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When Politicians Start Talking 'Tax Reform,' Check Your Wallet

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If Congress ever actually gets around to pursuing tax reform -- a big "if" given the current lay of the land in Washington -- voters should expect to hear lots of talk about the benefits that would derive from an overhaul of the nation's barnacle-encrusted tax code. Specifically, they will hear about the glorious results of tax cuts -- more money in their pockets, higher paychecks, increased economic growth, *et cetera*.

One thing they likely won't hear much about, unless they listen extremely closely, is how Americans will pay for those tax cuts and what the tradeoffs inherent in any decision to reduce government revenue really are. Will the revenue be replaced by an alternative source? Will spending simply be cut in recognition of

lower tax revenue? Or will the country continue borrowing money to maintain government expenditures at existing levels?

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Whatever the answers to these questions are, another question looms over all of them: Who pays? Because at the end of the day, either through new taxes or reduced services, somebody comes away from a tax cut as the loser, either through higher tax liability or a lower level of public services.

A new analysis by the Tax Policy Center, written by William G. Gale, Surachai Khitatrakun, and Aaron Krupkin, tries to get at this question by examining the outlines of a proposal for tax reform that the Trump administration released in April.

"Politicians love to talk about tax cuts, in part because it seems that almost everyone is made better off," the authors write. "Standard presentations of distributional analyses of tax cuts also typically show that all or most people would be better off with a tax cut. Such discussions and presentations are fundamentally misleading, however, because tax cuts must ultimately be financed. Over the long run, tax cuts must be offset by increases in other taxes, reduced spending, or both."

In the paper, Gale, Khitatrakun, and Krupkin take as their starting point the rough outlines of a tax plan put forward by the Trump administration last Spring.

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On the personal side, it includes a wide array of tax breaks including, but not limited to, elimination of the net investment income tax; elimination of the individual alternative minimum tax; a doubling of the standard deduction, and elimination of the estate tax. On the business side, it contemplates, again among other things, the reduction of the corporate tax rate and the small-business pass-through rate to 15 percent, the elimination of the corporate income tax, and the implementation of a territorial tax system that would eliminate US corporations' tax liability on money earned overseas.

Possible revenue-raisers in the Trump plan include a one-time tax on foreign earnings held abroad; elimination of some tax expenditures that benefit businesses and high-income individuals, elimination of most itemized deductions. The authors also consider other possible "pay-fors" not specifically mentioned in the administration's April proposal, but which have been floated as possible additions, including repeal of head of household filing status, elimination of personal exemptions, taxation of some capital gains at death.

The revenue-raisers articulated by the administration "do not come close to paying for the whole tax cut" they find. And so, they examined three broad scenarios for financing them, and assessed what's known as the "distributional impact." Or, more colloquially, they answered that overarching question from before: Who pays?

The Tax Policy Center researchers considered three different funding scenarios, in which the burden of paying for the proposed tax cuts is distributed across the populations of US taxpayers.

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The first assumes that the cost of the tax cuts is distributed evenly across all tax-paying households. "Something approximating this scenario would be the case if there were a combination of cuts in transfers (which would affect mainly low-income and to some extent middle-income households) coupled with an income tax increase (which would mainly affect high-income households and to some extent middle-income households)." The second assumes that the costs are distributed across all tax-paying households, with each paying the same percentage of income.

In both cases, they found that after netting out the benefits of the proposed tax cuts and the offsetting increases needed to pay for them, the "the vast majority of households, especially low- and middle-income households, would be worse off (i.e., would have lower after-tax income) under the proposals consistent with the Trump Administration's outline than under the status quo."

Households in the lowest 20 percent of the income distribution would lose $2,250 under the first option and $320 under the second. Households in the middle of the income distribution would lose an average $1,450 under the first approach and $910 under the second. The very wealthiest Americans, by contrast, would see their tax bills reduced by hundreds of thousands of dollars per year.

"Overall, 84 percent of households would experience a net tax increase under equal per-household financing, while 82 percent of households would experience a net tax increase under proportional-to-income financing," they found.

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While the first two options are, admittedly, so contrary to the idea of a progressive tax system that they would probably face massive resistance in Congress, the third option they examined is somewhat less so. It would finance the Trump plan with payments scaled to taxable income. Each household would face the same percentage increase in its tax liability, with the effect being something similar to uniform across the board increase to all marginal tax rates.

This final method would reduce the percentage of households facing net tax increases to about 36 percent. But like the others, it would concentrate benefits at the top of the income scale.

Given the sketchy nature of the Trump administration's proposals, the paper was not intended to be a precise analysis of specific proposals but rather an illustration of the need to speak honestly about tax reform's inherent trade-offs.

"While it would be nice if tax cuts could be designed to benefit everyone, accounting for the costs of financing inevitably produces winners and losers," the authors write. "Moreover, the choice of financing mechanism matters quite a bit. These results emphasize that there are no free lunches in tax reform."