The Daily Dish

Policy Lessons from Tax Reform 2.0

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Eakinomics: Policy Lessons from Tax Reform 2.0

Bloomberg reported that “House Republicans are hitting the pause button on ‘Tax Reform 2.0’ legislation.” A vote to make the expiring provisions of the Tax Cuts and Jobs Act (TCJA) permanent was largely intended as a Republican messaging effort to force Democrats to oppose lower taxes for the middle class just prior to the midterm elections. But there are policy lessons as well.

First, AAF research, conducted using the economic and budget models of E&Y, shows that making these provisions permanent would enhance investment, labor supply, real wages, and economic growth within the 10-year budget window and beyond. The ultimate level of gross domestic product (GDP) would rise by between 1.7 and 2.7 percent, investment by between 3.6 and 5.2 percent, and wages by between 2.9 and 6.6 percent. Taken at face value, Tax Reform 2.0 is good for growth.

Second, the reason that Tax Reform 2.0 has been put on the back burner is the politics surrounding capping the federal deduction for state and local taxes (known colloquially as SALT). Recall that in the TCJA, Congress limited deductibility of state-local taxes to the first $10,000. Those (affluent) individuals in high-tax states with more total taxes will owe federal tax on their state-local payments. What’s the fuss? The truth is, SALT is a classic base-broadener, and “lower rates, broader base” is the very definition of tax reform. Moreover, state-local taxes are just the “price” of state and local services (police, emergency, roads, education, etc.). There is no particular reason to use the tax code to lower that price; people should face the full consequences of the state-local services they choose. This logic notwithstanding, SALT has been a political hot potato, with opponents arguing that it will decimate the state-local sector. This is probably wrong, but the difficulty in pursuing a sensible base-broadener is instructive.

This leads to the final lesson, which is budgetary. According to the AAF research, on a static basis these tax changes are estimated to lose approximately $750 billion in revenue within the 10-year window. The EY method assumes these additional deficits are reduced after 20 years through either a reduction in transfer payments or tax increases. Thus, in the long-run, this analysis assumes that any increase in deficits and federal debt due to tax reform is eliminated.

Let me emphasize that the analysis assumes that there will be either a *tax increase* or a reduction in *transfer payments* to offset this deficit, which pales in comparison to the underlying fiscal train wreck that is underlying the federal budget outlook. When confronted with the exploding debt, the extreme right asserts they can deal with the problem without raising taxes, relying on faster growth. Progressives assert they cando it without touching the major entitlements (i.e., transfer programs). Both are wrong; the numbers don’t add up. Both should pray for rapid growth, but there are going to be increases in taxes and reductions in entitlements as well.

If you are going to have to raise taxes, the best way to do so is to broaden the base. The lesson of Tax Reform 2.0 is that this will be tough politics.