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William Watson: The surprising way Trump's tax reform could end U.S. income inequality

By William Watson

High-income taxpayers will twist like pretzels to become corporations, reversing the effect of 1986's reforms

Donald Trump's tax plan¹ on a napkin, issued last week, won't actually end inequality in the U.S. But a new study by economists Fatih Guvenen² of the University of Minnesota and Greg Kaplan³ of the University of Chicago suggests big tax reforms can induce what at least appear to be big changes in inequality. It has happened before, they show, and, though they don't actually say so, there's no reason to suppose it couldn't happen again.

The classic case, and the one that kicked off the spike in inequality that has become the overriding political issue in the U.S. and around the world, was the Americans' 1986 tax reform. It did a lot of good things in terms of eliminating loopholes and lowering tax rates, which had big real effects on the US economy and set a great example for tax reforms elsewhere, including in Canada.

But it also led to tax-induced income switching, in particular the movement of income from corporations to individuals. A big part of the tax reform was a cut in the top personal rate from 50 to 33 per cent. There was a little work on corporate taxes, too, but at the end of the day top personal rates that had started out above corporate rates ended up below them. That created an incentive for people to change corporate income into personal income. One mechanism for doing so was the "S-corporation," generally used by smaller businesses, which allows business income to be flowed through to personal income, which after 1986 paid a lower rate.

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After the reform, there was a noticeable drop in the number of regular corporations paying tax at the regular corporate rate and a big increase in the use of S-corporations. Lots of people - mainly upper-income people - switched from paying corporate taxes to paying personal income taxes.

How did that affect inequality? Some of the most influential inequality data are based on personal tax data. If there's a big influx of income from the corporate tax side to the personal tax side, and if income levels and shares are calculated with data from the personal side, it will look as if there's been a big increase in income, mainly at the top end.

But has that really happened? Or is it just a case of what used to be corporate income showing up as personal income, with nothing much changing in reality?

Guvenen and Kaplan note that "the increase in top income shares in the two years immediately following (the tax reform of 1986) is larger than the entire increase in top income shares over the period from 1981 to 2000." That looks very much as if tax-induced income switches are being counted as new income that really isn't. They also find that when they look only at labour income from the Social Security Administration, which leaves out entrepreneurial income of the S-corporation kind, inequality is flat or even down a bit since 2000. They find essentially the same thing with tax data if they discount the two big-change years of 1986 and 1987.

Donald Trump doesn't actually enter their story. But his 221-word tax plan (51 words shorter than the famously short Gettysburg Address) does exactly the reverse of 1986: It reduces the tax rate for all corporations, big and small, to 15 per cent, while on the personal side it has three rates: 15, 25 and 35 per cent.

What's the incentive for high-income taxpayers? They'll salivate at a 15 per cent corporate rate, 20 points lower than the top marginal personal rate, and twist like pretzels to turn themselves into corporations, thus sharply reversing the effect of the 1986 reform, which favoured the personal tax side over the corporate.

But if the advantage goes back to corporations, then lots of income that's currently being counted as personal income will go back to being corporate, as it was before 1986. If all the income that does go back to corporations gets dropped from the calculation of personal-income inequality, we could see the same kind of change in inequality that took place in 1986 and 1987, except in reverse.

Will the social commentary of the later Trump era focus on the dramatic drop in inequality of 2019–20 and how, against all odds, the billionaire populist stemmed an apparently inexorable social trend? Virtually all commentators say the Trump tax plan hasn't a hope of passing, so probably not. But it's interesting to dream. And it does raise an important policy point: Good tax reforms treat all types of income the same so that taxpayers aren't rewarded for changing the form of their income flows while leaving the substance the same.

References

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