Washington Center for Equitable Growth

U.S. Inequality and Recent Tax Changes

Greg Leiserson
Society of Government Economists
February 20, 2018

- What effects will TCJA have on economic inequality?

- Two versions of the question for this presentation:

    - What effects will TCJA have on the distribution of economic well-being (welfare)?
        - Central question for economic analysis of policy changes: what impact does the policy change have on economic well-being
    - What effects will TCJA have on the distribution of income?
        - Closely related but distinct question, can be misleading about welfare impacts of supply-side effects of policy changes

- Difference between the welfare impact and the impact on observed incomes
    - Consider an expansion of the Earned Income Tax Credit
        - Direct reduction in after-tax income inequality from larger credit
        - Indirect reduction in after-tax income inequality from increase in labor force participation
    - But the increase in labor force participation comes at a cost to the worker (e.g. child care costs, commuting costs, etc.)
- Preview of results
    - TCJA will likely increase disparities in economic well-being, after-tax income, and pre-tax income – even without assuming fiscal offsets
    - Only suggestive results for market income in this presentation, but expect inequality in market incomes would increase as well

- Distribution tables provide a first-order approximation to the change in welfare

- Change in welfare determined primarily by changes outside the agent's control: *mechanical change in tax* and *changes in relative prices*

    - Behavioral changes have no first-order impact on the well-being of the person changing behavior (envelope theorem)
    - Recipe for constructing distribution tables that are informative about welfare:
        - compute change in tax liabilities and relative price effects (i.e. incidence assumptions)
        - exclude behavioral changes reflecting unconstrained, rational choice
        - include other behavioral changes (easier said than done, esp. when there are quantitatively important market failures)

- Converting dollar change in after-tax income into utility requires an assumption about the marginal utility of income (e.g. 1/after-tax income)

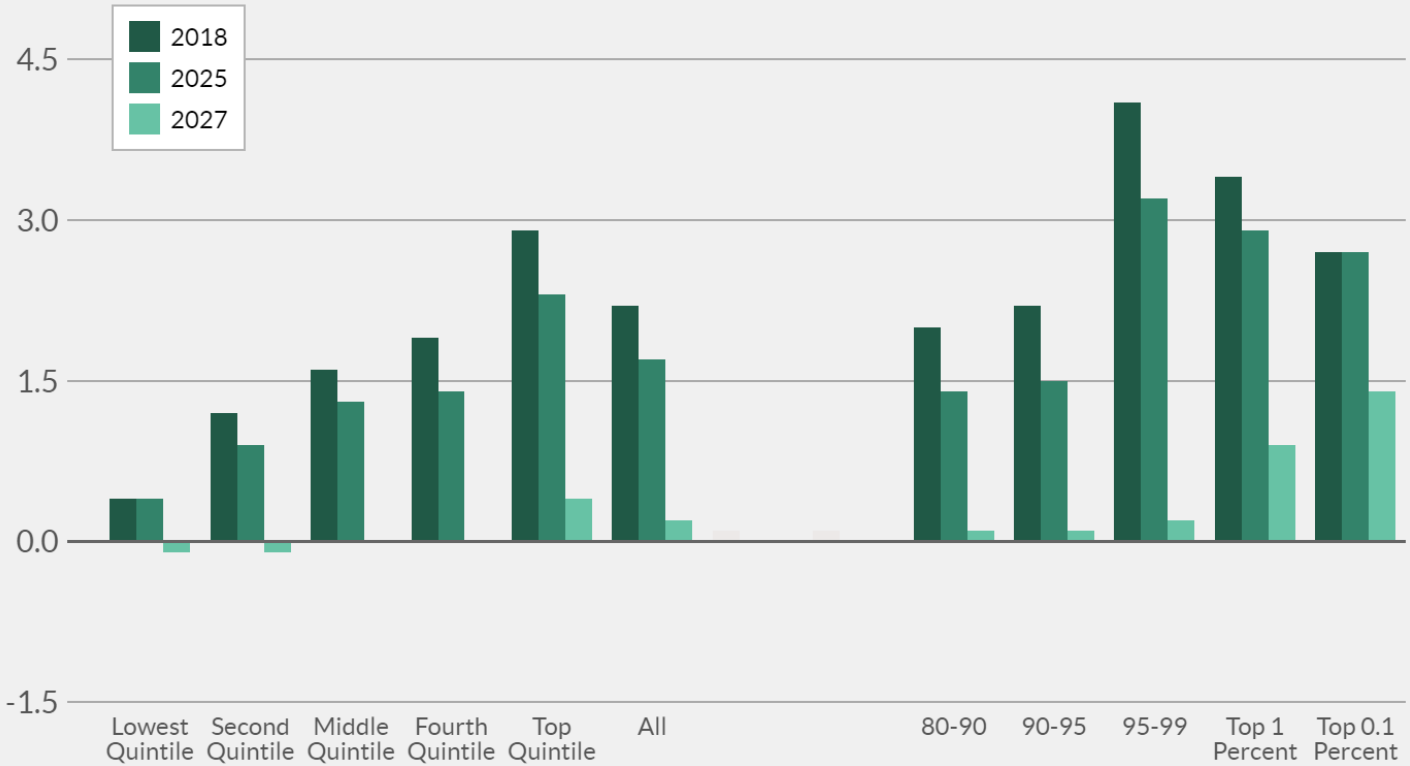
    - Conceptual difference between individual or family's marginal utility and social welfare weights used to evaluate redistributive policies

- Policymakers' desire for distribution tables may not reflect an ex ante desire for information about welfare impacts, but plausible that the desire for tables excluding behavioral changes/sample families is an implicit recognition that those changes are different

- Key observations for thinking about welfare impacts of taxation in policy context
  - Changes in macroeconomic aggregates (aka growth) have no first-order impacts on welfare in basic models
  - Potential efficiency gains primarily manifest in relaxation of the government budget constraint – impact on the public depends on legislated use
  - Excess burden is largely irrelevant as a practical matter in assessing the welfare impact (distribution tables do not impose a balanced budget constraint)
  - Distribution tables for deficit-increasing tax reform overstate the sustainable welfare gains
- Numerous difficult practical and conceptual questions when extending beyond basic models
  - Interaction of market failures and tax incidence
  - Timing of incidence for tax changes affecting investment incentives
  - Substance and timing of economics effects of higher deficits
  - Role and importance of gimmicks and sunsets
  - Political economy of future policy changes

TCJA Increases Welfare the Most for High-Income Families

Percent change in after-tax income (static), 2018, 2025, 2027



Source: Tax Policy Center.

Note: Excludes effects of repealing the individual mandate.

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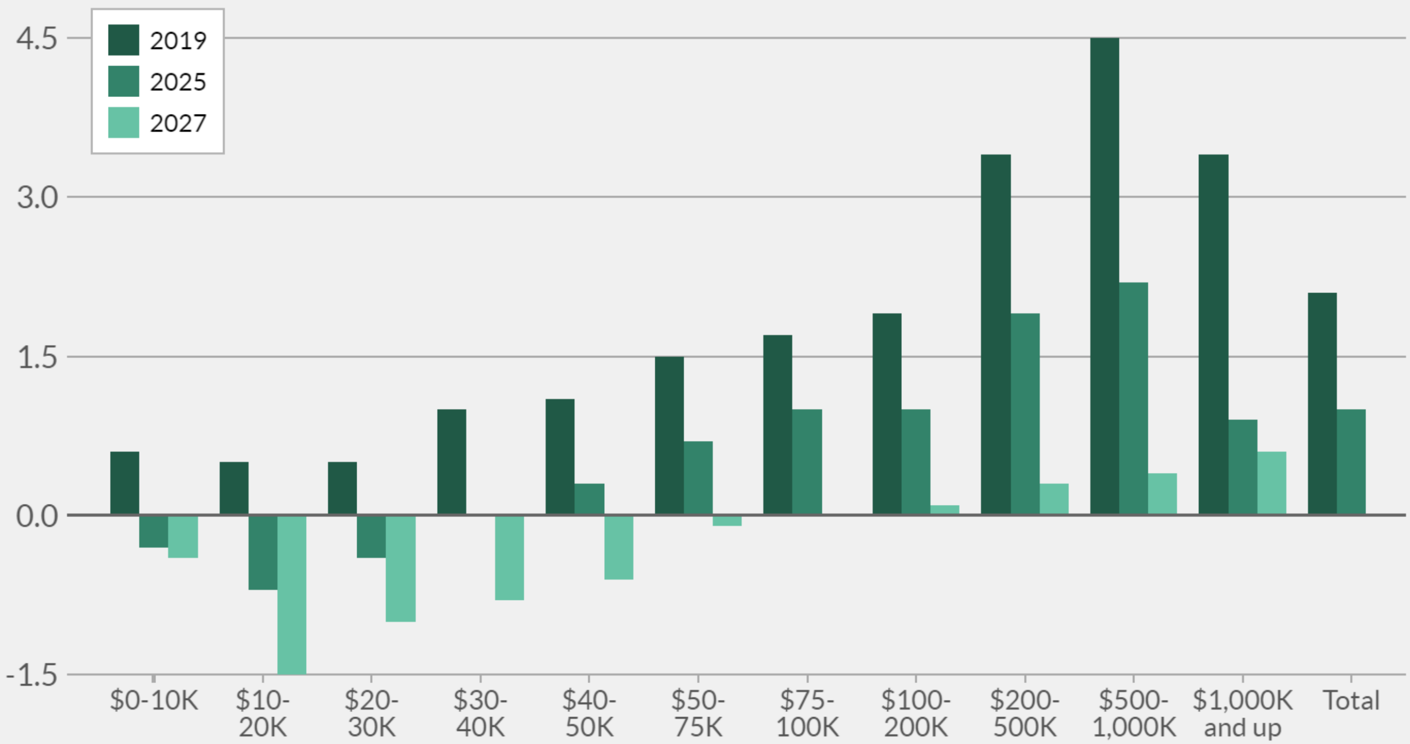
- TPC analysis excludes the impact of repeal of the individual mandate – should it?
  - General points:
    - Include effects of price changes
    - Include effects of behavioral changes if not solely a result of rational, unconstrained choice
    - These effects will not necessarily equal the change in tax liability or outlays received – implementation can be complicated
    - Luxury of tax analysis that many impacts are already measured in dollars
  - Takeaways for TCJA:
    - Should be including some value for welfare change of mandate repeal
    - Show CBO and JCT analyses as illustrative, but is only a proxy for a direct measure of welfare impact (what should be included)

TCJA Likely Reduces Welfare for Low-Income Families

Percent change in after-tax income (conventional ex. Medicaid/CSRs), 2019, 2025, 2027



Source: Joint Committee on Taxation.

Note: Excludes changes in the estate tax and Medicaid/CSR effects of repealing the individual mandate.

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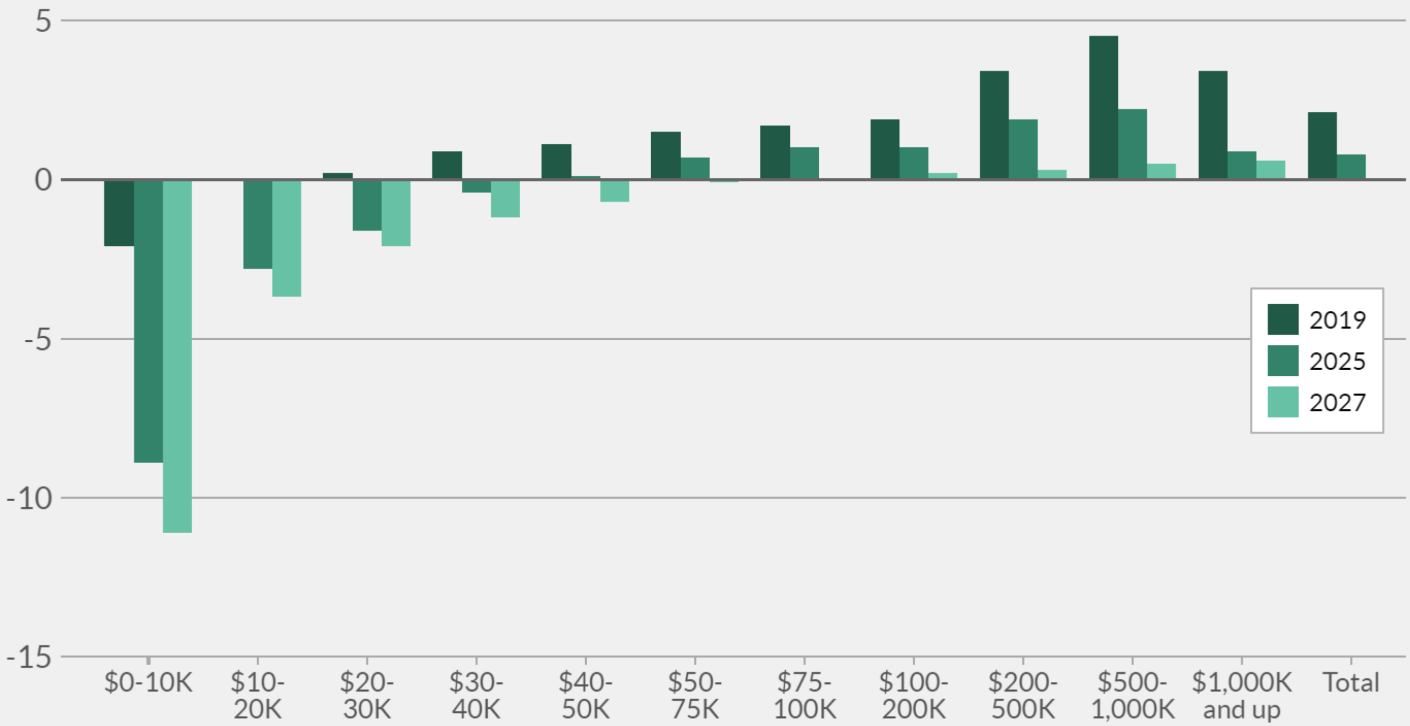
TCJA Likely Reduces Welfare for Low-Income Families

Percent change in after-tax income (conventional), 2019, 2025, 2027



Source: Joint Committee on Taxation and Congressional Budget Office.

Note: Excludes changes in the estate tax.

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- Key sources of uncertainty
  - Assumptions about static tax incidence, particularly relative price effects
    - Shifting of business tax changes to labor
    - Shifting of labor tax changes to business/capital
    - Timing of incidence effects
  - Assumptions about foreign investors in U.S. businesses
  - Assumptions about the economics of the individual mandate
  - Implicit assumptions (among many)
    - Ignore market clearing, implicit role for international trade
    - Fixed final prices for all goods and services

- Welfare impacts of TCJA
  - Increases welfare by more for higher income families than it does for lower income families
  - Reduces welfare for low-income families in the long run (i.e. after individual and estate provisions expire)
  - Likely reduces welfare for low-income families in the short run but quantification is difficult and depends on valuation of Medicaid and other sources of insurance coverage
- General observations
  - Progressivity often defined in terms of the percent change in after-tax income, but note that it requires providing larger tax cuts to high-income families *because* they receive little value from each additional dollar
  - This measure requires careful interpretation in the context of deficit-increasing and deficit-reducing tax changes – specific instance of general challenge of analyzing deficit-increasing and deficit-reducing policies

- Observed Inequality Impacts
  - Distribution tables provide an approximation to the welfare impact of a proposal by excluding certain behavioral responses, but the observed income distribution includes these behavioral responses
  - Impact of a proposal on the observed income distribution is thus a conceptually distinct question
  - Construct estimates of a proposal's impact on the income distribution by combining static distribution estimates and estimates of the behavioral responses
    - Add both the microeconomic response included in conventional revenue estimates and macroeconomic responses excluded from conventional estimates
    - NB: most/all distribution estimates include some microeconomic response (e.g. changes in itemization behavior), some include more types of response
    - In this presentation assume microeconomic behavior other than behavior associated with mandate repeal has no impact on distribution

- A macroeconomic model generally will imply an estimate of the impact of a proposal on the income distribution, but a macroeconomic model is not necessarily the best approach to evaluating these questions

    - Macroeconomic model priority: marginal incentives and equilibrium quantities
    - Distribution model priority: computing tax liabilities and relative prices
    - Tradeoffs may suggest using different models

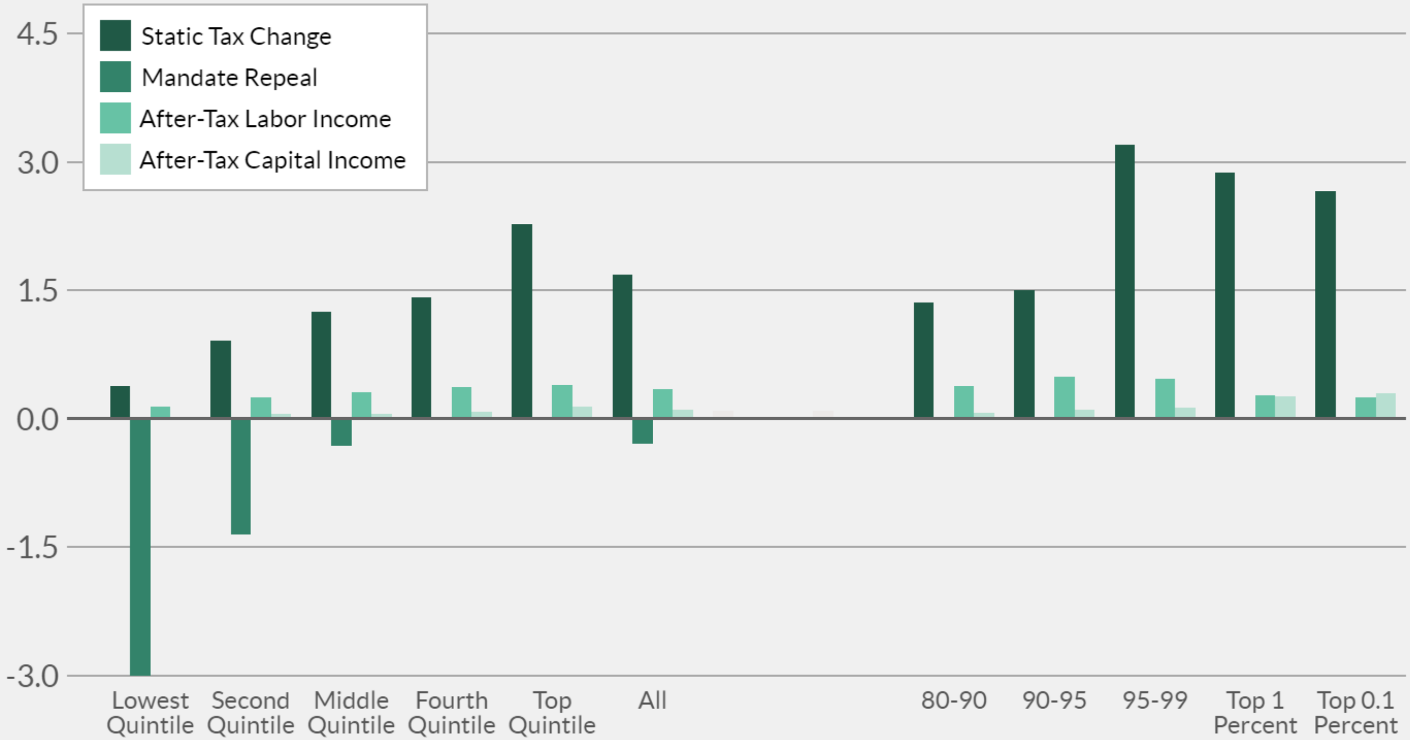
- In this presentation: ignore any inconsistencies between macroeconomic analysis and distribution analysis (other work in progress on that topic)

- In this presentation, results for 2025 based on Tax Policy Center estimates

    - 2018 includes initial transitory effects on revenues
    - 2027 is after individual tax cuts expire
    - Likely shows legislation in a more favorable light as judged by effects on inequality

TCJA Increases Disparities in Observed After-Tax Incomes

Percent change in observed after-tax income by channel, 2025



Source: Tax Policy Center, Joint Committee on Taxation, Congressional Budget Office, author's calculations.

- Static tax change (primary driver of total change): regressive

- Impact of repealing individual mandate (major driver for low incomes): regressive

  - No longer motivated by a welfare concept, concerned about distribution of observed incomes. Conventional effect of repealing individual mandate should be included.

- Change in labor incomes: regressive

  - Relatively less labor income in upper and lower tails
  - Percent change in net-of-tax rate increases with income

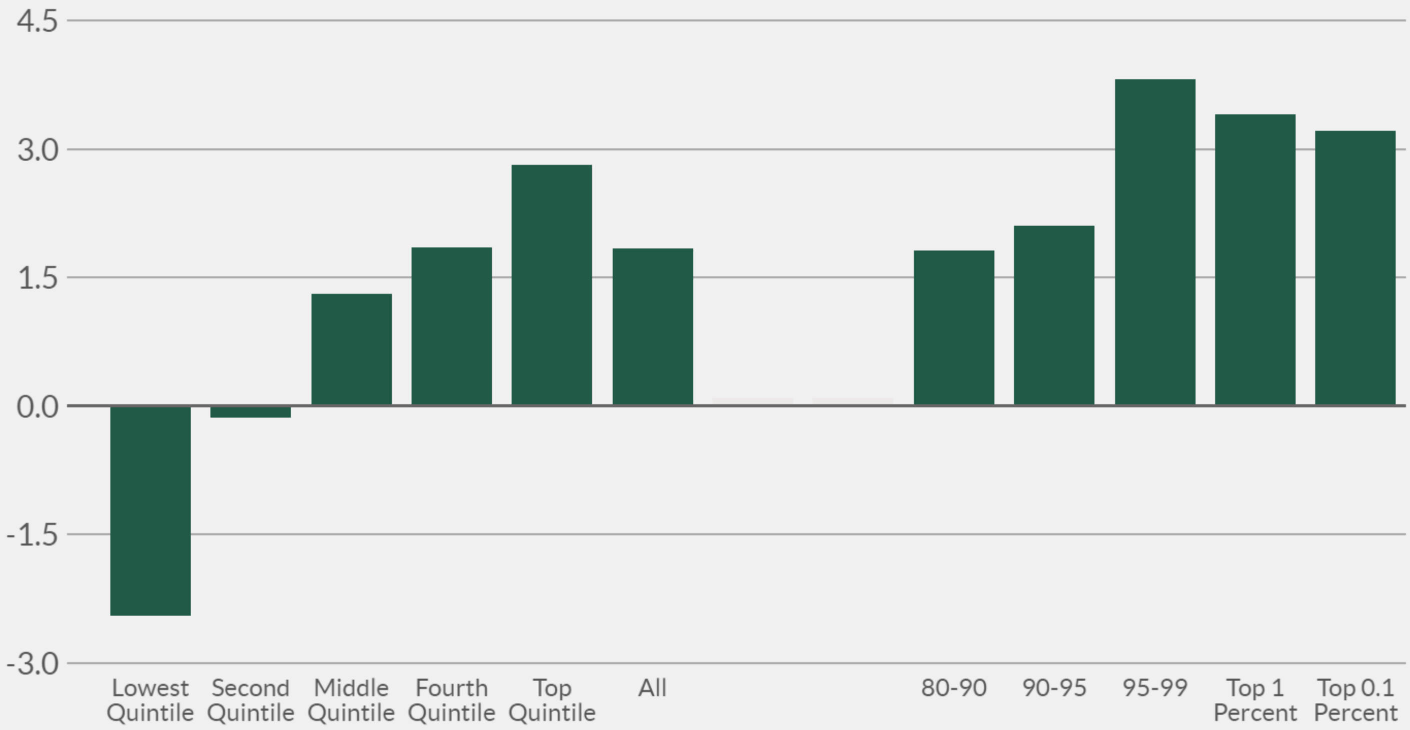
- Change in capital incomes: regressive

  - Capital income concentrated in the upper tails

- Will discuss the (many) sources of uncertainty in a few slides

TCJA Increases Disparities in Observed After-Tax Income

Percent change in observed after-tax income, 2025



Source: Tax Policy Center, Joint Committee on Taxation, Congressional Budget Office, author's calculations.

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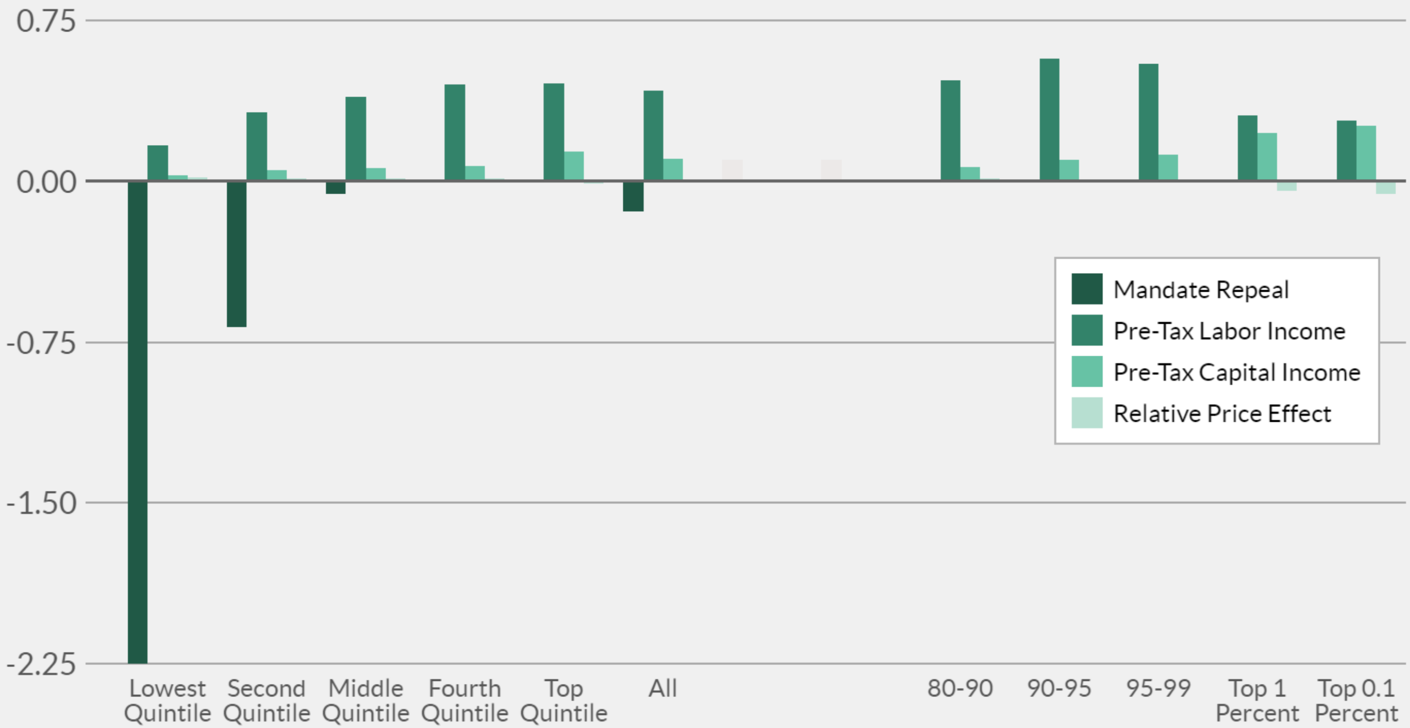
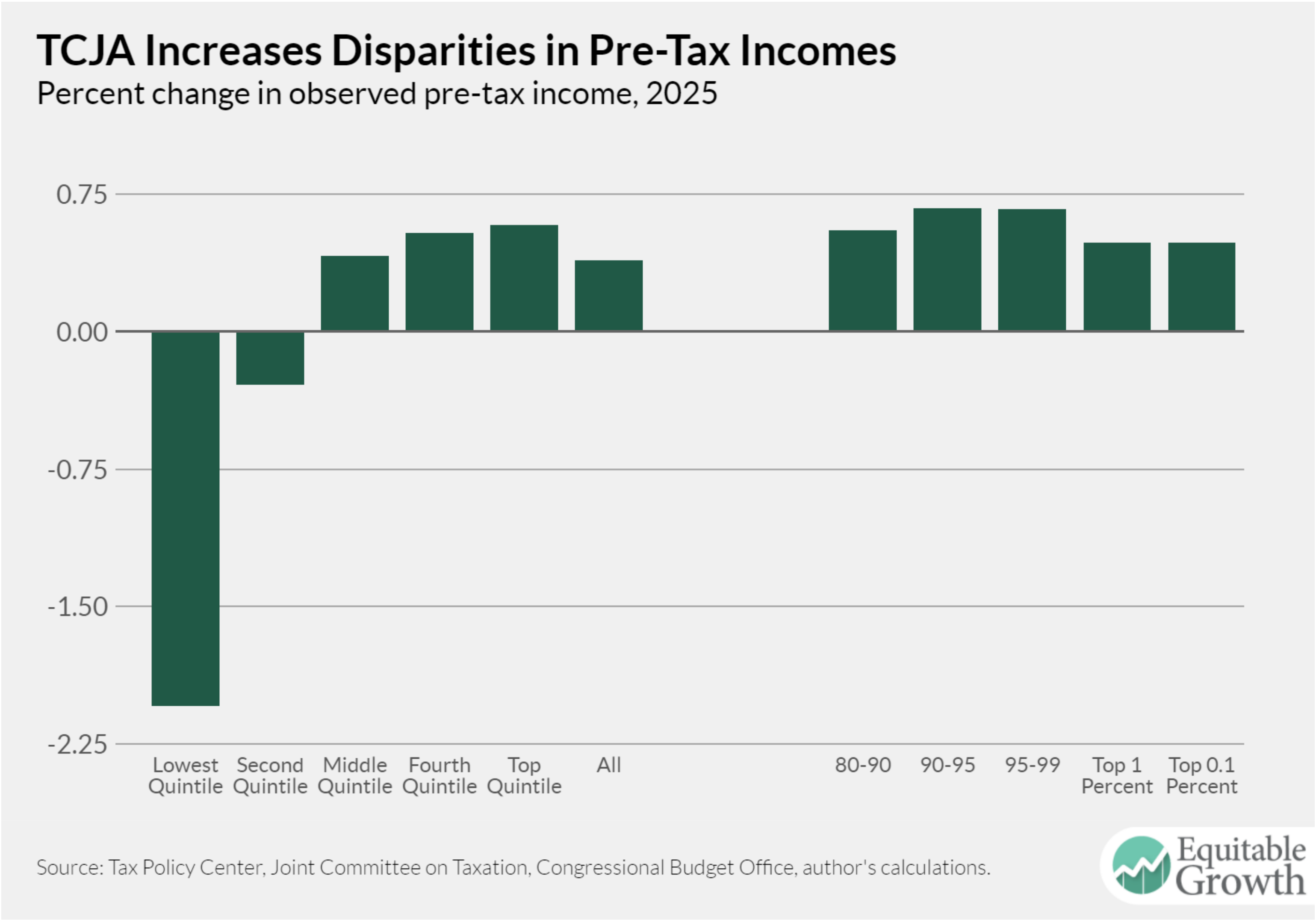
TCJA Increases Disparities in Pre-Tax Incomes

Percent change in observed pre-tax income by channel



Source: Tax Policy Center, Joint Committee on Taxation, Congressional Budget Office, author's calculations.

- Static tax change is “gone” (but see below)
- Includes only the Medicaid/CSR effects of repealing the individual mandate
- After-tax labor income is now pre-tax labor income (slightly more regressive)
- After-tax capital income is now pre-tax capital income (slightly more regressive)
- Relative price effect – the portion of the static tax change other than the mechanical change in tax liability (progressive)


TCJA Increases Disparities in Pre-Tax Incomes
Percent change in observed pre-tax income, 2025
0.75
0.00
-0.75
-1.50
-2.25
Lowest Quintile
Second Quintile
Middle Quintile
Fourth Quintile
Top Quintile
All
80-90
90-95
95-99
Top 1 Percent
Top 0.1 Percent
Source: Tax Policy Center, Joint Committee on Taxation, Congressional Budget Office, author's calculations.
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- Mandate repeal's Medicaid and CSR effects drive the result (regressive)
- Changes in labor income are second largest driver of result (regressive)
  - Labor share of aggregate income is larger than (net) capital share
- Overall impact of TCJA is regressive, though as before there is some tailing off in the upper tail
- Factor income shares would differ from pre-tax shares, particularly at the bottom, where transfer income is a substantial portion of total income
- Assumptions are strong to convert from TPC's expanded cash income to factor so no results in this presentation (but see next slide for one suggestive result)

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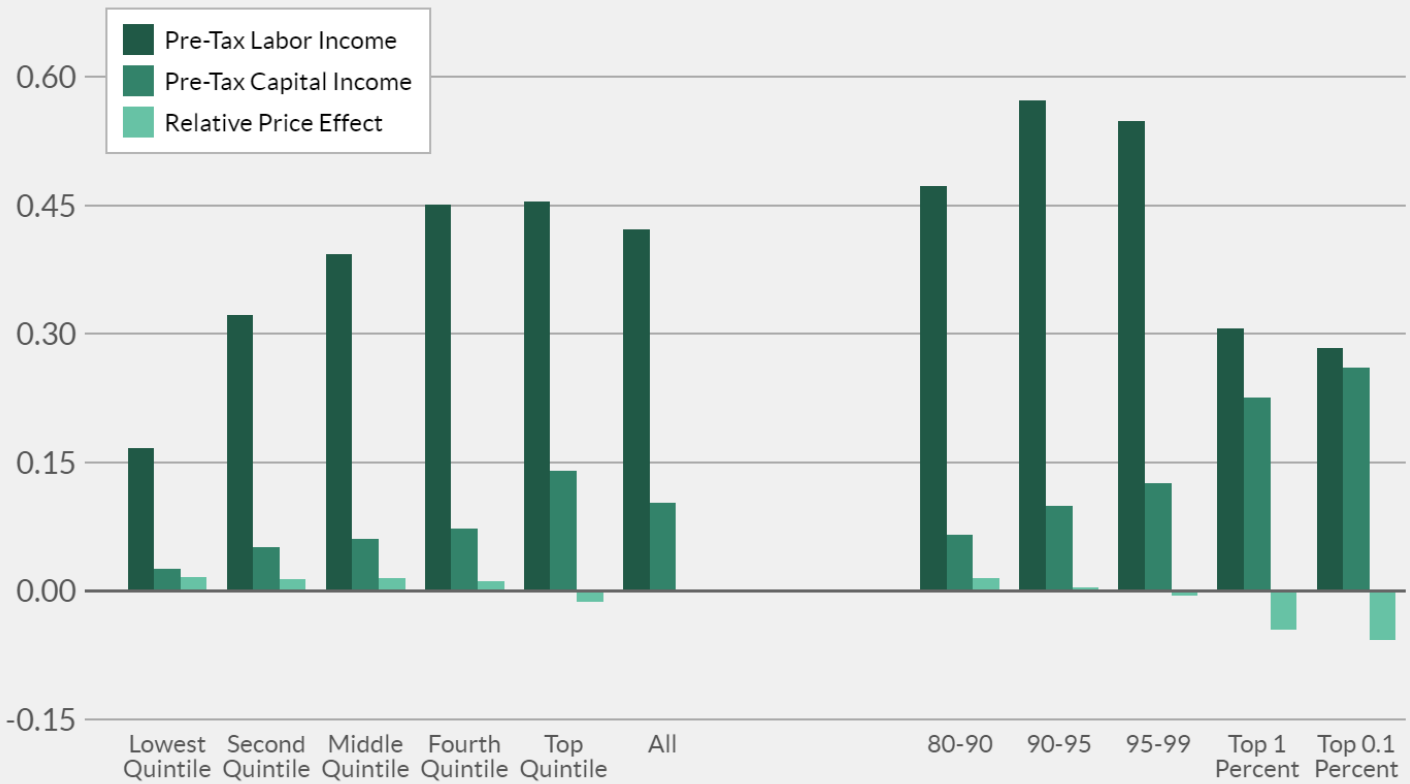
TCJA Likely Increases Inequality in Factor Incomes

Percent change in observed pre-tax income by channel



Source: Tax Policy Center, Joint Committee on Taxation, Congressional Budget Office, author's calculations.

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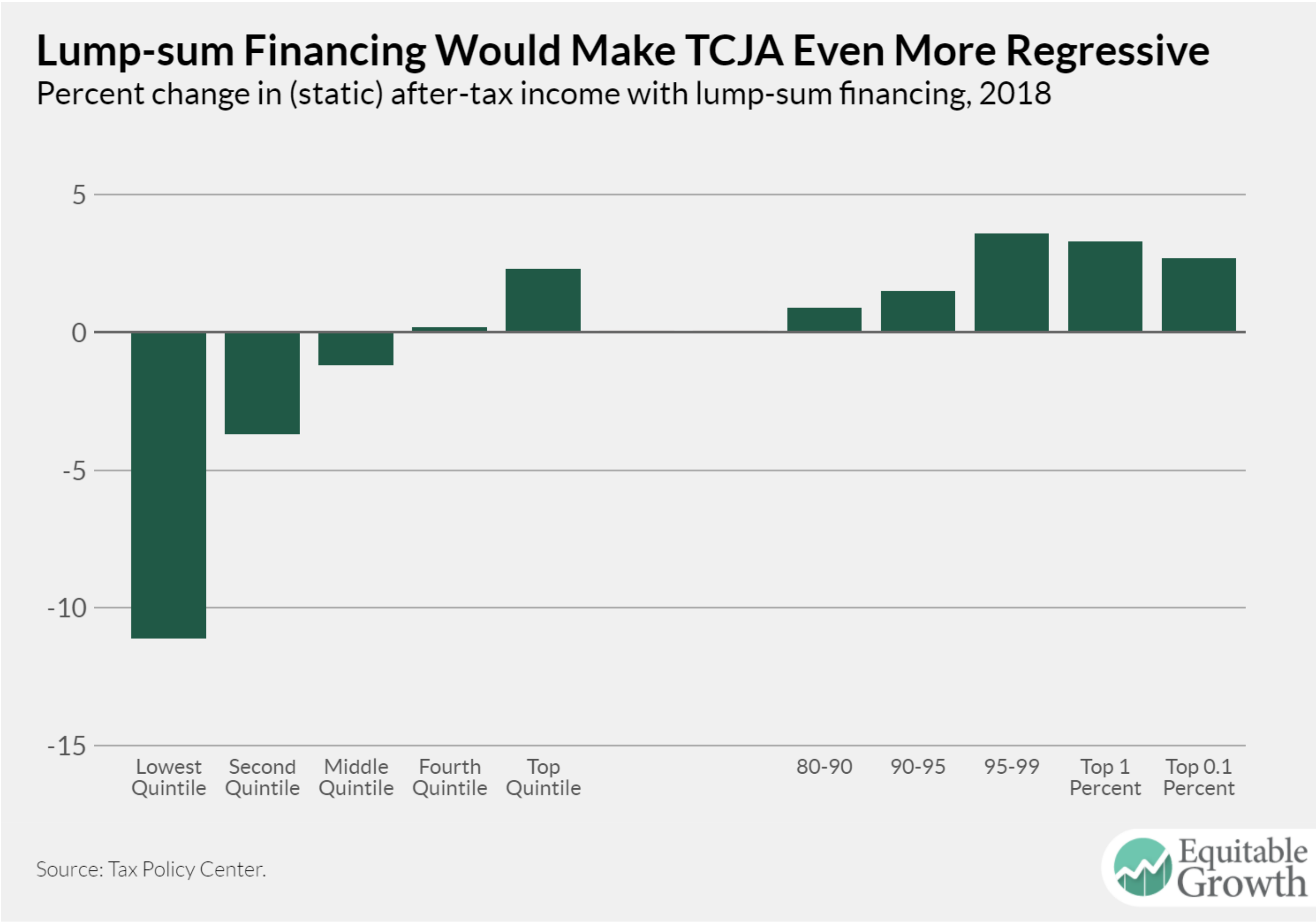
- Key sources of uncertainty
  - The sources of uncertainty in the welfare results
  - Assumptions about microeconomic behavioral responses on the distribution of income (here: zero except for health-related)
  - Assumptions about macroeconomic behavioral responses on output and income
  - Assumptions about macroeconomic behavioral responses on the distribution of income (here: proportional to current incomes adjusted for changes in tax rates)
    - Key role of reduction in pre-tax capital incomes
    - Is this reduction proportional to capital incomes in the baseline? Is the capital income of the very wealthy the same?
    - Assumptions about foreign investors
  - Assumptions about difference between NIPA income concepts and realization-based income concepts (here: half of net capital income change appears in ECI)
  - TPC estimates are ranked by pre-tax incomes (distribution of after-tax incomes ranked by after-tax incomes would differ)

- Recognizing a Role for Deficits
  - Estimates above ignore the deficits created by TCJA
  - Sufficiently large permanent deficits require offsetting fiscal adjustments in the future
    - Fiscal adjustments will also affect welfare and inequality
    - Size of adjustment is where growth/revenue feedback/excess burden matter
    - Assuming lump-sum offsets means you can assume a smaller fiscal adjustment for a deficit-financed tax cut


Lump-sum Financing Would Make TCJA Even More Regressive
Percent change in (static) after-tax income with lump-sum financing, 2018
5
0
-5
-10
-15
Lowest Quintile
Second Quintile
Middle Quintile
Fourth Quintile
Top Quintile
80-90
90-95
95-99
Top 1 Percent
Top 0.1 Percent
Source: Tax Policy Center.
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- Financing with proportional spending cuts would make TCJA even more regressive and make bottom 60% of the population worse off on average, even in the short run

- Progressive raisers required to undo TCJA's effects on inequality, e.g.

  - Higher statutory corporate rate
  - Tighter limits on interest deductibility (or deny deduction for net interest)
  - Strengthen minimum tax provisions
  - Reform investor-level taxation, e.g. mark-to-market, wealth taxation/taxation of imputed returns, deferral charges
  - Progressive increases in individual tax rates

- Concluding Thoughts
  - TCJA likely to increase disparities in economic well-being and incomes
  - Distribution tables provide a first-order approximation to the change in welfare
  - Growth does not have a first-order impact on welfare (already ignoring deficits)
    - Incorporating deficits directly (and thus incorporating benefits of growth) reduces the apparent benefits of a deficit-increasing proposal
    - Increases in total factor productivity are very different from increases in the use of inputs
  - Growth and other behavioral changes do have a first-order impact on the distribution of observed incomes – distinct question from welfare impact of proposals
  - Possible to design proposals that combine static tax cut and zero deficit impact: growth does not affect welfare, but it can *finance* policy changes that deliver a welfare gain
    - Gains will tend to be smaller than the apparent gains offered by deficit-increasing proposals
    - Proposals require tax offsets that are more efficient than the taxes that are cut
  - Policies intended to generate progressive increases in welfare and shared growth would look quite different from TCJA