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SPOTLIGHT REPORT

September 26, 2017

The Tax Reform Gauntlet Finally Begins

What's Happening: President Trump and congressional leaders will release the Republican tax reform framework created by the "Big Six" tomorrow. Trump will be in Indiana for the framework unveiling while House GOP leaders will gather with the GOP conference to talk through the details and the process moving forward.

Why It Matters: Along with President Trump, the "Big Six"—comprised of House Speaker Paul Ryan (R-WI), House Ways and Means Committee Chairman Kevin Brady (R-TX), Senate Majority Leader Mitch McConnell (R-KY), Senate Finance Committee Chairman Orrin Hatch (R-UT), Secretary of the Treasury Steven Mnuchin, and National Economic Council Director Gary Cohn—have been the driving force behind tax reform so far, keeping a tight lid on any details of the framework. This has frustrated rank-and-file Republicans, particularly the intractable House Freedom Caucus, leading the hard line conservative group to hold up a floor vote on a budget resolution in the House, which is the first step for tax reform legislation, until more details of the tax reform proposal are released. Consequently, tomorrow's announcements will be geared towards assuaging conservatives who have been frustrated with the lack of information from leadership rather than providing the contours of a truly substantive, concrete proposal. The hope of Hill GOP leadership and the White House is that Wednesday's announcements will at least satisfy conservatives enough to move forward on the budget resolution. But while we remain optimistic that Hill Republicans will eventually adopt a compromise budget resolution, the real challenge for achieving tax reform is building consensus on eliminating enough existing credits and deductions to find sufficient pay-fors to make the numbers work. Even though Republicans are warming to the idea of unpaid-for tax cuts, corporate tax cuts will still need substantial offsets to comply with the 10-year revenue-neutrality requirement under the Senate's reconciliation procedures. Nonetheless, we do not expect that the all-important pay-fors will be seriously addressed on Wednesday, leaving a critical aspect of tax reform untouched.

What's Next: While tomorrow's announcement and coordination among Republicans is meant to gin up support for tax reform, the real near-term objective is for both the House and the Senate to pass their respective budget resolutions and then pass a compromise resolution in order to allow for reconciliation. Reconciliation is key, as it is the only way Republicans can bypass the 60-vote threshold in the

Senate (although their attempts to use it for healthcare reform have demonstrated that even that is no guarantee of legislative success). While we ultimately expect the House and Senate to both pass their respective budget resolutions and then come to a compromise agreement eventually, we expect the process to drag on due to internecine fights -- the budget resolution process is seen as a microcosm for the larger discussion around tax reform, and even within their own conference, Republicans will disagree on their top priorities. The "Big Six" had enough trouble coming up with just a set of principles on tax reform; asking the diverse and often quarrelsome Republicans in the House and Senate to agree to a specific set of budget parameters and tax principles will be a similarly difficult undertaking**.** And as the budget resolution struggles are only a small taste of the real challenges that need to be cleared for the Republicans to pass meaningful tax reform legislation with a razor-thin Senate majority under reconciliation, our odds of tax reform passage remain at 20 percent. However, those odds may change if we see Republican leadership, including President Trump, step up and develop a laser-like focus on tax reform in the coming weeks.

The Myriad Hurdles to Tax Reform

There is a reason why tax reform is the ultimate policy unicorn. From afar, tax reform is a politically palatable and appealing undertaking. But the closer you get to the details, the more illusory and challenging tax reform becomes. As we look ahead, there are several substantial challenges Republicans face to successfully pass meaningful tax reform legislation.

Making the Numbers Work

Looking at the nuts and bolts of analyzing a tax reform proposal, there are four key components: costs; budget deficit allocation; dynamic scoring; and pay-fors. Essentially, costs need to equal the sum of budget deficit allocation, dynamic scoring, and pay-fors in order to have passable legislation through reconciliation. If the equation does not balance out and costs are not completely covered in years 11 through 20, then tax reform is unpassable through the reconciliation process.

Costs: After House Republicans released their "A Better Way" tax reform blueprint in 2016, the Tax Foundation–a conservative think tank—came out with a report that scored the blueprint, estimating the costs and revenue growth. While, the blueprint and what is expected from the "Big Six" are not identical (e.g. there was a border-adjustment tax in the blueprint which was discarded by the "Big Six"), many specific tax cuts and expenditures are similar. The following lays out the estimated gross cost, per the Tax Foundation, of certain elements in the "Big Six" proposal for tax reform:

- **C corporations:** Reducing the corporate tax rate from 35 percent to 20 percent would cost **$1.8 trillion** over 10 years.

- **Passthroughs:** Creating a passthrough rate for small businesses with a maximum rate of 25 percent would cost **$500 billion** over 10 years.
- **Expensing:** Allowing full expensing of capital investments would cost $2.2 trillion over 10 years. Recent reports note that full expensing under the "Big Six" plan could potentially sunset after five years, approximately halving the cost to **$1.1 trillion**.
- **Income Tax:** Consolidating individual income tax brackets into three of 12 percent, 25 percent, and 33 percent would cost **$2.0 trillion** over 10 years. The "Big Six" plan has not stated specific details of the tax brackets and the income thresholds for each level, but there are expectations that the top tax rate will be 35 percent.
- **Estate Tax:** Eliminating the estate and gift tax would cost **$200 billion** over 10 years.
- **Alternative Minimum Tax (AMT):** Eliminating the alternative minimum tax would cost **$400 billion** over 10 years.
- **Standard Deductions and Child Tax Credits:** Doubling the standard deduction and increasing the child tax credit by 50 percent would cost **$1.5 trillion** over 10 years, according to a September 2017 estimate by Kyle Pomerleau, an economist at the Tax Foundation.

Adding up all the components, the total gross cost of tax reform comes to $7.5 trillion. This is a rough beginning estimate, and the numbers can change as the House and Senate begin to craft their tax bills and new estimates of costs come along. But more generally, these numbers give a hint at the scope of what the GOP is looking to achieve. Take away the numbers, and this is what tax reform is from afar. Trump and Republicans like to tout the benefits of tax reform—being able to say you cut taxes for corporations, small businesses, and individuals is politically powerful. However, Republicans have an expectations problem with costs. Trump has set expectations high, noting this past week "I believe we will be successful in the largest tax cut in our country's history." His overarching goal of a 15 percent corporate tax rate caught on with the House Freedom Caucus, which is anchoring their expectations on a 16 percent rate. Ryan and other Republican leaders have dismissed 15 percent as an untenable number to reach, with the low to mid-twenties as a more reasonable starting point. In order to make the numbers work though, modesty is critical, and overpromising will only lead to disappointment. In staking out untenable positions, curbing back on the size of a tax cut may be a bridge too far for Republicans who were anchored to a larger tax cut.

Budget Deficit Allocation: Under reconciliation, a budget resolution outlines the parameters of the tax reform process and the legislation itself. This includes an allotment for the size of any tax cut. While at first, tax reform was going to be revenue-neutral, there is now growing momentum and agreement among Republicans for a tax cut that creates a deficit in the first ten years. Last week, a deal was made between two members of the Senate Budget Committee—Senators Bob Corker (R-TN) and Pat Toomey (R-PA)—for a budget resolution to include instructions to allow up to possibly **$1.5 trillion** in deficit-financed tax cuts over 10 years. This means the costs and lost revenue of any tax cut does not need to be completely offset, giving Republicans a $1.5 trillion cushion. But deficit-financed tax cuts present procedural hurdles in the Senate. According to the Senate's Byrd rule, reconciliation bills cannot increase deficits in years beyond the budget window. Unlike reconciliation bills themselves that require only a majority vote, the Byrd rule can only be

waived with approval from three-fifths of the Senate. While any tax cuts on the individual income side can sunset after 10 years, the effects of even temporary corporate tax cuts will have ramifications after the initial 10-year budget window. In a letter to House Speaker Paul Ryan (R-WI), the Joint Committee on Taxation (JCT) in April noted cutting the corporate tax rate from 35 percent to 20 percent for just three years would have "nonnegligible revenue loss in the tax years immediately following the budget window." A corporate tax cut for 10 years will undoubtedly create an even greater deficit, leaving Republicans in need of more offsets to the costs after 10 years.

Dynamic Scoring: In a Senate hearing earlier this year, Treasury Secretary Steven Mnuchin said about tax reform that "Any plan we put forward we believe should be paid for with economic growth." Republicans see dynamic scoring, which factors in any economic growth coming from tax cuts, as an integral part to generating the needed tax revenue to offset the costs of tax cuts. While the Joint Committee on Taxation (JCT)—the traditional non-partisan scorekeeper of tax legislation—does incorporate dynamic scoring in its analysis, the magnitude of such economic growth may be lower than what Republicans want. This is because the JCT, unlike some conservative think tanks, see tax cuts as increasing government debt on a net basis, leading to curtailed growth from higher interest payments. As such, Republicans may try to make up any deficit by using alternative scoring options. The GOP is seriously considering not using the JCT to score the tax reform legislation, upending long-standing precedent. Instead of the JCT score, Republicans could use a Treasury model that they will have more control over to show dynamic growth from tax reform. The Tax Foundation's estimate of tax revenue from the economic growth coming from the "A Better Way" tax reform blueprint was **$2.5 trillion**. However, the Tax Policy Center—a centrist think tank—has the projected revenue growth of the "A Better Way" plan as being **between $92 billion and $593 billion**. As seen, the variance of dynamic scoring is large. Additionally, bypassing the JCT is highly unorthodox, especially for a Senate that respects traditions and rules. The lack of regular order was a major factor in the downfall of Republican health care legislation. The JCT is a respected apolitical institution among most in DC, and going with a budget score that is largely different from the JCT's score and blatantly politicized will face serious credibility challenges. Moderate Republicans and budget hawks will have a hard time swallowing any such number, especially when presented with major discrepancies from any JCT estimates. Ultimately, any scoring changes will have to be written in the budget resolution, meaning the decision comes down to Senate Budget Committee Chairman Mike Enzi (R-WY) who is responsible for the budget resolution. Enzi has not indicated yet one way or the other on how he will proceed.

Pay-Fors: While tax cuts and expenditures are politically popular, the difficulty is how to pay for those cuts and expenditures. In general, there is ample reason for not yet addressing pay-fors as special interests are willing to fight tooth and nail to protect any tax loophole or carveout. By taking the costs ($7.5 trillion) and subtracting the budget deficit allocation ($1.5 trillion) and the range on dynamic scoring ($92 billion to $2.5 trillion), we estimate Republicans will need **$3.5 trillion to $5.9 trillion** in pay-fors. Even the conservative end of $3.5 trillion involves expending serious political capital to close

loopholes and tax expenditures that have meaningful special interest backing. Some potential pay-fors include:

- **State and Local Tax Deduction (SALT):** Closing the SALT deduction could generate $1.1 trillion in new revenue over 10 years, according to the Congressional Budget Office (CBO). SALT deductions are one of the likeliest pay-fors, as the White House and House Republicans have called for ending the deduction in previous tax reform blueprints, and the change would mostly affect blue state residents. But House Republicans from high tax states like New York and New Jersey are against ending the SALT deduction. Additionally, almost two dozen groups representing state and local governments, educators, and business officials formed the Americans Against Double Taxation, supporting SALT as a means of avoiding double taxation. A concerted advocacy campaign will sap time and energy from Republicans seeking to completely eliminate SALT deductions. While the heaviest lift for eliminating the SALT deduction lies in the House, if it is successfully removed in legislation that passes the House, it should be easier to include the prominent pay-for in any Senate tax reform legislation.
- **Interest Deduction:** Closing the deduction for interest could generate $1.2 trillion in new revenue over 10 years, according to the Tax Foundation. There are reports of the "Big Six" framework including net interest deductibility being capped at 30 percent of earnings before interest, tax, depreciation and amortization (EBITDA). However, this is not set in stone, and the White House, which does not support removing interest deductibility, and the Senate can be expected to push back. Additionally, industry support for interest deductibility is wide-reaching—including banks, private equity, farms, and real estate—and well-organized, with a concerted campaign led by the Businesses United for Interest and Loan Deductibility (BUILD) Coalition.
- **Mortgage Deduction:** Closing the mortgage deduction could generate $1.0 trillion in new revenue over 10 years, according to the CBO. In place since 1913, the mortgage interest deduction is a mainstay of the Tax Code. Mnuchin has already asserted that the mortgage interest deduction will not be eliminated. However, there are talks of reducing the maximum of the mortgage interest deduction to the $600,000 range. Such a change will unleash one of the most well-funded and active groups in DC – the housing lobby. The National Association of Realtors has been the second greatest lobbying spender in DC this year. Including groups like the National Association of Home Builders and the Mortgage Bankers Association, any changes to mortgage interest deductions will face a steep uphill climb.

Indications point to no new ground being made on tax pay-fors. In seeking the path of least resistance, the GOP is likely to tread as lightly as possible on pay-fors. However, when at least $3.5 trillion in pay-fors are needed in the tax reform legislation, the GOP will need to be strong and resilient to what is sure to be one of the largest lobbying campaigns in recent memory. There is no way around the math for tax reform, and major changes to entrenched and well-defended deductions need to be eliminated or meaningfully curtailed to make the numbers work. So far, little evidence points to the GOP being able to complete such a monumental undertaking.

Razor-Thin Margin

In addition to the challenges in the tax reform numbers in terms of dollars, Republicans face a numbers problem of their own in their caucus. As seen with health care, there is little room for defection among the Republican ranks. With only a 52-seat majority in the Senate, three no votes would sink any legislation that comes forward. This gives individuals, especially in the Senate, immense power and sway over the details. As Senate Finance Committee Orrin Hatch says about tax reform, "You have a doubling or tripling of the ideas of people who have been waiting a long time for a true tax bill, so they can put their own ideas and imprint on it." Without strong leadership, any tax bill can sink quickly under the demands of individual members of Congress. And while the White House has been busy seeking Democratic support for tax reform, the specifics of the Republican plan–including raising the deficit and providing tax cuts for the wealthy—are fundamentally at odds with current Democratic principles for tax reform.

Polling

Unlike the Bush 2001 and 2003 tax cuts which focused on individual taxes, the meat of the current tax reform plan is built around corporate tax cuts. While the Republican donor class is enthusiastic about corporate tax reform, the Republican base is not, highlighting a schism within the party. In general, polling for corporate tax cuts is poor. A recent *Wall Street Journal* poll showed only 16 percent of the public thinks corporations should have lower taxes. On the other hand, 57 percent think small businesses should have lower taxes. Getting public support behind tax reform—and avoiding the horrible optics behind the health care push—means framing the benefits of the Republican tax proposal for small businesses and the middle class. Without a groundswell of grassroots support, Republicans risk turning the tax reform push into a rich corporation vs. poor small business fight and, in the process, losing the battle for the narrative.

As seen, the numbers tell a more nuanced and complicated story on tax reform. While we will continue to monitor the legislative process closely, we remain bearish on the success of tax reform, with our current odds of passage at 20 percent.

What to Watch For

Despite our negative outlook on the tax reform process, we will be on the lookout for data points that can have an impact on our thinking. The tax reform process is not linear, and there may be moments of momentum and meaningful change. Specifically, we will be looking at:

- **Republican leadership:** McConnell and Ryan will face perhaps their greatest test of leadership over the Republican caucus. Tax reform is a more natural issue for the GOP than health care, and there is a general sense among the Republican caucus,

business trade groups, and conservative organizations that tax reform is critical to accomplish. If Republican leaders on the Hill are able to take charge in facilitating a collaborative process while also ensuring continued momentum forward, the chances of success in tax reform will improve. However, Republican leadership also includes Trump. The president will need to stop going on distracting tangents, as it only takes away from the tax reform debate. While Trump, himself, is not a major player on the tax reform specifics, he is a potential distraction to getting work done. If Trump is able to show sustained, laser-like focus on tax reform and remain on topic, it could provide a needed boost to the tax reform process in Congress.

- **Opposition:** While Democrats are not supportive of the Republican tax reform efforts, there has not been any concerted campaign against it. If Democrats see the likelihood increase of Republicans passing a tax reform measure, they will likely invest political energy into deterring its passage. This may include using the mandatory entitlement cuts from the statutory PAYGO Act we have previously written about as leverage to keep any moderate Republicans squeamish about voting for a deficit-raising tax reform measure. For more on the PAYGO Act, you can read our August 30th Spotlight Report, "Why Tax Cuts Just Aren't Possible."
- **Timeline:** When the Wednesday announcement occurs, there will be just 36 legislative days left for the House and 47 legislative days left for the Senate before the end of the year. The White House and House GOP leadership continue to adhere to the unrealistic timeline of competing tax reform by year end. Given that the budget resolution will likely not be adopted before the end of the October at the earliest, that essentially only leaves the House Ways and Means Committee three weeks in November to advance tax reform legislation before the Thanksgiving recess -- after that, congressional attention is expected to shift to the new end-of-year fiscal cliff created by President Trump's September deal with Congressional Democrats. But if Committee Chairman Brady moves too expeditiously in pressing for committee approval, he will risk angering rank-and-file members. However, if Brady and Ryan are unable to pass a tax reform package through the full House by the end of January at the latest, we expect the tax reform process to be at risk of stalling.