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If Republicans Agree on 80% of Tax Reform, What's the Other 20%?

by Carolyn Smith

Note: Updated September 5 to reflect the Senate parliamentarian's ruling on the FY 2017 budget resolution.

Senate Finance Committee Chairman Orrin Hatch (R-UT) and House Ways and Means Chairman Kevin Brady (R-TX) have both stated that Republicans agree on about 80% of tax reform. The needle might have moved closer to 90% with the recent announcement from the Big Six—Treasury Secretary Steven Mnuchin, National Economic Council Director Gary Cohn, House Speaker Paul Ryan (R-WI), Senate Majority Leader Mitch McConnell (R-KY), and Chairmen Hatch and Brady—to scuttle the controversial border adjustment tax (at least for now). With all this agreement, what stands in the way of a full proposal?

A Number of Non-Tax Issues May Impact Tax Reform

Upon returning from recess, Congress will be faced with a September full of "must-do" issues outside the tax world. Topping this list are the debt limit and the need for continuing appropriations to keep the federal government open. Republicans will need Democratic support to get both of these things done.

Secretary Mnuchin has told Congress that the debt limit needs to be raised by September 29 so that the United States can continue to meet its existing obligations and avoid defaulting on its debt. The full consequences of failing to extend the debt limit aren't really known, because it has never happened before (and may not this time around either), but range from bread and butter issues for the many Americans who rely on things such as social security and veterans benefits (which could no longer be paid) to significant negative impacts on the U.S. and global economies.

Current funding for the federal government runs out on September 30, the end of the federal fiscal year. Congress will need to act by then in order to keep the government running (even if the debt limit is separately increased before then).

What could hold up action on these must-do items? A variety of complicated policy and political issues. The short version is that some members of both parties see one or both of these measures as a way to effect policies relating to tax and spending, and Republican and Democratic objectives differ. For example, many Republicans want to tie the debt limit to significant spending cuts, while Democrats may want to use the opportunity to try to prevent tax cuts for the very wealthy. President Trump has stated he is willing to risk shutting down the government (by failing to provide funding past September 30) in order to get funding for his border wall. Any delays in resolving either the debt limit or government funding is likely to make comprehensive tax reform harder.

One of the Most Fundamental Issues for Tax Reform Has Not Been Decided

There is no clear answer yet as to whether tax reform will add to the deficit (and if so, how much). How this question is resolved will have a significant impact not only on the broader parameters of tax reform (such as how low rates will go) but also on various details of the reform package (such as the particulars of revenue raisers). In simple terms, this issue goes to the heart of how much the winners win and how much the losers lose.

One approach to resolving the budget question is "go big, go bold." That is, take advantage of the Republican control of the government to structure tax reform based on pure policy objectives and don't be concerned about adding to the deficit. Some proponents of this approach believe that in the long run, the type of tax reform and tax cuts this would produce would grow the economy and more than pay for themselves, despite what official government scorekeepers may say. Lowering taxes could also force spending reductions (either concurrently with tax reform or in the future), thus achieving another policy objective.

Others, however, are concerned about what could be called a "bust the budget approach" and potential negative economic consequences. Further, discussions of spending cuts will ultimately lead to political hot-button areas such as Medicare and Social Security, which could further slow the tax reform process. An alternative is a more budget-neutral approach, such as that taken in the House Republican Blueprint on Tax Reform.

"Budget neutrality" in this context has greater flexibility compared to the way that tax legislation has traditionally been scored. For one thing, macroeconomic scoring (which captures the extent to which tax cuts grow the economy) will lower the negative revenue impact from tax cuts. The use of what is called the "current policy" baseline would also provide some extra room. The baseline is used to measure the impact tax changes will have on the federal budget. If the current policy baseline is used, that means that the cost of extending current temporary tax provisions, such as bonus depreciation, will already be included in the baseline and won't be scored as having any revenue impact and won't have to be paid for. Estimates are that a current policy baseline would account for about $450 billion.

Not providing offsets for some provisions is not unique to Republicans; both parties have shown a willingness to extend expiring provisions without offsetting revenue raisers. For example, the PATH Act of 2015 made numerous expiring tax provisions permanent, including the R&D credit, largely without offsetting revenue raisers, and passed with bipartisan support. The PATH Act was passed, however, in a very different political environment.

Adding to Uncertainty Are the Restrictions of the Budget Reconciliation Process

Procedural intricacies are not just for policy wonks anymore.

Congressional efforts to repeal and replace the Affordable Care Act (ACA) have not exactly made "budget reconciliation," the "Byrd rule," and "the parliamentarian" common household terms, but certainly have heightened awareness of the impact that the process has on substance. While there is some mention of trying get tax reform done on a bipartisan basis, Leader McConnell has stated that budget reconciliation will be used. The benefit of using budget reconciliation is that it can be passed in the Senate with just 51 votes, meaning only 50 Senators are needed (allowing two Republican votes against assuming no Democrats vote for), with Vice President Pence casting the deciding vote. Normally, it takes 60 votes in the Senate to move legislation. While nothing precludes a reconciliation bill from being bipartisan, Democrats have objected to a process from which they are effectively excluded.

The other side of budget reconciliation is that there are limits on what can be done through this expedited process. An example will illustrate the point without going through the details. Remember the Bush-era tax cuts in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)? Concerns over the element of the Byrd rule that restricts revenue losses outside the budget window led to sunsetting most provisions after 10 years, including the individual income tax rate structure. The looming tax hikes that would occur if these provisions were not extended came to be known as "Taxmageddon." Ultimately addressed in a dramatic end-of-year deal passed by Congress on January 1, 2013, and signed into law the next day by President Obama, this was an experience no one really wants to repeat.

A further complication is that before the reconciliation process can begin, Congress needs to pass a budget resolution that will provide the necessary framework for tax reform. The budget resolution could address some open issues, such as the baseline to be used, the extent to which macroeconomic scoring will be used, and revenue/budget targets.

But wait, say keen observers, we already have a budget resolution for the current fiscal year (2017), which was being used for ACA repeal/replace. With that stalled, can't we use that budget resolution for tax reform? Short answer: not really. For one thing, the Senate parliamentarian has recently ruled that this resolution does not survive past September 30, making it effectively unavailable for tax reform. Even if it did survive, the FY 2017 resolution doesn't properly set up tax reform and would need to be amended for tax reform to be passed with just 51 votes in the Senate. Amending the current resolution could be at least as difficult as getting a new budget resolution.

Indeed, process on a FY 2018 budget resolution has already begun. The House Budget Committee approved a FY 2018 budget resolution in July that adopts a current law baseline, although this could change as the process continues.

What does this mean for the current tax reform discussions? While permanency in the tax laws is the preferred approach by all, use of reconciliation means that some provisions might need to be temporary. This is much harder to do for structural reforms, such as a move toward territoriality, than for many other provisions. Not everything would necessarily have to sunset; there could be a combination of some permanent and some temporary provisions. It also means that some provisions may be included or designed in large part because of the pattern of the revenue impact and whether money is needed inside or outside the budget window. For example, "Rothification" proposals for 401(k) and IRA contributions move money into the budget window, but tend to show a revenue loss in the out years. In short, it makes the normal give and take in the process just that much harder. And straight tax cuts instead of broader tax reform… hmmm, back to that EGTRRA sunset?

Budget rules are under focus now more than ever before, new questions are being asked, and some different interpretations may be made (was the EGTRRA sunset really necessary?). Nevertheless, the process will be a driver of substance to some degree.

Summing It All Up

What will be the end result? Temporary provisions, more revenue raisers, less generous transition rules, permanent revenue raisers supporting temporary tax cuts? Figuring all this out is what makes that last 20% pretty hard. Even in this type of environment there are real benefits to be gained from tax reform, but there are also potential changes to be concerned about—what matters most varies by industry and individual company. Can the rate be low enough to compensate for the loss of some tax deductions? Is a loss of a current deduction okay if there is appropriate transition? Are there acceptable trade-offs?

There are always winners and losers, but no one wants to be "The Biggest Loser" in tax reform.

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