Tax Policy in the Age of Trump (and Beyond)

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HOW
BIG
SHOULD OUR
GOVERNMENT
BE?

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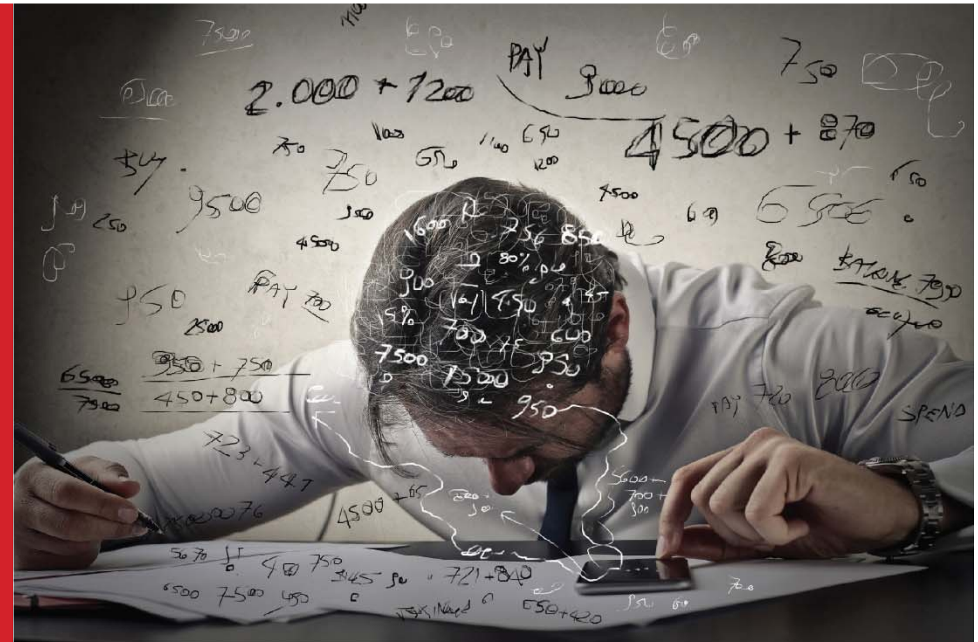


TAXING OURSELVES

A Citizen's Guide to the Debate over Taxes

fifth edition

Joel Slemrod and Jon Bakija

Criteria for Evaluating Tax Policy

- Equity / fairness / justice
- Economic efficiency and prosperity
- Simplicity / administrative and compliance costs
- Enforceability

Major Business Tax Changes in the Tax Cuts and Jobs Act of 2017 (TCJA)

- Statutory corporate tax rate cut from 35% to 21%
- Major changes to rules for taxing profits of foreign subsidiaries of US multinational corporations
- Temporary increase in depreciation deductions
- Disallows deductions for net interest payments in excess of 30% of adjusted measure of corporate taxable income
- 20% deduction for “pass-through business income” in individual income tax
    - Unlimited if taxable income is below $157,500 (single) or $315,000 (couple)
    - Above those income levels, deduction is phased out for certain “personal service” businesses (e.g., doctors, lawyers), unless business pays a enough wages and salaries to other people or has enough property

Tax classification of businesses in the United States

Tax classification of businesses	Subject to corporate income tax?	Pass-through entity?	Key restrictions	Percentage of businesses, 2012	Percentage of business income, 2012
Sole propietorship	No	Yes	Owned by individual or married couple	73	11
Partnership	No	Yes	Not publicly traded (with exceptions)	10	30
S corporation	No	Yes	No more than 100 owners	12	18
C corporation	Yes	No	None	5	40

Sources : authors' calculations based on data from IRS Statistics of Income *Tax Stats* website <http://www.irs.gov/taxstats/>.

Notes : Includes both non-farm and farm sole proprietorships. LLCs are included in the categories they choose for tax purposes (usually partnership). Excludes real estate investment trusts and regulated investment companies. Last column is calculated based on net income (less deficit) reported to the IRS.

Source: Slemrod and Bakija (2017). <https://mitpress.mit.edu/books/taxing-ourselves-3>

Tax planning 101

1) Buy an appreciating asset, and defer realization (i.e., don't sell it, and don't pay yourself dividends, so no individual tax is owed)

2) Borrow against it to consume, and deduct the interest

3) Die!

- The corporate income tax puts friction in the way of this strategy, serves as a "backstop" to individual taxation
    - Less friction when the corporate rate is well below the top personal rate (now 21% corporate vs. 37% individual)
    - Rate differential creates opportunities to shelter both capital income and labor income in corporations, deferring or eliminating individual tax

Major Individual Income Tax Changes in the TCJA

- Cuts tax rates
    - e.g., top tax rate falls from 39.6% to 37%

- Switches to a measure of inflation that grows more slowly over time for indexing tax law provisions

- Eliminates personal exemption ($4,150 deduction per person in 2018)

- Doubles child tax credit from $1,000 to $2,000

- Almost doubles standard deduction (to $24,000 for couple and $12,000 for single)

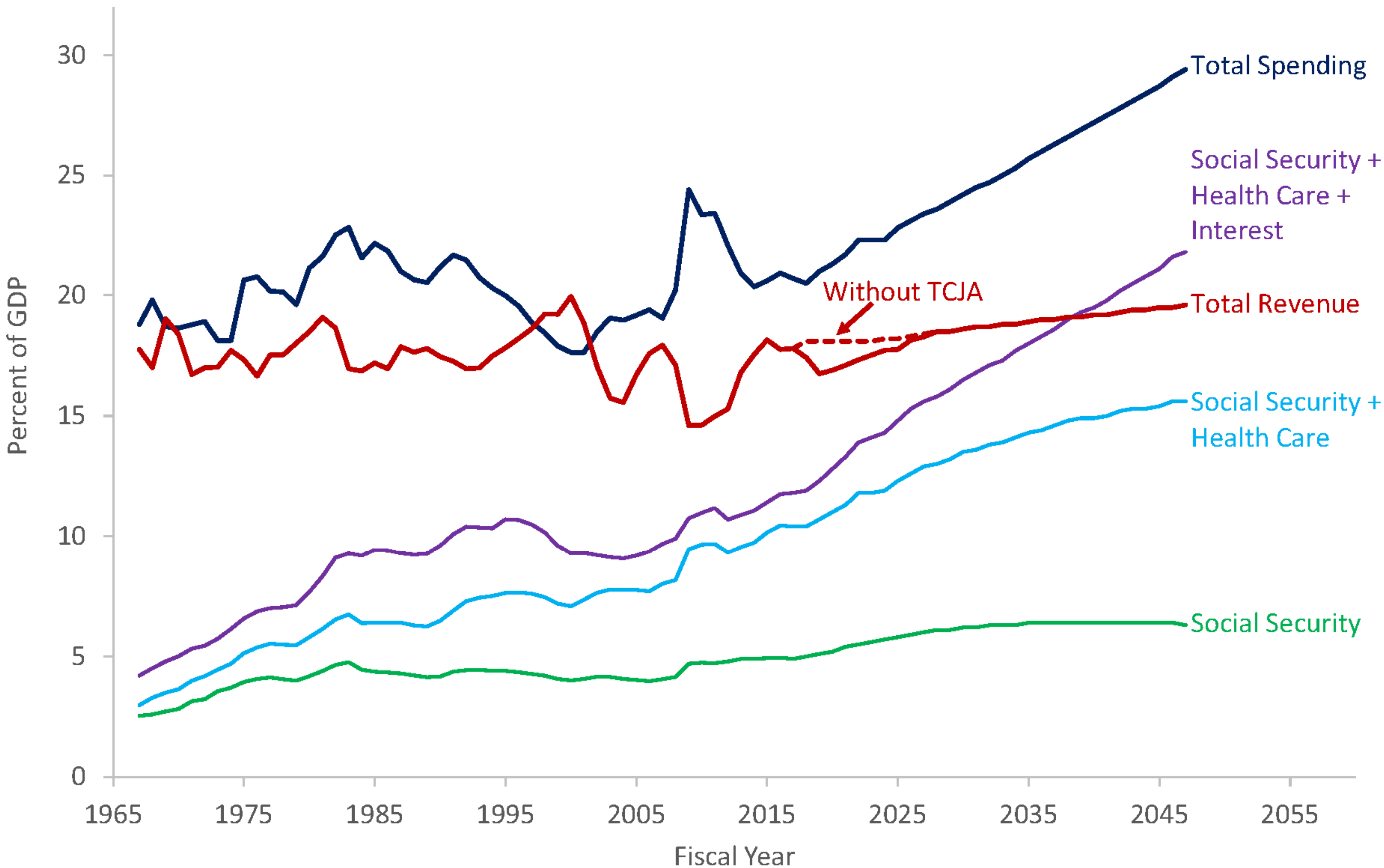
- Caps itemized deduction for state and local taxes at $10,000

- Caps mortgage interest deduction to interest on $750,000 of “new acquisition debt”

Other Notable TCJA Provisions

- Doubles estate tax exemption to $11.2 million per return
    - Estate tax rate above that amount remains 40%
- 1.4% tax on “net investment income” of colleges and universities with endowments above $500,000 per student
- Almost all individual tax provisions (except change in inflation indexing) and estate tax provision “sunset” after 2025

US Federal Government Spending and Revenue as a Percentage of GDP, 1967 - 2047



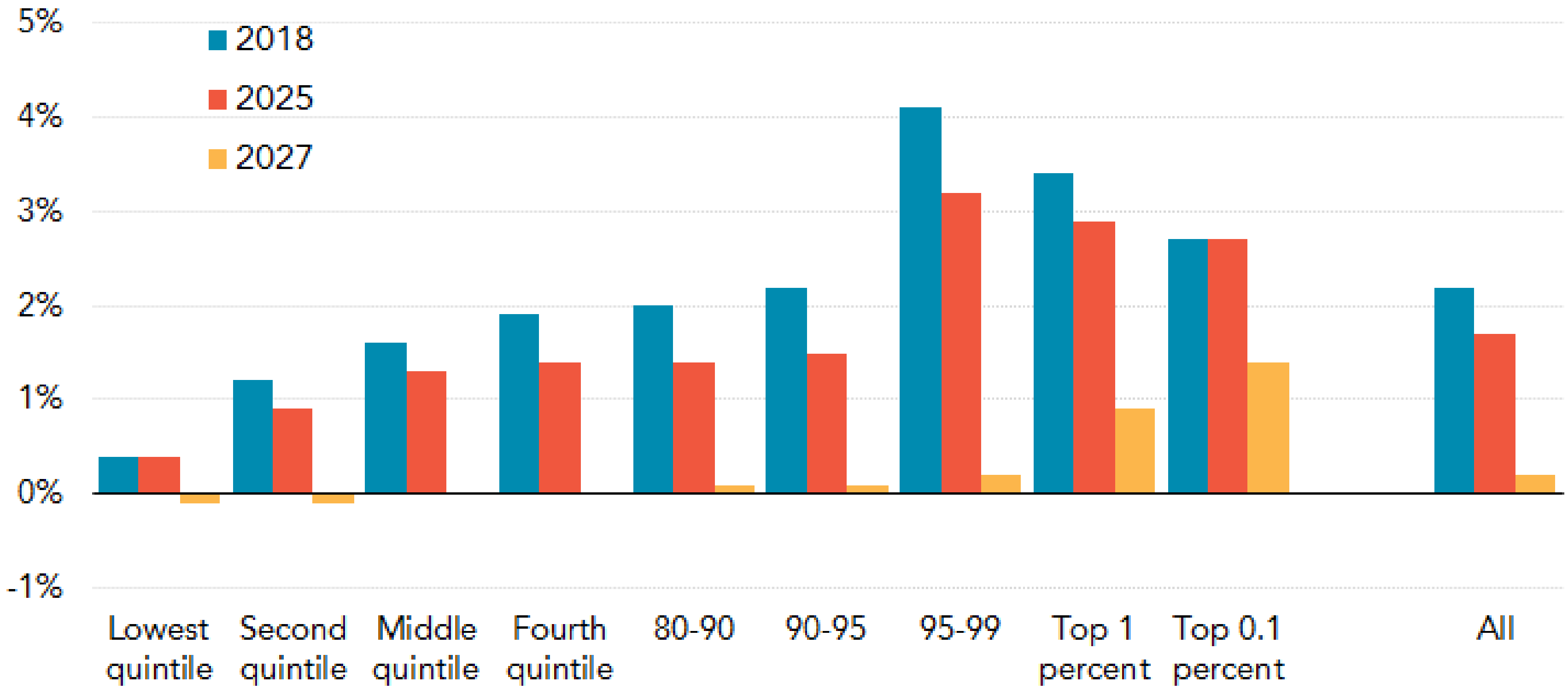
Source: author's calculations based on data from Congressional Budget Office (March 2017) <https://www.cbo.gov/publication/52480> and Joint Committee on Taxation (December 2017) <https://www.jct.gov/publications.html?func=download&id=5053&chk=5053&no_html=1>

Distributional Effects of the TCJA

FIGURE 1

Percent Change in After-tax Income of the Conference Agreement for the Tax Cuts and Jobs Act

By expanded cash income percentile, 2018, 2025, and 2027



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

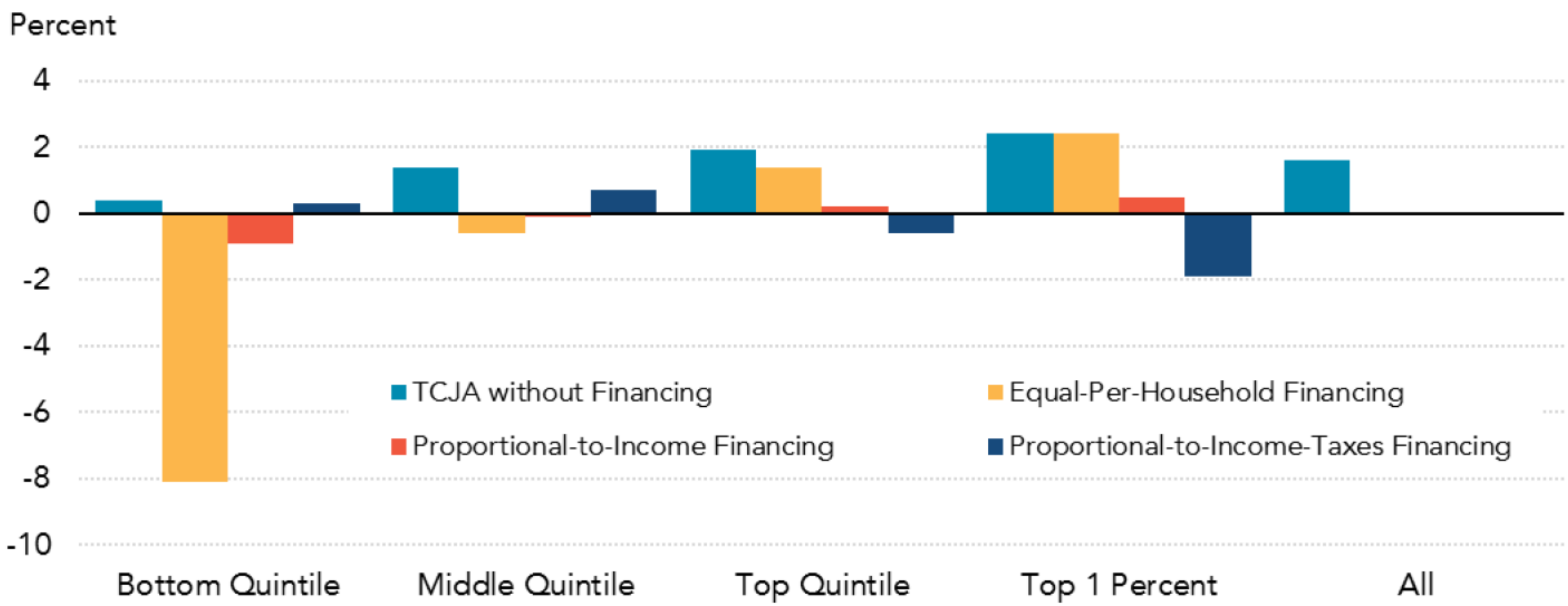
http://www.taxpolicycenter.org/feature/analysis-tax-cuts-and-jobs-act

Distributional Effects of the House Version of the TCJA under Different Assumptions about How We Eventually Pay for It

FIGURE 1

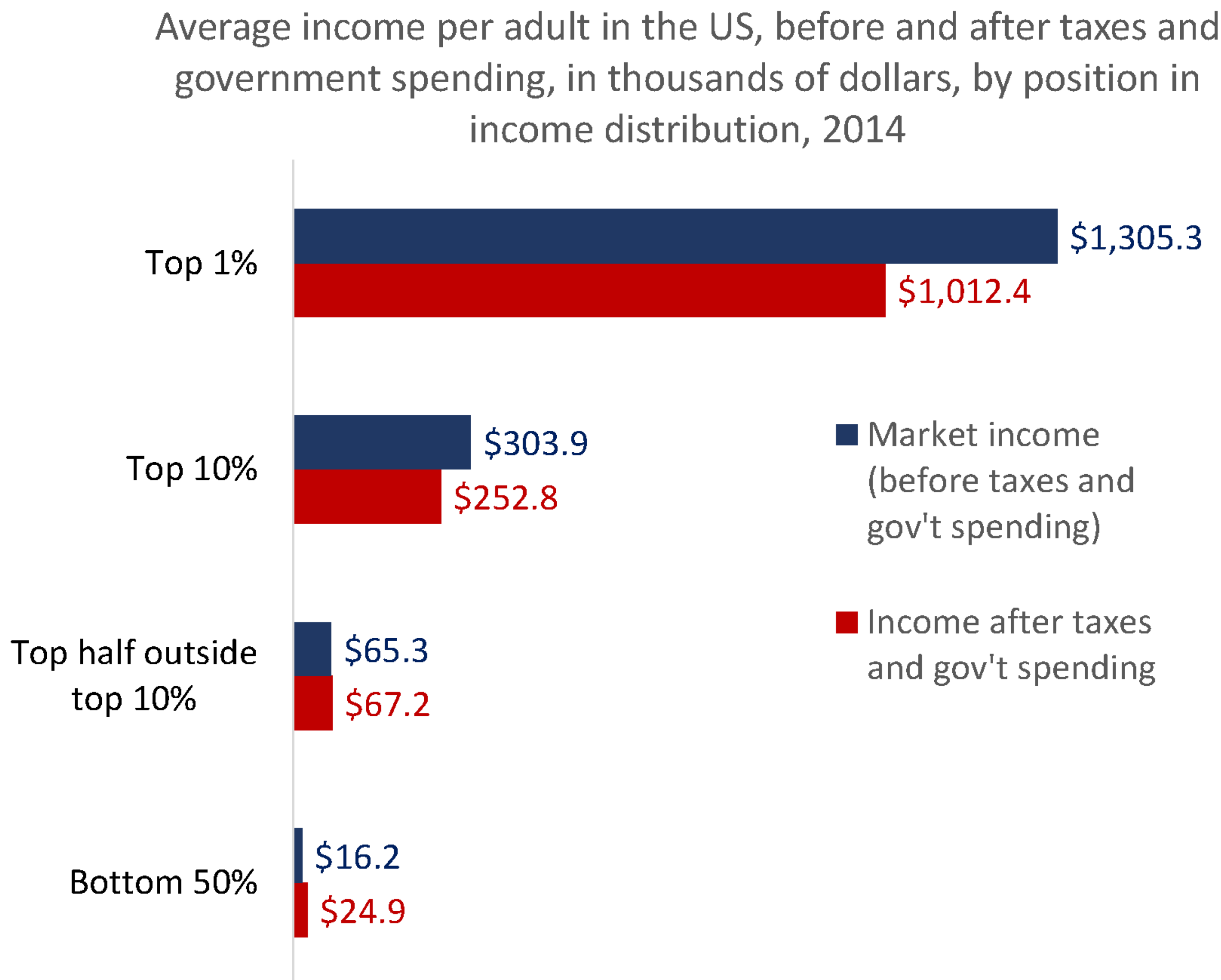
Percent change in after-tax income

House TCJA, 2018

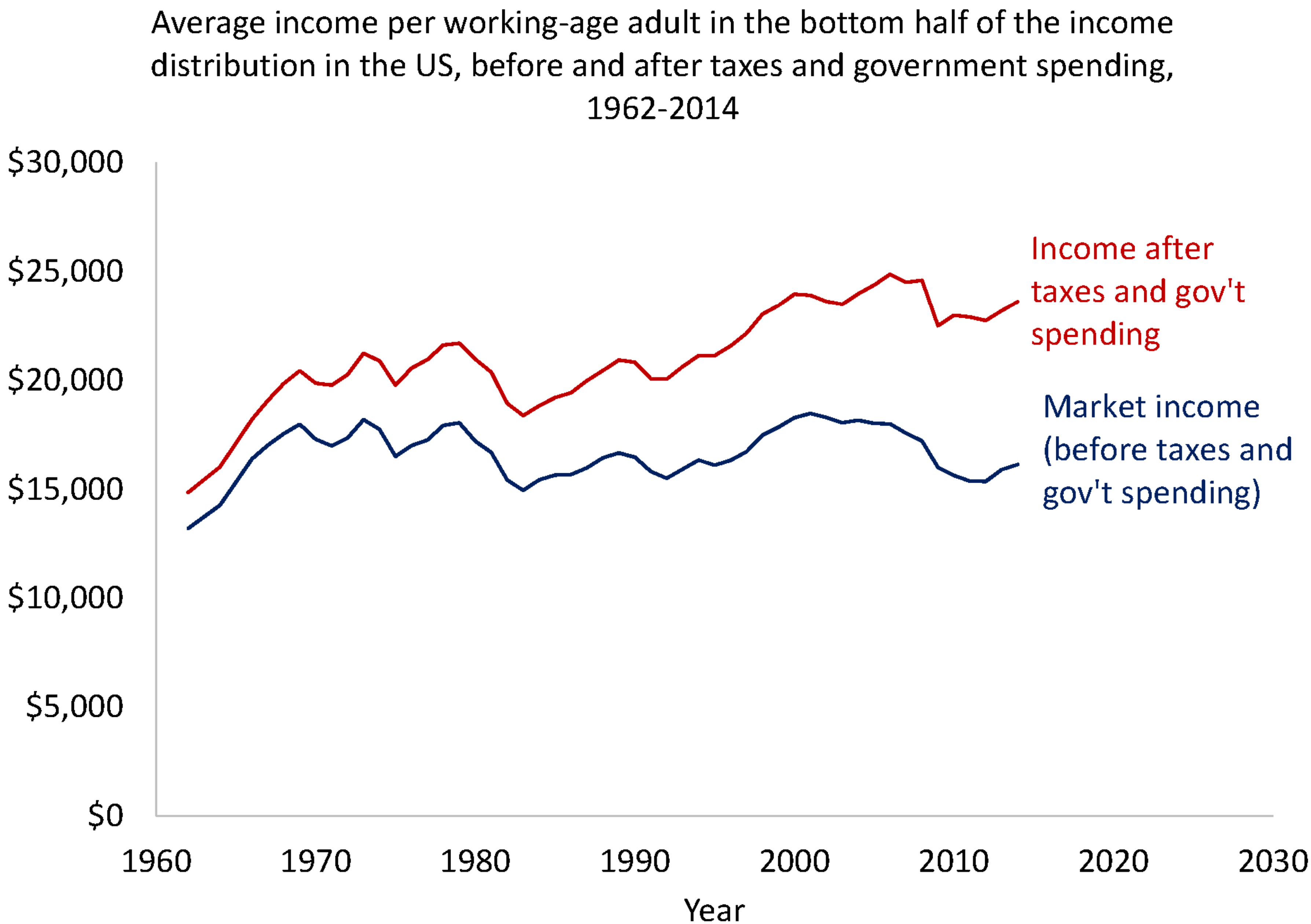


Source: Urban-Brookings Tax Policy Center.
Note: By design, the average percent change in after-tax income for the "All" category is 0 under each financing scenario.

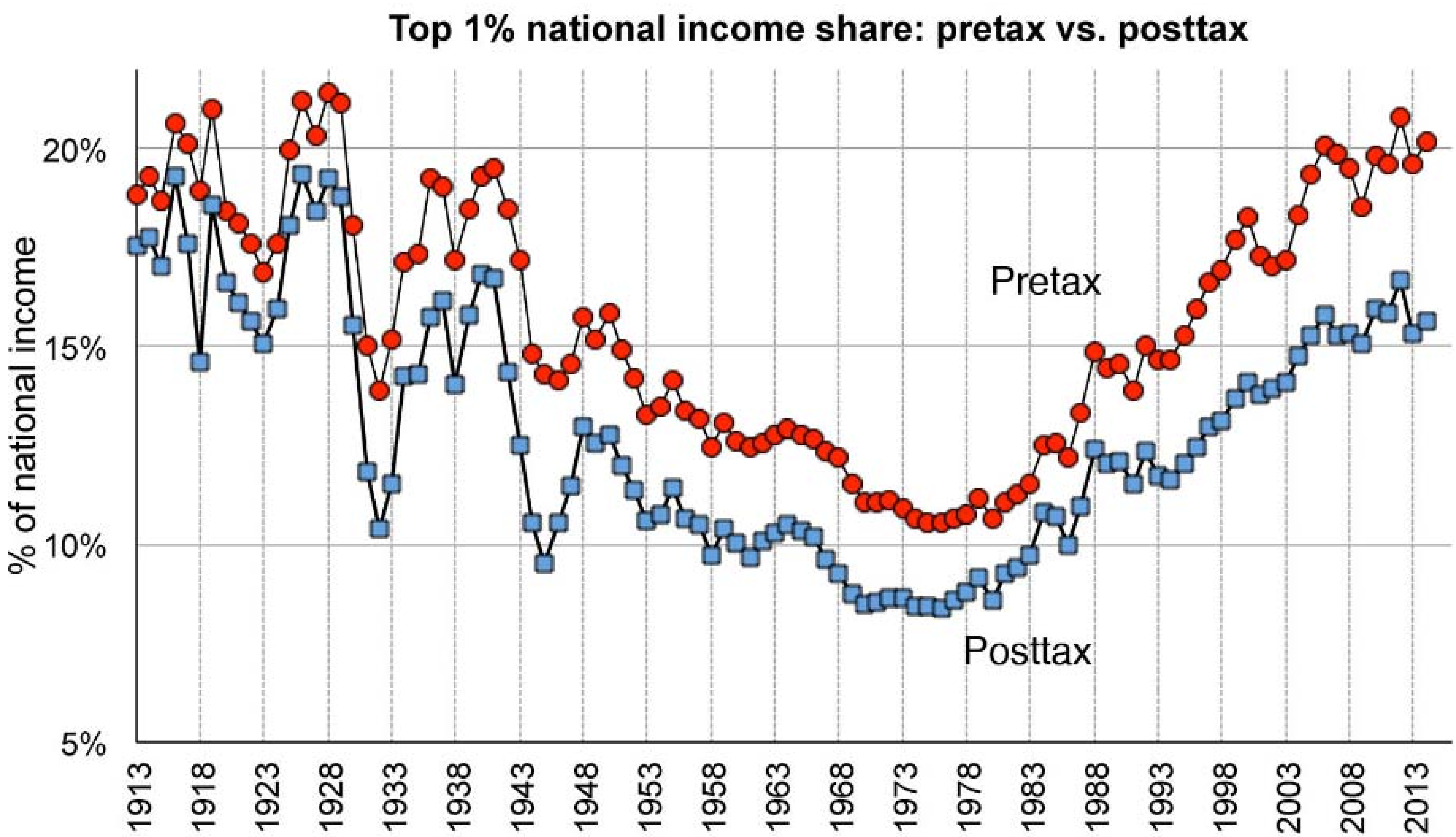
Source: Gale, Khitatrakun, and Krupkin (2017)
<http://www.taxpolicycenter.org/publications/winners-and-losers-after-paying-tax-cuts-and-jobs-act>



Source: author's calculations based on Piketty, Saez, and Zucman (2018) <http://gabriel-zucman.eu/usdina/>



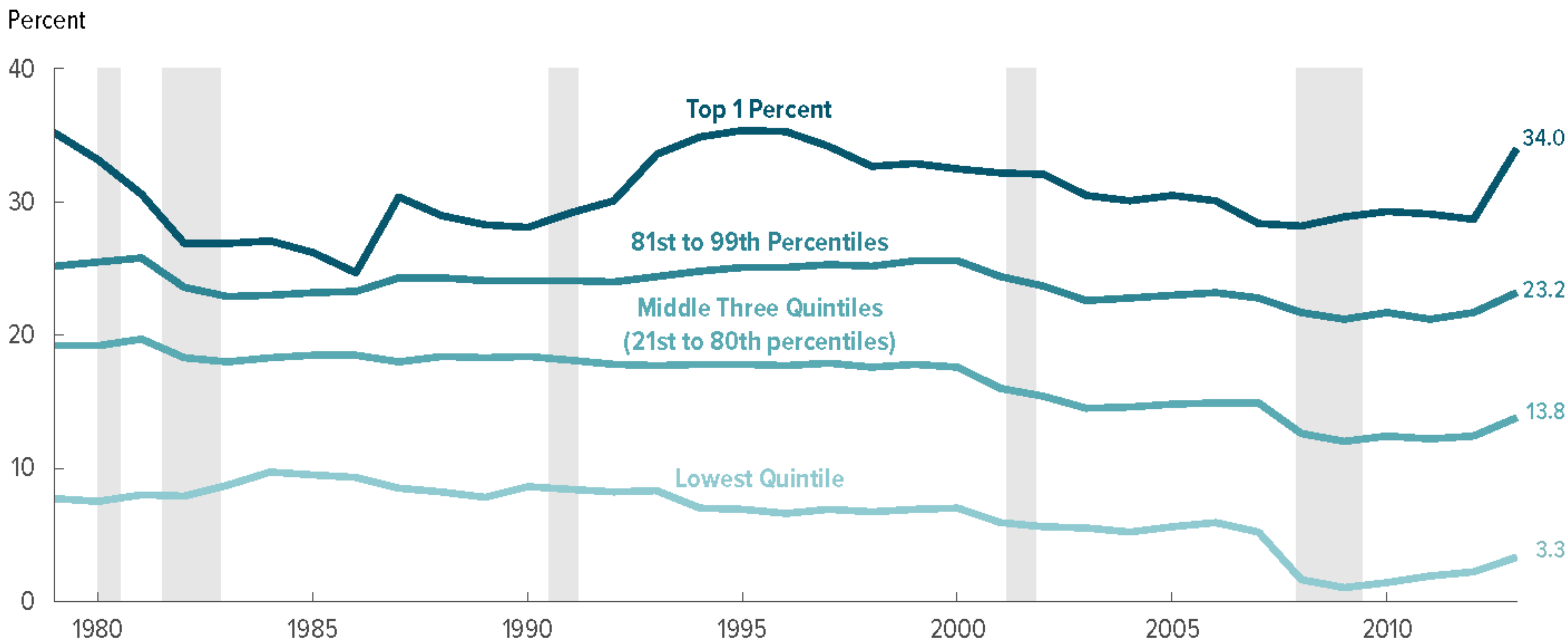
Source: author's calculations based on Piketty, Saez, and Zucman (2018) <http://gabriel-zucman.eu/usdina/>



Note: “pretax” represents market income before taxes and government spending, and “posttax” represents income after taxes and government spending.

Source: Piketty, Saez, and Zucman (2018) <http://gabriel-zucman.eu/usdina/>

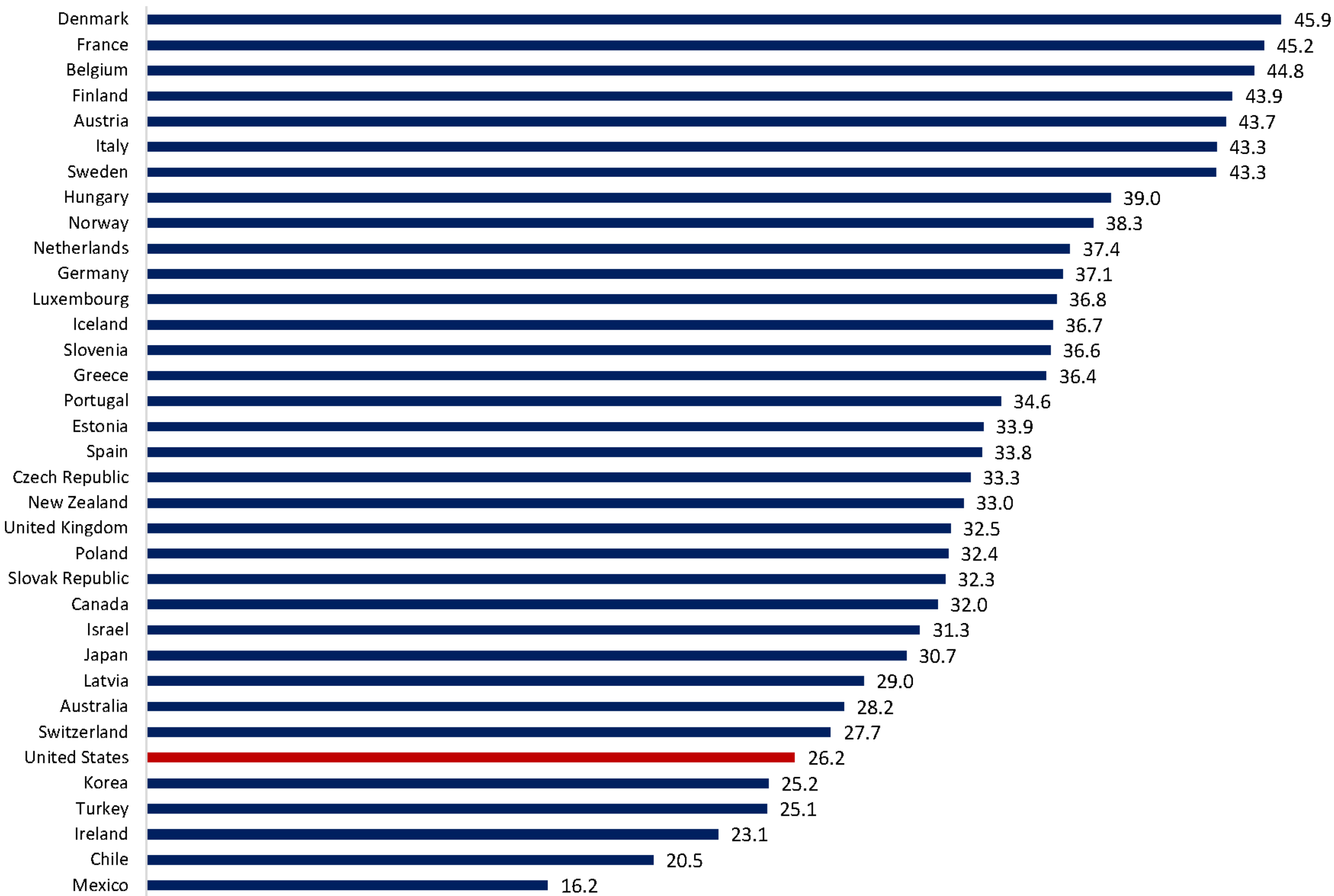
Average Federal Tax Rates, by Before-Tax Income Group, 1979 to 2013



Source: Congressional Budget Office.

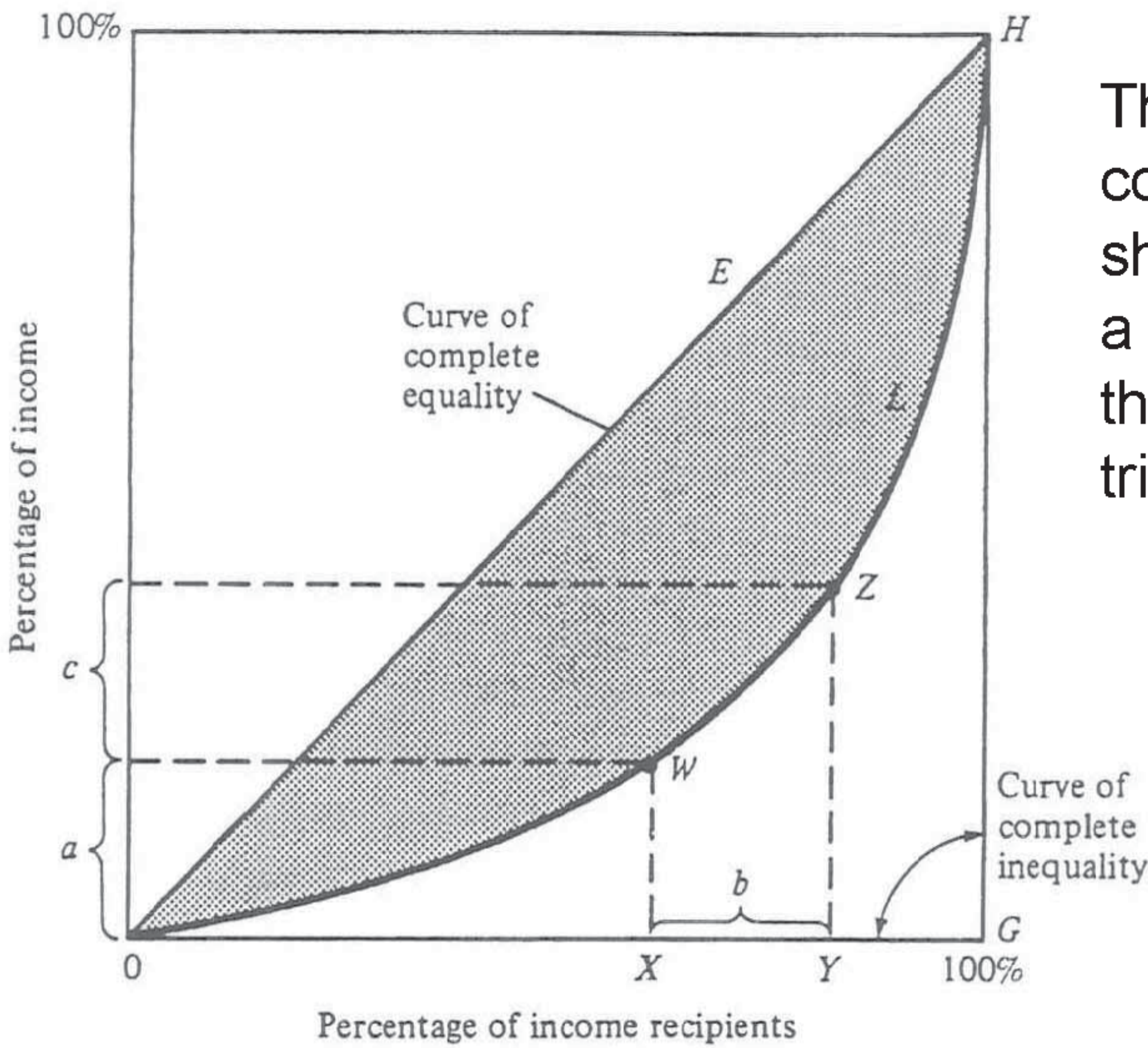
<https://www.cbo.gov/publication/51361>

General Government Tax Revenue as a Percentage of GDP in OECD Countries, 2015



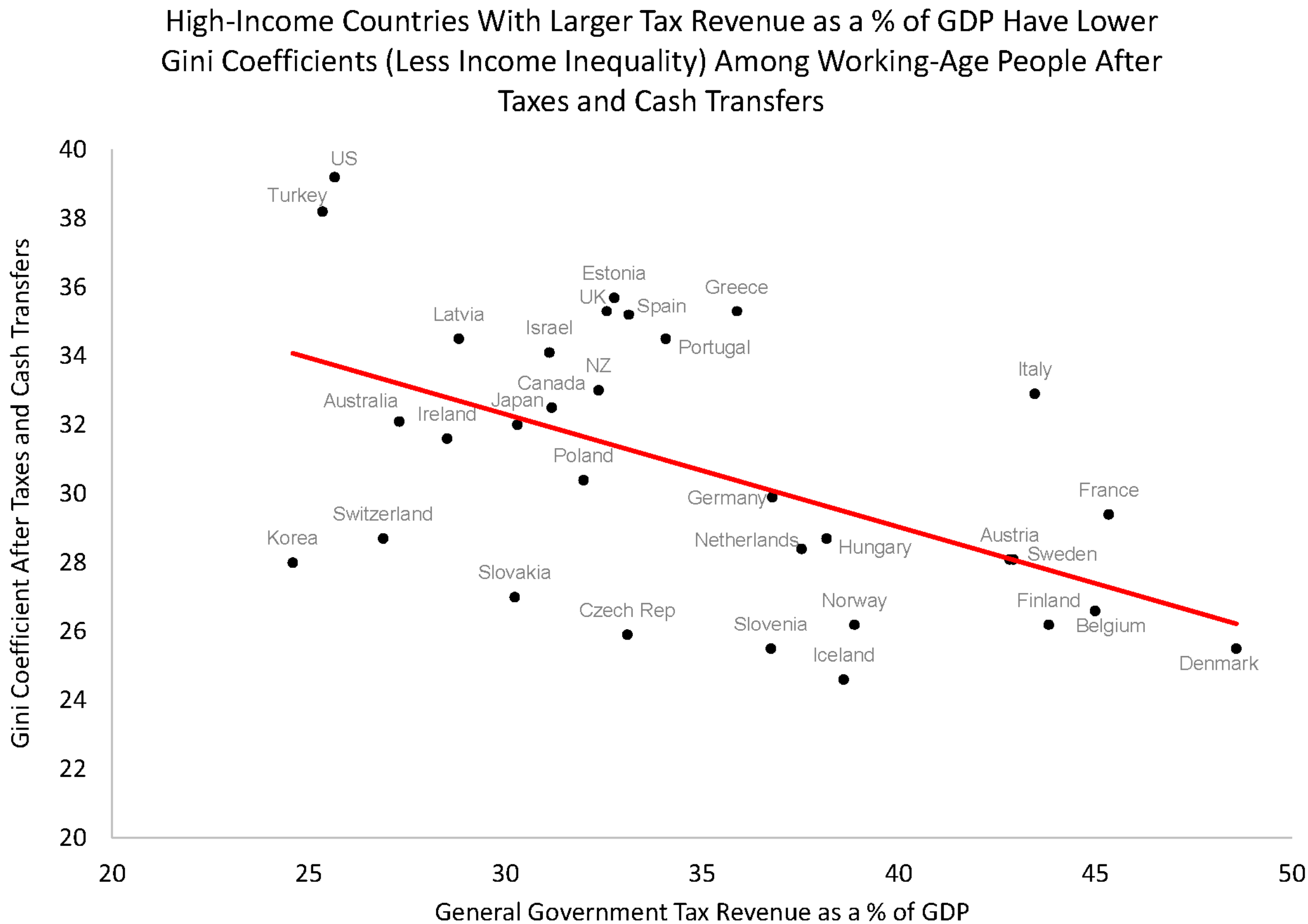
Source: OECD <https://stats.oecd.org/Index.aspx?DataSetCode=REV>

Figure 1. The Lorenz Curve



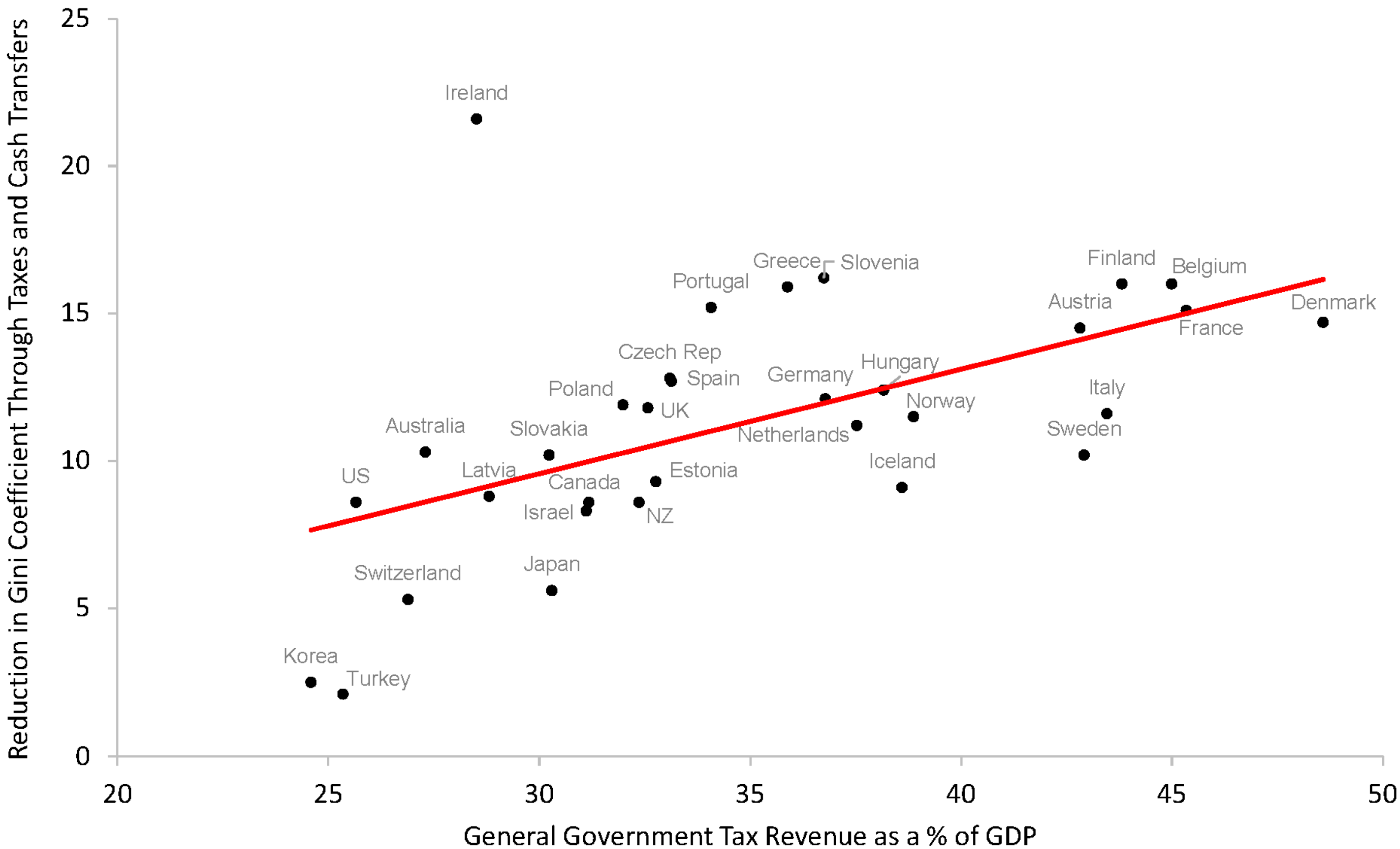
The Gini coefficient is the shaded area as a percentage of the area of triangle OHG.

Source: Meier, Gerald M., and James E. Rauch. 2005. *Leading Issues in Economic Development*, 8th ed., New York: Oxford University Press.



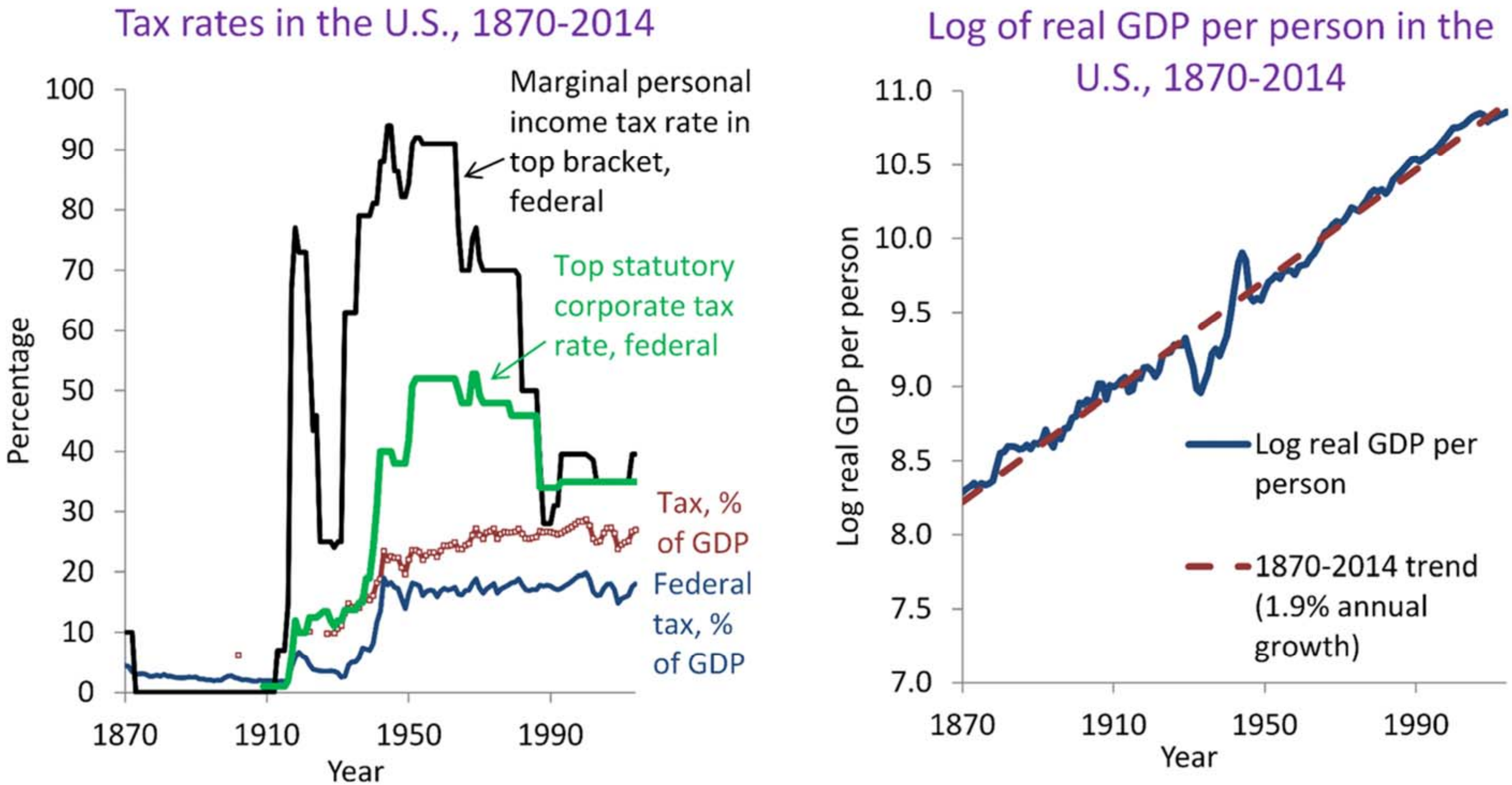
Note: data are for 2013.
Source: author’s calculations based on Lindert (2017) <https://econpapers.repec.org/paper/tulceqwps/73.htm> and OECD <https://stats.oecd.org/Index.aspx?DataSetCode=REV>.

High-Income Countries With Larger Tax Revenue as a % of GDP Achieve Larger Reduction in Gini Coefficient (Income Inequality) Among Working-Age People Through Taxes and Cash Transfers



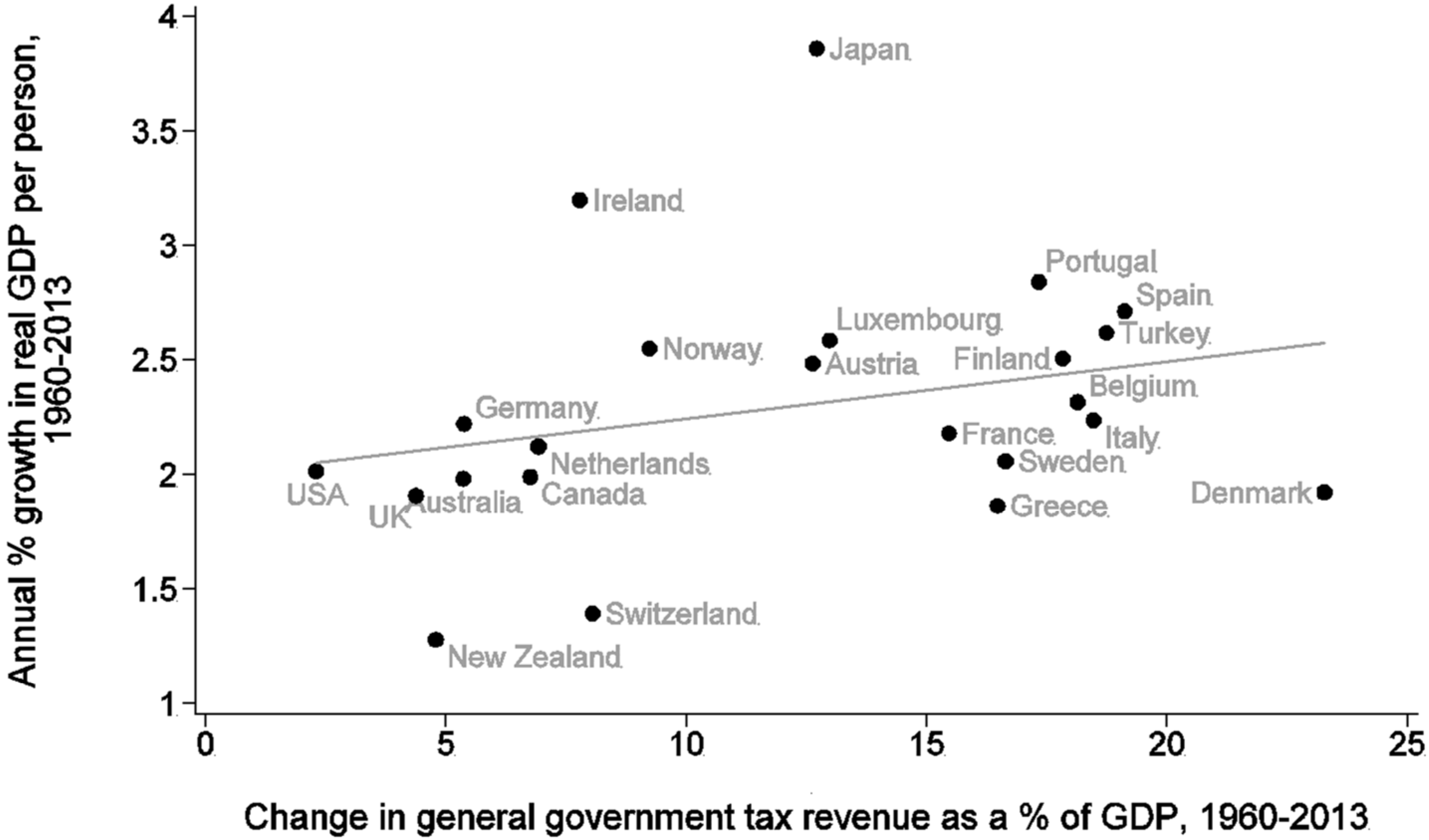
Note: data are for 2013.
Source: author's calculations based on Lindert (2017) <https://econpapers.repec.org/paper/tulceqwps/73.htm> and OECD <https://stats.oecd.org/Index.aspx?DataSetCode=REV>.

Over the long-run of history in the U.S., tax rates have experienced large persistent changes, but growth rates of real GDP per person have not



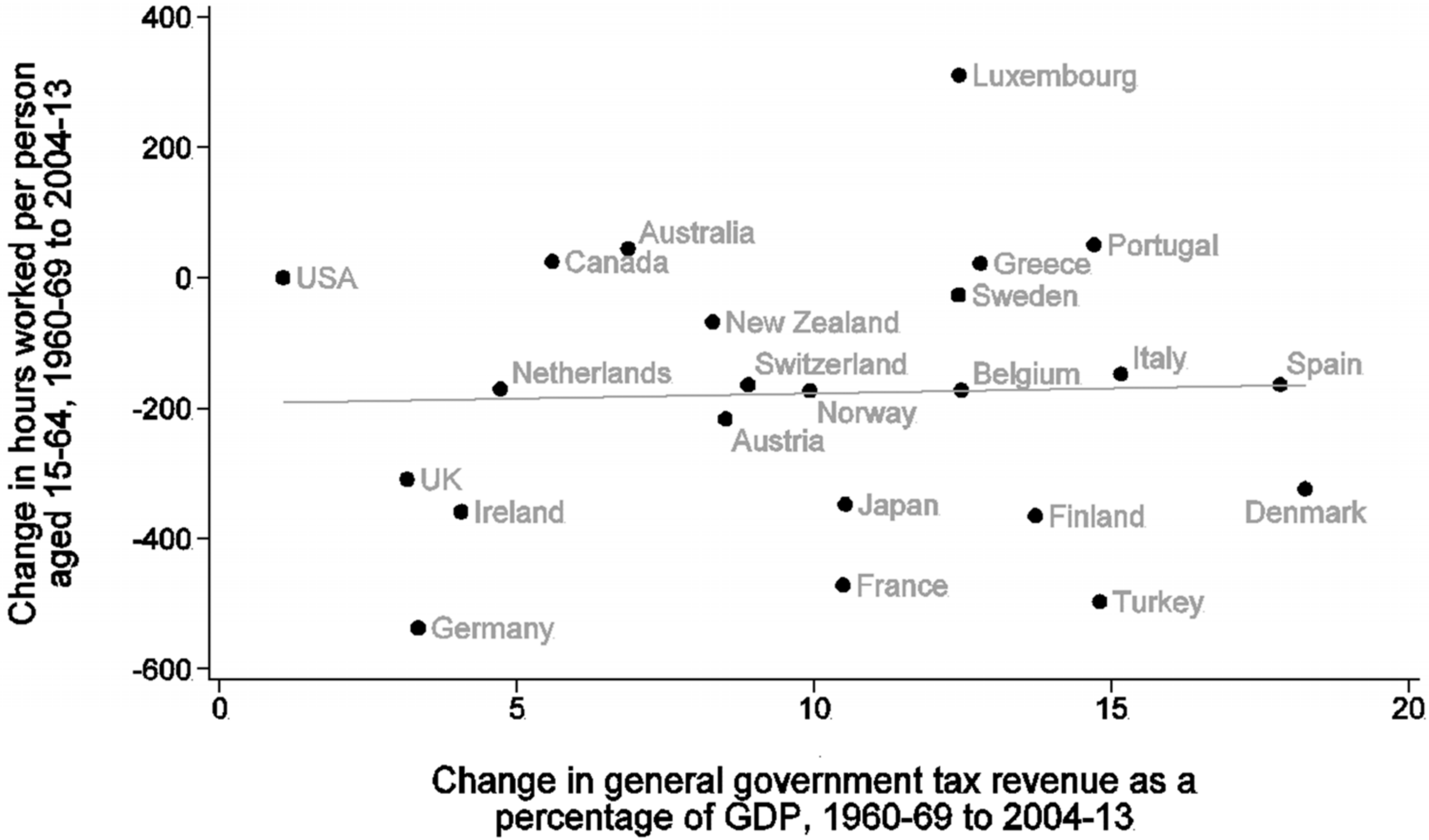
Sources: authors' calculations based on data from the Maddison Project (2013) and Bolt and van Zanden (2014), U.S. Bureau of Economic Analysis (2015) , Carter *et al*. (2006), Internal Revenue Service (2013a), Joint Committee on Taxation (2013b, 2014).
Notes: Real GDP per person is measured in constant year 2014 dollars. Trend in right panel is estimated by regression.

Growth in real GDP per person versus change in general government tax revenue as a percentage of GDP across industrialized nations, 1960-2013

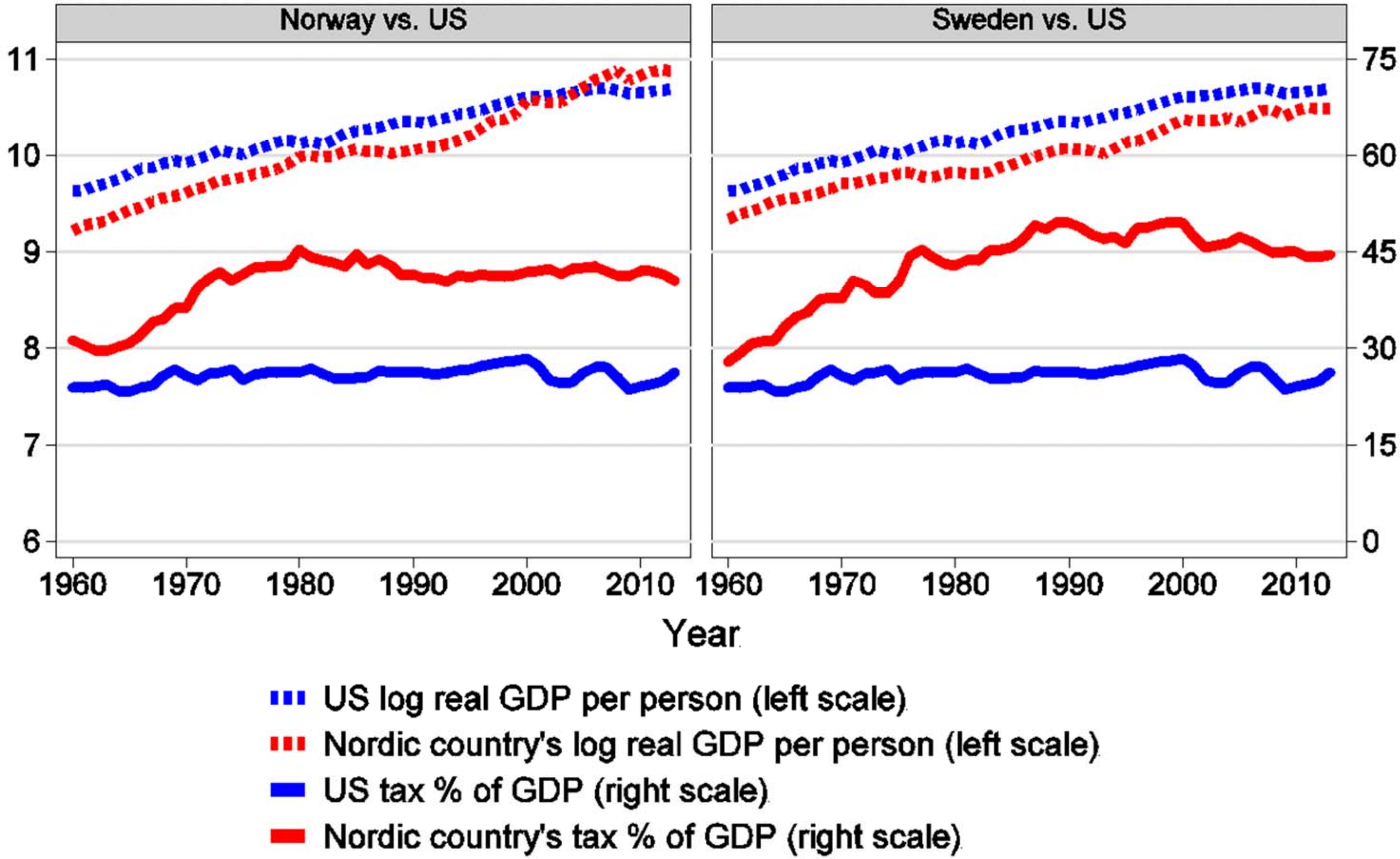


Source: Bakija (2016) <http://www.jstor.org/stable/10.1525/j.ctt1bpmb6b>

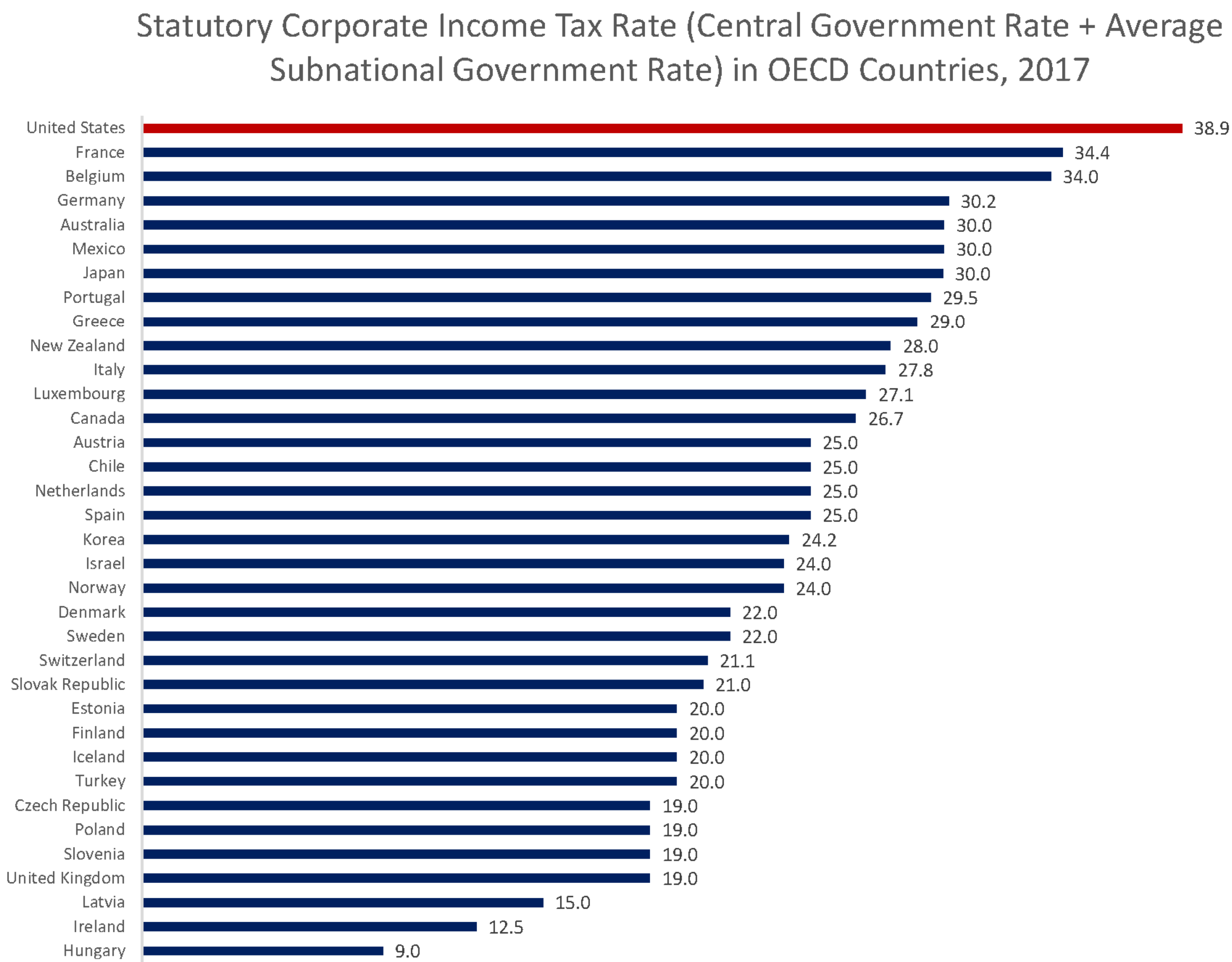
Change in hours worked versus change in tax revenue as a percentage of GDP across industrialized nations, 1960-2013



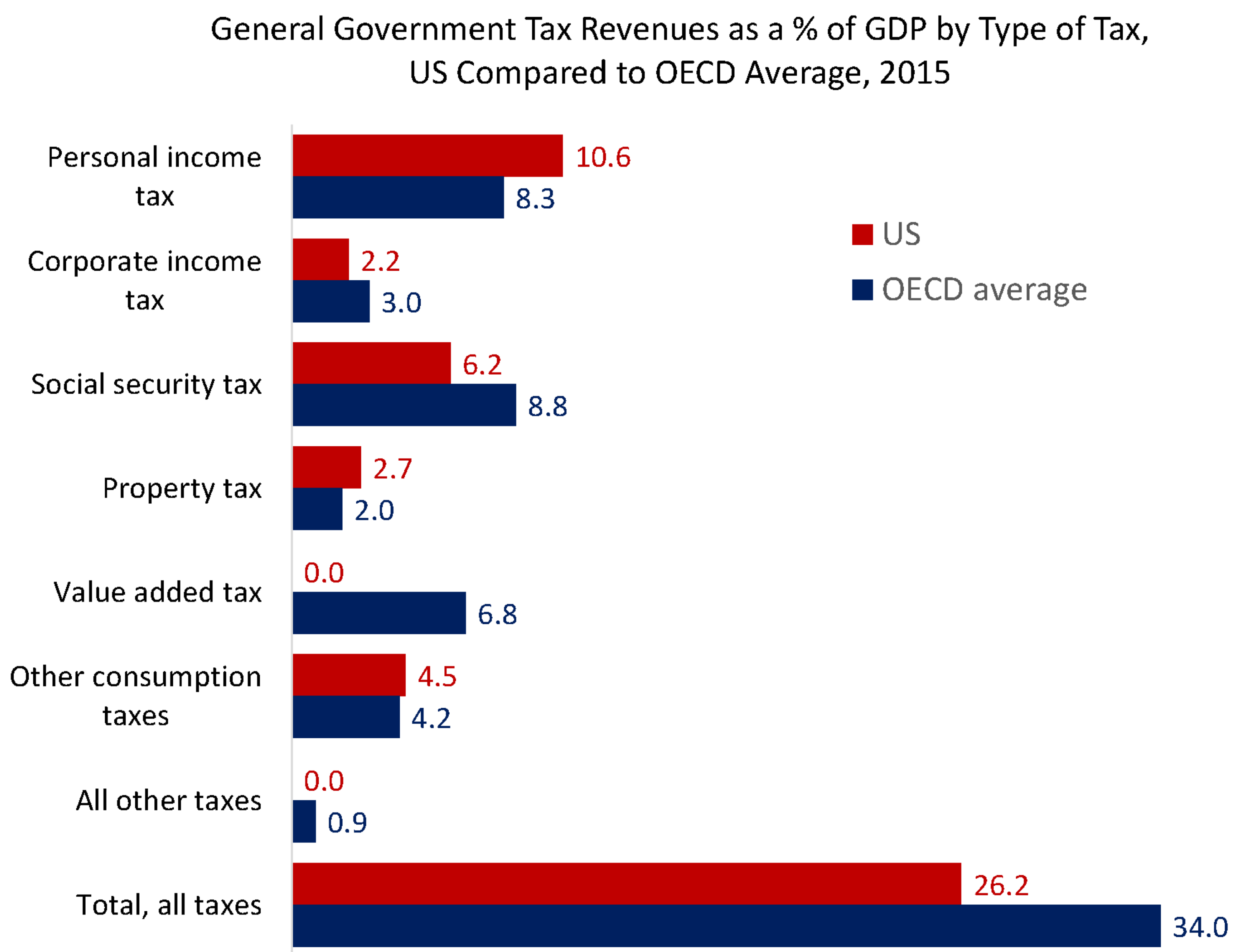
Source: Bakija (2016) <http://www.jstor.org/stable/10.1525/j.ctt1bpmb6b>



Source: Bakija (2016) <http://www.jstor.org/stable/10.1525/j.ctt1bpmb6b>



Source: OECD <https://stats.oecd.org/Index.aspx?DataSetCode=REV>



Source: OECD <https://stats.oecd.org/Index.aspx?DataSetCode=REV>

Business-level marginal effective tax rates on investment in the US before the TCJA

The business-level federal effective marginal tax rate on capital in the United States

The tax rate is calculated separately for each combination of business type (rows), asset type (rows), and financing arrangement (columns)

	With bonus depreciation			Without bonus depreciation		
	Average financing	Debt-financed	Equity-financed	Average financing	Debt-financed	Equity-financed
Business	8	-54	21	13	-46	24
C Corporation	7	-60	20	12	-51	24
Equipment	0	-71	13	11	-47	23
Structures	13	-49	25	16	-43	28
Inventories	28	-16	37	28	-16	37
Intangibles	-25	-157	-5	-24	-153	-4
Pass-through	10	-44	22	14	-38	25
Equipment	1	-57	13	11	-38	22
Structures	12	-41	23	14	-38	25
Inventories	25	-13	34	25	-13	34
Intangibles	-25	-139	-6	-24	-135	-5

Note: Under current law bonus depreciation expires in 2020. Average financing assumes that 36 percent of the investment is financed by debt and the remainder by equity.

Source: Author's calculations.

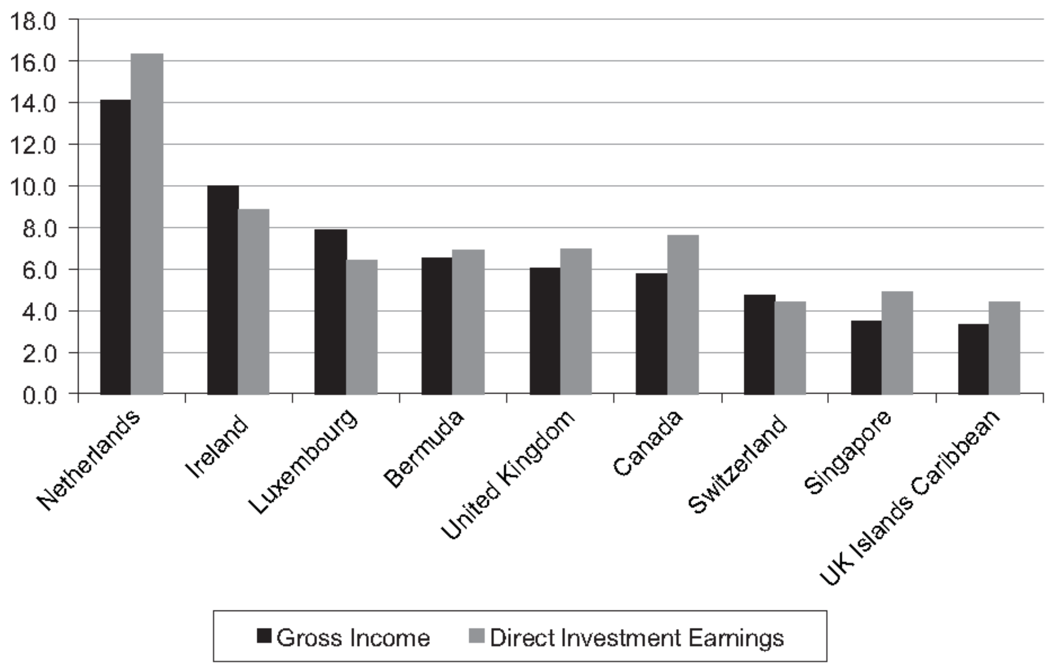
Equitable Growth

Source: Leiserson (2017) <http://equitablegrowth.org/research-analysis/what-is-the-federal-business-level-tax-on-capital-in-the-united-states/>

US Multinational Corporations Claim a Large Share of Their Foreign Profits Are Earned in Tax Haven Countries

Figure 1

Top Gross Income and Direct Investment Earnings Countries,
Affiliates of U.S. Multinational Firms, 2012
(Shown as Percentage of Total Income)



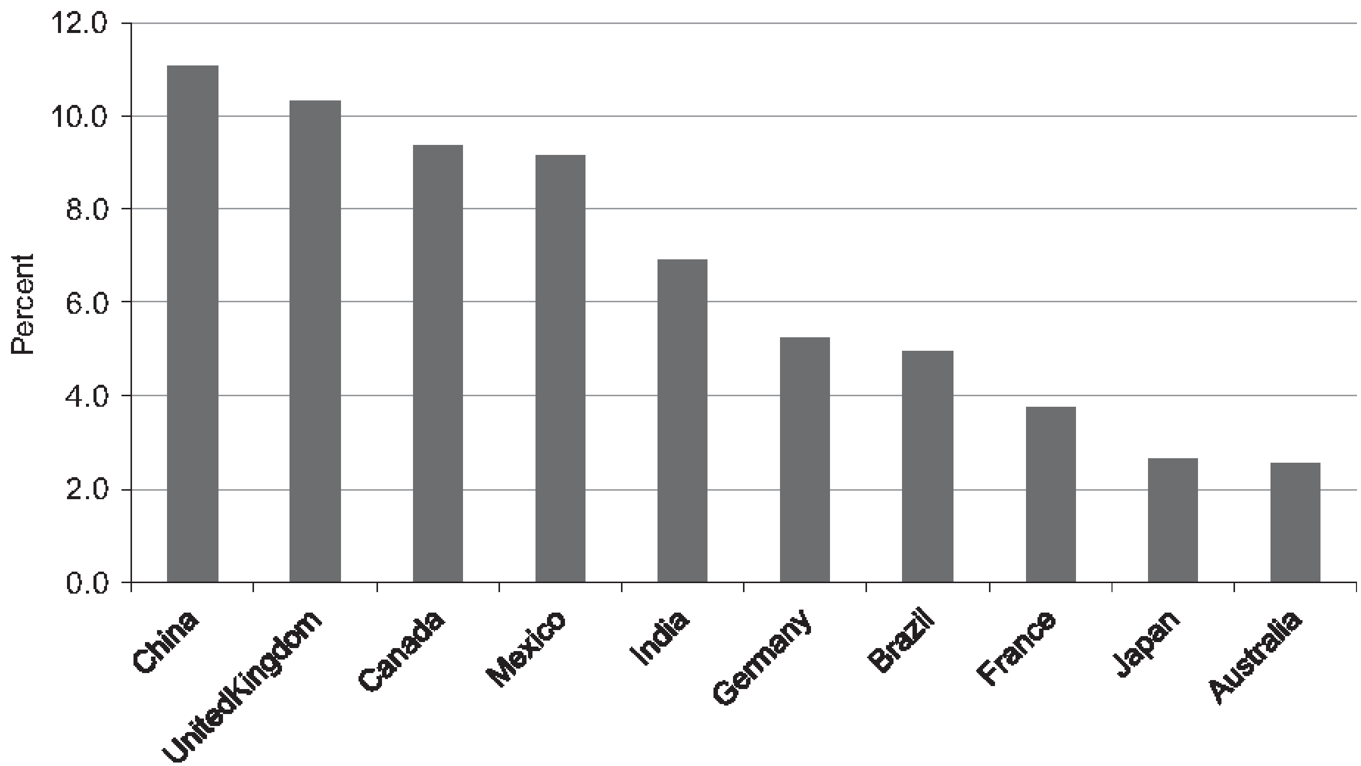
Notes: Gross income is net income with foreign tax payments added; differences with the direct investment earnings series are described in the text. The figure shows the top nine gross income and direct investment earnings countries; the list of top countries is the same for both series, thought there are small changes in ordering. Seven of the top nine countries (for both series) have effective tax rates under 5 percent in 2012: Netherlands, Ireland, Luxembourg, Bermuda, Switzerland, Singapore, and UK Islands. Together, these seven countries account for 50.1 percent of all foreign profits and 52.3 percent of all direct investment earnings.

Source: Clausing (2016) <https://www.ntanet.org/NTJ/69/4/ntj-v69n04p905-934-profit-sharing-effects-corporate-tax-base.pdf>

Indicators of Real Economic Activity of US Multinational Corporations are Not Concentrated in Tax Haven Countries

Figure 2

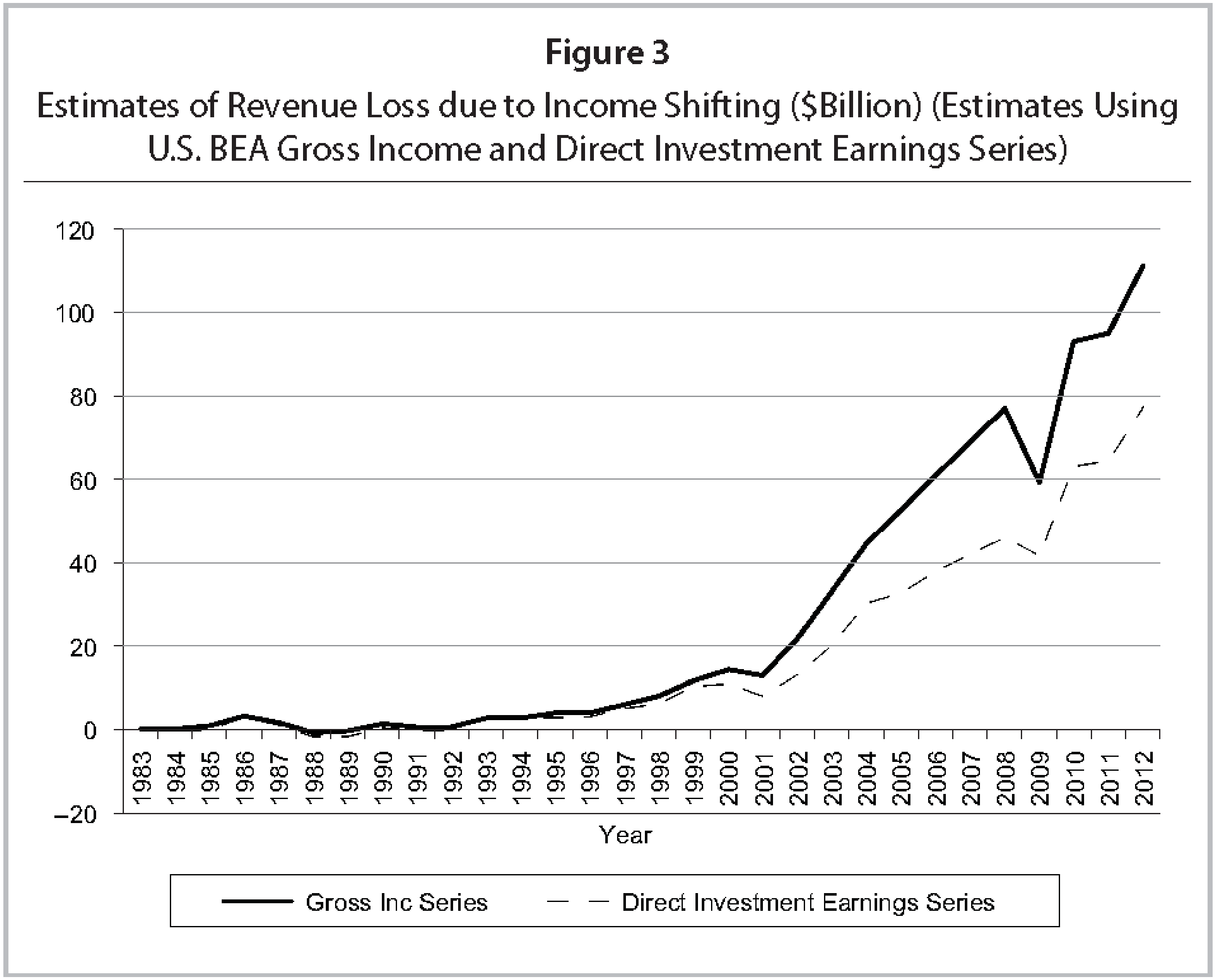
Top Employment Countries, Affiliates of U.S. Multinational Firms, 2012
(Share of Total Employment, Percent)



Notes: None of the top 10 countries have effective tax rates under 12 percent in 2012.

Source: Clausing (2016) <https://www.ntanet.org/NTJ/69/4/ntj-v69n04p905-934-profit-sharing-effects-corporate-tax-base.pdf>.

Recent Estimates Suggest Profit Shifting to Low-Tax Countries Costs around 30% of US Corporate Tax Revenue



Source: Clausing (2016) <https://www.ntanet.org/NTJ/69/4/ntj-v69n04p905-934-profit-sharing-effects-corporate-tax-base.pdf>.

TCJA's Changes to Tax Rules for Multinational Corporations

- Eliminates tax on repatriated profits of foreign subsidiaries of US multinational corporations (MNCs)
    - Previously, profits of foreign subsidiaries of US firms were only taxed when repatriated, with credit for foreign corporate tax paid
        - US firms effectively paid difference between US and foreign rate to US
        - But firms could and did defer repatriation, reducing present value of tax payment to US

- Adds new low tax rate (10.5% to 13.125% depending on the year) on income in excess of 10% of foreign tangible capital, with 80% credit for foreign taxes paid

- Transition tax on accumulated past profits of foreign subsidiaries of US MNCs (15.5% for liquid assets and 8% for non-liquid assets), gradually paid over 8 years.

- Reduced tax rate on profits from US exports arising from intangible investments (13.125% to 16.406% tax rate depending on the year)

- Base Erosion Alternative Minimum Tax (BEAT) – complicated minimum tax at low rate (10% to 12.5% depending on year) on a measure of profits that disallows certain deductible payments to foreign subsidiaries in low-tax countries

Possible Directions for Future Fundamental Tax Reforms

- Value-added tax?

- Nordic dual income tax?
    - Low uniform tax rate on capital income
    - High progressive tax rates on labor income
    - For closely-held businesses, capital income is imputed based on a normal return to capital, and the rest is taxed as labor income

- Progressive consumption tax?

- Carbon tax?