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Fact-Checking Claims about Winners and Losers with New Tax Reform (Part I)

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Abstract

"The changes incentivize more capital investment and less debt-financing."

Posting about how taxation legislation changes will affect Americans from *In All Things* - an online journal for critical reflection on faith, culture, art, and every ordinary-yet-graced square inch of God's creation.

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In the last piece, I evaluated the Tax Cuts and Jobs Act of 2017 in terms of the goals of tax reform that I wrote about last year. However, my nerdy, tax policy-oriented approach is far from the most popular way to look at this legislation. Instead, a massive amount of ink spilled over the new law was used in determining who the "winners" and "losers" are. (To prove my point, every word in this sentence is linked to a different article on that topic.) So, while the last article talked about what the tax law actually did and whether that was good from a tax policy perspective, today I'm addressing the perceived impact of the tax law and assessing the accuracy of some of the most common winner/loser assessments.

The perceptions addressed aren't always totally wrong, but they all invite some more careful analysis which proves that the reverse-Robin Hood narrative ("tax law gives to the rich and robs from the poor") is seriously flawed. In this article, we'll look at this assertion in both its most direct terms and in terms of the claim that the new tax law helps corporations while hurting individuals. Come back for Part II, where we look at whether the law targets Democrats and kills charities.

Perception: This is a victory for the rich at the expense of the poor.

Correction: The tax law cuts tax rates for virtually everyone, and taxes are not a strict zero-sum game.

There are plenty of charts out there showing that the after-tax income of the richest quarter of the country will be going up the most under the new law, with the most concentrated benefit going to those just below the top 1%. So, why isn't this proof that the rich are winning and the poor are losing? Because of two important qualifications: why the distribution looks like it does, and what we mean by "losing."

Figuring out why the distribution is what it is takes more than looking at whose individual tax rates went down, since the bulk of that benefit is in the middle bracket. The two big reasons why tax rates dropped more for people at the top end of the spectrum are that the corporate rate came way down and the law added a new deduction for pass-through (non-corporate) business income.[1] I will address the corporate rate reduction a little more with the next point, but the pass-through deduction is targeted to benefit to those making less than $207,500 ($415,000 for joint filers). While this puts those earners in the top 5-20% of all taxpayers, pass-through income goes to the owners of a company, and the people who are predominantly pulling in that sort of money as part of their ownership stake in a company tend to be part of small to mid-size partnerships, LLCs, and the like. That is, you can look at this as either a tax benefit to wealthy individuals or a benefit to small businesses. You can't really help the latter without helping the former, so judging the tax bill should not be driven solely by feelings about rich people.

The other big assumption about the winner/loser approach in general is that it typically treats taxation as a zero-sum game. That is, if one group fails to benefit (or fails to benefit equally) from the tax bill, this equates to being harmed by it. If the rich get richer, then that must mean the poor get poorer. However, that's not exactly how this works. As mentioned before, the new tax law cut taxes for almost everyone, which means that most families that pay taxes will take home noticeably more next year. True, the tax law did not expand the Earned Income Tax Credit or make the entire Child Tax Credit refundable, as Senator Marco Rubio pushed for, but the failure to expand social welfare programs is not the same as cutting them. Given what the government budget looks like (which I'll get to in the last article), tax policy and spending choices clearly don't equate on a one-to-one basis.

In other words, on an out-of-the-gate judgment, the new tax law is a windfall of varying degrees for most people, meaning that it puts extra money into the economy (the extra money in the economy is projected to end up boosting our Gross Domestic Product, or GDP, by between .4 and .6%)2 We may argue over who's getting how much of the economic pie, but we're almost all getting more pie, and that's not necessarily a loss.

Perception: This is a victory for corporations and a loss for individual taxpayers.

Correction: This is a victory for corporations and a political time-bomb that will still most likely benefit individual taxpayers.

There's no two ways about it: the new tax law is a boon to businesses of virtually all stripes, especially corporations. Last April, I talked about how the U.S. taxes corporations differently, and I mentioned in the last article that the new tax law eliminates some disincentives and establishes new incentives for corporations to invest in the domestic economy. In addition to the rate reduction and the capital repatriation issue I've mentioned, there were major changes to two other big areas of incentives: depreciation and interest.

I'll dip slightly into the weeds to explain this, so if that's intimidating, just skip the next two paragraphs with the knowledge that the changes incentivize more capital investment and less debt-financing.

Now, into the weeds. Businesses are generally taxed on profits, which means they can deduct their expenses against their revenues in figuring out their tax bills. When a company buys, say, a new truck, this expense would therefore offset a good chunk of revenue. Depreciation rules prevent a company from deducting all of that expense in one year and instead spread that deduction out over the useful life of the purchase. The new tax law allows much faster depreciation, even allowing a large number of purchases to be depreciated entirely in the first year.[3] This essentially allows a company to expense many of its costs up front, which is a massive incentive to invest in business infrastructure.

The other big incentive tweak is the way that interest payments are handled under the new law.Under the old system, there have long been a number of powerful incentives in favor of choosing to finance big new purchases and corporate acquisitions by borrowing money. For one, taking out a loan creates a liability that offsets the money received, so there's no tax associated with getting that money on hand right now (because there's no profit). Secondly, the owners of the company might prefer to use debt over equity (that is, issuing new shares), because debt won't dilute the ownership shares of the existing shareholders. Lastly, and very importantly, the interest payments a company makes on the debt it carries are generally deductible as ordinary business expenses. This means that there are corporations who have value on the market because they have a lot of high-interest loans which can help shelter the profits of any company that acquires them. It also means that the tax system itself favors debt over equity, which creates a distortion in the economy in favor of debt and, consequently, risk. The new law sharply reduces the deductibility of interest payments to 30% of earnings before interest, taxes, depreciation, and amortization (EBITDA), then reduces them to an even smaller calculation in 2022. This, along with the lower overall tax rate, is an important step to reining in excessive debt-financing in a way that could have important stabilizing effects for the whole economy.

For those of you who skipped our little excursion into the weeds, welcome back! For everyone, the upshot of this is that the new tax law is clearly a victory for corporations, but the low rate that corporations wanted comes with incentives to move overseas cash back to America, the possibility of investing in new improvements to company infrastructure, and a disincentive to deepen Corporate America's love affair with using debt to buy things. These are not just good things for corporations, but should be healthy changes for the American economy overall.

Lastly, the real lynchpin to the reverse-Robin Hood tagline is tied to the fact that the lowering of the individual income tax rate is temporary. In order to push through the new tax changes as a budget reconciliation item that needed only a majority to pass the Senate without a Democratic filibuster, the Republicans set a number of provisions of the new tax law to expire in 2025.

Virtually all assessments that have “individual taxpayers” in the loser column are doing so on the assumption that the individual tax cuts will expire. Of course, Republicans are banking on the fact that allowing individual tax rates to jump back up will look like political suicide to future lawmakers, and the cuts will in fact be extended.

Now, nothing is certain, but if 2012 is instructive, then it’s a reasonably safe bet that these changes will be made permanent. Further, the Republicans seem to have learned from the 2012 fiscal cliff debate by setting only the hottest of political potatoes to expire: rather than see the estate tax or higher corporate rates come back, the political debate in the future will be about hitting middle class families with higher taxes. I’ll address the political gamesmanship involved in this process in the last piece, but, for our purposes here, it’s somewhat ignorant (or, more likely, disingenuous) of *realpolitik* to assume that the tax cuts to individuals will expire, and, with those in place, the overall bill is far less of a giveaway than it is sometimes claimed to be.

Footnotes

1. This is a deduction for income that comes through so-called “pass through” entities, like partnerships, which are not subject to the corporate income tax. ↩

2. This may not seem like much, but remember that we’re talking about stupidly large numbers here, so that equates to well over $100 billion higher. ↩

3. If you really want to dive into the weeds on this, try here. ↩