jakob Berry +44 20 3465 2724
Alistair Campbell +44 20 3207 7876
Graham Doyle +44 20 3465 2634
Klara Fernandes +44 20 3465 2718
Tom Jones +44 20 3207 7877
Joseph Lockey +44 20 3465 2730
Louise Pearson +44 20 3465 2747
Laura Sutcliffe +44 20 3465 2669

INSURANCE
Trevor Moss +44 20 3207 7893
Emanuele Musio +44 20 3207 7916
Iain Pearce +44 20 3465 2665
Sami Taipalus +44 20 3207 7866

LUXURY GOODS
Zuzanna Pusz +44 20 3207 7812

MEDIA
Robert Berg +44 20 3465 2680
Laura Janssens +44 20 3465 2639
Alastair Reid +44 20 3207 7841
Sarah Simon +44 20 3207 7830

METALS & MINING
Alessandro Abate +44 20 3753 3029
Fawzi Hanano +44 20 3207 7910
Yuriy Vlasov +44 20 3465 2674

REAL ESTATE
Kai Klose +44 20 3207 7888
Tina Munda +44 20 3465 2716

TECHNOLOGY
Jean Beaubois +44 20 3207 7835
Georgios Kertsos +44 20 3465 2715
Gal Munda +44 20 3465 2746
Tammy Qiu +44 20 3465 2673

TELECOMMUNICATIONS
Ondrej Cabejsek (EM) +44 20 3753 3071
Usman Ghazi +44 20 3207 7824
Siyi He +44 20 3465 2697
Laura Janssens +44 20 3465 2639
Paul Marsch +44 20 3207 7857
Michael Summerville +44 20 3207 7914

THEMATIC RESEARCH
Nick Anderson +44 20 3207 7838
Asad Farid +44 20 3207 7932

TOBACCO
Jonathan Leinster +44 20 3465 2645

UTILITIES
Robin Abrams +44 20 3465 2635
Andrew Fisher +44 20 3207 7937
Lawson Steele +44 20 3207 7887

## ECONOMICS

Florian Hense +44 20 3207 7859
Carsten Hesse (EM) +44 20 3753 3001
Kallum Pickering +44 20 3465 2672
Holger Schmieding +44 20 3207 7889

## EQUITY SALES

SPECIALIST SALES
AEROSPACE & DEFENCE
Bruna Zugliani +44 20 3207 7818
AUTOMOTIVE & THEMATICS
Chris Armstrong +44 20 3207 7809
BANKS & DIVERSIFIED FINANCIALS
Iro Papadopoulou +44 20 3207 7924
BUSINESS SERVICES, LEISURE & TRANSPORT
Rebecca Langley +44 20 3207 7930
CONSTRUCTION,CHEMICALS, METALS & MINING
James Williamson +44 20 3207 7842
CONSUMER STAPLES
Rupert Trotter +44 20 3207 7815
CONSUMER DISCRETIONARY
Victoria Maigrot +44 20 3753 3010
HEALTHCARE
Frazer Hall +44 20 3207 7875
MEDIA & TELECOMMUNICATIONS
Julia Thannheiser +44 20 3465 2676
SPECIAL SITUATIONS
Jeremy Grant +44 20 3207 7890

SALES
BENELUX
Miel Bakker +44 20 3207 7808
Martin de Laet +44 20 3207 7804
Alexander Wace +44 20 3465 2670

GERMANY
Michael Brauburger +49 69 91 30 90 741
Nina Buechs +49 69 91 30 90 735
André Grosskurth +49 69 91 30 90 734

GERMANY (cont'd)
Florian Peter +49 69 91 30 90 740
Joerg Wenzel +49 69 91 30 90 743

UK
Alexandra Clément +44 20 3753 3018
Fabian De Smet +44 20 3207 7810
Karl Hancock +44 20 3207 7803
Sean Heath +44 20 3465 2742
David Hogg +44 20 3465 2628
Peter Kaineder +44 20 3753 3062
James Matthews +44 20 3207 7807
David Mortlock +44 20 3207 7850
Eleni Papoula +44 20 3465 2741
Bhavin Patel +44 20 3207 7926
Richard Payman +44 20 3207 7825
Joanna Sanders +44 20 3207 7925
Mark Sheridan +44 20 3207 7802
George Smibert +44 20 3207 7911
Anita Surana +44 20 3207 7855
Paul Walker +44 20 3465 2632

FRANCE
Thibault Bourgeat +33 1 5844 9505
Alexandre Chevassus +33 1 5844 9512
Dalila Farigoule +33 1 5844 9510
Clémence Peyraud +33 1 5844 9521
Benjamin Voisin +33 1 5844 9507

SCANDINAVIA
Frederik Angel +44 20 3753 3055
Marco Weiss +49 40 350 60 719

SWITZERLAND, AUSTRIA & ITALY
Andrea Ferrari +41 44 283 2020
Carsten Kinder +41 44 283 2024
Gianni Lavigna +41 44 283 2038
Jamie Nettleton +41 44 283 2026
Benjamin Stillfried +41 44 283 2033

CRM
Louise Hughes +44 20 3753 3066
Jessica Jarmyn +44 20 3465 2696
Edwina Lucas +44 20 3207 7908
Greg Swallow +44 20 3207 7833

CORPORATE ACCESS
Lindsay Arnold +44 20 3207 7821
Jennie Jiricny +44 20 3207 7886
Stella Siggins +44 20 3465 2630

EVENTS
Laura Hawes +44 20 3753 3008
Suzy Khan +44 20 3207 7915
Charlotte Kilby +44 20 3207 7832
Natalie Meech +44 20 3207 7831
Ellen Parker +44 20 3465 2684
Sarah Weyman +44 20 3207 7801

## SALES TRADING

HAMBURG
Tim Storm +49 40 350 60 415

PARIS
Vincent Klein +33 1 58 44 95 09
Antonio Scuotto +33 1 58 44 95 03

LONDON
Mike Berry +44 20 3465 2755
Stewart Cook +44 20 3465 2752
Mark Edwards +44 20 3753 3004
Tristan Hedley +44 20 3753 3006
Peter King +44 20 3753 3139
Christoph Kleinasser +44 20 3753 3063
Chris McKeand +44 20 3207 7938
Simon Messman +44 20 3465 2754
AJ Pulleyn +44 20 3465 2756
Michael Schumacher +44 20 3753 3006
Paul Somers +44 20 3465 2753

## EQUITY TRADING

HAMBURG
David Hohn +49 40 350 60 761
Gregor Labahn +49 40 350 60 571
Lennart Pleus +49 40 350 60 596
Marvin Schweden +49 40 350 60 576
Linus Weidner +49 40 350 60 798
Philipp Wiechmann +49 40 350 60 346
Christoffer Winter +49 40 350 60 559

LONDON
Edward Burlison-Rush +44 20 3753 3055
Richard Kenny +44 20 3753 3083

## ELECTRONIC TRADING

Daniel Eichhorn +49 40 350 60 391
Matthias Führer +49 40 350 60 597

BERENBERG CAPITAL MARKETS LLC Member FINRA & SIPC

E-mail: firstname.lastname@berenberg-us.com

## EQUITY SALES

SALES
Kelleigh Faldi +1 617 292 8288
Isabella Fantini +1 646 445 4861
Shawna Giust +1 646 445 7216
Rich Harb +1 617 292 8228
Zubin Hubner +1 646 445 5572
Jessica London +1 646 445 7218
Ryan McDonnell +1 646 445 7214

SALES (cont'd)
Emily Mouret +1 415 802 2525
Peter Nichols +1 646 445 7204
Kieran O'Sullivan +1 617 292 8292

CRM
Laura Cooper +1 646 445 7201

CORPORATE ACCESS
Olivia Lee +1 646 445 7212
Tiffany Smith +1 646 445 4874

EVENTS
Patricia Ehrhart +1 646 445 4863

## SALES TRADING

Christopher Kanian +1 646 445 5576
Lars Schwartau +1 646 445 5571
Brett Smith +1 646 445 4873
Bob Spillane +1 646 445 5574

## ECONOMICS

Mickey Levy +1 646 445 4842
Roiana Reid +1 646 445 4865