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Economics Group

Special Commentary

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Tax Reform 2.0: The Sequel

Executive Summary
The Tax Cuts and Jobs Act (TCJA) enacted into law at the end of last year was a significant change in U.S. policy that led to material changes in the economic outlook.[1] Recently, talk in Washington, D.C. has begun to swirl about a potential "Tax Reform 2.0". On July 24, Republican members of the House Ways and Means Committee circulated a two-page memo listing some high-level goals for Tax Reform 2.0. Given the impact the TCJA has had on the economy and financial markets, what are the potential implications of a possible tax reform sequel?

For now, details remain sparse, and there is yet to be one comprehensive draft of a bill. In short, however, most of the proposed changes in a possible tax reform encore are likely to be marginal rather than wholesale changes. The most ambitious aspect of the loosely outlined proposal is to make the individual tax cuts enacted last year permanent; at present, most of these cuts are scheduled to expire at the end of 2025. While we are skeptical this would be included in any final plan, were it to occur, there would likely be minimal short-run economic impact due to the back-loaded nature of the cuts. The long-run fiscal deterioration would be fairly large, however, and a more ominous debt outlook could cause long-term interest rates to rise a bit further.

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Beyond this potential change, most of Tax Reform 2.0's goals, such as expanding how 529 education accounts can be used or allowing families to access retirement accounts penalty-free when having a child, are unlikely to have a major macroeconomic impact in the context of the $20 trillion U.S. economy. In addition, the political calculus for passing a bill before the midterm elections in November looks a bit vexing, and a tight legislative calendar will likely be a second major hurdle. Thus, while tax reform 2.0 might come and go in the headlines over the coming months, we believe its near-term macroeconomic impact, should it become reality, would be far less significant than its predecessor. More often than not, the sequel disappoints relative to the original. We would not be surprised to see that hold true here.

What We Know So Far

Republican policymakers in Congress have been touting a potential follow-up bill to the sweeping tax reform legislation passed late last year for some time now. On July 24, members of the House Ways and Means Committee circulated a two-page memo that serves as our most useful starting point at this time. The goals can be broadly grouped into three buckets:

Bucket 1: Making the Individual and Pass-Through Business Tax Cuts Permanent
Although many of the changes to the corporate tax code were made permanent, much of the change to the individual and pass-through sections, such as the individual tax rate reductions and the doubling of the standard deduction, expire at the end of 2025. Republican policymakers have expressed a strong desire to make these tax changes permanent, as they did with the corporate tax rate reduction. Early signs are that this policy proposal would entail extensions of both the gross individual tax cuts (e.g. lower marginal rates) and the gross individual tax increases (e.g. the state & local tax deduction cap of $10,000).

Republican policymakers have expressed a strong desire to make individual tax rate reductions permanent.

[1] **Technically, the Tax Cuts and Jobs Act is codified as P.L. 115-97 "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."**

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Bucket 2: Promoting Saving Vehicles
The memo outlines different ways to tweak and improve the incentives to save. Examples include expanding 529 education accounts to pay for things like apprenticeship fees, creating "Universal Savings Accounts" that could operate something like a generic saving account but with the tax benefits of a Roth IRA and allowing families to access their retirement accounts penalty-free for expenses associated with having a child.

Bucket 3: Spurring New Business Innovation
This final bucket is the most vague of the three, with just two bullets and four sentences of explanation in the two-page memo. The purported goal is to help new businesses write off more initial startup costs and remove barriers to growth, but details much beyond that remain vague.

What Else Could Be Included?

There are a number of tax issues under discussion as the 115th Congress heads towards the finish line.

Beyond this rough outline, there are a number of other tax issues under discussion as the 115th Congress heads towards the finish line. Some of these issues have simply been discussed among legislators, while others have been proposed as standalone bills.

ACA Taxes
Although the Affordable Care Act's (ACA) individual mandate was de facto eliminated in the TCJA (by setting the penalty for not having health insurance at $0 starting in 2019), most of the taxes associated with the ACA were left alone. At the time, Republican policymakers stuck with the idea that ACA taxes would be dealt with alongside a possible repeal/replace effort and thus not as part of the tax overhaul. A wholesale repeal of all of the ACA's taxes and fees in Tax Reform 2.0 would likely prove too expensive, but some of the more politically unpopular ones, such as the medical device tax or the excise tax on high-end health insurance plans (i.e. the "Cadillac Tax") could be permanently repealed. The full implementation of these taxes has been repeatedly delayed in recent years, and a permanent repeal could garner some bipartisan support.

A leading idea appears to be indexing capital gains for inflation.

Capital Gains
Taxes on capital gains were left unchanged in the TCJA, but possible changes to this section of the tax code have gathered steam of late. The leading idea appears to be indexing capital gains for inflation. At present, if an individual buys a stock for $10 and sells it three years later for $15, the entire $5 capital gain is taxed, even though some of this gain may have been due to inflation.[2] Interestingly, some individuals have suggested that this change could come unilaterally from the executive branch. Though this idea was examined and eventually shot down by President George H.W. Bush's administration in 1992, it appears as though the Trump administration is at least kicking the tires on the idea.[3] In our view, this is one potential change that could have short-run implications for financial markets, particularly equity markets. However, the specific structure of any potential changes (e.g. are the changes backward looking as well as forward looking?) would be key to analyzing both the direction and magnitude of any possible financial market move.

What Is the Path Forward from Here?

In the House, progress has been in fits and starts. At this time, there is no single, comprehensive bill to which one can point. Some aspects of the plan have only been introduced by members, while others, such as a repeal of the medical device tax, have passed a full House vote as recently as July. At the moment, the House is on recess until after Labor Day. Upon returning, the plan in the House appears to be to draft a bill and vote on it by the end of September, allowing the Senate to take it up in October. Unlike the House, the Senate intends to work through the second half of August, but the legislative calendar is likely to be tight for the generally slower-moving upper chamber. A Supreme Court nominee battle is looming, other nominees still need addressing (such as the three Federal Reserve governors still awaiting a vote) and a budget must be passed by September 30 to avoid a government shutdown.

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In addition to a tight calendar, finding enough votes in the Senate will be a daunting task. This is in part because the reconciliation process, which was used to pass the TCJA with less than 60 votes,

[2] For more detail: The Tax Foundation. "Inflation Can Cause an Infinite Effective Rate on Capital Gains."
[3] For further reading on the Bush administration's decision, see "Legal Authority of the Department of the Treasury to Issue Regulations Indexing Capital Gains for Inflation."

is likely not an option for making the individual tax cuts permanent (had it been an option, they probably would never have been temporary in the first place). Thus, any bill with this policy item at its center will need 60 votes in a Senate with just 51 Republicans. With the midterm elections just three months away, we believe finding 60 votes in the Senate will be a tall order. Drumming up 60 votes could be particularly challenging if extending the individual tax cuts is coupled with other changes, such as indexing capital gains to inflation, which could be construed as a tax cut for the wealthy. A more probable outcome in our view would be for the Senate to take up a more watered-down version of Tax Reform 2.0 that focuses on small and less politically divisive tax changes, such as expanding the flexibility of 529 accounts or repealing the medical device tax. This could come either in October or during a lame duck session of Congress after the midterm elections.

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What Are the Macroeconomic Implications for our Forecast?

Other than the permanent extension of the TCJA's individual and pass-through business tax cuts, the changes outlined above are broadly an evolution rather than a revolution in the tax code. The biggest proposed change would likely be making the temporary provisions of TCJA permanent. The Congressional Budget Office (CBO) analyzed what this would do to the budget outlook, and it estimated that such a policy move would increase the cumulative budget deficit over the next decade by about $650 billion (Figure 1).[4] While this would be a sizable deterioration in the fiscal outlook, the effects would be heavily back-loaded: the estimated increase in the deficit over the FY 2019 – FY 2021 period would be just $7 billion according to CBO. Thus, were this to occur, the near-term impact on Treasury issuance would likely be very limited, though concerns about the government's long-term fiscal health could put some marginal pressure on the long-end of the curve. Similarly, any short-term stimulus derived from an increase in after-tax household income or corporate profits would likely be minimal, though the certainty associated with a permanent resolution to the tax outlook could be a small net positive for potential growth.

Beyond that, tweaks to 529 accounts, technical changes to the TCJA and other relatively minor changes are unlikely to have much of a measurable impact on short-run economic growth in the $20 trillion U.S. economy. Repealing the medical device tax, for example, would likely reduce federal revenues by only $20 billion or so over the next decade.[5] Individual sectors could be impacted, particularly the health care sector, should policies like the medical device tax or the Cadillac Tax be further delayed or permanently repealed. Changes to capital gains tax policy are perhaps the most relevant topic currently under discussion for financial markets, but the political realities on this front are daunting and the specifics are critical for understanding the potential impact. Thus, while we will be monitoring Tax Reform 2.0, the implications for our near-term macroeconomic outlook are likely to be fairly minimal based off of what we know at this time.

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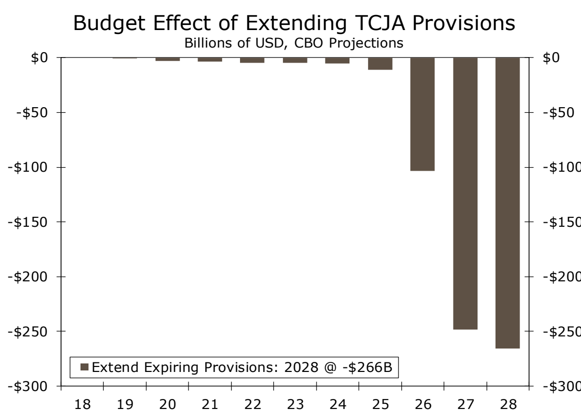
Figure 1



Source: Congressional Budget Office and Wells Fargo Securities

[4] **Congressional Budget Office. (2018). "The Budget and Economic Outlook: 2018 to 2028."**
[5] **Congressional Budget Office. "Cost Estimate of the Better Care Reconciliation Act of 2017."**

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