EconoFact Chats: The Coming Opportunity To Make a Fairer and More Efficient Tax System
Kimberly Clausing, UCLA
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I'm Michael Klein, executive editor of EconoFact, a non-partisan, web-based publication of the Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein
The national debt held by the public was 97% of national income at the end of 2022, and it's projected to rise to 119% of GDP in the next 10 years. The rising debt reflects ongoing federal government budget deficits, as well as policies of the past. The fiscal response to the COVID pandemic raised government debt. The 2017 Tax Cut and Jobs Act also contributed to higher deficits and increasing debt. The COVID relief policies have ended, but the effect on tax revenue from the Tax Cut and Jobs Act will be with us until the provisions of that act expire in 2025.

Or will they? It's typically the case that changes in the tax code that are scheduled to expire are, infact, kept in place. What will happen to government balance sheets if the provisions do not expire on schedule? What will be the effects on the fairness of the tax system? To discuss these issues, I'm pleased to be speaking with Professor Kimberly Clausing. Kim is an economist and a nationally recognized expert on tax policy. She is the Eric M. Zolt Professor of Tax Law and Policy at the UCLA School of Law. She has a new working paper published by the Hamilton Project of the Brookings Institution co-authored with Natasha Sarin entitled 'The Coming Fiscal Cliff: A Blueprint for Tax Reform in 2025.' Kim, welcome back to EconoFact Chats.

Kimberly Clausing
Thanks so much, Michael. It's always a pleasure to talk with you.

Michael Klein
Well, it's great to have you on again. Kim, I mentioned in the introduction that the expected rise in national debt, and also I mentioned your research paper with Natasha that warns of the coming fiscal cliff. What is that cliff, and what happens if and when we fall off of it?

Kimberly Clausing
Yeah, so to some extent it's perfectly okay if we let the tax cuts from the Tax Cuts and Jobs Act expire and in a way that's better than extending them carte blanche. It would mean a tax increase for many American families, but not an enormous one and it would simply reverse some previously unaffordable tax cuts. The last time we had a similar fiscal cliff we worried more about the macroeconomic impact because the economy was very weak so having a small tax increase would have reduced aggregate demand in a harmful fashion. But in today's economy a tax increase might actually help the Fed do their job without resorting to such high interest rates. So it's not clear that Congress doing nothing would be that big of a problem. That said, Congress has already stated an intention to extend a lot of the tax cuts that were in the Tax Cuts and Jobs

Act and it varies a little in terms of how systematic they are about that intention, but what that means is that in 2025 they're quite likely to open up the tax code and rethink some of these provisions, and this provides an enormous risk and an enormous opportunity for tax policy people. The risk is that they simply, at great expense extend, all of those tax cuts, but the opportunity is this is a chance to make a better tax system.

Michael Klein
So the fiscal deficit arises because of both spending and revenues. Your focus is on reforming policies that affect revenues. Is it your view that we can't avoid a fiscal cliff by cutting spending alone? Revenue raising measures are required also?

Kimberly Clausing
Yes, that's right and I think one underappreciated fact about our budget is how much of it is really going to things like social security, Medicare, Medicaid, national defense and interest. Those are all really important priorities that policymakers are going to be very reluctant to cut. So if you focus your cuts on the other parts of the budget though it implies something that's far too draconian, and there are a lot of other important priorities that the rest of the budget does as well. So this isn't to say that there isn't a role for spending reductions in both you know that first category of things and in the more discretionary items and there are some important changes one could consider there, but if you look at just the math, it looks very much like doing a more fiscally sustainable budget through spending cuts alone is just not feasible. So it's important to look at tax increases too, and Natasha and I are tax experts, so when we wrote this paper we focused on the areas where we think tax revenues can be raised but areas where, at the same time reform could build a better tax system that was more suited to some of the challenges we're facing today.

Michael Klein
Yeah we have a memo by Melissa Kearney about the amount of government spending that goes to the social safety net and how relatively small it is compared to those other things, and as you say it's very hard to cut the other things. So Kimberly how did the Tax Cut and Jobs Act affect government revenues, and what would be the effect on the deficit and the debt if these tax cuts are extended past 2025?

Kimberly Clausing
So the Tax Cuts and Jobs Act reduced revenue substantially and a blanket extension of those tax cuts combined with clawing back other provisions in Tax Cuts and Jobs Act that have sort of automatically raised revenue through small business tax provision changes for example; if you did both of those things together that would cost about $4 trillion dollars over the coming budget window; if it were legislated in 2025 that would apply to the 2026 to 2035 frame and that is simply just a lot of additional deficits beyond those forecasts that you mentioned at the beginning of the podcast right. So the CBO forecasts that you were raising which are already quite dire. Assume current law which assumes that all of those tax cuts expire so if you spend $4 trillion dollars extending them, then we're looking at a much more dire situation.

Michael Klein
You mentioned current law so there's a distinction between current law, and current policy and many of our listeners might be surprised to learn that a regular feature of tax rules and regulations is that they don't expire at the time initially set. Can you describe the difference between current law and current policy and what typically happens to keep tax rules and regulations in place even after they're scheduled to expire?

Kimberly Clausing
Yes so the budget reconciliation process encouraged this sort of provision expiration and the Tax Cuts and Jobs Act was passed under that process, which makes it easier to do legislation without needing a filibuster-proof 60 senators in the senate. So what those rules imply is that there's a 10-year budget window and after that window, you have to make sure that your budget package doesn't add to the deficits. This means that provisions that are often designed to get less generous over time or to expire, and things that cost revenue will simply disappear, or rates will increase or deductions will become less favorable. So policy makers often design these packages so that the popular things are the ones that are expiring hoping that subsequent legislation can simply fix it down the road. So when the architects of Tax Cuts and Jobs Act put that package together they made the corporate rate cuts permanent because they knew there would be less political support for those, but they made the individual ones expire with the hope that Congress would return those individual tax cuts and that includes also some business ones too like the R&D expensing provision that some of you may have heard about is a business raiser that also was set to expire.

In 2012, there was a similar situation a lot of the Bush tax cuts were expiring, and many of them were simply extended, but not all of them – we saw the top bracket revert to its prior level, but what this all means for policy in 2025 is that it's going to be a very important year. It's going to come with these risks and opportunities that I mentioned before. The hope is that we use that opportunity to revisit like which provisions of Tax Cuts and Jobs Act do we really think are good tax policy and which aren't, and also to think about fiscal sustainability and how we might raise revenue, or reduce spending in some cases to make for a more sustainable situation.

Michael Klein
So you mentioned good tax policy, and in the paper, you and Natasha write in favor of selecting reforms following the principles of sound tax policy. So what makes the tax policy sound or unsound? And did the Tax Cuts and Jobs Act result in sound tax policies in your estimation?

Kimberly Clausing
Yeah so we emphasize four characteristics that we think are really important for tax policy to focus on in our proposals in that paper, and one is the ability to raise revenue given the fiscal needs that were just described. One is to raise the revenue in an efficient manner like to avoid excessive distortion – there's always going to be some distortion when you tax, but to make that as minimal as possible. A third criteria is to have a progressive tax system one that asks more from those who've done really well in recent times, and less from those who've done poorly, and then a final criteria is to be able to respond to global collective action problems, and we have two examples in our paper which are tax competition, and climate change. And when you look at the Tax Cuts and Jobs Act with respect to these criteria it's kind of a mixed picture I think it clearly lost a lot of revenue and we're still seeing that consequence now in terms of the deteriorating

budget picture. The tax cuts were quite regressive so it made the tax system less fair overall. With respect to efficiency that's where you get a little bit of a mixed picture. There were some provisions that made the tax code simpler and more straightforward, and there was a novel attempt to cut down on profit shifting in the international side that didn't go far enough but there was a move in the right direction, but there were also other aspects of the law that we can talk about in a minute that I think actually made the tax system far less efficient including the pass-through income deduction. And it left a lot of the global collective action problems unresolved as well, so that's something that we're going to still need to focus on in the future.

Michael Klein
Are there in fact provisions in the Tax Cuts and Jobs Act that you and Natasha favor extending, and if so what are they, and why do you favor extending them?

Kimberly Clausing
Yeah so there's two sets of provisions that we think on net make more sense with the Tax Cuts and Jobs Act reform framework than returning to prior law. One is this combination of repealing personal exemptions, but making the child tax credit more generous, and allowing a much higher standard deduction. That combination of policies is roughly revenue neutral and distributionally neutral but it removes many taxpayers from the itemization group into the non-itemizing group and that makes it easier for many Americans to fill out their taxes because they're just getting this large standard deduction, and they don't need to track all of their itemizations. The child tax credit is more generous. That's somewhat offset by the loss of personal exemptions but if you made the child tax credit fully refundable which they didn't do in the Tax Cuts and Jobs Act, but which would be a modest tweak right you could really reduce child poverty a lot at the same time in a more targeted way than personal exemptions do.

The second area that is worth thinking about is the Tax Cuts and Jobs Act reduced the bite of the alternative minimum tax at the same time that it capped the ability of well-off taxpayers to deduct their state and local taxes. That combination as well affects many of the same taxpayers and typically taxpayers at the top, but the alternative minimum tax is much less transparent than the state and local tax deduction limit, so we think some revenue-neutral version of extending those tax provisions is sensible as well.

Michael Klein
So the things that you're mentioning tend to be revenue neutral, and you said that the Tax Cuts and Jobs Act is reducing or did reduce revenue. It was also less progressive. So what provisions of the Tax Cuts and Jobs Act would you like to see expire?

Kimberly Clausing
Yes I'll just go over three really briefly. The first is sometimes referred to as the 199A deduction, but it's a pass-through business tax deduction that allows some but not all businesses to deduct 20% of their qualified business income. That deduction is very complicated. It's very regressive, and it's very inefficient. It creates new distortions in the tax system, so I think it's an easy call to repeal it from a tax expert perspective. So the second thing that's an easy call here is to repeal the Tax Cuts and Jobs Act provision that doubled the estate tax exemption – that made the estate tax which already only applied to a very tiny number of estates apply to even fewer estates, and at

this point you have to have over $25 million as a married couple to be hit by the estate tax. So we think that that was you know an unwise provision that turbocharges income and wealth inequality and so getting rid of that is an easy call.

And finally, a somewhat harder call is the rate reductions in Tax Cuts and Jobs Act. Our view is that they're simply unaffordable and therefore we should let those rate reductions expire. I think many observers look at all those rates and say well can't you just keep some of the lower brackets you know when the 10% bracket doesn't change but the second lowest bracket went from 15% to 12%, maybe you can just keep that but that's not a very targeted way to help low-income people because of the way our tax rate structure works. Every individual gets some of their income taxed at those lower brackets. So it's a very expensive way to try to help those in the bottom part of the distribution, to extend a rate cut that would affect every single tax payer. So we suggest instead [a] more targeted approach to expand the earned income tax credit, expand the child tax credit, but let those rate cuts across the board expire, in part because they were never affordable in the first place, and it would cost about $2 trillion to extend them.

Michael Klein
So you recommend extending the earned income tax credit, recommending the child tax credit. You have other ideas, you and Natasha about how to improve the tax system. Let's start with the corporate tax. What do you advocate for taxing corporations?

Kimberly Clausing
I think we need to raise more revenue from the corporate tax. I think the corporate tax is really one of our best levers to reach capital income at all. If you look at the individual level, a lot of capital income goes entirely untaxed because it's held by untaxable individuals such as foreigners or its held in untaxed accounts such as retirement accounts. So if you want to take a tax bite out of capital income, often the business entity level is is your best chance for reaching it. Another interesting feature of the corporate taxes is it's more efficient than people think. A huge part of the corporate tax base is actually what economists refer to as above-normal profits, and what that means is that those profits can be taxed without distorting decisions about capital or labor, or the quantity of output because the same firm decisions that maximize after-tax profits and before tax profits are the same. So there's no reason to worry as much about distortion if you're hitting that sort of above normal return to profit. The corporate tax is also a progressive tax it falls disproportionately on shareholders and unlike our other tax instruments like labor taxes and consumption taxes it can hit the people who are holding capital – and capital is much more unequally distributed than labor income – so that makes it a tool of many of the objectives that we talked about earlier in terms of good tax policy. It raises revenue it's progressive and it's efficient.

Michael Klein
So talking a little bit more about corporate taxes there's a movement for countries to coordinate corporate tax policies to prevent tax shelters that enable corporations from shifting profits, and avoiding taxes in countries where they're active. What do you and Natasha propose along these lines, and how are these proposals similar to what's now being discussed?

Kimberly Clausing
What's really interesting here is that the biggest barrier that we faced earlier in trying to raise revenue from corporations was the fact that large profitable U.S. multinational corporations, the ones that we think of as holding these excess, supernormal profits they're very hard to reach because if you tried to tax them they would simply move the income offshore, and in addition they would argue that if you tax them too much you know they wouldn't be competitive with their trading partners abroad right? So if you're looking at them relative to firms that are based in other countries you know you would worry that you were disadvantaging them if you taxed them too much. But things have really changed a lot because in 2021 there's a historic tax agreement where 95% of the world economy agreed to tax large multinational companies at a minimum rate of at least 15%, and that makes it much easier for big countries like the United States to defend a higher corporate tax rate without losing their tax base to rock bottom tax rate jurisdictions abroad. So this agreement doesn't really end tax competition but it does constrain it right? Governments still have the ability to hand money to their firms if they want but they have a harder time lowering their tax rate below 15% and that's an important step forward for governments that want to tax corporate income because they can make their corporate taxes base more rigorous and defensible than it would be in the absence of this agreement. And importantly the rest of the world is moving forward with this agreement, so if we choose not to our companies will still face these kinds of taxes when they operate in adopting countries so this gives us a strong incentive to join the agreement ourselves, and to use that as a first step towards raising more revenue from the corporate tax base in general.

Michael Klein
So moving to a very different kind of tax, you have a discussion of a carbon tax; that's an effort to use market forces to combat climate change. We have a number of EconoFact memos on the carbon tax by Gib Metcalf my colleague at Tufts. How do you see tax policy being used towards trying to affect climate change, and what would be the revenue and distributional effects of such a policy, as well as its effect on [the] climate?

Kimberly Clausing
Yeah this this one is very important Michael for a few reasons. First I think is emissions if you look at the U.S. Paris goals under our nationally determined contribution, we're not going to meet our Paris goals even with the really important steps that we've taken in recent years, and even a very modest carbon fee like the one we suggest in this paper would help so much with those emissions reduction goals. It's a very cost-effective way to drive down emissions. A second goal is that of revenue. This is a cost-effective way to reach emissions goals if you compare it to some of the other ways that we drive down emissions, those involve spending taxpayer money on things like subsidies to companies and to consumers to encourage them to do things like by electric vehicles or use clean energy in their manufacturing processes. And the Inflation Reduction Act was an important step forward in doing those sorts of things but it was very expensive and some provisions have much lower bang for the buck than others right? So I think the production tax credits and the investment tax credits are thought to be quite good at emissions reductions, but some of these other provisions might have been less effective. But importantly the Inflation Reduction Act also lays the groundwork for making it easier to do a carbon fee than it would have been earlier, because clean energy sources will be less expensive than they would have been otherwise. That makes it easier for consumers and firms to switch

toward clean energy when dirty energy becomes more expensive. The carbon fee that we design in this paper though also takes into account the fact that consumers might worry about higher prices resulting from these kinds of policies, and so we explicitly carve out retail gasoline to say okay we realize gas prices are very sensitive issue for Americans, we're not going to subject those to the carbon fee, and we also suspect that utility bill impacts would be minimal when combined with the provisions of the Inflation Reduction Act.

A final reason I think that 2025 is a good time to think about a carbon fee is that if you look at what the rest of the world is doing this would align our approach to climate mitigation with what's happening in other countries like Europe, Japan, Canada, U.K., who have often approached pricing regimes, and are thinking about carbon border adjustments – and what a carbon border adjustment does is it basically incentivizes other countries to also adopt pricing regimes in order to avoid paying tariffs to the countries that are implementing the carbon border adjustment. So if we adopted a pricing regime too, it would be easy for us to join those efforts and to encourage countries throughout the world to do more climate change mitigation.

Michael Klein
Finally Kim, as you well know, tax policy is very political. It's hard to forecast what's going to happen in the political sphere. But what do you see as a likelihood of any or all of your proposals actually being enacted?

Kimberly Clausing
All of the proposals as a full package I would think it's about a zero percent probability, but some of the particular proposals might rise to the top, and these are really important conversations to have. If you look at the fiscal trajectory right now, we're in a period of rising interest rates. Those are going to take a bigger and bigger bite out of the government budget as we're paying more and more interest costs. So we're going to need to address these issues of fiscal sustainability soon, and policymakers are going to be looking for sources of revenue. So I think it's important for us to have these conversations now, so that when they are turning to sources of revenue, they can pick things…provisions that would make the tax code fairer, and more efficient, and be suited to these sorts of global collective action problems like climate change and tax competition, right? So we put those proposals forward with that spirit in mind.

Michael Klein
Well it's a very important role that economists can play to help inform policy and I applaud your efforts on this behalf, and thank you for joining me today to talk about it.

Kimberly Clausing
Thank you so much for having me.

Michael Klein
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