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The Tax Reform Legislation of 2017

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The tax law enacted in 2017 was the product of years of analysis and negotiation under the guidance of Paul Ryan while he was chairman of the House Ways and Means Committee. It was accepted by the Trump Treasury and advocated by President Trump.

The resulting legislation corrected two long-standing defects in the U.S. tax system. Before the recent reform the corporate tax rate was 35 percent, the highest among all the OECD countries, thereby discouraging investment in the United States and driving U.S. firms to invest abroad. The second problem was America's unique tax treatment of the profits of the foreign subsidiaries of U.S. firms. After paying corporate tax to the foreign government, the subsidiary could invest the after tax profits anywhere outside the U.S. with no additional tax but profits brought back to the U.S. would be subject to the full 35 percent U.S. corporate tax with a credit for the foreign tax already paid. As a result, U.S. foreign subsidiaries left their net profits abroad, with the accumulated overseas profits totaling more than $2.6 trillion.

The 2017 legislation reduced the federal corporate tax rate to 21 percent, causing the average combined federal and state rate to be some 25 percent, about equal to the average rate in the OECD. The shift to a "territorial" tax system for foreign subsidiary profits means that those profits can now be repatriated without any additional U.S. corporate tax.[1]

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[1] The ability to repatriate foreign earnings with no extra U.S. tax applies only to profits earned in jurisdictions that levy at least a minimal rate of tax. If the profits are earned in a "tax shelter" jurisdiction with no corporate tax, the U.S. will impose a low tax on repatriated profits.

The new legislation differs from the last major reform in two important ways. The Tax Reform Act of 1986 (TRA86) focused on personal tax reform and actually raised the effective corporate tax rate by unfavorable changes in the tax depreciation rules. TRA86 was also revenue neutral and distributionally neutral because eliminating tax shelter options like leveraged cattle feeding allowed lowering the top tax rate from 50 percent to 28 percent with no loss of revenue.

The personal income tax reforms in the 2017 law included eliminating the personal exemption and limiting the deductibility of state and local taxes. Doubling the standard deduction produced a major simplification that will cause the fraction of taxpayers who itemize their deductions to decline from about 30 percent to just 10 percent. The increase in the standard deduction and the elimination of the deductibility of state and local taxes also increases economic efficiency by reducing the incentive to spend on tax-deductible items.

The primary favorable effect of the corporate tax reform will be to increase capital formation in the United States. The capital stock of the U.S. corporate sector will grow over the coming decade because the low corporate tax rate will induce corporations to invest in the United States rather than sending capital abroad to their foreign subsidiaries. The combination of the low tax rate and the new territorial tax rule will encourage corporations to repatriate foreign profits as they are earned and to bring back some of the $2.6 trillion of previously earned profits that are now trapped abroad. Foreign companies will also choose to invest more in the United States. And within the United States capital will move from more heavily taxed activity like agriculture to the corporate sector. If companies use some of the $1.5 trillion of tax reductions and the funds repatriated from abroad to increase share buybacks, the shareholders who obtain that cash will invest much of it in new share issues of other companies to finance investment by those firms.

The growth of the corporate capital stock will raise productivity and real wages. Although it is hard to judge how much the capital stock will increase during the coming decade, it is reasonable to assume that the tax reform will raise the capital stock by about $5 trillion over the next decade. That would cause annual real GDP to rise by about $500 billion at the end of ten years, equivalent to a $3,500 increase in the annual income of the average household.[2]

[2] A GDP increase in 2027 of $500 billion is about 1.7 percent of the currently projected GDP of $30 trillion in 2027. That implies an average growth rate of just 0.17 percent per year over the next ten years.

This is very different from the criticisms that I heard in the months before the legislation passed. Early critics of the Republican tax initiative claimed that the Congressional Republicans would not be able to cooperate enough to pass tax legislation and that, if they did, it would be just a tax cut rather than tax reform. After the bill passed, the critics said it was just written at the last minute and aimed at favoring only the rich.

None of that turned our to be true. The tax bill passed the Senate with just Republican votes even though the Republicans had a majority of just two members. This was not just a tax cut but a major reform, including the shift to a territorial system, the doubling of the standard deduction, and the limits on the deduction for state and local taxes.

This was certainly not a last minute creation. The basic structure of the reform was developed over several years by the Ways and Means Committee when Paul Ryan, the current House speaker, was its chairman. A variety of details were added toward the end to get the support of individual members of the House and Senate, a process that happens with every major tax bill.

Contrary to the claim that the bill will only benefit high-income taxpayers, the changes in the personal income tax rules and rates will benefit taxpayers at every income level. The distribution tables produced by the Joint Committee on Taxation showed that the tax bills produced by both the House and the Senate did not change the distribution of the tax burden even though they scored the corporate tax change as primarily favoring capital and therefore higher income taxpayers. That was before the bill was modified by doubling the child credit to $2000, a change that helped middle class families and had a revenue cost equal to 40 percent of the tax bill. Recent estimates imply that more than 80 percent of taxpayers will experience a tax reduction.

Calculations illustrate how a wide variety of middle class families will pay lower taxes under the new law. The income level at which a four-person family will pay no tax rises from $48,000 under current law to $61,000 under the new law. A 5-person family making $100,000 with substantial deductions allowed under the previous law for mortgage interest, property taxes and state income taxes will get a tax cut of $1,915. A single parent with one child earning $35,000 currently pays $158 in tax. Under the new law that parent gets a refund of $366, equivalent to tax cut of $524.

Another misleading criticism of those who still oppose the tax bill is that high income taxpayers get much larger tax cuts than those with lower incomes. What that ignores is that the previous tax liabilities of those with high incomes were much larger so the tax reduction is often proportionately smaller.

Sunset Provisions

An unfortunate feature of the 2017 tax law is the sunset provisions that end the favorable personal tax changes after 2025. Because none of the Democrat senators would vote for a Republican tax bill, the Republicans had to pass the legislation in the Senate using a procedure known as "reconciliation". That procedure requires that the legislation must involve no increase in the budget deficit after ten years. To achieve this, the legislation ends the personal tax cuts after 2025. The drafters of the legislation focused on the personal income tax because they knew it would be easier to extend the personal tax cuts in a subsequent tax bill in the future rather than allowing a tax increase to occur.

Extending the personal tax changes after 2025 is an important challenge for the future of tax reform. It should be done sooner rather than waiting until closer to 2025 when the potential end of the lower tax rates will create a variety of adverse incentives.

The increased budget deficit

My primary unhappiness about the tax bill is that it raises the annual budget deficits and increases the national debt at the end of ten years by about $1.5 trillion, equal to about five percent of the 2027 GDP. But although I dislike deficits and have long warned about their adverse effects, I have concluded that the favorable effects of the corporate tax reform outweigh the adverse effects of the resulting increase of the national debt.

Here are the primary adverse effects usually associated with a fiscal deficit: (1) that government borrowing crowds out private capital formation; (2) that higher government interest payments require higher taxes or reductions in spending on defense and nondefense programs; (3) that a budget deficit implies an unwanted increase in aggregate demand when the economy is at full employment; and (4) that a higher debt ratio leaves less capacity for increased emergency government spending.

I believe that none of these problems will materialize during the coming decade. Consider them in turn.

(1) Although the $1.5 trillion of government borrowing caused by the tax bill during the next decade could crowd out an equal amount of private borrowing, the capital stock will grow by an even larger amount. The $1.5 trillion corporate tax cut will go directly to US companies, and the stock of corporate capital will grow further because of the inflow of funds from the rest of the world. Even with increased government borrowing, the proposed tax reform can therefore still raise the corporate capital stock by some $5 trillion over the next decade.

(2) Moreover, the $500 billion increase in GDP by 2027 would increase tax revenue by more than $100 billion a year. That is enough to cover the $60 billion in government interest payments on the $1.5 trillion of extra debt, with money left over to increase government spending or reduce personal taxes.

(3) Concern that an increase in the fiscal deficit would undesirably stimulate aggregate demand is misplaced. In fact, the stimulative effects of the fiscal deficit and increased corporate investment should be welcomed for two reasons. First, they will offset the contractionary effects of the expected increase in the federal funds rate and the shrinking size of the Federal Reserve's balance sheet. And, second, after nine years of economic expansion, most experts expect the US to enter recession sometime in the next five years.

(4) Concern about the increased ratio of government debt to GDP, which has doubled in the past decade and is now 77%, is exaggerated. The Congressional Budget Office projects that even with no further legislation, the debt ratio will rise to about 92 percent by 2027. The direct effect of the $1.5 trillion deficit implied by the tax reform would be to raise that to 97%. A military emergency or an economic downturn would call for additional debt-financed spending or tax reductions. But even a massive spending program like the $900 billion American Recovery and Reinvestment Act of 2009 would add only an additional three percentage points to the debt ratio. It is hard to believe that a debt ratio of 97 percent would make that more difficult to achieve than a debt ratio of 92 percent.

So, for all four of the usual reasons, I believe that the benefits of cutting the corporate tax rate more than offset the adverse effects normally attributed to budget deficits.

<u>The Border Tax Adjustment.</u>

The original version of the Republican tax plan did not imply a substantial increase in the fiscal deficit. In that version, a feature referred to as the "border tax adjustment" would have raised about $120 billion in 2018 and more over time by enough to pay for the corporate tax cuts.

Here's how that feature would have worked in the context of the 20 percent corporate tax rate called for in the original plan. Companies that import goods would not be allowed to deduct those imports' cost in calculating their taxable profits. With a 20 percent corporate tax rate, that would be equivalent to a 20 percent import tax. Companies that export goods would be able to exclude the export earnings from taxable income, equivalent to a 20 percent export subsidy.

Although it looks like this would reduce imports and increase exports, that would not happen. As every economics student learns, the trade balance depends on the difference between domestic saving and domestic investment. Because the border tax adjustment would not change saving and investment, it wouldn't change imports and exports. Instead, theory implies that the changes in taxes on imports and exports would lead to a rise in the value of the dollar that offsets the direct impact of the border tax changes.

More specifically, if the border tax adjustment had been adopted, the dollar would in theory increase by 25 percent relative to other currencies. A 25 percent rise in the dollar lowers the cost of imports by 20 percent (just enough to offset the increase in import prices caused by the 20 percent tax), while raising the cost of US exports to foreign buyers (just enough to offset the implied 20 percent subsidy).

But although the border tax adjustment would not improve the US trade balance, it would boost tax revenue substantially, without increasing the burden on US consumers or producers. Here is why. Currently, US imports and exports are 15 percent and 12 percent of GDP, respectively. Given the difference of 3 percent of GDP, the 20 percent import tax and 20 percent export subsidy raises a net 0.6 percent of GDP, now equal to $120 billion a year.

Because there is no change in prices paid by American consumers or received by American exporters, that tax revenue is borne by foreign producers, who, owing to the dollar's appreciation, receive less in their own currencies for their exports to the US.

There was substantial opposition to the border tax adjustment among US importers and retailers who were not convinced that the dollar would strengthen enough to balance the higher implicit import tax. Although the basic theory of the exchange rate response is clear, in practice the offset would be less than complete. For importers and American retailers, there was nothing to be gained by the border tax adjustment and a risk of a substantial loss. They therefore lobbied very heavily against the border tax adjustment, arguing that it would hurt American consumers. They were successful in causing the Republican leadership to abandon the border tax adjustment and forced them to accept a deficit increase subject to a ten-year cumulative ceiling of $1.5 trillion.

I believe that reducing the fiscal deficit should be a high priority after the 2018 congressional election. A tax on carbon dioxide emissions or a slowdown of spending growth for federal entitlement programs can start to bring the debt ratio back down toward the level of less than 50 percent that prevailed before the 2008-2009 downturn.

Future tax reforms

The 2017 tax law accomplished a great deal but leaves important fiscal problems for the future. At the top of the list is reducing the future budget deficits and extending the personal rate cuts. The fiscal challenge is even greater because of the need to reverse the across-the-board cuts in the defense budgets and in the non-defense discretionary budgets that were mandated by the sequestration provision of the Budget Control Act of 2011.

Because of that legislation, the budget of the defense department has been subject to across the board cuts that will reduce defense outlays to 3.0 percent of GDP in 2021, the lowest defense share of GDP since before World War II. The Congressional Budget Office projects that defense outlays will continue to decline relative to GDP to just 2.7 percent in 2027. Bringing that up to five percent of GDP in 2027 would add more than $600 billion to total government spending that year. The same historically low relative level is mandated for non-defense discretionary spending. Achieving Democratic support to raise the defense budget to five percent of GDP would no doubt require providing a similar increase for non-defense discretionary outlays. Adding $1.2 trillion to total outlays in 2027 would be equal to about 4 percent of GDP.

The budget deficit in 2027 was projected by the CBO to be 5 percent of GDP before the 2017 tax legislation. The addition of $1.5 trillion to the national debt implies additional interest payments of about 0.15 percent of GDP. Because of the sunset provisions, the tax cuts would add only about 0.10 percent of GDP to the 2027 deficit. A sustained deficit of 5.25 percent of GDP with a nominal growth rate of 4 percent implies that the debt to GDP ratio would rise eventually to more than 125 percent of GDP. If that happened, it would no doubt raise the interest rate on the debt, implying even larger deficits and a higher equilibrium debt to GDP ratio.

To reduce the equilibrium debt to GDP ratio to 50 percent requires cutting the annual deficits to about two percent. Combining the currently projected deficit of about 5 percent of GDP with the potential rise in discretionary spending of 4 percent of GDP implies a future deficit of 9 percent of GDP. Getting that back to two percent requires finding offsets from the mandatory spending and increased revenue of about seven percent of GDP, a formidable task.

Mandatory spending on Social Security has increased from 4.4 percent 25 years ago to 4.9 percent now and is heading to 6.0 percent ten years from now, an increase of

1.6 percent of GDP. Federal health spending has increased from 2.9 percent 25 years ago to 5.4 percent and is heading to 6.9 percent ten years from now, an increase of 4.0 percent of GDP. But although so-called mandatory spending is up by 5.6 percent of GDP in the past 25 years, achieving significant reductions will be very difficult.

One approach to raising revenue is to continue the process of limiting tax expenditures that was begun in the recent legislation. The most costly tax expenditure is the exclusion of employer payments for health insurance. Sixty percent of American employers collectively spend more than $1 trillion a year to provide such benefits. If those benefits were subject to the income tax like all other forms of employee compensation, the government would collect an extra $236 billion this year. Subjecting benefits to the payroll tax as well would raise an additional $135 billion, increasing the total extra revenue in 2018 by $371 billion or 1.2 percent of GDP.

My favorite source of additional revenue would be a carbon tax. A tax of $40 per metric ton would allow eliminating all of the existing emission regulations and would produce annual revenue of $150 billion or more than $1.5 trillion over the next ten years. That would be enough to offset the entire revenue loss of the 2017 tax legislation and would permit reducing taxes and budget deficits in the following decade.

We should recognize the major achievement of the recent tax legislation and turn to the major fiscal tasks that lie ahead.

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