TAX CUTS AND CONSTRUCTION

There is a lot of excitement among businesses about the direction of tax reform under President Trump, but the actual impact that the proposed changes would have remains ambiguous.

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Business is excited. A combination of hard and soft data suggests that corporate America's businesspeople are delighted by the new presidential administration's pro-business agenda, which includes a combination of deregulation, altered approaches to trade and immigration, a possible infrastructure spending-led stimulus package, potential health-care legislation, and, of course, tax cuts and tax compliance simplification. Investors have been positively ebullient since shortly after the presidential election transpired, with the NASDAQ and other indices routinely shattering previous highs.

Businesspeople are expressing greater confidence regarding their own prospects as well as the broader economy. A recent survey (soft data) conducted by the National Association of Manufacturers indicated that fully 93 percent of manufacturing executives are optimistic about the future of the economy.[1] As early as December 2016, a gauge of small business confidence generated by the National Federation of Independent Business had risen to a 12-year high.[2] Other data, including hard data pertaining to investment in nonresidential structures, indicates that some economic actors have already stepped up their rates of investment in the context of what they perceive to be a more advantageous business climate.

Perhaps nothing has captured the imagination of corporate America as much as plans to slash corporate taxes and to vastly simplify the nation's personal income tax regime. The Trump administration has repeatedly stated a desire to reduce the corporate tax rate from 35 percent to 15 percent.[3] Many observers suggest that this is merely the administration's opening gambit, with the goal being to reduce the U.S. corporate tax rate as much as possible, perhaps to around 25 percent. Time will tell.

The impact of tax cuts on construction spending is ambiguous

Although there is much anticipation in corporate America, the impact of tax cuts on construction spending is unclear. Theoretically, tax cuts should boost pri-

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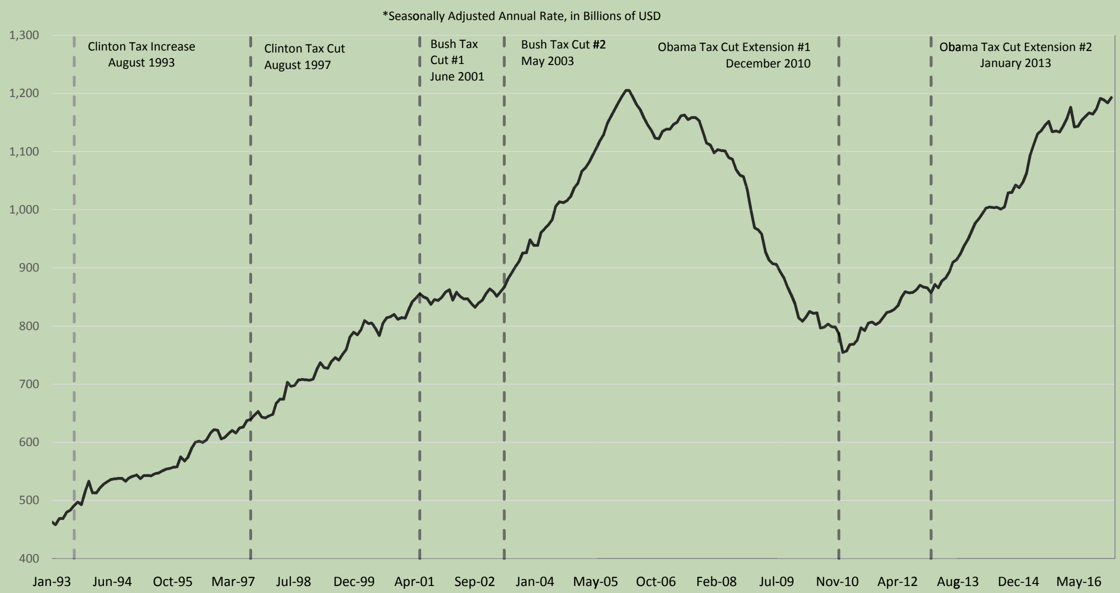
EXHIBIT 1 Total U.S. Construction Spending, 1993 to 2017*



vate construction spending. After all, with corporate cash flow enhanced, companies have more money to spend on many items, including construction. Moreover, lower tax rates increase the expected return on investment. That encourages greater risk-taking, which also positively correlates with private construction investment.

If the story ended there, the relationship between tax cuts and construction spending would be clear. But there are many countervailing forces at work. For instance, tax cuts in and of themselves do not create wealth. Initially, they are merely transfers of income from the public sector to private economic actors, whether corporations or households. To the extent that public sector funding is diminished, public construction spending is also likely to fall.

Some might point out that faster economic growth will expand tax bases and eventually replenish foregone public sector income. Perhaps. But this supply-side phenomenon is more likely to occur when tax rates are historically high, as they were when Ronald Reagan was first inaugurated, than when they are not.

The notion that the impact of tax cuts on construction spending is ambiguous is more than theoretical. For more than two decades, the U.S. Census Bureau has monitored the level of construction spending on a monthly basis.[4] Using these data, one can assess construction spending trends over time, including for both residential and nonresidential segments. This data series goes back to 1993, which is the year that President Bill Clinton raised taxes. If tax increases are bad for economic growth and for construction spending, one might have anticipated some poor economic outcomes thereafter. However, the economy performed brilliantly for the remainder of the decade, and construction spending continued to expand. A tax cut took place in August 1997, but any acceleration in the pace of construction spending can easily be explained by the tech boom of the late 1990s, which may have transpired even in the absence of the Taxpayer Relief Act of 1997.

The administration of George W. Bush cut taxes in 2001 and in 2003. There was an enormous surge in construction after the second tax cut, which lent credence to the idea that tax cuts stimulate construction spending, particularly private construction spending. In that instance, much of the expansion was in the single-family housing market. However, by 2006, construction spending momentum was on the wane and eventually collapsed with the onset of the global financial crisis. Construction spending began to rise again roughly one and a half years after the end of the recession in mid-2009. However, this cannot be attributed to tax cuts, since the Obama administration merely extended the ones already in place and did not introduce any significant tax cuts of its own.

Conclusion

This is not meant to suggest that tax cuts have no impact — merely that the impact may not be enough to offset a host of other factors ranging from the trajectory of various asset prices to interest rates or other aspects of public policy, including those related to state and local governments. Accordingly, perhaps what construction industry stakeholders should be more interested in is the proposed infrastructure spending package, which would more directly and positively impact construction spending. However, the Trump administration appears poised to address tax issues first.

It is conceivable that if the Trump administration is successful in reducing corporate taxes and simplifying personal income taxes, there will be less money available to finance a public infrastructure package. Of course, if the administration is successful in creating a reduced tax rate for offshore profits and is able to leverage that capital to help finance infrastructure spending, perhaps the U.S. construction industry will ultimately derive benefits from both tax cuts and a plan to begin to rebuild America's shattered infrastructure. ■

NOTES

1 Drogus, J., "Manufacturers' optimism at 20-year high, according to new NAM survey," National Association of Manufacturers (March 31, 2017) (press release). Available at: http://www.nam.org/Newsroom/Press-Releases/2017/03/Manufacturers--Optimism-at-20-Year-High--According-to-New-NAM-Survey/.

2 Golle, M., U.S. small-business optimism index surges by most since 1980, *Bloomberg* (Jan 10, 2017). Available at: https://www.bloomberg.com/news/articles/2017-01-10/u-s-small-business-optimism-index-surges-by-most-since-1980.

3 Herschfeld Davis, J. and Rappeport, A., Trump is said to seek cutting corporate tax rate to 15 percent, *The New York Times* (April 24, 2017). Available at: https://www.nytimes.com/2017/04/24/us/politics/trump-corporate-tax-rate-15-percent.html.

4 "Construction spending," United States Census Bureau (2017). Available at: https://www.census.gov/construction/c30/c30index.html.