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Balancing Lost Tax Revenue the Reagan Way

Gradually increasing the Social Security eligibility age can offset revenue loss from Trump's tax cuts.

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Treasury Secretary Steven Mnuchin calls the Trump administration's tax proposal "the largest tax reform in the history of our country." The plan would slash corporate tax rates from 35% to 15% and roll back increases in individual rates that occurred under Presidents Clinton and Obama.

The announcement represents a first step toward a White House budget proposal that combines the president's fiscal plans with reforms to defense spending and domestic policies including ObamaCare. If such a budget is passed, it would stimulate business investment, boost productivity and improve real wages. It would also reverse the decline in military preparedness by raising defense outlays from a projected 2.6% of gross domestic product back to at least 4%.

The challenge will be to do all of this without increasing long-run fiscal problems. The federal government's debt has already more than doubled in the past decade, reaching upward of 75% of GDP. The Congressional Budget Office projects that the debt will grow to more than 100% of GDP in the next 15 years even without a reduction in tax revenue or an increase in defense outlays.

Higher projected budget deficits could raise long-term interest rates, potentially triggering failures in the fragile financial markets and a serious economic downturn. The markets' current fragility reflects overpriced assets—the S&P price/earnings ratio is now 70% above its historical average—after a decade of excessively low long-term interest rates engineered by the Federal Reserve.

Republicans expect to pass their tax plan through the Senate's reconciliation process, but there are strings attached. If the bill causes deficits beyond the decadelong forecast horizon, a sunset rule kicks in and ends the tax cuts in the 10th year. To prevent this, congressional Republicans propose to balance revenue losses from the personal tax changes by eliminating all tax deductions other than those for charitable contributions and mortgage interest. That means the new revenue would come from the one-third of taxpayers who itemize deductions, households that tend to have higher incomes, supporting Mr. Mnuchin's promise that the tax plan will not be a gift to the rich.

In addition to cutting corporate rates, President Trump proposes a similar tax cut for partnerships and other unincorporated pass-through businesses. House Republicans have also promised to allow American companies to repatriate after-tax profits earned abroad without penalty.

Preventing the business tax cuts from increasing the budget deficit will not be easy. The corporate tax raises revenue equal to about 2% of GDP. Cutting the rate in half will increase the annual deficit by about 1% of GDP, or nearly $200 billion. Faster economic growth due to increased investment would bring in some extra tax revenue, but probably only about $50 billion per year.

Congressional Republicans propose to offset the other $150 billion by enacting their border-adjustment tax: a 20% levy on imports combined with a 20% subsidy for exports. That should raise about $120 billion or so a year, enough to offset most of the net cost of the corporate tax cut.

Textbook economics implies that a border-adjustment tax, or BAT, would push up the value of the dollar, reducing the price of imports by enough to offset the 20% tax. Americans would therefore see no change in the prices they pay for imported goods. The stronger dollar would also have no effect on the net prices American exporters receive for goods sold overseas. A BAT is thus a pure revenue raiser, with the tax falling on foreign firms that export to the U.S.

But the dollar's value may not rise as much as theory implies, so American importers and retailers are lobbying against a BAT while major exporters are lobbying for it. Without the BAT, however, the corporate rate cut would add more than $1

trillion to the national debt during the coming decade, weakening the favorable effects of tax reform on capital formation and threatening higher interest rates.

There is no way to shrink the deficit other than by slowing the growth of Medicaid, Medicare and Social Security. Outlays for these programs are now 10.4% of GDP and projected under current law to rise to 12.9% over a decade. ObamaCare's insurance subsidies and Medicaid expansion now cost the federal government more than $200 billion a year. Reform could contribute significantly to reducing the deficit, although not by enough to balance out everything Mr. Trump is proposing.

The bipartisan Social Security legislation enacted during the Reagan administration provides a useful history lesson for how to offset deficit increases. The 1983 law raised the age of eligibility for full Social Security benefits from 65 to 67 while still allowing actuarially equivalent benefits at earlier ages. The increased age was phased in gradually and began only after a substantial delay.

In the intervening decades life expectancy at 67 has increased by three years. Repeating the Reagan reform by gradually raising the age for full benefits from 67 to 70 for those now under the age of 55 would reduce the annual cost of Social Security by about 15%, or 1% of GDP. Together with reforms of federal health-care spending, that should be enough to close the budget gap created by tax reform and increased defense outlays.

Raising the age for full Social Security benefits would also prevent the crisis in the program that is projected to occur in 2029. That's when the Social Security trust fund will be exhausted, requiring either an immediate 30% cut in benefits or a sharp tax increase. A gradual rise in the age for full benefits would be the best way to prevent that crisis as well as to reduce the projected fiscal deficit.

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