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EXECUTIVE SUMMARY

The Next Business Tax Regime: What Comes After the TCJA

by Owen Zidar and Eric Zwick

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Introduction

The US economy has experienced large federal deficits since early in the first decade of the 2000s, even during times when the economy is operating at or beyond full employment. To rein in deficits and bring spending and revenue more in line, policymakers will need to consider various ways to increase tax revenue. Owen Zidar and Eric Zwick make the case for a reformed business tax regime that would raise substantial amounts of new tax revenue in a way that preserves productive business activity, promotes efficiency by harmonizing tax rates across income tax bases, and improves tax progressivity. Specifically, they propose eliminating tax preferences for pass-through businesses, adjusting corporate tax rates to better incentivize investment, and returning to tax policies that prevailed in 1997.

Background

Given how important business income is to the nation's overall tax base, the taxation of business income must be a key element of fiscal reform. Furthermore, since a substantial portion of top income and wealth comes from business activity, increasing the progressivity of the overall federal tax code requires grappling with how to tax business income.

To set the stage for a consideration of business tax reform, Zidar and Zwick note that since the 1980s, there has been a substantial shift in US business income from traditional C-corporations subject to corporate income tax to "pass-through" businesses, whose owners pay taxes on this pass-through income based on individual (rather than corporate) tax rates. Much of this pass-through business income accrues to individuals at the top of the US income distribution, including doctors, lawyers, and middle-market business owners. A substantial amount of top compensation for the owners of pass-through firms comes in the form of qualified small-business stock, carried interest, and stock options, which the authors argue are more appropriately thought of as labor compensation provided in a tax-advantaged way.

The key point here is that the shifting of income to pass-through business structures allows many high-income business owners to legally reduce their overall tax burdens, resulting in a reduction in tax revenue collected by the US government. Reforming business taxation to address the nebulous boundary between labor and capital income provides a progressive way to increase tax revenues.

Revisiting the provisions of the 2017 Tax Cuts and Jobs Act (TCJA) is an obvious place to start when it comes to reforming business taxation in the US. The TCJA provided the largest corporate tax cut in US history (measured as a share of GDP) and continued a trend of steadily declining corporate tax rates since 1950. Among other provisions, the TCJA lowered the corporate tax rate from 35 percent to 21 percent, repealed the corporate Alternative Minimum Tax, and moved the corporate tax regime in the direction of territorial rather than worldwide taxation. The lower corporate tax rate increased the attractiveness of C-corporations relative to pass-throughs, but the law also introduced a 20 percent deduction of qualified business income (QBI) in certain sectors. This provision lowered top marginal income tax rates and strengthened the incentives for eligible pass-through owners to characterize wages as profits.

Research conducted on the effects of the 2017 TCJA has established that the TCJA likely increased investment, but it did not lead to an increase in revenue or wages. Zidar and Zwick observe that corporate revenues increased in the wake of TCJA but not enough to lead to a net increase in tax collections. Tax collections fell from around $375 billion per year in the middle of the 2010s to below $250 billion per year following the TCJA. TCJA advocates also predicted wage increases of $4,000 to $9,000 for the average worker. They did not materialize. Though payroll spending of C-corporations did increase by 1.2 percent post-TCJA, researchers have found that almost all that increase went to top-paid workers and executives. There was no observed increase in the wages of the median worker.

Policy Proposals

Zidar and Zwick outline four sets of reforms to business taxation. They estimate that these proposed changes would increase federal revenues by an estimated $4.4 trillion over 10 years, setting US fiscal policy on a more sustainable path without undercutting the United States' business competitiveness.

- **Return to a 1997-style tax policy.** Zidar and Zwick recommend returning to 1997 tax rates and restoring the IRS to the funding levels and audit rates that existed in the late 1990s and first decade of the 2000s. They cite simulations by the Penn Wharton Budget Model showing that modestly increasing dividend, estate, capital gains, and top individual income tax rates to those that existed in 1997 would raise trillions of dollars in tax revenue and increase the progressivity of the tax code.

- **Reduce tax preferences for pass-through businesses.** The authors advise eliminating the so-called Gingrich-Edwards tax loophole that allows some pass-through owners to more easily characterize labor income as lower-taxed business income. They also argue that the TCJA QBI deduction, which allows owners to deduct up to 20 percent of their qualified business income on their taxes, has limited economic benefits and should be allowed to expire.

- **Raise the corporate rate to 28 percent, restore research and development incentives, and limit interest deductions.** Zidar and Zwick recommend raising the corporate tax rate to 28 percent; they cite estimates suggesting that doing so would raise $1.3 trillion over the next ten years. Furthermore, they cite estimates showing that three quarters of US corporate stock is held by nontaxable groups, including foreigners, tax-advantaged retirement accounts, and nonprofits. They question the rationale for subsidizing the activities of such actors, especially if the lower rate is paired with strong investment incentives (such as accelerated depreciation) and more-generous support for research and development, which was weakened by the TCJA.
- **Reduce TCJA's incentives to invest abroad by reforming international tax provisions.** Zidar and Zwick recommend removing incentives to offshore physical investment by reforming the way the TCJA taxes multinational corporations. They observe that current TCJA rules effectively subsidize the movement by multinationals of capital to other countries, and that changing these rules would mitigate these factors. They also recommend that the US align, with cooperating countries, its policies on global minimum corporate tax rates.

Conclusion

The approaching expiration of several TCJA provisions (many at the end of 2025) presents an opportunity to reform the business tax code. Given the flexible boundary between labor and business income among top US earners, any effort to meaningfully address revenue shortfalls should include reforms of the business tax regime. Drawing on recent lessons from the Tax Cuts and Jobs Act, the US can implement reforms to the business tax code that raise revenue in a progressive way, without meaningfully hindering business activity or America's global competitiveness.

ABOUT THE AUTHORS

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Owen Zidar is a professor of economics and public affairs in the Princeton University department of economics and School of Public and International Affairs. He is also a research associate at the National Bureau of Economic Research and a co-editor of the Journal of Public Economics. Professor Zidar is a public finance economist who studies the taxation of firms and top earners, local fiscal policy, and the creation and distribution of economic resources. Before joining Princeton, Zidar worked as an assistant professor of economics at the University of Chicago Booth School of Business, a staff economist at the Council of Economic Advisers, and as an analyst at Bain Capital Ventures. Zidar holds a

PhD in economics from the University of California, Berkeley. His pre-doctoral studies were at Dartmouth College where he earned a BA, summa cum laude, in economics (high honors). He is a 2018 recipient of a National Science Foundation CAREER award and a 2020 recipient of the Sloan research fellowship.

Eric Zwick

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Eric Zwick is currently a faculty research fellow in the NBER programs on public economics and corporate finance. He studies the interaction between public policy and corporate behavior, with a focus on fiscal stimulus, taxation, and housing policy. His research draws insights from finance and behavioral economics while using a variety of methods: new data, natural experiments, theory, and anecdotal exploration. Zwick is particularly interested in the problems that small and medium-sized private firms and new ventures face, from the perspective of owners, investors, managers, and workers. A secondary area of interest concerns the role of bounded rationality and imperfect information in the design of policies that promote behavior change. This work focuses on determinants of habit formation in health and workforce productivity settings. Zwick earned a PhD and MA in business economics from Harvard University and a BA in economics and mathematics with high honors from Swarthmore College. Prior to grad school, he worked as a research assistant at the National Bureau of Economic Research and as a web and software developer for several start-ups and nonprofits.

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