5-10-25

WSJ Print Edition

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The Incredible Shrinking GOP Tax Cut

REVIEW & OUTLOOK

The House Ways and Means Committee will soon release the GOP's first draft of the party's tax proposals, and the irony is that the bill may be getting worse even as a good bill becomes more urgent. President Trump has pitched a tax-rate increase that even Democrats failed to pass, and parochial demands are shrinking the pro-growth value of the bill.

Republicans seem to have forgotten the principles of sound tax policy, even the lessons of the successful 2017 reform. Most of the 26 GOP Members of Ways and Means weren't in Congress in 2017. The intellectual capital of previous tax-writing leaders Kevin Brady, Paul Ryan and Dave Camp is missing. The Senate is somewhat better but will miss Pat Toomey.

Can a good bill be salvaged? Perhaps, but to do so Republicans will have to relearn the good and bad lessons of the first Trump tax cut, the Bush tax cuts of 2001 and 2003, the Reagan tax cuts of the 1980s, the Kennedy tax cuts of the 1960s, and even the Mellon cuts that kicked off the Roaring '20s. X

• *Permanent.* People and businesses like certainty so they can have more confidence making plans. The 2017 bill showed the benefit of making tax law permanent, or not. The corporate reform was made permanent, for the most part, while the individual tax cuts weren't.

Republicans are now scrambling to renew the individual cuts before they expire at the end of this year. The Bush tax cut of 2003 made a similar mistake and gave Barack Obama the leverage to raise taxes in 2012.

A successful reform will make tax changes permanent, rather than end in four, six or eight years. This will make the tax bill more economically potent and politically durable. Treasury Secretary Scott Bessent has been hitting this point, but other Republicans seem to define permanent as lasting through 2028.

• *Immediate.* One lesson of the Reagan tax cuts is that phasing them in is counterproductive. It can lead businesses to postpone investment until the full cut kicks in. The Reagan boom didn't begin until the tax cuts that passed in 1981 finally took full force in 1983. Republicans aren't talking about phaseins this time around, but it's always possible this idea pops up amid deficit fears.

• *Marginal rates matter most.* One lesson to relearn is the difference between the marginal and average tax rate. The average rate is the tax share of total income. The marginal rate is the tax paid on the *next dollar* of income. Economists know that the marginal rate matters most for growth because it most affects the incentive to work, invest, or take risks.

The most successful tax cuts of the last 100 years—the Mellon, Kennedy and Reagan cuts— all focused on cutting rates at the margin. The least successful—the Bush cut of 2001—handed out rebates that boosted consumption for a short period but did little for growth.

Mr. Trump has floated raising the top marginal rate to 39.6% from 37% for filers making more than $2.5 million. The Tax Foundation says this would affect about 175,000 filers, the most likely to invest and take risks in new ventures. Small businesses that pay at the individual rate would pay more than corporations.

More damaging would be the GOP surrender to left-wing soak-the-rich economics. If marginal rates don't matter, why not 50%, or 70%? As the nearby chart shows, in 2022 the top 1% paid 40.4% of income-tax revenue on 22.4% of reported earnings. The point of low marginal rates isn't to help the already rich, but to offer incentives to those who want to become rich.

• *Lower rates, broader base.* As long as the U.S. has an income tax—no thanks, 16th Amendment—the best tax code has low tax rates spread over a broad base of income. This does the least economic damage as it raises revenue, and it reduces the incentive for carve-outs for the politically connected.

The 2017 reform did this well on the corporate side, cutting the corporate rate to 21% from 35% and closing corporate tax loopholes. The individual reform did it less well. Its rate cuts were good and at the margin, but the rate cuts were modest.

Mr. Trump now wants to shrink the tax base with costly deductions: no tax on tips, Social Security benefits or overtime, plus a write-off for interest on car loans. These help specific groups, but they lose hundreds of billions in revenue, which raises the pressure to keep tax rates higher. This is tax reform in reverse.

• *Growth, not income redistribution.* Democrats these days view the tax code as they do spending—a goodie bag to parcel out favors to special interests. Credits for EVs, or carbon capture, or housing. These credits are a form of income distribution through the tax code. They promote investment based on political preferences rather than market returns. This inevitably leads to misallocated capital and slower economic growth.

This wasn't always the case for Democrats, by the way. Kennedy's Treasury spurred his taxrate cuts that led to the 1960s boom, while Bill Bradley and Dan Rostenkowski played vital roles in Reagan's 1986 tax reform that cut the top income tax rate to 28%. But too many Republicans these days now also view the tax code as a form of social spending. Instead of EVs, they want tax credits for families with children or low-income housing. The $2,000 per child credit is hugely expensive—$690 billion over 10 years—and does little to spur growth, as numerous studies have shown.

The best pro-family tax policy is one that helps the economy grow and raises everyone's incomes. That's especially true this year, as Mr. Trump's tariffs hammer the economy with the largest tax increase in decades. One problem for Republicans is that merely extending the 2017 reform, while crucial, doesn't provide new growth incentives.

Restoring 100% expensing for business investment is an essential growth provision. But if Republicans really want to offset the tariff taxes, they should consider further cuts in corporate and individual tax rates. Short of that, indexing capital gains for inflation would help. The trade-offs would be fewer tax deductions such as for family foundations, mortgage interest or municipal bonds.

The shame is that all signs point to a Republican Party that no longer understands the difference between good and bad tax policy. It's all the more unfortunate because this is a rare moment of unified GOP government that is likely to end in 2026 and may not return for years. If Republicans are merely going to pile on tax credits and deductions and raise taxes on entrepreneurs, we could have elected Kamala Harris.

