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Trump's Tax Plan...Will it Make America Great Again?

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Abstract

The research and analysis is presented in order to develop an understanding of the new tax law and its implications to the individual tax payer. To gain perspective on tax reform, a brief history of the origin of tax and its development over time in the United States is given. After a basic understanding of tax and its reform is gained, I go on to present the major changes contained in the law. This paper concentrates on the policy changes to individuals as opposed to businesses. I included charts that I believe support the analysis that is provided. Following the presentation of changes to the current tax law, I project the law's possible effect on the economy and the average American. This section of the report is succinct, showing a visualization of estimated GDP growth over the next 10 years. I mention the average monetary effect each class of American should observe following the law's implementation. I conclude that even though a modest tax reduction is expected for most Americans, this tax law is geared toward big business and the real benefits for individuals will be experienced indirectly.

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A Brief History of Tax and its Reform

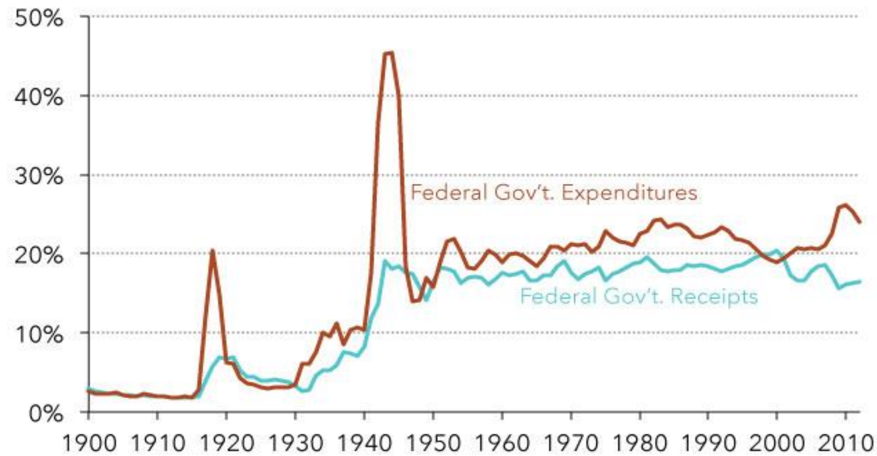
With a change in administration, one thing is always certain, tax reform. It is a principle that is deeply rooted in American history and politics, a debate that has separated the two major political parties since the origination of the U.S. income tax system. The push and pull between tax policies and their opposition is the cause of continuous tax reform. An understanding of the history of government revenue collection helps to simplify the complexity of the current tax system and demonstrate why there is a constant need for reform. Without looking back at previous tax reforms and the progression of tax policies throughout history, one would not be able to understand the scope and direction of the Tax cuts and jobs act.

America owes its existence to taxes. The primary reason for America's rebellion against the British in 1773 was direct taxation. An example of direct taxation is income tax. The ability of the government to take money directly from an individual's earnings. After the rebellion was successful and a new country began to form, the government came to realize that revenue must collected from its citizens in order to maintain sustainability as a ruling body. Thus originated the idea of "indirect taxing." This is where much of the complication of current tax systems can find its roots. The American government began to collect revenue through "tariffs," really another word for taxes, on specific items. These items could include anything from liquor to sugar and legal documents. This way the government could collect the revenue it needed without violating the pact it had made to not levy tax directly. The causal relationship between tax and its opposition then came into existence. It is a relationship that has proved to be a determining factor in Presidencies and tax legislation alike. The first such opposition was in reaction to the indirect tax placed on the sale of liquor, called the "Whiskey Rebellion", in 1794. Groups of Pennsylvanian farmers were angry about the liquor tax and resorted to burning down the homes of tax collectors in the area (Beattie). The government made a decision to put the revolt down by use of military force, setting a precedent for enforcement of tax law that future government regimes would follow.

Government is similar to any other company in that it has revenues and expenses. But unlike most companies, the government generally spends its money first and then generates its revenues accordingly. A government's greatest expense is war. The American government began to learn this in the 1790s when a war was waged against France. This was the inception of property tax, a tax that is prominent in the modern tax system. The sanctity of the forbidden direct income tax was maintained through the War of 1812. It took the war that divided the nation in two to break this sanctity. The American Civil War destroyed and recreated a new United States. Along with this recreation came the first direct tax implemented on incomes over $800 in the Revenue Act of 1861 (Beattie). The Internal Revenue Service was founded and the basis for the modern tax system was created. The Constitution at the time did not permit there to be a direct tax unless it was pro-rated to states based on their population. This immediately caused problems within the lower classes and soon flat taxes were declared to be unconstitutional. This was followed by the 16th Amendment to the U.S. Constitution which disallowed the pro-rating of taxes based on a state's population and led to the traditional form of income tax.

Over the first half of the 1900s, tax policies were formed and reformed surrounding the three major events of the time period, the World Wars and the Great Depression.

Chart 1: Federal Government Receipts and Expenditures as Percent of GDP*, 1900-2012



* Numbers are shares of GNP for 1900-1928.
Sources: For 1900-1928, U.S. Bureau of the Census and National Bureau of Economic Research. For 1929-2012, U.S. Bureau of Economic Analysis. Calculations by author.

Each world war caused a significant increase in government expenditures which in turn created an increased need for revenue. Following the graph, federal receipts and expenditures spiked in the years 1914-1918 (World War I) but returned to lower rates in the 1920s, creating an economic boom. It was not until the Great Depression and World War II that federal receipts would begin the gradual climb that has continued more or less until the modern era. The Hoover and Roosevelt administrations were in power during these events and the highest tax rates began to rise to unprecedented levels (Schuler). While rates increased, tax policy remained fairly simple until the 1950s. This is when tax relief was first given. Not in the form of lower rates, but instead in the form of different types of deductions. For businesses in particular, rates were changed depending on their classification. Enter the loopholes and fine print that created the tax preparation profession (Beattie). In time, taxes became a way for the government to promote certain business practices and discourage others.

Taxes continued to increase to rates that could not be sustained by American citizens. This led to the election of Ronald Reagan, who promised to lower every tax bracket. Once elected, he fulfilled this promise by lowering each bracket by 25%, signing what is recognized to be the single largest tax reform in United States' history. This led to more Americans having "taxable income" which helped to offset the rate drops. This introduced the "trickle-down effect" which proposed that lowering the highest tax bracket would have a net effect on all brackets below it. The economy experienced success during this time period and many still believe in the strategy today. The Tax Reform Act of 1986 was often referenced by the GOP as they developed the new tax law. President Trump and the Republican Party wanted to have similarities to the 1986 reform while taking a more modern approach.

The Clinton administration election meant the tax reform would shift back to Democratic influences. Clinton's policy modestly raised taxes and expanded the "negative income tax." Individuals who do not earn enough income to pay income tax are eligible for tax credits that act as supplementary income from the government. The Bush administration continued the seesaw of power between political parties and sought to lower tax rates. The lowered rates continued to add to the already growing deficit. This was intended to be combatted by the Obama administration as tax rates were again moderately raised for upper class individuals. With the creation of new social programs and Obamacare, the deficit has continued to grow (Beattie).

This is a crucial point in the history of the United States economy with an enormous financial deficit that shows no sign of slowing down. Having now looked at a brief history of tax policy and its effects on the economy, it is easy to understand its significance. Tax policy has been responsible for slowing economies or ushering in periods of growth and success. Since the first tariff was levied in America, there has been a constant cycle of new tax policy, opposition, and reform. Will President Trump's tax law prove to be strong enough to stand the test of time, or is it destined to be repealed and reformed like the many others that have come before it?

Introduction to the GOP Tax Reform for Individuals

The process of developing a new and progressive tax reform, called the Tax Cuts and Jobs Act, began long before it was signed into law by President Trump on December 22, 2017. The real work began in February 2016, when House Speaker Paul Ryan oversaw the creation of six task forces that were charged with the responsibility of collecting information on how to appropriately form a new tax code. The tax reform task force held sessions to hear from fellow members of Congress as well as professionals who had knowledge of the tax code. Simultaneously, the Committee on Ways and Means held public meetings to listen to the opinions of the American public. The meetings and idea forums were held in order to determine what kind of reform was needed to most benefit the economy, as well as individual citizens (A Better Way).

The ideas behind the tax reform were simple, to create more jobs for Americans by bringing companies back home that had expanded their business abroad, and to lessen the tax burden on the middle-class. There were four simple goals that President Trump believed would align with these ideals. They can be found in a pdf document on Donald Trump's website:

1. Tax relief for middle class Americans: In order to achieve the American dream, let people keep more money in their pockets and increase after-tax wages.

2. Simplify the tax code to reduce the headaches Americans face in preparing their taxes and let everyone keep more of their money.

3. Grow the American economy by discouraging corporate inversions, adding a huge number of new jobs, and making America globally competitive again.

4. Doesn't add to our debt and deficit, which are already too large. (Trump)

It is evident that President Trump and the Republican members of Congress had middle class Americans in mind when developing this reform. The law centers around incentivizing domestic companies to bring their outsourced jobs back to the United States. It also is designed to simplify the tax paying process for a vast majority of Americans, which would save them money on tax preparation. In this thesis, I will focus on the changes made to the tax policy for individuals. Specifically, I will target the major changes involving tax brackets, personal exemptions, filing statuses, and deductions. Once I have explained in detail the changes to the actual tax policy regarding this areas, I will discuss possible outcomes for individuals and the economy on a macro scale.

Tax Brackets and Filing Statuses

The new tax law slightly modifies the existing tax brackets for all filing statuses. Shown in the table below are the rate and bracket changes for single filers. It can be seen in the graph that middle class taxpayers, on average, will be subject to a slightly lower tax rate for their bracket. Although, taxpayers that have been on the upper end of their bracket, earning between $160,000 and $195,000 approximately, will actually see an increase in their income tax. This exception also applies to earners between $200,000 and $424,000 (Katzeff).

Old Vs. New Tax Brackets For Single Filers

Old brackets		New brackets	
Taxable income	Tax rate	Taxable income	Tax rate
$0-$9,525	10%	$0-$9,525	10%
$9,526-$38,700	15%	$9,526-$38,700	12%
$38,701-$93,700	25%	$38,701-$82,500	22%
$93,701-$195,450	28%	$82,501-$157,500	24%
$195,451-$424,950	33%	$157,501-$200,000	32%
$424,951-$426,700	35%	$200,001-$500,000	35%
$426,701+	39.6%	$500,001+	37%

Sources: docs.house.gov, taxfoundation.org

These are not the dramatic differences that were originally promised by President Trump. The initial tax plan had called for only three brackets.

The changes remain consistent through the other major filing statuses of married filing jointly and separately. The new tax law removes the so-called "marriage penalty" for all but the highest brackets. The penalty occurs when two individuals who earn similar incomes are married and choose to file jointly (KPMG). With their incomes combined, the tax penalty they experience can reach up to 12% of their income (Pomerleau). This will have a large impact on younger and middle class couples whose marriage decision will not have a negative effect on their bottom line.

Head of household will experience the largest change of the filing statuses. In the current law, head of household experienced a considerable tax relief as opposed to the single or married filing jointly statuses. The figure shows how the new law eliminates any differences in single and head of household filers at the 24% rate and above. Overall, the lower rates and higher tax brackets mean that the

Head of Household			
2018 Current Law		New Law	
Tax Rate	If taxable income is:	Tax Rate	If taxable income is:
10%	$0 to $13,600	10%	$0 to $13,600
15%	$13,601 to $51,850	12%	$13,601 to $51,800
25%	$51,851 to $133,850	22%	$51,801 to $82,500
28%	$133,851 to $216,700	24%	$82,501 to $157,500
33%	$216,701 to $424,950	32%	$157,501 to $200,000
35%	$424,951 to $453,350	35%	$200,001 to $500,000
39.6%	$453,351 or more	37%	$500,001 or more

average taxable income will attract a lower effective tax rate (KPMG). This will benefit a majority of individuals.

Personal Exemption and Deductions

A major change that will affect all taxpayers is the elimination of personal exemptions. This alteration in the tax code has drawn significant scrutiny from the media and public because of its magnitude. For a family of four, personal exemptions would total $16,600 for the 2017 tax year. Taking away these exemptions would obviously have a substantial impact on the average taxpayer.

To combat the removal of the exemptions, the new tax plan nearly doubles the amount of the standard deduction. The standard deduction allowed for single taxpayers goes from $6,500 to $12,000 and from $13,000 to $24,000 for married taxpayers filing jointly. A near doubling in the standard deduction is meant to not only offset the lack of personal exemptions, but to also simplify the tax filing process for the working class (KPMG). President Trump and the GOP had set out to make tax reform simpler and less time consuming. This alteration in the tax law will play a large role in helping them achieve the goal of simplicity. According to the Tax Policy Center, 30% of taxpayers choose to itemize their deductions under the current tax law but that number could drop to 10% with the raising of the standard deductions (Strauss). That is a staggering difference.

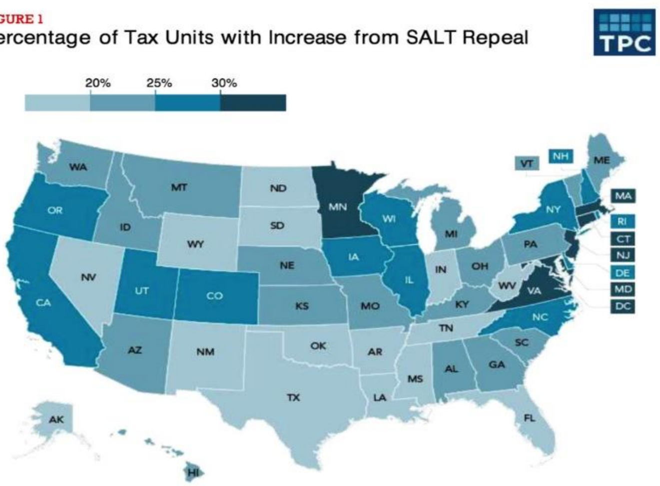
The drop can also be attributed to removal or changes made to several existing itemized deductions. Here are four of the most popular itemized deductions and how the Tax Cuts and Jobs Act has altered them:

State and Local Taxes:

Under the current tax law, the "SALT" deduction, as it is often referred to, allows taxpayers who itemize their deductions to deduct their property taxes and then choose whether to deduct their state income or sales tax. This benefits high income earners in states where the state income or sales taxes are higher. Depending on the state, the taxpayer may choose either the income or sales tax to deduct. These deductions had no limit which caused the government to forfeit a great deal of possible revenue. In response to losing revenue from lowering individual and business federal income tax rates, legislative bodies decided to cap the amount of SALT deduction allowed to $10,000. The $10,000 is a combined limit on state and local property and income taxes (Josephson). This will have a very large impact on high income earners in states with higher income or sales taxes. This will also have play a large role in the decision to itemize or take the standard deduction.

The figure below shows an initial approximation of the effect that a change or repeal of the SALT deduction on taxpayers. The figure shows the percent of taxpayers that would see a net increase in their yearly taxes if the deduction were to be repealed or changed. It shows that a majority of states would see between 20% and 30% of its residents negatively affected, while a few states are shown to have greater than 30% affected (Matthews). It demonstrates the importance of the SALT deduction and its widespread use by taxpayers.

FIGURE 1
Percentage of Tax Units with Increase from SALT Repeal



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0515-1).

An example of how large of an impact it will have on taxpayers in certain states would be New York. Thirty four percent of taxpayers in the state of New York currently deduct their state and local taxes as an itemized deduction. The average size of that deduction is $21,038.02. That is $11,038.02 over what is now the $10,000 limit created by the Tax Cuts and Jobs Act (Josephson). That is a large decrease for the average taxpayer of New York. The GOP claims that this reduction is offset by the lowering of federal income tax rates, but as we have discussed previously, those who are on the upper border of certain current income tax brackets may not be experiencing a tax break in the first place.

Medical Deduction:

The medical deduction does not see any radical changes. However, it is restored to the 7.5% threshold that had been in place before the most recent reform bumped it up to 10%. Taxpayers will be able to deduct all unreimbursed medical expenses in excess of 7.5% of their adjusted gross income. The 2.5% drop is substantial to citizens with high medical costs. The change is supposed to only last two years before reverted back to the 10% mark, but there is expected to be a large push for legislation to amend this reversion. Again, fewer Americans will be choosing to itemize deductions with the increase in the standard amount, but those who do will see a benefit from this lower threshold.

Mortgage and Home Equity Loan Interest:

Under the current law, mortgage interest is deductible on up to $1 million of the principle mortgage. This $1 million amount is lowered to $750,000 by the new tax law. This change will affect individuals who live in areas with high costs of living. San Francisco, for example, has an average home value of $1.5 million. Also, the new law disallows the deduction of qualified residence interest. Qualified resident interest includes interest on debt that is used in "acquiring, constructing, or substantially improving a taxpayer's residence" (KPMG). Formally, qualified resident interest was deductible regardless of how the debt proceeds were used. These changes will likely have a negative effect on the housing market by decreasing the incentive to purchase residencies.

Charitable Contributions:

The Tax Cuts and Jobs Act increases the limitation for charitable contributions of cash from individuals to public charities and certain private foundations to 60% from the previous 50% amount (KPMG). This will encourage those who itemize and participate in philanthropy to increase their donations to the charities of their choice. In 2015, 82% of the taxpayers that itemized their deductions included some form of charitable donation. Under the previous tax law, donations made to higher education institutions in order to obtain seating at an athletic event in the stadium of the institution were deductible up to 80%. Large institutions collected enormous amounts of revenue from these donations that were incentivized by this deduction. The new tax law completely eliminates this deduction in order to increase government revenues to help pay for tax reductions in other areas of the law. This deduction elimination alone is projected to raise government revenue by $2 billion over the next 10 years (KPMG). Companies, individuals, and colleges will experience an adverse effect from this repeal. I expect changes to be made in the collegiate athletic system to compensate for the loss of this incentive to donate to the programs. Top athletic programs will lose millions of dollars in annual revenue. I have spoken with company executives that have decided to not renew ticket purchases for next year due to the loss of this deduction.

The relationship between the personal exemption and deduction changes in the new tax law can be understood by thinking of the two being on the opposite ends of a seesaw. When a change is made to one, an adjustment must be made to the other in order to balance. In this case, the complete elimination of personal exemptions leads to major changes in deduction laws. The increase of the standard deduction alone does not balance the exclusion of personal exemptions. "Under the current law, for the 2018 tax year a married couple with two qualifying dependent children would have had a standard deduction of $13,000 and individual exemptions of $16,600, for a combined deduction of $29,600, $5,600 greater than the deduction allowed under the current law" (KPMG). It seems that after most changes to exemptions and deductions are accounted for, the repeal of personal exemptions will have a larger, negative effect on the taxpayers than the positive effect of the higher standard deductions.

Adjustments made to the child tax credit may create a larger benefit than personal exemptions allowed under current law. The child tax credit has been raised from $1,000 to $2,000 per qualifying child. The child must have a social security number in order to receive the full amount, otherwise they would receive only $500. The credit is now subject to phase-out at $400,000 instead of $110,000 for joint filers and $200,000 instead of $75,000 for single filers. Raising the credit and the phase-out threshold will greatly benefit middle class families. As the trend continues, the upper class will not be affected or helped by this credit adjustment. These individual policy changes have been made with middle and lower class Americans in mind, to save them money and simplify their tax return. Overall, the modification to the standard deduction will decrease government revenues by an estimated $720 billion over the next 10 years and the repeal of personal exemptions will increase revenues by an estimated $1.21 trillion over 10 years (KPMG). The GOP plans to use these changes to generate additional revenue to help pay for tax cuts in other areas of the law.

Projecting Economic Impact

Economy

Different analysts have varying opinions on how much the new tax law will affect the overall economy. They agree that it will have a positive effect on the country's GDP over the first 10 years. The tax policy center projects an immediate .8% change in GDP in 2018 followed by a steady declining growth rate over the next 9 years. They attribute this increase largely to an increase in aggregate demand in the short term. As household after-tax incomes rise due to more favorable tax rates, even if only moderately, the extra income will be put back into the economy through consumption of goods and services. This will boost the GDP over the next few years (James).

TABLE 1

Dynamic Effects on GDP of the Tax Cuts and Jobs Act

FY 2018–37

	Fiscal Year										
	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2037
	GDP ($ billions)										
Before macroeconomic feedback	19,926	20,661	21,378	22,168	23,037	23,948	24,899	25,889	26,917	27,985	41,419
After macroeconomic feedback	20,077	20,800	21,493	22,279	23,157	24,075	25,032	26,029	26,944	27,978	41,420
	Percentage change in GDP caused by macroeconomic feedback										
	0.8	0.7	0.5	0.5	0.5	0.5	0.5	0.5	0.1	0.0	0.0

Source: The GDP forecast through 2027 is from CBO, *The Budget and Economic Outlook: 2017 to 2027* (January 2017) and for 2028–37 is from CBO, *The 2017 Long-Term Budget Outlook* (March 2017); macroeconomic feedback estimated using TPC's macroeconomic models.

Note: CBO = Congressional Budget Office; GDP = gross domestic product.

The temporary increases in GDP will be offset in later years when rising interest rates and prices will cause the economy to correct to its long term potential level. A large factor in the rising national GDP is the substantial lowering of the corporate rate. Companies now have the financial ability to hire and maintain a larger number of employees, increasing the national labor supply. These increases will exist until the expiration of the tax changes in 2025. The combination of aggregate demand and labor supply increases leads to a GDP increase. Thus, the overall economic outlook is positive in at least the short term and then corrects back to normal growth past that.

Individual

The impact for individuals appears to be modest. The lower income tax rates for most individuals will benefit them proportionately based on their income level. Some, as was analyzed earlier in this report, will actually see an increase in their taxes. This is mainly due to modifications of the deductions and personal exemptions or being on the upper border of a current tax bracket.

The top 5% of income earners in the country will see the most benefit under the tax changes. The chart below is based mainly on changes in the income tax rates without regard for filing statuses and some of the nuances associated with the changes in deductions and exemptions (Amadeo).

TABLE 2

Distribution of Federal Tax Change of the Tax Cuts and Jobs Act as Passed by House Ways and Means

By expanded cash income percentile, 2027[a]

Expanded cash income percentile[b]	Percent change in after-tax income[c]	Share of total federal tax change (%)	Average federal tax change (dollars)	Average federal tax rate[d]	
				Change (% points)	Under the proposal (%)
Lowest quintile	0.1	0.4	-10	-0.1	4.2
Second quintile	0.1	1.3	-50	-0.1	8.8
Middle quintile	0.5	8.1	-360	-0.4	13.4
Fourth quintile	0.7	15.8	-840	-0.6	16.4
Top quintile	1.3	73.6	-4,590	-1.0	25.3
All	0.9	100.0	-860	-0.7	19.5
Addendum					
80-90	0.4	6.7	-810	-0.3	19.4
90-95	0.2	2.4	-600	-0.2	21.7
95-99	1.4	17.5	-5,690	-1.0	24.6
Top 1 percent	2.6	47.1	-62,300	-1.8	31.7
Top 0.1 percent	3.0	24.4	-320,640	-2.0	31.8

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0217-1)

Notes: Number of Alternative Minimum Tax (AMT) taxpayers (millions): Baseline: 5.6; Proposal: 0.

(a) Calendar year. Baseline is current law. Proposal includes all provisions contained in H.R. 1 as passed by the Committee on Ways and Means on 11/9/2017.

(b) Percentiles include both filing and non-filing units but excludes those that are dependents of other tax units. Tax units with negative adjusted gross income are excluded from their respective income class but are included in the totals. The income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks are (in 2017 dollars): 20% $28,100; 40% $54,700; 60% $93,200; 80% $154,900; 90% $225,400; 95% $304,600; 99% $912,100; 99.9% $5,088,900. For a description of expanded cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm

(c) After-tax income is expanded cash income less: individual income tax net of refundable credits; corporate income tax; payroll taxes (Social Security and Medicare); estate tax; and excise taxes.

(d) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, the estate tax, and excise taxes) as a percentage of average expanded cash income.

Every individual should save money on their next tax return, even though some more than others.

Conclusion

Looking at the tax law in its entirety, it is clear that the policies favor businesses more than individuals. While individuals are receiving a modest tax benefit, businesses will be seeing the largest drop in tax rates. The business tax cuts are permanent, while individual changes are set to expire in the year 2025. Areas that significantly increase the deficit on the business side are compensated for by changes made to the individual side such as the repeal of personal exemptions. The average American's greatest benefits from this new law will be experienced more indirectly. Rather than a simpler tax form to turn in, middle and lower class Americans will have to look past significant tax savings to find the advantages of this law. Businesses' large tax cuts will allow them to spend more money on hiring and maintaining a larger workforce, as well as increasing salaries and wages for existing employees. It is a tax reform built for big business and upper class individuals. This is a recipe that has been used, and repealed before. I believe that this reform is no different than the many that have preceded it. While the impact on business and the economy remains to be seen, it is my opinion that there will definitely be a next tax reform and it will include numerous changes to these individual policies.

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