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THE TAX CUTS AND JOBS ACT: A MISSED OPPORTUNITY TO ESTABLISH A SUSTAINABLE TAX CODE

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ABSTRACT
The Tax Cuts and Jobs Act of 2017 leaves many promises of tax reform unfulfilled. In this paper, we examine the plan's prospects to boost future growth, and discuss fundamental reforms that would boost the stock of capital and generate sustained, long-term growth. After making the case that the current tax code is unsustainable and that reform will be revisited, we recommend a series of strategies for future Congresses, including limiting windfall tax breaks on already-committed capital, providing targeted tax cuts on wages to boost labor supply, reducing the most harmful tax distortions, and administering the tax code more effectively.

I. INTRODUCTION

The Tax Cuts and Jobs Act of 2017 (TCJA) leaves many promises of tax reform unfulfilled. The bill's cost sets revenues far-below projected spending levels, and puts deficits and debt on an unsustainable trajectory. Many provisions are temporary and expire, require clarification in regulation, or may not survive court challenges from our trading partners—creating uncertainty for individuals and businesses and punting hard choices to future policymakers. While the bill provides temporary economic stimulus, it delivers only a meager boost to long-term economic growth, and even less for Americans' future living standards. And it fails to achieve other goals of tax reform by making the tax system more complicated and more difficult to administer, and creating new opportunities for avoidance or noncompliance. These shortcomings, coupled with voters' expressed dissatisfaction with the legislation, seem likely to drive efforts to repeal and replace it.

Fortunately, the tax system is fixable. In the 1980s, an ill-conceived deficit-burgeoning tax cut in 1981 was quickly revised in subsequent years, culminating in comprehensive reform in 1986. America would benefit if history repeated itself—and soon. When the time comes to revisit tax reform, policymakers will have the opportunity to install a tax code that is pro-growth, simpler, sustainable, and more equitable.

When Congress takes up another tax bill, a lasting and beneficial reform will include several ingredients. As a starting point, the most important function of the tax system is to raise revenue to pay for the spending Congress has authorized and that Americans expect. Hence, one objective of reform is to set federal tax revenues on a sustainable path. Given commitments to popular social programs and shifting demographics, and today's strong economic situation, stabilizing the debt over the next 30 years would require revenues close to 21 percent of GDP (Auerbach, Gale, and Krupkin 2018).

A second priority in reform is to focus incentives toward labor supply and new investment. While tax policy choices are sometimes portrayed as a choice between revenues and efficiency, successful tax reform can raise the necessary level of revenues and still encourage the activities that contribute to long-run growth. That's because the macroeconomic effects of tax reform are determined jointly by its effect on the deficit and its incentives for work and new investment—areas in which it's possible to make progress at the same time.

We see two complementary approaches to achieving these joint objectives. One approach is to reverse many of the windfall cuts in the TCJA, bringing income from existing investments and economic rents back into the tax base, while retaining low rates on new investments and employment. This is what idealized consumption taxes do; but there are ways to move in the direction of consumption taxes without throwing out our existing system. Intuitively, under a consumption tax, taxes are paid not just out of new wages and future income, but also out of the streams of returns on investments already made—including corporate profits, interest income, sales of stock, or unrealized capital gains. In practice, this could mean reversing some of the statutory rate reductions in the TCJA, eliminating the new special preferences for pass-through income, imposing stronger limits on interest deductibility, tightening the new international tax provisions, and recouping corporate windfalls using higher taxes on shareholders. Some revenues could be allocated to deficit reduction and some for incentives for new investments.[1]

A second approach is to move closer to a traditional broad-base, low-rate income tax at the individual, corporate, and shareholder levels by closing inefficient tax expenditures, simplifying the tax system, and improving compliance. Pushing business-level taxes to owners and shareholders offers an alternative route to reducing investment and locational-choice distortions at the business level. For instance, elimination of stepped-up basis, a contraction in tax expenditures for tax-exempt organizations or tax-exempt savings vehicles, and higher taxes on certain dividends and types of capital gains could facilitate deficit reduction, revenue stability, and allow us to retain more efficacious tax expenditures.

Similarly, reform could also take on inefficient tax expenditures introduced or preserved in the recent bill. Poorly designed tax incentives, such as the mortgage interest deduction, exclusions for certain business owners in the payroll tax system, certain benefits for education, and the uncapped exclusion on employer-provided health insurance, encourage investment in lower-productivity investments and lower-value services or fail to deliver promised benefits. Finally, simplifying filing and providing more funding for tax administration—an often-overlooked aspect of tax reform—would reduce taxpayer costs and help collect taxes that are already due.

There would be marked benefits to these strategies. The expansion of the tax base to "old capital" would allow for lower tax rates on future wages and new investment than will otherwise apply in our current system. These lower rates and fewer distortions would encourage sustained capital formation and labor supply, boosting income and productivity. Shifting the burden to shareholders (or to domestic consumers) could reduce profit-shifting and incentives to relocate productive activities, expanding the domestic tax base. Bringing the tax rates that apply to income earned by workers, corporations, or pass-through businesses closer together would simplify the tax system and improve compliance by limiting the need to differentiate wages from profits and the efforts devoted to costly tax avoidance schemes.

This paper lays out the economic arguments for a reform that raises revenue, makes the tax code simpler and fairer, and retains the key elements of a pro-growth agenda. We first review the newly legislated tax plan and its prospects to boost growth over the next decade and beyond. We next discuss fundamental reforms that would boost the stock of capital by favoring investment over consumption and by rewarding new investments over those investments already made. Finally, we recommend a series of strategies for future tax reform, including limiting windfall tax breaks on already-committed capital, imposing targeted tax cuts on wages to boost the labor supply, reducing the most harmful distortions, and effectively administering the tax code. All of these elements could conceivably be included in a tax reform package should Congress elect to address the deficiencies in the current plan.

II. EVALUATIONS OF THE TAX CUTS AND JOBS ACT OF 2017

The TJCA includes four major elements with respect to business taxation. One, steep and permanent cuts in the top corporate tax rate from 35 percent to 21 percent. Two, a temporary expansion of expensing provisions, allowing for temporary accelerated write-offs for machinery and equipment, offset by scaling back of some business tax benefits. Three, substantial changes to the system of taxing multinational corporate activity abroad, including elimination of the tax on repatriated dividends, a new minimum tax on intangible profits in low-tax countries, an anti-base erosion tax, and a one-time transition tax on pre-existing foreign earnings. Four, a new and complicated tax deduction on profits for the owners of pass-through businesses, such as partnerships, S corporations, and limited liability corporations.

The individual side includes five major elements. One, temporarily lower statutory tax rates through 2025 and, due to changes to the indexing formula, higher tax burdens thereafter. Two, temporary elimination of personal exemptions in return for a larger standard deduction and a more generous Child Tax Credit with expanded eligibility. Three, temporary limits on certain kinds of itemized deductions, including a lower limit on the size of a mortgage that generates deductible interest, a $10,000 annual limit on deductible state and local taxes, and the elimination of the deduction for miscellaneous itemized deductions. Four, a temporarily higher Alternative Minimum Tax exemption. Five, permanent elimination of the penalty for not obtaining health insurance. All of the temporary provisions expire after 2025.

The bill also shrinks the estate tax by approximately doubling the estate tax exemption to roughly $20 million per couple, with conforming changes to the gift tax. This provision also expires after 2025.

The TCJA's sweeping cuts to the individual income, corporate, and estate tax rates are partially financed by shrinking selected tax expenditures or eliminating certain deductions, but also by provisions that raise revenue in the budget window but actually worsen long-term deficits.[2] On net, however, the legislation is projected to increase the cumulative deficit by 2028 by $1.9 trillion (Congressional Budget Office [CBO] 2018b). And the cost of the legislation rises if the expiring provisions are assumed to be permanent. According to the CBO, extending the provision that allows businesses to immediately deduct the cost of their investments—which expires in 2022—would increase deficits by $122 billion over the 2019–28 period. Extending expiring individual income tax provisions and the increase in the estate and gift tax exemption would add another $650 billion to the cost. Along with extensions of several smaller non-TCJA tax provisions, and postponement of healthcare taxes, this alternative fiscal scenario increases the federal debt by an additional $1.2 trillion by 2028. This would place federal debt at 105 percent of GDP that year, its highest level since World War II.

As a result, the tax code under TCJA is unstable. The bill leaves revenues far below enacted spending—especially in the wake of spending increases enacted before the ink had dried on the TCJA. Most individual tax changes expire after eight years; many features of the new tax code are unclear and require clarification through regulation; and many international tax provisions may not survive challenge from our trading or treaty partners or include flaws that require legislative remediation. Other elements, like the repeal of unreimbursed employee business expenses or sharp limitations on businesses net operating losses (NOLs), represent departures from basic tax principles and seem likely to be revisited in the future. While certain elements appear to take reasonable approaches to solving existing tax problems—replacing our outdated international tax system with a global minimum tax or swapping personal exemptions for a more generous Child Tax Credit—most will require substantial revision to realistically meet our fiscal needs and provide a stable tax system.

Economic analysis of the TCJA

Overall, the TCJA is projected to boost economic activity initially, but slow the growth rate of the economy in later years. In the first few years, lower corporate and business taxes, temporary expensing of investment, and lower rates on individuals increase investment and labor supply. Over time, rising interest rates due to growing deficits and the expiration of temporary tax cuts drags down economic growth. In addition, the legislation drives up borrowing from abroad, giving foreign investors a larger claim on domestic income—leaving national income earned by Americans little changed by 2028.

That the Act has such modest effects on economic activity despite its dramatic revenue cost derives in large part from the choice to deliver large tax cuts to existing business owners over cuts for new investment and future activity. For instance, the sharp cut in the corporate tax rate applies to both new investment and investments already made, providing a windfall to current investors and only modest incentives to generate new capital. As we emphasize throughout this paper, this is a central flaw of the bill's design.

All told, the bill sharply cuts tax rates on capital (both new and old). Accounting for the various impacts CBO estimates the business reforms lower the marginal tax rate on capital by 1.5–3.4 percentage points in the budget window (CBO 2018b)—with the most pronounced impacts coming in 2020 and 2021, leveling off around 1.5 percentage points in 2027 and 2028. These changes in marginal tax rates on capital, coupled with other changing incentives, produce markedly different impacts on various types of investment, with equipment and non-residential structures generally benefitting and intellectual property and residential structures suffering.

As with capital, the TCJA's impact on labor income varies over time. Over the first eight years of the budget window, the temporary tax cuts on individual income boost labor supply, while their expiration and permanent changes in price indexing more than reverse the initial boost. The impacts of tax cuts are also balanced against idiosyncratic changes that offset the benefit of the individual cuts, including the limits on deductions for mortgage interest and state and local taxes, higher taxes imposed on compensation over $1 million paid to certain employees, and the repeal of deductions for unreimbursed employee business expenses. With the expiration of the individual income tax cuts in 2025, the positive impacts of the bill on labor supply dissipate. All told, marginal tax rates on labor are a few percentage points lower in the initial years, but are then slightly higher in the year's following the expiration of the cuts.

The plan does little to permanently broaden the tax base. On the individual side, the increases in the Child Tax Credit and expanded standard deduction offset the repeal of personal exemptions. The plan makes judicious changes to the mortgage interest deduction and places limits on state and local tax deductions. On the business side, the tax base is narrowed both by the new pass-through business deduction, new deductions for intangible income and the shift to a territorial tax system, and the extension of expensing and expansion of favorable accounting treatment to businesses. These changes are partially offset by limitations on interest expense and NOL deductions, and the new minimum tax on global intangible income. The economic efficiency of these changes in business tax expenditures is uncertain; while the new tax breaks encourage certain types of new investment, the limitations on interest deductibility and NOLs raise taxes elsewhere and discourage risk taking and entrepreneurial activities. Many of the largest tax expenditures are left untouched, including the exclusion of employer-provided health insurance, deferred taxes on retirement contributions, and preferential rates on investment income.

These offsetting impacts mean that a large share of income (and consumption) remain untaxed. Lower rates and the little-changed tax bases means the bill sharply increases deficits and the cumulative public debt. CBO estimates that the deficit as a share of GDP will rise to 5.4 percent in 2022, compared to a 50-year average of 2.9 percent. As a consequence, public debt as a share of GDP is projected to rise an additional 6 percentage points by 2028 (CBO 2018a). These new additions to near-term deficits exacerbate an already precarious long-term debt trajectory. Auerbach, Gale, and Krupkin (2018) show that stabilizing the debt-to-GDP ratio at its current level requires shrinking the deficit by 4 percent of GDP—equal to an immediate (and permanent) increase in revenues of 24 percent (or shrinking spending by 21 percent).

Higher deficits and rising debt will push up interest rates, crowd-out private investment, and increase borrowing from abroad. Claims that the revenue lost from the bill would be replaced by economic growth are greatly exaggerated, with CBO (2018b) estimating that the bill would generate just $461 billion in deficit reduction through economic growth. Put differently, just 20 percent of the $2.3 trillion revenue cost would be offset.[3] Because private capital investment is more productive than public consumption, higher deficits crowding out private capital investment lowers long-term growth. Thus, the effects of crowd-out peak in 2022, when the impact of rising federal deficits reaches its high point. CBO (2018b) puts the reduction in private investment from crowd-out at approximately $60 billion.

As a result of these shortcomings, most independent analysis of the bill's growth impacts find the bill will have only modest effects on economic growth. Macroeconomic analysis from CBO found that the average change in key macroeconomic variables—the capital stock, employment, and most importantly, output—would all rise by less than 1 percent throughout the budget window.[4] The moderate declines in statutory tax rates, in part because of the corresponding limits on itemized deductions and the impact of bracket creep due to indexing for inflation using the chained CPI, ultimately only reduce marginal tax rates on wages by less than 2 percentage points—with changes effectively falling to zero after the expiration of the cuts in 2025 (2018b).

Between tepid effects on growth and the increase in borrowing from abroad, gross national product—income earned by Americans—is little changed in 2028.

Analysis by academic economists have reached similar conclusions. A recent paper by Barro and Furman (2018) utilizes a standard neoclassical to model the macroeconomic impacts of the TCJA. Under their analysis, the tax cut primarily impacts the economy through reductions in the user cost of capital, which will lead to changes in the aggregate stock of capital in the economy. Barro and Furman find that the impacts of the tax cut are positive, but generally modest at best. Barro and Furman estimate that the tax law boosts GDP by 0.4 percent over a decade if higher interest rates don't crowd-out investment and by just 0.2 percent if it does.[5] Under a scenario where the provisions of the tax cut are made permanent, the 10-year GDP impact is 1.2 percent assuming no crowd-out effects and 1.0 percent incorporating crowd-out. These growth levels imply 10-year average annual growth impacts of between 0.02 percent and 0.13 percent.

TABLE 1

Ten-Year Growth Estimates of Tax Cuts and Jobs Act, with and without Crowd-out

		Legislation as Enacted	Provisions become Permanent
10-year change in GDP	without crowd-out	0.4%	1.2%
	with crowd-out	0.2%	1.0%
10-year change in GDP, annualized	without crowd-out	0.04 percentage points	0.13 percentage points
	with crowd-out	0.02 percentage points	0.10 percentage points

Source: Barro and Furman 2018.

Analysis of the TCJA by other research institutions also find small growth effects in the 10-year budget window. Comparing various organization's projected growth impacts shows a remarkably similar pattern (CBO 2018b, see Table 2 below). Virtually all of the projections find the 10-year impact on the level of GDP to be less than 1 percent—with the lone exception being the conservative Tax Foundation estimates. (The International Monetary Fund found that the tax cut would slightly shrink the economy after ten years, all others found positive impacts.) Almost all organizations find a moderate uptick in the level of GDP in the initial years, following by negative or subdued growth between 2020 and 2022.

Moreover, focusing on GDP overstates the boost to American's incomes from the TCJA because much of the new activity will benefit foreign investors. As Gale and Page (2018) explain, lower taxes on corporations and capital investments will encourage additional capital investment, but most of that new capital will be financed by foreigners. As a result, payments to foreign owners—interest, dividends, or corporate profits—will rise. They note that while CBO's projection of production within U.S. borders will increase by 0.5 percent by 2028, the projected income accruing to Americans will rise by just 0.1 percent. After accounting for the depreciated capital owned by Americans, the net change in real income for Americans is projected to be effectively zero after ten years.

TABLE 2

Assorted Estimates of the Effects of the 2017 Tax Act on the Level of Real GDP

	First Five Years					Tenth Year	Average		
	2018	2019	2020	2021	2022	2027	2018–2022	2023–2027	2018–2027
Moody's Analytics	0.4	0.6	0.2	0.1	0	0.4	0.3	0.3	0.3
Macroeconomic Advisers	0.1	0.3	0.5	0.6	0.6	0.2	0.4	0.5	0.5
Tax Policy Center[a]	0.8	0.7	0.5	0.5	0.5	*	0.6	0.3	0.5
International Monetary Fund	0.3	0.9	1.2	1.2	1.0	-0.1	0.9	0.3	0.6
Joint Committee on Taxation	–	–	–	–		0.1 to 0.2	0.9	0.6	0.7
Congressional Budget Office	0.3	0.6	0.8	0.9	1.0	0.6	0.7	0.8	0.7
Goldman Sachs	0.3	0.6	0.7	0.7	0.7	0.7	0.6	0.7	0.7
Tax Foundation	0.4	0.9	1.3	1.8	2.2	2.9	1.3	2.9	2.1
Penn Wharton Budget Model	–	–	–	–	–	0.6 to 1.1		–	–
Barclays	0.5	–	–	–	–	–	–	–	–

a. Values are for fiscal years.

GDP = gross domestic product; – = not available; * = between -0.05 percent and zero.

Source: CBO (2018b)

Beyond its aggregate effects, the bill has uneven effects across sectors. Increases in marginal tax rates in high-tax states (because of the limit on the deductibility of state and local taxes) and implicit reduction in the exclusion for municipal bond interest may shift the level and composition of subnational government spending and financing. The elimination of the penalty for not carrying health insurance will cause fewer healthy people to carry insurance and may increase cost of insurance for some groups. Changes to the use of itemized deducitons will raise the after-tax cost of charitable giving and will shift incentives for homeownership (Gale *et al. forthcoming*).

Lastly, aggregate growth and sectoral impacts aside, the package also represents a shift in tax burden away from capital and towards labor. At 21 percent (plus shareholder-level taxes), the corporate burden is now below the combined payroll plus income tax rates applied to wage earners; for qualifying pass-through business owners, the rate can be much lower. In addition, with new limitations on the deductibility of executive compensation and a corresponding tax on tax-exempt entities, the top marginal rate on those wages exceeds 50 percent; unreimbursed business expenses are no longer deductible for employees; and state and local taxes remain deductible for corporate businesses, but are limited for wage earners. Hence, the bill encourages more of national income to accrue to businesses and less in the form of wages.

All told, the combined evidence on the growth impacts of the tax act suggest it will slightly grow the economy in the near-term, reduce growth over the longer term, and net out close to zero for income earned by Americans. While that conclusion varies slightly depending on modeling assumptions, all estimates suggest a small long-run impact. Our view is that the TCJA provides too little boost to economic growth to offset the eventual pain that will come later with higher public debt. This is a missed opportunity to reform the individual and corporate tax codes. In an era of slowing economic growth, a more thoughtful reform could have provided a welcome lift to the trajectory of U.S. growth.

III. PRO-GROWTH FUNDAMENTAL TAX REFORMS

It is useful to compare the design of TCJA—a reform motivated by its purported economic effects—with idealized reforms studied in the economics literature. Economists have long-studied the economic impacts of major tax reforms that would fundamentally alter incentives for various factors of production and have profound impacts on capital and labor markets.[6] A critical observation is that the pro-growth effects of fundamental tax reform are not about the level of tax revenues, but rather about the structure of the tax system. In particular, the benefits of fundamental reform, such as moving from an income tax to a consumption tax, reflect one fundamental element: using a tax on old capital to finance lower rates on wages and new investment.[7] Such reforms improve the prospects for both workers and active investors because they increase new investment, but without shifting the tax burden to workers. The losers in this scenario are the owners of already committed capital or investments earning economic rents who see their after-tax return decline.

The importance of the tax on old capital is widely recognized in the academic literature studying and simulating tax reform.[8] This literature examines an assortment of tax reforms using a wide variety of models, but the clear winners are those reforms that use the levy on existing capital to reduce rates on more productive activities. For instance, several papers attempt to model the effects of alternative tax reforms on economic growth, wages, and the wellbeing of workers (Altig *et al.* 2001; Fullerton and Rogers 1995; Elmendorf and Reifschneider 2002).

Altig *et al.* (2001) model a variety of reforms and offer the clearest hierarchy for ranking fundamental tax reforms. In their ranking, the *only* reform that is both pro-growth and net positive for middle-class wage earners is the X-Tax—a progressive consumption tax. In effect, the X-Tax uses the tax on old capital implicit in the business cash flow tax to provide expensing for new investment and lower the tax rate on wages. Taxpayers get the triple benefit of low tax rates, increased productivity, and progressive incidence—the primary cost of such reform is that investors on already-committed capital pay higher taxes (and receive lower profits) than initially anticipated.

Reforms receiving mixed evaluations are those that impose a broad-based, flat-tax income tax. Lower rates (derived from the broader base) tend to boost growth, but the elimination of tax expenditures imposes higher taxes on wage earners. On net, workers are not necessarily better off. At the bottom of the ranking, the worst reforms for workers are shifts toward wage taxes. Such a reform requires workers to bear a relatively higher tax burden while imposing a higher tax rate owing to the narrow tax base, reducing growth. That is doubly bad for workers, who would experience both slow wage growth and higher relative tax burdens.

Indeed, the lesson "tax old capital" is a standard and fundamental result. As Auerbach and Kotlikoff (1987) note, the capital levy implicit in a consumption tax is essential to the growth and long-run welfare gain in tax reform. It is the feature that allows for reductions in distortionary marginal tax rates on new activities, shifts the burden to older, higher-wealth individuals, and allows future generations to benefit from both lower taxes and more growth. This standard finding is reflected in a host of other research.[9]

As a practical matter, taxing old capital presents political and distributional challenges. For example, raising the tax rate on gains or making depreciation treatment less generous on old capital may be met with opposition based on fairness grounds. And yet, it is a useful practical guide to the likely effects of proposed reforms. Reforms that provide windfalls to old capital (the opposite of taxing them) have no hope of producing long-term benefits.

Similarly, straight tax cuts (rather than fundamental reforms) do not produce long-term benefits, in large part because of the harmful impacts of higher deficits. Diamond and Viard (2008), for instance, show that deficit-financed tax cuts, even when they raise the size of the economy, generally lower the welfare of future generations. The intuition is straightforward: deficit-financed tax cuts must eventually be repaid, either explicitly in the form of higher future taxes or implicitly in the form of higher interest rates. In either case, saving and investment suffer.

Deficit-financed tax cuts affect growth because higher interest rates crowd out private-sector investment. The empirical link between higher debt and higher interest rates is well-established, as is the impact between higher interest rates and lower private-sector investment. For example, Gale and Orszag (2005) find that a one percentage point increase in the anticipated debt-to-GDP ratio leads to a 2.8–5.6 basis point increase in long-term interest rates. These higher interest rates depress private investment. Based on its review of the economic literature, the Congressional Budget Office (2014) estimates that a $1 increase in the federal deficit reduces private investment by 33 cents. As a result, deficit-financed tax cuts have muted effects on long-term activity. For instance, a study by CBO economists found that, under a range of models, the effect on GDP of a deficit-financed 10 percent cut in federal income tax rates is in a range close to zero—slightly higher or lower depending on model assumptions (Dennis *et al.* 2004).

This link between deficits and lower growth returns us to the initial observation about the critical role of capital levy. As summarized by Hassett (2012), growth depends on achieving a lower marginal tax rate on corporate investment, better saving incentives, limiting economic distortions and cross-industry subsidies, and improving work incentives. This approach is only mathematically possible with a capital levy to finance cuts to both investment and labor supply.

This doesn't mean policymakers need immediately transfer to a pure consumption tax. But one implication the higher deficits owing to TCJA's generous windfall gains for old capital is that the bill's purported benefits are likely to be meager over the long run. As a result, reversing TJCA's major components which reinforce these windfall gains won't hurt—and could even help boost—long-lasting growth.

IV. THE PATHS TOWARD IMPROVING THE TAX CODE

The just-passed tax law is explicitly temporary and Congress will need to act relatively soon to address expiring provisions and the general fiscal imbalance. This presents an opportunity to enact a lasting tax reform composed of elements that raise necessary revenue and support long-term growth. To that end, we offer a few selected strategies, and corresponding policies, for raising revenue, reducing economic distortions, and promoting economic growth. This is not a tax reform plan *per se*, but rather a series of reasonable approaches intended to inform future legislative action.

First, one basic approach is to move in the direction of consumption tax treatment by raising revenue from "old capital"—such as reversing certain windfalls in TCJA, raising statutory tax rates, and limiting certain business deductions—while retaining incentives for new investment, such as accelerating depreciation allowances or expensing. A second approach is to address the international provisions within the corporate sector. Improved international taxation would limit the scope for tax avoidance and income shifting, raise corporate tax revenues, reduce incentives to locate certain investments in low-tax jurisdictions, and encourage activity domestically. Third, a future reform could shift more of the tax burden from corporations to their shareholders and reduce tax expenditures that allow business or investment income to escape tax. Such changes could reduce economic distortions at the business and individual level, simplify compliance and enforcement, and allow for a combination of higher revenues and lower marginal rates. Fourth, tax reform should broaden the base and lower the rate. On the individual side, in particular, there are opportunities to eliminate, reduce, or reform countless tax expenditures in ways that reduce their budgetary cost and adverse economic consequences, or to increase their efficacy. For example, redesigning the mortgage interest deduction and exclusion of employer-supplied health insurance, and applying the revenue offsets to reduce distortionary taxes elsewhere in the tax code could both boost growth and compensate the bulk of taxpayers losing out from the tax expenditures' reform. Fifth, reform should restructure taxes on wages and earnings to promote employment and labor supply, drawing on empirically-relevant examples of supply-side economics to boost workers' pay. Finally, Congress should appropriately fund tax administration and enforcement, to collect the taxes that are already on the books.

Tax old capital and provide incentives for new investment

Any new reform that provides windfall gains to already-committed capital must compensate for those gains in ways that will stunt growth. That makes it difficult for any reform that increases the reward for old capital to be growth enhancing. As a starting point, that suggests that reversing or recapturing the TCJA's windfalls should be a top priority.

For instance, there are good arguments that the reduction in the corporate rate to 21 percent went too far; raising the corporate rate to somewhere between this new low and the old rate of 35 percent has several advantages. First, the corporate tax system applies to a large share of income and produces substantial revenues, which cannot be replaced without imposing new taxes elsewhere in the economy. Second, it is progressive with almost 70 percent of its burden falling on high-income taxpayers (Cronin *et al.* 2013). Third, setting the total tax rate on corporate (or business) income at or above the top rate on wages is a substantial source of simplification because it encourages most labor income to be paid out as wages (rather than retained as profits). That treatment largely eliminates inefficient tax sheltering and tax avoidance behaviors, and reduces the need for complex and onerous rules differentiating each type of income. Raising the U.S. corporate rate to the range of 25 to 28 percent would remain comparable to peers in developed economies, but the effective tax rates on new investments would be far lower because domestic investments could benefit from R&E credits and expensing of investment.

Similarly, windfall gains to non-corporate capital owners could also be reversed by eliminating the newly-enacted pass-through deduction. From the perspective of simple, efficient, and fair tax policy, the single worst change in the entire legislation is the reduced rate on qualified pass-through business income because it reduces progressivity, picks winners among businesses, increases complexity, and exacerbates domestic distortions, all while cutting revenues. As we discuss further below, tax cuts on corporate and business capital could also be recouped by higher taxes on shareholders and reductions in tax expenditures that exclude capital gains or dividends from tax.

But taxes on old capital need not impair new capital formation and other elements pro-growth elements could be retained or expanded. The most pro-growth element of the recent reform is to allow companies to expense new investment. This reduces the effective tax rate on break-even investments to zero—the same treatment those investments would face under a consumption tax. Similarly, expensing could be expanded to inventories and even to structures—under certain conditions—and made permanent. And the amortization of R&E expenditures scheduled to go into effect after 2025 could be repealed, and existing credits for R&E expenditures retained.

The recently enacted legislation includes instances of notable relief from accounting rules for small businesses including relief from inventory accounting, accrual accounting, and certain capitalization rules. Again, these changes shift the tax base more closely to that which would apply under a consumption tax. For both C corporations and pass-through businesses, the accounting simplifications applied to smaller businesses could be applied more generously.

Of course, as under a consumption tax, taxpayers should not be able to benefit from both expensing and deductions for interest expense, especially not for long-lived investments like structures, and so the deductibility of interest expense should be further limited or eliminated entirely.

Fix the international tax system and limit provisions that facilitate corporate avoidance and income shifting

On the international side, the recently enacted plan puts in place three conceptual elements of a rational reform, but in ways that would benefit from practical improvements. First, it eliminates the incentive or ability of U.S. multinational corporations (MNCs) to defer taxes on foreign profits and allows U.S. companies to operate in most foreign economies without facing an additional U.S. tax on their overseas earnings. Second, it provides a practical, simplified way to restrain U.S. multinationals from shifting profits and jobs to tax havens by imposing a minimum tax on excessive foreign profits (profits above a threshold return on foreign investment). Finally, the bill includes measures to reduce inbound earnings stripping (the use of deductible payments between related foreign-owned parties to reduce U.S. taxable income). The plan also includes a new tax expenditure providing a deduction for Foreign Derived Intangible Income (FDII).

This general approach to reform is sound, particularly if the U.S. is to remain locked into the basic corporate tax structure and tax base that has prevailed in the past. However, the plan does too little to reduce profit shifting, encourages a race to the bottom in international tax rates and norms, and retains incentives for U.S. companies to locate activities abroad.

For instance, rather than raising revenue from the foreign-source income of U.S. multinationals—as one might expect of a reform concerned with profit shifting—the net effect of the international reforms are to reduce tax revenues from U.S. multinationals on their foreign earnings (even after accounting for the 21 percent corporate rate). In short, U.S. multinational corporations pay less tax on both domestic and foreign activities than they would have been under the pre-existing regime.

For foreign-owned MNCs operating in the U.S. the plan includes stronger anti-abuse provisions. While the bill dropped a key earnings stripping rule at the last minute, it includes a provision called the base erosion and anti-abuse tax (BEAT). This helps eliminate the prior-law inequitably favorable treatment provided to foreign-owned multinationals operating in the U.S. by limiting their ability to reduce or eliminate their U.S. tax burden by using payments like interest, insurance premiums, or royalties that are deductible in the U.S. but are often never taxable to the foreign parent. Although the provision, as enacted, includes technical flaws and is likely to be challenged by trading partners for violating tax treaties intended to eliminate double taxation of income, its core purpose makes sense. A priority in reform would be to retain and strengthen those provisions, limit earnings stripping with stronger limits on interest deductibility, and make modifications to ensure they comply with international obligations.

Several changes in the international tax regime are warranted. First, the special low rate on export income associated with intangibles (i.e., FDII) is unlikely to comply with WTO rules and could be designated an export subsidy. Moreover, there is little justification for the provision: it is complicated, costly, and difficult to enforce—and there is little evidence similar approaches encourage innovation or influence locational choices. Other approaches, like the R&E credit, are better, more efficacious ways to promote domestic innovation. (A delayed provision in the TCJA requiring firms to amortize R&E expenditures then could be eliminated.)

Second, the international minimum tax rate is too low, its base-narrowing allowance for foreign income from tangible investments is too generous, and the rules for applying foreign tax credits need fixing. With a low rate and a narrow tax base, the incentive to locate certain activity in foreign jurisdictions rather than the U.S. is strengthened. Moreover, because companies are allowed a generous deduction against the foreign income in proportion to 10 percent of their foreign tangible investment, they have enhanced incentives to shift tangible property—factories, plants, and equipment—abroad. Increasing the minimum tax rate to 15 percent—net of 80 percent of foreign taxes paid—and reducing the tangible equity allowance from 10 percent to the rate applied to risk-free investments would reduce the ability and incentive to shift profits abroad to very low-tax jurisdictions. Furthermore, rather than calculating the minimum tax based on the average tax paid across all foreign income, which allows companies operating in high-tax jurisdictions to benefit by booking more profits in tax havens to offset the tax, the minimum tax should be applied on a country-by-country basis (or allow pooling of income and credits only within non-tax haven countries).

Third, while the corporate reform includes stronger rules to limit interest expense, key provisions that prevented multinational (or foreign-owned) corporations from loading up their U.S. subsidiaries with disproportionate amounts of interest expense were dropped at the last minute. As a result, foreign-owned firms—including inverted companies—retain a tax advantage over domestic firms. That provision should be enacted in a reform and should require that interest expense deductions be allocated across countries in proportion to income.

Finally, by retaining a system that taxes corporate income based on source of income and corporate residence, we are stuck in a world that relies on transfer pricing to measure cross-border, related-party transactions. We should recognize that there is no magic bullet to this challenge, and that alternative approaches like formulary apportionment are no better, and plausibly worse, at protecting revenues and reducing distortions. Instead, ensuring compliance will require cooperation from trading partners, and old-fashioned, diligent and informed enforcement by IRS authorities—which necessities funding for corporate oversight and enforcement.

Change the taxation of capital to promote more uniform taxation

While shareholder-level taxes were little changed in the TCJA, many pre-existing distortions are exacerbated by changes at the corporate or pass-through level. For instance, lower rates on corporate and pass-through businesses and expensing provisions exacerbate the costs of tax expenditures ranging from the exclusion of capital gains at death to tax-exempt savings vehicles.[10] And tax rates on investments continue to face markedly different effective and marginal tax rates depending on the type of account in which it is held, when the assets is sold, and how the investment is financed. All of these distortions reduce economic activity by shunting investments away from their most efficient uses. Addressing these shortcomings is a critical component of any reform.

The most significant approach to reform would be to eliminate stepped-up basis for inherited assets and taxing capital gains at death or requiring carryover basis. Stepped-up basis refers to the treatment of capital assets, whereby upon the death of an owner of capital, the gains accrued to date are exempt from tax and the basis for the heir is re-established on the date of death. Some of the gains may be taxed through the estate tax, although this does not mitigate incentives to retain appreciated assets until death to avoid capital gains tax. [11] (And the recent increase in the estate tax exemption means that an even greater share of capital gains held until death will go untaxed.) For owners of capital assets that have appreciated considerably, the tax-based incentive to hold the asset until death is considerable.

Recent experience allowed economists to study the magnitude of stepped-up basis on investor behavior. In 2010, due to budget conventions that required certain tax cuts to expire, taxable estates could effectively choose between paying the estate tax and losing their stepped-up basis benefit. It turns out the share of long-term locked-in gains was substantial. All told, unrealized capital gains comprised 44 percent of estates' value. Among those gains for which holding periods were known, 71.9 percent of corporate stock gains and 85.2 percent of closely-held stock were held for more than 20 years (Gordon *et al.* 2016). Eliminating stepped-up basis and taxing gains at death would substantially reduce the distortion from lock in. (The effect of changing to carryover basis is less clear.) In either case, the provision would raise considerable tax revenue from owners of appreciated assets—including the appreciation arising from lower tax rates on business income. Raising revenue from closing this tax expenditure could thus help pay for the lower tax rates at the business level, where the distortionary effects of taxes are likely larger. And it could help keep the overall tax burden on existing business capital more similar to the rate on other income, reducing distortions to organizational form and retaining a progressive element in the tax system.

Limiting stepped-up basis at death is just one example of how to shift the tax burden on business activity from corporate-level income taxes to shareholders by increasing revenues from taxes on dividends and capital gains. One motivation for this strategy is that corporations are more mobile and their investment decisions more responsive to taxation than individuals, especially given the rise in globalization and the ease with which profits can be shifted between jurisdictions.[12]

Another option for shifting the burden to shareholders from corporations would be to increase them at the shareholder level. In the abstract, it is clear that such reforms could finance reductions in the corporate rate in a revenue-neutral manner (Altshuler, Harris, and Toder 2010). A more creative approach would be shift to an annual mark-to-market system (to discourage deferral), while also taxing investment income at regular income tax rates and allowing investors a credit for corporate taxes paid (and levying a new tax on interest received by tax-exempt institutions and retirement accounts). Such a reform could be revenue-neutral, and strongly progressive, while limiting incentives to shift income abroad and mitigating the preference for debt over equity (Toder and Viard 2016).

The tax code should also require taxpayers in all brackets to pay at least some taxes on capital gains and dividends. Currently, less than 6 percent of taxpayers will pay any capital gains tax this year, according to estimates from the Tax Policy Center.[13] In part, this is because the tax rate on capital gains and dividends is zero for most taxpayers (including, for instance, married couples with incomes up to $101,400). Current practice allows, for instance, taxpayers to accrue profits within a corporation, paying only 21 percent tax, and avoid capital gains tax entirely in some circumstances.

Similarly, reform could curtail a wide range of tax expenditures that allow corporate income to avoid tax at the shareholder level. For instance, one approach is to strengthen anti-abuse rules for closely held stock in Roth IRAs, which allow IRA owners to shelter labor income by allowing an effective tax rate of zero on income from these assets. Similarly, reform could eliminate the exclusion of capital gains on qualified small business stock or in Opportunity Zones and limit other preferences for capital gains. Investments in qualified small business stock are excluded from capital gains tax entirely up to a limit of $10 million (per business, per investor). This tax expenditure has little justification on economic grounds, accrues almost entirely to the highest-income taxpayers, and will prove costly with a 21 percent corporate rate. It should be repealed or reformed.

Lastly, reform should tax tax-exempt organizations on a larger share of their business profits. Tax-exempt organizations pay no tax on activities related to their exempt purpose. With a few exceptions, they also avoid tax on their investment income, including capital gains and dividends from corporations. And when tax exempt organizations earn income from non-exempt purposes, they generally will pay unrelated business income tax at the lowered corporate tax rate. Tax reform could aim to recapture some of TCJA's windfall reduction in the corporate rate by, in the absence of a higher overall corporate tax rate, increasing the rate applied to unrelated business income. Alternatively, reform could broaden the base of the excise tax that today applies to investment income of private foundations and certain private universities with large endowments to include a larger share of tax exempt institutions with substantial income or assets.

Reduce distortionary tax preferences in the individual tax code

The tax code creates a dizzying array of incentives that distort economic behavior. In some cases, the incentives improve efficiency by addressing an existing distortion or rewarding behavior with positive social benefits ("externalities"). Many of the distortions are minor, but some have profound implications on the U.S. economy. A reform designed to maximize sustainable growth should address, at least, the most severe distortions.

In the individual income tax code, one of the most significant distortions is the unlimited exclusion for employer-provided health insurance, which encourages employers and individuals to receive their income in the form of insurance rather than wages. This, in turn, encourages overconsumption of health services and pushes up the cost of health insurance. The Institute of Medicine (IOM 2012) estimates overconsumption of health care services cost $210 billion in 2009, bringing the total excess cost of health care to $765 billion.[14] The exclusion is also certainly expensive, with the Joint Committee on Taxation recently putting the 2017 cost of this tax expenditure at $155 billion.

Several worthwhile reforms are available. If allowed to go into effect, the "Cadillac Tax" is a judicious and effective incremental approach, which imposes a surcharge on extremely expensive plans whose generosity exceeds a high threshold. This approach was included in the original Affordable Care Act, but has subsequently been delayed on several occasions and is now scheduled to take effect in 2022. Should the Cadillac Tax eventually commence, one proximate impact would be to shift employee demand for expensive plans to more reasonably priced alternatives, reducing the cost of health insurance, and shifting compensation into higher wages. By one estimate, implementing the tax in 2018 could lead to a reduction in health care expenditures of $48 billion to $69 billion, or 2.2 percent to 3.2 percent (Gravelle 2017). Those savings would translate directly into higher wages.

A second major distortion is the way the tax code subsidizes homeownership. Without weighing on the merits of subsidizing homeownership, the mortgage interest deduction is an inefficient way to subsidize homeownership.[15] The academic evidence on the mortgage interest deduction shows that it does not increase homeownership (Harris, Steuerle, and Eng 2013). Partly that reflects its structure, which subsidizes interest on housing debt rather than homeownership directly. Partly that reflects that it will be unavailable to the nearly 90 percent of taxpayers who will not itemize deductions this year. Partly this is because it is a regressive benefit, with most of its value accruing to high-income families who would own a home anyway, and with limited value going to middle-income taxpayers.

Other options, such as providing a first-time homebuyer tax credit or a flat annual subsidy for homeownership, would more effectively match incentives with the desired behavior—namely higher rates of homeownership and greater accumulation of housing equity. Similarly, the $250,000 per-person exclusion on capital gains derived from owner-occupied housing creates a lock-in effect whereby homeowners—due to the requirement that they live in their homes for two years—may allocate capital to homeownership rather than more productive uses to qualify for the tax break. On the margin, this leads to an inefficient allocation of capital, which can have a negative impact on economic output.

Tax writers should also revisit strategies to encourage retirement saving. The tax code offers a host of various incentives designed to promote saving by allowing savers to receive a deduction for their initial contribution and relief from taxes during the accumulation phase, while requiring them to pay taxes when the assets are withdrawn. The system of retirement saving, in addition to costing the government billions annually, is a poor engine for spurring additional saving. For example, (Chetty *et al*. 2014) found that every dollar in pro-saving tax incentives leads to about one cent in higher saving; examining IRAs in the U.S., Gale and Scholtz (1994) report similar magnitudes for pro-saving incentives.

Finally, a wide array of smaller credits, deductions, and exclusions could be consolidated, simplified, and more narrowly targeted. For instance, gaps between the tax base of the net investment income tax, self-employment taxes, and Medicare taxes mean that some high-income taxpayers structure their compensation such that it is taxed neither as earned income (which would be subject to payroll taxes) nor unearned income (which would be subject to the net investment income tax). Such loopholes should be closed. Similarly, in the drafting of the TCJA, legislators considered (but decided against) eliminating several duplicative or inefficient incentives related to education. Reform is exactly the time to reconsider cutting back on inefficient and costly tax breaks.

Encourage working-age Americans to enter the labor force and supply more labor

Tax reform can also boost incomes by targeted reductions in tax rates on wage income. Reforms that reduce effective marginal tax rates (EMTRs)—which include the effects of both taxes and transfer programs—can increase incentives for non-workers to enter the workforce and for current workers to supply more labor. Tax rates can be exceptionally high for subsets of workers, especially those who are in the phase-out range for various programs—such as the Earned Income Tax Credit (EITC) and Supplemental Nutrition Assistance Program (SNAP) benefits. For example, CBO (2015) found that "When federal payroll taxes, state income taxes, and benefits from SNAP and the cost-sharing subsidies for health insurance are included, the marginal tax rates are much higher: Only 16 percent of taxpayers will face marginal tax rates between 10 percent and 19 percent, and 78 percent will face higher rates. More than half will face marginal tax rates between 20 percent and 39 percent."

In most cases, the resulting high marginal tax rates reflect an efficient balance between a desire to lift low-income families and children out of poverty against the budget-busting costs of expanding benefits to higher-income families. In some cases, however, the design of programs and tax rules impose artificial or inefficient barriers to employment or carve out important constituencies—flaws that could be fixed in a reform.

First, expanding the EITC to childless workers and to currently ineligible younger and older workers would boost employment and earnings of American workers. The EITC is a wage subsidy for low-income workers that features a phase-in range of 7.65 percent for childless taxpayers and between 34 percent and 45 percent for taxpayers with children, with a higher rate for workers with more than three dependents. A large empirical literature studying the EITC shows large impacts on employment and earnings.

Under current law, workers without dependents can receive only a limited EITC benefit—a maximum of $510—and those workers need very low levels of income can qualify (the credit phases out around $15,000).

Increasing the phase-in range and raising the subsidy rate for workers without dependents would raise the returns to work for this group. For example, the Obama Administration proposed to double the phase-in and phase-out rates from 7.65 percent to 15.3 percent, in effect doubling the maximum credit to $1,022 (U.S. Treasury 2015). The Obama Administration also proposed to broaden the age eligibility and expand the phase-out range for single filers from roughly $8,360 to $11,500 (so the credit would phase out at income of about $18,173). A related proposal by Hilary Hoynes (2014) would expand the EITC for one-child families so that it is on par in family equivalence terms with the two-child EITC.[16]

A similar strategy for increasing returns to work would be to reform the payroll tax, either by directly cutting the tax or by providing a refundable tax credit based on payroll taxes paid, and paying for those changes by limiting payroll tax exclusions and broadening the base of the tax, or lifting the cap on taxable earnings. For instance, in 2010 the employee-side payroll tax was reduced by 2 percentage points for two years. This cut had similar economic impacts as the Making Work Pay Tax Credit, which was effectively a rebate up to $800 ($400 for single filers) on payroll taxes paid. This lower tax rate can increase labor supply.

Second, providing tax relief for secondary earners would increase labor supply of married taxpayers. Because the United States taxes couples on their joint earnings, the marginal tax rate on spousal earnings is higher than it would be if couples filed independently. In most cases, this results in a higher marginal tax burden on the second worker's earnings—a tax rate which can approach 50 percent in high-income families in high-tax states. The Obama Administration proposed a secondary earner tax credit worth up to $500 that would subsidize the return to work on the first $10,000 in spousal earnings (U.S Treasury 2015).[17] With about 40 percent of working-age married couples reporting earnings from one or no spouses, the secondary earner tax credit is designed to spur greater labor force participation by married working-age adults.[18]

A more radical change would tax spouses on their individual earnings rather than jointly. Such a change isn't necessarily progressive because two earner households tend to have higher income, but they are more equitable on different dimensions because they treat workers in married couples more like their unmarried peers, and value the work of second-earners—usually women—at the same rate as their husband's. Even if a disproportionate share of the tax savings went to higher-income groups, the tax cuts would be justified as they'd be pro-family, pro-growth, and pro-gender equity. Those benefits are far more compelling than the TCJA's changes to the standard deduction and child credits.

Finally, a third broad strategy for increasing take-home pay is to provide more generous benefits for child care, which should arguably be deductible as a cost of producing income under an ideal income tax.[19] Childcare costs represent a powerful barrier to employment for parents, especially when superimposed on the existing tax system. As discussed in Ziliak (2014), when childcare costs decline, women increase their labor force participation.

Some policymakers have proposed a more generous tax credit for working parents to offset childcare expenses. As part of the unified framework for tax reform, the Trump Administration advanced an endorsement of an expanded childcare tax credit. The proposal had limited details. As described by the Administration, President Trump's version of the credit would significantly increase the size of the tax credit and expand the income limits at which the credit begins to phaseout, while maintaining the current law limits on refundability. Similarly, the Obama Administration proposed a plan to increase the maximum size of the tax credit to equal 50 percent of the first $6,000 in childcare expenses for one child and the first $12,000 in expenses for two children, with a higher benefit for children under five years old.

Like the EITC and a cut in the payroll tax, a more generous tax credit for childcare would reduce the penalty on labor for working parents. The exact magnitude of the labor supply response would vary based on the particulars of the credit, with a key factor being the extent of refundability offered to low-income workers. Importantly, a more generous childcare tax credit can also help to offset the higher effective marginal tax rate associated with the phaseout of the EITC.

Improve compliance

Finally, taxpayers need help complying with the tax code and tax laws need to be enforced. Tax compliance is often measured in terms of the "tax gap," which is the difference between taxes owed and taxes paid. The nature of the tax gap makes measurement difficult. The IRS's measure of the tax gap put it at $458 billion annually for the years 2008–2010 (IRS 2017); a separate estimate put it at $654 billion in 2015 (Raczkowski and Mróz 2016). The U.S. tax gap of 3.8 percent of GDP puts it around the 25th percentile relative to other developed economies, but the U.S. also collects fewer taxes as a share of the economy relative to other countries. Because of its absolute size, even small, sustained reductions in the tax gap can contribute to deficit reduction.

The tax gap has two principal effects on growth. One, to the extent that some taxpayers choose to comply and others do not, non-compliance by a subset of taxpayers drives up tax rates across the whole economy and exacerbates the attendant distortions with tax rates. These impacts are offset by offset by the lower marginal tax rates on labor and investment for non-compliant taxpayers. Two, since non-compliance is not uniformly distributed across economic activity, it encourages workers and investors to operate in areas of the economy that are characterized by low compliance over areas that are not.

IRS data on tax compliance show that, among non-corporate tax collections, compliance is substantially higher by wage earners relative to those who report pass-through income. The average annual tax gap for 2008–2010, for example, was just $5 billion for wage and salary income, representing just 1 percent of the total tax gap (Dubois *et al.* 2016). During the same period, the tax gap for income from pass-through business owners underreporting was $190 billion, or 41 percent of the total tax gap (Krupkin and Looney 2017). The stark discrepancy in compliance drives down the effective (compliance inclusive) tax rate for operators of pass-through entities relative to wage earners, creating an unintended penalty on wage labor. Economic theory suggests that this will unintentionally allocate resources towards industries that permit low levels of compliance, away from the most productive economic occupations and sectors. There is no shortcut when it comes to tax compliance; improvement requires a simpler tax system and more resources for the IRS to aid taxpayers and enforce the law.

CONCLUSION

If the fiscally-irresponsible tax cuts in 1981 led the nation toward more comprehensive reform in 1986, our optimistic take is that the TCJA should lead to a future reform that results in a sustainable, permanent, and efficient tax code that lays the foundation for higher rates of growth and national prosperity.

Congress can and should take another try at righting the tax code. While the profession disagrees on some of the details of tax reform, most economists support fundamental reforms which approach a pure consumption tax or which apply broad-based, low-rate income taxes to efficiently raising revenue. Unfortunately, the recently-passed tax bill moves in the opposite direction. Even in the absence of fundamental reform, a collection of modifications can improve economic efficiency, reduce harmful distortions, and moderately raise growth rates in the near-term—all while avoiding sharp deteriorations in the national debt situation.

Plausible reforms include a eliminating the loophole for stepped-up basis to broaden the base on capital income; fixing shortcomings in the new corporate minimum tax to limit corporate tax avoidance and encourage domestic activity; imposing relief for new business investments that lowers the after-tax user cost of new capital; boosting the EITC, especially for childless workers; instituting a second-earner tax credit and providing widespread child care relief to reduce disincentives for spouses to work; reducing distortions in tax preferences for homeownership to, at the very least, actually encourage homeownership itself; addressing exclusions for employer-provided health insurance to limit tax-based overconsumption of health care; and instituting improved simplification measures that, coupled with sufficient funding for tax administration, that would limit opportunities for evasion and avoidance that afflict the current code.

NOTES

1 The original blueprint from the House leadership incorporated some of these principles under the guise of our existing system: no tax on new investment (expensing for not just equipment, but also structures and inventories), a border adjustment, and limits on interest expense.

2 In particular, the one-time repatriation on deferred foreign income and the zeroing of the Affordable Care Act shared responsibility tax each raise roughly $300 billion over the 10-year budget window, but worsen deficits in the long-run.

3 The $571 billion in additional revenue is offset by a $110 billion increase in the cost of servicing the increase in debt.

4 Specifically, private non-residential fixed investment, employment, and overall output would be 0.3, 0.6, and 0.7 percent higher through the 10-year budget window (CBO 2018b).

5 Barro and Furman model interest rate changes based on Laubach (2009) which assumes that a 1 percentage point increase in the unified deficit (as a share of GDP) raises interest rates by 25 basis points.

6 For example, see Aaron and Gale (1996).

7 While taxing old capital is sometimes viewed as applying a second (consumption) tax to income that has been previously subject to income or payroll tax, the reality is that a sizable share of income either avoids income tax or benefits from preferential rates.

8 In testimony before Congress, Hassett (2012) reviews the economic literature on optimal taxation at length, observing that the strongest effects on economic growth derive from expensing of business investments, rather than reducing corporate taxes or taxes on capital gains.

9 For additional discussion, see Fullerton and Henderson (1987), Gravelle and Kotlikoff (1989), Diamond and Zodrow (2008), and Rogers (1997).

10 The mechanical response to lower tax rates is that they reduce the cost of tax expenditures, as the value of a deduction or exclusion is a correlated function of the tax rate. However, in the case of taxexpenditures such as the preferred rate on capital gains, the exclusion of capital gains on small business stock, or step-up in basis at death, the combination of unchanged rates on capital gains and lower business taxes increases the gain income that benefits from these preferences.

11 The estate tax was created, in part, to compensate for the exemption of accrued gains at death, as the basis for capital assets used to be more difficult to tax. With advances in technology and recordkeeping, the basis for capital assets can more accurately be determined.

12 When other countries, like Ireland, lowered their rates and shifted the burden from corporations to people, they did so by ensuring that income was taxed when consumed or at the individual level with dividend taxes, capital gains taxes, and a robust inheritance tax. In short, they lowered taxes on mobile corporations by increasing them on less-mobile shareholders.

13 Tax Policy Center Table T18-0052.

14 Sources of excess costs include overuse of care (beyond evidenced-based levels), discretionary use beyond benchmarks, and unnecessarily choosing costlier, but equivalent, services. IOM (2012) admits that there might be overlap between the costs generated by overconsumption and the other sources identified, but does not provide an estimate of this overlap.

15 Tax-based housing subsidies—which include the mortgage interest deduction, but also deductions for property taxes paid and a generous exclusion on capital gains attributed to owner-occupied housing—may also lead to overconsumption of housing, with households choosing to buy second homes and live in more expensive homes than they would otherwise. This overconsumption and overinvestment in housing means that tax expenditures for homeownership lead to underinvestment in non-housing industries by drawing resources away from other investments like small businesses and financial assets. And the overconsumption tends to cause housing prices (and rents) to increase, which may make some low-income homeowners (and renters) worse off than they would be if homeownership were not subsidized.

NOTES

16 Specifically, for one-child families in 2014, Hoynes proposes to raise the minimum income eligibility from $9,720 to $13,650; increase the phase-out rate from about 16 percent to roughly 21 percent; and increase the maximum credit from $3,305 to $4,621.

17 Kearney and Turner (2013) proposed a similar approach, calling for a 20 percent deduction on the first $60,000 in secondary earnings for low- and middle-income families with children.

18 This approach was tried before. In the Economic Recovery Tax Act of 1981, to help blunt the impact of high marginal tax rates, Congress added a deduction on the first $3,000 in earnings for second-earners. The design of the deduction was regressive, with much stronger impacts on higher-income taxpayers (Eissa 1996).

19 Current tax law provides a modest credit for child care costs. In families headed by a single-working parent, or by a married couple where both parents work, taxpayers can claim a credit equal to 35 percent of the first $3,000 in child care expenses for a single child or the first $6,000 in expenses for two or more children. The children must be under age 13 and the credit phases down to a 20 percent rate at moderate levels of income.

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