EconoFact Chats: Is a Major Tax Change Coming?

William Gale, Brookings Institution

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Michael Klein
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 Tax Cut and Jobs Act, signed into law on December 22, 2017, is arguably the most sweeping realignment of the U.S. tax code in over three decades. To comply with Senate procedural rules, Republicans opted to make almost all the individual income tax provisions expire at the end of 2025. So some of the big changes brought about by the Tax Cut and Jobs Act will end a little more than a year from now. But there are sure to be political fights about extending these provisions. What were the effects of the Tax Cut and Jobs Act? And what would be the most likely effect of the expiration of many of its provisions? To answer these questions, I'm very happy to welcome back to EconoFact Chats, Bill Gale. Bill is an economist at the Brookings Institution, and he is also a co-director of the Tax Policy Center. He's widely recognized as one of the country's top experts on public finances. Bill has written the book, *Fiscal Therapy: Curing America's Debt Addiction and Investing in the Future*. Bill, welcome back to EconoFact Chats.

William Gale
Thank you very much. Always a pleasure to be here.

Michael Klein
So first off, Bill, how did the Tax Cut and Jobs Act change the American tax landscape?

William Gale
The TCJA made very substantial changes to the income tax, the estate tax, and the corporate tax. Probably the most well-known changes are in the corporate tax, where it cut the top rate to 21%, and increased incentives for investment. There are also a variety of technical changes in the corporate tax that limited firms' ability to take losses, for example. On the individual side, everyone who pays taxes got a reduction in their marginal tax rate, and there was a change in the treatment of children and families. We used to have personal exemptions and a relatively small standard deduction, and what the Tax Act did was eliminate the personal exemption, but increase the standard deduction. So small families had a tax cut on net from that, large families had a tax increase on that on net, but the legislators also increased the child credit to offset that impact on large families. There are a variety of other changes in the individual tax as well. The most kind of tricky one is that they change the way that the tax brackets will be indexed for inflation in the future. This is kind of a clandestine tax increase that will continue on indefinitely and will most likely be invisible to most people.

Michael Klein
That's because we have a progressive income tax system, so when you go into a higher bracket, you pay a higher marginal tax rate, right?

William Gale
That's right, and if there's less of an adjustment for inflation, then you're more likely to be boosted into a higher tax category.

Michael Klein
So Bill, what was the motivation for these changes?

William Gale
I think the title of the Act sums it up pretty well, Tax Cuts and Jobs Act. Republicans wanted tax cuts, they wanted to boost employment. They wanted to do two things in particular. One is increase the competitiveness of U.S. companies relative to other companies, so there were a variety of changes to international tax rules, and they wanted to eliminate the tax differences between a traditional corporation, and what are called pass-through businesses, partnerships or S-corporations or sole proprietorships. Under the old system, investors and corporations paid a little more overall tax on their corporate and individual returns than investors in pass-through businesses, so they wanted to eliminate that difference.

Michael Klein
And I would just mention that you have a very nice EconoFact memo about pass-through corporations. So if we think about the title Tax Cut and Jobs Act, I guess clearly there was a tax cut, and it's less clear that, in fact, it helped boost jobs, productivity and U.S. competitiveness. What's the evidence on that Bill, and why is it so hard to—I know it's difficult—to get that evidence, can you explain why that is?

William Gale
Let me talk about four things that we think we know about TCJA and three things that we're not sure about. The four things we think we know are that marginal tax rates and tax burdens went down, that's number one. Number two is the Tax Cut and Jobs Act, simplified taxes for a lot of people by raising the standard deduction and reducing their tendency to itemize, and by a variety of changes that made the alternative minimum tax, which is this opaque parallel system, made the AMT (alternative minimum tax) less relevant for almost all households. So it simplified for households. On the other hand, it may have complicated taxes for businesses through a couple of provisions. The third thing we know is that TCJA lost a lot of money for the government. The revenue and interest costs put it at over $2 trillion for the decade, and the fourth thing we know is TCJA was regressive. Households in the top 1% got a tax cut of about $1,000 per week. Households in the bottom 20% got a tax cut of about $1 per week.

Michael Klein
So before we go on to the three things that are less certain, in terms of the lost revenue and also in terms of the regressivity of it, the fact that rich people got a better deal out of this than people who are middle class or poor, was the lost revenue understood at the time? Did people know that

by doing this revenue was going to be decreased? And also at the time, did people understand, who were drafting this legislation, that it was going to be that regressive?

William Gale
I think there was a general understanding of the regressivity and the revenue effect. Certainly CBO—the Congressional Budget Office, the Joint Tax Committee, all the major groups that estimate the effects of taxes, like the Urban Brookings Tax Policy Center or the Penn Wharton Budget Model or so on, everybody estimated it as costing a lot of money and being regressive. Republican policymakers occasionally denied that it was losing revenue, but there's no credible evidence to that effect. The evidence all suggests it lost a lot of revenue.

Michael Klein
So is that a feature and not a bug?

William Gale
Certainly it was designed by Republicans, and the evidence shows that people in Republican states benefited significantly more than people in Democratic states.

Michael Klein
And what about the three things that we aren't as certain about, or, I should say, as you and other public finance experts aren't as certain about?

William Gale
Well, let me characterize them as GDP, wages, and investment. The easiest one to talk about is wages where there's basically no impact on median wages in the aggregate data. There were a lot of bonuses at the beginning, very well publicized, but they turned out to be quite small and largely politically motivated. So if you look at the aggregate data, there's nothing in the wage data that would tell you, or the employment data, that would tell you that there's a big impact, but that's just aggregate data. It's not dispositive.

Michael Klein
What was the idea behind what would happen to wages by the proponents of the bill?

William Gale
The basic idea would be the TCJA would raise investment by cutting corporate tax rates and pass-through business tax rates. That would spur investment, that would make workers more productive, that would raise wages, etc. As I said, there's basically nothing in the data that suggests that that's true. But let me issue the caveat too, that the data, I feel like you can only get reliable numbers on the effects of TCJA through the end of 2019. Once 2020 comes around and COVID hits in the first quarter, and then there are massive stimulus plans after that, it's very hard to tease out the effect of TCJA in later years.

Michael Klein
I imagine that's true for investment and GDP as well, right?

William Gale
That's true, and that's part of the problem why it's uncertain. With investment, if you look at the aggregate data in 2018-2019, there's no real shift from earlier years. And interestingly, if you look at the U.S. relative to other countries in 2018-2019 versus earlier years, there's no evidence that there's any aggregate uptick in investment. There's some microdata, some microanalysis, micro studies that suggest that TCJA did raise corporate investment by about 10%. That's consistent with aggregate investment not changing, but if both of those facts are correct, it means either that TCJA crowded out non-corporate investment, or it means that other factors were causing investment to fall over the period. If you look at the other factors that might have done that, it doesn't seem likely that other factors would have on net, reduced investment. Monetary and fiscal policy were both quite stimulative in 2018 and 2019.

Michael Klein
So let's reiterate for a second. So what we do know, it seems, is that the tax system was simplified by the Tax Cut and Jobs Act. There was a revenue loss and it was regressive, but now we're talking about the possible expiration of a number of provisions of the Tax Cut and Jobs Act in 2025. Which provisions would expire if there's not an effort to extend them through legislation?

William Gale
Basically, all the individual provisions would expire. The individual income tax and the estate tax provisions would expire at the end of 2025, except the change in inflation indexing that I mentioned. So the main things are the rate cuts, the change to the personal exemption, standard deduction, and the child credit, the subsidy for pass-through businesses, and the cap on the state and local tax deduction, which was a big Republican win in 2017, and which Donald Trump just suggested he would be willing to repeal if he were re-elected in 2024. And so the politics of the state and local deduction have always been odd and they just got a little even odder with Trump's announcement. So in total, extending the temporary provisions would cost about $4.6 trillion over the next decade. That's a very large number. And then extending, removing the cap on state and local tax deductions would cost another trillion or $1.2 trillion. So we're talking enormous cost of extending the individual provisions.

Michael Klein
So like they say, a trillion here, a trillion there, pretty soon you're talking real money?

William Gale
Exactly.

Michael Klein
Exactly. The state and local tax exemption, that's thought to mostly benefit people in blue states, right? Because the state and local taxes are higher there?

William Gale
Yeah, it benefits high-income people in high-tax states, and those tend to be Democratic states. New York and California jump to mind. Massachusetts and Connecticut are not far behind.

Michael Klein
So Bill, if the provisions are not extended, is it symmetric to what you were describing before about the effects on, say, regressivity and lost revenue and also simplification that those would just be reversed to the pre-TCJA period, and we'd expect to see more revenue and a less regressive tax system, and also a tax system that becomes a little bit more complicated again?

William Gale
It's tricky. If none of the provisions are extended, then the simplification gains would be lost. The revenue losses would be eliminated going forward. But the regressivity is interesting because the things that are scheduled to expire are more progressive, that is less regressive, than the things that got made permanent. To put it differently, when Republicans chose what provisions to make permanent, the basket of provisions they chose to make permanent are on balance more regressive than the basket of provisions they chose to make temporary.

Michael Klein
So I guess the question comes up, is this any way to run a tax system? Because businesses and individuals have to plan on what taxes would look like in the future. Now there's a lot of uncertainty because of this possible expiration of parts of the TCJA. First off, why did it come up that these would expire? What's the politics or the legislative reason for that?

William Gale
There's a multi-step answer. First, the Republicans did not have 60 votes in the Senate, which means that they could not run the legislation through regular channels. They had to use something called reconciliation. Reconciliation is a special procedure that allows a majority vote to win in the Senate. That is, it's not 'filibusterable', if that's a word, but it has certain rules attached to it. One is that only budget-related items can go through reconciliation, and another is that reconciliation legislation cannot increase the deficit after the 10th year. So the Republicans either had to go for a relatively big tax cut, making some of the provisions temporary, or go for a relatively smaller tax cut and making the whole thing permanent. They chose to go for the big tax cut and make some of the provisions temporary.

Michael Klein
Is there any evidence on the effects of this kind of uncertainty on business investment or on other factors that could adversely affect the economy?

William Gale
Well, the good news in that regard is that the pass-through deduction, so-called Section 199A, does not seem to have influenced business investment. It seems to have been more a windfall gain for owners of existing businesses, and that's in part because the deduction took the form of a reduction in the tax rate rather than an increase in investment incentive. If you think about it, a business's income in a given year is primarily due to investments that it made in the past. So if you cut the tax rate on its current income, you're basically cutting the tax rate on the investments it made in the past, which is essentially giving a windfall gain for something that can't change behavior. So it's very inefficient. It's a very inefficient way to encouraging investment, and it would make much more sense if they wanted to stimulate investment by passers to provide stronger depreciation deductions rather than lower rates. So on the pass-through side, it doesn't

seem to be that much of an issue. On the corporate side, again, there's a debate about what happened to investment. I think the reform, the discussion about how to reform the corporate tax will take that debate into account.

Michael Klein
So I'm not going to ask you to forecast unconditionally what would happen and whether these changes will be extended or not, but does it really depend upon who controls Congress after the November election, do you think?

William Gale
I think it depends a lot on that. It depends a lot on who's in the White House, but there is a very interesting political issue. There are some cross-currents. It's not just that Republicans want to extend everything and Democrats want to extend things for people under $400,000. The latter thing is almost impossible to do because of the changes in the base, not just the rates, but also there are camps within each party that are relatively more dovish or hawkish on the deficit effect. I think you'll see a significant effort to extend a lot of the proposals, but also a significant effort to pay for those extensions with some other tax increases.

Michael Klein
And any guesses on what those other tax increases might entail?

William Gale
There's a great search for so-called pay-fors right now in Washington. I could see the corporate rate going up to 24, 25 percent. I could see this section 199A deduction being reformed, probably not eliminated. I could see the estate tax exemption which was raised to 11-something million for a couple was doubled in 2017. I could see that being tightened, some other estate rules being tightened. All of those things would raise some revenue, but don't come close to paying for the whole package.

Michael Klein
Well, it remains to be seen what happens with this very important issue. And you've done a very good job, Bill, in laying out what the issues in fact are and what the consequences of the extension of these tax cuts, or the elimination of them, would spell for government budget deficits, but also for the economy more widely. So thank you very much for joining me today, Bill. And thanks once again for being such a good and important contributor to EconoFact.

William Gale
Many thanks to you for what you do, and I'm always happy to be here.

Michael Klein
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