The Intelligence Report

Our views on the latest investment events - FOR PROFESSIONAL INVESTORS - 03 April 2017

Overview

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In one of the more surprising developments in a six month period which has been, in itself, packed with surprises, the American Health Care Act, the Republican's alternative to Obamacare, was pulled from a House Vote late on Friday, March 24. This effectively kills off the Trump administration's attempt to repeal and replace Obamacare, one of the central pillars of President Trump's election campaign. The political and market implications of this unexpected setback are explored by Steve Friedman in this week's lead article.

US tax policy in the aftermath of the AHCA

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President Trump suffered a stinging defeat in the decision to withdraw the American Health Care Act (AHCA) from a vote in Congress. This outcome effectively shelves for the time being any concerted effort to repeal and replace the Obama administration's signature Affordable Care Act (ACA). Presidents suffer legislative setbacks all the time. But it is truly remarkable that such a setback should occur when the president's own party controls both houses of Congress, when the effort is intended to make good on a campaign promise of the president and the party's representatives in Congress, and when the initiative was the new president's very first effort.

So what does this early defeat mean for Trump's pro-growth agenda, and for tax reform in particular? Will it prove to be the first of many legislative failures, with the Trump team and the Republican leadership in Congress unable to hold together a fractious majority to pass major tax and spending legislation? Or was it merely a stumble, from which the administration can quickly right itself? I subscribe to the second of these views, and believe the probability of legislation by the end of this year to cut corporate taxes to be higher now than before the AHCA's defeat. This is because the Trump team will now pivot from health care to their pro-growth agenda of tax cuts, infrastructure spending, and deregulation. They will probably seek a quick, high-visibility win that they can claim supports job growth and Trump's "Make America Great Again" agenda. And the greater urgency placed on a fiscal policy victory implies keeping tax reform simple so as to increase the probability that the legislation can make it through both the House and Senate. The implications are as follows:

- The administration will have little appetite for controversial, comprehensive tax reform with uncertain prospects for passage through Congress, in particular the move to a destination-based cash flow tax system and the border adjustment provision contained in Speaker Ryan's tax reform blueprint.
- Instead of reform, look for an emphasis on tax cuts. But without the revenue-boosting effects of the border adjustment provision, tax cuts will be less aggressive than the Ryan plan originally proposed.
- To bolster prospects for smoother sailing through Congress (including reliance on the reconciliation process), Republicans may decide to focus just on corporate tax cuts, delaying personal tax cuts until after the mid-term elections (or perhaps indefinitely).
- With a focus on tax cuts instead of tax reform, Republicans will likely be more willing to make the cuts temporary so they can rely on the filibuster-proof reconciliation process.

There is also the possibility that President Trump could choose to ignore the demands of fiscal conservatives in the Republican Party and aim for deeper tax cuts by working across the aisle with Democrats, perhaps appealing to them by making tax cuts less regressive and seeking common ground on infrastructure spending. But I see this outcome as unlikely. The Democratic base has been invigorated by the administration's failure on health care, and they will reward their representatives who continue to oppose President Trump's agenda. For Democrats in Congress, the path to winning re-election likely lies through opposition, rather than compromise.

Despite the pivot to tax cuts and a desire for a relatively speedy legislative victory, the heavy lifting on tax policy probably won't start until May because between now and then, there is the slight matter of whether a government shutdown can be avoided. The current Continuing Resolution (CR) – a funding measure that maintains pre-existing government spending levels when Congress fails to pass regular appropriations bills – expires on 28 April. And because there is a two-week Congressional break in the middle of April, there are now only ten working days left before the CR expires and a government shutdown occurs. It is very possible that a new CR to fund the government for the rest of the fiscal year will not be passed until just before the expiration of the current CR.

Once an agreement to fund the government is reached and the serious work on tax policy gets under way, Republicans in Congress will pass a budget resolution to kick off the filibuster-proof reconciliation process. Drafting the budget resolution could take until mid-May, after which drafting of the bill will begin. Then figuring in a conference to reconcile differences between House and Senate versions of the bill, scoring by the CBO, and possible re-drafting, it is quite easy to see how enacting even simpler tax cuts (as opposed to a tax system overhaul) will slip well into the second half of the year.

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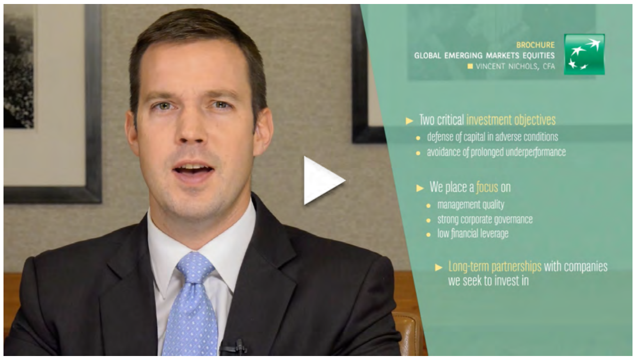

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