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Beware the Ides of April

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April 15th has come and gone, and now you know just how much your income taxes changed in the first year after enactment of the Tax Cut and Jobs Act. Were you surprised? Was it a happy or unhappy surprise?

Most employed Americans enjoyed slightly fatter paychecks in 2018, as employers generally trimmed the amount of income taxes withheld during the course of the year. But as Deborah Harry and Blondie predicted the IRS would say,

> *One way or another, I'm gonna get you …*
> *One day, maybe next year, I'm gonna get you …*
> *I'm gonna trick you!*

At first, I thought that my accountant was daft; my federal tax return required me to pay vastly more than he had forecast in our annual planning discussion early last year. After I regained my equilibrium, the accountant assured me that I'm not alone; almost every one of his (mostly affluent) clients was facing significantly higher income tax burdens than they had expected. A few phone calls among friends and coworkers confirmed that my accountant wasn't alone, either: We're all paying much higher taxes than we had expected to pay.

What happened, and what does it mean? One thing is clear: Many Americans were caught off-guard. Through the end of March, according to IRS data, total federal income tax refunds have dropped by more than $6 billion – about 3% – in comparison with the first quarter of 2018. The IRS issued about 1.6 million fewer refunds over the same period.[1] That's a lot of purchasing power unexpectedly drained from the economy.

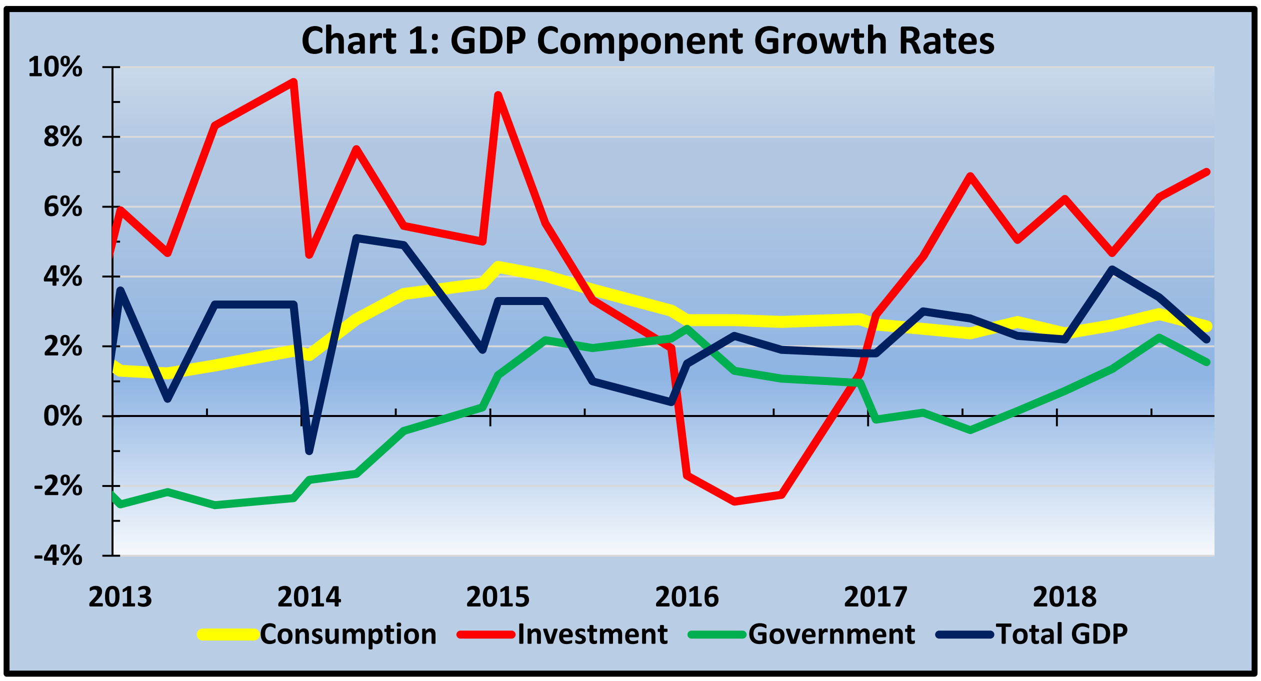
What is less clear is whether we are actually paying higher taxes than we did a year ago. The independent and non-partisan Tax Policy Center reported that only 6% of households had a higher effective federal tax rate for 2018 than they did in 2017,[2] but recent New York Times and Wall Street Journal / NBC News polls suggest that most Americans think they are paying more under the new tax law. Until the final statistics for the 2018 tax year are compiled, however, it will be impossible to know whether the combination of withheld taxes and paid refunds truly resulted in a net tax cut for consumers.

[1] If you wish to follow this data through the end of tax season, go to https://www.irs.gov/newsroom/filing-season-statistics-for-week-ending-march-29-2019 or subsequent weeks.

[2] See https://www.taxpolicycenter.org/model-estimates/individual-income-tax-provisions-tax-cuts-and-jobs-act-tcja-february-2018/t18-0026 for details.

The discrepancy between tax reality (we probably paid less) and perception (we think we paid more) is probably attributable to the way in which the TCJA was implemented. In early 2018, the IRS issued guidelines for employer withholding to reflect the new rates, and it seems clear in retrospect that the guidance was too generous. Had employers been guided to higher withholding rates through the course of 2018, our paychecks would have been smaller and our April refunds larger, in both cases more similar to the 2017 tax year experience.[3]

The issue is highly relevant as investors attempt to forecast the direction of the U.S. economy through the balance of 2019. We already know that the economy slowed materially in the second half of last year, as GDP growth slid from 4.2% in the June quarter to 2.2% by year-end (see Chart 1; the blue line represents total GDP growth). Most economists have anticipated further slowing in the quarter just ended, with consensus estimates hovering around 1.5%. Yet the consensus thus far has been that the economy will revive through the spring and summer, growing better than 2% for the full year after its slow start.

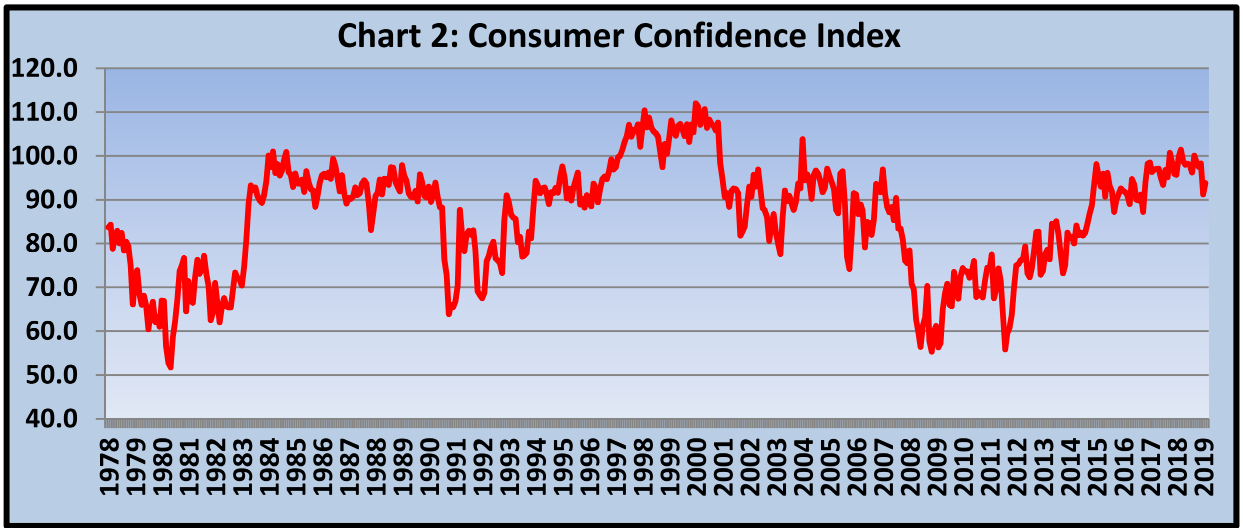


Source: U.S. Department of Commerce, Bureau of Economic Analysis

A deeper dive into the GDP data shows that the American consumer has been amazingly resilient through the ups and downs of the past few years. In Chart 1 above, it's evident that investment in long-lived assets (housing, automobiles, buildings, factory equipment, etc.) has been highly volatile, and government spending has been erratic; that's why the blue total GDP line looks so bumpy. Through it all, consumer spending (the yellow line, which represents more than 65% of the economy) has been growing steadily at around 3%.

[3] I will leave it to others to assess the IRS's motives for its erroneous guidance. The Trump administration conceivably could have encouraged smaller withholding amounts as a way of creating greater perceived take-home pay (and thus economic stimulus), or it could simply have guessed wrong on some of the relevant variables.

Steady consumer strength is hardly surprising. Consumer confidence remains at very high levels (see Chart 2), not least because unemployment remains at shockingly low levels: Weekly first-time jobless claims dropped to 196,000 last week, the lowest level in the past 50 years.[4] Incomes are finally growing in excess of inflation, too, for the first time in a decade: On top of 3.2% gains in hourly wages, we are also working longer hours and earning higher variable compensation (bonuses, commissions, stock grants, and so on). All told, total compensation is growing at about 5% in comparison to only 2% consumer price inflation.



Source: University of Michigan

But what if the newly-released tax data call into question the American consumer's continued resilience? Will consumers respond to the nasty surprises on their tax returns by raising the amounts they ask their employers to withhold? If so, the "tax cut" could actually lead to *lower* net paychecks this year, with a corresponding reduction in the types of discretionary spending that drive economic growth most effectively. If this scenario plays out, a recession may be closer to hand than many investors expect. In this respect, the mild dip in confidence evident in the past year (see the rightmost portion of Chart 2) may reflect consumers' recognition that the proverbial full glass can only get emptier.

Before jumping to that conclusion, however, one additional consideration is salient: Although the IRS hasn't released any detailed data yet, it seems reasonable to assume that the TCJA's cap on state and local tax deductions is the biggest reason that refunds have shrunk so markedly this year. This change primarily affects a relatively small number of high-income taxpayers in high-tax states like Massachusetts, New York, and California. These taxpayers typically don't live paycheck-to-paycheck; they spend smaller percentages of their income and correspondingly invest more. For these taxpayers, lower refunds might affect *investment* decisions, but the effect on *consumption* may be greatly ameliorated.

[4] Note that jobless claims (i.e., layoffs) are not reported as a percentage rate, but as an absolute number. The U.S. population has grown by more than 50% in the past half-century, and the work force has more than doubled in that time due to the large influx of women in the 1970s through the 1990s, yet we see fewer layoffs today than at any time since 1969; this is simply astonishing.

So maybe Deborah Harry (*ahem*, the IRS) was being quite selective in promising to "get you, one way or another" (through higher withholding or smaller refunds); maybe the only affected group consists of taxpayers least likely to change their spending behavior after they write big and unexpected checks to the IRS. We'll find out soon enough; in the meantime, we retain our faith in the American consumer's resilience and financial health.