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Post-COVID-19 Tax Policy: Keeping Taxes Low to Ensure a Robust Recovery

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KEY TAKEAWAYS

The 2017 tax cuts will eventually expire, raising taxes on Americans and threatening the economic recovery from the coronavirus.

Congress should prioritize making the 2017 tax cuts permanent, expanding full expensing, and enacting universal savings accounts.

Keeping taxes low in the future requires paring effective, pro-growth tax policy with necessary spending reforms.

Tax policy can no longer be pro-growth without also being deficit conscious. Irrespective of current tax rates, growing deficits, and increasingly popular new spending proposals mean that taxes would need to rise in the future, not just for high-income Americans, but also for middle-income wage earners. This is an unacceptable outcome that will dampen economic opportunity and slow down the recovery.

Passed at the end of 2017, the Tax Cuts and Jobs Act (TCJA) includes a series of cliffs, after which tax rates increase and many other important reforms expire. While the TCJA is not the cause of the systemic deficits, the deficits are the greatest threat to making the 2017 reforms permanent and keeping taxes low for future generations. Congress should make the current tax code permanent so that Americans can better plan for their futures. Congress should also enact universal savings accounts (USAs) so that more Americans can save in a flexible format for a rainy day. The next Congress must also advance pro-growth structural reforms, such as full expensing, to ensure a predictable environment for post-coronavirus investment.

By removing tax subsidies and reforming direct spending, Congress can pursue a number of other critical structural reforms. Increasing access to tax losses can help start-up firms and businesses struggling with slow sales to reach profitability. The tax code should also treat interest properly, keep international taxes from rising, and protect online sellers from out-of-state sales taxes.

When future tax liabilities are uncertain and likely to increase, people work less, businesses delay or cancel new purchases, and consumers reduce their spending. Cutting spending will allow Congress to credibly keep taxes low, boosting the recovery and enabling additional tax cuts to support continued economic growth.

Prevent Future Tax Increases by Making the TCJA Permanent

Following the devastation and economic uncertainty of the coronavirus crisis, Congress must protect Americans from facing new or higher taxes, especially during the economic recovery. When large deficits lead investors and businesses to expect higher taxes, cutting taxes is not necessary to activate a supply-side response resulting in additional economic activity. Congress can boost private investment and consumption simply by preventing scheduled tax increases and constraining spending growth.

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Significant parts of the TCJA are temporary, with scheduled tax increases beginning in 2022 on business investments, and culminating in 2026 when individual taxes increase. The primary permanent component of the 2017 reform, the lower 21 percent corporate income tax rate, is also expected to be rolled back. According to a recent PricewaterhouseCoopers poll, 70 percent of corporate executives expect business tax rates to increase regardless of who wins the presidency in November.[1] Vice President Joe Biden has made higher business taxes a key part of his tax agenda.

Businesses looking to expand or make new investments care about the future tax rate more than the current tax level because the profits generated by current investments will be taxed in future years. Generalizing this effect for all taxpayers, economists John Cogan, Daniel Heil, and John Taylor illustrate how holding down projected expenditure growth can boost short-term and long-term gross domestic product (GDP) growth by an "equivalent to a 7 percent increase in the economy's real growth rate."[2] If taxpayers think taxes will be higher in the future to cover increasing spending, one can assume that those expectations are depressing current investment and growth.

The Benefits of the TCJA. The TCJA reduced federal income tax rates, increased the standard deduction, doubled the child tax credit, repealed the personal and dependent exemptions, and capped the deduction for state and local taxes (SALT), among many other changes. Each of these significant changes for individual taxpayers expires at the end of 2025. In 2026, taxes will automatically increase for most Americans.[3]

After the TCJA tax cuts, Americans in every income group benefited from lower effective tax rates, sending an average of $1,400 less of their paycheck to Washington in 2018.[4] Middle-income taxpayers saw a bigger drop in average tax rates than those who reported more than $1 million in income.[5] Across all taxpayers, effective tax rates declined by 9.5 percent on average (about 1.4 percentage points). The tax cuts were also largest as a percentage of overall taxes paid for lower-income and middle-income Americans. Preliminary tax data from 2019 show that the tax cuts may have even been even larger for income groups making less than $250,000 in the second year of the reform.

Making these tax cuts permanent will likely not have a significant impact on the sustainability of the federal budget. Still, large deficits do threaten the political sustainability of maintaining the 2017 tax changes and blunt any positive economic effects that may have otherwise followed.

Tax Cuts and Deficits. The TCJA itself was a modest one-time reduction in the level of federal revenue, and actually increased the growth rate of federal receipts over time.[6] Assuming that the tax cuts are made permanent, revenue as a percentage of GDP is projected to reach 17.5 percent in 2030, above the historical average of 17.4 percent.[7] The TCJA increased the deficit by about $200 billion in 2018, as well as in 2019, a 6 percent decline from pre-reform revenue projections each year.[8]

Because most tax cuts reduce revenue, spending reforms have long been a critical component of sustainable, pro-growth tax reform. Historically, tax cuts have been partly reversed within five years of passage because they were not appropriately paired with spending cuts.[9] Portions of both the Reagan tax cuts in 1981 and the Bush tax cuts in the early 2000s were reversed after deficit concerns. Making matters worse, the 2017 tax cuts were followed by spending increases rather than the necessary reforms. Between 2018 and 2019, outlays increased by 8 percent. In the three years following 2017, Congress increased discretionary spending limits by $618 billion.[10]

While the TCJA did increase the deficit, the law is not the underlying cause of the unsustainable U.S. budget. The systemic gap between revenues and expenditures is driven by sustained growth in mandatory spending programs since the 1970s.[11]

Budget sustainability is best measured as the growth rate of spending in relation to the growth rate of the economy and revenue. Over the next decade, federal spending is projected to grow faster than the economy, consuming more than 30 percent of GDP growth.[12] Tax revenue is projected to grow by about 5 percent per year through 2025, when the law expires.

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The problem is that outlays grow at a faster rate than both revenues and the economy. Neither repealing the 2017 tax cuts, nor any politically realistic tax increase, can cover the current trajectory of federal spending.[13] Over the next 30 years, 87 percent of new debt can be accounted for by Medicare and Social Security. If extended, the TCJA would account for about 10 percent of new debt accumulation.[14]

Congressional inability to constrain spending growth resulted in a deficit-financed tax cut, which was followed by spending increases rather than the necessary reforms. Keeping taxes low and constraining spending growth are mutually reinforcing goals. Ultimately, without spending reform, today's lower taxes must result in higher taxes on future generations.[15] Uncertainty about future tax rates and new revenue sources could further delay the necessary business re-openings and depress investment levels, wage growth, and GDP. Congress must put reasonable spending controls on entitlement growth, reject new revenue sources, and make the TCJA's rate cuts and other reforms permanent.

Expanding Full Expensing to Structures

Tax reform for economic recovery should expand and make permanent the benefits of full expensing for new investments. The lower corporate tax rate is permanent for businesses, but the 2017 law's adjustments to cost-recovery rules are temporary and bring equally critical economic benefits.[16] The pre-TCJA U.S. tax system made companies wait to deduct the cost of their investments from their taxable income. This delay between paying for an investment and being able to write off the cost against taxable income amplifies the negative effect of the corporate income tax by raising the after-tax cost of investment and thus shrinking the U.S. capital stock.

The TCJA reformed the cost-recovery system by allowing businesses to write off new short-lived investments (cost recovery periods of 20 years or less) immediately—often referred to as full or immediate expensing. The TCJA's expensing provision begins to phase out after the end of 2022, reducing 20 percentage points each year for four years. Research and development expenses will also not be eligible for full expensing after 2021. Structures (cost-recovery periods of 27.5 years and 39 years), such as new manufacturing floor space, storefronts, and residential buildings, were not included in the 2017 reforms and still must use the costly and complicated pre-TCJA system. Congress should extend expensing for short-lived investments permanently and give similar treatment to structures.

Permanent expensing for structures can be accomplished in two different ways. First, Congress could simply allow full and immediate write offs, similar to those available to other investments. While more straightforward, this option would move 39 years of tax deductions into the 10-year budget window, increasing the policy's *perceived* revenue reduction. However, this timing shift means that years outside the budget window will benefit from higher revenues, significantly decreasing the total revenue losses. Otherwise, Congress could create a system of neutral cost recovery, allowing businesses to index their deductions for inflation and the time value of money, resulting in a system similar to full expensing.[17] Neutral cost recovery could significantly reduce the budget window cost of expensing for structures.

Universal Savings Accounts as Personal Rainy-Day Funds

Universal savings accounts (USAs) are all-purpose savings accounts, which would allow Americans to build personal rainy-day funds to weather the risks of a future economic downturn or health crisis, or simply save for other life priorities. USAs reduce taxes on savings for all Americans and help families to build their own financial security through a single, simple, and flexible account. Each American adult should be allowed to contribute at least $10,000 in post-tax earnings to a USA each year, and all accrued earnings should be tax-free. Simple and flexible accounts allow more Americans at all income levels to save more of their earnings with fewer restrictions on where and when they can spend their own money.[18] In future economic downturns, USAs would be particularly helpful for lower-income workers, who are often most affected by business closures and layoffs. USAs would help more Americans build a financial cushion to weather income losses and the inevitable delays of government-provided assistance, such as rebate checks and unemployment payments.

No More Distortionary Tax Subsidies

There are about $650 billion worth of narrowly targeted tax credit subsides with few economic benefits and high economic and budgetary costs that lawmakers should eliminate from the tax code. These include credits for low-income housing, green energy investment, orphan drug research, energy production, and biodiesel producers, among more than 25 others detailed in the 2020 *Blueprint for Balance*.[19] Congress should also allow the temporary 20 percent pass-through business deduction to expire and apply the $10,000 individual SALT deduction cap to corporate taxpayers, or eliminate the deduction altogether.

> Existing subsidy programs have a proven track record of providing few benefits while engendering high unintended costs.

Further, Congress should resist new proposals to manipulate taxpayer behavior with new credits and deductions. In response to the coronavirus recession, bipartisan proposals in both the House and the Senate include new tax credits for businesses who hire unemployment recipients, and to cover the costs of employee-protection expenses, as well as expansions of the employee retention tax credit and expansions of the child tax credit, among others. Similarly, presidential candidate Biden proposes more than 18 new or expanded tax credits,[20] and President Donald Trump has proposed new credits for domestic manufacturing and job onshoring.[21]

While it is understandable to want to get people back to work and help to create jobs for Americans, additional business tax subsidies will not meaningfully boost job creation. Instead, they will complicate the hodgepodge of existing incentives, making the tax code even less efficient and even more burdensome. New tax credit programs are also unlikely to help the most vulnerable and smallest businesses amid mounting complexity. Existing subsidy programs have a proven track record of providing few benefits while engendering high unintended costs.

Adequate Access to Offsetting Tax Losses

When businesses are not profitable, the tax code allows net operating losses (NOLs), or negative profits, to be carried forward to future years and used to offset subsequent taxable profits. Access to offsetting tax losses helps start-ups that might see losses in the first few years of operation, supports entrepreneurs, and functions as an essential safety valve for businesses that lose money in an economic downturn. Offsetting NOLs simply allows taxable profits to be averaged over time, rather than assessed in arbitrary annual installments.

Under current law, businesses are generally prohibited from carrying NOLs back to previous tax years in normal times (claiming a deduction against past years' positive profits and thus receiving a current-year tax refund). For c-corporations, NOL carryforwards are limited to 80 percent of net income. For many privately owned pass-through businesses whose owners pay taxes as individuals, NOLs are limited to as little as $250,000 a year. The Coronavirus Aid, Relief, and Economic Security (CARES) Act expanded access to offsetting NOLs by allowing losses from tax years 2018, 2019, and 2020 to be carried back five years, and suspends the 80 percent and $250,000 limitation for tax years beginning before January 1, 2021.

Similar limits exist for individual investor capital losses. In general, taxpayers can offset any capital gain with a capital loss, but are allowed only a $3,000 annual loss deduction above the value of realized gains.[22] Like NOL limits, the tax code asymmetrically taxes profits immediately and forces losses to be spread out over a number of years, delaying and reducing their benefit.

Limits on the use of tax losses make businesses less resilient in economic downturns and penalize entrepreneurs who take financial risks to bring new products to market.[23] Full access to tax losses should be a permanent policy. Congress should eliminate restrictions on NOL carryforwards and allow ongoing five-year NOL carrybacks for all firms. The capital loss limitation should also be expanded.[24]

Rationalizing Taxation of Interest for Businesses and Individuals

The current treatment of interest in the tax code is neither uniform nor ideal. The current system can incentivize firms to take on too much debt, creating additional balance sheet risks during recessions. Interest costs are partially deductible for businesses, and interest income is taxable as ordinary income to the lender. Many forms of interest expenses are not deductible for the individual and can often escape taxation when distributed to international or other tax-preferred entities. If interest income is taxable, interest expense should be deductible. If interest expense is not deductible, interest income should not be taxable.[25]

The business interest deduction is limited to 30 percent of earnings before interest, taxes, depreciation, and amortization (EBITDA, a measure of profitability) through the end of 2021 for firms with $25 million or more in gross receipts over three years. In 2022, the 30 percent limitation will be based on a narrower definition of operating income, earnings before interest and taxes (EBIT). The CARES Act temporarily increased the 30 percent limitation to 50 percent for 2019 and 2020. Congress should allow the temporary increase to a 50 percent limitation to expire, but should not limit the business interest deduction to a narrower definition of earnings by blocking the scheduled shift from EBITDA to the more limiting EBIT.

> If interest income is taxable, interest expense should be deductible. If interest expense is not deductible, interest income should not be taxable.

However, Congress should consider reforming the tax treatment of interest more fundamentally by denying the deductibility of new interest expenses for all taxpayers while eliminating interest income from taxable income. Among many benefits, this shift would help to remove future tax incentives to use debt rather than equity financing and to strengthen corporate balance sheets for future downturns. The reform could both increase the economic efficiency of the tax code and raise revenue to help offset the revenue losses from making the 2017 tax cuts permanent and other changes.[26]

Keeping International Taxes Competitive

The new international tax system includes automatic tax increases over the next five years, and American businesses will face additional pressures from European proposals to tax digital trade.

The TCJA abandoned the outdated worldwide international tax system for a new quasi-territorial regime. In principle, the new system only taxes corporate income earned in the U.S., but it includes a series of three new, highly complex international levies to maintain U.S. taxing rights on highly mobile income.[27] The inclusion of global intangible low-tax income (GILTI) increases taxes on high-return foreign profits, and the newly defined foreign-derived intangible income (FDII) lowers taxes on foreign income from domestically held intangible assets. The third component, the base-erosion and anti-abuse tax (BEAT), is a global minimum tax on large multinationals. In 2026, all three taxes increase, creating a higher tax burden on American firms doing business with global consumers.[28] Congress should stop these automatic tax increases on international business.

More radical changes to the international tax system should also be resisted, such as moving away from aggregate measures of international income and instead employing a country-by-country approach to taxing international income or significantly increasing the GILTI rate.[29] The Organization for Economic Co-operation and Development is also pursuing a two-pronged plan to remake the international tax system, aiming to move many business tax decisions to the Paris-based organization and away from domestic politicians.[30] Many individual countries and the European Commission also plan to implement additional "digital services taxes," which act as tariffs, on digital trade.[31] The explicit goal is to increase global business taxes, especially those paid by the most successful and innovative American companies.

Protecting American Businesses from Out-of-State Sales Taxes

Congress should protect vulnerable online retailers by codifying a physical presence test for tax collection. In 2018, the Supreme Court of the United States overturned previous protections when it upheld a South Dakota law that requires out-of-state businesses to collect the state's sales taxes on goods sold to customers in the state, even if the business has no physical connection—or political recourse—in the customer's state.[32] The regulatory compliance and tax-assessment risks from state revenue collectors around the country were threatening to bankrupt many small retailers before the COVID-19 crisis.[33] These rules are now prohibiting small distributors from retooling to ship new products during the crisis for fear of regulatory entanglement.

Every small business that sells online now can be subject to the more than 10,000 different taxing jurisdictions around the country—each with varying rates of taxes and rules about what is taxable. In the post-coronavirus economy, most every small business is now an online business. Congress needs to ensure that sales taxes are based on the location of the business, not the consumer's address.

More Tax (and Spending) Cuts

If Congress can credibly reduce spending, taxes should be cut further on personal income, capital gains, business income, and estates. These pro-growth reforms would benefit American workers through higher take-home pay and greater economic opportunity. Congress can also reduce payroll taxes by making necessary structural reforms to Social Security. The program can be preserved for the most vulnerable while empowering workers to strengthen their financial futures through more control over their own wages and savings.[34]

> Spending reforms, not tax increases, are the only way to put the budget on a sustainable path.

Without spending reform, the long-term benefits of large tax cuts will be limited by a lack of sustainability. If unsustainable, across-the-board tax cuts will increase the likelihood of entirely new taxes being added to the system. There is already frequent talk of a federal value-added tax (VAT), a carbon tax, wealth taxes, and financial transactions taxes, each designed to raise more revenue. None of these proposals can fix the deficit, but they could delay necessary entitlement reforms for a period of time. Spending reforms, not tax increases, are the only way to put the budget on a sustainable path.

A new tax would increase complexity, allow the federal government to extract more money from American taxpayers, and further depress economic growth. A VAT, for example, would raise taxes on the middle class to the tune of trillions of dollars. A carbon tax would inflate energy costs, kill jobs, and shrink incomes, hitting lower-income and middle-class taxpayers the hardest. The new revenue would enable an unprecedented expansion of the federal government while making Americans poorer and more dependent on Washington.

Conclusion

The recommendations above will help set up the United States for a strong economic recovery and a successful return to responsible federal budgeting. Congress can ensure a stable policy that is conducive to working, hiring, and investing by protecting Americans from scheduled tax increases, expanding the most pro-growth parts of the 2017 tax cuts, such as full expensing, and enacting USAs. Reducing spending growth will be a crucial part of effective, pro-growth tax policy in the coming years. Paired together, tax and expenditure reforms can calm uncertainty about federal fiscal sustainability, protect the nascent economic recovery from punishing tax increases, and provide a more neutral tax environment so businesses and individuals are able to build a brighter future.

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