TCJA: A Boost to Growth or Missed Opportunity?

Urban-Brookings Tax Policy Center

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Northwestern | Kellogg

Overview

- What's in the TCJA for individuals and business?
- How does the TCJA impact taxpayers and the economy?
- Is this a lasting tax plan? If not, what's next?
- How can the next plan be improved?

What's in TCJA for business?

- Corporate rate cut: 35% to 21%
- Temporary expensing
- International reform:
  - "Territorial system"
  - minimum tax
  - anti-base erosion tax
  - transition tax
- Complicated deduction for pass-throughs
- Little base broadening

What's in TCJA for individuals?

- Temporary lower rates; permanent indexing
- Temporary changes to family benefits
- Temporary limits itemized deductions
  - Mortgage interest
  - SALT
  - Miscellaneous.
- Temporary Alternative Minimum Tax fix
- Permanent elimination of mandate penalty
- Temporary doubling of estate tax exemption

What's the main impact on individual taxpayers?

Short-term

- Lower income tax rates
- 27 million fewer itemizers, somewhat fewer payers of income tax.
  - Share of MFJ itemizing drops from 44% to 16%.
- AMT taxpayers sharply cut
  - From about 5.2 million to 200,000 in 2018
- Fewer taxable estates
- No penalty for not carrying health insurance.

Long-term

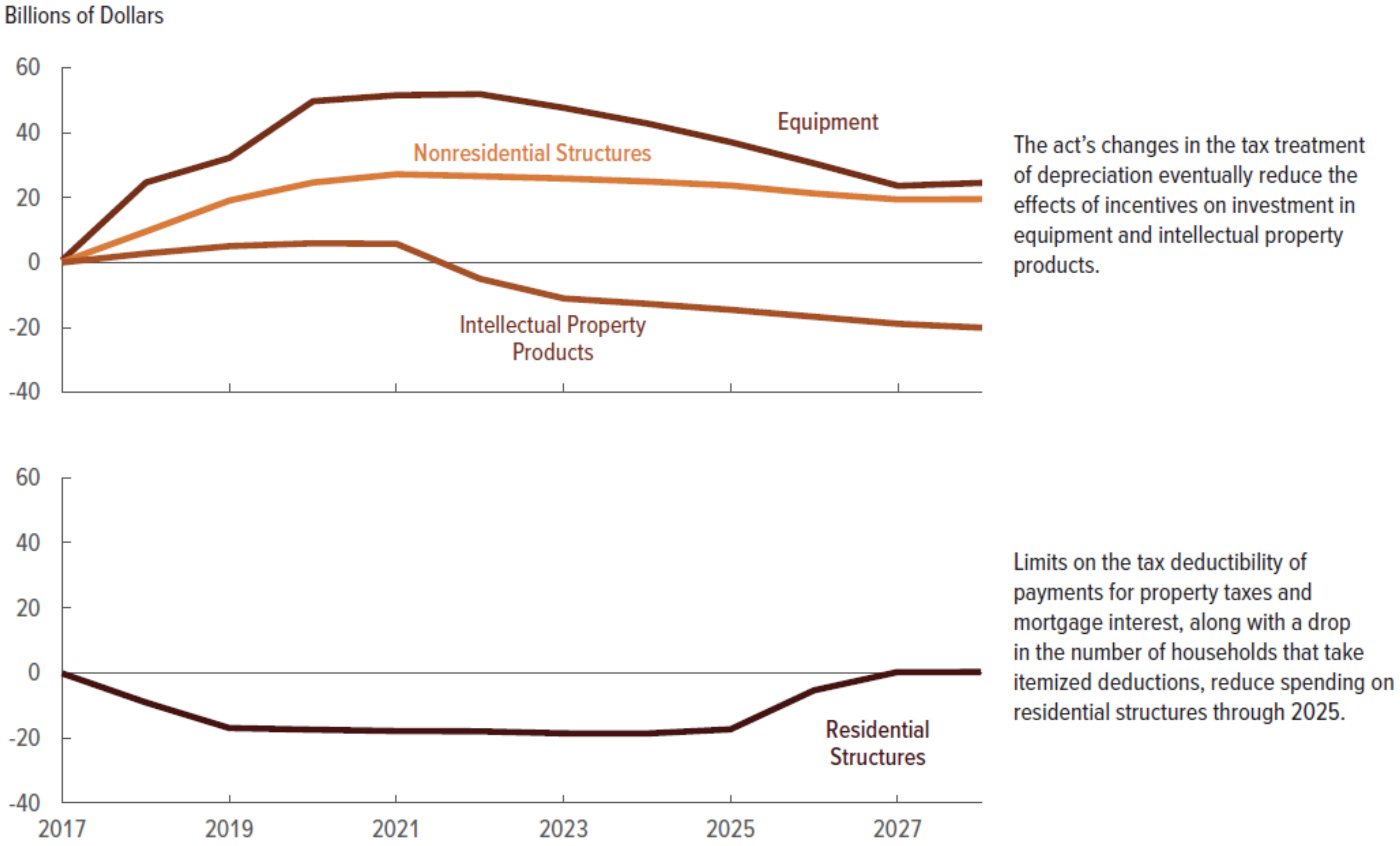
- Higher statutory tax rates due to chained CPI

What are the main economic effects?

- Large, temporary stimulus
- Moderate cuts in marginal rates on capital and labor
  - About 2 p.p. through 2025
  - Reverses thereafter on labor, falls a bit on capital
- Higher deficits and higher projected interest rates.
  - 2018-2028 deficit projected to be $1.8 billion higher
    - $1.3t in net primary deficit, $600b in interest
  - Ten-year Treasury already up ~66 bps since passage
- Moderate short-term boost in output produced within U.S. borders (GDP), almost zero boost to U.S. incomes (NNP).

Not all investment fared the same

Effects of the 2017 Tax Act on Investment Through Changes in Incentives



Source: Congressional Budget Office.

The changes in incentives consist of changes in the user cost of capital, which is the gross pretax return on investment that provides the required return to investors after covering taxes and depreciation, and changes in the benefits of locating business establishments in the United States.

Is this a stable tax plan?

- No.
  - Many provisions explicitly expire
  - Key international provisions may not survive challenges
  - Fundamental tax structure out of line with spending
  - Tax policy is a mixed bag
    - Eliminates provisions that aren't expenditures; introduces new ones

How will this play out? In retrospect....

(1) Everything we knew about public finance was wrong

➔TCJA led to sustained boosts in investment and labor supply, increased efficiency and compliance, and grew the economy while closing the deficit. TCJA was extended.

(2) Everything we suspected about debt was wrong

➔ Growing debt and rising projected debt never impacted the economy. TCJA was extended.

(3) We were right about tepid growth and deficits

➔ Congress paired back large social programs to pay for the (temporary) cuts

(4) We were right about tepid growth and deficits

➔ Congress eventually raised taxes to pay for the (temporary) cuts

(5) We were right about tepid growth and deficits

➔ Components of TCJA expire as scheduled, buck is passed.

Strategies for the next round

(1) Tax old capital and provide incentives for new investment

(2) Fix the international tax system and limit provisions that facilitate corporate avoidance and income shifting

(3) Change the taxation of capital to promote more uniform taxation

(4) Reduce distortionary tax preferences in the individual tax code

(5) Encourage working-age Americans to enter the labor force and supply more labor

(6) Improve compliance

Tax old capital and provide incentives for new investment

- TCJA windfall for owners of old capital (mixed with some incentives for new investment).
- Economic literature emphasizes negative impact of windfall gains on old capital ➔ no boost in investment, but anti-growth deficit impacts
- Way forward:
  - Rollback some of the corporate tax cut to 25% to 28%
  - Eliminate pass-through deduction.
  - Return to prior treatment for research.
  - Make permanent pro-investment incentives

Fix the international tax system and limit avoidance and shifting

- General approach is sound, but several reforms are warranted
- Need to better address profit-shifting and have stronger incentives for domestic production.
  - Higher minimum tax and applied on country-by-country basis
  - Eliminate FDII and replace with better incentives
  - Reduce 10% tangible equity allowance to rate on 10-yr Treasury
  - See Harris and Looney (2018) for more discussion

Change the taxation of capital to promote more uniform taxation

- TCJA retains and exacerbates distortions in the taxation of capital.
  - One example: exclusion for gains held at death.
- These distortions both cost revenue and decrease efficiency.
  - One example: lock-in effect due to gains held at death.
- Possible fixes include:
  - Repeal step-up in basis or change to carryover basis.
  - Closely-held stock in IRAs
  - Unrelated business income by tax-exempts

Reduce distortionary tax preferences in the individual tax code

- Despite high-visibility reforms (e.g., SALT and MID limitation), TCJA does little to improve some of the largest tax expenditures
  - employer-provided health insurance, retirement saving, capital gains; host of smaller provisions.
- Could improve many, for example:
  - Introduce Cadillac Tax or like reforms
  - Make MID more pro-ownership; first-time homebuyer tax credit
  - Make retirement incentives more equitable, effective

Encourage working-age Americans to enter the labor force

- TCJA temporarily lowers marginal tax rates on labor, could target reductions better.
- Reform could focus on high-elasticity individuals
  - Boost childless EITC
  - Second-earner tax credit
  - Child care subsidy

Improve compliance

- Compliance is an underappreciated aspect of tax reform
  - Raises rates on complying taxpayers and/or shifts activity to less-enforceable activity
- Massive tax gap, plausibly in the range of $500b to $650b annually
- Incentives to switch to pass-through income may exacerbate tax gap (while lower rates and less itemization limit the lost revenue)
- Fund the IRS to administer the tax code you have
  - Adequate IRS funding OR
  - Simpler and more enforceable tax code