If Republicans can't pass tax reform, what can they do?

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Donald Trump has kicked off a "Tax Reform Roadshow", as he begins efforts to encourage lawmakers (particularly Republicans) to get legislation passed.

Sounds fun. How important is it that tax reform is successful?

Politically? Very. Having seen attempted healthcare reform fail and with infrastructure investment now relegated to a second-order priority, Trump needs a legislative win on a big issue.

Perhaps more importantly, his promise of sustaining America's annual growth rate at 3 per centis widely believed to require an increase in the productive potential of the economy.

Most economists really do believe pro-growth tax reform could provide a significant boost, whether that be through raising the level of GDP through improved efficiency, or even perhaps raising the economy's underlying growth rate.

A good tax system should raise revenues in the least distortionary way possible, making it equitable, simple and growth friendly. Few Republicans or Democrats would argue the US code lives up to these ideals. It has not undergone major reform since 1986, and federal tax rules now span 75,000 pages. Many taxes entail significant distortions to decision-making, with exemptions and deductions which encourage some activities over others, necessitating higher marginal rates than a "neutral" code.

People seem to say that about all tax systems. Is America's any worse than the others?

Well, almost everyone agrees that the US corporate income tax is particularly egregious. The federal rate sits at a world-beating 35 per cent, or 40 per cent once you factor in state taxes. This is way above the average 24.8 per cent for OECD countries. But not every corporation actually ends up paying this. Tech giants and big pharmaceutical companies can utilise exemptions and deductions to pay relatively little, as retailers and purely domestic firms get hit hardest.

But the distortions do not stop there. As Sam Dumitriu has outlined for the ASI blog, corporations at the moment can "immediately deduct labour and running costs (stationary, raw materials) from their total tax bill, but can only deduct capital costs (plants, machinery) as they depreciate." Since money today is more valuable than more money in the future, this deters investment relative to spending on workers or other everyday spending. Different depreciation schedules for various assets mean that some investments are more tax preferential than others too.

Add to this the fact that currently the US taxes corporate income on a worldwide basis, requiring American-domiciled firms to pay tax on income that was earned – and already subject to tax – in other jurisdictions, and one can see that the whole thing is a mess. Rates are high, deductions and exemptions cause inequities, and productive investment that would boost productivity and wages is discouraged.

But if everyone recognises these types of problems, then surely a base-broadening, rate-lowering agenda which removed these distortions could get bipartisan support?

The problem with any kind of tax reform is that it creates winners and losers. The losers kick up much more of a political stink over their losses than the winners cheer on their gains. That's especially true when the winners are "the broader economy". Often those in Congress represent districts and states with particular interests in terms of industries, meaning it is tough even to get consensus along party or ideological lines. So-called "revenue neutral tax reform" then is difficult enough.

The Republican Better Way Plan, for example, wanted to completely abolish the corporate income tax and replace it with a VAT-like cash flow tax at a rate of 20 per cent with a deduction for wages. This would have included a controversial border-adjustment provision, taxing imports and (in effect) subsidising exports. It would have eliminated most of the problems outlined above.

As a result, lots of economists from across the spectrum liked the idea, with a recent paper suggesting it would bring large economic gains. But large importers, such as retail chains, lobbied hard against the proposal, which has now apparently been jettisoned.

There is an additional front to disagreements over US tax reform though, which relates to the deficit and long-term debt outlook. The majority of Republicans want to cut corporate and income tax rates, above and beyond those which could be made by eliminating deductions to maintain revenue. But to keep these deficit-neutral would require large spending cuts, which may be desirable but look unlikely.

Republicans are constrained by process on this. They want to pass tax reform through the budget reconciliation process so that it can be achieved by a simple majority vote in the Senate. But this process currently does not allow policies which add to the deficit ten-years hence. This means that if it wants to pass substantial tax cuts, it would have to make them temporary, reducing their economic potency.

So what do the Republicans actually want to do?

Trump's own team has released previous plans that would slash the corporate rate from 35 to 15 per cent, cut the tax rate faced by pass-through businesses to 15 per cent, and switch to a territorial corporate income tax system. On individual taxes he has said he wants to reduce the number of federal income tax brackets from seven to three, double the standard deduction (personal allowance), end the estate tax and a couple of other smaller taxes. These would be in part "paid for" by eliminating damaging deductions, such as the ability to deduct state or local taxes and, more recently mooted, restricting the mortgage interest deduction.

Many of these changes would be good for growth and take the tax system in a more coherent direction, with the exception of the low-rate for pass-through businesses. But this plan would add dramatically to the deficit over the 10-year period, making it a non-starter as a comprehensive package which could get passed on a simple majority vote in the Senate.

Republican lawmakers then look as if they are going to have to the hard yards in making the sums add up. They are coalescing towards focusing on corporate income tax reform, lowering rates, eliminating deductions, moving to a territorial system and introducing full expending. Though many desire individual tax cuts too, these ambitions are likely to be scaled back, with any cuts targeted at those on moderate incomes.

What would they ideally do?

Obtaining the pro-growth tax system Trump desires requires significant spending restraint to keep the public finances sound. As my colleague Jeff Miron says, as a first approximate all that matters for the US's long-term public finances is reforming entitlements. Take significant efforts to curb long-term spending growth with entitlement reform and a host of tax reform options present themselves.

Absent that, focusing on corporate tax reform makes sense. It is widely acknowledged to be one of the most damaging forms of taxation, and movements towards full expensing and a lower statutory rate would be economically beneficial.

Though economically it makes little sense to worry too much about corporate tax reform alone being "revenue neutral", the reconciliation process means that to get to a super-competitive rate without increasing the deficit will require substantially paring back deductions across other areas of the tax code though – a politically much more difficult endeavour. Already, the real estate industry is limbering up to oppose reductions in the generosity of the mortgage interest deduction.

So will anything substantial will be passed?

There is big will on the Republican side to get something substantial done. After all, if Republicans can't do tax reform while holding the executive and both houses of Congress, what can they achieve?

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