Five Questions About US Tax Legislation

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The US Senate approved a tax bill last weekend, and it now appears highly likely that final tax legislation will be passed in the next few weeks. Big changes to the tax rules will impact the economy, taxpayers and financial markets.

Of course, the House and Senate still need to meet in conference committee to iron out the differences between their respective bills. Both chambers will then vote on identical legislation. Assuming it passes, President Trump will then sign it into law.

There could still be delays—or even challenges that keep the bill from passing. However, we feel strongly that the differences between the House and Senate bills will be overcome and the tax law enacted in relatively short order.

Here's our take on five questions many investors are likely asking:

1. What Does Tax Legislation Mean for US Economic Growth?

In looking at the likely shape of the final legislation, it seems to us that the changes to the tax code won't be revolutionary and are unlikely to have a large impact on the real economy.

We estimate a small increase in growth—something on the order of 0.2% or 0.3% in both 2018 and 2019. But parts of the tax law will likely expire after a few years (this is necessary for the bill to comply with the $1.5 trillion deficit ceiling required to pass it through the Senate). So, the longer-term impact on growth will likely be minimal. Extending the expiring provisions could boost that impact, but there won't be much clarity on that topic for several years.

2. What Are the Implications for Monetary Policy?

With faster growth comes higher inflation. And with economic growth already above the Fed's estimate of full capacity, any fiscal stimulus raises the probability of tighter monetary policy. We already expect the Fed to raise rates four times in 2018; the tax legislation increases our conviction, but isn't by itself big enough to mandate a forecast change—the impact on growth isn't that large. Still, the likelihood of higher rates has gone up, and that could further limit the economic growth impact of the tax legislation.

3. How Much Will the Tax Cuts Cost?

Some members of Congress have argued that the tax cuts will pay for themselves, that higher growth would provide the same government revenue even at lower tax rates. We disagree: we don't think the legislation is likely to be revenue neutral going forward. The boost to growth simply isn't large enough to produce that level of revenue. We expect the tax cuts to expand government deficits by roughly $1 trillion over the next 10 years. If the increased deficit pushes interest rates higher, that could further dampen the growth the legislation was intended to create.

4. Who Wins and Who Loses?

The corporate sector seems like the big winner, getting both lower tax rates and favorable treatment of capital expenditures. And some parts of the corporate tax cuts have a good chance of becoming permanent. On the other side of the coin, much of the benefit to individual taxpayers will be made temporary.

High-income earners in low-tax states will also benefit, particularly if the alternative minimum tax (AMT) is repealed, as the House bill calls for. Individuals living in high-tax states, by contrast, may see a tax increase, because the deductibility of state and local taxes will be limited.

Americans who rely on Affordable Care Act (ACA) exchanges for health insurance may also suffer, assuming the ACA individual mandate is repealed as seems likely. That move will probably cause many people (the Congressional Budget

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Office estimates more than 10 million) to leave the exchanges, which will likely boost premium costs for those who remain.

5. What Could a Tax Bill Mean for Markets?

For equities, the tax legislation is good news—at least for now—because it should increase net corporate profits.

With the business sector already sitting on record amounts of cash, we think additional money from the tax cuts is more likely to go into stock buybacks and other shareholder-friendly activity than to spark a wave of capital expenditure. That's good for the stock market in the short term but limits the growth impact of the legislation in the long term. So we think of the plan as providing a near-term boost, but not a long-term reason to change one's expectations.

For bond markets the story is more mixed. Improved corporate profitability is a good thing for credit markets, but the possibility of generally higher interest rates limits the impact of a better credit picture. In the end, we expect that higher interest rates will prove longer lasting than the short-term boost the legislation gives to credit markets.

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