

# THE 2017 TAX LAW AMPLIFIES U.S. ECONOMIC VULNERABILITY IN THE NEXT RECESSION

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*The 2017 tax law – the signature economic policy legislation of the Trump Administration – has clearly failed to produce economic benefits promised by its backers. Moreover, it has left American workers and families, and by extension the entire economy, in a more vulnerable position heading into the next recession. Not only does the law increase the inequality of after-tax incomes, but it reduces health insurance affordability and access. In addition, the deficit-financed tax cuts will reduce the fiscal flexibility of the US government, making it more difficult to adopt an expansionary stance in the next recession.*

## THE 2017 TAX LAW WORSENS ECONOMIC INEQUALITY, EXACERBATING THE NEGATIVE EFFECTS OF THE NEXT RECESSION

Increasing income inequality in recent decades has been so substantial that, despite strong gains in GDP per-capita, about half of the US population has seen little improvement in their standard of living, and many others have experienced income growth that has fallen short of that of prior periods.<sup>2</sup> This dramatic surge in income inequality has been extensively documented using multiple data sources, and economists are nearly unanimous in expressing grave concern about this development. Rising inequality reduces the extent to which economic growth translates into shared prosperity. The slow or nonexistent growth in income for so many Americans sows discontent, as outcomes fall short of expectations and there is a reduced sense of relative well-being.

Income inequality can also exacerbate the effects of recessions. When households are left behind others in society, they are more likely to borrow to finance their consumption, in part due to the competitive nature of some economic transactions (e.g., spending on housing to afford better school districts). Borrowing increases household debt, increasing vulnerability to economic shocks. In the wake of economic adversity or unemployment, indebted households have less ability to cushion their consumption from savings.<sup>3</sup>

Income inequality also drives concerns over secular stagnation, or the notion that there is an imbalance between the large supply of financial capital and the opportunities for worthwhile investments. Since investment is a crucial ingredient for economic growth, but ultimately depends on a healthy middle class that can afford increased consumption on the goods that the investment would ultimately generate, secular stagnation implies a link between economic inequality and suboptimal economic growth.<sup>4</sup>

While there is some disagreement about the source of increased inequality in the United States, economists blame several factors, including systematic and large technological changes that have shifted labor demand away from typical workers, the increased market power of companies, the diminished bargaining power of labor, increased international competition, and important changes in social norms and public policy.<sup>5</sup> Not all of these factors are pernicious; both international trade and technological change come with serious, large benefits.

However, the large scale of these changes implies that the tax system should be responding in order to counter their detrimental effects on the distribution of income. By varying tax rates for different groups, and even providing negative tax rates for those at the bottom, the tax system can have large effects on the after-tax distribution of income. Indeed, the tax system is strong enough to counter the changes in our economy that have caused increasing income concentration at the top of the distribution.

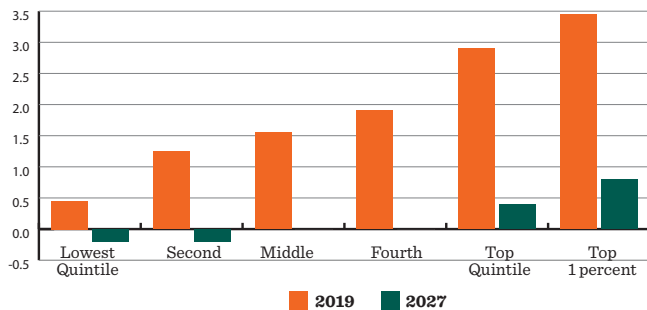
Unfortunately, as income inequality increased in prior decades, many of the tax law changes actually made the tax system less progressive. Declines in top labor rates, top capital gains rates, top dividend rates, and cuts to the estate tax reduced progressivity at the top, although there were a few changes that worked in the other direction, including the investment income surtax that helped fund the Affordable Care Act. At the bottom of the distribution, expansions of the earned income tax credit have reduced the federal income tax burden of the lowest earners. Yet while the overall effect of the tax system is to reduce inequality, the tax system reduces inequality a bit *less* than it did in the past. According to the Congressional Budget Office, the federal tax system did less to reduce a standard measure of income inequality (the Gini coefficient) in 2013 than it did in 1980.<sup>6</sup>

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2 Between 1980 and 2014, cumulative income growth for the bottom 50 percent of the income distribution was only 1 percent. Income growth for those in the 50<sup>th</sup> to 90<sup>th</sup> percentile was 42 percent, in comparison to 105 percent between 1946 and 1980. See Piketty, Thomas, Emmanuel Saez, and Gabriel Zucman. 2016. "Distributional National Accounts: Methods and Estimates for the United States." Working Paper 22945. NBER Working Papers. National Bureau of Economic Research.  
3 For a nice overview of work on this topic, see Chapter 2 of Boushey, Heather. *Unbound: How Inequality Constricts Our Economy and What We Can Do About It*. Harvard University Press. 2019.  
4 Interested readings are referred to Larry Summers's excellent pieces on these concerns. Summers, Lawrence H. 2016a. "The Age of Secular Stagnation." *Larry Summers Blog*. February 15. And Summers, Lawrence H. 2016b. "Secular Stagnation and Monetary Policy." *Federal Reserve Bank of St. Louis* 98 (2): 93–110.  
5 A nice overview of these factors is provided in Chapter 2 of Clausing, Kimberly A. 2019. *Open: The Progressive Case for Free Trade, Immigration, and Global Capital*. Cambridge, MA: Harvard University Press.  
6 See Congressional Budget Office. 2016. "The Distribution of Household Income and Federal Taxes, 2013." <https://www.cbo.gov/publication/51361>

Against this background of soaring income inequality and wage stagnation for many Americans, the new tax legislation (TCJA) has moved the tax system in a clearly regressive direction. According to both the nonpartisan Tax Policy Center (TPC) and the Joint Committee on Taxation (JCT), tax cuts were much larger for those at the top than those at the bottom, even as a share of their prior income. Figure 1 shows the TPC estimates of the percent change in after tax income due to the legislation, by quintile, with the top 1 percent pulled out separately.<sup>7</sup>

Changes in dollar tax payments are even more stark, as shown in Table 1. The changes between 2018 and 2027 are caused by the fact that the individual income tax cuts expire over time, whereas as the corporate tax cuts do not.

**FIGURE 1: PERCENT CHANGE IN AFTER-TAX INCOME DUE TO THE TCJA, BY QUINTILE**



Source: Tax Policy Center (2017, 2018)

**TABLE 1: CHANGES IN TAX PAYMENTS, 2018 AND 2027**

	2018	2027
<b>Lowest Quintile</b>	-60	30
<b>Second Quintile</b>	-380	40
<b>Middle Quintile</b>	-930	20
<b>Fourth Quintile</b>	-1,810	-30
<b>Top Quintile</b>	-7,640	-1,260
<b>Top 1 Percent</b>	-51,140	-20,660

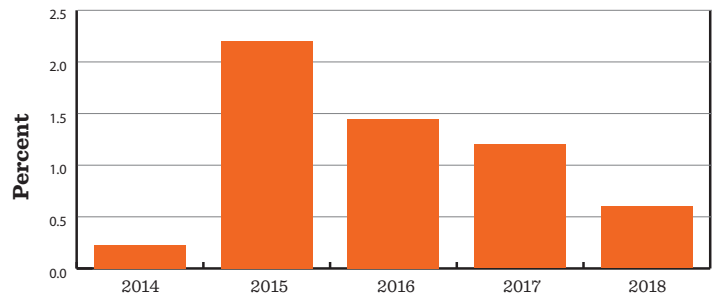
Source: Tax Policy Center (2017, 2018)

While these distributional effects seem clear, there has been some controversy surrounding the effect of business tax cuts on wages. Both the TPC and the JCT (and others) assign only a small share of the burden of the corporate tax, 20 percent in the TPC case, to labor.<sup>8</sup> However, Trump administration economists claimed that the corporate tax cuts would ultimately benefit US workers, raising their

wages by \$4,000 to \$9,000 each year! Unfortunately for us all, these claims are wildly optimistic and not in keeping with a large literature that shows a much smaller impact of corporate tax cuts on wages.

Proponents of the legislation argue that the corporate tax cuts would ultimately benefit workers, since workers might experience higher wage growth if companies share their tax cuts or made investments that enhance worker productivity. However, there is little evidence of stronger than usual wage growth in 2018. Figure 2 shows that real wage growth in 2018 is distinctly middling. This can be contrasted with record stock buybacks in the same year, as well as a large run-up in the stock market in 2017, as the corporate tax cuts were capitalized into stock prices. The stock market (DJIA) increased by 25 percent in 2017.<sup>9</sup>

**FIGURE 2: US REAL WAGE GROWTH, ANNUAL RATE, 2014-2018**



Source: Federal Reserve Economic Data. Median usual weekly earnings, for those employed full time.

In short, the TCJA clearly made our tax system more regressive, and there is no reason to suspect that corporate tax cuts will ultimately benefit workers enough to change that conclusion. Further, this legislation missed clear opportunities to improve after-tax incomes at the bottom of the distribution. It did not choose to expand the earned income tax credit, our strongest anti-poverty tool, despite frequent bipartisan support for this policy tool. Also, the expansion of the child tax credit was much more favorable to high-income families than to low-income families. The credit now extends to married couples making up to \$400,000 per year, in contrast to \$110,000 under prior law. Further, the expansion of the child tax credit was not made fully refundable, so benefits are quite modest for those with low incomes. The legislation also ends the child tax credit for those children of immigrants (typically, the “dreamers”) that were brought to the United States with undocumented status.<sup>10</sup>

<sup>7</sup> See Tax Policy Center Staff. 2017. “Distributional Analysis of the Conference Agreement for the Tax Cuts and Jobs Act.” Tax Policy Center. The numbers are unchanged in a later analysis: Gale, William, Hilary Gelfond, Aaron Krupkin, Mark Mazur, and Eric Toder. 2018. “Effects of the Tax Cuts and Jobs Act: A Preliminary Analysis.” Tax Policy Center.

<sup>8</sup> In addition to the TPC and the JCT, the Congressional Budget Office and the Treasury reach similar conclusions, at least until the Trump administration removed the Treasury assessment from their web site, where it had been listed as Office of Tax Analysis: Technical Paper 5. It was also published as Cronin, Julie-Anne, Emily Y. Lin, Laura Power, and Michael Cooper. 2013. “Distributing the Corporate Income Tax: Revised U.S. Treasury Methodology.” National Tax Journal 66 (1): 239–62.

<sup>9</sup> Stock prices reflect increases in expected future profits as soon as expectations change. (If stock prices did not rise as expectations changes, there would be speculative reasons to buy stocks prior to the law change, which itself would cause prices to go up. Thus, stock markets quickly absorb news into the market price.) Gains in 2018 were actually negative, although there was a recovery in early 2019. By mid-March, the DJIA was up 4 percent relative to the end of 2017. For information on buybacks, see, e.g., Yardeni Research Inc. “Stock Market Indicators: S&P 500 Buybacks and Dividends”. 15 March 2019. <https://www.yardeni.com/pub/buybackdiv.pdf>. See also <https://americansfortaxfairness.org/stock-buybacks/>

<sup>10</sup> For more on these concerns, see the Testimony of Chye-Ching Huang before the House Budget Committee, 27 February 2019.

## DEFICIT-FINANCED TAX CUTS ARTIFICIALLY LIMIT STIMULUS AND PUT PRESSURE ON THE SAFETY NET

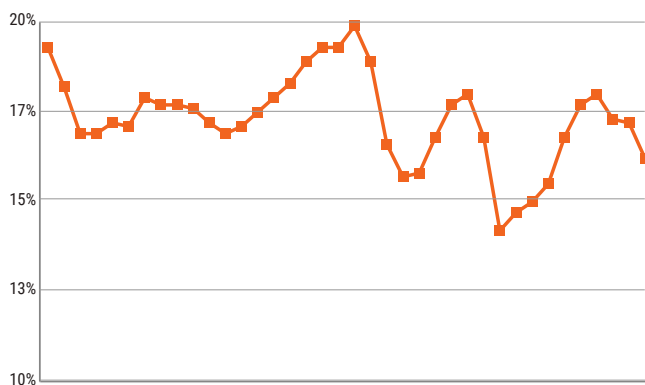
The recent tax legislation dramatically expands the size of government budget deficits, and it increases the debt to GDP ratio of the United States, now projected to reach 93 percent by 2029. Static estimates from the JCT and the CBO place the revenue costs of the legislation between \$1.5 and \$2.3 trillion over ten years, depending in part on whether the interest cost of additional debt is included in the estimated costs.<sup>11</sup>

Early data make it quite clear that the legislation has dramatically reduced tax revenues. For example, Figure 3 shows that federal revenues as a share of GDP have dropped sharply since the legislation, from 17.2 percent in 2017 to 16.2 percent in 2018, driven by sharp drops in individual and corporate income tax receipts. Normally, when the economy is doing well -- unemployment in 2018 averaged 3.9 percent, at historic lows -- tax revenues increase as a share of GDP. In the year 2000, when the economy was booming (and the Bush tax cuts had not yet been enacted), federal revenue was 20 percent of GDP.

During recessions, budget deficits naturally increase as a share of GDP due to falling tax revenues and increased spending on unemployment insurance and means-tested programs. Beyond this automatic response, it is typically wise for the government to engage in deliberate fiscal stimulus to fuel aggregate demand, mitigating the impact of the recession.

Starting from a position of high debt, and large ongoing budget deficits, makes such stimulus more politically difficult to undertake. Worries of excessive deficits and debt can constrain policy-makers, causing them to act more timidly than they should in these difficult situations. During the great recession, deficit fears were a substantial force limiting the size of stimulus. In the wake of the 2017 tax law, deficit fears are also being used to justify attacks on the social safety net.

### FIGURE 3: TOTAL FEDERAL RECEIPTS AS A SHARE OF GDP, 1981-2018



Source: US Federal Reserve FRED database. Monthly receipt data include up to December 2018 and are aggregated for the annual totals, which are then compared to GDP. Recessions are shaded.

When the next recession comes, policymakers may conclude that we “can’t afford” adequate stimulus and support for workers and families because we increased the deficit to finance these tax cuts. In that event, the recession will be unnecessarily deep in terms of GDP loss as well as more damaging in human terms.

But even before recession hits, spending such large amounts of resources on tax cuts diverts resources from other urgent fiscal priorities, including investments in workers and communities that would generate broadly-shared benefits. We have many urgent needs in terms of spending on infrastructure, R&D (including green investments to combat climate change), education, and healthcare. These are all more important priorities for economic growth and stability than tax cuts, especially tax cuts that are so tilted toward the top end of the income distribution.

## THE TAX LAW TOOK HEALTH CARE -- AND FINANCIAL SECURITY -- FROM MILLIONS OF FAMILIES

In order to raise about \$300 billion over ten years, and perhaps to intentionally weaken the functioning of the Affordable Care Act, the TCJA also repealed the tax penalty that enforced the individual mandate to purchase health insurance. The repeal saves the US government funds due to the fact that more people will choose to remain uninsured. Since these uninsured people would have qualified for large health insurance subsidies had they purchased health insurance, the government saves the costs of the subsidies.

According to the Congressional Budget Office, this change will increase the number of Americans without health insurance by 4 million in 2019, rising to 13 million by 2027.<sup>12</sup> CBO also predicts that health insurance premiums will be 10 percent higher due to the mandate repeal. For most families, rising health insurance costs will dwarf their modest tax cuts.<sup>13</sup> For those Americans now going without health insurance, their financial fragility is dramatically increased, since they will more often face serious financial strain, or even medical bankruptcy, if they are unlucky enough to have serious healthcare needs.

Overall, this tax legislation has both worsened income inequality and left American workers in a more financially vulnerable position heading into the next recession.

11 See Joint Committee on Taxation. 2017. “Estimated Budget Effects Of The Conference Agreement For H.R.1, The “Tax Cuts And Jobs Act.” Joint Committee on Taxation. <https://www.ict.gov/publications.html?func=startdown&id=5053> And, see: Congressional Budget Office. 2018. “Estimated Deficits and Debt Under the Conference Agreement of H.R. 1.” Congressional Budget Office. <https://www.cbo.gov/publication/53437>

12 See Congressional Budget Office. 2017. “Repealing the Individual Health Insurance Mandate: An Updated Estimate.” Congressional Budget Office. <https://www.cbo.gov/publication/53300>

13 This is the case for the bottom three quintiles, while the fourth quintile will experience tax cuts that are quite similar in size to the typical premium increase. For a state-by-state illustration, see the appendix table of the Testimony of Chye-Ching Huang before the House Budget Committee, 27 February 2019.