Tax Reform

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October 13, 2025

[1]With editing and conceptual assistance from ChatGPT and Cursor.

Recent U.S. Tax Policy Timeline

2017 — TCJA
- Corp rate → 21%; corp AMT repealed
- SALT cap $10K; raised standard deduction; removed exemptions
- 20% deduction for pass-throughs
- Key items sunset end-2025

2019 — SECURE
- New later RMD age; 10-year rule for many inherited IRAs
- Expanded plan access, small-plan incentives

2020 — CARES
- Stimulus rebates, ERTC, PPP
- NOL carrybacks; relaxed cap (30% → 50%)

2021 — ARPA
- Expanded Child Tax Credit (2021), monthly advances
- Enhanced EITC, extended ACA premium support

2022 — IRA, SECURE 2.0
- 15% book minimum tax, 1% buyback excise
- Increased IRS funding; extended ACA subsidies; climate credits
- SECURE 2.0: higher catch-ups, plan tweaks

2025 — One Big Beautiful Bill
- Cemented many individual TCJA provisions
- New exemptions/deductions
- Partial rollback of green subsidies, new revenue items

Shutdown — Government Shutdown
- Senate failure to secure 60 votes for bill/continuing resolution
- Dems aim to keep COVID-era ACA subsidies; GOP wants to postpone discussion

Time

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 "teritorial" system to measure domestic taxable income)
  - changes in tax treatment of investments (endowment tax on tax-exempt universities)
- Individual income tax changes (revenue loss)
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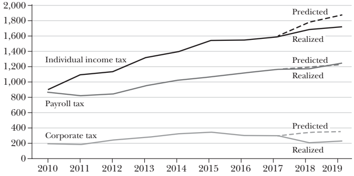
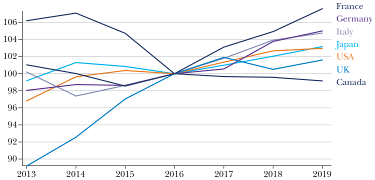
- COVID makes it harder than usual to identify effects of TCJA

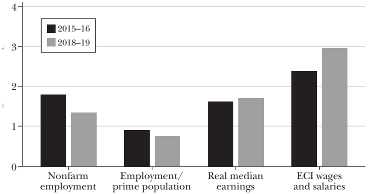
Hard to assess effects of TCJA



(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*

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)
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- 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
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- Signed July 4 $\rightarrow$ 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"
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- 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

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- **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

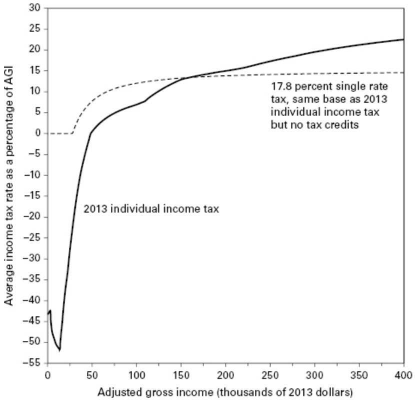
Features of fundamental tax reform

- 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 goverment 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

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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

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

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- It is unaffected by taxation!

Equivalence between consumption and earnings tax

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- 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:

$$(1+t^C)C_1 + \frac{(1+t^C)C_2}{1+r} = w_1 L_1 + \frac{w_2 L_2}{1+r} + W$$

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

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- 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

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- 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

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- 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)

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- 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.