# REFLECTIONS ON THE TAX CUTS AND JOBS ACT

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*The views expressed are my own, and should not be attributed to the Urban Institute, the Brookings Institution, the Tax Policy Center, their trustees or their funders.

I want to start by thanking Chairman Paulsen and Ranking Member Heinrich and all the members of the Committee for inviting me to participate in this important hearing.

Given my position and background, my testimony focuses primarily on fiscal issues, with particular emphasis on the recently enacted Tax Cuts and Jobs Act (TCJA). How we as a nation ensure a thriving economy in which all can participate along with fiscal responsibility are key issues. Obviously, none of us want to burden future generations with the financial results of our choices today. Rather, we should strive to provide our children and grandchildren with better sets of economic choices than we had provided to us.

The Tax Cuts and Jobs Act was the most consequential tax overhaul in three decades. The new law contains several major structural changes to our tax code and many other nonstructural changes. These all will have a variety of economic implications. Some of these implications are clear and fairly well known. Others are much less clear and involve trade-offs among conflicting goals or are contingent on future legislation or future economic behavior or future reactions by other countries. And some implications are just inherently uncertain given the state of economic knowledge.

As a starting point for evaluation, consider the four basic tenets of good tax policy:

- Revenue adequacy: Tax systems should raise enough revenue to meet the current and future obligations of the government (rather than to meet the demands from citizens for public goods and services).
- Efficiency: Tax systems should raise that revenue in a way that minimalizes negative effects on resource allocation, underlying economic behavior, and economic growth prospects.
- Equity: Tax systems should raise that revenue in a way that citizens find to be fair. In general, this means that the tax system exhibits horizontal and vertical equity. Horizontal equity means that taxpayers with similar incomes are treated in a similar manner by the tax system. Vertical equity means that taxes are assessed on a taxpayer’s ability to pay tax, which usually is characterized as a progressive tax system—one where tax liabilities as a share of income tend to increase with income.
- Simplicity: Tax systems should be as simple as possible so taxpayers understand the consequences of their economic decisions and so there are fewer unintended consequences. Generally, this means that tax laws and rates are clear, comprehensible, and predictable.

In the real world these policy goals all involve trade-offs. There are an infinite number of transactions that taxpayers can enter into, and so laws will never be simple. Similarly, raising adequate revenue requires trade-offs related to efficiency and equity. But if one keep these policy goals in mind, it becomes possible to evaluate changes in tax law qualitatively as well as quantitatively.

## CLEAR EFFECTS OF TCJA

There are several effects of the Tax Cuts and Jobs Act that are quite clear. First, there is a large tax cut in the short term. According to the Joint Committee on Taxation, the nonbusiness individual income tax provisions will cost around $60 billion in FY 2018 and around $160 billion in FY 2019. The business provisions have a similar revenue cost. So, to a first approximation, this is a large, stimulative tax cut in the short term.

And these tax cuts are tilted toward those with the highest incomes. Tax Policy Center estimates indicate that the short-term tax cuts as a share of after-tax income increase throughout the population as income gets higher. We estimate that the 20 percent of the income distribution with the lowest incomes will benefit by about $60 per year on average, or about 0.4 percent of average after-tax income. In contrast, those in the top 20 percent of the income distribution with the highest incomes receive an average tax cut of more than $7,600, or 2.2 percent of their average after-tax income.

TABLE 1

### Distribution of Federal Tax Change of the Conference Agreement for the Tax Cuts and Jobs Act

By expanded cash income percentile, 2018[a]

| Expanded cash income percentile[b] | Percent change in after-tax income[c] | Share of total federal tax change (%) | Average federal tax change (dollars) | Average federal tax rate[d] | |
|---|---|---|---|---|---|
| | | | | Change (% points) | Under the proposal (%) |
| Lowest quintile | 0.4 | 1.0 | -60 | -0.4 | 3.7 |
| Second quintile | 1.2 | 5.2 | -380 | -1.1 | 7.6 |
| Middle quintile | 1.6 | 11.2 | -930 | -1.4 | 12.4 |
| Fourth quintile | 1.9 | 18.4 | -1,810 | -1.6 | 15.8 |
| Top quintile | 2.9 | 65.3 | -7,640 | -2.2 | 23.3 |
| All | 2.2 | 100.0 | -1,610 | -1.8 | 18.1 |
| | | | | | |
| **Addendum** | | | | | |
| 80-90 | 2.0 | 13.1 | -2,970 | -1.6 | 18.5 |
| 90-95 | 2.2 | 9.6 | -4,550 | -1.8 | 20.2 |
| 95-99 | 4.1 | 22.1 | -13,480 | -3.1 | 22.2 |
| Top 1 percent | 3.4 | 20.5 | -51,140 | -2.3 | 30.3 |
| Top 0.1 percent | 2.7 | 7.9 | -193,380 | -1.8 | 31.6 |

**Source:** Urban-Brookings Tax Policy Center Microsimulation Model (version 0217-1)

**Notes:** Number of Alternative Minimum Tax (AMT) taxpayers (millions): Baseline: 5.2; Proposal: 0.2. Itemizers (millions): Baseline: 46.5, Proposal: 19.3.

(a) Calendar year. Baseline is current law. Proposal includes provisions contained in the conference agreement for the Tax Cuts and Jobs Act as filed on 12/15/2017. Excludes the effects of repealing the Affordable Care Act's Individual Shared Responsibility Payment (i.e., "individual mandate").

(b) Percentiles include both filing and non-filing units but excludes those that are dependents of other tax units. Tax units with negative adjusted gross income are excluded from their respective income class but are included in the totals. The income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks are (in 2017 dollars): 20% $25,000; 40% $48,600; 60% $86,100; 80% $149,400; 90% $216,800; 95% $307,900; 99% $732,800; 99.9% $3,439,900. For a description of expanded cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm

(c) After-tax income is expanded cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); estate tax; and excise taxes.

(d) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, the estate tax, and excise taxes) as a percentage of average expanded cash income.

In the longer term, the Tax Cuts and Jobs Act becomes even more regressive. By 2027, we expect the legislation to provide a small net tax cut on average. But the 60 percent of the population with lower incomes would experience, on average, a net tax increase under the law as written. This is because most of the individual income tax cuts will have expired, and the substitution of a slower-growing price index to adjust for inflation will gradually raise taxes on individuals, compared to earlier law. The portion of the population receiving net tax cuts is primarily those with the highest incomes and those with capital income, who benefit from the ongoing corporate income tax cuts.

TABLE 2

## Distribution of Federal Tax Change of the Conference Agreement for the Tax Cuts and Jobs Act

By expanded cash income percentile, 2027[a]

| Expanded cash income percentile[b] | Percent change in after-tax income[c] | Share of total federal tax change (%) | Average federal tax change (dollars) | Average federal tax rate[d] | |
|---|---|---|---|---|---|
| | | | | Change (% points) | Under the proposal (%) |
| Lowest quintile | -0.1 | -4.6 | 30 | 0.1 | 4.4 |
| Second quintile | -0.1 | -5.4 | 40 | 0.1 | 8.9 |
| Middle quintile | 0.0 | -2.1 | 20 | 0.0 | 13.8 |
| Fourth quintile | 0.0 | 2.9 | -30 | 0.0 | 16.9 |
| Top quintile | 0.4 | 107.3 | -1,260 | -0.3 | 26.0 |
| All | 0.2 | 100.0 | -160 | -0.1 | 20.0 |
| | | | | | |
| **Addendum** | | | | | |
| 80-90 | 0.1 | 4.4 | -100 | 0.0 | 19.7 |
| 90-95 | 0.1 | 3.9 | -190 | -0.1 | 21.8 |
| 95-99 | 0.2 | 16.4 | -1,010 | -0.2 | 25.4 |
| Top 1 percent | 0.9 | 82.8 | -20,660 | -0.6 | 32.9 |
| Top 0.1 percent | 1.4 | 59.8 | -148,260 | -0.9 | 32.9 |

**Source:** Urban-Brookings Tax Policy Center Microsimulation Model (version 0217-1)

**Notes:** Number of Alternative Minimum Tax (AMT) taxpayers (millions): Baseline: 5.6; Proposal: 6.0. Itemizers (millions): Baseline: 56.8, Proposal: 57.4.

(a) Calendar year. Baseline is current law. Proposal includes provisions contained in the conference agreement for the Tax Cuts and Jobs Act as filed on 12/15/2017. Excludes the effects of repealing the Affordable Care Act's Individual Shared Responsibility Payment (i.e., "individual mandate").

(b) Percentiles include both filing and non-filing units but excludes those that are dependents of other tax units. Tax units with negative adjusted gross income are excluded from their respective income class but are included in the totals. The income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks are (in 2017 dollars): 20% $28,100; 40% $54,700; 60% $93,200; 80% $154,900; 90% $225,400; 95% $304,600; 99% $912,100; 99.9% $5,088,900. For a description of expanded cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm

(c) After-tax income is expanded cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); estate tax; and excise taxes.

(d) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, the estate tax, and excise taxes) as a percentage of average expanded cash income.

A second clear effect of the Tax Cuts and Jobs Act is that the vast majority of tax cuts for individual taxpayers are temporary, and the tax cuts for businesses (especially corporate income) tend to be permanent. However, a number of the investment provisions for business, such as bonus depreciation, are temporary. And a reduction in the incentive to invest in research and development is scheduled to start in 2022.

A third clear effect is shifting the system for taxing US-based multinational corporations in a direction similar to many of our trading partners. The prior tax system had been described as “worldwide taxation with deferral,” but the ability of many cash-rich US multinationals to defer recognizing income from their foreign subsidiaries indefinitely meant that the tax system really functioned as a hybrid between a worldwide and a territorial tax system (where only income earned in the US would be subject to US taxation).

A fourth clear effect is a shift away from a broad-based, lower-rate income tax system in two ways. One way is in the direction of a hybrid tax system with more consumption tax aspects. By embracing 100 percent bonus depreciation, at least temporarily, Congress moved the business tax system toward a consumed income tax. Similarly, by denying deductions for net operating losses and for items that are costs of producing income, such as interest payments, FDIC premiums, housing expenses, and certain corporation expenses, the Tax Cuts and Jobs Act moves away from a traditional income tax base.

A fifth clear effect is the further establishment of different tax systems for different taxpayers. The Tax Cuts and Jobs Act maintained the preferential income tax rates for long-term capital gains and for dividends. But it added new tax regimes for income from pass-through entities (many of which are smaller businesses, but some of which are very large entities) that provide lower tax rates than for comparable wage earners, for income from exports by US multinational firms, and added a Base Erosion Anti Abuse Tax on certain intra-company transactions with foreign affiliates.

And the final clear effect I want to highlight is that the Tax Cuts and Jobs Act represents a large fiscal experiment, especially when considered in conjunction with the budget bill enacted in January. Taken together, these legislative efforts reduce federal revenues by $1.5 to $2 trillion over the 10-year budget window, under conventional federal budget scorekeeping methods. This large reduction in future revenues occurs at a time when the US economy is at or near full employment, so there is little need for added economic stimulus and the medium- and long-term pressures on the federal budget are likely to grow. The reason I call this an experiment is that proponents of the tax cuts contained in the legislation claim that they will have positive effects on the overall US economy and that economic growth will help improve the Nation's Fiscal outlook. But this is an untested claim.

## LESS-CLEAR EFFECTS OF THE TCJA

Conventional macroeconomic analysis indicates that the positive economic effects of the Tax Cuts and Jobs Act are likely to be small for the bill as written. This is because many of the investment incentives are temporary, as are most of the individual income tax provisions. In the longer term, the positive economic effects will be driven by a lower corporate tax rate, largely paid for by individual income tax increases because of a change in the price index used to adjust individual income tax parameters for inflation and less federal support for health care coverage because the individual penalty for not obtaining adequate health insurance is set to zero.

The macroeconomic analyses conducted on the Tax Cuts and Jobs Act by the Tax Policy Center, the Penn Wharton Budget Model, and the Congressional Joint Committee on Taxation all come to similar conclusions. There is an initial burst of extra economic growth as households and firms deploy the initial round of tax cuts. There may even be additional capital investment above what would have occurred in the absence of legislation because of improved investment incentives. But over time, larger federal budget deficits cause interest rates to tick up, providing a disincentive for firms to invest. This later effect erodes the initial burst of economic growth, and, within a decade or so, the overall economy is back to about where it would have been without the tax law changes.

To trigger strong positive economic growth, a number of effects need to occur through linkages among economic actors. To sketch out how this might work, consider the following possible set of effects. A lower corporate income tax rate makes investments in the United States more attractive because of a higher after-tax rate of return. More investment capital for business entities encourages them to add to their stock of productive capital. In turn, this means that workers are more productive and the increased output is sold to willing consumers. This increased productivity leads to firms competing for the now more-productive workers, increasing wage rates commensurately. Each of these linkages is uncertain as to its strength, which is why I characterize this tax overhaul as a large fiscal experiment. In similar situations in the past, the promised additions to economic growth have not materialized. But those who support the Tax Cuts and Jobs Act on economic grounds have argued that this time will be different.

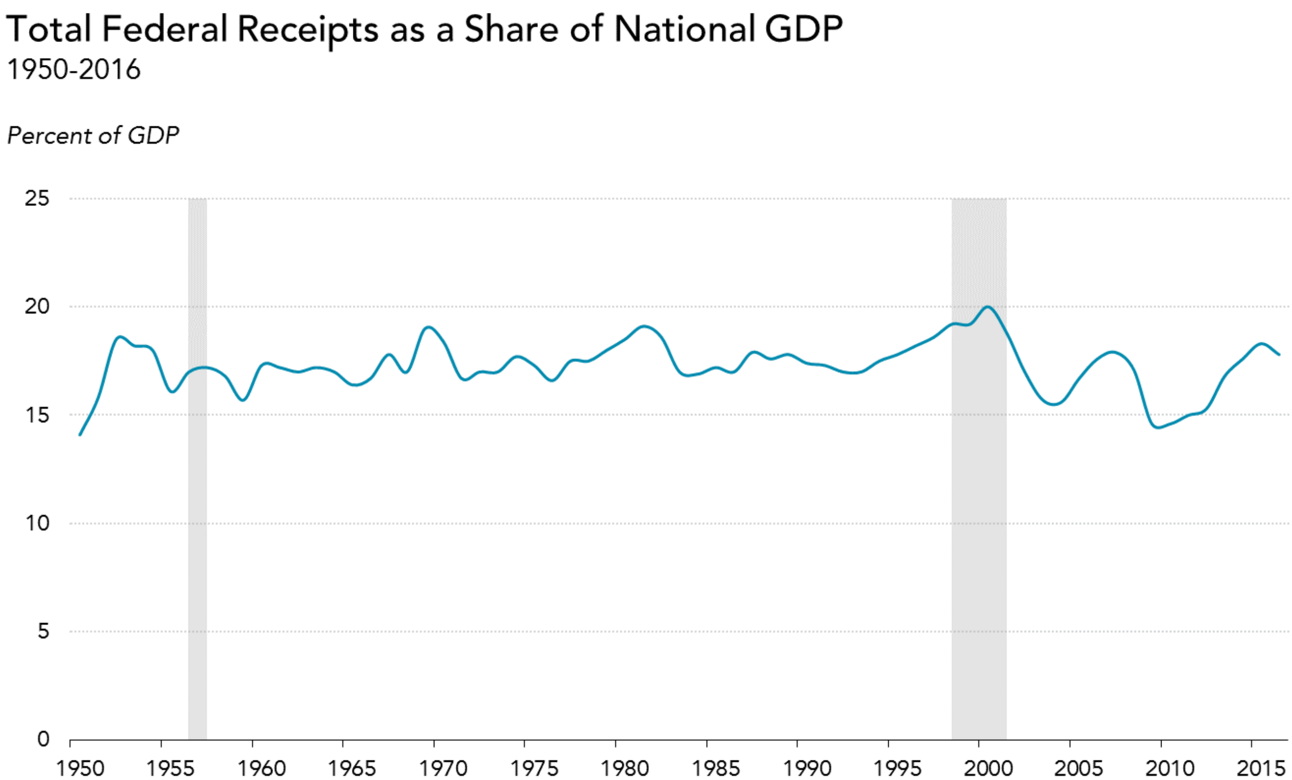
The Tax Cuts and Jobs Act also will have some effect on overall complexity of the Tax Code, but different provisions push in different directions, so the overall effect is unclear. There are a number of provisions that certainly will increase complexity, notably the changes to the way income from multinational firms is taxed, the changes to the way that income from certain pass-through business entities is taxed, and the creation of a new geographically-based investment incentive called Opportunity Zones. There also are several provisions that likely will reduce complexity for many taxpayers, such as the large increase in the standard deduction amount under the individual income tax, which will reduce the number of taxpayers claiming itemized deductions by millions, reducing complexity and record-keeping burden for these taxpayers. In the area of business taxation, repealing the domestic production activities deduction and introducing simplified accounting methods for smaller businesses should make complying with the income tax a bit easier for many businesses.

The Tax Cuts and Jobs Act also will have mixed effects on tax system certainty. It is true that many taxpayers will experience tax cuts for 2018 and 2019. But the new law also brings a lot of uncertainty. A chief reason is the built-in phase-outs, phase-ins, rate changes, and other scheduled changes that are part of the Tax Cuts and Jobs Act. This includes the favorable treatment for medical expense deductions and the lower excise tax rates on some production by alcoholic beverage producers. And there is the scheduled expiration of most individual income tax provisions after 2025, including the preferential tax treatment for income from pass-through businesses. For companies making long-term investments and having to choose their form of operating entity and the size and scope of their investment activity, making these choices with the prospect of wholesale changes in the tax law is a daunting task.

There also is some added uncertainty because of the speed with which the tax bill was enacted. Both the international tax provisions and the special tax regime for pass-through businesses were enacted without the chance for outside experts to analyze and evaluate design choices. That rapid legislative process means that US Department of the Treasury and the IRS will have to issue detailed regulatory guidance to explain how these provisions will operate in practice. The uncertainty surrounding the outcomes of these regulatory decisions and the speed with which they can be delivered adds to the uncertainty for affected parties.

## IMPACT ON FISCAL POSITION OF THE TCJA

The following chart shows federal revenues over the last 65 years or so. Despite changes in the economy, tax laws, and the political climate, federal revenues have fluctuated in a fairly narrow band—between 15 and 20 percent of GDP.




**Source:** Office of Management and Budget, Fiscal Year 2018, Historical Tables, Table 2.3.

But only two periods since 1950 have seen a balanced federal budget (the shaded areas in the chart). The more recent period was the late 1990s/early 2000s when revenues were around 20 percent of GDP. Given demographic trends (aging Baby Boomers, longer lifespans, relatively low birth rates), we can expect the public's demand for goods and services to be at least as high as it was during that time frame. So balancing the federal budget is likely to require federal revenues at least approaching 20 percent of GDP. The Tax Cuts and Jobs Act, as a net medium-term tax cut, goes in the opposite direction.

## CONCLUSIONS ABOUT THE TCJA

The recent tax overhaul contains both desirable and undesirable features. It included a necessary updating of the tax system applied to multinational firms. And it simplified tax filing for millions of individuals by substantially increasing the standard deduction and reducing the number claiming itemized deductions.

But the Tax Cuts and Jobs Act also has some negative features. It will worsen income inequality in the short and long run by reducing the overall progressivity of our tax system. It added several new complexities to the tax code while adding considerable uncertainty about how the law will be interpreted and administered and also whether various provisions will phase in, phase out, sunset, or come into being as scheduled. And the Tax Cuts and Jobs Act reduces tax revenues at a time when fiscal pressures and economic conditions indicate that may have negative consequences.

## THE PATH FORWARD

As with any new tax legislation, there will be a lot of interest in seeing its effects on the economy and on federal receipts. There will be opportunities to make necessary and desirable fixes to the legislation as defects become apparent. And Congress will have numerous opportunities to evaluate and reevaluate this legislation as provisions sunset, or phase down, or spring up. For example, at the end of 2019, the modification to the medical expense deduction (lowering the threshold to 7.5 percent of adjusted gross income) and the lower excise taxes on certain alcoholic beverage production will sunset. After 2022, the bonus depreciation provision begins to phase down and it sunsets in 2026. And most individual income tax provisions and the estate tax cuts expire after 2025. A number of other provisions have similar scheduled changes under the new law. Each of these will provide Congress with a good opportunity to evaluate how the provisions are working (or have worked) and to make a well-considered decision about whether the scheduled legislative treatment should be modified. And those decisions will have important implications.

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