The Daily Dish

Tax Reform 2.0

DOUGLAS HOLTZ-EAKIN | APRIL 19, 2018

Eakinomics: Tax Reform 2.0

I devoted most of yesterday to discussing the Tax Cuts and Jobs Act (TCJA)—first at an Urban Institute panel on how the law impacts people's opportunities, and later at the the Heritage Foundation on the topic of "Tax Reform 2.0." (Basically, I spend a lot of days bartering tax talk for coffee. It's a living.) Three interesting observations emerged.

First, there is an obvious and large gap between my relatively favorable assessment of the TCJA and, for example, that of my Urban Institute co-panelist Chye-Ching Huang even though we agree that reform should be focused on improving the lives of middle class workers. Why? Because we fundamentally disagree on the "ideal" tax code toward which the country should be aiming. I adhere to the view that the tax code affects the "prices" or "returns" to economic activities, households and firms respond to those incentives just as they respond to supermarket prices, and their ultimate welfare is dictated by the degree to which tax-based incentives lead to work, saving, investment, productivity, growth, and higher real wages. My benchmark tax code has no taxes on the return to saving and investment, and thus taxes equally all the purchases financed by earned income. There would be no carve outs, preferential treatments, or other tax-based reasons to change the way you run your life.

In this view of the world, corporate tax reforms are a good tool to help the middle class because they can provide incentives to upgrade factories, improve productivity, and lead to higher wages and take-home pay. The opposing view does not believe that corporations will respond to these incentives. Any benefits of corporate reform will be pocketed by the executives or paid to shareholders via stock buybacks.

The lack of response to tax-based incentives means that the other side of the debate does not worry about the consequences of raising large amounts of revenue. Indeed, they argue that is desirable because it provides the wherewithal to distribute targeted benefits to deserving constituencies. Child credits, low-income credits, tax-exemptions, and so forth improve the welfare of their recipients. In particular, it necessary to transfer resources directly to middle class workers because business tax reform won't accomplish this goal. As a result, their ideal tax code is 180 degrees different. It features both higher rates and a (perhaps quite long) list of provisions targeting benefits.

There is no real difference in policy intent, but the worldview diverges enormously.

The second observation is about the strategy for additional tax reform. A lesson of 1986 and 2017 is that major tax reform is politically contentious, legislatively difficult, and happens infrequently. Perhaps a better strategy would be to settle on the long run objective and make it regular practice to improve the tax code steadily on a year-by-year basis. One can think of downsides to the incremental strategy as well, but it may be worth a try.

The final observation is that there will be no Tax Reform 2.0 if there aren't spending reforms. The Congressional Budget Office projects $12 trillion in deficits over the next decade and dangerously high accumulation of debt. If left untouched, this will inevitably produce pressures for much more revenue, a reversal of Tax Reform 1.0, and even more. In the end, the most important part of Tax Reform 2.0 will be Entitlement Reform 1.0.