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Magic on Pennsylvania Avenue

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How do you change something without changing it? That conundrum has overtaken both ends of Pennsylvania Avenue lately. At the White House, President Trump wants to "drain the swamp" at the Federal Reserve without actually changing the central bank's interest rate policy; on Capitol Hill, Congress wants to squeeze more than $2 trillion of tax cuts into a budget that limits the cost of tax reform to only $1.5 trillion over ten years.

How do you solve these paradoxes? *It's magic, you know; never believe it's not so!* In the coming weeks, we will learn whether Congress and the President can pilot the tax reform bill and the Fed overhaul to successful conclusions.

Overhauling the Federal Reserve

President Trump has the easier challenge. His nominee, Jerome Powell, is already a member of the Fed's Board of Governors. He has voted with the majority – in other words, with current Chair Janet Yellen – ever since his appointment by President Obama in 2012. He is seen as a mainstream thinker, heedful of economic data and unlikely to unleash sharply higher interest rates. This stands in stark contrast to his leading rival for the position, Stanford economist John Taylor, who likely would have been more rule-driven and pushed for a more hawkish tone.

The selection of Mr. Powell fulfills two distinct objectives for Mr. Trump: First, he can tell his political base that he has drained the swamp by overhauling the Fed's Board of Governors. Ms. Yellen is the first Fed Chair in decades not to be invited for a second term.[1] If she chooses to leave the Fed when her term as Chair ends in February (although her term as Governor extends to 2024), President Trump would have the immediate opportunity to appoint another four Governors in addition to Mr. Powell, because three seats are already open.[2]

[1] William Miller was the last Fed Chair before Yellen not to serve at least two terms. President Carter appointed the former Textron CEO (and non-economist, non-banker) to helm the Fed in 1978, but his dovish policies proved disastrous and incited a mutiny among the other Fed governors. Barely a year after his confirmation, President Carter yanked him off the Fed and installed him as Secretary of the Treasury.

[2] In another instance of political magic, five Trump nominees among seven Governors does not constitute a majority of votes on the policy-setting Open Market Committee; the president of the New York Fed and a rotation of four of the other eleven regional Federal Reserve Bank presidents also vote. In that respect, it's also worth noting that New York Fed President William Dudley is expected to retire early, but his replacement will be determined by the other regional Fed presidents, not by President Trump.

Second, in changing the names on the Fed's masthead, President Trump appears determined to avoid actually changing the Fed's modus operandi or its policy outcomes. Even before selecting Mr. Powell for the Chairmanship, his first nominee to fill an open Governorship was Randal Quarles, a widely respected mainstream thinker with deep experience in both banking and government (as a long-time Treasury official in the George W. Bush administration); he is not likely to upend the Fed.

Likewise, the selection of Mr. Powell over Mr. Taylor indicates a preference for continuity of policy. If Mr. Trump's remaining selections similarly prioritize experience and consistency over sharp policy divergence, he will have pulled off the trick of changing the faces of the Fed without actually changing anything meaningful about the bank's policy and impact.

Tax Reform

At the other end of Pennsylvania Avenue, Congressional Republicans are working on their own magic act. The Senate recently passed a budget that allows for $1.5 trillion in tax cuts over the next ten years; if the tax reform plan fits within that rather wide framework, it can be enacted with only 51 Senate votes (i.e. with no Democrats participating).

The magic here will be whether House Ways and Means Committee Chair Kevin Brady and Senate Finance Committee Chair Orrin Hatch can corral their fellow Republicans to support the bill. Mr. Brady has already acknowledged that substantial changes will be required to win sufficient votes, and it is not at all clear that making changes to satisfy one bloc won't alienate other blocs in the process.

The "Tax Cuts and Jobs Act" released last week puts important meat onto the bones of the initial "Unified Framework for Fixing Our Broken Tax Code."[3] That document identified the key priorities, which the Republican bill now would implement:

- **Reducing the corporate income tax rate to 20%, and establishing a flat 25% tax on income from pass-through entities**. This is perhaps the most straightforward aspect of the bill, and some protections have been added to deter abuses by pass-through entities. However, the drop from the current 35% corporate rate to 20% may need to be phased in over time, in order to leave revenue available for other cuts not currently in the bill; this will be part of the negotiating process in the next few weeks.

- **Shifting to a territorial (rather than global) system.** The bill would implement this concept by eliminating all U.S. taxes on future profits earned overseas, except for a 10% tax on "high-profit foreign subsidiaries." Previously-earned profits would be taxed at a 12% rate for cash and 5% for illiquid assets, thereby encouraging repatriation to the U.S. Many investors and corporate executives were disappointed with the details here, as they had hoped for a lower rate on cash repatriation.

[3] Please refer to "Taking Care of Business," an *On Our Minds* commentary published October 13, 2017, for an assessment of the initial framework.

- **Eliminating the alternative minimum tax, generation-skipping tax, and estate tax.** All of these would disappear under the Brady proposal. The elimination of these taxes would amount to a huge tax cut for this group, even with no change in the marginal rate. The estate tax repeal would be phased in, with full repeal delayed until 2024; this is just one of many acts of legislative legerdemain incorporated into the bill in order to squeeze it under the $1.5 trillion cap.

- **Effecting a middle class tax cut while reducing the number of brackets.** The plan does reduce the number of brackets, from seven to four; but the effect on different income cohorts would be more complex than simply calling it a middle-class tax cut. Chart 1 shows that there is no clear bias toward any economic stratum of society, but the devil will lie in the details. The New York Times published an analysis[4] showing that about 32% of middle-class families would see their taxes rise immediately, and 45% would be paying higher taxes by 2026 due to the use of less generous inflation measures, expiration of some provisions, and other magic tricks of the IRS Code.

Chart 1: Proposed Individual Tax Rates			
Income Group, Married Filing Jointly	Current Law Tax Rate	Proposed New Rate	Change
Over $1,000,000	39.6%	39.6%	None
$470,000 to $1,000,000	39.6%	35.0%	-4.6%
$416,700 to $470,000	35.0%	35.0%	None
$260,000 to $416,700	33.0%	35.0%	+2.0%
$233,350 to $260,000	33.0%	25.0%	-8.0%
$153,100 to $233,350	28.0%	25.0%	-3.0%
$90,000 to $153,100	25.0%	25.0%	None
$75,900 to $90,000	25.0%	12.0%	-13.0%
$18,650 to $75,900	15.0%	12.0%	-3.0%
Up to $18,650	10.0%	12.0%	+2.0%

Source: House Ways & Means Committee

- **Doubling the standard deduction while eliminating personal exemptions.** The bill incorporates these provisions, but the effect isn't nearly as helpful to individuals and families as Rep. Brady advertises. The intent is to simplify tax returns by pushing many individuals and families away from itemized deductions; for many families, this effectively eliminates middle-class deductions for things like mortgage interest, charitable donations, and health care expenses. Especially for families with children, the elimination of the $4,050 personal exemptions (partially offset by a small $500 credit) would wipe out most or all of the benefit of doubling the standard deduction.

[4] "Republican Plan Would Raise Taxes on Millions," by Ben Casselman and Jim Tankersley, in The New York Times, November 6, 2017.

- **Eliminating the deduction for state and local tax payments.** This provision was perhaps the most controversial aspect of the original proposal, and – even with some changes – it is still a potential landmine. The new bill makes one concession by allowing up to $10,000 in property taxes to remain deductible, but it still eliminates deductibility of all state and local income taxes. It also limits the deductibility of mortgage interest to loans under $500,000, half the current cap.[5] Both changes will push individuals and families away from itemizing their deductions and potentially result in higher taxes.

- **Retaining current low rates for dividend and capital gains income, but curtailing favorable treatment for corporate interest expense.** These provisions were retained mostly intact from the original proposal. The effect is to perpetuate the preference for earning income from capital as opposed to labor, and to reduce the preference for debt financing over equity financing.

The legislative sleight of hand here is remarkably sophisticated, as the tax bill's authors shift money around. To take an example that will be notably painful for more affluent earners, the bottom 12% rate on ordinary income would be phased out for incomes over $1 million; this would create a "bubble bracket" in which the effective marginal rate becomes 45.6% for incomes between $1.2 million and $1.6 million, then drops back to 39.6% – effectively a tax hike on some millionaires. This seeming arbitrariness was needed raise sufficient revenue to fit within the budget cap.

One final aspect of the Brady tax bill, first reported in the Wall Street Journal over the weekend, is worth noting: The bill treats different types of income differently, with remarkably different effects. The article[6] considers four people who each earn $2 million but in different ways:

- A salaried executive would pay $868,000 (43.4% effective rate) based on a direct reading of the individual tax brackets.
- The owner-operator of a manufacturing firm would pay $704,400 (35.2% effective rate), because 30% of the income would be subject to the 25% rate on pass-through income while 70% would be considered as ordinary income.
- A passive business owner would pay $576,000 (28.8% effective rate) by taking full advantage of the pass-through rate.
- A passive investor would pay $476,000 (23.8% effective rate) based on the current rates for dividends and long-term capital gains.

In all four cases, the individual received the same $2,000,000 in gross income, but the effective tax rates vary widely and reflect the Trump administration's focus on the business community over wage-earning workers. This is not ideologically indefensible, but it does fly in the face of rhetoric supporting "working middle-class families."

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[5] The $500,000 cap would only apply to new mortgages, not to existing mortgages or to new refinancing mortgages.

[6] "In Tax Bill, How you Get Rich Matters," by Richard Rubin, in the Wall Street Journal, November 4, 2017. The article also considered a fifth case, of an heir who receives a $2 million bequest, but this would not properly be considered "income." With no estate or alternative minimum tax, this person's tax liability would be zero.

In this respect, Congress must pull two rabbits out of the same hat: First, the leadership needs to find ways to win the votes of Republicans from districts that will likely suffer under the plan – most notably areas with high state and local income taxes and high property values. The entire GOP delegations from New York, New Jersey, Illinois, and California should be considered at risk; if they act as a bloc, they could derail this legislation.[7] Second, Congress and the President need to persuade middle-class and many affluent families that this bill is in their interest, when they may in fact wind up paying higher taxes.

Rep. Brady knows this, of course. In the next few weeks, we will all see whether he has any magic up his sleeves. The goal is to get a bill through the House and Senate committees, then through the floor amendment process, and then through a House-Senate reconciliation before sending it to President Trump before Christmas. More improbable things have happened, but a little *abracadabra* might still make all the difference.

[7] There are 36 House Republicans from the eight states with the highest marginal state tax rates (California, Maine, Oregon, Minnesota, Iowa, New Jersey, Vermont, and New York). All but Iowa went for Hillary Clinton in the last Presidential election. If those 36 Republicans and all Democrats vote against the tax bill, the bill would fail by 13 votes.