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Corporate Tax, Job Growth and Inequality: An Analysis of Tax Cuts and Jobs Act, 2017

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Abstract

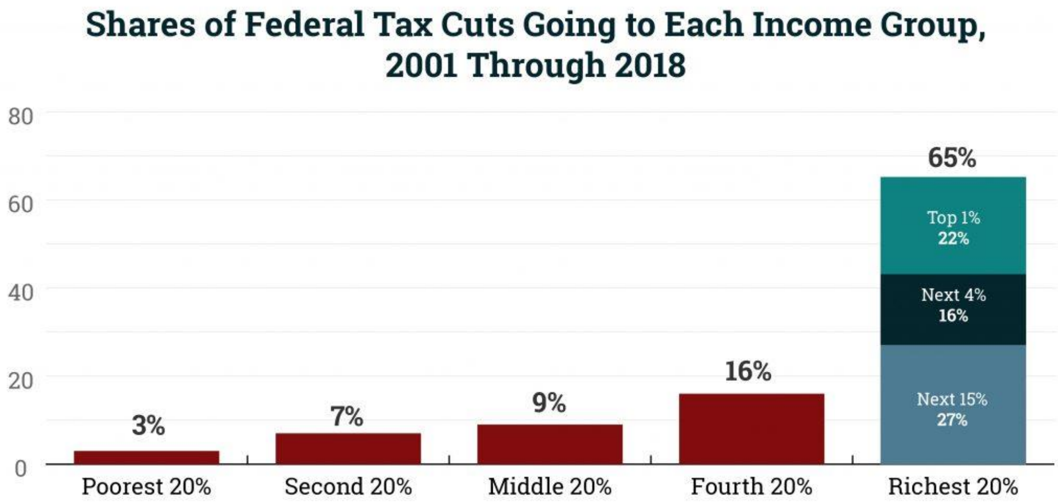
In December 2017, President Trump signed into law the Tax Cuts and Jobs Act of 2017 (TCJA). The most significant aspect of TCJA was cutting the Corporate Income Tax (CIT) rate from 35 per cent to 21 per cent or by 40 per cent. This was the highest reduction of CIT in the history of the United States. The other land mark of tax cut in the United States occurred during the Reagan era between 1981-86. By enacting the Economic Recovery Tax Act of 1981 (ERTA) and the Tax Reform Act of 1986 (TRA), President Reagan slashed the top income tax rate by 60 per cent – from 70 per cent to 50 per cent in 1981 and from 50 per cent to 28 per cent in 1986. Tax cuts in general, and the TCJA in particular have many implications, most significant being its impact on inequality. According to Organization for Economic Cooperation and Development (OECD) data, United States possesses the worst record of all OECD countries in terms of reducing income inequality. Early studies indicate that the TCJA would exacerbate income inequality. In so far as job growth is concerned, studies show that tax rate increase helped growth of jobs significantly more than tax cuts. In this paper, we analyze the early effects of the TCJA, job growth and inequality in relation to tax cuts occurring during 1981 to 2017.

Key words: Tax cut, job growth, Gini coefficient, inequality, crowding out

1. Experimenting with Tax Cut: 1981-2017

The idea of stimulating economic growth through tax cut is popular for many reasons, political expediency being the most important. The conventional wisdom is that additional expenditure by consumers received through tax cut boosts aggregate demand, which in turn creates a multiplier effect leading to higher economic growth and thereby creates new jobs. While there is evidence that tax cut boosts aggregate demand, it also exacerbates income inequality. Six Presidential regimes dating back to 1981 has provided some form of tax cut. As Figure 1 shows, during 2001-2018, the richest 20 per cent of U.S. income earners received 65 per cent of the federal tax cut while the poorest 20 per cent received 3 per cent in federal tax cut.

Figure 1



Excludes tax break "extenders" for businesses like bonus depreciation
Source: ITEP analysis

Source: https://itep.org/federal-tax-cuts-in-the-bush-obama-and-trump-years/

In addition to increasing income inequality, tax cut has other intended and unintended consequences including higher inflation rate, higher interest rate and crowding out. In this section, we discuss a brief history of tax cut and tax increases enacted by five Presidents prior to Trump and conclude that job growth is higher during the tax increase regime than the tax cut regime.

1.1 Reagan Experiments: No president in modern history has experimented more with tax cuts than Ronald Reagan during his two terms. Soon after being elected, President Reagan successfully enacted Economic Recovery Tax Act (ERTA) in August 1981. The ERTA also known as Reaganomics for the dogmatic anti-tax approach of Reagan, slashed the top income tax rate from 70 per cent to 50 per cent, highest reduction of taxes in American history until that time. The Act also slashed the bottom rate from 14 per cent to 11 per cent. The drastic reduction of federal taxes was inspired by Reagan's economic advisor Arthur Laffer, a proponent of Supply Side Economics. Laffer had theorized that a significant reduction of taxes on the wealthy would induce more capital investment and innovation, which would in turn spur economic growth that would "trickle down" to the ordinary citizens through increased job growth. However, the effects of the massive tax cut enacted through ERTA did not produce the desired results. Capital investment did not grow as expected. The basic tenet of Laffer hypothesis was that a significant reduction of tax rate would increase tax revenue due to a booming economy. On the contrary, the year following the ERTA witnessed a significant reduction of tax revenue leading to increased public debt which resulted in a significant reduction of private investment due to crowding out. The prime rate, an indicator of major investment soared to 21.5 per cent in June 1982. In September 1982, the Dow Jones Industrial Average (DJIA) went down by 30 parentage points. The unemployment rate which was 5.6 per cent in May 1979 soured to 10.8 per cent in November 1982, the highest since the Great Depression. The economy plunged into recession.

The Reagan years are known for many tax reforms and simplification of complex tax codes. After the disastrous effects of the massive tax cut enacted through the ERTA, the Congress and President Reagan initiated major reforms of the tax loopholes which resulted in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). As a result, tax revenues started showing an upward trend. The "Reagan Recession" which began in July 1981 officially ended in November 1982.

Perhaps the biggest tax reform undertaken by Reagan was the Tax Reform Act (TRA) of 1986, which for the first time in U.S. history simultaneously lowered the top tax rate and increased the bottom tax rate. The TRA lowered the top tax rate of ordinary income from 50 per cent to 28 per cent and raised the bottom tax rate from 11 per cent to 15 per cent. Thus, during Reagan's two-term Presidency, the top income tax rate was slashed by 60 per cent – from 70 per cent in 1981 to 28 per cent in 1986.

1.2 **George H. W. Bush Reversal:** George H.W. Bush succeeded Reagan, and in a stunning reversal of his campaign promise ("Read my lips, no new taxes") raised the highest rate from 28 per cent to 31 per cent by enacting the Omnibus Budget Reconciliation Act of 1990 (OBRA 1990).

1.3 **Clinton Omnibus Budget Reconciliation Act of 1993**: President Clinton is known for inheriting a large budget deficit but leaving office after eight years with a surplus of federal budget. His approach to tax reform was more comprehensive than any other President in modern history. Below are main provisions of Clinton era Omnibus Budget Reconciliation Act of 1993 (OBRA 1993):

- Previously, the top individual tax rate of 31% applied to all income over $51,900. The Act created a new bracket of 36% for income above $115,000, and 39.6% for income above $250,000.
- Previously, corporate income above $335,000 was taxed at 34%. The Act created new brackets of 35% for income from $10 million to $15 million, 38% for income from $15 million to $18.33 million, and 35% for income above $18.33 million.
- The 2.9% Medicare tax had previously been capped to apply to only the first $135,000 of income. The cap was removed.
- Transportation fuels taxes were raised by 4.3 cents per gallon.
- The portion of Social Security benefits subject to income taxes was raised from 50% to 85%.

1.4 **George W. Bush Tax Cuts:** President George W. Bush inherited a strong economy with a significant budget surplus. However, after eight years, he left office with the highest public debt and the onset of the Great Recession of 2008. It is not the purpose of this paper to analyze the economic policies pursued by George W. Bush other than his tax cut policies. Bush enacted two landmark tax legislations in 2001 and 2003 known as Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). The oncome tax rates existing at that time were revised significantly by the above two legislations. Table 1 below shows the full extent of Bush tax cuts:

TABLE 1

Income Tax Rate Reductions Under the 2001 and 2003 Tax Cuts

Taxable Income	Previous Rate	New Rate
Below $17,000	15%	10%
$17,000 — $68,000	15%	15%
$68,000 — $137,000	28%	25%
$137,000 — $209,000	31%	28%
$209,000 — $374,000	36%	33%
Above $374,000	39.6%	35%

Source: Horton (2017)

2. **Obama Tax Reform:** Soon after being elected, President Obama was confronted with the Great Recession of 2008 which was taking shape during the last year of Bush's Presidency. Obama initiated various measures of tax reforms including continuation of Bush era tax cut with a view to ending the Great Recession. Accordingly, Congress passed the American Recovery and Reinvestment Act of 2009 (ARRA), signed by Obama in February 2009. The ARRA is credited with ending the Great Recession of 2008. Subsequent to ARRA, Obama undertook reforms of the federal tax structure by reverting back to the highest tax rate of 39.6 per cent which was earlier lowered by Bush to 35 per cent.

3. Trump Tax Cuts and Jobs Act, 2017

In December 2017, United States enacted a massive tax cut for corporations and individuals. The legislation known as the Tax Cuts and Jobs Act (TCJA) lowered CIT rate from 35 per cent to 21 per cent or by 40 per cent. In contrast, personal income tax rates went down by about 2.5 per cent at the median tax bracket.

After its implementation, it was found that the biggest beneficiaries of TCJA were the biggest corporations. The following analysis is adapted from Cerullo (2019).

"Big companies have long relied on strategies to reduce their tax bills. But the new tax law is making it even easier, with a new analysis finding that 60 profitable Fortune 500 companies paid no taxes on a total of $79 billion of profits earned in 2018.

The companies, which include tech giants such as Amazon and Netflix, should have paid a collective $16.4 billion in federal income taxes based on the Tax Cuts and Jobs Act's 21 percent corporate tax rate, according to the left-leaning Institute on Taxation and Economic Policy. Instead, these corporations received a net tax rebate of $4.3 billion. The analysis is based on the corporations' annual financial reports, which were filed earlier this year to report their 2018 results."

The TCJA retained all seven tax brackets but restructured the marginal tax rates from the pre-TCJA rates of 10%, 15%, 25%, 28%, 33%, 35%, and 39.6% to the new rates of 10%, 12%, 22%, 24%, 32%, 35%, and 37%. The median marginal rate in the pre-TCJA tax law was 28% which was revised to 24% in the TCJA. Even though the median rate seems like a reduction of 4% in the TCJA, because of other adjustments such as limits on various deductions and elimination of personal exemption, the actual reduction is in the neighborhood of 2.5%. It is also to be noted that at taxable incomes of 32% or higher, individual tax payers would pay higher in dollar terms under TCJA than they used to pay before. Perhaps the most significant aspect of TCJA is the permanent reduction of Corporate Income Tax while the nominal reduction of individual tax rates is subject to expire in 8 years. Table 2 below summarizes the tax structure of TCJA, 2017.

TABLE 2
Tax Brackets and Rates, 2018

Rate	For Unmarried Individuals, Taxable Income Over	For Married Individuals Filing Joint Returns, Taxable Income Over	For Heads of Households, Taxable Income Over
10%	$0	$0	$0
12%	$9,525	$19,050	$13,600
22%	$38,700	$77,400	$51,800
24%	$82,500	$165,000	$82,500
32%	$157,500	$315,000	$157,500
35%	$200,000	$400,000	$200,000
37%	$500,000	$600,000	$500,000

The above Table does not show the reduction of corporate income tax rate which was slashed from 35 per cent to 21 per cent or by 40 per cent, the largest in U.S. history. The biggest beneficiary of the corporate tax cut would be the pass through businesses like the ones owned by President Trump. According to Congressional Budget Office (CBO), as a consequence of the drastic reduction of corporate income tax, federal budget deficit will exceed $1 trillion annually beginning in Fiscal Year 2020 — two years earlier than previously projected and federal debt held by the public will approach 100% of GDP by 2028 (https://taxnews.ey.com/news/2018-0763-cbo-forecasts-higher-deficits-debt-due-to-tcja-and-spending-bills)

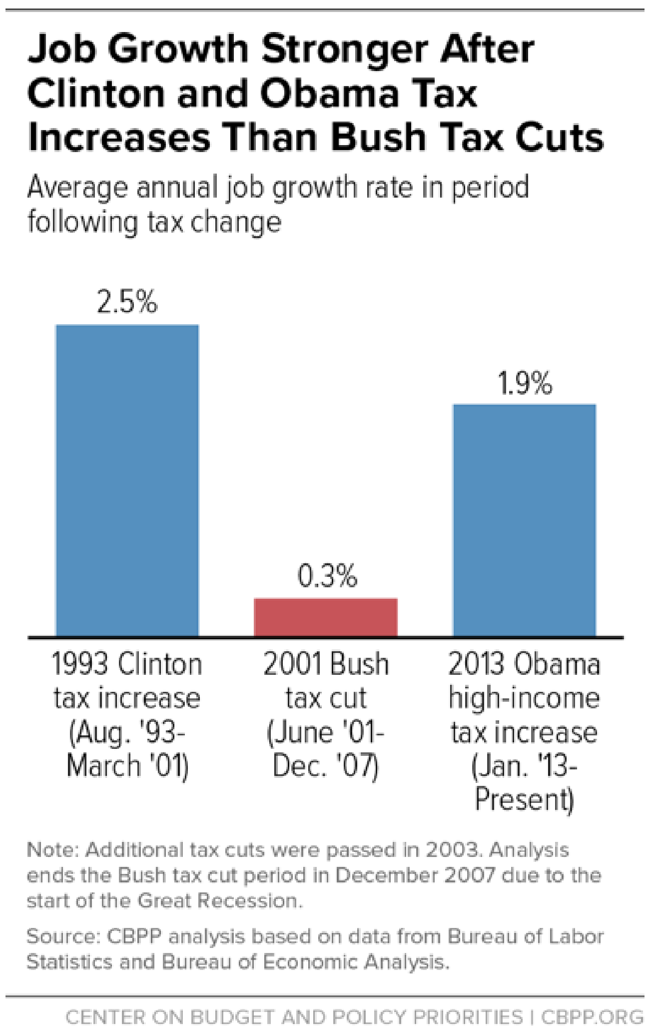
4. Stimulating the Economy: Tax Cut or Tax Increase?

As demonstrated by Keynes (1936), the multiplier effect of government spending is higher than the multiplier effect of tax cut. In other words, the entire disposable income received through tax cut does not go into the expenditure stream to create a multiplier effect. In the United States, consumers spend a big part of their incremental disposable income known as Marginal Propensity to Consume (MPC). This means a part of the tax cut equal to the Marginal Propensity to Save (MPS) does not go into the expenditure stream. Therefore, the impact of the tax cut in generating additional income through the multiplier process is smaller than the impact of additional government spending made possible through increased tax revenue. Below is a simplified example of the Keynesian expenditure multiplier and the tax multiplier.

Because of the size of the population and the presence of many income groups, estimates of MPC in the United States vary widely. A recent study estimates the MPC to be in the range of .90 to .98 (https://www.investopedia.com/contributors/53893/) Estimates of MPC are both income-sensitive and time-sensitive; however, a better indication of the MPC may be obtained by comparing the average savings of an American. In November 2018, the average personal savings rate in the United States was 6 per cent of disposable income(https://www.statista.com/statistics/246268/personal-savings-rate-in-the-united-states-by-month/)
Therefore, it will be safe to accept the estimated MPC, especially for the bottom half of U.S. population to be in the neighborhood of 90 per cent. In other words, 10 per cent of incremental disposable income is saved by consumers leading to MPS of .1. This assumption leads to an expenditure multiplier of 10 (1/MPS or 1/.1). Expressed otherwise, every dollar that the government spends out of increased tax revenue generates 10 dollars of income for the economy. However, the multiplier impact of tax cut is smaller compared to the additional government expenditure made possible by tax increase. Below is a simple proof of this axiom. Assume as above, the MPC is .9 and the MPS is .1 and thus the expenditure multiplier is 10. Because consumers spend 90 per cent of the tax refund, the tax multiplier would be 9 (10 times .9).

Job growth is a consequence of the aggregate demand. As shown in Figure 2, comparing two regimes of tax increases (Clinton and Obama) with a regime of tax cut (George W. Bush), we find that the multiplier effect of spending generated through additional spending had a much stronger impact on job growth than the tax cut effect.

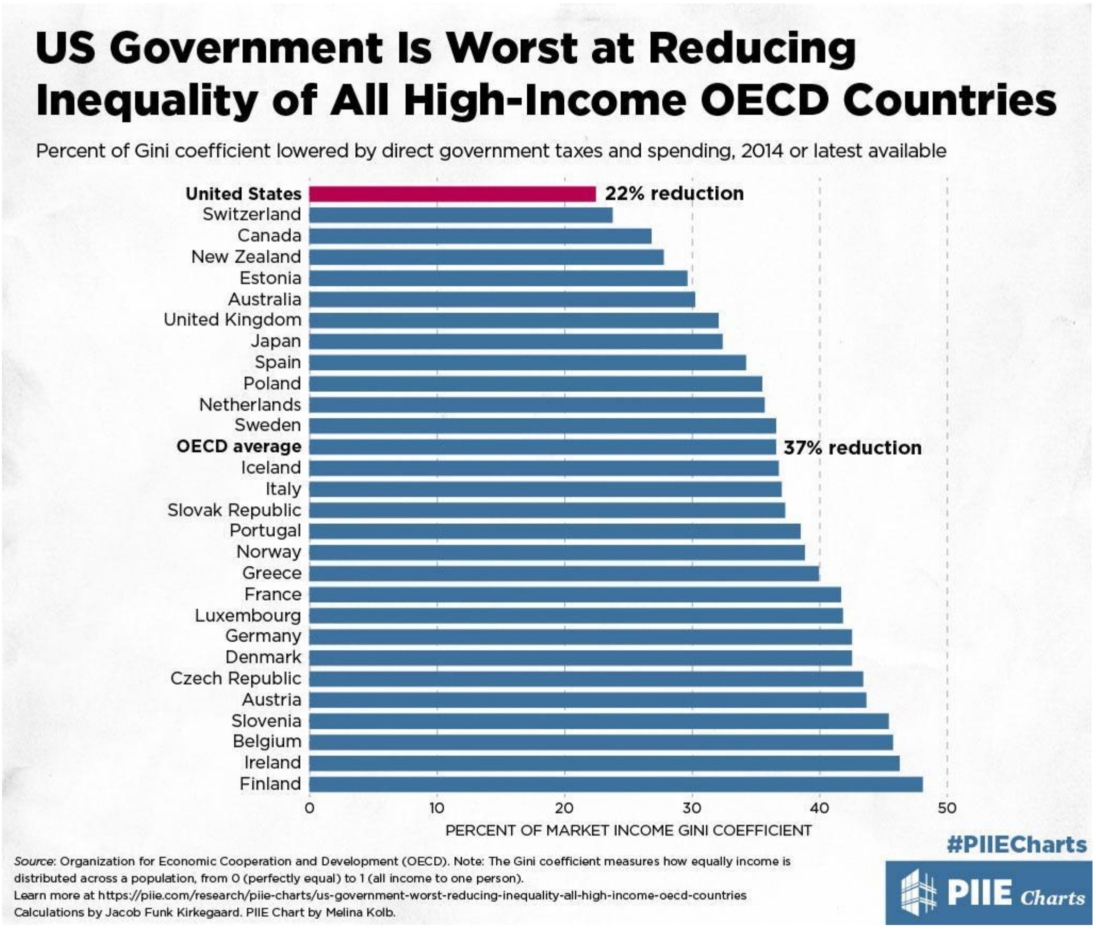
Figure 2: Job growth in relation to tax increase and tax cut



5. Tax Cut and Inequality

Tax cut and tax increase has significant impacts on income distribution as measured by Gini coefficients. In this section, we show the income inequality of the United States in comparison to OECD countries followed by a longitudinal study of Gini coefficients of the United States.

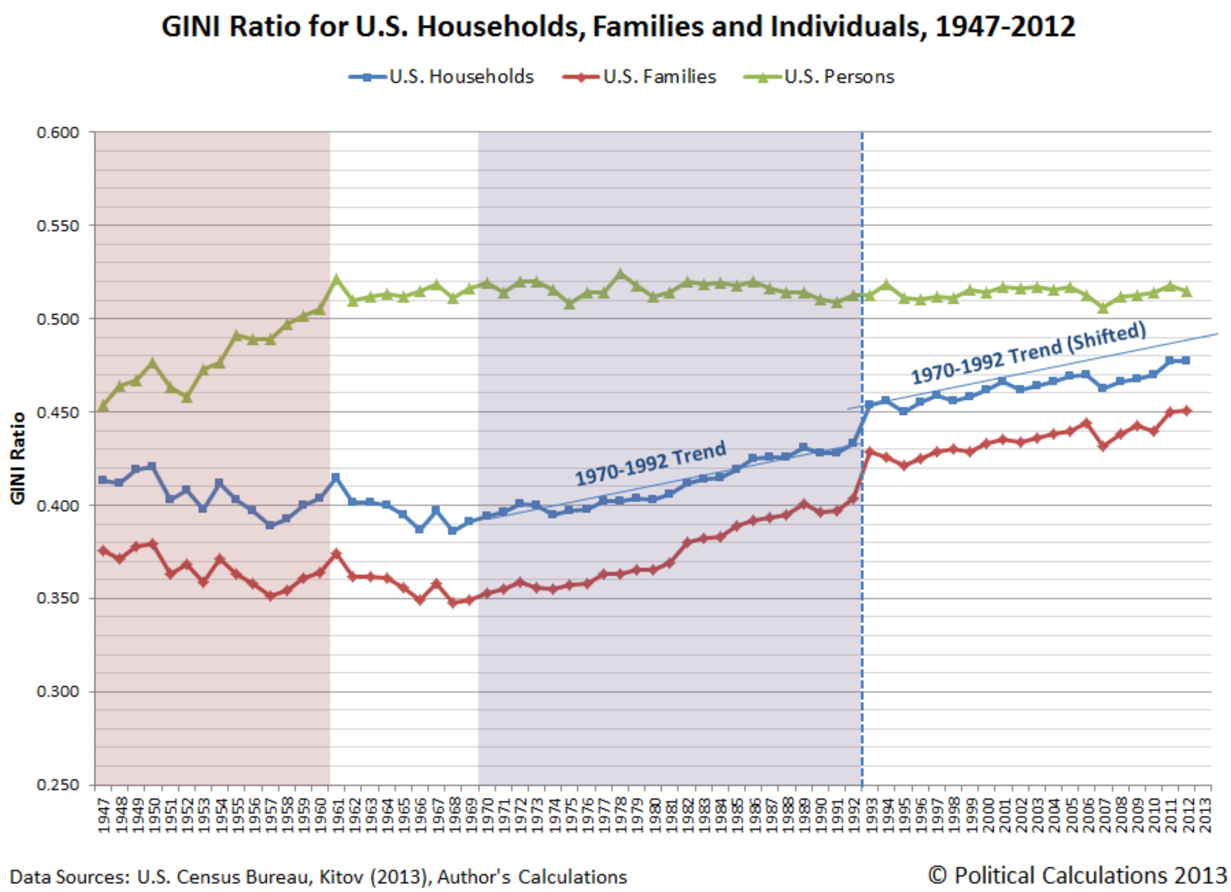
Figure 3: Reducing inequality: U.S. in comparison to OECD countries



As Figure 3 shows, of the 34 OECD countries, United States stands last in reducing the Gini coefficient, a measure of income inequality.

Comparing the Gini coefficient data for 67 years, from 1947 to 2013, Figure 4 sheds important light on the impact of Reagan era tax cut on the upward trend of Gini coefficient of U.S. families. In Figure 4, a trend analysis of the longitudinal data shows the distribution of the Gini coefficients for U.S. persons, U.S. households and U.S. families for the period 1947-2012. In the U.S., the largest group of tax payers are the households consisting of spouses and children even though taxes are paid by individuals and two-person families. An analysis of the Gini coefficient of U.S. households for the period 1970 to 1992 shows an upward trend of inequality with higher Gini coefficients. Notably, the later part of the period is known for the highest tax cut rate by President Reagan. This upward trend of Gini coefficient continued until the George H.W. Bush era but shifted during the Clinton era when taxes were raised proportionally more than tax cuts.

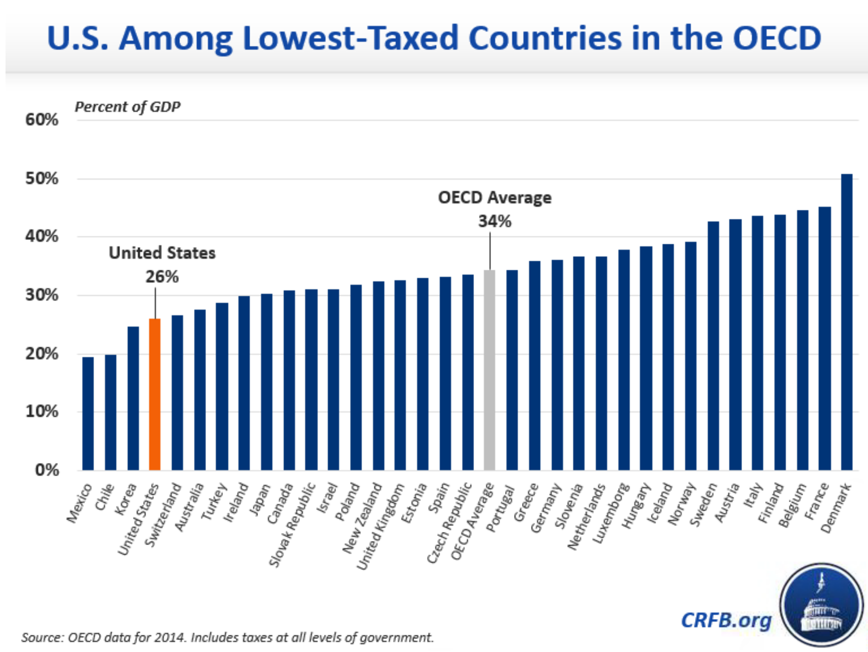
Figure 4: Upward shift of Gini Coefficient as a consequence of tax cut of the highest income group



6. Is there a need for Tax cut in the U.S.?

Americans like to complain about high taxes. However, as Figure 5 shows, when taxes at all levels of government are considered, United States ranks among the least four taxed countries of the group of 34 OECD countries. Figure 5 shows that the OECD average of taxes as per cent of GDP is 34 while that for the United States is 26.

Figure 5: Taxes as a per cent of GDP – OECD countries



7. Summary and Conclusions

Among the 34 OECD countries, United States ranks as the fourth lowest-taxed country in terms of taxes at all levels of government as per cent of GDP. During 1981 to 2017, all U.S. Presidents resorted to some form of tax cut with the stated objective of boosting economic growth. In this paper, we have analyzed tax cuts enacted by six modern U.S. Presidents from Reagan to Trump. Reagan is noted for the highest federal income tax rate cut and Trump is noted for the highest reduction of corporate income tax in U.S. history. We have also analyzed the federal tax rate increase of three Presidential regimes with reference to three two-term Presidents - Clinton, George W. Bush and Obama. Our analysis shows because government spending has a higher multiplier impact on aggregate demand than tax cut, the Clinton and Obama era tax increases are associated with higher rate of job creation than George W. Bush era tax cut. Our analysis shows that the biggest beneficiary of federal tax cut was the richest 20 per cent of income earners receiving 65 per cent of the tax cut while the poorest 20 per cent of the income earners received 3 per cent of the tax cut. While it is still early to evaluate the effect of the Tax Cuts and Jos Act 2017, the Congressional Budget Office projects an increase of public debt to the extent of $1.3 Trillion in 10 years because of the 40 per cent cut of corporate income tax. This may result in significant hike of interest rate in near future and crowding out of private investment as happened during Reagan era tax cut.

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