Morgan Stanley

WEALTH MANAGEMENT

INVESTMENT STRATEGY

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US Policy Pulse

The Architecture of Tax Policy

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In this report, we discuss recent developments impacting the 2025 budget reconciliation bill, as well as the implications for tax policy, debt and deficits, and the markets.

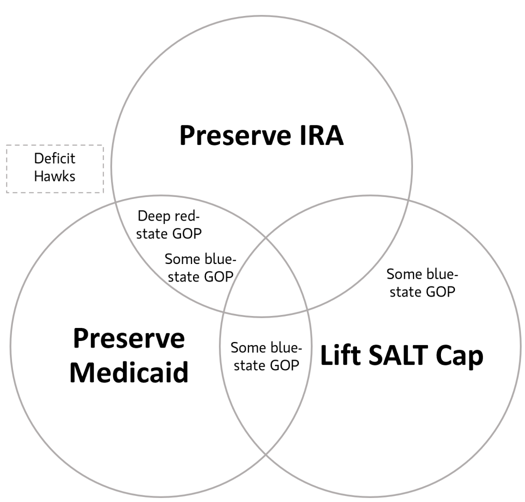
Key Insights:

- The Republicans' slim margins in Congress compel GOP leadership to find a balance among several different groups—namely, GOP fiscal hawks, members seeking to retain Medicaid spending, members seeking to increase the SALT cap and those looking to preserve clean energy tax credits.
- The House budget reconciliation bill provides for a net estimated deficit impact of $3 trillion over 10 years. The deficit and growth impacts are front-loaded in the first five years, while the spending cuts are back-loaded in the last five years.
- Greater deficit expansion could place upward pressure on term premiums and lead to higher-for-longer bond yields.
- The $3.7 trillion of tax cuts are focused on permanent extensions of the individual components of the TCJA, revival of the TCJA's pro-growth business provisions and new tax cuts such as those pertaining to President Trump's "no-tax" agenda.
- Offsets totaling an approximate $1.2 trillion mainly target climate initiatives, including quicker phaseouts of clean energy tax credits, and tighter Medicaid-related spending, which could impact health insurance coverage rates, as well as nonprofit hospital and state and local government credit quality.
- Despite policy headwinds, clean energy stocks have outperformed the S&P 500 Index this year by over 10%, supported by the bill's phased rollback of clean energy tax credits rather than an immediate one. Carveouts for nuclear energy could provide additional tailwinds for the alternative energy sector.
- Importantly, potential tax policy change favors industrials, communication services and energy stocks with elevated capex and revenues in the US.

A reconsideration of federal spending and approval of the budget have been top priorities for President Trump and the unified Republican Congress. From the introduction of the Department of Government Efficiency (DOGE) to the 2025 budget reconciliation bill negotiations, shrinking the federal footprint has been one of the primary drivers of recent policy change. While there have been notable efforts to reduce the federal labor force and cut programing, as well as agency mandates through DOGE, the vast initiative to meaningfully reshape government has yet to materialize, as federal unions and the courts have halted or reversed executive branch actions. For example, DOGE's initial goal was to cut $2 trillion from the deficit over a 10-year period. Currently, the nongovernment advisory committee has identified just $170 billion in estimated savings over the same time frame. The complexities of government administration and the rules that govern public finance decision making should not be underestimated.

This has become apparent not only within the bounds of executive branch actions but also when considering the congressional budget process. The 2025 budget reconciliation policy includes extension of the Tax Cuts and Jobs Act (TCJA) tax cuts and the addition of new tax cuts. Priorities also include government spending reductions to limit deficit expansion. These considerations have presented a unique set of challenges between GOP fiscal hawks, who are concerned with rising debts and deficit spending, and Republicans representing coastal districts, whose sights are set on increased state and local tax (SALT) benefits. The policy tensions are likely to result in more tempered tax reductions for both individuals and corporations and may require the introduction of revenue raisers and steep spending cuts to offset tax provisions. More specifically, a slim GOP margin of control in the House meant that Republican leadership is tasked with balancing deficit hawks' spending-cut goals with positions and priorities of other cohorts, including red state beneficiaries' desire to preserve aspects of the Inflation Reduction Act (IRA), resistance to deep Medicaid cuts from representatives of states heavily reliant on the program and coastal Republicans' goal of delivering tax relief through a higher SALT deduction (see Exhibit 1).

Exhibit 1: Four GOP Factions in Congress May Influence the Outcome of Tax Negotiations



Source: Morgan Stanley Wealth Management Global Investment Office as of May 20, 2025

While negotiations continue, the strategic inclusion of the debt limit in the budget reconciliation bill provides a deadline for the legislation's consideration, as Congress will be required to vote before the X-date, or potential date of default, is breached. We currently expect the X-date to occur between July and October of this year.

These competing forces and the final provisions in the bill could impact market performance and future debt and deficits. Here, we discuss the recent budget reconciliation bill framework, and highlight the most pressing market implications of potential changes to taxes, spending and debt.

Tax Cuts

According to the Congressional Budget Office (CBO), the latest version of the House budget reconciliation bill delivers roughly $3.7 trillion in tax cuts, offset by $1.2 trillion in spending cuts and revenue raisers, for a net estimated deficit impact of $2.3 trillion over a decade. However, we believe the deficit could be closer to $3 trillion, after considering economic impacts, tax interactions and interest expense (see Exhibit 2). That said, the bill may be altered through the rest of the reconciliation process, which could result in a different deficit impact. Having passed the House, the Senate will either approve it as is or go to conference with the House and reconcile the differences between their budget proposals. While lawmakers hope to send a final bill to the president by July 4, actual passage may extend beyond this date.

Exhibit 2: House GOP Reconciliation Bill Deficit Impact

House Committee	10-Year Deficit Impact (billion)
Agriculture	$238
Armed Services	-$144
Education & Workforce	$349
Energy and Commerce	$988
Financial Services	$5
Homeland Security	-$67
Judiciary	-$7
Natural Resources	$20
Oversight and Government Reform	$51
Transportation and Infrastructure	$37
Ways and Means	-$3,775
Subtotal, CBO	**-$2,305**
Interactions	-$200
Subtotal, Primary Impact	**-$2,505**
Interest Outlays	-$550
Estimated Total Deficit Impact	**-$3,055**

Note: Estimated impact includes dynamic scoring and interest outlays
Source: Committee for a Responsible Federal Budget, Joint Committee on Taxation, CBO, US House of Representatives, Morgan Stanley Wealth Management Global Investment Office as of May 20, 2025

In its current form, the legislation extends or expands the TCJA provisions set to expire at the end of 2025, including the individual tax rates, increased standard deduction, child tax credit, estate and gift tax exemptions and more (see Exhibit 3). The bill also alters the SALT deduction, a key component for gaining support from Republicans representing higher-tax states, by raising the individual cap from $10,000 to $40,000 per household, up to income of $500,000. We note, however, that the SALT cap or limits on earnings could change as negotiations continue. Other key tax cut provisions include President Trump's "no-tax" agenda, as well as a $4,000 benefit for seniors, both of which sunset after four years. Lastly, previously expired TCJA business provisions, which are considered the most pro-growth elements of the bill, have been revived. These include 100% bonus depreciation for equipment investment, immediate deduction of domestic research and development (R&D) expenses and looser business interest expensing through 2029, among other provisions.

Exhibit 3: Major Provisions in Budget Reconciliation Bill

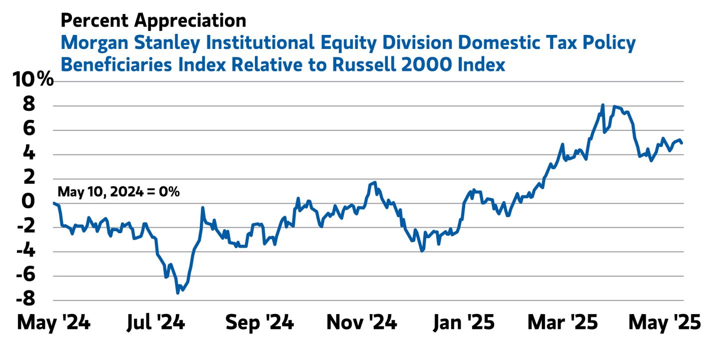
Policy
Extend and Expand TCJA Personal Provisions
Extension of all other TCJA personal provisions
Cap SALT at $40k, up to $500k income, increasing by 1% annually for ten years
Subtotal, Extend and Expand TCJA Personal Provisions
Revive TCJA Business Provisions
Revive bonus depreciation through 2029
Revive domestic R&E expensing through 2029
Revive looser interest limit through 2029
Extend lower international rates
Extend and expand opportunity zones through 2033
Subtotal, Revive TCJA Business Provisions
New Tax Cuts
No-tax agenda
Health savings account expansions
Establish "TRUMP Accounts"
Other individual tax cuts
Allow expensing of factories through 2028
Extend clean fuel tax credit through 2031
Other business and related tax cuts
Subtotal, New Tax Cuts
Offsets
Repeal EV tax credits; early phase-out of energy, production and manufacturing credits
Nuclear production carve-out
Foreign corporate retaliation tax
Reduce ACA overpayments and payments to certain individuals
Tighten Medicaid work requirements and eligibility
Expand executive compensation deduction limit
Increase college endowment tax
Impose remittance excise tax
Other revenue provisions
Subtotal, Offsets
Total

Source: Committee for a Responsible Federal Budget, Joint Committee on Taxation, US House of Representatives, Morgan Stanley Wealth Management Global Investment Office as of May 22, 2025

When considering the potential impacts of tax policy on market outcomes, it is first important to acknowledge that changes to marginal individual income and statutory corporate income taxes have little correlation with equity market performance. Our base case is that market performance is more strongly correlated with the business cycle than top-line tax policy changes. The S&P 500 Index has a weak correlation with individual income and corporate taxes since 1928, with a correlation coefficient of less than +/-0.1, a statistically insignificant relationship. Furthermore, since the 2025 tax cuts are primarily an extension of the current tax code, we expect changes to provide only marginal benefits to equity performance, with short-term market tailwinds when the budget finalizes.

That said, we expect some sector and industry winners to emerge, as the Morgan Stanley Institutional Equity Division Domestic Tax Policy Beneficiaries Index has outperformed the Russell 2000 Index by about 5% over the past year (see Exhibit 4). The Domestic Tax Policy Beneficiaries basket is composed of stocks positively exposed to domestic tax changes this year, including increased bonus depreciation and lower tax rates for US domestic firms, as well as stocks with elevated capex and revenues in the US. It includes sectors such as industrials, communications services and energy.

Exhibit 4: Investors Are Rewarding Stocks With Favorable Exposure to Pro-Growth Tax Changes



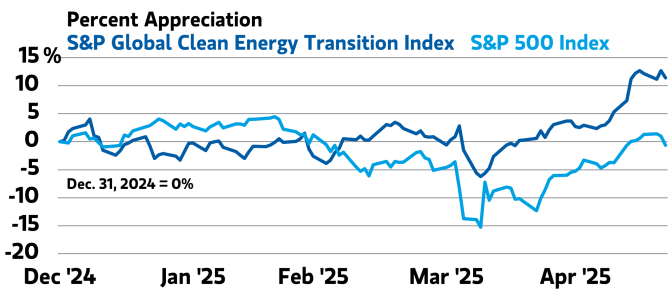
Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of May 20, 2025

Revenue Raisers and Spending Cuts

While prospects for tax cuts are top of mind for many investors, we must also consider the bill's revenue raisers and spending cuts, which the CBO estimates total approximately $1.2 trillion. The tax increases include a progressive excise tax rate on net investment income of university endowments and private foundations up to 21%, as well as a 3.5% excise tax on foreign remittance transfers. The bulk of the reconciliation bill's "pay-fors," however, come from spending cuts directed at the IRA, as well as Medicaid and Affordable Care Act (ACA) provisions. Changes to health insurance include reducing ACA overpayments, limiting Medicaid coverage and tax credits for certain individuals and implementing work requirements and eligibility checks, saving approximately $200 billion. The CBO estimates that these health care changes would reduce the number of people with health insurance by at least 8.6 million by 2034, impacting states such as New York, Louisiana and Washington the hardest. Reductions to Medicaid funding also shift the cost to state and local governments that may be burdened by increased health care costs. This may cause notable revenue losses for hospitals, potentially pressuring credit quality of both state and nonprofit health care municipal bonds.

The bill would repeal or phase out many of the IRA's clean energy tax credits, including for electric vehicles, home efficiency and production of hydrogen and clean electricity—saving over $560 billion over 10 years. We have [previously noted]() that attempts to rescind IRA funding is unlikely as it has benefited Republican states the most, with 84% of all funding going to Republican-controlled states and districts, and 73% of all active facilities located in Republican states, supporting local jobs and growth. The IRA's importance to these communities can be seen in the bill's phaseout approach to the clean energy tax credit provisions rather than an immediate repeal. The bill also includes a carve-out for advanced nuclear reactors and existing nuclear facilities, extending tax credits for six years. That said, clean energy stocks have outperformed the S&P 500 by over 10% this year, though expectations have been tempered in recent days due to accelerated phaseouts emerging from negotiations (see Exhibit 5).

Exhibit 5: Clean Energy Stocks Have Outperformed the Market This Year

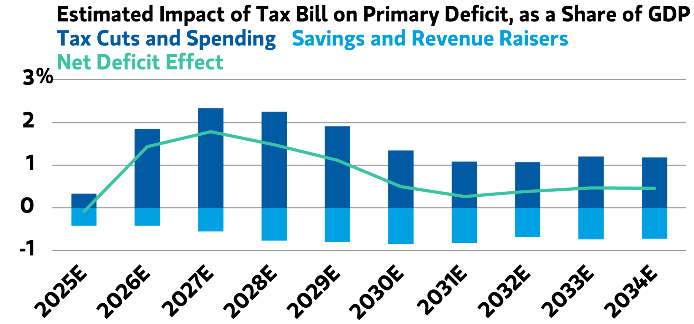


Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of May 21, 2025

Debt and Deficits

The impact of the budget, which appears positioned to increase both the primary deficit and government interest expenses, is especially important to consider amid a hawkish fiscal policy environment. The bill adds approximately $3 trillion in deficit spending over the 10-year budget window, based on dynamic scoring and accounting for interest expense. However, deficit borrowing is nuanced. Deficit impacts and new borrowing are heavily front-loaded, with business tax cuts and the "no-tax" provisions expiring in 2029, while offsets are back-loaded. Without using dynamic scoring, the CBO estimates that of the $2.3 trillion deficit increase, 74% will take place in the first five years, during which 26% of the offsets will likely be accumulated. To illustrate this, we see that the first five years have the greatest deficit impacts, peaking at roughly 1.8% of GDP in 2027E, which is the first year that the bill's policies will be fully in effect (see Exhibit 6). Once again, we note that we could see significant changes to provisions, timing and scoring of the final bill as it progresses through the Senate.

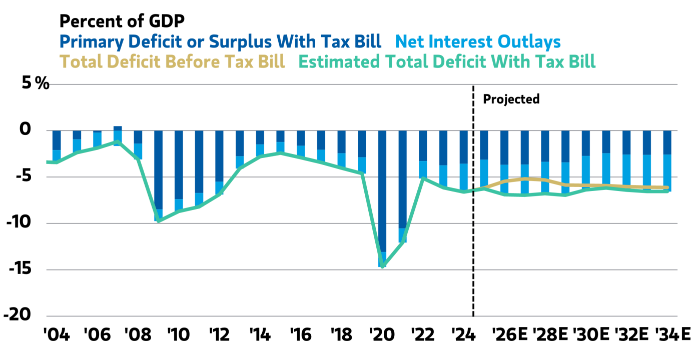
Exhibit 6: Deficit Impact Peaks in 2027E as Tax Cuts Are Front-Loaded and Offsets Are Back-Loaded



Source: Pantheon Macro, Morgan Stanley Wealth Management Global Investment Office as of May 20, 2025

According to a January CBO report, net interest outlays could account for nearly 65% of the federal deficit by 2034E, with the total deficit reaching 6.1% of GDP the same year. When factoring in current estimates, the budget reconciliation bill could cause the total deficit to increase to approximately 6.6% of GDP by 2034E (see Exhibit 7). Importantly, that does not reflect the impact of interest expense accruals resulting from potential new debt issuance.

Exhibit 7: The Total Deficit Could Increase to 6.6% of GDP by 2034E With the Budget Reconciliation Bill



Source: Congressional Budget Office, Pantheon Macro, Morgan Stanley Wealth Management Global Investment Office as of May 20, 2025

The continuation of elevated debt and deficits may drive elevated term premiums as investors demand greater compensation for taking on greater risk and could lead to higher-for-longer rates, as more US Treasury supply hits the market. The effect of the supply increase is critical, as the demand side of the equation, signified by foreign holdings of US Treasuries as a percent of total US debt, has fallen modestly over the same period (see Exhibits 8a and 8b). This indicates that the magnitude of Federal Reserve balance sheet growth in recent years is reinforcing the current high-rate environment through added term premium. Relatively stable investor demand likely indicates that higher US Treasury rates are not primarily attributable to an investor flight from US Treasuries. That said, should foreign holdings of US Treasuries meaningfully decline, the term premium may experience further upward pressure.

Exhibit 8a: Federal Reserve Balance Sheet Puts Upward Pressure on Term Premium

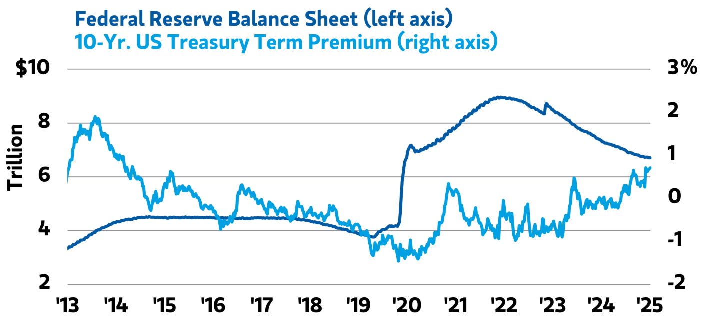
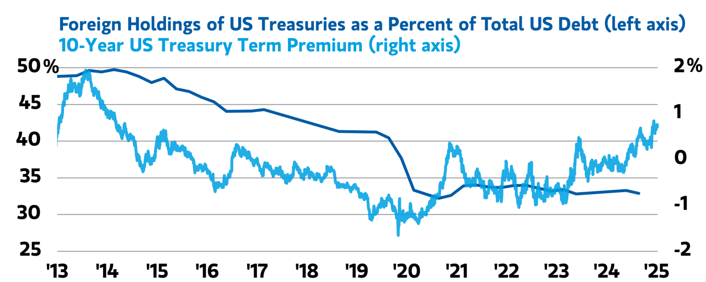


Exhibit 8b: Foreign Investor Participation Remains Stable, Yet Term Premium Rises



Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of May 20, 2025

Growing debt and deficits underscore Congress' heightened budgetary constraints. While we expect notable additions to the deficit, tariff revenues, which are not included in the budget reconciliation process, could serve as a partial offset. The Trump administration has prioritized the use of tariffs partly for their revenue-raising abilities. Under the current framework, it is estimated that a 10% universal tariff, with 34% on China, along with industry-specific tariffs on autos, steel and aluminum, could raise approximately $2 trillion in revenue over 10 years, in turn reducing deficit spending to roughly $1 trillion, assuming a $3 trillion deficit increase from the bill. That said, trade negotiations are ongoing and dynamic, with the potential for much lower revenue than current projections. Regardless of potential revenue offsets, the ballooning US deficit will need to be factored into future budgetary decisions, as tighter fiscal policy parameters limit legislators' ability to respond to potential economic weakness and crowd out other spending and priorities.

Investment Conclusion

As congressional Republicans press forward with the budget reconciliation tax bill, GOP leadership must strike a delicate balance among deficit hawks and those members seeking to retain Medicaid spending, increase the SALT cap and/or preserve the clean energy tax credits. The legislation's $3.7 trillion in tax cuts, focused on extending and reviving TCJA provisions and adding new relief measures, is offset by $1.2 trillion in spending cuts largely targeting health programs and climate initiatives. The total $2.3 trillion of deficit over 10 years, which we believe could be $3 trillion after taking into account economic impacts, tax interactions, and outlays, could push the total deficit to 6.6% of GDP by 2034E. With deficit impacts front-loaded and offsets back-loaded, the bill may continue driving elevated term premiums and a higher-for-longer interest rate environment. For investors, this backdrop favors US-focused, domestic tax beneficiaries in certain parts of the industrials, communication services and energy sectors. Clean energy stocks, meanwhile, have outperformed the broader market this year due to a phaseout of tax credits in the bill, rather than abrupt repeals.

Disclosure Section

Index Definitions

For index, indicator and survey definitions referenced in this report please visit the following:

https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

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General: Hypothetical performance should not be considered a guarantee of future performance or a guarantee of achieving overall financial objectives. Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

Hypothetical performance results have inherent limitations. The performance shown here is simulated performance not investment results from an actual portfolio or actual trading. There can be large differences between hypothetical and actual performance results.

Despite the limitations of hypothetical performance, these hypothetical performance results may allow clients and Financial Advisors to obtain a sense of the risk / return trade-off of different asset allocation constructs.

Investing in the market entails the risk of market volatility. The value of all types of securities may increase or decrease over varying time periods.

This analysis does not purport to recommend or implement an investment strategy. Financial forecasts, rates of return, risk, inflation, and other assumptions may be used as the basis for illustrations in this analysis. They should not be considered a guarantee of future performance or a guarantee of achieving overall financial objectives. No analysis has the ability to accurately predict the future, eliminate risk or guarantee investment results. As investment returns, inflation, taxes, and other economic conditions vary from the assumptions used in this analysis, your actual results will vary (perhaps significantly) from those presented in this analysis.

The assumed return rates in this analysis are not reflective of any specific investment and do not include any fees or expenses that may be incurred by investing in specific products. The actual returns of a specific investment may be more or less than the returns used in this analysis. The return assumptions are based on hypothetical rates of return of securities indices, which serve as proxies for the asset classes. Moreover, different forecasts may choose different indices as a proxy for the same asset class, thus influencing the return of the asset class.

Glossary

Correlation This is a statistical measure of how two securities move in relation to each other. This measure is often converted into what is known as correlation coefficient, which ranges between -1 and +1. Perfect positive correlation (a correlation coefficient of +1) implies that as one security moves, either up or down, the other security will move in lockstep, in the same direction. Alternatively, perfect negative correlation means that if one security moves in either direction the security that is perfectly negatively correlated will move in the opposite direction. If the correlation is 0, the movements of the securities are said to have no correlation; they are completely random. A correlation greater than 0.8 is generally described as strong, whereas a correlation less than 0.5 is generally described as weak.

Risk Considerations

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

Investing in foreign markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks. **Investing in currency** involves additional special risks such as credit, interest rate fluctuations, derivative investment risk, and domestic and foreign inflation rates, which can be volatile and may be less liquid than other securities and more sensitive to the effect of varied economic conditions. In addition, international investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with **emerging markets and frontier markets**, since these countries may have relatively unstable governments and less established markets and economies.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

Alternative investments may be either traditional alternative investment vehicles, such as hedge funds, fund of hedge funds, private equity, private real estate and managed futures or, non-traditional products such as mutual funds and exchange-traded funds that also seek alternative-like exposure but have significant differences from traditional alternative investments. The risks of traditional alternative investments may include: can be highly illiquid, speculative and not appropriate for all investors, loss of all or a substantial portion of the investment due to leveraging, short-selling, or other speculative practices, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized, absence of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than open-end mutual funds, and risks associated with the operations, personnel and processes of the manager. Non-traditional alternative strategy products may employ various investment strategies and techniques for both hedging and more speculative purposes such as short-selling, leverage, derivatives and options, which can increase volatility and the risk of investment loss. These investments are subject to the risks normally associated with debt instruments and also carry substantial additional risks. Investors could lose all or a substantial amount of their investment. These investments typically have higher fees or expenses than traditional investments.

Treasury Inflation Protection Securities' (TIPS) coupon payments and underlying principal are automatically increased to compensate for inflation by tracking the consumer price index (CPI). While the real rate of return is guaranteed, TIPS tend to offer a low return. Because the return of TIPS is linked to inflation, TIPS may significantly underperform versus conventional U.S. Treasuries in times of low inflation.

Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Interest on **municipal bonds** is generally exempt from federal income tax; however, some bonds may be subject to the alternative minimum tax (AMT). Also, municipal bonds acquired in the secondary market at a discount may be subject to the market discount tax provisions, and therefore could give rise to taxable income. Typically, state tax-exemption applies if securities are issued within one's state of residence and, if applicable, local tax-exemption applies if securities are issued within one's city of residence. The tax-exempt status of municipal securities may be changed by legislative process, which could affect their value and marketability.

Because of their narrow focus, **sector investments** tend to be more volatile than investments that diversify across many sectors and companies. Risks applicable to companies in the **energy and natural resources** sectors include commodity pricing risk, supply and demand risk, depletion risk and exploration risk. **Health care sector stocks** are subject to government regulation, as well as government approval of products and services, which can significantly impact price and availability, and which can also be significantly affected by rapid obsolescence and patent expirations.

Environmental, Social and Governance ("ESG") investments in a portfolio may experience performance that is lower or higher than a portfolio not employing such practices. Portfolios with ESG restrictions and strategies as well as ESG investments may not be able to take advantage of the same opportunities or market trends as portfolios where ESG criteria is not applied. There are inconsistent ESG definitions and criteria within the industry, as well as multiple ESG ratings providers that provide ESG ratings of the same subject companies and/or securities that vary among the providers. Certain issuers of investments may have differing and inconsistent views concerning ESG criteria where the ESG claims made in offering documents or other literature may overstate ESG impact. ESG designations are as of the date of this material, and no assurance is provided that the underlying assets have maintained or will maintain and such designation or any stated ESG compliance. As a result, it is difficult to compare ESG investment products or to evaluate an ESG investment product in comparison to one that does not focus on ESG. Investors should also independently consider whether the ESG investment product meets their own ESG objectives or criteria. There is no assurance that an ESG investing strategy or techniques employed will be successful. Past performance is not a guarantee or a dependable measure of future results.

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