Tax Reform is Out, Tax Cuts are Possible

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After failing to repeal or replace Obamacare, Republicans are now focused on tax reform, a seemingly much easier task. Distance, however, is tax reform's best friend. Proposals that look great in theory are routinely derailed by details. And, that is why there has been no significant tax reform since 1986. Moreover, passing tax reform has historically required a bipartisan coalition to withstand the many opposition groups that intensively lobby to protect their deductions. Moreover, it will be inordinately difficult for Republicans to pass revenue-neutral tax reform on a partisan basis with a slim two-vote majority in the Senate and with a president with an approval rating in the upper-thirties. Thus, expect -- a small tax cut, but no structural tax changes.

Republicans generally agree that individuals should not be able to deduct state and local income taxes from their federal taxes. The problem is that if Congressional Republicans attack this deduction, they will incur the wrath of dozens of interest groups, as well as court the potential loss of Republican seats in high tax states such as California, New Jersey, and New York. Simply put, a partisan Republican effort that raises taxes is politically next to impossible. This is why the border tax adjustment - which was a very good idea - was withdrawn even though it would have raised $1 trillion over the next decade from importers. The intense political pushback from large retailers and others was simply too much. For this same reason, the mortgage interest deduction and charitable deduction are already off limits.

Reducing corporate taxes is an idea that has broad support across the political spectrum since many US-headquartered firms have already "moved" to Europe to escape high US corporate taxes. The problem is that financing the lower tax rate requires eliminating corporate deductions for, among other things, investment, and doing that would have perverse effects. It would raise the cost of new investment and thus reduce economic growth, the opposite of the intended effect. If we reduce the corporate rate to 15% or 20%, enough to overcome the investment problem, we create enormous incentives for people to re-characterize wage income as business income, leading to enormous deficits.

This leaves the most likely outcome being a small tax cut. While a large tax cut might seem more appealing, with an existing budget deficit that is already large, and on track to get much worse over the next decade, because of rising healthcare and retirement costs, the votes for a large tax cut that will increase our already enormous debt are simply not there. In short, the inability to increase the deficit on one hand and the political inability to raise revenues by closing loopholes on the other makes this entire exercise very difficult.

Tax reform is hard, demands unpleasant trade-offs, and even creates divisions that cut across party lines. For example, some Republicans oppose tax breaks for renewable energy, but members of Congress from states with substantial wind and solar energy will strongly disagree. While Republicans may agree on the broad outline of tax policy, such as lower rates and fewer loopholes, they will divide on the details as they reveal themselves. With a slim Republican majority, Democrats in no mood to help, and an election year fast approaching, meaningful tax reform will wait for another Congress. Despite the legislative need, I peg the chances of a meaningful tax cut at 65%/35%.

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