Tax reform has passed. What now?

Having been told by Democrats that tax cuts will help only the rich, most Americans are in for a pleasant surprise

Democracy in America

Dec 20th 2017

by H.C. | WASHINGTON, DC

THE tax bill initiated by the Republican party completed its journey through America's Congress on December 20th. The bill is President Donald Trump's first major legislative accomplishment, and America's first significant tax reform since 1986. Once Mr Trump signs it into law, America's tax system will change in numerous ways. Its corporate tax will become "territorial", like those of most other rich countries. As a result, firms will no longer pay taxes on their overseas profits. At home, the corporate tax rate will fall from 35% to 21% in 2018. Workers will benefit from across-the-board cuts in income taxes until 2025, after which, if Congress takes no further action, most levies for individuals will return to today's levels or even rise.

The final bill first passed the House of Representatives on December 19th. But Democrats' parliamentary jockeying forced the House to vote again, after parliamentary problems were found with three of the bill's provisions. In the final vote, the bill passed the House by 224 votes to 201. No Democrats voted yes; 12 Republicans also voted no. Most of the Republican dissenters were from California, New Jersey or New York. Many rich residents of these high-tax states will see their taxes rise because the bill caps at $10,000 the deduction, from federally taxable income, of money used to pay state and local tax bills.

In the Senate, the bill passed on party lines, 51-48. (John McCain of Arizona, who is suffering from brain cancer, was not available to vote.) The vote revealed the power of tax cuts to unify Republicans. Senator Bob Corker of Tennessee had voted against an earlier version of the bill, citing concerns about the national debt, which the bill is forecast to increase by about $1.5trn over the next decade, or perhaps $1trn after accounting for its effect on economic growth. But Mr Corker came around. So did Susan Collins of Maine, one of the three rebels who sunk Republican efforts to overhaul Obamacare earlier in 2017. She voted for the bill despite its abolition of the individual mandate, the requirement to buy health insurance or pay a fine. In exchange for her vote, Ms Collins won a promise of a vote on other measures to shore up Obamacare's troubled insurance markets. Yet few believe those measures can pass in the House.

The tax reform has important economic and political implications. Start with the economics. The bill doles out a fiscal stimulus of about 0.7% of GDP in 2018 and 1.4% of GDP in 2019. This should boost growth a little, but it will probably also quicken the pace at which the Federal Reserve raises interest rates to stop the economy from overheating. The Fed's model says that deficit-financed tax cuts worth 1% of GDP eventually raise interest rates by 0.4 percentage points (see article). Janet Yellen, the Fed's outgoing chair, told a press conference last week that the central bank does not want to stand in the way of faster economic growth, and will only concern itself with the tax bill to the extent that it affects inflation and employment. It surely will, because the fiscal stimulus dwarfs the likely boost to the underlying productive capacity of the economy. The Tax Foundation, a think-tank that is usually optimistic about the effect of tax cuts on growth, projects that the bill will increase long-run GDP by only 1.7%. By its calculations, this will add about 0.3 percentage points to annual GDP growth over the next decade. (Others are less optimistic.)

The reform simplifies America's taxes in places, and complicates them in others. It boosts the standard deduction (the amount that can be earned before paying tax regardless of behavior). That means fewer Americans will choose to itemise their deductions (ie, add up those to which they are entitled). Less use of deductions means fewer economic distortions. For example, the housing lobby opposed the bill in part because homeownership, and the associated deduction of mortgage interest, will be less beneficial thanks to the higher standard deduction. (The bill also limits the mortgage interest deduction for new purchases to $750,000 in mortgage debt.)

Yet there are two areas of fresh complication. First, owners of so-called pass-through businesses, whose profits flow directly onto the tax-returns of their shareholders, will receive a large tax cut. That, and the cut to the corporate tax rate, will increase the incentive for individuals to ask accountants to turn their wages into business income. Second, the bill contains complex new rules regarding international trade. For example, profits from exporting intellectual property are taxed at a lower rate of about 13%. Such rules are bound to be gamed by tax planners. And the export subsidy may violate

World Trade Organisation rules—foreign finance ministers have already complained to Steve Mnuchin, the treasury secretary.

What are the political consequences? Republicans have passed an unpopular bill. A poll for NBC News and the Wall Street Journal found than only 24% of Americans back the bill while 41% oppose it. Fewer than one in five Americans expect to benefit personally next year. Americans think, rightly, that the bill's main beneficiaries are the rich. Yet its unequal effects will be sharpest only if its income tax cuts are allowed to expire after 2025. In the meantime, four in five Americans can expect a tax cut next year, according to the Tax Policy Centre, a think-tank. Republicans say that when voters see their payslips fattening, the bill will become more popular, benefitting Republicans in Congressional elections in November 2018. Democrats hope, optimistically, that rising tax bills in high-tax states might help them pry some seats in California and New York away from Republicans. In many cases, however, that will be difficult: the average margin in Republican-held House seats in New York, for instance, is over twenty percentage points.

The most significant political consequences are long-term. The expiry of tax cuts for individuals is a ticking time-bomb in the tax code. It will explode just as America approaches a budget crisis, driven by rising spending on health care and pensions for the elderly. This gap will probably eventually be plugged by a combination of tax rises and spending cuts. But by cutting taxes now, Republicans have moved the starting point for any future negotiations. Deeper eventual cuts to entitlement spending now look likely. Some Republicans want to get started on that project now: Paul Ryan, the Speaker of the House, is keen to move onto welfare reform in 2018—a remarkable aim in an election year.

What about Mr Trump? The president will be delighted to have a major legislative accomplishment to tout. He was never much concerned with the details of the bill, so long as the cut to business taxes was large enough. And although America is very unlikely to enjoy the sustained 3% economic growth his administration promises, taxes are falling while the labour market booms. However unpopular the bill—or the president—Democrats would be wise to worry.