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Grading the New Tax Law

Donald Roth
Dordt College, donald.roth@dordt.edu

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Abstract

"The biggest restructuring of the tax code that the new tax law enacts is a substantial reduction in the corporate income tax rate."

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Donald Roth April 10, 2018

Last April, iAt ran a series I put together on the federal Tax Code. Two of those articles focused on what tax reform should look like and how the plans on the table at that time measured up. Well, if you happened to miss the news over the last month or so, the Tax Cuts and Jobs Act of 2017[1] was signed into law on December 22. Because I wrote a series arguing what tax reform should look like, some of you might be curious how the actual law measures up. And for the rest of you, this is the only article iAt is putting out today, so why not come along for the ride?

Summarizing the Law

By now, I'm sure most of you are aware of the big changes that the new tax law brought about, especially the lowering of individual income tax rates, the doubling of standard deductions, and the substantial reduction in the corporate tax rate. However, there are a large number of smaller tweaks and changes that were also made, some of which won't have their full impact until regulations are rolled out.[2]

We'll go into more detail with some of these smaller changes in the next article of this taxation series. For now, though, the second tier of big changes that affect the economics of the new tax law includes: the elimination of personal exemptions, the doubling of the child tax credit, the capping of several itemized deductions, and the elimination or modification of a large number of business deductions.

There, those are the high points. Not bad for covering 185 pages in less than 185 words, right?

Grading the Changes

While the new tax law does not rename the Internal Revenue Code (as was last done in 1986), it substantially overhauls several key attributes of the Code, just as in historic reform efforts. So, we can compare certain themes of previous reforms to this new law.

Specifically, such major changes have usually sought to simplify the growing complexity of the system, to tweak tax mechanisms that are having undesirable effects, and to eliminate loopholes that have been carved out over time. So, how does the most recent law measure up in these three categories?

Complexity: B

On the individual income tax side, filing taxes will become much less complex for many Americans due to the doubling of the Standard Deduction. Far more individuals will begin to use this much simpler route when filing taxes. That is, about 70% of Americans currently itemize their deductions, and that number is predicted to climb to nearly 90% with the new tax law. Of course, unless it's very clear that you won't need to itemize, the best practice is to calculate itemized deductions anyway, so this won't necessarily be a huge time-saver for everyone, but there will likely be many for whom it will be so clear that they don't even need to make that alternate calculation.

Further, because of the removal of exemptions, it is quite possible that many more filers will be able to use the 1040EZ, the IRS form that actually lives up to the promise of fitting on a postcard. Currently, that form is only available to those who make less than $100,000, have very limited investment income, and who claim no dependents—among other restrictions.[3] However, with the removal of exemptions, it's possible that this filing form could be extended to far more filers.

In the balance, then, filing should be less complicated for a large majority of taxpayers next year. However, the law doesn't reduce the number of tax brackets and doesn't guarantee broader access to simplified forms. Also, there remain a large number of complicated return issues for both the wealthy and for businesses.

On the whole, the goal of reducing complexity has typically been aimed at individual filers, and this law takes some substantial steps toward making that easier, but leaves some questions up in the air, which is why I give the tax law a solid B for this category.

Restructuring: B+

Last April, I said that tax reform is often about changing *how* we tax more than *how much* we tax. The idea is that removing market distortions and loopholes can have a beneficial effect on revenue; this effect offsets a reduction in the rate of tax imposed. Of course, just whose loopholes are closed and whose rates go down has a big impact on who we think of as winners and losers (something we'll look at in the next article), but projections currently show that tax receipts are still going to fall well within Hauser's Law ranges. This means the new law hasn't radically changed *how much* we're collecting. So, what has it done to *how* we tax?

In the world of tax policy, there's an important principle called neutrality, which states that ideal tax policy allows taxpayers to make decisions based on their economic merits and not their treatment for tax purposes. Every deviation from this oft-discarded principle creates economic distortions—sometimes intentionally, sometimes more than intended, and sometimes completely unintentionally. A typical goal of tax reform, then, is to try to restructure policy to correct for the latter two cases.

The biggest restructuring of the tax code that the new tax law enacts is a substantial reduction in the corporate income tax rate. As I mentioned in the series last April, the United States taxes its corporations differently from the rest of the world. In addition to slightly higher rates of taxation, the form of taxation in the US is incompatible with the Value-Added Tax regime elsewhere. This, along with several other factors, created an incentive for American corporations to invest in capital and infrastructure outside the country and to then keep their profits out there in foreign subsidiaries. That is, our tax system encouraged the most successful US companies to invest and keep their money outside of the country. This is the distortion that the adjustment of the corporate rate sought to address.

So, how did the new law do? Well, Apple is already moving to repatriate as much as $252 billion, and experts estimate there are trillions more to come from similar moves from overseas. Through the incentive of lower tax rates for bringing foreign cash home, the new tax bill has clearly started to correct for a market distortion. In addition, the lower corporate rate should help to reduce the factors that created that distortion in the first place.

There are other, more minor structural tweaks that I'm not covering, and the neutrality of all the changes is debatable, as the changes clearly favor the domestic economy. Also, the fact that no Value-Added Tax regime has been created means there are still some barriers in international trade. So, the new tax law isn't perfect, but it's pretty good in this regard, which is why I give it a B+ for restructuring.

Closing Loopholes: D+

I won't spend too much time on this last category today because it will feature prominently in the next article. However, I will note that the new tax law's weakest point is that, while it takes a swing at a big tax deduction that economists have long criticized, it is still peppered with new deductions that present significant advantages for very specific businesses. In this way, it becomes very difficult to say that the law does anything terribly comprehensive in regard to closing loopholes.

The high point of the new tax law is that it does something substantial about two of the deductions that most economists detest: the mortgage interest deduction and deduction for state and local taxes. Both deductions have historically disproportionately benefitted the wealthy, but they're also the biggest reason why many in the middle class claim itemized deductions. Thus, the benefit to the middle class has made striking these deductions a political non-starter. However, the new tax law both reduces the number of middle-class taxpayers who will claim these deductions (due to the increased Standard Deduction) and puts caps on deductibility that reduce the benefit for the wealthy.

That's the good news, but a raft of smaller deductions remain. These include the creation of a new deduction for pass-through business income (think partnerships, LLCs, etc.), and a variety of tweaks that some tax experts think will generate workarounds, gutting the effectiveness of some limitations mentioned above.

Further, although not a tax loophole, the elimination of the penalty tax for not maintaining insurance guts a key piece of the Affordable Care Act—essentially creating an enforcement loophole that wrecks healthcare reform without offering any replacement.

The IRS may work to staunch the flow of some of these unintended loopholes, and there's always room for future tweaks, but on the whole, there is genuine weakness in the new law that could only be partially repaired through regulation. Because of this, I give the tax bill a D+ on closing loopholes.

Overall: B-

Overall, the new tax law doesn't do a terrible job of enacting its goals, at least by the standards of modern legislation. The biggest changes are largely positive, and the smaller details are a mixed bag, but things could have been much worse.

That said, while it's not shocking that Democrats would be against the law, opposition to the bill has led to a substantial amount of coverage claiming that the new law is a big handout to wealthy individuals and corporations. We'll leave that issue for the next article, but, for now, a more structure-focused analysis has led to my mildly positive overall impression of this attempt at tax reform.

We'll turn to the question of the impact of the Tax Cuts and Jobs Act of 2017 in the next article.

Footnotes

1. or, thanks to a little bit of "sour grapes" rules lawyering by the Democrats, the "Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018" ↩

2. This seems a somewhat monumental task for an agency that currently sits in the long list of government agencies with sharply cut budgets and no appointed leadership. ↩

3. If we want to get really in the weeds, it's possible that more people are filing using Form 1040 than necessary because the vast majority of taxpayers electronically file using online tax preparation services. However, the biggest excluder currently is the dependency issue, which prevents families with children from using a 1040EZ. ↩