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Why the Pessimists Are Wrong About the New U.S. Tax Law

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The new U.S. tax law is surprisingly unpopular. According to a New York Times survey, only one-third of Americans think their taxes will go down in 2018 as a result of the new tax law. These pessimists are wrong. Almost every household will pay less in tax. And over time the corporate tax reforms will lead to more capital accumulation, higher productivity, and higher real wages, raising pre-tax incomes as well as lowering the share of incomes taken in taxes.

Before the tax bill passed, critics said that the Congressional Republicans would not be able to cooperate enough to pass legislation and that, if they did, it would be just a tax cut and not tax reform. When it passed the critics said it was written in secret at the last minute. All of that affected the public's attitude about the tax bill.

Fortunately, none of those criticisms have turned out to be true. The basic features were not created in secret at the last minute, but were developed over several years of hearings by the Ways and Means Committee under Paul Ryan and widely described in a series of publications called "A Better Way."

The bill was a major reform of the corporate tax code, lowering the corporate rate from 35% – the highest in the industrial world – to 21% and following all other countries in adopting the "territorial" system of taxing foreign subsidiary profits, thus ending the tax penalty on repatriation of foreign profits. By removing the penalty on repatriating the earnings of the foreign subsidiaries of U.S. corporations that has trapped $2.5 trillion of earnings abroad, this reform will encourage companies to bring those funds back to the United States.

On the personal income side, it simplified the tax code by doubling the standard deduction. Experts estimate that the share of taxpayers who will choose to itemize deductions will decline substantially. And the child tax credit is doubled to $2,000 per child and begins to phase out only for couples with incomes above $400,000.

Here's what the changes in the individual tax return will mean for a variety of middle class families. A four-person family will pay no tax under the new law until their income exceeds $61,000, up from $48,000 under the old law. A single parent with one child who earns $35,000 paid $158 in tax under the old law but will get a cash refund of $366 under the new law. A five-person family with income of $100,000 and substantial deductions for the state and local taxes that are disallowed under the new law would still get a tax cut of nearly $2,000.

But the reduction in tax liabilities is only part of the benefit that most households will enjoy. The lower corporate tax will induce American corporations to invest in the United States instead of shifting capital abroad and will induce foreign companies to invest in the United States. The new rule on the taxation of the profits of foreign subsidiaries of U.S. firms will induce companies to bring back those profits as well as some of the $2.6 trillion in profits that are now trapped abroad. The increased corporate capital will raise productivity and real wages. If the combined sources of increased capital raise GDP at the end of ten years by $500 billion – equivalent to an extra annual growth of less than 0.2% — the average increase in annual income per household would be $3,500. So even a very moderate rise in the growth of GDP would raise average incomes substantially.

There were, of course, a number of special features put into the tax law to induce various members of the Congress and the Senate to support the legislation. That is the way tax legislation always happens. But they don't detract from the very positive effects of the major changes in the corporate and personal tax rules.

The big negative of the tax bill is its impact on the fiscal deficit. The increased taxable income generated by the tax bill will not be enough to pay for the tax reductions. In the end, the national debt at the end of the decade will probably rise from the 92% of GDP projected under current law to about 97%.

That increases the difficulty and the time needed to return the debt to the 50% level that prevailed in the past. But in my judgment the benefits of the tax reforms outweigh the adverse effects of the temporarily larger debt. The net inflow of capital will offset the crowding out caused by the deficit and the increased GDP will produce enough extra tax revenue to pay for the government's higher interest cost.

The Republicans did a bad job of selling the tax plan to the general public because of their emphasis on the corporate rate reduction and the reduced tax on foreign subsidiary profits. While economists could see how that would lead to increased capital inflows to the United States and therefore to higher real wages, that was lost on the broader public. But the reduced withholding that will begin in the first part of 2018 will send a clearer signal to most taxpayers that they do benefit from the recent reform. Over time, rising productivity will induce firms to raise wages to attract and retain employees. Over time the current skeptics will see that the tax reform is better than they now think.

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