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A PRACTICAL CASE FOR EXTENDING CORPORATE TAX CUTS

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One issue that investors will be monitoring in the run-up to the U.S. elections is whether the Tax Cut and Jobs Act of 2017 (TCJA) will be extended next year when many provisions are set to expire. While the legislation included changes in corporate and personal taxes, investors have focused mainly on the reduction in corporate tax rates, which were the largest in U.S. history.

The act is widely considered to be the signature legislation of the Trump administration. One of the principal motivations was to make the U.S. tax code competitive with the rest of the world by lowering the marginal corporate tax rate from 39 percent to 21 percent, roughly the average for OECD countries. Another goal was to spur business capital spending, which had slowed after the 2008 financial crisis.

The Biden administration, however, is at odds with extending the Tax Cut and Jobs Act, except for the provision that granted tax cuts to households earning less than $400,000. In a Bloomberg interview earlier this year, Treasury Secretary Janet Yellen said that the president is fixated on tax fairness. She indicated, "He's going to be sure that tax cuts disappear for those corporations, and we're not negotiating new tax breaks for wealthy individuals."

The case for extending corporate tax cuts rests on four considerations: First, is it effective in lessening outsourcing? Second, does it incentivize businesses to increase capital outlays? Third, will the initial loss in government revenues be offset by revenues from stronger economic growth? Fourth, will it be good for the stock market?

Based on evidence over the past seven years, my assessment is that corporate tax cuts have delivered on three of the four considerations.

PASSAGE OF TCJA WAS A PIVOTAL MOMENT IN U.S. TAX POLICY

When the act became law, I believed it would be more effective in slowing outsourcing than the Obama administration's unsuccessful attempt to block so-called "tax inversion" deals. They occurred when a U.S. company reincorporated overseas after merging with a foreign business.

This finding is supported by Kevin Brady, former House Ways and Means Committee chair, and Douglas Holtz-Eakin, former director of the Congressional Budget Office, in a recent Wall Street Journal opinion piece.

They argue that the passage of the Tax Cuts and Jobs Act was a pivotal moment in U.S. tax policy, ranking close to the Tax Reform Act of 1986 in terms of simplifying the tax code. They also point out that since its passage, the U.S. has not lost a single multinational corporate headquarters following a decade in which there was an exodus of ten multinationals per year on average.

By comparison, it was more difficult to substantiate the act's impact on business capital spending until recently. The reason: Macro data on business capital spending as a percent of GDP did not point to a clear change in trend. For example, there was an increase in business investment in anticipation of the legislation, but it stalled in 2018 when President Trump engaged in a trade war with China. Accordingly, it is difficult to sort out these cross currents.

LONG-TERM EFFECTS OF THE TCJA ON DOMESTIC AND TOTAL CAPITAL

Recently, a comprehensive study of the Tax Cuts and Jobs Act undertaken by economists associated with the National Bureau of Economic Research and the Treasury Department has clarified the impact on individual businesses. The findings are based on a sample of 12,000 corporate tax returns covering several years before the act was enacted and two years after.

The principal conclusion is that the act caused domestic investment of firms with the mean tax change to increase substantially, by roughly 20 percent relative to firms with no tax change. Novel international tax provisions incentivizing U.S. multinationals to increase their tangible capital increased domestic investment further.

Taken together, the long-term effects of the TCJA on domestic and total capital are estimated to be 7 percent and 13 percent, respectively.

The study, however, did not find that the corporate tax cuts were self-financing, as economists with a supply-side bent have asserted. At the time of its enactment, the corporate tax changes were estimated to reduce corporate tax revenue by $100-$150 billion per year, according to the Joint Committee on Taxation and the Congressional Budget Office. On the revenue side, the study found that the effects of higher corporate income and wage payments in creating extra tax revenue were small and did not overturn the preliminary findings.

Considering the large federal budget deficits in recent years and the massive buildup of federal debt that has ensued, some may argue against maintaining the current tax rates. I share these budgetary concerns but believe the best way to address the problem of a revenue shortfall is for Congress to close tax loopholes in the next round of negotiations rather than to increase the marginal tax rate. This is especially true with the global minimum tax rate being set at 15 percent in 2021.

Finally, I believe the stock market would most likely react favorably to an extension of the TJCA as it did after its passage. The principal reason is it would boost after-tax earnings.

In my book on Trump's economic policies, I placed them into three categories—good, bad and ugly—according to their likely impact on financial markets. I gave corporate tax cuts a good overall rating then, and the positive effects on business investment have now been validated by empirical research.

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