

Risks and Opportunities in the 2025 Tax Debate

Testimony of
Kimberly A. Clausing
Eric M. Zolt Professor of Tax Law and Policy
University of California, Los Angeles

Before the
Joint Economic Committee

12 March 2024

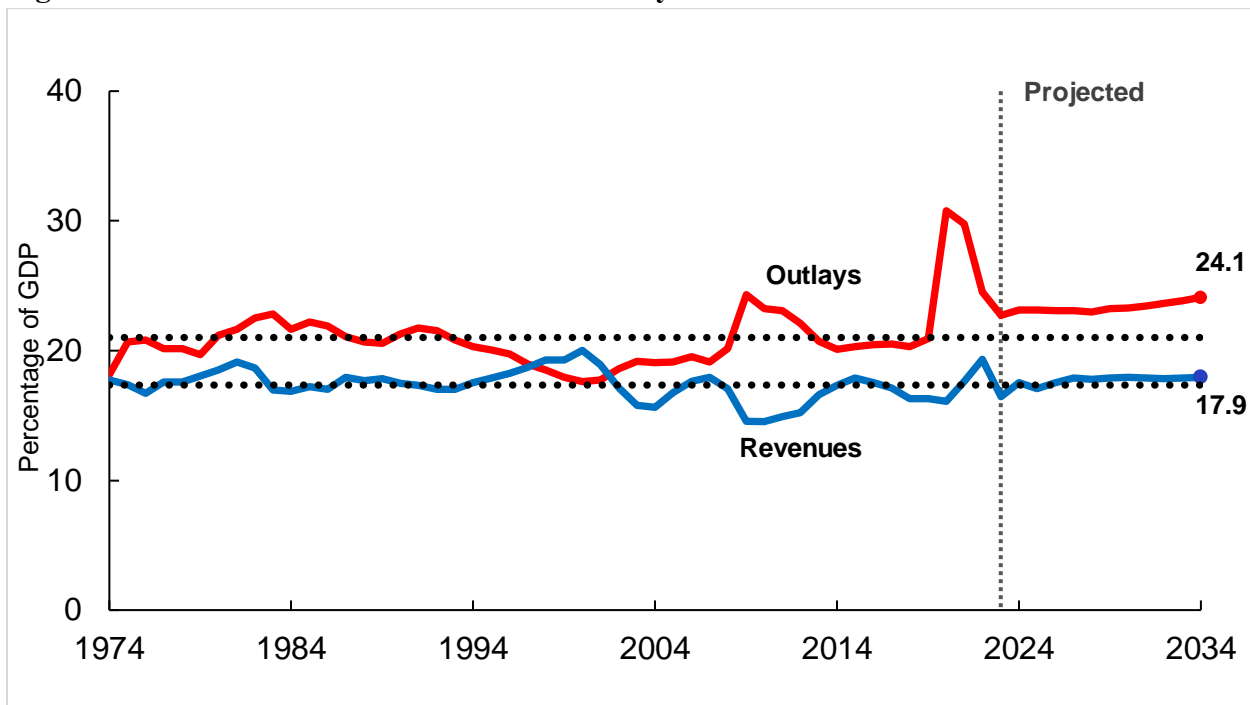
Chairman Heinrich, Vice Chairman Schweikert, Members of the Committee: Thank you for inviting me to share my views on the U.S. fiscal situation. The time ahead marks an important moment in U.S. tax and budget policy. In my testimony today, I will make five key points.

1. Our fiscal situation comes with important challenges. In an environment of rising deficits and debt, the looming expiration of many Tax Cuts and Jobs Act (TCJA) provisions will create pressures for lawmakers to extend these provisions. However, simply extending these unaffordable tax cuts without a broader rethink of tax policy principles would be unwise.
2. In 2025, tax reform can be a key component of responding to fiscal pressures and building a tax system that is fairer, more efficient, and better suited to U.S. economic leadership.
3. A suite of corporate and international tax reforms would help meet these challenges while reducing the offshoring and profit shifting incentives that are baked into current law. Such reforms are now more desirable than ever due to the adoption of the international tax agreement in many jurisdictions abroad, which is reducing tax competition pressures.
4. Climate policy can help achieve both fiscal and environmental goals in 2025. Layering a modest carbon fee on top of the Inflation Reduction Act could reduce emissions, generate large streams of revenue, and facilitate cooperative efforts with our partners abroad to incentivize worldwide emissions reduction.
5. Many other sensible revenue-raisers are available to finance fiscal priorities and reduce the deficit while simultaneously building a more fair and efficient tax system. At the same time, we can afford to better support workers and families. Toward that end, both the child tax credit and the earned income tax credit should be expanded.

Fiscal Pressures

The latest Congressional Budget Office (CBO) budget forecasts are concerning. Deficits for the decade ahead are expected to average about 5.7 percent of GDP, and federal debt (held by the public) is expected to rise over the next decade from its current level of about 99 percent of GDP to 116 percent of GDP. Due to higher interest rates, interest costs are estimated to be about 3 percent of GDP in 2024, or about \$870 billion, which is an amount very similar to what we spend on national defense; interest spending will rise to about 4 percent of GDP by the end of the decade. According to the CBO, the fiscal outlook for decades further out is even more concerning, with deficits steadily rising over the coming three decades, and federal debt reaching about 160 percent of GDP by mid-century.

Figure 1: CBO Forecasts of Total Federal Outlays and Revenues as a Share of GDP



Source: Figure 1-3 of [CBO \(2024\)](#).

In fact, these forecasts are optimistic since they assume current law will remain in effect. This means all TCJA provisions slated to expire next year truly expire, and several important TCJA business tax provisions continue to become less taxpayer-favorable over time, provisions that are currently raising the after-tax costs of research and development and investment.

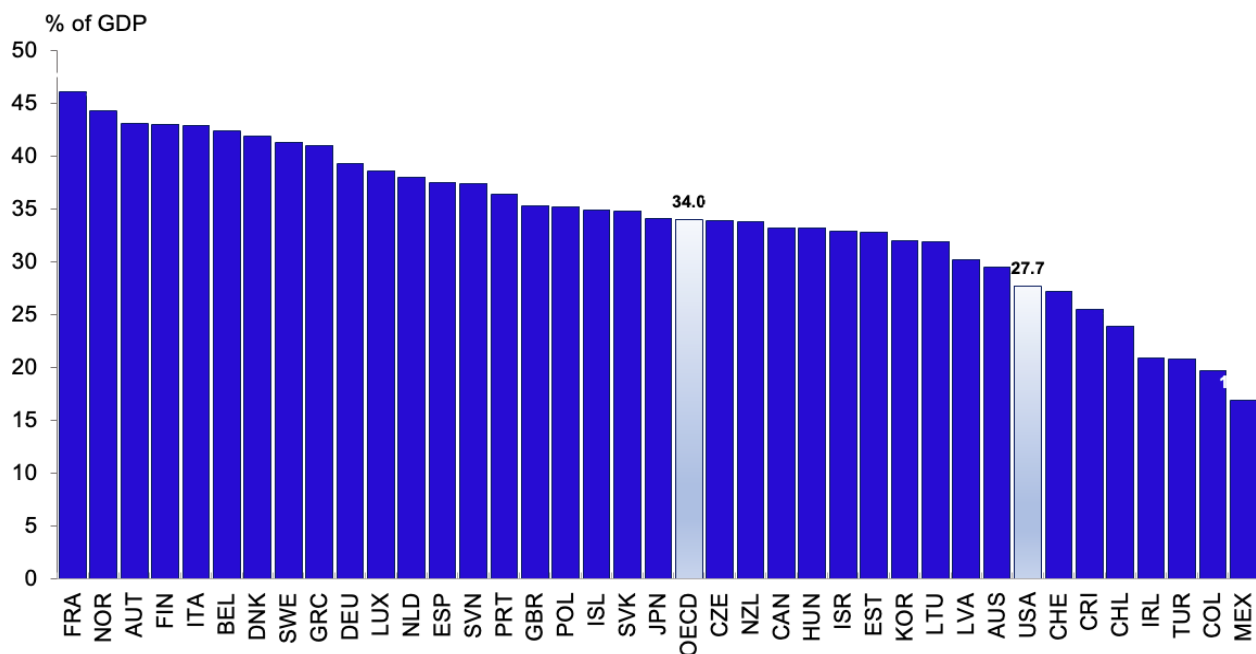
Such fiscal forecasts are concerning for several reasons. First, high levels of deficits and debt reduce the fiscal flexibility of the U.S. government, flexibility that may be needed to respond to future emergencies or recessions. Second, government borrowing redistributes fiscal resources away from our children and grandchildren toward current taxpayers. Third, government

borrowing (all else equal) will tend to increase interest rates, resulting in either a reduction in domestic investment, an appreciation of the dollar (and thus a weakening of our trade balance), or most likely, some of both effects.

In [recent work](#), I've suggested that Congress should seek to cut primary deficits in half in order to stabilize the debt to GDP ratio. To do so, there is a role for both spending reductions (when feasible) and tax increases. In my testimony, I will focus on tax increases, since my expertise lies in that area. But regardless, spending cuts alone will not be sufficient to address our fiscal situation.¹

At present, U.S. federal revenues are simply inadequate to meet our fiscal needs. Over the last fifty years, government outlays have averaged 21 percent of GDP. When we last ran a balanced budget, at the turn of the century, we collected about 20 percent of GDP in federal taxes. At present, we collect about 17.5 percent of GDP in federal taxes. Even considering state and local taxes, U.S. tax revenues as a share of GDP are quite low. The United States was ranked 32 out of 38 well-off countries in terms of tax relative to GDP, with only Switzerland, Costa Rica, Chile, Ireland, Turkey, Columbia, and Mexico having lower tax shares.

Figure 2: OECD Rankings of Tax Revenues as a Share of GDP, 2022

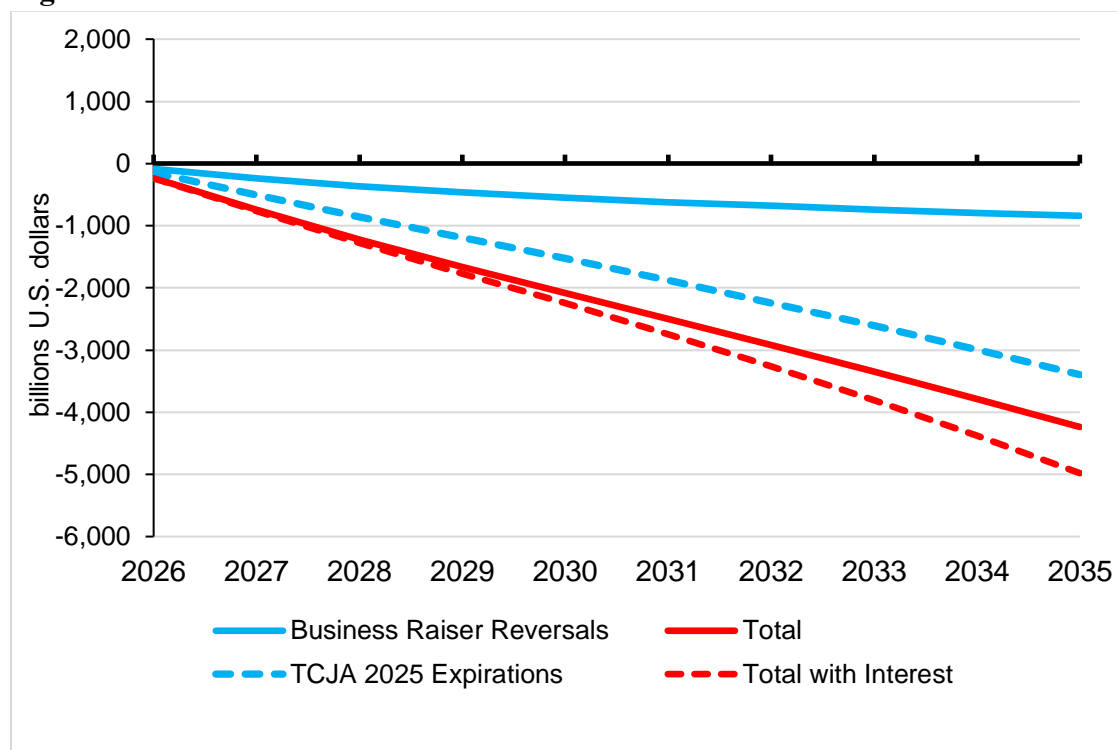


Source: [OECD Revenue Statistics](#).

¹ As one example, a [recent CBO analysis](#) found that, if the Tax Cuts and Jobs Act provisions are extended past 2025, it is mathematically impossible to balance the budget in ten years without either tax increases or spending cuts in Social Security, Medicare, defense, or veterans' programs. Even if the Tax Cuts and Jobs Act provisions are not extended, budget balance would require draconian (86 percent) cuts in every other program, should Social Security, Medicare, defense, and veterans' programs be left untouched.

In recent decades, the U.S. federal government has engaged in a tax policy ratchet whereby Republican lawmakers lower tax rates and revenues, and Democratic lawmakers raise them again, but only partially making up the difference. After the Bush tax cuts were due to expire in 2012, a compromise kept tax cuts from being extended for the highest income taxpayers, but other tax cuts were retained. Now, as many Tax Cuts and Jobs Act provisions expire at the end of next year, we simply cannot afford to extend them as they stand. A full extension of the expiring TCJA provisions, alongside a reversal of the business tax raisers that are built into TCJA, would cost more than \$4 trillion (\$5 trillion with interest) over the 2026-2035 budget window, adding substantially to current CBO estimates of deficits and debt, which assume that TCJA provisions evolve (and expire) according to current law.

Figure 3: Cumulative Deficit Effects of TCJA Extensions

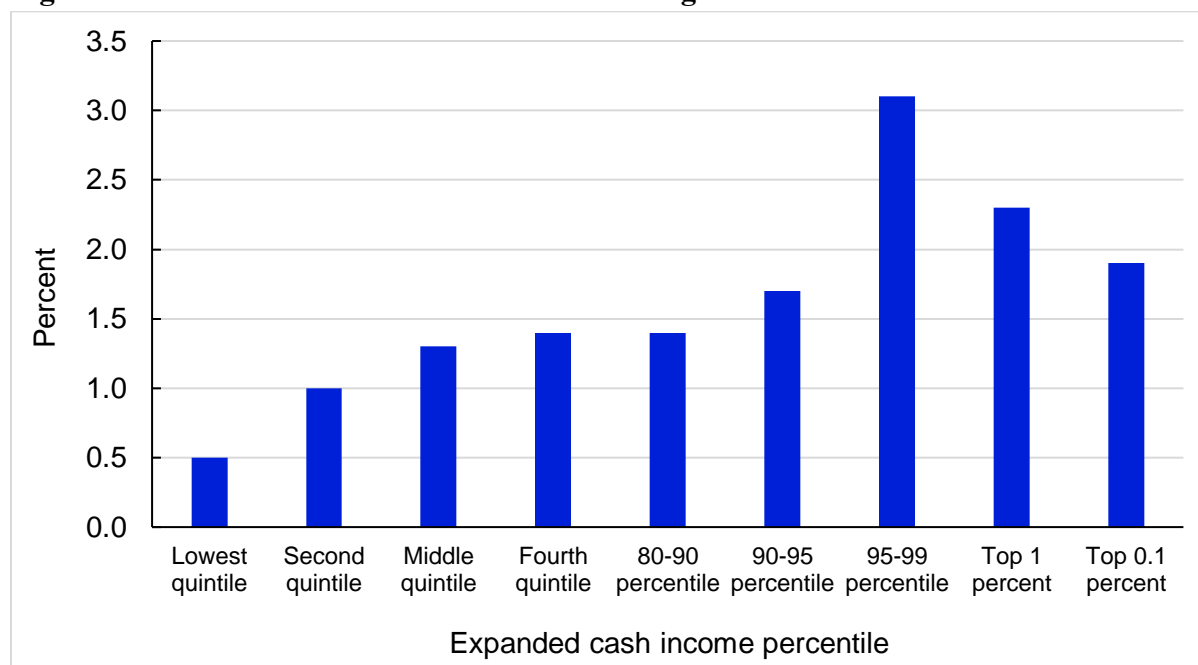


Source: Estimates are from the Committee for a Responsible Federal Budget. These estimates are similar to those published by the Congressional Budget Office if the latter are extended to the 2026-2035 window.

Further, extending TCJA provisions would disproportionately benefit those at the top of the income distribution. When Congress passed the 2017 tax legislation, they made the most unpopular and regressive parts of the tax bill permanent, while making more popular provisions temporary.² Still, even the individual tax cuts disproportionately benefited those at the top. This is not just the case for the estate tax and the top-income tax bracket; those with high incomes also benefit from the entire structure of lower tax rates on portions of their income.

² This strategy was acknowledged by former Speaker Paul Ryan during a [recent event](#).

Figure 4: Gains in After-Tax Income from Making TCJA Provisions Permanent



Source: [Tax Policy Center](#). Analysis includes all expiring individual income tax, estate tax, and pass-through business tax provisions. It does not include reversing corporate tax provisions that would otherwise become less favorable under TCJA; that inclusion would further skew the benefits of extension toward the top of the distribution.

Several expiring TCJA provisions simultaneously lose revenue, create a less fair tax system, and generate new inefficiencies; such provisions should be at the top of the list for expiration. For example, the Section 199A provision provides a 20 percent tax cut for some recipients of pass-through business income. This provision is complicated, it distorts investment across sectors of the economy, and it is also [highly regressive](#), with about 55 percent of benefits going to the top 1 percent of households, and only 3 percent going to the bottom half of the income distribution. Extending the provision would be costly, costing about \$700 billion over 2026-2035. Likewise, extending the estate tax cut (which only benefits the richest 2 in 1,000 estates) would be costly and regressive, costing about \$170 billion over the same window and helping only a tiny fraction of wealthy heirs.³ Other TCJA provisions raise more difficult questions. By far the most expensive extension is the current rate structure. While policymakers may be tempted to extend the tax cuts in all but the top tax brackets, doing so would drive trillions of dollars of deficits in the decades ahead, while mostly benefiting higher-income households.

Instead of blindly extending the TCJA tax provisions, I suggest a revenue-neutral extension of parts of TCJA in [recent work](#); this would allow lawmakers to keep elements of TCJA that have worked well without increasing deficits.

³ These estimates simply extend prior estimates published by CBO to the budget window 2026-2035.

In general, we should view 2025 as an opportunity to make the U.S. tax system better. Prior decades of high and rising inequality have strengthened the case for progressive tax reforms, even as tax policy has too often moved in the opposite direction. Many changes in our economy, such as rapid technological progress, create both winners and losers, even as they improve productivity and economic growth. Progressive tax reforms would ask somewhat more from those that have seen strong income growth while at the same time better supporting lower-income workers and families.

There are also ample opportunities to make our tax code more efficient; such opportunities will allow the government to raise revenue while reducing distortions at the same time. Finally, there are important opportunities to use tax reform to work better with partners abroad in addressing global challenges such as climate change and tax competition. I describe two examples of reforms that meet these criteria next.

Key Tax Policy Priorities for 2025

Corporate and International Tax Reform

2025 presents an important opportunity to make our corporate tax system fit for purpose: raising revenue, creating a more efficient system, and reducing the profit shifting and offshoring incentives that are baked into current law. Further, progress in addressing tax competition abroad makes it easier for the U.S. government to pursue these corporate and international tax reforms. Since jurisdictions throughout the world are adopting coordinated minimum taxation on the world's largest multinational companies, the United States can undertake its own reforms without creating undue worry about the ability of U.S.-headquartered companies to compete in global merger and acquisition bids.

As I've argued at more length in [recent testimony](#) before the Senate Committee on the Budget, the U.S. corporate and international tax system is in great need of reform. [An OECD analysis](#) recently indicated that, out of more than 110 jurisdictions, the United States is in the bottom ten percent in terms of corporate tax revenue relative to the GDP, despite the fact that the United States has a disproportionate share of the world's most profitable companies.⁴ The 2017 Tax Cuts and Jobs Act reduced corporate tax revenues substantially; these changes also made the tax system less progressive, since the corporate tax disproportionately burdens higher-income taxpayers.⁵

⁴ See data from recent Forbes Global 2000 lists of top global companies.

⁵ Both conventional scoring authorities and outside experts (e.g., JCT, CBO, Treasury, and the nonpartisan Tax Policy Center) agree that the corporate tax predominately burdens shareholders and the owners of capital income, whereas alternative tax instruments (such as payroll or income taxes on earned income) much more heavily burden labor. For JCT modeling assumptions on the corporate tax incidence, see [here](#). For CBO, see [here](#). For Treasury, see [here](#). For the Tax Policy Center, see [here](#). Further, taxing capital income at the entity level reaches more of capital

Moreover, TCJA’s international tax rules contain a large tax preference for earning income abroad, perversely incentivizing *all* sources of foreign income relative to U.S. income and encouraging the offshoring of physical investments. For example, TCJA’s “GILTI” provision provides a 50% deduction for all foreign income relative to U.S. income, and tax credits from income earned in high-tax countries can offset tax due on low-tax jurisdiction income, incentivizing both types of foreign income relative to domestic income. Further, GILTI’s exemption for the first ten percent return on foreign tangible assets, together with another provision that makes export subsidies less generous as U.S. tangible assets increase (holding constant other factors), encourages investments offshore. Early evidence indicates that companies have responded to these tax incentives by increasing foreign investment.⁶

International tax reform can simultaneously raise revenue and reduce such profit shifting and offshoring incentives. The GILTI tax can be strengthened by eliminating the exemption for a certain return on foreign assets, reducing the 50% deduction for foreign income, and levying the tax on a country-by-country basis so that credits from high tax operations no longer offset tax due on income earned in low-tax jurisdictions. This feature would also have the beneficial consequence of better aligning the U.S. international tax system with the international (“Pillar 2”) reforms being adopted throughout the world that levy coordinated minimum taxation on multinational income. Better alignment would reduce the number of overlapping tax regimes that U.S. multinational companies face when they do business abroad, while providing greater tax certainty for global business.

Strengthening the taxation of the world’s largest companies also creates a fairer tax system *between* corporate taxpayers, building a more vibrant capitalism. At present, large multinational companies pay lower tax rates than smaller domestic firms.⁷ Further, an underappreciated fact is that the corporate tax base is very concentrated. Fewer than one-half of one percent of corporations account for 87 percent of the tax base.⁸ Ensuring that large, dominant multinational companies pay adequate tax on their foreign income will help create a level competitive playing field, benefiting the many small, domestic companies that compete against these large multinational companies.

income, since [more than 70 percent of U.S. equity income goes untaxed](#) at the individual level by the U.S. government. Foreign shareholders bear a significant burden from the corporate tax since they own more than one-third of U.S. equity.

⁶ This evidence is described in [Dharmapala \(2023\)](#), [Atwood et al. \(2020\)](#), [Huang, Osswald, and Wilson \(2023\)](#), and [Beyer et al \(2021\)](#).

⁷ For example, the U.S. Joint Committee on Taxation calculated that U.S. multinational companies paid an average tax rate of only 7.8 percent on their worldwide income in 2018. See table 3 on page 58 [here](#). These tax rates are far lower than those paid by domestic companies, and lower than tax rates faced by MNCs abroad. JCT finds that our top ten trading partners levied an average tax rate of 18.1 percent. A recent [Reuters study](#) found that U.S. multinational companies pay *effective* tax rates that are 8 percentage points lower than those of multinational companies in other countries.

⁸ Data are from the [2019 IRS SOI report](#).

Shoring up the U.S. international tax system helps support the mainline corporate tax rate. Raising the corporate rate to 28 percent alongside a suite of international tax reforms can raise well over \$1 trillion in the budget window. One corporate reform package outlined in [recent work](#) would also reform the research and experimentation tax credit so that it is both more effective and more aligned with international tax rules; that package raises about \$1.5 trillion. A similar suite of corporate and international reforms outlined in the FY25 Biden Administration Greenbook raises about \$2 trillion. (The FY25 budget also includes other corporate reforms that raise the total further.)

Opportunities for a Greener Tax System

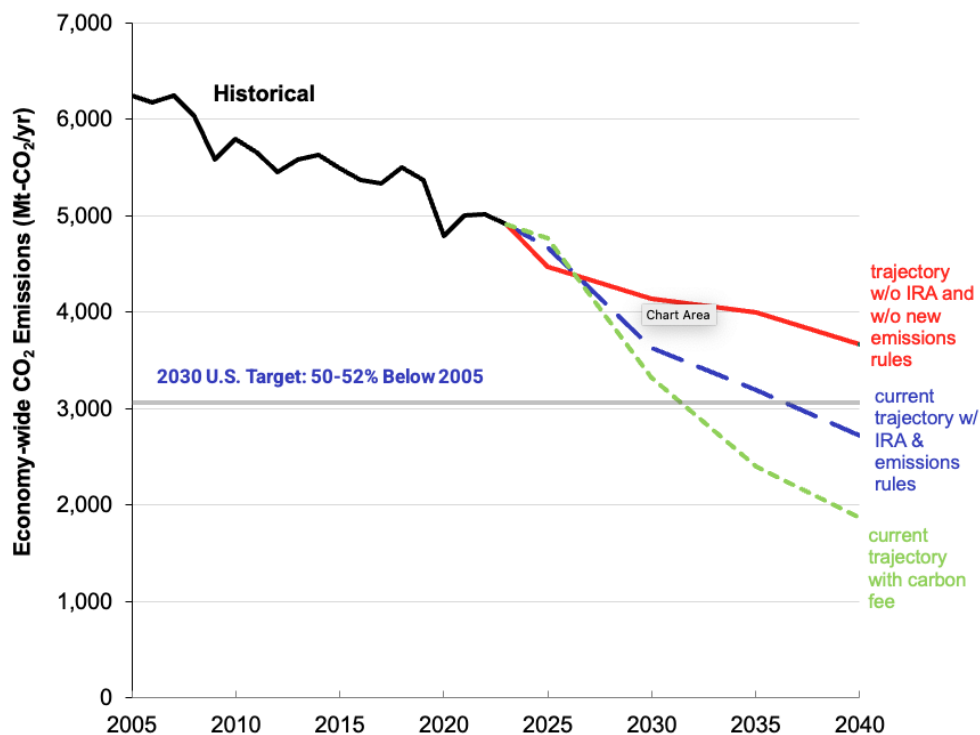
Climate-oriented tax policy reform in 2025 can also boost both emissions reduction and fiscal health. As a first step, repealing existing fossil fuel subsidies in the tax code (including those that affect foreign oil and gas income), as consistently proposed in Biden Administration Greenbooks, would raise more than \$100 billion over the budget window and take an important step toward a cleaner tax code. But far more significant, the emissions reductions achieved through the Inflation Reduction Act can be turbocharged through the adoption of a modest carbon fee, while simultaneously protecting households from increases in energy and fuel costs.

In a [recent working paper](#), we consider the emissions, fiscal, and abatement cost effects of layering a modest carbon fee on top of the existing emissions reduction progress due to the investments in the Inflation Reduction Act and forthcoming emissions rules. While recent policy actions during the Biden Administration have made enormous progress in reducing U.S. greenhouse gas emissions, the United States will still likely fall short of Paris Agreement emissions reduction commitments.

One option worth careful consideration is a modest economy-wide carbon fee. We model one that would begin at only \$15 per metric ton (in the second year post-enactment), and then rise slowly until eventually reaching \$65 per metric ton at the end of the budget window (thereafter increasing with inflation); this modest carbon fee would be accompanied by a nondiscriminatory carbon border adjustment on imports. The carbon fee would also exempt retail gasoline. Layered on top of the Inflation Reduction Act, such a fee would have minimal effects on household energy costs, raising them by about \$30 compared to the status quo. Yet emissions reductions are very significant, as demonstrated in Figure 5 below, and fiscal benefits are also quite large.

Traditional methods are likely to score even such a modest carbon fee in the range of \$600 billion in revenue, and the score could be hundreds of billions of dollars higher if exports are not rebated on the border, a policy design that may be desirable. By pricing the emissions of fossil fuels that are exported, the policy acknowledges that the consumption of fossil fuels contributes to global climate change irrespective of its location.

Figure 5: Emissions Reductions from a Modest Carbon Fee



Source: [Bistline et al. \(2024\)](#).

In addition to driving down abatement costs, a final benefit of adopting a carbon fee is that it would better align U.S. climate policy with important policy developments in the European Union, Canada, the U.K., and elsewhere, allowing us to work with partners throughout the world on policies that would encourage emissions reduction. For example, collaboration on a nondiscriminatory carbon border adjustment mechanism would ensure that any seller serving markets with carbon pricing faces an incentive to decarbonize, alongside the incentives faced by domestic firms. This could encourage countries throughout the world to adopt carbon pricing systems of their own, insulating their exporters from border adjustments and serving their own fiscal capacity and decarbonization goals. These policy dynamics are discussed in [other recent work](#).

Other Important Tax Policy Priorities for 2025

[Elsewhere](#), I've discussed a full menu of tax policy options that would provide important sources of revenue for the years head; these include reforming SECA/NIIT rules to treat all income similarly, and capital gains tax reforms that include ending step-up in basis at death for unrealized capital gains as well as the carried interest loophole. Two additional topics merit some attention here.

First, IRS funding has become an intensely political issue, but it really should not be. Adequately funding our tax administration system provides very significant benefits for taxpayers:

- The IRS can provide taxpayer services and process returns in a timely and efficient manner. Too often in the past, an underfunded IRS left phone calls unanswered and returns piling up, since there simply wasn't enough manpower to handle tax filings.
- The IRS can work to close our large tax gap (i.e., the amount of tax due under the laws enacted by Congress that we fail to collect); thus, bringing in revenue and enabling lower tax rates elsewhere in the tax system. The federal tax gap is [very large](#), at over a half trillion dollars per year, so fully funding the IRS has the potential to [increase revenue substantially](#).
- An adequately funded IRS will have the technological tools required to better target their audits toward areas of concern rather than randomly targeting taxpayers; this means that audits will become less of a concern for many taxpayers.
- A fully funded IRS helps build tax morale by assuring honest taxpayers that they are not overpaying relative to those who would shirk their tax obligations. It can also help level the competitive playing field between businesses that pay their tax in full and those that do not.

Second, expanding the child tax credit, the earned income tax credit, and the premium tax credit are all important steps toward increasing economic security, labor force participation, and children's outcomes. Recent expansions in the child tax credit under the American Rescue Plan (ARP) led to the most significant decrease in children's poverty in recent decades, but the expiration of that expansion reversed those gains. We can afford to invest in children, to encourage labor force participation by expanding the earned income tax credit, and to address health insurance affordability. The fiscal measures outlined above provide enough revenue to substantially reduce deficits, even as we invest in the future and support the most vulnerable.

The unifying conceptual framework for the policy suggestions in this testimony is that they build a tax system that better suits today's challenges. By addressing our fiscal needs through stronger tax revenues, the U.S. government will have the resources needed to respond to future emergencies or priorities. By building a more progressive tax system, these tax reforms help respond to economic forces that act to exacerbate income inequalities. By focusing on efficiency through revenue sources that reduce emissions and tax the excess profits of large corporations, these proposals build a more cost-effective tax system. And by working together with partner countries abroad, U.S. tax policy can also help tackle important global collective action problems such as climate change and tax competition.