On Wednesday, Sept. 27, the U.S. Treasury Department published the long-anticipated tax reform framework formulated by the White House, the House Committee on Ways and Means, and the Senate Committee on Finance. For GOP officials, it came not a moment too soon. The Trump administration and members of the Republican Party are desperate for their first legislative ‘win.’

The end of 2017 is rapidly approaching. Entering a new year after effectively wasting the first one would not be a good look for GOP leadership, especially with the midterm election cycle ramping up.

The key aspects of the GOP’s tax reform proposal (called the “Unified Framework for Fixing Our Broken Tax Code”):

1) Reduce the number of tax brackets from seven to three (12 percent, 25 percent, 35 percent), double the standard deduction, and increase the child tax credit
2) Eliminate the death tax and alternative minimum tax
3) Lower taxes for U.S. corporations (from 35 percent max to 20 percent) and lessen the burden on small businesses
4) Grant a tax holiday to encourage repatriation of U.S. cash ‘trapped’ overseas by existing punitive tax treatment of multinationals’ profits (U.S. Department of the Treasury)

Several aspects of the proposal will enjoy bipartisan support. U.S. corporations currently face the highest top corporate tax rate in the developed world. Even though corporate tax deductions and credits ultimately reduce most U.S. companies’ tax bill, these liabilities are still a significant point of pain. Both sides of the aisle agree that lower corporate taxes could supply a much-needed boost for domestic growth. Also, the idea of a repatriation holiday should receive broad-based backing, depending on the terms of the tax break. Congress will expect companies to deploy the repatriated funds toward new hires, capital investment, and research and development initiatives. The last major repatriation holiday occurred in 2004. Post hoc studies showed much of the cash brought home was ultimately used for share buybacks and other strategies with minimal impact on domestic growth (Dharmapala, Foley, Forbes, 2010). Congress will need to feel confident the repatriated funds will find a productive use this time around before signing off.

The recommended tax reforms for individuals and families will face more scrutiny. At first glance, it appears the three simplified tax rates raise taxes on the country’s lowest earners and lower them for top earners. More deductions and credits could theoretically decrease the total tax burden within the lowest bracket, but some Congressional Democrats will still attack the optics of the new structure. Those lawmakers will not allow even the perception of siding with America’s wealthiest demographics after years of railing against accommodations for the ‘1 percent’ and growing income inequality. The framework does leave open the possibility of creating a fourth, higher tax bracket to apply to tip-top earners. This could quickly become a bargaining chip for pushing through the suggested 12 percent, 25 percent, and 35 percent rates. Furthermore, lawmakers will have to hammer out the income thresholds assigned to each bracket. The framework doesn’t explicitly say who will be taxed what. On the ledger, the lower taxes will significantly reduce direct federal revenues. How much of household incomes are progressively taxed at 12%, then 25%, then 35% will be intensely debated. Each ‘tweak’ to the income thresholds has a major effect on federal revenues either raised or forgone.

Still, this initial proposal from GOP leadership suggests the most transformative changes to the U.S. tax code in decades. It frees up cash that could help start new projects, fuel new technological advancements, and inspire greater productivity. It could untether thousands of dollars in many U.S. households to spend on goods and services – the primary driver of GDP. But will the greater disposable income really be spent or simply sheltered away under mattresses? For it to be injected into the economy,
producers and consumers need to feel good about current and future economic conditions. The University of Michigan Consumer Sentiment Index is within a stone’s throw of a 17-year high (Bloomberg). The all-time highs in U.S. equity markets foster good vibrations as well. Recently, Moody’s Analytics reported only a 10 percent probability of a recession in the next six months based on their research. Statistics like these suggest the time is now to unleash fiscal stimulus.

Seeing reform details on paper is energizing U.S. markets, particularly fixed income. Lower tax rates on corporations and individuals are inflationary in nature. In theory, it increases the money supply and encourages more spending. In turn, this should drive prices higher through greater demand. The historical relationship between looser fiscal policy and faster growth is pulling U.S. yields higher right now, particularly in the long end of the yield curve. The 30-Year U.S. Treasury bond (UST 30) is the main gauge of long-term inflation expectations. Higher yields suggest greater potential for higher prices in the future. The release of the tax reform framework has pushed UST 30 yields to a two-month high. Much like we saw after President Trump’s victory last November, traders are reacting to a new, potential source of economic activity. Whether the recent move to higher rates continues will depend on whether or not the framework can become legislation similar to its current form. That is what we must closely watch in the weeks ahead. A more tepid final version of tax reform would likely spell disappointment (i.e., a risk-off move) in capital markets. Also, can Congress offset the federal deficit the lower taxes will create? If it relies on increased borrowing (i.e., intermediate and long U.S. Treasury debt issuance) to close the gap, that could support higher rates based on a more robust supply outlook.

Putting forth a tax reform plan is the first step towards what could be major change. As Chinese philosopher Laozi said in the 6th century B.C., “A journey of a thousand miles begins with a single step.” The U.S. has struggled with the slowest post-recession rebound on record. Rebounding from the throes of the harshest downturn since the Great Depression should result in a faster pace of recovery – not slower. Legislators have the opportunity to answer the calls of the Federal Reserve for adding fiscal stimulus just as the limitations of monetary policy have been reached. Yellen & Co. want to get out of the accommodation game. They are strongly signaling a preference to gradually raise short rates (they still project a December hike) and reduce their U.S. Treasuries and mortgage-backed securities holdings (reducing the Fed’s $4.5 trillion balance sheet commences this month). A friendlier federal tax environment may harness the power to push the recovery into the higher gear that has eluded it for almost 10 years.

But we won’t know until we try.