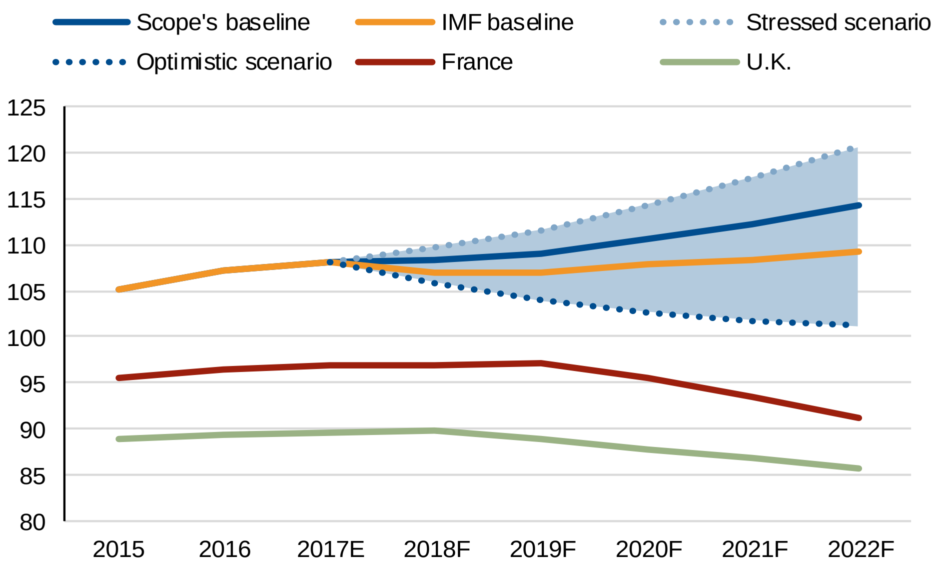
US Fiscal Outlook: Politically polarising tax cut boosts short-term growth, raises deficits

The substantial tax cuts for businesses and households approved by Congress on December 20 without any Democrats supporting the bill have further heightened political polarisation. It is Scope's view that the tax cuts are (i) geared towards short-term growth, (ii) unfunded, with a clear negative impact on the deficit and debt level, expected to reach 115% of GDP by 2022, and (iii) unevenly distributed.

President Trump signed the 'Tax Cuts and Jobs Act' (TCJA) into law on December 22, 2017. Going into effect in 2018, the law cuts individual tax rates temporarily until 2025 and corporate tax rates permanently. The TCJA's short-term impact on economic activity is mostly driven by corporate income tax cuts and the temporary allowance for full expensing, supporting investments. While estimates disagree on the extent of the growth and fiscal impact, Scope shares the view that higher economic growth notwithstanding, the TCJA increases the deficit and debt of the US federal government. Scope believes that Treasury Secretary Steven Mnuchin's assessment of a 2.9% real GDP growth rate for the next 10 years, resulting in a net reduction to the national debt, is too optimistic.

A more conservative estimate of US growth prospects is based on three observations: First, the economy has expanded for eight consecutive years, averaging about 2.2% since 2010. This is already one of the longest consecutive growth periods in US history. Adding to aggregate demand at this stage of the cycle may thus lead to higher inflation and faster-than-expected interest rate hikes. Second, increases in corporate income may not be fully invested, but are likely to be distributed and to shareholders instead. Third, additional significant household consumption, which has been the main growth driver in the US, is unlikely to be spurred by aspects of the TCJA that exacerbate inequality.

Figure 1: US debt projections vs AA-rated peers, % of GDP



Source: IMF, CBO, Scope Ratings GmbH

Scope's baseline scenario is for US real GDP growth to trend at 1.9%, slightly below the IMF's 2.1%, over the medium term. Together with primary deficits of 2.5%, which do not account for a possible infrastructure spending programme, and a moderate increase in interest rates, Scope expects the debt-to-GDP ratio to increase to around 115% by 2022. Notably, even under an optimistic scenario, the debt-to-GDP ratio of the United States will not fall below 100% by 2022, and will therefore remain significantly above its AA-rated peers France (91%) and the U.K. (86%).

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The TCJA's growth impact

TCJA to increase growth in the short-term, mostly due to corporate tax cuts

Given the changes to the after-tax rates of return to owners of capital (both domestic and foreign) and labour, the tax reform is expected to enhance economic growth. Estimates vary depending on assumptions about how much economic growth, in the form of higher investments, labour supply and consumption, the law will spur.

The TCJA reduces permanently the federal corporate tax rate from 35% to 21%. Combined with the average of state and local corporate tax rates, the US statutory rate is estimated to fall to 26.5% which puts the United States below the weighted average of EU countries, 26.9%, and well below the current weighted average of OECD economies, 31.4%[1]. Changes in the taxation of income from capital, the extension and expansion of bonus depreciation (full expensing for five years) and the reduction in tax rates on business income, result in a reduction in the after-tax cost of capital investment, and thus an increase in the after-tax rate of return on business investment. In addition, according to the Joint Committee on Taxation (JCT) the overall net effect of the changes to the individual income tax will reduce average tax rates on wage income by about one percentage point[2] (Annex I summarises the details of the TCJA).

Given this, the IMF[3] expects US tax reform to stimulate economic activity, with the short-term impact mostly driven by the investment response to the corporate income tax cuts and the temporary allowance for full expensing of investment. Compared to previous projections without the tax reform, the IMF projects US real GDP to be 1.2% higher by 2020. Reflecting this, the US growth forecast was raised from 2.3% to 2.7% in 2018, and from 1.9% to 2.5% in 2019.

A long-lasting recovery, share buybacks and distributional effects dampen growth forecast

While Scope agrees with the short-term economic benefit, three factors give rise to caution for the optimistic growth figures over the medium-term:

- First, the US economy is close to full employment[4], with an unemployment rate below 5% since 2016, and core personal consumption expenditure inflation near, albeit slightly below, the Federal Reserve's price stability mandate of 2% (1.5% in December 2017). The economy has grown for eight consecutive years, averaging 2.2% since 2010. This is one of the longest consecutive growth periods in US history and is unlikely to continue indefinitely. While Scope is mindful that the TCJA could increase labour participation, leading to higher consumption and aggregate demand, extending the current growth period, the distributional effects of the TCJA reduce the likelihood of this potential growth channel. Instead, by adding to aggregate demand at this point in the cycle the tax cuts could add to inflationary pressures and lead to faster-than-expected monetary policy tightening. Scope notes that wages grew at 2.9% in January 2018, the highest growth recorded since June 2009[5].
- Second, large cash holdings of US corporates already exceed USD 1.5tn[6], more than ample for any planned investments in machinery and equipment before the TCJA. Scope does not expect that, over the medium term, the TCJA alone will increase corporate investments significantly. While Scope acknowledges the relative attractiveness of lower tax rates, corporate investments mainly depend on locational factors such as skilled workers, infrastructure, local suppliers and potential growth opportunities. In addition, Scope recognises that other governments may change

[1] https://taxfoundation.org/tax-cuts-and-jobs-act-corporate-tax-rate/
[2] https://www.jct.gov/publications.html?func=startdown&id=5055
[3] http://www.imf.org/en/Publications/WEO/Issues/2018/01/11/world-economic-outlook-update-january-2018
[4] With the caveat that low labour participation rates may distort the anticipated effect of full employment.
[5] In addition, as noted by the ECB, in a mature stage of the business cycle, fiscal multipliers tend to be smaller than when there is a large output gap. Tax multipliers tend to be smaller than government spending multipliers, which also implies a rather limited positive demand effect from the tax reform. https://www.ecb.europa.eu//pub/pdf/other/ebbox201801_01.en.pdf
[6] Checkable deposits and currency of nonfinancial business at end Q3 2017. Federal Reserve. https://www.federalreserve.gov/releases/z1/current/z1.pdf

their respective tax policies in response to the TCJA. Scope therefore expects that tax cuts will more likely be distributed to shareholders via dividends and share buybacks than directly invested into the real economy. Any disbursement to shareholders, may, however, result in an increase in their investments, if the additional income is not consumed.

- Third, the distributional effects of the TCJA, discussed in greater detail below, may not result in permanently significantly higher consumption, the main driver of economic growth in the US. This is because consumption levels are already high, helped by reductions in personal savings, which are, as of December 2017, at a 10-year low (2.4%). Hence increased incomes may be used to restore savings rates rather than being consumed.

Based on these considerations, Scope's baseline is that US real GDP growth will tend to be lower compared to the previous five years despite the tax cuts, averaging 1.9% in 2018-2022.

The TCJA's fiscal impact

Higher growth partially offsets revenue loss from tax cuts

The TCJA argues that the negative direct impact of lower revenues as a result of the tax cuts will be tempered by stronger growth in a positive feedback loop. The JCT estimates that the national debt will increase by USD 1.46tn over 10 years on a static basis, or by about USD 1.1tn including macroeconomic effects. Revenues are estimated to be USD 451bn higher, given a 0.7% increase in average real GDP growth over the 10-year period. However, the JCT also estimates an increase in interest payments on the federal debt of about USD 66bn, reducing the overall net impact from macro-economic effects to USD 385bn[7].

Still, US tax reform is deficit enhancing

Alternatively, the Tax Foundation estimates an increase in long-run GDP by 1.7%, a decrease in federal revenues by USD 1.47tn over 10 years on a static basis (without growth effects) and by USD 448bn on a dynamic basis[8]. Further, the Committee for a Responsible Federal Budget notes that if expiring provisions are extended and late-stage tax hikes avoided, the official cost of the bill would be about USD 570bn to USD 725bn higher. This could ultimately increase the cost of the bill to USD 2tn to USD 2.2tn before interest on a static basis with approximately USD 1.5tn to 1.7ttn on a dynamic basis over the next decade[9].

The Tax Policy Center estimates that a boost to GDP of 0.8 percentage points in 2018, diminishing until 2027, results in a cumulative higher revenues of USD 186bn over a 10-year period. However, including interest costs, the debt is expected to increase by approximately USD 1.5tn, or an additional 5.5% of GDP[10], by 2027.

White House growth and fiscal projections unlikely

While these estimates disagree on the extent of the impact, all believe that the deficit and debt of the US federal government will rise, higher economic growth notwithstanding. Scope therefore believes that Treasury Secretary Steven Mnuchin's assessment of a net reduction to the national debt as a result of the tax reform is too optimistic. The administration assumes a 2.9% real GDP growth rate over the next 10 years, and concludes that higher GDP growth will result in the tax cuts paying for themselves[11].

[7] The projected increase in GDP during the budget window results both from an increase in labour supply, in response to the reduction in effective marginal tax rates on wages throughout most of the budget window, and from an increase in investment in response to the reduction in the after-tax cost of capital. The projection includes an increase in investment in the US both as a result of the proposals directly affecting taxation of foreign source income of US multi-national corporations, and from the reduction in the after-tax cost of capital in the US due to more general reductions in taxes on business and income. https://www.jct.gov/publications.html?func=startdown&id=5055
[8] https://taxfoundation.org/final-tax-cuts-and-jobs-act-details-analysis/
[9] http://www.crfb.org/blogs/final-tax-bill-could-end-costing-22-trillion
[10] http://www.taxpolicycenter.org/sites/default/files/publication/151176/2001651-macroeconomic_analysis_of_the_tax_cuts_and_jobs_act.pdf
[11] https://www.treasury.gov/press-center/press-releases/Documents/TreasuryGrowthMemo12-11-17.pdf

Table 1: Estimates of TCJA's fiscal impact, USD bn

Debt 2018-2027	Static Effect	Incl. Dynamic Effects		
		Revenues (-)	Interest (+)	Total
White House	1,500.0	1,800.0		- 300.0
Tax Foundation	1,470.0			448.0
Joint Committee on Taxation	1,456.0	451.0	66.0	1,100.0
Tax Policy Center	1,500.0	186.0	300.0	1,500.0
Committee for Responsible Federal Budget*	2,000.0			1,500.0

* Estimates a range of 2.0 to 2.2tr on a static and 1.5 to 1.7tr on a dynamic basis.

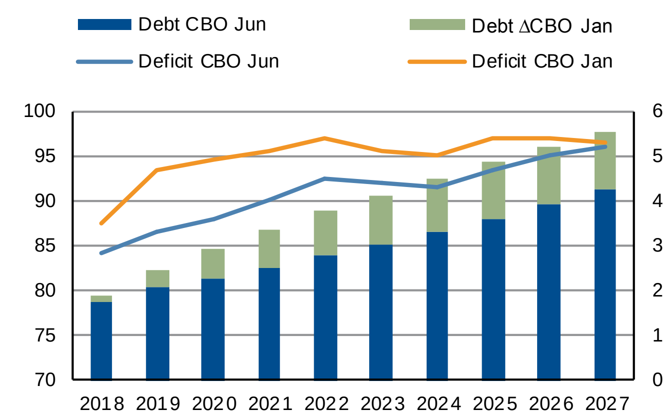
US debt sustainability

Debt-to-GDP ratio to increase by about five percentage points by 2022

In Scope's opinion, deficits growing faster than GDP will ultimately adversely affect US debt levels. The Congressional Budget Office (CBO) estimates the increase in the fiscal deficit alone will raise debt held by the public by about 6 percentage points by 2027, elevating the debt-to-GDP ratio, as estimated in June 2017, from 91.2% in 2027, to 97.5%[12]. Scope notes that these figures do not include intra-governmental debt, specifically, the US Treasuries held as assets by the Trust Funds, but which are however included in the IMF's gross general government debt figures.

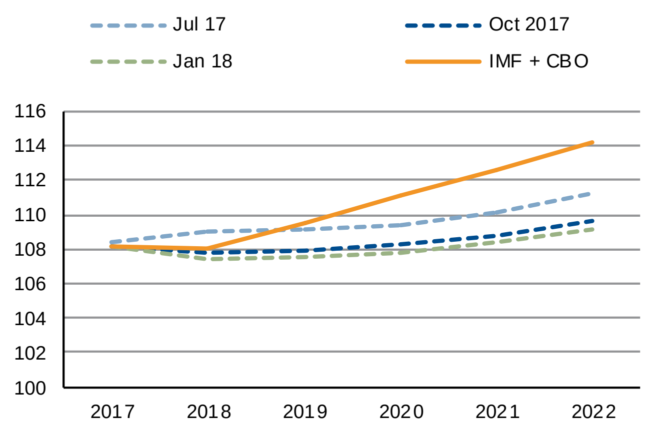
Prior to the passing of the TCJA, in October 2017, the IMF projected the general government debt-to-GDP ratio to increase to 109% by 2022. Notably, this estimate was conducted based on unchanged policies, given the uncertainty that a tax reform would be passed at that time. The October 2017 estimate was based on an average fiscal deficit of around 4% from 2018-2022. Adding the CBO's estimate of a TCJA-induced increase in the federal debt to the IMF's general government debt figures, and including the revised growth projections of the IMF released in January 2018, capturing the positive growth effects of the TCJA, the debt figure increases to around 114% of GDP by 2022.

Figure 2: Increase in debt held by the public, % of GDP



Source: CBO

Figure 3: IMF's and CBO's debt projections, % of GDP



Source: IMF, CBO.

NB. 'Jul 17' refers to IMF Article IV projections. 'Oct 2017' to the IMF's WEO projections in October 2017. 'Jan 2018' includes the revised growth projections from the IMF, keeping all other figures as in the October 2017 projections. 'IMF + CBO' uses the IMF growth projections and adds the increase in the debt held by the public estimated by the CBO.

[12] https://www.cbo.gov/system/files/115th-congress-2017-2018/costestimate/53437-wydenltr.pdf

On this basis, Scope's debt sustainability analysis raises concerns about the US federal debt trajectory. Over the next five years, Scope's baseline scenario assumes real GDP growth of around 1.9%, slightly below the IMF, a primary deficit of 2.5% and a moderate increase in interest rates resulting in a real effective interest rate of around +0.8%. These assumptions point to the debt-to-GDP ratio increasing to around 115% by 2022.

US rising debt contrasts that of France and the UK

However, Scope notes that the falling US potential growth outlook, combined with the expected increase in interest rates in line with the ongoing normalisation of the Federal Reserve's monetary policy, and the risk of further fiscal slippage[13], could quite quickly result in a debt-to-GDP ratio of around 120% by 2022. Finally, even an optimistic scenario results in the debt-to-GDP ratio failing to fall substantially, remaining around 100% by 2022, well above its AA-rated peers France (91%) and the U.K. (86%).

Figure 4: US debt sustainability vs AA-rated peers, % of GDP

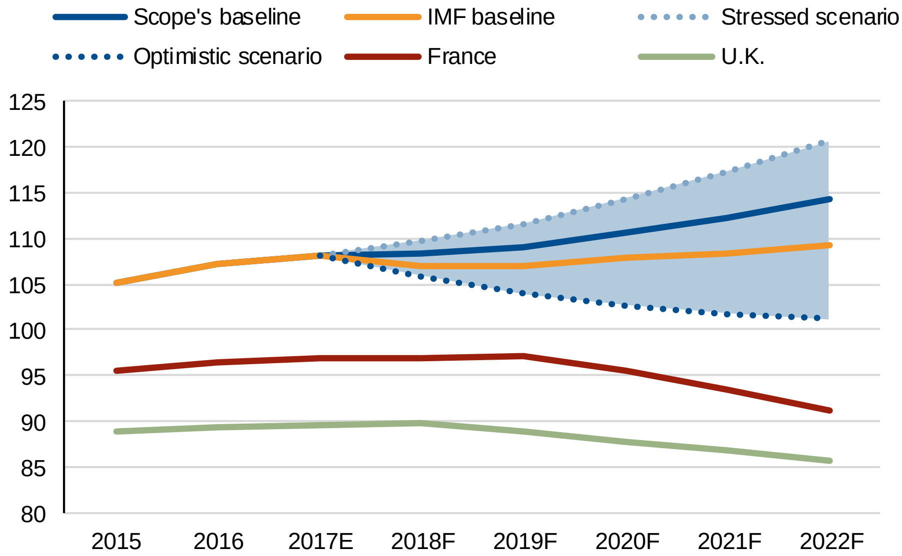


Table 2: Debt sustainability assumptions

Scenario	Time Period	Real GDP growth (%)	Primary Bal. (% of GDP)	Real Eff. Int. Rate (%)	Debt End Period (% of GDP)
History	2012-2017	2.2	-2.7	0.4	108.1
IMF Baseline	2018-2022	2.1	-1.5	0.3	109.2
Scope's Baseline		1.9	-2.5	0.8	114.7
Optimistic Scenario		2.6	-1.0	0.3	101.1
Stressed Scenario		1.6	-3.0	1.1	120.6

Source: IMF, CBO, Scope Ratings GmbH.

Sizeable pension- and healthcare obligations further challenge US fiscal outlook

In addition to these fiscal developments, Scope notes that US long-term debt dynamics are further challenged by sizeable pension- and healthcare-related obligations and contingent liabilities, which are set to rise over the next decade. The US' total obligations, including contingent liabilities, could be estimated at around USD 90trn, or 478% of GDP, implying additional significant economic and fiscal risks. Scope notes that among 32 advanced economies, the US ranks second in terms of total government liabilities once the net present value of future pension and healthcare obligations is included (see US Government Obligations & Contingent Liabilities: A High and Rising Fiscal Risk).

[13] The United States has an almost 48-year track record of fiscal deficits (with four years of exception).

Distributional impact

Scope's lower growth estimate also due to distributional effects

Scope's conservative estimate of the US' growth prospects is also based on the distributional impact of the TCJA. As noted by the IMF, income inequality affects US growth prospects as it curbs consumption, which has been the main growth driver, weighs on the labour supply, and reduces the ability of households to adapt to shocks[14].

80% of all taxpayers expected to benefit in 2018

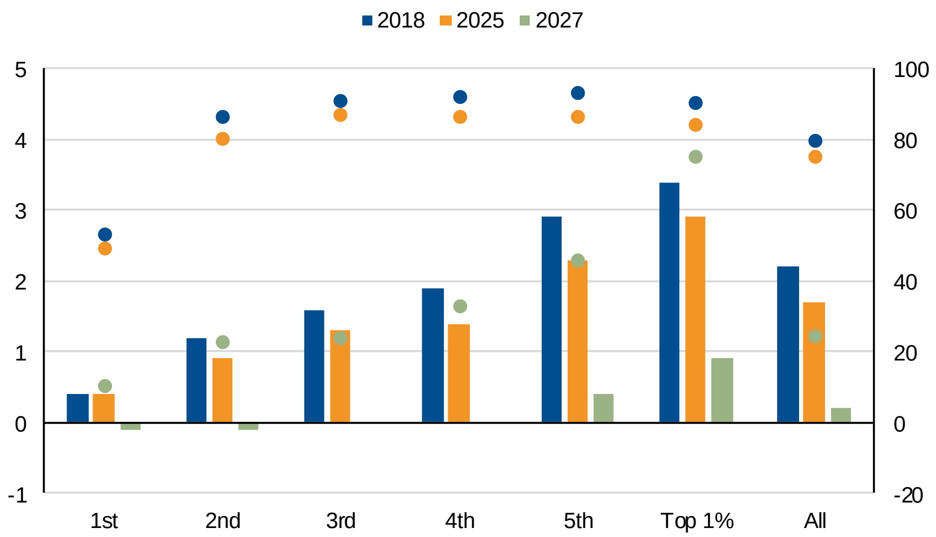
In this context, according to the Tax Policy Center, the TCJA is expected to increase after-tax income, on average, for all income groups in 2018 by 2.2%, in 2025 by 1.7% and in 2027 by 0.2%. On average, 80% of all taxpayers will benefit from the tax cuts in 2018 whereas by 2025 the share drops slightly to 76% and by 2027 again to 25%[15].

Higher income households to receive larger tax cuts

However, disparities by income groups are significant. In general, higher income households are likely to receive larger average tax cuts as a percentage of after-tax income, with the largest cuts as a share of income going to taxpayers in the top 1% of the income distribution[16]. Specifically, the bottom 20% are expected to see their after-tax income increase by about 0.4% in 2018 and 2025, but this may fall by 0.1% in 2027. In addition, only about 50% of taxpayers in the lowest quintile are expected to benefit from this tax cut. By contrast, the top 1% are expected to see their after-tax income increase by about 3.4% in 2018, 2.9% in 2025 and 0.9% in 2027. In addition, about 90% of taxpayers belonging to the top tax bracket will benefit in 2018 from tax cuts (85% in 2025 and 76% in 2027). These findings are similar to those of the JCT's analysis[17] but differ slightly from the Tax Foundation, which finds that, on average, the bottom 80% of taxpayers will see an increase in after-tax income ranging from 0.8% to 1.7%, whereas the top 1% is expected to benefit from a 1.6% increase in after-tax income[18].

Figure 5: Distributional impact of tax cuts by quintile

After-tax income change, % (LHS); Share of taxpayers receiving tax cut, % of total (RHS)



Source: Tax Policy Centre; Quintiles: 1st < 20,000; 2nd < 48,600; 3rd < 81,100; 4th < 149,400; Top 1% < 732,800.

[14] IMF, 2017 Article IV Consultation United States, IMF Country Report No. 17/239.

[15] The size of the average tax cut as a share of after-tax income decreases in 2025 as the tax system is indexed to the slower-growing chain-weighted consumer price index and due to the phase-out of certain business tax cuts, and phase-in of certain business tax increases. By 2027 most benefits will have expired. http://www.taxpolicycenter.org/publications/distributional-analysis-conference-agreement-tax-cuts-and-jobs-act/full

[16] However, higher-income taxpayers may be adversely affected by limits to the application for the mortgage interest deduction which for married couples filing jointly will be reduced to USD 750,000 down from USD 1mn as well as a cap to the deduction for state and local taxes (SALT) of USD 10,000.

[17] https://www.jct.gov/publications.html?func=startdown&id=5054

[18] https://taxfoundation.org/final-tax-cuts-and-jobs-act-details-analysis/

Scope believes that these distributional effects are unlikely to lead to greater consumption spending going forward given that the marginal propensity to consume of wealthier income groups is smaller compared with those of lower income households.

TCJA also affects politically sensitive health-care issue, exacerbating polarisation in Congress

Finally, the JCT estimates exclude the distributional impact due to the repealing of the Affordable Care Act's individual mandate, which will take effect in 2019. According to the CBO this measure is likely to reduce federal deficits by around USD 338bn from 2018 to 2027, but may leave 13 million people without insurance, whilst pushing up premiums by an average of around 10%[19]. This is mostly due to healthier people no longer being required to obtain insurance and because the resulting increase in premiums is expected to reduce demand. Given that not a single Democrat voted for the bill in either the House or the Senate[20], and the fact that the TCJA is expected to reduce insurance coverage provided by the Affordable Care Act – a key achievement for Democrats – Scope expects the TCJA to exacerbate the already strong political polarisation in the US government.

[19] https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/53300-individualmandate.pdf

[20] On December 20, Congress passed the bill by party-line votes in the Senate (51-48) and House (224-201) with no Democrats supporting the bill.

Annex I: The Tax Cuts and Jobs Act

Personal taxes

The law lowers the income bands and applicable tax rates. In addition, the law raises standard deductions, suspends personal exemptions, raises child tax credits, limits the application for the mortgage interest deduction for married couples filing jointly to USD 750,000, down from USD 1mn, caps deductions for state and local taxes at USD 10,000, suspends a number of miscellaneous itemised deductions and temporarily raises estate tax exemptions. Permanent changes include the replacement of the CPI for all urban consumers with the chain-weighted CPI-U for tax indexing. THE CPI-U considers changes consumers make to their spending habits in response to price shifts and tends hence to change more slowly than the standard CPI, reducing bracket creep. The law also permanently removes the individual mandate, a key provision of the Affordable Care Act, which may increase insurance premiums and significantly reduce the number of people with coverage. The individual mandate provided for tax penalties for individuals who do not obtain health insurance coverage. Finally, the law eliminates the deductibility of alimony payments.

Corporate taxes

The TCJA reduces permanently the federal corporate tax rate from 35% to 21%. Combined with the average of state and local corporate tax rates, the U.S. statutory rate is estimated to fall to 26.5%. This puts the United States below the weighted average of EU countries, 26.93%, and well below the current weighted average of OECD economies, 31.39%[21]. However, the effective corporate tax rate, that is, the percentage of income from a marginal investment that must be paid in corporate income taxes was 18.6% in 2012, above Germany (15.5%) and France (11.2%) according to the CBO[22]. The law allows full expensing of short-lived capital investments for five years, creates a 20% deduction for pass-through income affecting sole proprietorships, partnerships and S-corporations, limits net interest deduction to 30% of EBITDA for the first four years, and thereafter caps it to 30% of EBIT and enacts a repatriation of overseas profits at a rate of 15.5% for cash and equivalents and 8% for reinvested earnings. The law introduces a territorial tax system under which only domestic earnings are subject to tax.

[21] https://taxfoundation.org/tax-cuts-and-jobs-act-corporate-tax-rate/
[22] https://www.cbo.gov/sites/default/files/115th-congress-2017-2018/reports/52419-internationaltaxratecomp.pdf

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