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The tax reform agenda

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Abstract High tax rates that distort incentives and create large deadweight losses have been reduced, but there is still much more to be done to improve the tax system. It is useful to distinguish between tax rules that represent tax expenditures relative to a pure income tax from rules that represent tax expenditures relative to a consumption tax. I think it is important to focus on tax expenditures relative to a consumption tax base. It is possible that if there were no estate tax, the present value of the taxes paid by future heirs would exceed the revenue lost by abolishing the estate tax. On the corporate side, a shift to a territorial system of taxation would have very substantial favorable effects, while pass-through entities have a very weak case for a significantly lower tax rate. The net effect of such tax changes would be an increase in the budget deficit, though that increase is likely to be only temporary due to legislative rules. I am optimistic that there will be tax reforms enacted in the next twelve months holding great promise for improving our tax system and our economy.

Keywords Tax reform · Corporate tax · Territorial system · Pass-through

Thank you. I am pleased to have this opportunity to talk with my fellow members of NABE about the subject of tax reform, a subject that has interested me all of my professional life. And this is a very good time for all of us to be thinking about tax reform because there is a good chance that Congress will be enacting major tax reform legislation during the next 12 months.

The good news about our tax system is that, over the years, our tax rules have been getting better. Those who write the tax laws have been listening to the advice of economists—or at least what they have been doing for other reasons is in line with what economists have advised.

High tax rates that distort incentives and create large deadweight losses have been reduced: the top marginal rate of the personal income tax has come down from 92 to 40% now, and the corporate tax rate has come down from 50 to 35%. It has been possible to lower rates in that way by eliminating a variety of tax loopholes, i.e., tax accounting rules that allow taxable income to be less than economic income. So we have a less distorting—a more efficient—tax system than we did in the past.

So that's the good news. The bad news is that there is still much to be done to improve the tax system. The next 12 months provide a great opportunity to make those improvements. The Ways and Means Committee of the House of Representatives has been working for years on developing proposals for desirable tax reforms. The very knowledgeable and analytic chairman of that committee—Paul Ryan—has become Speaker of the House, passing the chairmanship of the Ways and Means Committee to an equally committed Kevin Brady. The President has asserted that tax reform is now his top priority.

Today I will focus on the potential tax reforms that are now on the Congressional agenda. Although it is tempting to talk about such fundamental reforms as a value-added tax or the Hall–Rabushka flat tax, I will limit my remarks to the proposals that are on the table. What impact will they have if they are enacted? And how will these tax reforms affect the outlook for the budget deficit?

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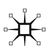


1 The tax reform act of 1986

Before I talk about the current agenda, let me provide a little historic background by focusing on the last major tax reform, the Tax Reform Act of 1986.

TRA86 focused on the personal income tax. It combined base broadening with rate reduction to generate a reform that was revenue neutral on a static basis, i.e., even without taking into account the favorable effect of the lower tax rates on increasing taxable incomes.

Here is the strategy that produced that important reform. For each income group—i.e., for each tax bracket—the Treasury calculated the revenue gain that would be achieved from eliminating a variety of "tax benefits"—i.e., exclusions, deductions, and also the "tax shelters" like cattle feeding and oil drilling used by high-income taxpayers. The Treasury then reduced the tax rate for each bracket to offset that revenue gain in a static calculation. Amazingly, because of the widespread use of tax shelters by high-income taxpayers, that strategy allowed reducing the top rate from 50 to 28%.

Perhaps even more amazing, the legislation passed on a bipartisan basis with a Republican in the White House (Ronald Reagan) and a Democratic majority in the House of Representatives. Since the legislation reducing tax rates had come as a surprise to taxpayers, they had not been able to shift income from the high tax rate years before 1986 to the years after the rate reductions. It was a great natural experiment to see how taxpayers responded to a major change in marginal tax rates.

Looking back after the fact, it was clear from the data that taxpayers responded to the reductions in marginal tax rates in ways that substantially increased taxable incomes. I studied that effect using a large panel of anonymous tax returns provided by the IRS (Feldstein 1995). The panel structure of the data meant I could compare the behavior of the same individuals in 1985 and 1988. The detailed data for each taxpayer meant I could exclude the effects on revenue of the tax shelter losses.

Taxpayers who faced a marginal tax rate of 50% in 1985 had a marginal tax rate of just 28% after 1986, implying that the marginal net-of-tax rate rose to 72% from 50%, an increase of 44%. For this group, the average taxable income rose between 1985 and 1988 by 45%. A more detailed difference-in-difference analysis also implied that the elasticity of taxable income to the net-of-tax rate was about one.

This dramatic increase in taxable income reflected three favorable effects of the lower marginal tax rate: the greater net reward for extra effort and extra risk-taking leading to increases in earnings, in entrepreneurial activity, in the expansion of small businesses, etc. Lower marginal tax rates also caused individuals to shift some of their compensation from untaxed fringe benefits and other perks to taxable earnings. Taxpayers also reduced spending on tax-deductible forms of compensation.

Let me just note that this estimated response to lower marginal tax rates was not the full-scale dynamic scoring now used by the Congress, the Treasury, and the Congressional Budget Office. The response that I described was just the short-term change in taxable income in response to the change in marginal tax rates.

The tax rate reductions of TRA86 were too good to last. President George H. W. Bush agreed to raise the top rate from 28 to 31%. President Clinton then raised that rate to 36%, adding what he called a "temporary" 10% increase to 39.6% for high-income taxpayers, an increase that still remains. And President Obama added a 3.8% extra tax on investment income of high-income taxpayers.

One final bit of tax history: The Congressional Budget Office (2016) did a very careful study of effective tax rates by income quintiles for the 35 years from 1979 to 2013. The CBO concluded that while the effective tax rate fell in every income quintile over those 35 years, it rose to well above the 35-year average for taxpayers in the top one percent of the income distribution.

2 The current proposals for changing individual taxes

That brings me to the proposals that are now on the table. I will start with the personal tax proposals and then turn to the corporate income tax.

The Congressional tax writers are proposing to lower the top rate from 39.6 to 35% and to reduce the tax rates on lower brackets as well. The experience of TRA86 implies that this will change taxpayer behavior in ways that increase taxable incomes, partially offsetting the revenue losses of the rate reductions. Full dynamic scoring calculations will add longer-term growth effects that imply additional increases in taxable incomes.

The plan is to pay for the remaining revenue losses by eliminating or limiting some of the deductions and other tax expenditures. The tax writers have not spelled out the details of what would be eliminated, although they have said that they will not eliminate the deductions for mortgage interest or charitable contributions.

Preserving the deduction for mortgage interest is important because eliminating it would be capitalized in declines in the value of homes, potentially by enough to wipe out the equity of a home owner with a high loan-to-value ratio.

Preserving the charitable deduction is important for maintaining the decentralized private support for cultural,

educational, and religious organizations and for hospitals. Without that decentralized support, the United States could be forced to follow the European model in which those organizations are all financed and controlled by the government.

The tax writers have indicated that their primary target is to eliminate the deduction for all state and local taxes, a tax expenditure that reduces federal revenue by about $100 billion a year (Joint Committee 2017). The current deduction for state and local taxes can be viewed as a subsidy for the consumption of such government services and therefore as an incentive for voters to support increased spending and taxes for services provided by state and local governments.

There is no doubt that eliminating the deductions for state and local taxes will be strongly resisted by the governors of states with relatively high taxes and by their representatives in Congress. The Administration and others who want to pass this important revenue raiser might increase their chance of political success by postponing the effective starting date for several years to a time past the political horizon of most governors.

More generally, it is useful to distinguish between tax rules that represent tax expenditures relative to a pure income tax from rules that represent tax expenditures relative to a consumption tax that does not tax saving or the income from savings. Except for the proposed limits on deductions for state and local taxes, virtually all of the other current deductions on the tax expenditure list produced by the Joint Committee would not be considered as tax expenditures under a consumption tax because they are designed to encourage saving and personal investment, including the deduction for contributions to pension plans and individual retirement accounts and the reduced tax rates on dividends and capital gains.

While I have long been an advocate of limiting tax expenditures, I think it is important to focus on tax expenditures relative to a consumption tax base. Taxing saving or the return to saving weakens economic growth and creates an excess burden in addition to the deadweight loss created by taxing ordinary earnings.

It would be useful to go beyond eliminating the deduction for state and local taxes to limit the exclusion from taxable income of the employer payments for health insurance. That is the largest of the tax expenditures with a revenue loss of $165 billion in 2017. Limiting the untaxed amount that can be provided to employees would not only produce substantial revenue but would reduce the demand for the kind of insurance policies with low copayments that contribute to the rapid increase in health care costs. Since only about half of employers provide these untaxed health insurance benefits, subjecting the benefits to taxation would increase the fairness of the tax system.

I have recently suggested a political compromise of subjecting employer payments for health insurance to the payroll tax (Feldstein 2017) rather than the income tax. Doing so would produce revenue of about $135 billion this year, reducing the overall deficit by that amount and adding it to the Social Security Trust Fund. The increase in the size of the Trust Fund would postpone the time when the Trust Fund would be depleted, requiring either a substantial cut in Social Security benefits or a significant increase in taxes to pay the benefits.

More generally, subjecting health insurance benefits to either the income tax or the payroll tax would raise revenue without increasing marginal tax rates and would therefore not reduce incentives to work or to invest.

An alternative to eliminating a few deductions and exclusions would be to put an overall limit on the amount that a taxpayer can benefit from such tax expenditures. That might be politically easier to enact since no group of taxpayers would feel that they were being singled out to lose their deductions. A few years ago, Dan Feenberg, Maya MacGuineas, and I (2011) proposed such a plan, allowing each individual to benefit from the full range of tax expenditures but limiting the resulting tax reduction to two percent of that taxpayer's adjusted gross income. Simulations using the NBER TAXSIM model projected that such a cap would have raised $278 billion in 2011. A two percent cap would also cause substantial simplification by inducing more than 35 million taxpayers to shift from itemizing their deductions to using the standard deduction.

3 Changing estate and gift taxes

The change in personal taxes may extend beyond the personal income tax to the estate and gift tax. Although only a tiny fraction of all individuals will ever pay any estate tax, surveys show that most Americans think that the estate tax is unfair because it levies a tax on wealth that was previously taxed when it was earned as wage and salary income and then taxed again as a tax on interest, dividends, and capital gains. The estate tax with a maximum federal rate of 40 percent also has a discouraging effect on saving among high-income older individuals. Since capital gains are not taxed on assets that pass when an individual dies, the current arrangement also creates a lock-in effect with older individuals induced to hold securities that they would otherwise want to sell.

Defenders of the existing estate and gift tax assert that it produces revenue that is currently about $25 billion a year. Although this is less than one percent of total tax revenue, I think that even this relatively small amount overstates the revenue effect that would result from eliminating the estate tax. Individuals with substantial wealth now give a large

fraction of their wealth at the time of death to charitable entities rather than lose more than half of those assets to federal and state taxes. But once those assets pass to non-profit organizations, the return on those assets is no longer subject to the income tax. If there were no estate tax, those funds would pass to taxable heirs where the returns on the investments would be subject to the income tax. I have not done the calculation, but it is certainly possible that, if there were no estate tax, the present value of the taxes paid by future heirs would exceed the revenue lost by abolishing the estate tax itself.

The Administration and the Congressional leadership have said that they will eliminate the estate tax but they have not provided any details of how the law would change. It is possible that they will follow the example of Canada where the estate tax was abolished, but capital gains on accumulated assets are subject to the capital gains tax at the time of death. That would be a change from the current US capital gains rule in which there is no tax on the accumulated capital gains at the time of death or in the hands of the heirs. Another possibility would be to treat capital gains at death the way the US now treats capital gains on assets that are given during life, requiring the recipient of the gift to carry over the basis of the assets and pay the capital gains tax when those assets are sold. Depending on the details of the treatment of accumulated gains, the elimination of the estate tax could have different tax consequences for estates of different size and with different amounts of accumulated gains.

4 Proposals for changing corporate taxes

I will turn now to the proposed changes in the taxation of corporations.[1]

The Tax Reform Act of 1986 did not improve the taxation of corporate income. The changes in depreciation rules in TRA86 actually reduced corporate incentives to invest, biasing the tax system more in favor of owner-occupied housing in comparison to productivity-increasing investments in corporate plant and equipment.

In contrast, the current tax reform proposals aim to change the corporate tax system in three ways: lowering the statutory rate on corporate profits; changing the tax treatment of the foreign subsidiaries of US corporations; and shifting from a traditional corporate tax to what its advocates call a destination-based cash flow corporate tax. I will discuss each of these although I believe that the plan for a cash flow corporate tax will not happen.

4.1 Reducing the corporate tax rate

The federal corporate tax rate is now 35%, the highest among all the major industrial countries. In addition, individual states levy corporate taxes with an average rate of 9%. Since those state taxes are deductible when calculating the federal taxable income, the overall tax rate is about 40%. The average rate among OECD countries is only about 25%.

The effective corporate tax rate is reduced by accelerated depreciation of investment in plant and equipment and by the deduction of nominal interest payments rather than the lower real interest payments. These are similar to the practices in other industrial countries.

The House Republican tax plan developed when Paul Ryan was chairman of the Ways and Means Committee called for reducing the statutory rate from 35 to 20%. The Trump presidential campaign called for reducing it to 15%.

Reducing the corporate tax rate would attract funds to the corporate sector from other uses like owner-occupied housing and agriculture. It would also attract foreign capital to the US corporate sector. These shifts would increase the efficiency with which capital is allocated across sectors and across international markets. The increased capital in the US business sector would raise the productivity and real wages of American workers. It would also increase real GDP growth as the corporate capital stock grows.

There is substantial debate and confusion about who benefits if the corporate tax rate is reduced. Much of the discussion assigns a substantial share of the benefit to the shareholders or the owners of capital more generally with the rest going to labor. Basic theory makes it clear that the incidence of a reduction in the corporate tax rate depends on the effect of that rate reduction on the flow of capital to the corporate sector. Over time, the induced flow of capital to the corporate sector drives down the pretax rate of return to capital and raises the marginal product of labor. The division of the gain from the reduction of the corporate tax rate therefore evolves over time with a larger share going to the initial owners of capital in the short term and less as time goes by.

The advocates of reducing the corporate tax rate often claim that doing so would also increase employment in the United States. This would obviously be true as a response to a corporate rate cut in an economy with substantial unemployment in which a reduction of the corporate tax would stimulate demand and aggregate employment. But in the current condition of the US economy with an unemployment rate of just 4.4% there is no scope for a corporate tax cut to have such a traditional Keynesian effect on aggregate demand and employment.

A cut of the corporate tax rate could nevertheless cause an increase in employment as the increased flow of capital

[1] This section draws on remarks that I made at the September 2017 meeting of the Brookings Panel on Economic Activity.

to the corporate sector raised the productivity of labor in that sector. Corporate firms would raise wages to attract labor, leading to an increase in the labor force participation rate and therefore in overall employment (See Feldstein 2016).

Although lowering the corporate tax rate would have substantial economic benefits, it would also have a significant budget cost. Since the corporate income tax now collects about 1.6% of GDP, cutting the rate from 35% to about half that level would reduce revenue directly by about 0.8% of GDP. Although this would be partly offset by the faster economic growth and by the rise in real wages and profits, there would still be an increase in the budget deficit.

Unlike the personal income tax, there are very few tax expenditures in the corporate tax rules that could be eliminated to raise revenue. The analysis by the Joint Tax Committee identifies only relatively few corporate tax expenditures in comparison to the large number and substantial value for personal tax expenditures. The largest of these is the deferral of income of foreign subsidiaries, a subject to which I will turn in a minute. The only other large corporate tax expenditures are the deduction for domestic production activities (a tax expenditure of $15 billion) and the effect of accelerated depreciation (a tax expenditure of $25 billion). In order to limit the revenue loss and achieve a long-run budget balance, the statutory rate might have to be reduced to no less than 25%.

4.2 Correcting the tax treatment of the foreign subsidiaries

I turn now to proposed changes in the tax treatment of the profits of foreign subsidiaries. The United States is virtually alone in the way that it taxes the profits earned by the foreign subsidiaries of its corporations.

Consider a foreign subsidiary of a US corporation that earns profits in Ireland. It pays the Irish government a corporate profit tax equal to 12% of those profits and is then free to do what it wants with the after-tax profits without paying any extra Irish tax. It can invest them in Ireland, or hold them in financial assets, or invest them in any country of the world except the United States. But if it brings those after-tax profits back to the United States, it must pay the US tax of 35% minus the 12% paid in Ireland before it can either invest them in the United States or distribute them to shareholders. Not surprisingly, American corporations generally decide not to repatriate those after-tax profits. The Treasury estimates that American corporations have decided to leave about $2.5 trillion of the after-tax profits of its subsidiaries outside the United States.

In contrast, other countries follow what is called the "territorial" method of taxing the profits of foreign subsidiaries. Profits can be repatriated and invested in the home country or distributed to domestic shareholders after paying either no tax or a very small corporate tax (like 5 or 10%).

American multinational corporations that don't want to repatriate the profits of their foreign subsidiaries have two options if they don't want to earn only the low rate of return available on financial assets. They can invest those profits in offshore businesses or they can hold those profits in financial assets and borrow an equal amount at home to invest in the United States. The fact that about half of the $2.5 trillion of unrepatriated funds are invested in foreign operating businesses shows that US multinationals prefer to invest a substantial part of their foreign subsidiary profits in overseas businesses. Their reluctance to borrow in the United States in order to invest at home may reflect the equity market's negative view of increased debt on the company's balance sheet even if it is in principle balanced by the holding of bonds or bank deposits in the foreign subsidiary. This behavior implies that a shift to a territorial tax system will cause multinational corporations to repatriate more of the profits of their foreign subsidiaries rather than investing them abroad.

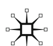
A shift by the United States to a territorial system of taxation would therefore have very substantial favorable effects. Much of the $2.5 trillion of funds that have been accumulated abroad would eventually be repatriated and invested in the United States. In addition, the future profits of the foreign subsidiaries of US corporations would also be more likely to be repatriated instead of being invested in new companies outside the US. But even if paid out as dividends or used to buy back shares, most of those funds would find their way into new investments by other firms.

In this way, the shift to a territorial system would have favorable effects similar to a reduction of the corporate rate cut: raising capital per worker, increasing productivity and real wages, and stimulating higher growth and higher taxable incomes.

A US shift to a territorial system would also increase the incentive for foreign companies to invest in the United States and to establish the United States as their headquarters, knowing that they could repatriate foreign profits to the US for further investment in the US or elsewhere.

A territorial system would thus raise corporate tax revenue for the United States by shifting more profits to be invested in the United States. An initial "deemed repatriation tax" on the $2.5 trillion of previously untaxed foreign subsidiary profits would provide a significant short-term boost to corporate tax revenue.

But there are potential adverse effects of the shift to a territorial system. It could encourage the US firms to establish subsidiaries in "tax shelter" countries with extremely low tax rates in order to earn profits there and



then return them to the US with little or no further tax. It could encourage firms to shift profits to such tax shelter jurisdictions by transfer pricing or debt transactions. These would require careful monitoring or special rules for such tax shelter countries. Since every other industrial country with a territorial tax system has dealt with this challenge, I assume that the United States could do so as well.

A permanent shift to a territorial system would be quite different from the one-time repatriation holiday that was tried in 2004. Companies were then allowed to repatriate foreign subsidiary profits with the understanding that those funds would be invested in the United States. Much of the repatriated funds were nevertheless used for share buybacks and dividends. It is not possible however to know how much of the funds that were paid out as dividends or share buybacks were then used to finance investments in other firms. Moreover, a permanent shift to a territorial system would have different incentives than the one-off repatriation holiday.

4.3 Adopting a cash flow corporate tax

I'll turn now to the idea of adopting a cash flow corporate tax.

At an annual AEA meeting some years ago, I proposed replacing our corporate income tax with a cash flow tax. Each company's tax base would be increased by any inflow of cash—whether from product sales, borrowing, or the issuance of equity—and would be decreased by any outflow of cash—whether from the cost of inputs, from repaying debt, from paying interest or dividends, or buying back shares. I was not alone in proposing such a cash flow tax to replace the traditional corporate tax. Like many good ideas, it was not pursued at the time so I will not comment on its potential virtues.

There is now discussion of a so-called "destination-based cash flow tax" that has a very different structure. There are three components to this DBCFT: first companies would get an immediate write-off for all investments in plant and equipment; second, companies would not be allowed to deduct interest on new loans; and third there would be a deduction for export sales and an extra tax on imports. I think that in some long-run steady state this would be equivalent to the simpler cash flow tax that I proposed earlier although it would be very different during the transition years.

Allowing an immediate write-off of all expenditures for plant and equipment would provide a strong incentive for productivity-increasing investments. It would also cause a very large loss of revenue.

Eliminating interest deductions on new loans would raise significant revenue but would be difficult to implement. When is a loan "new" rather than a rollover of an existing loan? How should leasing be distinguished from borrowing? How should loans of foreign subsidiaries be treated?

The firms that gain from expensing would be different from those that lose from eliminating interest deductions, making it politically difficult to enact such a pair of proposals.

To complete the similarity to a true cash flow tax, the DBCF plan adds a border adjustment piece: all imports would be subject to an additional tax at the corporate tax rate, while all exports would be granted an additional deduction at that rate in calculating table profits. Although this might look like a plan to increase exports and decrease imports, it need not be. As economists understand, an improvement in the trade balance requires a change in the difference between national saving and national investment. The fundamental economic relation is that "exports minus imports equals national saving minus national investment." Since the border adjustment tax causes no net change in saving or investment (because the net revenue would be used to pay for the corporate rate cut), there would be no change in imports and exports despite the tax on imports and subsidy to exports. The textbook resolution of this apparent paradox is that the exchange rate of the dollar would rise enough to make the value of foreign goods when they reach the US lower by enough to just balance the effect of the tax on imports. The same exchange rate effect would apply to neutralize the subsidy on exports.

The real purpose of the border adjustment tax was, as I just indicated, to raise revenue to pay for the reduction in the corporate tax rate. The BAT would raise substantial revenue because the tax on imports would raise more revenue than the subsidy on exports loses. The US imports about 15% of GDP and exports about 12%. With a 20% corporate rate applied to both, the net revenue effect would be to raise revenue by 20% of 3% of GDP, equivalent to 0.6% of GDP or about $120 billion at today's level of GDP. That would probably be enough to offset the net revenue loss of the corporate rate reduction. Although the gap between imports and exports should in theory reverse in the long run, it has continued for many decades, presumably because foreign savers welcome the opportunity to invest in the United States.

In principle, therefore, the border adjustment tax would have no net effect on the prices paid by US consumers or the prices received by US exporters. There are of course reasons why the full textbook adjustment of the exchange rate might not happen in practice. Importers and retailers therefore fear that they might lose from the tax on imports. Since there is no gain for them in the border adjustment and a risk of a serious loss, they have been opposing it

politically, arguing that it would raise prices to American consumers.

The opponents of the border adjustment tax system appear to have won the political battle. A statement by the Republican leadership dealing with taxes has explicitly withdrawn support and my judgment is that Congress will not enact the border adjustment tax or any other part of the DBCF plan.

4.4 Dealing with pass-through businesses

There is a further tax issue about dealing with pass-through businesses. It is said that about half of business activity in the United States is conducted by organizations that are not traditional Subchapter C corporations. These include subchapter S corporations (the income of which is added to other personal income for personal income tax purposes), partnerships, and sole proprietorships.

If the top rate of the personal income tax is reduced from the current 39.6 to 35%, the pass-through entities would pay tax on their profits under current law at their personal tax rate or 35%. The owners of such businesses complain that would be much higher than the proposed 20% rate that would be paid by regular Subchapter C corporations.

The representatives of small businesses and other pass-through entities are therefore lobbying to have a special lower rate for these entities. Doing so would create an incentive for salaried individuals who are able to do so to incorporate their activities as Subchapter S corporations or other forms that qualify for the proposed lower tax rate in order to take advantage of that new lower rate.

The gap between the proposed personal income tax rate of 35% and the proposed corporate rate of 20% exaggerates the true effective difference between owners of Subchapter C corporations and owners of pass-through businesses. The full effective rate on corporate businesses includes not just the corporate tax rate but also the additional tax that must be paid by shareholders when the after corporate tax profits are distributed to the owners of the corporation.

Here is the relevant arithmetic. A pass-through entity with $100 of profits would have a net-of-tax income of $65. A Subchapter C corporation with the same $100 of pretax profits would pay the new 20% corporate rate, producing an after-tax profit of $80. If that $80 were paid out as dividends, the net income to the owner would be less than $65 if the tax on dividends exceeds 18.75%. Even with a 15% tax on dividends, the $80 paid out as dividends would yield a net income of just $68 and therefore only $3 more than the income of the pass-through owner. If instead the after-tax profits were retained until the corporation is dissolved, the accumulated profits would under current law be subject to tax at both the corporate and personal levels. In short, the pass-through entities have a very weak case for a significantly lower tax rate.

4.5 Tax reform and the budget deficit

I will conclude with some brief comments about the impact of tax reform on future budget deficits.

The direct effect of the lowering tax rates on personal and corporate income will be to reduce tax revenue and raise the budget deficit. This will be offset in part by the limits on personal deductions. Limiting the exclusion of employer payments for health insurance could raise substantially more revenue, at least as much as the amount that had been expected from the border adjustment tax. Lower marginal tax rates on personal income will induce individuals to increase taxable income by a combination of greater earnings, a shift of compensation from fringe benefits to taxable cash, and a reduced use of deductible consumption expenditures. The shift to a territorial system for taxing the income of foreign subsidiaries of US corporations will raise taxable profits, especially in the short run as companies pay the deemed repatriation tax. The combination of lower tax rates on personal incomes and corporate profits will lead to increased growth of taxable incomes and profits.

Nevertheless, the net effect of the tax changes would be an increase in the budget deficit. That deficit increase is likely however to be only temporary because of the pressure created by legislative rules. Here is why.

Unless there is a change in the attitudes of the Democratic members of the Senate, the Republicans will have to pass the tax legislation without any support from the Senate Democrats. Although it is generally difficult to pass legislation without Democratic votes because the Republicans have a majority of only two in the Senate and it takes 60 votes to stop a filibuster, there is an exception for budget legislation. The tax reform legislation can be passed with a simple majority using the so-called reconciliation process. But the reconciliation process can be used only if there is no projected increase to the fiscal deficit after the 10-year budget period.

Even with dynamic scoring that recognizes the extra revenue from faster economic growth, achieving that necessary long-term budget balance may require limiting the size of the corporate rate reduction and offsetting the reductions in the personal tax rates by eliminating or limiting a variety of personal deductions and exclusions.

I am optimistic that the advocates of tax reform will adopt the changes needed to pass the legislation using reconciliation. If this happens, the deficit increase will be only temporary and the tax reforms enacted during the next

12 months will hold great promise for improving our tax system and our economy.

Thank you.

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