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Buried in the Tax Bills, Multiple Unintended Consequences.

Republicans' determination to pass overhaul magnifies risks in an already complicated system

In their rush to pass a sweeping tax overhaul, Republicans and the Trump administration may be headed for a reckoning with the law of unintended consequences.

The U.S. tax system is a complex, jury-rigged contraption. At the best of times, tampering with any part invariably triggers collateral consequences. Those risks are magnified now by Republicans' determination to pass the plan with minimal hearings on party lines by Christmas.

Gary Cohn, President Donald Trump's chief economic adviser, touched on this in a recent interview on CNBC: "We not only have to think about what the objective is with taxes, and tax reform. We have to think how do we get 218 votes [in the House of Representatives], and how do we get 51 votes [in the Senate] on top of understanding the intended consequences [and] the unintended consequences."

The bills, as they stand, contain countless incentives for gamesmanship: differing tax rates for different types of foreign property and profits, arbitrary expiration and implementation dates to hold the 10-year deficit impact below $1.5 trillion, and changes to the Affordable Care Act to free up government dollars that could roil private insurance markets. "There are more ticking time bombs in this bill than a Road Runner cartoon," says Martin Sullivan, chief economist for the nonprofit group Tax Analysts.

Two components in particular could have significant, unintended consequences: the treatment of pass-throughs—businesses such as partnerships that pay taxes as individuals rather than corporations—and of state and local taxes.

Historically, pass-throughs paid the same rate as individuals. Small businesses often say this is unfair because the top individual rate, now 39.6%, is above the corporate tax rate, now 35%.

Those complaints have little economic foundation: 86% of pass-throughs are so small they pay a personal rate of 25% or less, according to the Tax Policy Center, a think tank. Moreover, pass-through income is taxed once whereas corporate income is commonly taxed twice: at the corporate level, then on dividends and capital gains to shareholders.

Nonetheless, to appease business owners the House bill taxes 30% of pass-through income at just 25%. The Senate bill would let them deduct 17.4% of their income. Professionals such as doctors and lawyers above a certain income level would be prohibited from paying that lower rate.

Sen. Ron Johnson (R., Wis.), who has been a holdout, complains pass-throughs are still unfairly disadvantaged compared with the proposed corporate rate of 20%.

This change doesn't come cheap: the nonpartisan Joint Committee on Taxation says the House provision will lose nearly $600 billion in revenue over the coming decade and the Senate provision

$225 billion, due to tighter eligibility and an early expiration to reduce the deficit impact.

Yet the loss could easily be far more. Legions of attorneys, accountants and consultants will work over time to help any high-income client reclassify him or herself as a pass-through.

Suppose you're a doctor or lawyer. Daniel Shaviro, a law professor at New York University, says: "Not to worry. Some law partnerships or doctors own their buildings, so you form two pass-throughs, one is the service business and the other owns the building, rents it out to the first and gets the low rate." Or, he says, a law firm may form a partnership that owns its name and charges partners royalties for its use.

Treasury may struggle to craft guardrails against such maneuvers that hold up in court, says Kent Smetters, director of the Penn Wharton Budget Model, which simulates fiscal policy effects. His team estimates the pass-through changes will lose $71 billion to $94 billion more than JCT estimates.

There is precedent: After Kansas eliminated state income taxes on pass-throughs in 2012 it suffered a huge hit to revenue and finally reversed course this year. The federal tax reform in 1986 reduced personal rates below corporate rates, so many businesses became pass-throughs and corporate tax revenue fell short of expectations.

To pay for lower corporate and pass-through rates, legislators will eliminate several deductions, the largest of which is for state and local taxes (although the House would preserve a $10,000 break for property tax.) The rationale: the deduction serves no economic purpose and merely subsidizes state and local government spending.

The same is true for the federal break for municipal bond interest, yet its benefits are more evenly shared by Republican and Democratic states and thus it hasn't been touched. The state and local deduction benefits mainly affluent residents of Democratic states like California, New York and Maryland.

Sacrificing that deduction serves a purpose: It finances a more growth-friendly federal tax code. Yet many states have come to rely on hefty taxes paid by their wealthiest residents to finance extensive and costly public services.

Losing the federal deduction will raise effective tax rates on wealthy residents of states such as California, New York, Connecticut and New Jersey by two to five percentage points, according to Goldman Sachs economists. Some residents will move; others will never come. Goldman reckons New York City could lose 2% to 4% of its top earners as a result. The erosion of their tax base could imperil those states' fiscal health and force them to slash public services.

For some conservative lawmakers that may be an intended consequence. But it's also why no Democrats back the plan and will likely try to undo it if they retake Congress, much as Republicans have tried to undo the Affordable Care Act ever since Democrats enacted it on party lines. That sort of instability is yet another unintended consequence of the nation's increasingly polarized politics.

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