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Tax Reform Was No Giveaway to the Rich by Conventional Measures

When correctly analyzed, the 2017 tax reform is fair based on economics' standard fairness measures.

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Many view the 2017 Republican tax reform (Tax Cut and Jobs Act) as a giveaway to the rich. "The most regressive tax cut in the past 50 years," proclaimed one *Washington Post* blogger. "The most regressive tax policy change of our lifetimes," wrote a contributor to The Hill. A big tax cut for (primarily rich) stockholders, opined New York Times columnist Paul Krugman. The Tax Policy Center (Brookings/Urban Institute) claimed that the top 1 percent would receive 82.8% of the reform's total reduction in taxation. The Joint Committee on Taxation shows top-income households receiving much larger tax cuts than low-income households.

Unfortunately, as laid out in my recent ***Forbes*** article, which I reprise here, these economists, government agencies, D.C. think tanks and everyday critics are making five mistakes.

Mistake 1: Treating current year's income as a proxy for well-being.

This static, outmoded approach classifies households as rich or poor based on this year's income. But economics tells us that for purposes of studying fiscal fairness we should not classify households by what happens this minute, this week, this month or even this year. Instead, we should classify households based on all their remaining lifetime resources (the present value of future labor earnings plus their current net worth).

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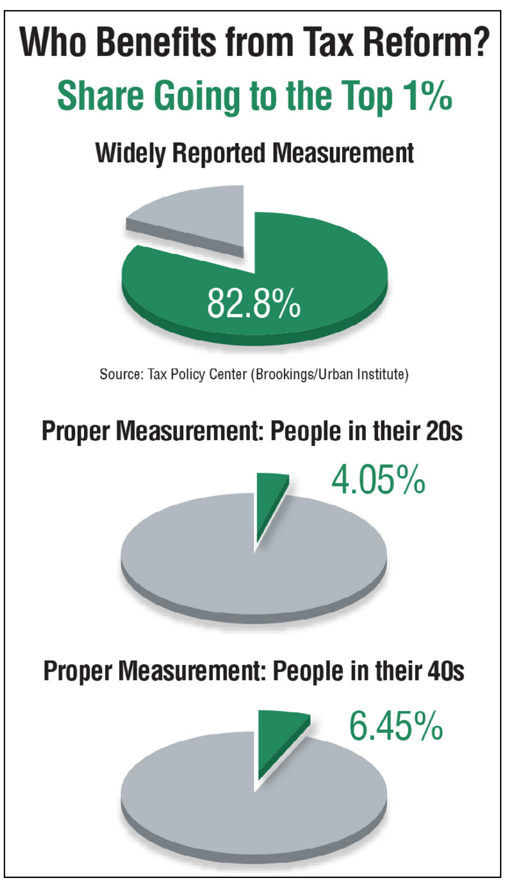
Mistake 1 means that Warren Buffett, whose wealth totals $85 billion, will be classified as poor if his after-tax income this year is zero or negative. That could easily happen if Buffett has capital losses that exceed his other income. You'd expect Mistake 1 to be made by people with limited economics training. But the folks in D.C. making this mistake are well-trained economists and are doing so consciously because they think that is what politicians are used to seeing.

Mistake 2: Using current income as a proxy for current spending.

Since the young save on average, their income exceeds their spending. Since the old dissave on the average, their spending exceeds their income. This means that using this year's disposable income as a proxy for spending will overstate inequality: it will overestimate the well-being of the young and underestimate the well-being of the old. The economists who do this are serving as the tailors in a modern version of the Emperor's New Clothes.

Mistake 3: Using this year's spending as a proxy for remaining lifetime spending.

If ignoring future spending made sense, we could study inequality by comparing the spending of different households over the next week or the next hour or even the next minute. But just as this minute's spending doesn't tell us much about this year's spending, this year's spending doesn't tell us much about remaining lifetime spending. Certainly, there is no fixed relationship between what happens this year and what happens over a lifetime. For the young, remaining lifetime spending is many times current-year spending. For the old, the multiple is far smaller.



Mistake 4: Failing to sort households by age.

Imagine a world in which everyone is absolutely identical, apart from their year of birth. Since everyone enjoys the same lifetime spending and pays the same lifetime taxes, there is no inequality. But if one compares young and old people at a point in time based on this year's income, things can look very unequal. The young, who work, will have far higher income than the old, who are retired. Moreover, if only wage income is taxed, this perfectly equitable fiscal policy would be mistakenly viewed as progressive since those with higher incomes would pay taxes and those with lower incomes would not. And if only spending by the old is taxed, the policy would be mistakenly declared regressive since those with lower incomes would pay taxes whereas those with higher incomes would not.

Mistake 5: Assuming tax cuts will not be permanent.

Because of arcane budget rules, Congress passed a tax reform bill in which many provisions (mainly those that affect individuals) will expire before the end of 10 years. No one in Washington believes this will happen, however. That's why FactCheck.org declared the claim that 82.8% of the tax cut goes to the top 1 percent "misleading" – noting that according to the Tax Policy Center's own numbers, that figure drops to 25.3% in 2025, the last year before the tax cuts begin to expire. It turns out that even this much lower number is far too high, however.

Doing the analysis correctly.

Economic theory tells us to

study inequality by comparing remaining lifetime spending among people of the same age. A person in an age group who will be able to spend substantially more over their lifetime is "richer" than a person in the same age group with less potential for lifetime spending. Economic theory also tells us to study how progressive a tax is by examining the degree to which fiscal policy reduces inequality in the remaining lifetime spending within the same-age cohort.

My recent study with U.C. Berkeley economist Alan Auerbach and Darryl Koehler, an engineer at my software company, does just this. It runs household observations from the Federal Reserve's 2016 Survey of Consumer Finances (SCF) through a detailed life-cycle consumption-smoothing program called The Fiscal Analyzer. This determines how much each household will spend, pay in taxes, and receive in government benefits in each year over the rest of their lives. These data can then be used to calculate remaining lifetime spending and remaining lifetime taxes net of benefits. The program incorporates all federal and state taxes, including corporate income taxation, and all federal and state benefits, including food stamps, Supplemental Security Income, Social Security, Medicaid, Medicare, welfare (TANF), etc. Our study assumes the tax cut is permanent, but we've also produced results assuming its temporary.

We find very little change in the distribution of remaining lifetime spending within each age group under tax reform. We also find that the top 1 percent, as a group, receives a disproportionately small share of the tax cut.

Results.

Take 40-year-olds. The richest 1 percent, the middle 20 percent and poorest 20 percent accounted for 12.9%, 14.1%, and 6.5% of total remaining lifetime spending under the old tax law. Under tax reform, the respective figures are 12.9%, 14.1% and 6.4%. Spending inequality is essentially unchanged. The rich, the middle class and the poor experience almost identical changes in their ability to consume.

What share of the tax cut do the richest 1 percent of 40-year-olds receive? Not 82.8%, but 9.7%. Meanwhile, the broad middle class (the three middle fifths of the distribution) receives 42.8% of the tax cut.

Moreover, the share of the tax paid by the top 1 percent in this cohort increases slightly. The 9.7% share of the tax cut is smaller than the 16.6% share of taxes paid by the richest 1 percent under the old tax law. Consequently, the tax share of the top 1 percent in this cohort rises to 16.9%. So, tax reform makes the distribution of income more progressive than it was before.

The 40-year-olds aren't special. We find a small rise or essentially no change in the tax share of the top 1 percent for all cohorts. (See Table I.) For 20-year-olds, the share of the tax cut realized by the top 1 percent is 7%, while the share going to the broad middle class is 52%.

TABLE 1

Share of Tax Reform Benefits Going to the Top 1 Percent by Age

(Assuming all tax cuts are made permanent)

20-29	6.90%
30-39	10.04%
40-49	9.70%
50-59	15.05%
60-69	21.84%
70-79	28.52%

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Table II shows how much of the tax cut is received by the top 1 percent assuming the individual tax cuts are allowed to expire. Contrary to the calculations of the Tax Policy Center, tax reform is even more progressive (the rich get less of the pie) if the tax cuts are not made permanent – when the analysis is done correctly. (As stated, however, the tax cuts are likely to remain permanent.)

TABLE II

Share of Tax Reform Benefits Going to the Top 1 Percent by Age

(Assuming individual tax cuts are allowed to expire)

20-29	4.05%
30-39	5.27%
40-49	6.45%
50-59	14.67%
60-69	20.17%
70-79	28.07%

Why is the tax reform much fairer than many believe? First, the benefit for the wealthy from a lower corporate tax rate is far smaller than generally perceived. Second many of the personal income-tax provisions are quite progressive. But, third, measuring fiscal fairness the right way matters.

All the above said, the roughly identical percentage tax cut for the rich and the poor also means a dramatically larger absolute remaining lifetime tax cut for the rich than for the poor. The reason is that the rich pay far more taxes than the poor. Hence, for those who focus on absolute tax cuts, the 2017 tax reform represents a massive give away to the rich. But based on standard economic measures of inequality and tax progressivity, that's not the case.

Dynamic Effects.

In a different study, my colleagues and I estimate that tax reform will lead to a large inflow of capital – as investment in the U.S. economy becomes more attractive relative to other nations. For an average-age, average-income household, the lifetime gains are about $60,000 to $70,000. Of this amount, approximately one-third is due to the direct impact of the tax cut and two-thirds is due to economic expansion.

However, the distribution analysis reported here is largely unaffected by the dynamic enlargement of the economy. That is, the distribution of the benefits across all income groups is virtually the same, whether or not a potentially larger economy emerges as a result.

Bottom Line.

The 2017 tax reform Congress passed last December is not as good as the 2016 Better Way Tax Plan proposed by House Speaker Paul Ryan and Ways and Means Chairman Kevin Brady. And the Better Way Plan was far worse than tax reforms that Alan Auerbach and I have separately espoused. But the tax reform has the potential to raise investment, output and wages. And, when correctly analyzed, it's fair based on economics' standard fairness measures. The reform leaves the distribution of spending between the rich and poor essentially unchanged. It leaves the progressivity in average net tax rates essentially unchanged. And the rich do not receive a larger share of the tax cut than their pre-reform share of taxes. This is true whether the reform is permanent or temporary. Ignoring the fallout from the emerging trade war and other negative economic shocks, the reform will, over time, likely raise domestic investment, real wages and GDP.