Comments on Fiscal Policy

Tax Policy

As the new 115th Congress begins to legislate, tax reform is high on its agenda. It is difficult at this time to know how it all will end up, but we can start with a "better way" for the House GOP Tax plan. Cutting the corporate income tax rate from 35% to 20% sounds really good, but this writer is appalled by the many details. The plan includes a border adjustment or a destination cash flow tax of 20%. Don't call it a tariff! The gross value of all imports, both intermediary and final goods, will be taxed 20%. **The exchange rate adjustment argument for such a tax is a fallacy** and is based on faulty assumptions.

The annualized nominal value of all imported goods during the third quarter of 2016 was $2.222 trillion dollars and services were $512 billion. With a GDP of $18.651 trillion, the 20% import tax **will add to the inflation rate** by more than 1% after it is enacted. This would most likely be a one-time adjustment and is a conservative estimate since services are not included and GDP is used rather than just final consumption. What will the Fed do if inflation is approaching 3% or more during 2017?

Closer to home, **what happens to cap rates on real estate when interest costs are not deductible?** Full deductibility of capital costs rather than depreciation and interest can create initial NOL's to help in the future (but not the past) and the little NOL buggers can grow "by a factor reflecting inflation and the real return of capital". What does that mean?

The 1986 tax act had a large impact on real estate over many years after its passage. 2017 could be the same.

Infrastructure

Infrastructure is also a legislative outcome. There are deficit hawks and supply-side views that want to decrease annual deficits while simultaneously cutting tax rates. There are Keynesians that would prefer government spending on infrastructure that increases the national debt. Legislative outcomes take time. It is expected that this outcome will not be known until mid-2017 at the earliest, so any fiscal policy stimulus most likely will not have an impact during at least the first half of 2017.

Given the current size of nominal GDP, **a government spending increase of $100B…solely financed by debt issuance…and a need to continually spend at that rate in future years will initially increase GDP by one-half of 1% in the first year only.** An expectation of greater or future GDP growth is solely predicated on any **multiplier effect** of the spending increase. Therefore, just plug in the eventual dollar amount of increased infrastructure spending ($ x billion) when it is known and the first round effect is y%. Future effects depend on the multiplier (MPC).

$$\left(\frac{\$\ x \text{ billion}}{\$100 \text{ billion}} \text{ X } 0.5 \right) = y\%_{t} \ ; \ (y\,\% \text{ x MPC})_{t+1} = y\%_{t+1}$$

For those that prefer reduced deficits and lower taxes, the impact on GDP is predicated on the **propensity to consume or save** the after-tax income increase. In last year's comments on Friedman's permanent income hypothesis, this propensity depends on how a society is structured and exactly who gets the tax savings. Additionally reduced deficits and lower taxes have offsetting impacts on economic growth.

Fiscal policy legislation is unknown at this time. Any impact on economic growth is dependent on what is enacted and when. Direct government spending on infrastructure has the most direct impact on aggregate demand and economic growth (the initial MPC is one). Reduced taxes and deficits have less of an impact.

The rocket scientists who designed the "better way" perhaps did not mean it was better for everyone. It is certainly not a Pareto solution. The "better way" seems to be **a reallocation of tax burden from corporations to consumers, by increasing prices** and decreasing real incomes in the short run.

Our clients ask for ideas…but remember the above is based on plans for of future policy, not policy actually implemented.