What to Expect from the Tax Cuts and Jobs Act

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The Tax Cuts and Jobs Act, approved by Congress in the last days of 2017, substantially reforms the tax code and, in the aggregate, reduces taxes for U.S. corporations and households by $1.5 trillion over the next ten years, the equivalent of slightly less than 1% of GDP a year. It has generated a lively debate on how these cuts may benefit the U.S. economy. How much of a boost to GDP can we expect in the next couple of years and the medium-term? Will it lead to higher inflation and a faster-than-expected monetary tightening by the Federal Reserve? How much will the U.S. debt increase? What does it all imply for shareholders and more broadly for financial markets? Most of the answers to these questions depend on what corporations, which are seeing the first major income tax cut in 20 years, will do with the higher after-tax profits.

What Is in the TCJA?

The Tax Cuts and Jobs Act is a complex piece of legislation that reforms numerous aspects of the tax code. It includes permanent tax cuts for businesses and mostly temporary cuts for households, as summarized in Table 1.

The stated goal of the new legislation is to boost economic growth and create jobs. A stimulative tax bill is unusual at this point of the economic cycle. We are eight years into one of the longest economic recoveries in the U.S. and there is limited slack in the economy. Typically, tax cuts are implemented when the output gap is negative, as was the case with the 1981 Reagan administration tax cuts, or in the wake of the Great Recession, when President Obama extended the Bush administration tax cuts. The 1986 tax reform to boost the economy supply side, also under President Reagan, did occur at a time the economy was not in recession, but was revenue-neutral, as a broadening of the tax base compensated for cuts in rates.

The current recovery is unusual too though. The U.S. economy is still dealing with sluggish productivity growth and investment shortage. Wage growth and inflation are also historically low at this point of the cycle. Moreover, while unemployment has declined back to pre-crisis levels, this hides the fact that many of the workers who lost jobs in the past decade have withdrawn from the labor force.

In an ideal scenario, the new tax legislation would expand both supply and demand sides of the economy, hence leading to stronger economic growth and more jobs now and in the future, without generating inflation pressure. In such an outcome, it would likely pay for itself without worsening the already high U.S. public deficit and debt.

Table 1:

Corporations	Households (all expire by 2025)
• Corporate income tax rate cut from 35% to 21%; elimination of AMT.	• Reduction of personal income tax rates (same number of brackets).
• Business interest deduction at 30% of EBITDA through 2021, then 30% of EBIT.	• Increase in AMT exemption threshold.
• New deduction of 20% for qualified business income of pass-through entities (expires in 2025).	• Increase in standard deductions.
• Capital expensing: 100% for five years.	• Doubling of child tax credit ($2,000 for each qualifying child under age of 17).
• Shift of foreign income taxation to territorial system and a one-off tax on past unremitted overseas earnings.	• $10,000 cap on property and state and local income tax deduction.
	• Caps on new mortgage interest deductions.

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A Positive but Declining Impact on GDP and Higher Debt

Most available estimates agree that the new tax legislation will boost the U.S. economy in the next couple of years, with a positive impact on GDP potentially reaching around 0.5% each year. For instance, Oxford Economics expects a 0.4% boost to GDP in 2018 while the IMF foresees that U.S. real GDP will be 1.2% higher by 2020 than in a projection without the tax policy changes.[1]

However, this impact is likely to fade away as some of the new tax provisions expire. The estimated ten-year impact on the economy varies greatly according to the tools used and how ideological points of views are reflected in these models.[2] The Tax Policy Center expects the positive short-term impact of the tax package to vanish completely over time, with no effect on the level of U.S. GDP by 2027. The Penn-Wharton Budget model estimates that GDP growth will be between 0.6% and 1.1% higher at the end of ten years than without the tax package; this estimate is close to the U.S. Congress Joint Committee on Taxation estimate of a 0.7% impact by 2027. The more optimistic Tax Foundation expects a boost of 1.7% on the level of U.S. GDP by 2027.

All estimates, even the most optimistic ones, suggest that the new tax legislation will not generate enough extra growth to pay for itself, leading to a higher public deficit and debt going forward. This is expected to call for fiscal consolidation measures, such as expenditure cuts down the road, that weaken further the impact on growth. This would be especially the case if consolidation takes the form of cuts in public investment at a time that the lack of public infrastructure is already considered as an obstacle to future growth. To the extent that these consolidation measures are anticipated sooner, they could also limit the initial boost on growth.

1 See Oxford Economics (2017) "Research Briefing – US The final tax cut bill and what it means for the forecast" ; IMF (2018) World Economic Outlook update, January.

2 For a discussion on the difference between the models see https://eml.berkeley.edu/~auerbach/dynamic%20scoring.pdf

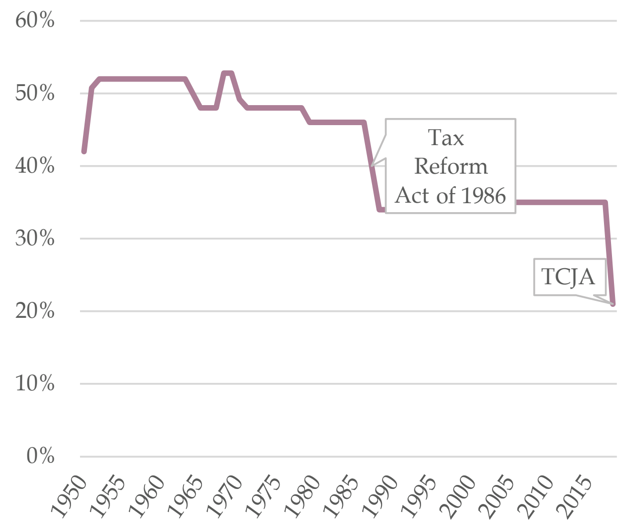
3 According to CBO estimates, the US effective corporate tax rate, i.e., after taking into account tax credit and deductions, while substantially lower than the statutory tax rate was also among the highest in the G20 countries. See https://www.cbo.gov/sites/default/files/115th-congress-2017-2018/reports/52419-internationaltaxrate-comp.pdf

What Will U.S. Corporations Do with the Extra After-Tax Profits?

The estimations of the impact of the tax cuts are derived from historical behavior of economic actors, especially corporations. The cut in the Federal corporate income tax rate from 35% to 21% is the largest ever, and the only substantial one since the Tax Reform Act of 1986 (Figure 1). It will move the U.S. from the top of the range in the OECD to well below average.[3] How U.S. corporations respond to the package is, therefore, key.

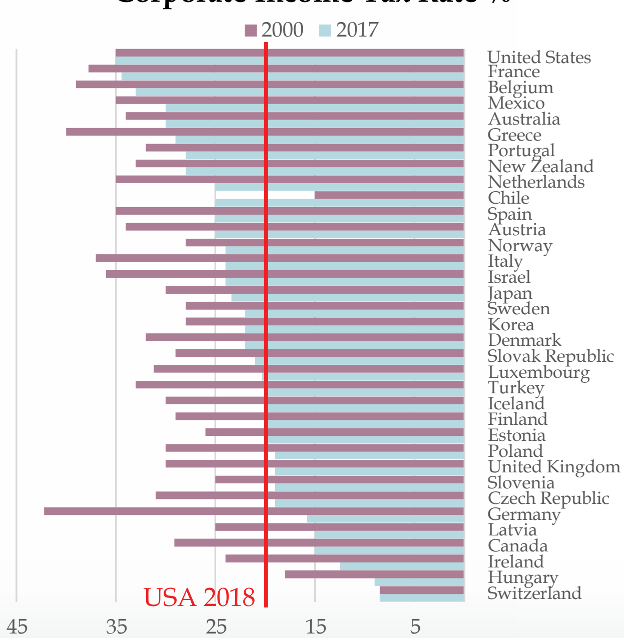
Figure 1: A Major Cut in the Corporate Top Tax Rate

Historical Corporate Top Tax Rate



Source: Tax Policy Center.

Central Government Statutory Corporate Income Tax Rate %



Source: OECD

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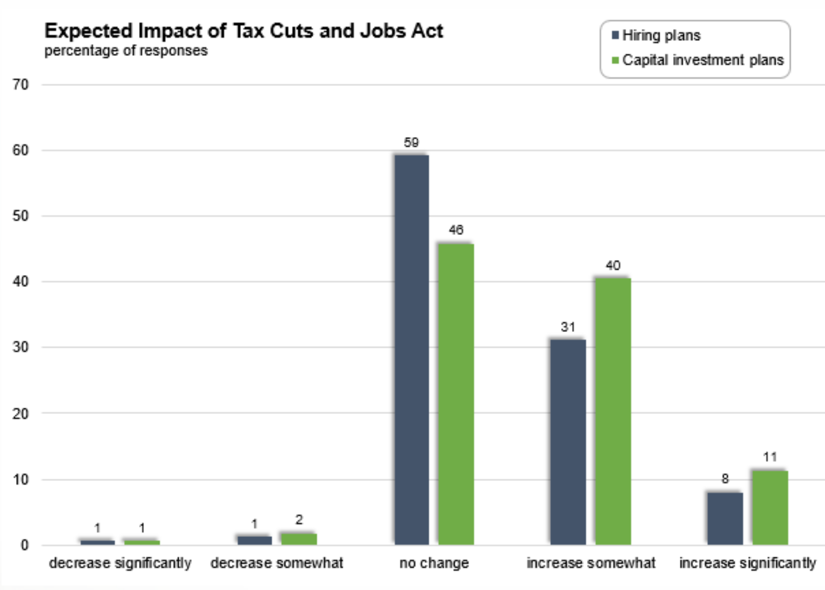
A lower corporate tax rate means higher after-tax profits for U.S. corporations. Companies may either save the added profit and pass it on to shareholders or spend it on higher wages, hiring, and investment. The higher the spending on investments, job creation, and higher wages, the higher the boost on GDP, especially if it feeds both demand and supply in a positive feedback loop. In highly competitive sectors, such as retail, or in regulated sectors, such as electricity, the tax cut may also be used to reduce prices, which would also support households' purchasing power, while taming the potential wage impact on inflation. For instance, several electricity companies have announced they will pass some of the tax cuts on to customers.[1]

Corporate surveys at the end of 2017 suggested, however, that the impact of the new tax legislation on hiring and capital investments plans may be limited (Figure 2). Corporate after-tax profits are already high (Figure 3), and the main obstacle to higher investment levels does not seem to be a lack of internal financing. While the new ability to fully and immediately expense investment should give a boost, other factors behind low investment, such as global uncertainties, regulatory constraints, and infrastructure bottlenecks that weigh on profitable investment opportunities will persist.

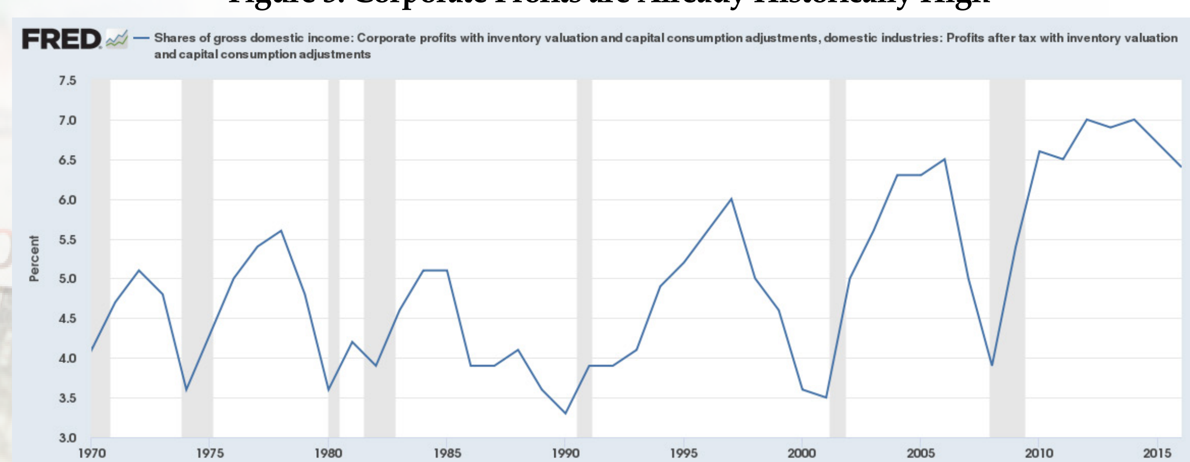
The impact on employment is likely to be limited, given the already low level of unemployment and the difficulty in hiring those outside the labor force who may not have the required skills, or may not be able to work. In these circumstances, and as some companies are already struggling to hire and keep the workers they need, the impact on wages may be stronger than expected. Already, several companies have distributed exceptional bonuses in 2018 and announced increases in hourly wages and benefits. The long overdue acceleration in wages may be forthcoming. This would help end the low inflation puzzle, bringing core inflation towards the

Figure 2: Corporate Surveys Call for Moderate Optimism



Source: Atlanta Fed Business Inflation Expectations Survey.

Figure 3: Corporate Profits are Already Historically High



Source: Federal Reserve Bank of St. Louis. **Shaded areas indicate U.S. recessions.

1 See New York Times , January 9th.

Fed target of 2%. Most estimates do not foresee inflation overshooting the Fed target. A potentially stronger U.S. dollar driven by higher rates and economic activity, along with a lower supply abroad due to repatriation, could act as a counterbalancing force. This is, however, one of the most important short-term uncertainties associated with the tax cuts and it may prompt a faster-than-expected tightening of the Fed monetary stance.

Corporate announcements also suggest that a substantial share of the after-tax bonanza will be transferred to shareholders via share buybacks, higher dividends, and M&A, which has contributed to fueling stock price appreciation.

What About Inwards Foreign Direct Investment and Profit Reparation?

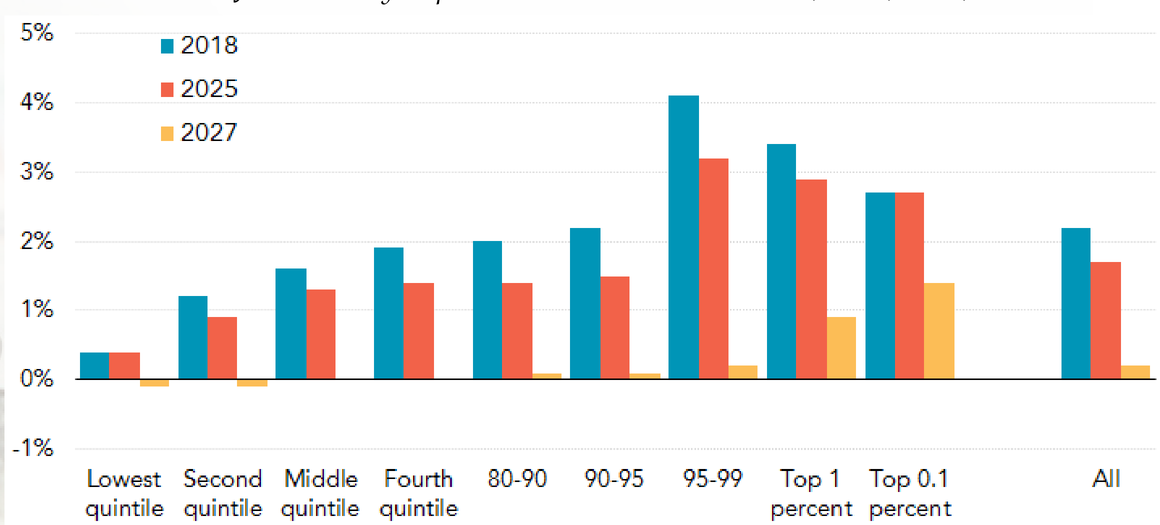
Another goal of the corporate tax cut is to attract foreign companies to the U.S. and reduce the incentives for U.S. companies to relocate abroad. In addition, the shift to a territorial system for foreign income taxation combined with a one-off tax on past unremitted overseas earnings is expected to lead to profit repatriation.[1] This represents a much more ambitious reform than the 2004 tax holiday on deferred overseas profits (2004 Homeland Investment Act), which allowed corporations to repatriate foreign income at a reduced tax rate for two years, but did not change the nature of the overseas taxation system.

Optimistic assumptions on the impact of the new tax legislation also assume that higher FDI into the U.S., and profit repatriation by U.S. companies, will boost domestic investment and employment. This suffers the same limitations as those stated previously on the use of higher after-tax profits. Moreover, higher FDI into the U.S. may take time to materialize, and be counterbalanced by corporate tax cuts abroad as already planned in other high tax countries such as France.

How Much More Will Households Spend and Work?

The new tax legislation supports household purchasing power indirectly via its impact on jobs and wages, as well as directly (but temporarily) via the personal income tax cuts. This second effect is, however, likely to be limited. Everything else being equal, tax cuts that benefit the wealthy, and/or are temporary, tend to have a smaller multiplier effect on economic growth. As shown in Figure 4, the personal income tax cuts will be more beneficial to those with higher incomes, who have a lower propensity to spend, than to lower income groups. Moreover, the limited duration of the tax cuts may limit the impact on consumption even in the short-term (no impact in long-term), unless people expect an extension on temporary tax measures (as happened before).

Figure 4: Percent Change in After-tax Income of the Conference Agreement for the Tax Cuts and Jobs Act: *By Expanded Cash Income Percentile, 2018, 2025, and 2027*



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0217-1).

1 The worldwide tax system applied up to the tax reform allowed companies to defer taxes owed on foreign profits by reinvesting them abroad, discouraging profit repatriation.

POTENTIAL IMPACTS ON CAPITAL MARKETS

Even though the new tax legislation was largely priced into markets, its adoption was initially welcomed. Higher stock market prices partly reflected the expected increase in after-tax earnings. It is worth noting, though, that many multinational companies are already paying much lower effective tax rates than the previous 35% rate. The key outstanding questions related to domestic equities are how much of the tax cut benefits are already priced into the market and will they lead to investment and hiring or just additional share buybacks. Higher interest rates are also a potential headwind, by increasing borrowing costs and discount rates.

We do not think the U.S. tax cuts will have a major impact on international equity markets. In a scenario where economic growth in the U.S. really accelerates and the dollar strengthens, this could hurt international equities. We do not think this is likely, though, particularly due to where we are in the economic cycle. Accelerated growth would more likely lead to even higher interest rates, a pick-up in inflation, and further monetary tightening.

There are a variety of headwinds to fixed income assets related to the tax cuts and where we are in the economic cycle. Increased debt levels/deficits from the reduction in tax revenue will likely raise borrowing costs, while higher economic activity could cause an increase in inflation. The Fed is already raising rates and reducing its balance sheet, activities that could accelerate if inflation heats-up. In the high yield sector, a reduction in taxes should be beneficial, but the new limits on interest deductions could act as a counter force, particularly for highly levered companies. In an environment of higher rates and interest deduction restrictions, we could see a reduction in the supply of high yield bonds.

The new tax legislation also has several supporting effects on the U.S. dollar, including the impacts of higher investment in the U.S. by foreign companies and of corporate sector profit repatriation (even though some estimates suggest that the share of profits already in USD is high). Increased U.S. growth would also support the dollar, as well as higher interest rates, unless looming debt and increased inflation erode that effect.

Applying fiscal stimulus at this point in the economic cycle poses risks. We are at close to full employment and wage growth has started to pick up. This, along with further economic activity from the tax cuts, could lead the Fed to accelerate its pace of increasing rates, in effect hitting the monetary brakes while the tax reform steps on the fiscal gas. Higher interest rates from the Fed and from higher debt/deficit levels could negatively impact both equity and bond prices, as demonstrated by the market volatility in early February of this year. Despite these near-term uncertainties, we think the recent tax reforms do not warrant any significant changes in investors' long-term strategic asset allocations.

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