First Trust
Monday Morning OUTLOOK

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Clearing a Path for Tax Reform

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Washington D.C. used to complain that Ronald Reagan employed a strategy of "starving the beast" – cutting taxes so that new spending was tough to legislate. Now, D.C. seems to employ the strategy of "gorging the beast" – spending so much that tax cuts are hard to pass.

Persistent over-spending, and costly entitlements have created permanent deficits. In addition, arcane budget rules and "scoring" models (which estimate the budget impact of legislation) make tax reform very complicated.

In order to let it pass with just 51 votes in the Senate, the cost of the legislation must not increase the deficit by more than $1.5 trillion over 10 years. And any increase in the deficit in year 11, or beyond, must be paid for. These arcane hurdles are why the tax reform bill passed by the House of Representatives last week looks like it does.

In essence, the tax bill cuts taxes on companies and just about anyone in the bottom 60% of the income spectrum, but pays for this by shifting an even larger share of the income tax burden onto high earners. So, while we think the tax plan will boost economic growth, it falls well short of what we would call an "ideal" supply-side tax cut.

The corporate side of the tax plan is very positive. At 35%, the US has the highest corporate tax rate in the developed world. Bringing that rate down to 20% makes the US competitive, will bring more investment to the US, and will boost economic growth. In addition, it allows 100% expensing of most investment for the next five years.

Notably, the proposal makes the 20% corporate tax rate permanent (not just 10 years, like the changes to individual tax rates). Combined with the budget rules against showing revenue losses beyond ten years, that's why the proposal treats high individual earners so harshly.

Congress says companies won't invest if they think their tax rate will go back up in 2028. But we think this fear is overblown. US economic growth will pick up, and future lawmakers are not going to risk upsetting that by letting the rate jump back to 35% overnight. Politicians are always worried about the next election, and the threat of a stock market selloff or rising recession risk would spook even the most liberal Democrats.

In turn, extra economic growth should generate lots of extra revenue, which means the deficit would not rise as much as the official budget scorekeepers (the Joint Committee on Taxation or the Congressional Budget Office) say it would. For example, an extra 1 percentage point of real GDP growth per year would close the budget gap by $2.7 trillion over ten years, which is more than the cost of the tax cut itself.

In fact, there are early signs that the economy is accelerating already. The Trump administration has rolled back an incredible amount of regulation. That regulatory rollback - combined with expectations of tax reform and a more business friendly government in general - has lifted economic growth.

In spite of the double-whammy of Hurricanes Harvey and Irma, US economic activity has accelerated this year. In fact, we have had two quarters of real GDP growth at or above 3% so far this year, with our fourth quarter growth forecast at 3.5%.

But the Joint Tax Committee is expecting only a 1.9% real GDP growth rate over the next ten years. We think this is way too pessimistic. The economy has been stuck in the doldrums since 2009 because government grew too large. Between 1985 and 2005, real GDP averaged 3.2% growth. Using those growth rates (which we believe are achievable) would allow for more robust tax reform that actually cuts tax rates across the board.

To be blunt, we are not particularly enthusiastic about the way the proposal treats individuals, and think it's a huge missed opportunity. For one thing, the top tax rate of 39.6% is unchanged, and that's the tax bracket where earners respond the most to incentives.

And while we wholeheartedly support the idea of limiting the deductibility of state and local taxes – because it creates political pressure for shrinking government at the state and local level – we're concerned about the downside incentive effects for some high earners who would then pay even higher marginal tax rates. Put it all together, and some earners in high tax states like California are going to pay a marginal rate north of 60% once Medicare taxes are included.

With full GOP control of the House, Senate, and White House, Republicans have a rare opportunity to adopt policies to get the US back on the path of faster economic growth. Instead, they remain hampered by rules set up long ago that are hostile to growth, the same kind of rules that underestimated the costs of programs like Obamacare, but also underestimate the benefits to growth from lower tax rates.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
11-7 / 2:00 pm	Consumer Credit– Oct	$17.8 Bil	**$17.2 Bil**		$13.1 Bil
11-9 / 7:30 am	Initial Claims - Nov 4	230K	**231K**		229K
11-10 / 7:30 am	U. Mich Consumer Sentiment -Nov	100.8	**101.2**		100.7