First Trust
Monday Morning OUTLOOK

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630-517-7756 • www.ftportfolios.com August 8 2022

Tax Hikes: Bad, But Bearable

With the Senate having passed a budget plan yesterday with only Democratic votes as well as a tie broken by Vice President Harris, it is only a matter of time before President Biden signs the first significant tax hike since the "Fiscal Cliff" tax hike in early 2013. What's important to keep in mind is that it could have been worse…much, much worse.

President Biden originally set out to raise the top tax rate on regular income to 39.6%. That didn't happen. Biden wanted to raise the top tax rate on long-term capital gains and dividends to 39.6% (versus a current 20%). That didn't happen. He wanted to get rid of the step-up basis at death. Nope. He wanted to raise the regular corporate tax rate to 28% (versus the current 21%) and tax "carried interest," as well. Again, no dice.

Compared to what the President sought, the tax hike we're soon getting is a shadow of its former self. But that doesn't mean it's good for the economy. The three most prominent sources of more government revenue will be a new 15% minimum tax on the book profits of large publicly-traded companies, beefed-up IRS enforcement against the middle class, and a new 1% tax on stock buybacks.

Although these changes are not, all by themselves, going to throw the economy into a recession (monetary policy eventually getting tight should generate a recession all by itself!), that doesn't mean the tax changes are good ideas.

Take the new 15% minimum tax on companies. Essentially, Congress is outsourcing tax policy to FASB, the Financial Accounting Standards Board, which is a private organization that develops accounting standards. Meanwhile, companies that might be affected by this tax will find ways to avoid it, for example, by reorganizing so tax deductions are taken by more profitable spin-offs that are going to pay taxes above the minimum anyhow.

The 1% tax on stock buybacks is another new and bizarre policy change. The theory is that companies should be using that money for business investment, not buybacks. But if a company is generating more cash flow than it can effectively invest, then a buyback is better than just having the money sit in the corporate treasury, where bad managers might use it for empire building, unprofitable investments or even to boost their own pay.

Moreover, many of the political advocates for a buyback tax claim they want fewer large companies dominating markets. But slowing buybacks means big incumbent companies have more of a reason to simply keep cash on their own books, instead of distributing it to shareholders who can then, if they want, invest more in newer upstart companies.

The good news is that, just like with the 15% minimum tax, companies can adjust their behavior to avoid the new tax on buybacks, for example, by raising dividends. This is also why Congress is probably over-estimating the revenue the new law is going to generate.

We're also highly skeptical the federal government will hit its revenue projections for the next fiscal year and beyond. This year there's been a surge in tax revenue, a side-effect of all that temporary COVID-related stimulus in 2020-21, creating a feedback loop of borrowing, printing, and spending that also created illusory tax receipts. As a result, the budget deficit in the past twelve months is actually slightly *smaller* than it was in the twelve months prior to COVID. But, as the economy slows, and the artificial stimulus wears off, revenue growth will slow, and, when a recession eventually hits, could easily turn negative.

The bottom line is that this budget deal will raise spending and tax rates over the next decade, and this is bad for the economy's long-term growth potential. But we've had much larger tax hikes in the past and survived. Yes, we're headed for a recession, but investors should be much more worried about how tight monetary policy needs to get, not the current tax hike.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
8-9 / 7:30 am	Q2 Non-Farm Productivity	-4.6%	**-5.1%**		-7.3%
7:30 am	Q2 Unit Labor Costs	+9.5%	**+10.3%**		+12.6%
8-10 / 7:30 am	CPI – Jul	+0.2%	**+0.3%**		+1.3%
7:30 am	"Core" CPI – Jul	+0.5%	**+0.5%**		+0.7%
8-11 / 7:30 am	Initial Claims – Aug 6	265K	**258K**		260K
7:30 am	PPI – Jul	+0.2%	**+0.3%**		+1.1%
7:30 am	"Core" PPI – Jul	+0.4%	**+0.4%**		+0.4%
8-12 / 7:30 am	Import Prices – Jul	-0.9%	**-0.3%**		+0.2%
7:30 am	Export Prices – Jul	-1.0%	**+0.3%**		+0.7%
9:00 am	U. Mich Consumer Sentiment- Aug	52.5	**51.5**		51.5