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House tax deal suggests chaos in 2025

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The House passed a bipartisan tax bill last month by an eye-popping margin of 357 to 70. The bill keeps some good pro-growth tax policies alive, reins in pandemic-era fraud, and expands tax subsidies to families with children and developers. Yet obscured by the large vote margin is a more concerning development — the lack of consensus about how to address the looming 2025 fiscal cliff when taxes increase on almost everybody.

In 2017, Congress passed the most comprehensive tax reform in three decades. It wasn't perfect, but it made significant improvements by cutting taxes and simplifying taxpaying for millions of individual taxpayers. It also boosted wages, employment, and investment through business tax cuts.

Getting there wasn't easy. It took years to build consensus around the parameters of the reform. In 2014 and again in 2016, two chairmen of the Ways and Means Committee, Dave Camp and then Paul Ryan, each released comprehensive tax reform discussion drafts. Presidential campaigns, including that of former President Donald Trump, released tax reform proposals.

There were certainly disagreements, but there was also consensus that America's internationally high corporate tax rate and outdated international tax rules were making it hard for U.S. businesses and American workers to compete around the world. This motivated a long list of politically difficult decisions to improve the tax code, such as limiting the state and local tax deduction.

Congress fell short of making the reforms permanent. The tax cuts began to expire in 2022 and will crescendo at the end of 2025, raising taxes by about $400 billion annually.

As the bipartisan House tax bill waits for Senate action, it's clear that, unlike in the lead-up to 2017, there is no consensus on a long-term path forward for the tax code.

The bill extends temporarily through 2025 three pro-growth business tax cuts — most importantly, the ability for businesses to write off their research and development and new investment costs fully. Due to congressional inaction, these changes are also retroactive, providing a windfall for firm investments that have already been made.

The price for such broad bipartisan support of the bill is expanding the child tax credit. Taken together, the changes will have countervailing incentives for and against the work decisions of some lower-income families. Perhaps most concerning is a provision that only requires work every other year to claim the tax credit.

Lost in the work-incentive debate is the bigger picture. The new child tax credit institutionalizes a tax subsidy program — indistinguishable from new mandatory spending — that, when combined with the temporary $2,000 base credit, will cost more than $100 billion a year by 2033. That's compared to about $45 billion for the business tax cuts, according to the Tax Foundation.

The bill also increases low-income housing tax subsidies primarily captured by developers and financial firms, in addition to other provisions to reduce taxes on trade with Taiwan and ease tax compliance for independent contracting.

Not included in the bill is a proposal by lawmakers in New York, Connecticut, and California to double the SALT deduction for joint tax filers (which was limited to $10,000 a year in 2017). This change would increase the federal tax subsidy for high state taxes at a cost of almost $12 billion in 2023.

The SALT changes will likely get a separate vote in the House, a compromise for the change not being included in the base bill. When the SALT deduction cap expires in 2025, it will still be necessary for offsetting lower tax rates in any permanent package, but it will continue to be a political thorn.

Ultimately, the components of the House tax bill tell a story of a fundamental lack of agreement on what the tax code should be used for. Is the tax code primarily a mechanism for wealth redistribution and subsidies? Or should it be a predictable system for raising revenue in the least economically distortionary way possible?

The current tax bill is a retroactive, temporary patch, held together by new spending, for a tax system that will require considerably more work in a few short years. Before 2025, lawmakers will need to come to terms with the difficult trade-offs necessary to maintain a pro-growth tax code in an era of unsustainable spending growth.

Now, the Senate has the chance to improve the House tax bill. Instead of delaying the inevitable, the Senate should make the most pro-growth tax cuts, expensing for research and development and equipment, permanent. Permanent expensing would lower the stakes of 2025 by taking the most critical reforms off the table and giving businesses the certainty they need to plan future investments.

To help offset the changes, Congress could expand its reform of the employee retention tax credit, which could be close to $500 billion over budget, and rescind the $120 billion in other unobligated pandemic funds. Rather than expanding SALT, it should be entirely repealed. The child tax credit and housing credit should certainly not be expanded; in an ideal world, they'd also be repealed.

Whatever happens with this bill, it should be a wake-up call for those looking forward to the 119th Congress. As it faces a roughly $2 trillion annual deficit, keeping taxes low without cutting spending in 2025 will be fiscally irresponsible and politically difficult. Now is the time for Congress to get its priorities straight.

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