Tax Reform: Overview of Economic Effects and Evidence

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https://crowe.wisc.edu
Center for Research on the Wisconsin Economy (CROWE) recently established in the Department of Economics.

**Mission:** to support and disseminate economic policy research, with a particular focus on the Wisconsin economy and state-level economic policy issues

**Goals:**
- Understand forces driving economic outcomes and the impacts of policies at the state-level
- Make economic research accessible to policymakers, businesses, and community in Wisconsin and beyond
- **Provide opportunity for UW students to engage in research & policy process**
- Recently added staff, but looking to grow.
Overview

- Elements of the recent tax reform (TCJA)
- General tax principles: efficiency vs. distribution, incidence, dynamic impacts
- Personal income tax: labor vs. capital income, growth impact
- Corporate income tax: incidence, tax base, pass-throughs
- Economic impact: counterfactuals, empirical strategies, estimates for TCJA
- State tax reform: project underway
The Tax Cuts and Jobs Act (TCJA)

- First major federal tax reform legislation since 1986.
- Most significant changes were on the business side (permanent)
- Cut corporate tax rate from (top rate) of 35% to flat rate of 21%.
- Allowed 20% deduction of pass-through business income (with limitations)
- Allowed full expensing of capital investment for five years
The Tax Cuts and Jobs Act (TCJA)

- Additional reforms to personal side (expiring in 2025)
- Lowered marginal tax rates and adjusted brackets. Top rate: 39.6% to 37%.
- Roughly doubled standard deduction, limited state and local tax (SALT) deduction to $10,000. Lowered mortgage interest limit.
- Doubled child tax credit to $2,000 and increased refundability.
Main economic criterion for evaluating impact of taxes is **efficiency**.

- Taxes distort decisions, so want to raise revenue in a way to minimize distortion.
- Suggests taxing more heavily activities which are more inelastic: tax does not affect behavior (much).

Efficiency criterion may conflict with **equity** (distributional) goals: raise more revenue from those most able to pay.

- Example: lump-sum taxes (poll tax) charge all people same amount.
- Most efficient: does not distort any behavior on margin
- But “regressive”: tax has larger percentage impact on low incomes
General Tax Principles

- Tax *incidence* captures who pays tax, may differ from tax administration
  - Example: Corporate tax administered on businesses, but incidence is partly on owners, partly on workers.
  - In general, incidence is larger for more inelastic factor. Unable to change behavior to avoid tax.

- Accounting for *dynamic* impact affects incidence, impacts economic growth
  - Example: In short run capital is (relatively) fixed, suggests high tax on it.
  - But dynamic impact: tax on capital will diminish savings and investment, lead to lower growth
Personal Income Tax: Issues

- **Progressive income tax:** increasing marginal tax rate on labor income and capital income (net of deductions).

- **Elasticity** of taxable income affects how revenue responds to change in tax rates.

- Laffer curve: at high enough tax rates, further increases in tax rate leads to lower revenue.

- Labor supply elasticities generally low for main earners, larger for households and over lifetime.

- Phasing out of safety net programs (EITC, etc.) increases effective marginal tax rates at low income levels.

- Dynamic efficiency favors taxing labor rather than capital. Reducing investment leads to output losses in future, compounding distortion.

- Equity considerations conflict, since capital income concentrated among wealthy.
A Famous Cocktail Napkin: \[ T = \tau wN(\tau) \]

If you tax a product less results in a subsidizer and more in a subsidy.

We've been taxing work, output and income and subsidizing non-work, leisure and unemployment. The consequences are obvious!

To Don Rumsfeld,
at our two concerts,
et our various engagements.
9/13/74

[Signature]
There were arguments in 1981 and 2001 that US economy was on the bad side of the Laffer curve, and revenue could increase with tax cuts.

Although these tax cuts may have increased economic growth, there is no evidence that revenue increased.

Estimates of peak tax revenue in US are at 60% or greater federal income tax rate.

A 2010 ECB study found Sweden was on the bad side, with a top labor income tax of 57% and a payroll tax of 31%. Historically it had been even higher, up to 90%.

Laffer curve arguments are more likely apply to narrower categories of goods which have higher elasticities of substitution, like luxury goods, possibly capital gains, corporate taxes.
Many economists favor moving from an income tax base to a *consumption tax* base.

Taxing consumption less distortionary, promotes growth, and is simpler. Most of the complexity in the tax code results form defining “taxable income”

State sales tax, VAT in Europe and Japan. Can tax consumption via the income tax (exempt interest income).

Flat tax (Cruz, Paul) and FAIR tax (Huckabee) are versions of a (flat) consumption tax that have been proposed.

X-Tax (Rubio) is a progressive consumption tax.

The main reform component of the TJCA was the increase in standard deduction, limitations of SALT, mortgage interest deduction.
Corporate Income Tax: Issues

- Incidence of corporate tax: in short run mostly on owners (lower profits), over time passed on to workers (lower wages), customers (higher prices)
- Favors debt (deductible) over equity, retained earnings over dividends (taxed twice)
- Increases cost of capital similar to capital income tax.
- Increasing interstate and international mobility of businesses shifts incidence, reduces tax base
- Treatment of C-Corps vs. pass-throughs affects incentive to incorporate, treatment of corp vs non-corp sector
Several proposals to reform corporate tax based on tax base
- Worldwide vs. territorial
- Origin based vs. destination based (border adjustment)
- Tax base: profits (corporate tax), profits + wages (VAT), profits - investment (cash flow)
- Original House GOP proposal: Move from worldwide corporate tax to destination based cash flow tax.
- The border adjustment component was dropped, but the territorial reform was kept
- Main additional reform: (temporary) full expensing of business investment → cut cost of capital
- Tax credits, like WI Manufacturing and Agriculture Credit
To measure impact of taxes, need to construct **counterfactual**: what would have happened to the economy if the policy had not changed. (Treatment and control)

**Structural**: Model how households & firms respond to taxes, simulate alternatives. Static: hold output fixed. Dynamic: incorporate growth impact. JCT, TPC, Tax Foundation, goal of work at CROWE.

**Empirical**: Condition on observed factors to hold them fixed, try to isolate impact of policy change.

- Cross-state comparisons direct, but confounding factors
- Regressions: more controls, endogeneity problems
- Border county comparisons: treat county on other side of border as control. Look at difference-in-difference.

**Limitations**: Assumes only policy changes across borders, cross-border spillovers may overstate effect.
Selective Overview of Literature

- Huge empirical literature, in general finds negative impact of taxes on growth. Big variation in magnitudes, sensitive.
- In general, income and corporate taxes have most negative growth impact, consumption and property least.
- For states, migration and business location also crucial. Positive (but mixed) evidence higher taxes lead to outmigration, lower levels of business formation.
- Moretti and Wilson (2016): Mobility of “star scientists” significantly negatively impacted by state personal income and corporate tax rates
- Ljungqvist and Smolyansky (2014): Border counties. Increases in state corp taxes ⇒ reductions in employment and income. Cuts have positive impact in recessions.
Studies on the Impact of the TCJA

- Different studies are similar on static impact: loss of revenue, roughly 2% income increases.
- Differ on distribution, and differ greatly on dynamic impact:
  - Incidence of corporate tax
  - Growth effects of capital tax reductions
  - Crowding out effect of increased government debt
- Much of the media and Democratic coverage focused on expiration of personal tax cuts, leading majority of people to (mistakenly) believe their taxes would be increased initially.
Key Findings

- The Tax Cuts and Jobs Act would reform both individual income and corporate income taxes and would move the United States to a territorial system of business taxation.

- According to the Tax Foundation’s Taxes and Growth Model, the plan would significantly lower marginal tax rates and the cost of capital, which would lead to a 1.7 percent increase in GDP over the long term, 1.5 percent higher wages, and an additional 339,000 full-time equivalent jobs.

- The Tax Cuts and Jobs Act is a pro-growth tax plan, which would spur an additional $1 trillion in federal revenues from economic growth, with approximately $600 billion coming from the bill’s permanent provisions and approximately $400 billion from the bill’s temporary provisions over the budget window. These new revenues would reduce the cost of the plan substantially. Depending on the baseline used to score the plan, current policy or current law, the new revenues could bring the plan closer to revenue neutral.

- Over the next decade, the Tax Cuts and Jobs Act would increase GDP by an average of 0.29 percent per year; GDP growth would be, on average, 2.13 percent, compared to 1.84 percent. In 2018, GDP growth would be 0.44 percent over the baseline forecast.

- On a static basis, the plan would lead to 0.3 percent lower after-tax income on average for all taxpayers and 0.6 percent lower after-tax income on average for the top 1 percent in 2027, due to the expiration of the majority of the individual income tax cuts, but retention of chained CPI. When accounting for the increased GDP, after-tax incomes of all taxpayers would increase by 1.1 percent in the long run.
ABSTRACT

The Tax Policy Center has released an analysis of the macroeconomic effects of the Tax Cuts and Jobs Act as passed by Congress. We find the legislation would boost US gross domestic product (GDP) 0.8 percent in 2018 and would have little effect on GDP in 2027 or 2037. The resulting increase in taxable incomes would reduce the revenue loss arising from the legislation by $186 billion from 2018 to 2027 (around 13 percent). Because most of the individual provisions expire after 2025, we expect deficits (not including interest costs) would decline by $415 billion from 2028 to 2037, and macroeconomic feedback would boost the deficit savings by $3 billion over that interval. Including macroeconomic effects and interest costs, the legislation is projected to increase debt as a share of GDP over 5 percentage points in 2027 to 97 percent of GDP, and almost 4 percentage points in 2037 to 117 percent of GDP.
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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

THE IMPACT OF THE FEDERAL TAX REFORM ON WISCONSIN TAXPAYERS

OVERVIEW

The tax reform legislation which recently passed Congress will affect most households and businesses in Wisconsin. The centerpiece of the legislation was the major reductions in business taxes, with a cut in the corporate tax rate from 35% to 21% and a 20% deduction on the income earned by pass-through businesses which pay on the individual returns of their owners. (Wisconsin Senator Ron Johnson was a key contributor in securing the pass-through provisions.) While the business tax changes will be the most significant economically, most taxpayers in Wisconsin will more directly and perhaps more immediately feel the impact of the changes to the individual income tax code. These changes include reductions in marginal tax rates and substantial changes to income tax deductions. This post attempts to gauge the impact of these individual tax changes for Wisconsin taxpayers.

I find that a broad range of taxpayers in Wisconsin would receive tax cuts that would lead to increases in after-tax income of 2% or more. Taxpayers with business income, particularly those with partnership or S-corporation income which is concentrated at high income levels, would receive larger gains, of 4% or more. These gains are similar to what microsimulation analyses by the Tax Policy Center (nationally), the Institute on Taxation and Economic Policy (nationally, scaled to state level) have found. But rather than microsimulation, my results are based off summary statistics for Wisconsin tax returns from the IRS.

In addition, the changes in deductions could substantially alter behavior. In 2015, 31% of Wisconsin households itemized tax deductions, but under the new system this fraction will fall dramatically, likely to less than 10%. While most households will be better off after this change, the lack of deductibility will increase the marginal cost of housing, charitable deductions, and state and local taxes. This has the scope to change behavior substantially, affecting the housing market and by downward pressure on prices, and leading to increased pressure for state and local tax reform.
CROWE Policy Brief:
The Effects of Removing the Corporate Repatriation Tax

Adam Hal Spencer, University of Wisconsin-Madison

December 7, 2017

Abstract
Congress is currently considering substantial reform of the United States tax code. One important component of reform which has been largely overlooked is the treatment of corporate income of multinational firms. The bills under consideration move the U.S. from a worldwide system to a territorial one that taxes only domestic activity. My research shows that this change would lead to higher output, wages, and productivity in the U.S. In addition, while official government estimates suggest that removing this “repatriation tax” would cost hundreds of billions of dollars, I find that the increased economic activity resulting from the reform makes it roughly revenue neutral.
CROWE Study on Wisconsin MAC

- Analyze WI border counties, compare with neighbors in MN, IA, IL, MI
- Look at impact on manufacturing employment to measure impact of Manufacturing and Agriculture Tax Credit.
- Find relatively large impact on manufacturing employment: **1.9% increase** in average annual growth. Smaller impact on non-manufacturing employment: 0.7% increase.
- Estimate 20,000 manufacturing and 42,000 total jobs due to MAC by Sept 2016.
Impact on Manufacturing Employment: Counterfactual

Wisconsin Manufacturing Employment, Dec. 2012=100

- Actual
- Counterfactual

Williams Tax Reform
There is interest in the state government and policy community in considering reform of state tax system.

Relative to other states, Wisconsin remains high tax state overall (#11 in tax burden), with higher income tax lower sales tax.

Goal of this project is to evaluate the potential impact on the state economy of state tax reform.

Evaluate not only revenue, but output, investment, and income.

Currently beginning modeling: macro and micro.