



## Tax Reform . . .

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The biggest tax reform bill in decades passed Congress on December 20, and President Trump signed it into law two days later, delivering on its promised passage before Christmas. However, the tax bill has been critiqued in some quarters and remains a puzzle to taxpayers as they try to anticipate how its myriad provisions affect them.

Various polls have shown that more respondents disapprove than approve of the new legislation. The lack of public support for the tax reform is possibly due to inadequate public education on how the changes to the personal income tax code affect each family, and how the cut in the corporate tax rate is linked to families' well-being.

Here, we provide some of the economic rationales for tax reform, as well as point out where this reform falls short. We focus on the centerpiece of the legislation, which is a significant cut in the federal corporate income tax rate from 35% to 21%, but also discuss the distributional effects of the total tax reform.

The initial motivation behind cutting the corporate rate was no doubt to enhance the competitiveness of American firms and to give offshore U.S. firms an incentive to move back to the country.

In this highly integrated world economy where capital can move relatively freely between countries, firms tend to move their production to countries with lower corporate income taxes. Before the tax reform, the U.S. had one of the highest corporate tax rates at 35%. By comparison, major economic competitors have much lower corporate rates: the EU (25% on average), China (25%) and Japan (a little over 30%).

The new 21% corporate rate will make U.S.-based firms competitive with other developed economies. Those U.S. firms that have already moved headquarters and/or production facilities elsewhere to avoid the previous high corporate tax rate have a strong incentive to move them back, which they can do by paying a one-time 14% tax on their offshore profits.

One thing to watch regarding the business relocation benefits of the corporate tax cut is the possibility that other countries may follow the U.S. to lower their corporate rate as well. China has already announced a temporary exemption on taxes owed by foreign companies, provided they invest their exempt earnings in certain sectors of the Chinese economy.

The main objection to the tax reform is that it is not revenue neutral, but instead will increase the deficit and lead to increased government debt. The magnitude of the deficits are mollified to some degree with the dynamic scoring of the tax reform.

First, the corporate tax cut stimulates investment and facilitates economic growth. As the economy grows, the tax base becomes larger, generating more revenue for a given tax rate. Static estimates of the Joint Committee on Taxation (JCT) – estimates that do not consider the growth effect of the tax cut – put the cumulative deficits over the next de-

cade from the tax reform at \$1,456 billion; the JCT’s dynamic estimates, that do incorporate the growth effect, put the cumulative deficit over the next decade at \$1,005 billion. However, given that the reform increases the debt, the JCT’s dynamic estimates forecast higher interest payments of \$66 billion, so the JCT’s ultimate dynamic estimate of the 10-year cumulative additional deficits is \$1,071 billion.

Second, the real cost of deficit financing is that it crowds out private investment because investors hold government bonds instead of productive capital. Compared to spending increases or other types of tax cuts, the deficits associated with a reduction in the corporate tax rate may have the least crowding out effect. Indeed, the corporate rate cut is expected to attract more investment in the U.S.

Some criticism of the corporate tax cut is based on a fairness argument. Yes, corporations are responsible for remitting the corporate income tax to the government, and in this sense corporations ‘pay’ the tax. But the economic incidence of the tax, the actual impact of the tax on the economy, does not necessarily fall on those who are responsible for remitting the tax to the government. It is true that big businesses and their shareholders make tax payments under the corporate income tax, but they do not bear the entire burden of the taxes they pay.

At a simple level, corporate profits are revenue minus costs, where costs include payments to labor and some portion of payments for capital, depending on the depreciation allowed in the tax code. The corpo-

rate income tax taxes some portion of the firm’s investment in capital, and the existence of a corporate income tax provides a disincentive to capital investment.

Basically, corporations invest less than they would if there were no corporate income tax. Furthermore, corporations can move in order to avoid high rates, and businesses can reorganize their legal form in order to avoid taxes borne by incorporated business. A lower capital stock means lower output, lower demand for labor, and hence less employment and/or lower wages.

As a result of these responses to the corporate income tax, corporate owners don’t actually shoulder the entire burden of their tax payments. Instead, workers bear some burden in the form of lowered wage and increased unemployment.

The reverse is true with a cut in the corporate income tax rate. With a cut in the corporate income tax, investment increases and so does demand for labor. As a result, while only the corporations (and their shareholders) see a reduction in tax payments under the corporate income tax, they do not harvest the

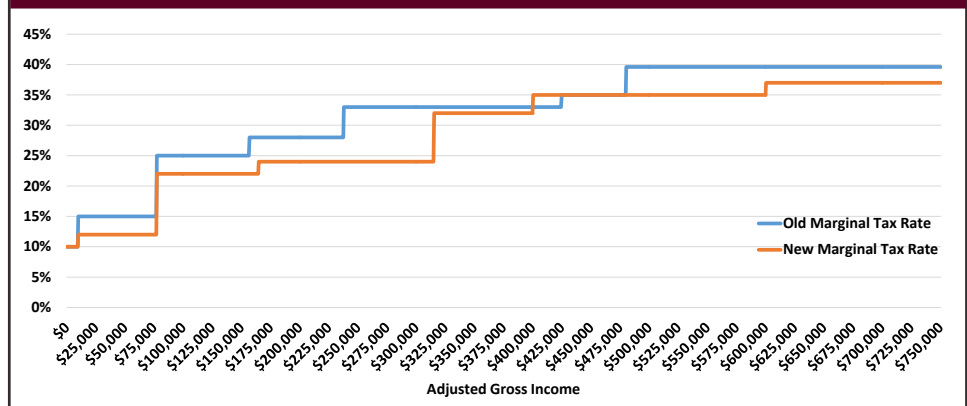
entire benefits of the tax cut.

Workers also receive benefits in the form of higher wages. In fact, economic theory suggests that the benefit to workers from the cut in the corporate income tax, measured as total increase in wages paid to all workers, may well exceed the amount of the reduction in government tax revenue! This happens because the increase in investment increases the capital stock and results in more workers and higher wages. Further, this increase in payments to labor will increase personal income tax collections and partly offset the decline in corporate tax collections.

Certain recent corporate responses to the corporate income tax cut seems to validate this tax incidence theory. Firms have already announced pay raises, bonuses, and increases in investment. If oversees U.S. firms begin to move back and corporations continuously invest in new projects and hiring, the corporate tax cut will be deemed to be a success.

Some have raised the concern that the tax reform may fail to produce the desired outcome if corporations simply profit from re-

**Figure 1. Old and New Marginal Tax Rates (Married Filing Jointly)**



ductions in tax payment and sit on the cash without sustained increases in investment and hiring, but this seems unlikely in the extreme. Firms' primary incentive is to maximize shareholder wealth, meaning that they seek the best investment opportunities. So idle cash should not be a concern – firms will invest internally, externally, or distribute it in higher dividends, which will be reinvested by the recipients.

Much of the commentary on the tax bill has centered on the corporate tax rate cut, but the many provisions affecting the individual income tax code account for the majority of the bill's cost over the next ten years. The marginal tax rates are generally lower until 2025, as depicted in Figure 1. Both marginal rates and the income thresholds at which the marginal rates come into play are changed with the new legislation.

Other provisions also lower the taxes individuals pay, including: higher standard deductions, higher child tax credits, and increases in the income levels triggering the alternative minimum tax. An end to personal exemptions will work

in the opposite direction. Several other provisions related to itemized deductions raise taxes, with a few caveats. Notably, up to \$10,000 in state and local taxes are still deductible as is mortgage interest payments on mortgages less than \$750,000. These provisions also end in 2025. These provisions in total result in the new effective tax rate schedule each family will face.

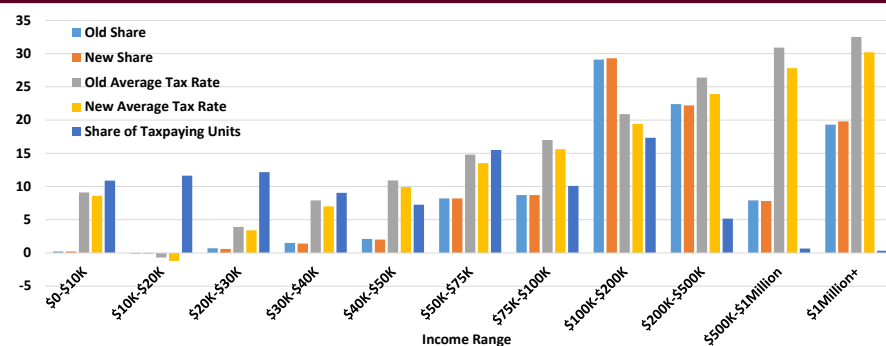
The Joint Committee on Taxation (JCT) has estimated the distributional effects all of the tax bill's provisions. The JCT's estimates include all of the individual and the corporate provisions and are depicted in Figure 2 for 2019. Several conclusions come from this figure. First, the share of total tax payments made by taxpayers within each income range remains essentially unchanged with the new tax law. Second, the average tax rate in each range is reduced with this tax reform. We also see the progressive nature of income taxes, with the average rate rising in income, as we also saw with the marginal rates. Taxpayers in the top two income ranges, whose incomes exceed \$500,000, account for less than 1%

of taxpayers, and will pay 26.6% of all federal taxes under the new tax law just slightly below the 26.9% estimated under the present law.

Despite the potential benefits of the tax reform, the lack of an associated spending reform is a major shortcoming. This reform increases deficits at a time when the U.S. is already facing growing deficits, and mounting explicit debt in the form of government bonds and liabilities in the form of accrued pension and health care commitments payable to federal civilian employees and military personnel. Total federal liabilities came to more than \$22.8 trillion in 2016, according to the Financial Report of the US Government. And adding even a conservative estimate of accrued Social Security and Medicare benefits payable to current retirees pushes the total to \$42.6 trillion, or 229% of GDP.

While the tax reform, and perhaps especially the change in the corporate income tax, is expected to give a boost to the economy, there is still much work to be done in reconciling federal revenues and expenditures. The current generation is imposing high obligations on the next generation of taxpayers, obligations that are growing as deficits are forecasted to grow into the future. On that point, this tax reform is not neutral – it contributes to the problem. The next task for Congress is to adopt real reforms to entitlement programs and to the financing of these programs.

Figure 2. Shares of Tax Payments, Average Tax Rates, and Share of Taxpaying Units (Joint Committee on Taxation Estimates for 2019)



Source: Joint Committee on Taxation, December 18, 2017, JCX-68-17



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**Winter 2018**

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