THE 2017 TAX CUTS AND JOBS ACT

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INTRODUCTION

The Tax Cuts and Jobs Act (TCJA) was a signature piece of legislation passed and signed into law in 2017 (Radnofsky, 2017). It helped usher in fast, noninflationary growth that benefited all Americans, but particularly those at the lower income rungs. A reversal of some of the most important provisions of this Act would likely have severe negative consequences for the U.S. economy, especially for those households who gained the most after TCJA became law and who had been most disadvantaged prior to 2017. Small businesses, the driver of new job creation, also would disproportionately suffer.

INVIGORATING GROWTH THROUGH PRUDENT SUPPLY-SIDE MEASURES

Median household income was stagnant for much of the past two decades.[1] After reaching a peak in 1999, in fact, real median household income would remain below that level until 2019, after the implementation of TCJA. Tax reform was a key plank of the economic policies that were implemented in the 2017-19 period.

TCJA was passed in December 2017 and was a historic piece of legislation that meaningfully lifted lower- and middle-class living standards while at the same time making the U.S. tax system more globally competitive (CEA, 2019a; CEA, 2020; Pomerleau & Schneider, 2021). Prior to TCJA, the economy had suffered a hollowing out of manufacturing jobs, the result of offshoring and United States capital flight (Autor et al., 2016).[2] Capital flight was evident from a significant increase in the U.S. international trade deficit, which had increased nearly six-fold from the early 1990s to the mid-2000s.[3]

TJCA lowered corporate and individual tax rates and simplified the tax-filing process (Eastman, 2019; York, 2018). The federal statutory corporate income tax rate was cut from 35 percent to 21 percent, bringing it in line with the average rate of other industrialized nations (OECD, 2021). A five-year window of 100 percent bonus depreciation was adopted for new business investment (York & Muresianu, 2018). Furthermore, TJCA created a modified

[1] Census Bureau figures show zero annualized growth in real median household income from 2000 to 2016.
[2] From 1992 to 2010, manufacturing jobs as a share to total employment fell at a 3 percent annualized rate. This represented the fastest decline over any 18-year period on record. The ratio has been steady since then at an historic low of around 8.6 percent.
[3] Real net exports of goods and services went from -1.0 percent of GDP in 1990 to a record high of -6.0 percent of GDP in 2006.

territorial tax system whereby corporate taxes would be paid only in the jurisdiction where they were earned (CEA, 2019a). This aimed to alleviate the growing problem of corporate inversions and allow more capital to be on-shored in the U.S. economy (CBO, 2017; Rubin & Hopkins, 2019).

Marginal income tax rates were reduced, with the top rate declining to 37 percent from 39.6 percent. The standard deduction was nearly doubled from $13,000 to $24,000 for joint filers (CRS, 2021; York, 2018). State and local income, real estate, and sales tax deductions were limited to $10,000 per household, ending the subsidization of higher-tax jurisdictions by the Federal government. In addition, TCJA reduced the amount of deductible mortgage debt from $1 million to $750,000 per home. This reduction in tax expenditures aimed to mitigate the distortionary effects of the tax code by providing fiscal rectitude at the municipal level while avoiding a misallocation of capital in nonproductive residential investment (Hilber & Turner, 2014).

These substantive changes in corporate and individual tax policy were designed to lift underlying real GDP growth, incentivize business capital spending (capex), and improve corporate profitability. The resulting increase in productivity growth would lift household living standards and in turn produce durable, non-inflationary economic activity. This was how the TCJA was designed and implemented and was likely a positive contributing factor to the much stronger than expected economic recovery that began in 2020:Q2 (McBride & York, 2020).

STRONG CAPEX, GDP AND WAGE GAINS

In the four quarters from which the tax cut took effect, real nonresidential fixed investment (capex) grew nearly 7 percent. This was more than twice as fast as the economy, which grew by a robust 3.1 percent. The acceleration in capex was a catalyst underpinning productivity growth. In turn, this lifted labor compensation by its fastest rate in over a decade. For example, the employment cost index for civilian workers expanded 3 percent at an annualized rate in the two years immediately following passage of TCJA. This was the quickest pace since 2008.

Unfortunately, the full potential of TCJA was likely limited by a tightening of monetary policy between 2017 and 2019. In the 12 months following passage of TCJA, the federal funds rate more than doubled, and the Federal Reserve balance sheet declined over 8 percent. The combination of rising interest rates and quantitative tightening acted as a headwind to economic growth. The Treasury yield curve inverted. Acknowledging that policy had become too restrictive, by July 2019, the Federal Reserve began to lower interest rates and to re-expand its balance sheet.

ROBUST PRODUCTIVITY

Business investment spurred by TCJA was likely an important contributor to underlying productivity growth. Evidence of this can be seen in capital spending metrics in the Institute for Supply Management and the National Federation of Independent Business Small Business Survey. They rose sharply in anticipation of TCJA's implementation (CEA, 2019a).

Remarkably, growth in productivity improved in each successive year of the Trump Administration, an unprecedented achievement. Despite a global pandemic, U.S. productivity growth was 2.5 percent in 2020, its best performance in a decade. While it is unclear how much of the gain in productivity was directly a function of TJCA, it was very likely a positive contributing factor to business confidence. This laid a solid foundation for longer term investment decisions and hence better than expected gains in real GDP and household living standards.

The economy's growth following the passage of TCJA far exceeded professional forecasters' expectations (CEA, 2019a; CEA, 2019b; CEA, 2020). The ensuing gains in GDP, capex, corporate profitability, and productivity that followed the passage of TCJA led to a historic increase in household living standards according to official government data.

UNPRECEDENTED GAINS IN REAL LIVING STANDARDS

In 2019, the latest year for which data are available, comprehensive Census Bureau figures show a $4,379 increase in real median household income to $68,703. This is an all-time high. Furthermore, it was the largest annual increase in both dollar and percentage terms on record. Theoretically, capital deepening leads to rising productivity growth, which leads to faster wage growth (CEA, 2019a).[4] The sharp gain seen in household incomes following TCJA is consistent with this economic theory.

To put the 2019 improvement into historical perspective, real household income increased by more than it had under the full eight years of 2008-16 period, when the cumulative gain was just $1,120. This figure incorporates two Census Bureau adjustments, the 2013 survey redesign and the 2017 data processing change. The 2019 increase is even more impressive when analyzing longer history.

Under the two administrations prior to the Trump administration, household living standards stagnated. From 2001 to 2016, real median income fell by $164. Not surprisingly, this is the weakest income performance on record over a 16-year period. Conversely, over the two years following the passage of TCJA, real median household income rose $4,942 or 3 percent per annum. This is the largest gain in history. But the good news does not end here. When analyzing the data by income quintile, there were record gains in living standards at the lower- and middle-income levels. Since passage of TCJA, average real income for the

[4] Capital deepening occurs when companies make investments in plant and equipment, thereby allowing workers to be more productive. In turn, this tends to increase labor wage rates.

lowest fifth of wage earners grew at a 4.9 percent annualized rate. The second fifth rose 4.8 percent, the third fifth increased 3.8 percent, and the fourth fifth advanced 3.7 percent. The highest fifth was up only 3.2 percent, by far the weakest growth rate among the income quintiles. This performance was matched by the top five percent of earners. They also experienced a 3.2 percent increase in wages in the two years following passage of the tax bill.

Three percent per annum wage growth is robust in a historical context (Bump, 2017). However, the largest gains came at the lower- and middle-income levels. This is consistent with the design of the TJCA. Lower corporate taxes galvanize investment, thereby improving labor productivity, which allows an increase in company profits to be earned among workers. In addition, the reduction in individual marginal tax rates buttressed the drop in the corporate tax rate. This is because many small businesses do not pay the statutory corporate income tax rate but rather the marginal tax rate. Small businesses account for well over 40 percent of total U.S. employment.

A BOON TO SMALL BUSINESS

Following the passage of TCJA, small business optimism skyrocketed. In the 2017-19 period, small business sentiment was higher than what was experienced under any previous president (NFIB, 2020). Hiring plans and capital investment plans both boomed. This kept the U.S. jobs engine running. In fact, the fundamental health of small businesses allowed the economy to produce a record run of employment gains. This led to a historic low in unemployment. Before the onset of the pandemic, the national unemployment rate stood at 3.5 percent, a level not seen in over 50 years. Moreover, many categories of unemployment—age, race, and sex—experienced a record low unemployment rate.

In fact, in early 2020 there were more job openings than there were people unemployed. Despite robust wage growth, inflation remained dormant, rising less than 2 percent in 2019. This development confounded much of the professional forecasting community, including economists at the Federal Reserve who had modeled the inflation based off the Phillips Curve. Strong noninflationary growth was an important factor in allowing monetary policymakers to reduce interest rates on several occasions in 2019. The relationship between unemployment, wages, and inflation had shifted, as evidenced by a flattening in the Phillips Curve.

ANTI-SUPPLY-SIDE

Despite the success of TCJA, the Biden administration seeks to undo many aspects of the legislation. Their proposal would raise the corporate tax rate from 21 percent to 26.5 percent, while the top marginal tax rate would go back to 39.6 percent. This would severely impact small businesses and is likely a reason why the latest National Federation of Independent Businesses survey was so downbeat. The percentage of small firms expecting their sales and the overall economy to improve in the next six months remains depressed (NFIB, 2021).

Capital spending plans continue to slow according to surveys from the Institute of Supply Management and the National Federation of Independent Business.

These are remarkable developments considering the fact that the consensus of economists is that the country will see the strongest real GDP growth since the early 1980s. This hints that the staying power of the initial V-shaped recovery that began last summer under the Trump administration may dissipate by next year.

The currently proposed reconciliation plans also call for raising the tax rate on capital gains. This means that the top rate on capital gains would be 28.8 percent when the 3.8 percent Affordable Care Act tax is included (Davison, et al., 2021). The capital gains rate has never been above the highest marginal rate and for good reason. Economic theory posits that higher capital gains taxes provide a strong disincentive for capital investment. To the extent the latter drives productivity growth, lower capital formation bodes ill for future gains in worker wages. The upshot is a decline in household living standards. Unfortunately, the bad policies do not stop here.

Under the Biden Administration's plan, payroll taxes on individuals earning more the $400,000 per year will go significantly higher (Rubin & Lucey, 2021). All income above this threshold will be taxed at 15 percent, split between employer and employee. There will be no cap on payroll taxes. This will ensnarl many small businesses and weigh on the current jobs recovery. The upshot is that the combined payroll/income tax rate would bring the marginal tax rate on an additional hour of work to roughly 54 percent. But this does not include state and local income tax rates.

Since state and local taxes are not tax deductible, the Biden Administration's plan will lift the marginal tax rate on high-tax states such as California, New Jersey and New York to around 70 percent. Economic dynamism will likely suffer as the most productive people and innovative firms will be stifled by the disincentive to work and expand the business. Raising corporate and individual tax rates at this particular time (emerging from the pandemic when unemployment is still elevated) places the United States at a serious strategic disadvantage to our economic competitors, potentially doing irreparable damage to the U.S. economy.

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