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Republican tax plan is no revolution but it will boost the US economy

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The legislative tax reform process in the United States is the political equivalent of sausage making – a process so ugly it risks turning you off the end product.

In Britain, tax changes are rammed through Parliament following Budgets, often with insufficient scrutiny.

In Washington DC, the interest group lobbying is arguably a worse spectacle, with politicians bought off with revisions to guarantee votes in plain sight.

As a result, the package working its way through both houses of Congress now sits far from the lofty ideals of the fundamental overhaul Republicans promised.

Nevertheless, it is reasonable to think that, on net, it will improve US growth prospects. The plan, after all, substantially lowers business taxation, cuts marginal tax rates on income and eliminates a host of implicit subsidies within the tax code.

The key reform is that the US's 35pc corporate tax rate (currently the highest in the OECD) would be permanently cut to 20pc. As the economist Martin Feldstein has noted, this will attract substantial capital to the US corporate sector, by increasing the after-tax return on investment, encouraging profit repatriation and more headquartering in the US, and shifting capital from less productive sectors.

Higher investment, encouraged by this and the introduction of full and immediate expensing for equipment investment for five years, can be expected to boost productivity and wages. The magnitudes here are hotly debated, but reasonable economic estimates suggest this alone could raise GDP by between 1pc and 4pc over 10 years.

Changes to the federal income tax have been less ambitious, but could boost GDP further. The Republicans want lower marginal tax rates, paid for by eliminating deductions that taxpayers are able to make.

The package of reforms would see a huge fall in the number of households who seek to "itemise" – the wasteful (from an economic perspective) filing of complex returns to minimise their tax bills.

Though unlikely, there's still even a chance the final bill might restrict the mortgage interest deduction – widely acknowledged by economists to lead to the over-consumption of housing.

In order to make all this palatable, the GOP are doubling their equivalent of the personal allowance and expanding credits for families too. These will do little for growth, but tax reform is as much about politics as economics.

Nevertheless, given the bills substantially cut a damaging tax, trim marginal income tax rates and eliminate deductions – long considered the holy grail of tax policy – why has the Republican plan generated such fierce criticism?

From the Left, the plan is most commonly denounced as a sop to the rich. Progressive economists highlight that the biggest cash gainers are at the top of the income distribution. But this is in part a statistical artefact, arising firstly because most on the lowest incomes do not pay federal income taxes already and, second, because procedural rules on future deficits mean that many individual tax cuts are notionally scheduled to "expire" in future years.

My colleague Chris Edwards calculates that in 2019, when both corporate and individual tax cuts apply, all affected income groups will see tax cuts on average, with the biggest coming for those earning between $40,000 (£30,000) and $50,000, who see their tax bill halved on average. In comparison, those earning over $1m would see their average tax bill fall by just 5.8pc.

A more legitimate economic concern is the effect on the US public finances. The bill is forecast to add $1.5 trillion over 10 years to the national debt – lower once the macroeconomic effects on growth are factored in; higher again if the tax cuts are not allowed to expire.

This sum is unlikely to have catastrophic consequences for the US's ability to borrow, not least because it's relatively small compared to capital available on global markets. But with the potential impact of a future recession and the headwinds of an ageing population to come, there is a case for getting the US's fiscal house in order and this inevitably will not help. Republicans have been right to highlight over many years how, at a first approximation, the US's terrifying debt outlook is driven by rising entitlement spending caused by an ageing population.

But they may find it that bit harder to make the case for cutting future healthcare or pensions spending if they are seen to be blasé about the debt in relation to tax cuts today.

The main economically worrying aspect of the bill is in fact the tax treatment of businesses other than corporations. Corporations are, on average, disadvantaged relative to other businesses today in the US code. But with the corporate rate being slashed, politicians have pushed for similar tax cuts for other types of business, who currently pay income. Yet creating a whole new tax deduction or a new rate for other businesses risks creating huge tax avoidance opportunities and a continual battle between tax collectors and businesses for funds. It will lead to considerable complexity, and though it could increase investment, is likely to prove economically damaging overall.

There are other imperfections, of course: economists would argue good tax policy should be permanent, whereas the Republican bill allows for lots of tax changes to expire. There are lots of damaging distortions in the tax code that have been left entirely untouched too.

But it would be a mistake to let the perfect be the enemy of the good. For all its faults and scaled-back ambitions, the tax plan the Republicans could deliver and President Trump could ultimately sign may modernise US corporate taxation and marginally make the income tax more coherent. And that will be a net benefit for the US economy.

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