

# Tax Reform

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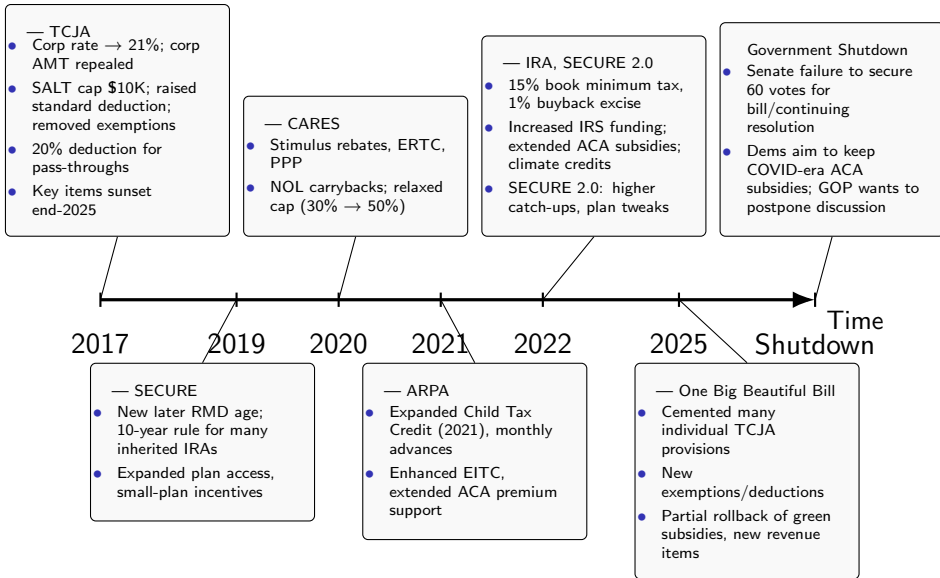
Vassar College

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<sup>1</sup>With editing and conceptual assistance from ChatGPT and Cursor.

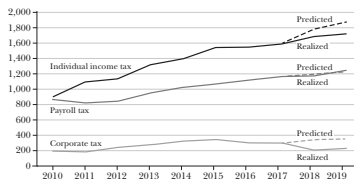
# Recent U.S. Tax Policy Timeline



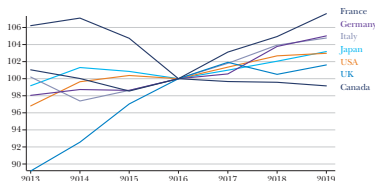
## 2017 tax reform

- ▶ Corporate tax changes (revenue loss):
  - ▶ reduction in corporate tax rate (from 35% to somewhere close to 20%?) and removed AMT for corporations
  - ▶ treatment of foreign income (going from “worldwide” to “territorial” system to measure domestic taxable income)
  - ▶ changes in tax treatment of investments (endowment tax on tax-exempt universities)
- ▶ Individual income tax changes (revenue loss)
  - ▶ elimination of most deductions and many other tax preferences
  - ▶ somewhat offset by raising standard deduction, rate changes
- ▶ Preferential income tax treatment for some business owners (revenue loss, massive avoidance opportunities)
- ▶ Repeal of individual mandate for health insurance coverage (weirdly, a revenue raiser by reducing fringe benefit)
- ▶ Many smaller changes
- ▶ COVID makes it harder than usual to identify effects of TCJA

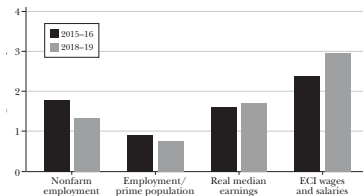
# Hard to assess effects of TCJA



(a) Tax Revenues



(b) Investment as a Share of GDP



(c) Labor Market Changes

**Figure:** Tax revenues down and investment not standout, but time series evidence of short run labor market improvements *Source: Gale et al. JEP (2024)*

# Inflation Reduction Act (2022)

- ▶ Corporate and business taxes (revenue raisers):
  - ▶ 15% **minimum tax** on book income for large corporations
  - ▶ 1% **excise tax on stock buybacks** (a modest curb on 2017-style avoidance)
  - ▶ Increased IRS enforcement funding by \$80B over 10 years to close tax gap
- ▶ Climate and energy:
  - ▶ Massive clean-energy subsidies and credits for EVs, renewables, manufacturing
  - ▶ “Green industrial policy”—linking subsidies to domestic content and wages
- ▶ Health care:
  - ▶ Medicare empowered to negotiate drug prices (phased in)
  - ▶ Extended COVID-era ACA premium subsidies
- ▶ Fiscal trajectory:
  - ▶ Unlike TCJA, overall CBO estimated *deficit reduction* of \$238B over 10 years
  - ▶ Signaled turn toward industrial policy + revenue discipline

# One Big Beautiful Bill Act (2025)

- ▶ Individual provisions: (Revenue loss)
  - ▶ Extends TCJA rate cuts, standard and pass-through deductions
  - ▶ Raises SALT cap to \$40K
  - ▶ Exempts tips and overtime pay for some workers
  - ▶ Deductions for seniors and auto loan interest on US-made cars
- ▶ Business provisions: (Revenue loss)
  - ▶ Restores 100% expensing and stronger R&D write-offs
  - ▶ Rolls back IRA green-energy credits
- ▶ Spending changes: (Net spending decrease)
  - ▶ Immigration enforcement/border security
  - ▶ Military spending
  - ▶ Agriculture support
  - ▶ Trims SNAP, Medicaid, Medicare
- ▶ Budget effects (FY2025–34):
  - ▶ Net deficit impact (per CBO):  $\approx$  \$3.4T more over 10 years up to \$4.1T from added interest costs
  - ▶ If all changes made permanent:  $\approx$  \$5.5T more over 10 years
- ▶ Signed July 4 → major fiscal reset

# The Government Shutdown

- ▶ **Immediate cause:** Did not pass appropriations bill for FY2026
- ▶ **Deeper cause:** Fiscal trajectory clash:
  - (Most) Democrats:
    - ▶ Keep COVID-era ACA tax credits/reverse Medicaid cuts
    - ▶ Take a “stand”
    - ▶ Arguably burned by avoiding shutdown in early 2025
  - (Most) Republicans:
    - ▶ Address later, divided stances within party
- ▶ 14 days and counting, 900K furloughed (4th longest)
  - ▶ Longest in 2018: 35 days + 380K furloughed
  - ▶ Second longest in 1995-1996: 31 days + 284K furloughed
  - ▶ Third longest in 2013: 21 days + 800K furloughed
- ▶ **Economic stakes:**
  - ▶ Disruption to federal workers, contractors, and data releases
  - ▶ Continued reduction in federal workforce

## Some of the current proposals within existing tax system

- ▶ Corporate tax rate changes
- ▶ International corporate tax coordination
- ▶ Enforcement initiatives
- ▶ Changes in taxation of capital gains
  - ▶ end step-up of capital gains at death
  - ▶ rate change (those two are linked!)
  - ▶ expanding taxation on accrual (“mark-to-market”)
- ▶ Rate changes at the top of the distribution, wealth tax



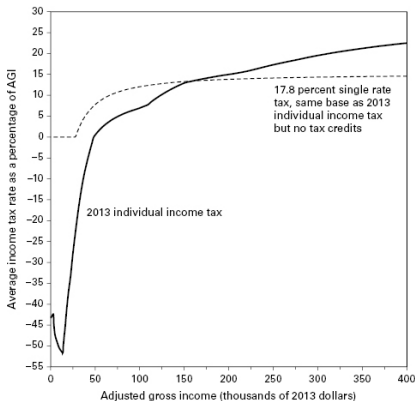
# Features of fundamental tax reform

- ▶ Revenue neutral: create a tax system that raises the same revenue with better incentives
- ▶ Can raise/lower rates as needed if revenue targets change
- ▶ Many revolve around “flattening” the tax system, but that can mean different things
  - ▶ “Flat rate”: One tax rate for all income
  - ▶ “Flatten rates across choices”: Clean tax base (remove arbitrary differences in tax treatment of income)
  - ▶ “Flatten consumption tax over time”: Tax actual consumption instead of income (no saving distortions)
- ▶ Others advocate for taxing wealth to improve vertical equity
- ▶ These are not mutually exclusive

# Flat tax rate: One rate to rule them all

- ▶ Single tax rate above threshold
- ▶ Advocates:
  - ▶ Simpler: no brackets, no reason for tax returns
  - ▶ Better work/saving incentives
  - ▶ “Neutral” on distribution
- ▶ Critics:
  - ▶ Empirics show low disincentives from many rates
  - ▶ Nothing special about a single rate
  - ▶ Much less progressive

**Bottom line:** Flat tax is not magic



Source: “Taxing Ourselves” by Slemrod and Bakija

# Clean and expand the tax base

- ▶ Remove special treatment for certain consumption/investment
  - ▶ Mortgage interest deduction
  - ▶ Health care/health insurance
  - ▶ Charitable contributions
  - ▶ State/local government taxes and borrowing
  - ▶ IRA, 401(k), 403(b) contributions, etc.
  - ▶ Double taxation of corporate income
  - ▶ Capital gains
- ▶ Burden of proof for special treatment on proponent. Will it:
  1. Correct market failures?
  2. Improve fairness?
  3. Reduce work disincentives?
- ▶ Is the deduction the best way to achieve the goal?

**Bottom line:** Simplify the tax base

# Consumption tax

Consumption tax: tax actual consumption instead of income (potential consumption).

Why consider?

- ▶ consumption in different periods treated symmetrically — no saving distortions
- ▶ reduce administrative difficulties (no need to measure capital gains/depreciation)
- ▶ fewer problems with inflation
- ▶ realistic way to raise more revenue

**Bottom line:** Consumption tax easy to implement

## No saving distortion under consumption tax

- ▶ Consider budget constraint

$$(1 + t^C)C_1 + \frac{(1 + t^C)C_2}{1 + r} = Y$$

- ▶ The relative price of consumption in period 1 and 2 is

$$\frac{1 + t^C}{1 + r} \bigg/ (1 + t^C) = \frac{1}{1 + r}$$

- ▶ It is unaffected by taxation!

# Equivalence between consumption and earnings tax

- ▶ Consumption tax

$$(1 + t^C)C_1 + \frac{(1 + t^C)C_2}{1 + r} = w_1L_1 + \frac{w_2L_2}{1 + r}$$

- ▶ Labor earnings tax (Note: not an income tax — no tax on interest!)

$$C_1 + \frac{C_2}{1 + r} = (1 - t^L)w_1L_1 + \frac{(1 - t^L)w_2L_2}{1 + r}$$

- ▶ This is the same budget constraint when  $t^L$  equals ad valorem of  $t^C$

$$1 - t^L = \frac{1}{1 + t^C} \leftrightarrow t^L = \frac{t^C}{1 + t^C}$$

## Transition

- Denote by  $W$  the initial wealth and a consumption tax:

$$(1 + t^C)C_1 + \frac{(1 + t^C)C_2}{1 + r} = w_1L_1 + \frac{w_2L_2}{1 + r} + W$$

- Convert it to the labor income tax  $1 - t^L = \frac{1}{1 + t^C}$

$$C_1 + \frac{C_2}{1 + r} = \frac{1}{1 + t^C} w_1L_1 + \frac{1}{1 + t^C} \frac{w_2L_2}{1 + r} + \underbrace{\frac{W}{1 + t^C}}_{W - \frac{t^C}{1 + t^C} W}$$

- Consumption tax is equivalent to labor earnings tax with  $1 - t^L = \frac{1}{1 + t^C}$  and **confiscation** of  $\frac{t^C}{1 + t^C} W$  of  $W$
- Shift to consumption tax corresponds to a tax on wealth.
- What is the intuition?
  - Under labor earnings tax, consumption out of existing wealth is tax free (earnings taxed in the past)
  - Under consumption tax, consumption out of existing wealth taxed

# Options

- ▶ Sales tax
- ▶ Value Added Tax: the tax is imposed on the difference between sales and cost of inputs (not including labor though) at each stage of production. The final outcome is the tax on the full value of the final production. Good compliance properties — producers police themselves
- ▶ Hall-Rabushka flat tax: business tax structured like VAT with an additional deduction for payments to workers; individual tax imposed on labor (but not capital) income.  
If rates are the same, it is equivalent to VAT.  
Having individual tax allows to introduce some progressivity by using exemptions.  
One can add more progressivity (“X-tax”), but possibly with extra compliance costs and avoidance opportunities.
- ▶ Income tax with exemptions for capital income
- ▶ Cash-flow taxation



## Problems with consumption tax — economic objectives

- ▶ Compensating for transition costs difficult, costly, eliminates much of gains
- ▶ Some types of consumption difficult to measure and define: are health expenditures consumption? How to value fringe benefits? Home production?
- ▶ Progressivity harder (but not impossible) to achieve (e.g. collect savings and income, tax difference progressively)

# Problems with consumption tax — administration

- ▶ In the case of VAT:
  - ▶ retail stage is always a problem; fake receipts; treatment of exports.
  - ▶ varying rates on different types of goods creates a lot of issues with calculating liability, credits and re-classification of goods
  - ▶ compliance costs a problem but exempting businesses also creates issues by breaking the VAT supply chain
- ▶ In the case of sales tax:
  - ▶ Very hard to distinguish final consumption from business inputs
  - ▶ Retail stage is a huge problem (potential solution: shift liability higher in the supply chain)

# Summary of first half of class

- ▶ The role of the government is to:
  - ▶ Raise revenue with minimal excess burden
  - ▶ Redistribute (failure of the 2nd welfare theorem)
  - ▶ Correct market imperfections (failure of the 1st welfare theorem, second half of class)
- ▶ Interventions involve both direct and indirect effects.
- ▶ Understanding/measuring indirect effects is crucial for evaluating incidence and efficiency cost of *actual* policies.
- ▶ *Optimal* policy is about maximizing welfare subject to constraints. Take efficiency costs of policy seriously.