A Ratchet and a Shift: Comments

NTA Annual Conference, New Orleans
16 November 2018
Len Burman

TPC TAX POLICY CENTER
URBAN INSTITUTE & BROOKINGS INSTITUTION

Synopsis

Glowgower and Kamin: 199A is a symptom, not the problem

Oei and Ring: 199A might be a problem, but not as big as people think

Glogower and Kamin, Tax Rate Ratchet

1. Pass-through businesses taxed less than c-corporations

   (click)

2. C-corporations get a tax cut

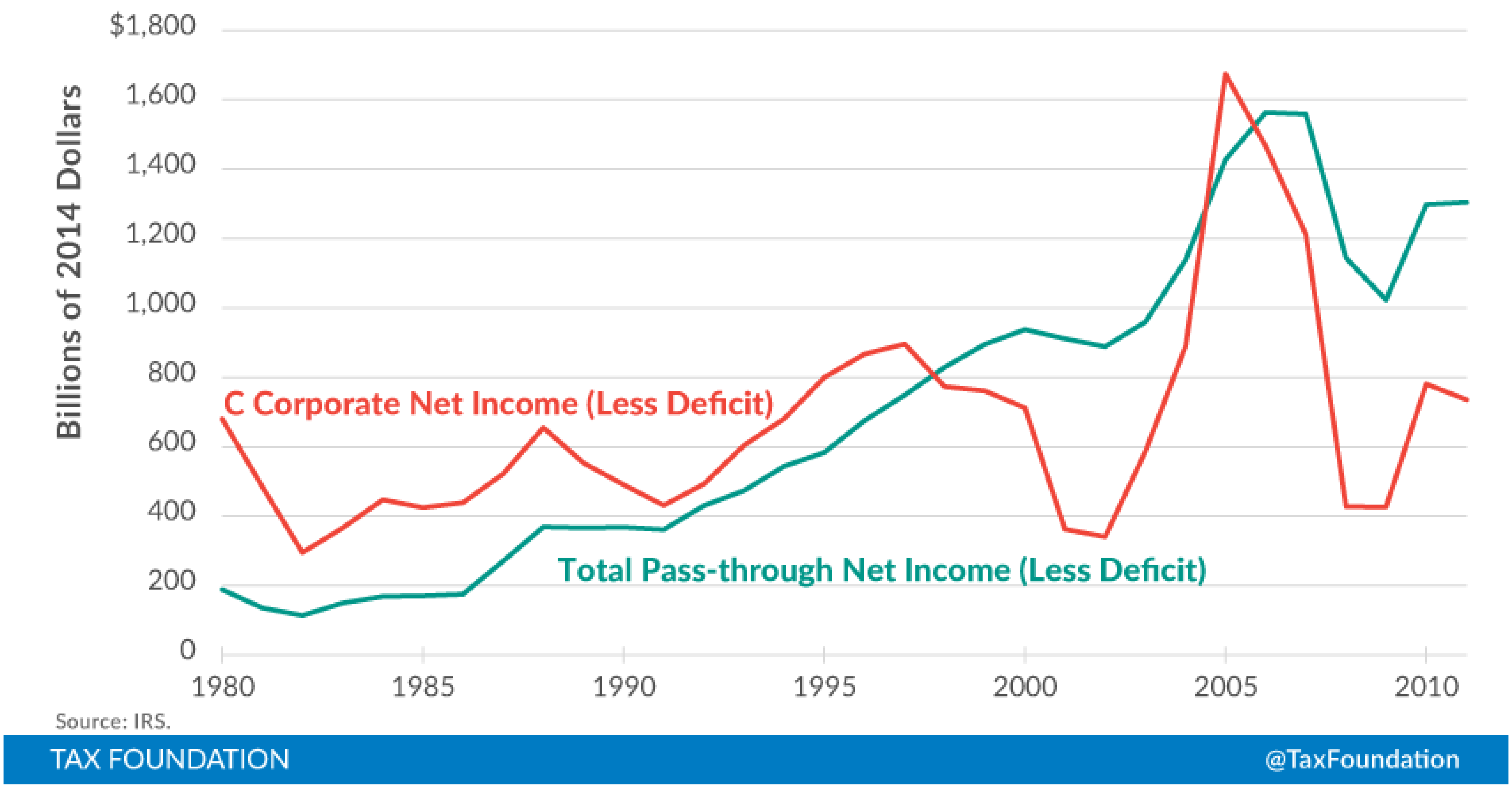
   (click)

3. Pass-throughs demand a tax break to keep their relative advantage

   (click)

4. Go to step 1

Rate differentials have real effects
C-corporation versus pass-through income, 1980-2011



Source: Kyle Pomerleau, "An Overview of Pass-through Businesses in the United States," Tax Foundation, 2015.

Alternative framing

- Another ratchet: foreign corporate tax rates
- We cut corporate tax rate in 86; other countries quickly followed, which put pressure on us to cut rates again
  - Although we restrained the impulse for 30+ years
- Other countries may cut their corporate rates
  - (Clausing (2018) points out that GILTI and BEAT may temper this incentive)

Ratchet changes assessment of 199A

- Lowering corporate tax rate makes c-corps a tax shelter

⇒ higher elasticity of taxable income

⇒ larger deadweight loss

⇒ 199A might be justified on second-best grounds (assuming corporate tax rate cut immutable)

Economic costs of the ratchet

- Lost revenue must be made up by other distorting taxes
- May make tax system less progressive, depending on how lost revenue is offset
- Paper speculates that any gains from reducing incentives for income shifting between jurisdictions likely offset by these costs
- Could you formalize this argument in explicit model with clear assumptions about elasticities and social welfare function?

Alternatives to the tax rate ratchet

- Corporate tax integration
  - How you do it matters
  - There's still a role for corporate-level withholding tax (Burman and Clausing 2017)
- Reduce distortionary costs of corporate tax and incentive to further cut the rate (Clausing 2018)
  - DBCFT
  - Formulary apportionment

Oei and Ring, Tax Law's Workplace Shift

- Aside from revenue loss and inequity, 199A might distort labor markets
- Oei and Ring present an exhaustive study of likely effects of the legislation and interaction with employee benefits, ACA, and risks it might pose for workers
- Optimistic that the guardrails—especially, limiting reclassification of existing workers and limiting deduction for high-income people—will deter abuse, *assuming effective enforcement*

Interaction between employers and workers

- Workers might want to become independent contractors, but there are limits
  - High-income pass-through businesses need W-2 wages to qualify for full deduction
  - Simply reclassifying workers as contractors probably doesn’t work
  - Costs to the firm of reorganizing work force

Risk to workers

- Losing benefits and statutory protections
  - Paper points out that many benefits still available in some form
- Uncertainty about value of deduction given progressive tax rates (and high-income phaseout)
  - Note: the phaseout can also create very high marginal effective tax rates as my colleague Joe Rosenberg has pointed out
- May affect EITC if low-wage jobs are reclassified (and self-employment income>wage)

Allocation of 199A benefits between firms and workers

- An employer that shifts worker to IC status will save money because of reduced statutory and fringe benefits
- Might also cut wages in effort to capture benefit of deduction
  - This is hard because the employer doesn't know the employee's MTR
- In competitive labor markets, employers have to compensate workers based on what they produce

What are the general equilibrium effects?

- In the long run, some employers may find it advantageous to classify more jobs as independent contractor and workers in higher tax brackets but below the phaseout range might prefer IC status to W-2 employment
  - How does this endogenous sorting with transaction costs affect equilibrium compensation, employment, productivity?
- But we may never see these effects because 199A is temporary