NATIONAL REVIEW

The GOP's Tax Dilemma

Ryan Bourne

October 19, 2017

Tax reform without tax cuts is political suicide; tax cuts without tax reform is a huge missed opportunity.

Opponents of the Republican tax-reform framework are adept at intellectual contortion.

On the one hand, they bemoan that the proposed changes will widen the budget deficit. On the other, they denounce that eliminating some deductions will make certain households worse off.

Since net tax cuts, and hence higher initial deficits, are the only way to make everyone financially better off, one might think that some progressives would oppose any tax-reform agenda.

Yet behind the slippery critiques lies an important consideration for lawmakers: How much increased borrowing should be tolerated as part of a tax-reform plan?

Several commentators, and even some Republican tax-cut proponents, distinguish "tax cuts" from "tax reform," defining the latter as revenue-neutral changes to the tax code. Freedom Caucus leader Mark Meadows (R., N.C.), for example, has reportedly said that "revenue neutral" reform "doesn't do anything to the economy" because it is "just moving money around."

This is not a view economists would share. Lowering marginal rates, even if fully financed by eliminating deductions and exemptions, can raise the efficiency of the economy. Lowering marginal rates improves work incentives, while base-broadening efforts remove distortions to economic decision-making. For a given level of revenue, this package acts as a supply-side boost to the economy. The expected result is faster growth until the economy reaches a permanently higher level of GDP.

Yet as we have already seen with the furor over limiting the mortgage-interest and state-and-local-income-tax deductions, revenue-neutral tax reform could fall victim to political opposition. Financial losers (those who lose generous deductions and exemptions) tend to be more vocal and motivated than winners (those who obtain the higher standard deduction and lower rates). With revenue-neutral reform, there would be a lot of losers if rates were lowered substantially. In order to avoid or mute some opposition, accepting higher borrowing would allow greater rate cuts, easing the financial impact for those losing out from eliminating deductions.

Allowing higher borrowing can therefore be useful in helping grease the wheels of economically beneficial tax reform. In fact, the positive effects of rate cuts on incentives can be so powerful in some circumstances that they reduce deficits over the long term thanks to higher growth. This

could well be the case with a significant corporate rate cut. Canada and Britain have cut their rates substantially without revenues falling as a share of GDP.

The Republican tax framework may not be a complete overhaul of the tax code, but it does attempt to make the code more economically coherent. The message Republicans should be selling is that their tax changes will improve the growth prospects of the economy, in turn raising productivity and living standards.

Yet the debate thus far has focused on who will be most affected financially by the immediate changes. Republicans are getting increasingly defensive about the “pay-fors,” with some members questioning the wisdom of fully eliminating certain exemptions and others insisting that everyone must get a net tax cut, which would require huge borrowing increases.

This is dangerous territory. Republicans in the Senate have purportedly already agreed to a budget that would allow additional borrowing of up to $1.5 trillion over ten years for tax cuts. If they back away from the base-broadening proposals, though, such as the abolishing of the state-and-local-income-tax deduction, less of this allotted revenue can be used to lower marginal rates, muffling the economic benefits of the reform.

But let’s suppose there were no constraints in the Senate. Would huge tax cuts without any base-broadening measures be wise? There is little evidence that deficit-financed tax cuts will provide any short-term demand boost at all.

Some Republicans seem to believe that tax cuts are good for the economy because they will boost demand by leaving more money in people’s pockets. Yet with the economy approaching full employment and the Federal Reserve unlikely to accommodate further boosts to demand, there is little evidence that deficit-financed tax cuts will provide any short-term demand boost at all.

Cutting marginal rates would of course still boost the supply side of the economy by sharpening incentives, and we would expect this to improve the economy’s growth prospects. But without reductions in government spending (the true burden of government on the market sector), taxes would then need to be higher in future, negating this pro-growth effect. Sadly, there is little evidence that cutting taxes to “starve the beast” has been a particularly effective strategy.

Tax cuts resulting in initial higher deficits are therefore worth it only if they grease the wheels for growth-boosting tax reform or come with guarantees for future spending cuts. Tax reform without a degree of tax cuts would be politically suicidal. Cutting tax rates without reforming the code or cutting spending would be a huge missed opportunity.

Ryan Bourne holds the R. Evan Scharf Chair for the Public Understanding of Economics at the Cato Institute.