Moody's Analytics chief economist: Why the Republican tax plan is set up to fail

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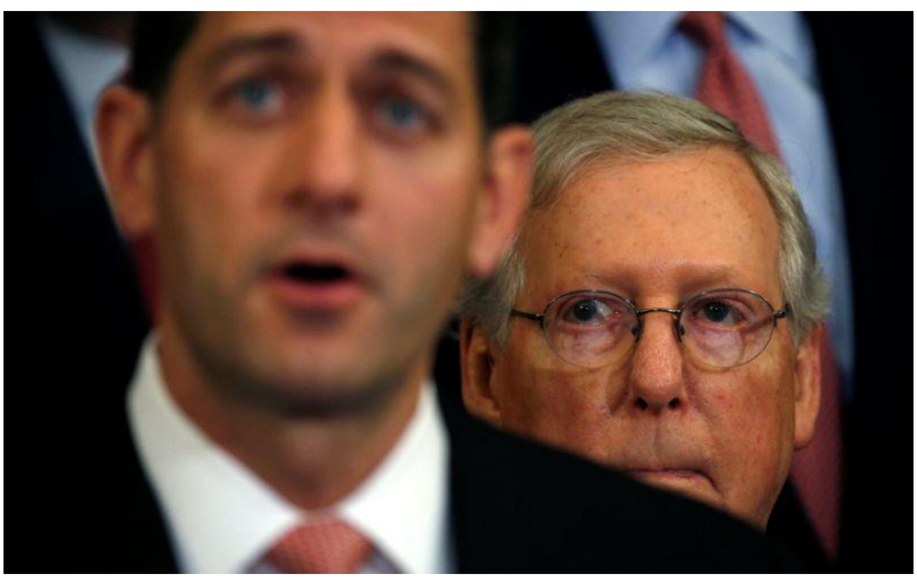
The Trump administration and Republican Congressional leadership want to go big on tax reform. They have proposed a broad set of changes to the corporate and personal income tax codes, including tax cuts and revenue raisers.

While the proposal is light on many important details, taken in total, it would not add significantly to economic growth, but it would add significantly to future budget deficits and the nation's debt load.



U.S. Senate Majority Leader Mitch McConnell (R) listens to Speaker of the House Paul Ryan (L) speak about the Republican tax plan in the U.S. Capitol in Washington, U.S., September 27, 2017. REUTERS/Kevin Lamarque

Boon for business

Businesses would be big beneficiaries of the Republican plan, enjoying an estimated net tax cut of $2.5 trillion over 10 years on a static basis—ignoring the impact of the tax cuts on the economy and thus tax revenues. Large multinationals would benefit by a move from the current global taxation system to a territorial one, and a one-time tax holiday on the trillions in earnings they are holding overseas to avoid the current high tax rate. Smaller pass-through entities—businesses whose owners pay personal income tax on their companies' earnings—would see their top tax rate decline significantly.

The biggest corporate tax expense is the proposed reduction in the top marginal rate from 35% to 20% and repeal of the corporate alternative minimum tax. Lowering the top tax rate on pass-through income and allowing businesses to reduce their tax bill by completely expensing their investment for at least five years are also costly. To help pay for this largess, the plan eliminates business-related tax loopholes, although they are not spelled out, and even closing them all would not raise much revenue. Deducting interest payments made by businesses would also be partially limited, although the proposal is also opaque on how this would work.

Wash for individuals

Individuals as a whole get no tax cut under the Republican plan, although some do very well under the plan while others get dinged. The big winners are the top 5% of taxpayers, with current incomes well over $300,000 per year. Taxpayers that make between $150,000 and $300,000 per year benefit the least, and would actually eventually pay more in taxes. Taxpayers making less than $150,000 will take home a modestly higher sum after-tax.

The biggest individual tax expense is the proposal to collapse the current seven tax brackets into three or perhaps four brackets. The standard deduction would increase significantly, as would the child tax credit. The estate tax and alternative minimum tax would also be eliminated—a boon to wealthy households. To help pay for these cuts, the plan eliminates personal exemptions except for mortgage interest and charitable giving along with most itemized deductions. The big revenue raiser is the elimination of deductions for state and local income, sales tax and property taxes.

Stronger growth?

Boosters of the Republican tax proposal argue that it will significantly increase economic growth. The most common refrain is that it will lift real GDP growth closer to 3% per annum from the roughly 2% that has prevailed during the current expansion. They also argue that this additional growth will generate roughly enough additional tax revenue for the plan to pay for itself. That is, there would be large so-called supply-side effects from the tax cuts. So large that on a dynamic basis—after accounting for the bigger economy—the plan will not add to the nation's deficits and debt.

They are wrong on both counts. The plan will not meaningfully improve economic growth, at least not on a sustained basis. Growth would be stronger initially, since the deficit-financed tax cuts are fiscal stimulus. Given that the economy is currently operating at full employment, however, stronger inflation and higher interest rates will result. The higher rates wash out the economic benefit of the lower tax rates on investment, and the economy ends up no bigger than it would have been without the tax cuts.

This is evident in simulations of the Moody's Analytics macro model, which is similar to models used by the Federal Reserve, Congressional Budget Office, and the Joint Committee on Taxation—the official budget scorer of tax legislation. Real GDP growth is just over half a percentage point stronger in 2018 because of the plan, which pushes unemployment to below 4% by year's end. The Fed responds by tightening monetary policy more aggressively, and long-term interest rates jump due to the Fed tightening and to investor expectations of larger future budget deficits.

While lower tax rates incentivize more investment, the higher interest rates hurt it. In the end, the economic lift from the tax cuts is marginal, adding an estimated 4 basis point per annum to real GDP growth over the next decade. That is the tax plan will not lift growth from 2% to 3%, as the proponents argue, but from 2% to 2.04%.

Big dynamic deficits

No harm, no foul. Right? Unfortunately no, as the plan will also significantly exacerbate the nation's fiscal problems. The dynamic cost of the plan to taxpayers is not much different from its dynamic cost. There are economic benefits on revenues from the lower marginal rates, but they are not sufficient to pay for the cuts. Government borrowing thus increases, causing interest payments on the accumulating debt to rise. The added interest payments offset the economic benefits on revenues, making the static and dynamic budget deficit and debt load about the same. Under the Republican tax plan, the government's debt-to-GDP ratio rises from just over 75% today to more than 100% a decade from now, measured on either a static or a dynamic basis.

Plusses and minuses

There are aspects of the tax plan that are difficult to model and quantify: Some add to economic growth, and others detract from it, but on net, they cancel each other out. On the plus side is moving from a global to a territorial system, which will stop inversions by U.S.-based multinationals, ensuring more headquarters stay here. On the downside it will very likely sunset in 10 years. Under Senate rules, tax and spending legislation that passes using the reconciliation process, in which only a simple majority of votes is required, must be deficit-neutral by the last year of the 10-year budget horizon. If the JCT scored-legislation shows there will be a deficit a decade from now, then all of the provisions in that legislation expire. This is a likely fate. Uncertainty over how future lawmakers would deal with this tax cliff will crimp investment, particularly longer-lived risker types, as the cliff comes into view.

What next?

Clearly, nothing like the plan Republicans recently put forward will become law. The plan does not just fail to lift economic growth meaningfully, it adds significantly to the nation's fiscal problems. It also is politically unpalatable. The brouhaha over eliminating the state and local income tax deduction, the principal source of additional tax revenue in the plan, has even forced some of the authors of the legislation to step back from it.

If a tax bill makes it into law, and odds appear no better than even that one will, then it will be significantly scaled back. The Senate already put some limits around the tax legislation when it recently passed a budget resolution, necessary for the use of the reconciliation process, which limits the total cost of tax reform to $1.5 trillion over the 10-year horizon. Even this seems a political stretch.

Tax reform would be a big win, but to boost economic growth on a sustained basis, it must be dynamically deficit neutral. Particularly when the economy is operating at full employment, as it is today. This is very difficult to do. It is increasingly difficult to see the Trump administration and Congress getting it done.