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Taxes, Cut

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By Jose Trejos and Dominic Bayer

The Republican party has for years sought to reform an American tax code widely viewed as uncompetitive, expressing their ambitious goal as simply making the tax system "that looks like someone designed it on purpose." Last November, when the party gained control of both chambers of Congress and the White House, tax reform emerged as the party's main fiscal priority for its first year in power. Despite the sometimes fitful nature of the Trump administration's relationship with Congress, Republicans passed a sweeping reform of the tax system shortly before the end of Mr Trump's first year in office, known as the Tax Cuts and Jobs Act (TCJA).

The US tax code stands out for the enormous amount of deductions and credits that it offers for a long list of miscellaneous incentives. Typically, lower-income individuals favor the Standard Deduction, which allows them to subtract a flat amount from their taxable income [1]. The wealthiest third of Americans prefer individual deductions and credits to lower their tax bill, often relying on costly legal assistance to do so. While these deductions were originally implemented to help the middle class and incentivize economically-beneficial behaviors, experts of both the right and left have come to believe that its arbitrary complexities cost more than they help, and suffer from regressive incidence.

The intended goal of the TCJA was to reduce the impact of these tax credits and deductions in favor of a simpler tax base. Tax provisions that were repealed or capped most prominently included the State and Local Tax Deduction[2], which allowed individuals to deduct state taxes from their federal tax bill, and the mortgage interest deduction[3], which allows individuals to deduct interest on their mortgages from their taxable and harshly regressive effects.

In their place, the TCJA doubled the Standard Deduction[4], which makes taxes simpler and more progressive by making the Standard Deduction a better alternative to itemized deductions, and made the Child Tax Credit partially refundable, which means it can result in a negative tax bill, extending a flat benefit to millions of lower-income Americans. These changes are forecasted to reduce the amount of families itemizing by around 60%, and House Speaker Paul Ryan claims it will save the typical family of four around $1,100 a year. As measures that are both progressive and beneficial to the economy, the repeal of major tax exemptions and shift to smaller benefits available throughout the socioeconomic spectrum are among the better policies in the TJCA[4:1].

Other aspects of the TJCA were more contentious. The TCJA directly reduced the marginal tax rate for most brackets, with a generous cut to the upper rate[5]. It also doubled the amount needed to qualify for the estate tax, aimed at multi-million-dollar inheritances. Combined with changes to corporate taxation expected to increase earnings for stockholders, the overall bill was widely criticized for its regressive effects, with the clearest beneficiaries being those in the top decile of income[6]. There is significant economic literature suggesting that these measures will result in increased economic growth, making the overall virtue of the reforms a matter of debate, but those most concerned about inequality have solid grounds to condemn the TCJA. It is further worth noting that most cuts to income taxes will expire if not renewed by 2027, which would further the regressive effects of the law[7].

Moreover, the TCJA has also been criticized for not being revenue-neutral. Even accounting for economic growth, the TCJA will add somewhere between $600 and $1,500 billion to the deficit over the next decade. Not only is this concerning from the standpoint of the nation's fiscal health, but it also partially undermines the pro-growth effects that the tax bill was will grow[5.1] the economy an additional 1.7% over a decade; the Wharton School's model, which particularly emphasizes the deficit, expects the tax bill will actually decrease economic growth over the same time frame[8].

Finally, the TCJA repealed the Affordable Care Act's individual mandate[9], which previously made purchasing health insurance a legal requirement. While the merits of Obamacare and the Republicans' proposals for replacements are highly contentious, it is generally agreed that repealing the individual mandate will massively destabilize the healthcare market. If Republicans fail to implement an alternate system to Obamacare, this repeal will likely take a serious toll on a health care system built around the mandate.

In addition to lowering individual income tax rates across the board and reforming various deductions, the Tax Cuts and Jobs Act also drastically lowered corporate tax rates, in pursuance of President Trump's campaign promise to make American companies more competitive in the increasingly globalized economy. Prior to the TCJA, the United States had the world's fourth-highest statutory corporate tax rate[10]. Economists generally agree that corporate taxes are the most harmful type of taxes for growth, which provides powerful support for the idea of shifting the tax burden towards consumption and personal income[11]. The TCJA dramatically lowered the corporate income tax rate from 35% to 21%[12], a move that President Trump heralded as "probably the biggest factor" in the bill[13]. Those in favor of the shift celebrated IMF projections that the tax cut would boost U.S. GDP growth by stimulating business investment and growth[14], and heralded a slew of announcements of bonuses and wage increases by major corporations as a sign that the corporate tax cut would boost wage growth[15]. Meanwhile, critics complained that cutting taxes on corporations would have minimal[16] impact on economic growth and would merely serve to line the pockets of the well-to-do[17].

passage of the TCJA, the US government charged American companies on all profits, regardless of where they were made. Not only was this highly uncompetitive, as it provides companies with an incentive to relocate to other countries with more modern systems, it also fails to raise much money, as companies can merely stash foreign-earned revenues in other countries. Because of this, the United States had the last remaining global system in the OECD[18], with all other developed countries having shifted to a territorial system throughout the 20th century.After shifting to a territorial tax system, US corporations will only pay taxes on profits earned in the US, helping to boost their competitiveness vis-a-vis their foreign competitors.

Last, but not least, the TCJA also lowered the level of taxes paid by pass-throughs, a tax category that includes partnerships, limited-liability companies, and other privately-held small businesses. Thanks to late lobbying by Ron Johnson, a Republican senator[19], the TCJA will now include rate cuts and increased deductions for pass-through income[20]. Mr Johnson and others argued that this decrease in the level of taxes paid by pass-throughs would avert rewarding corporations over small businesses and serve to encourage America's declining middle-class entrepreneurs. However, many liberals skewered these changes, reverting to the tested-and-tried criticism that it would favor the well-to-do over working-class Americans[21]. Even some conservative economists were critical of the change, pointing out that it might unduly reward S-corps over corporations and incentivize tax evasion, given that C-Corps have to pay two levels of taxes (corporate taxes and dividend tax)[22].

The long-awaited goal of the GOP is here. While unpopular at the time of passing, the reform has steadily grown in popularity following strong economic growth, at least for the few months since its passage. Most Republicans are hoping it helps them win re-election, as it remains the main legislative accomplishment for the 115th Congress. While many economists express doubts about the deficit, and liberals are widely

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