Prepared Testimony on the House and Senate Tax Reform Bills

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Thank you for the opportunity to testify on the Tax Cuts and Jobs Act (TCJA) that passed the House and the Senate and will shortly be taken up by the Conference Committee. This bill would be the largest change to the tax code in over thirty years and holding hearings is essential both to understand the overall impact it has on households and the economy as well as to understand the substantial technical complexities in the bill. In my testimony today I will focus on this first set of subjects and would refer you to a recent analysis by leading Law Professors on many of the important avoidance opportunities and technical problems in the bills (Avi-Yonah et al. 2017).

My testimony makes four main points:

1. The tax bills would raise taxes on tens of millions of middle-class families, increase after-tax income inequality, and provide the largest gains to households at the top. These tax increases are despite the fact that they would cut revenues by nearly $1.5 trillion in total over the next decade.

2. The tax bills have a very small impact on growth over the next decade with a wide range of estimates finding a boost to growth of less than 0.1 percentage point per year over the next decade. In the long run, the additional debt accumulation associated with the bills would most likely reduce the size of the economy.

3. The bills would have a number of deleterious effects including causing future tax increases or spending cuts, increasing the number of uninsured, raising health insurance premiums, and reducing State and local services.

4. Tax reform could do much more to promote growth and help middle-class families. Relative to the House and Senate bills, this would require, at a minimum, a number of changes, including a smaller corporate rate reduction, no new loopholes for passthrough businesses, no reduction of the estate tax, adding refundable child tax credits, an expansion of the Earned Income Tax Credit for childless workers, and permanent expensing of both equipment and structures, among other changes.

1. The Direct Effects of the Tax Cuts and Jobs Act: Disproportionate Benefits for High-income Households and Tax Increases for Tens of Millions of Middle Class Households

Economists across the political spectrum assess the distributional impacts of tax changes by looking at the percentage change in after-tax income. By that standard both the House and Senate bills are regressive—providing little for the bottom quintile, making a relatively small difference for the after-tax income of households in the middle, and conferring the largest percentage gains on households at the top—widening the inequality in after-tax income. I show this in Figures 1a and 1b from the Tax Policy Center that include the business, estate, and individual provisions but exclude the impact of the individual mandate which I discuss in Part 3 of this testimony. Note that under both the House and Senate bills the tax cuts become more regressive over time.

Figure 1a

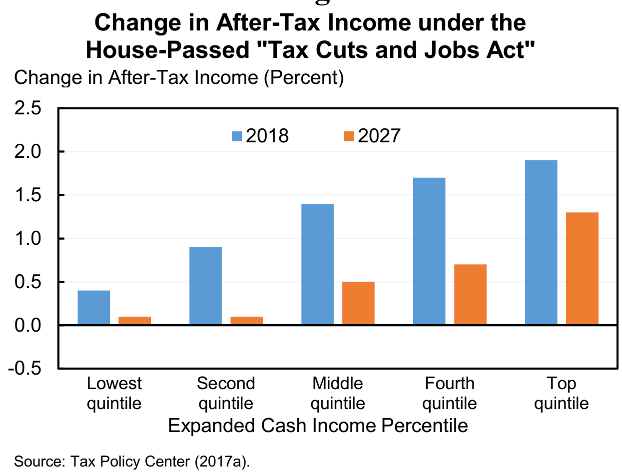
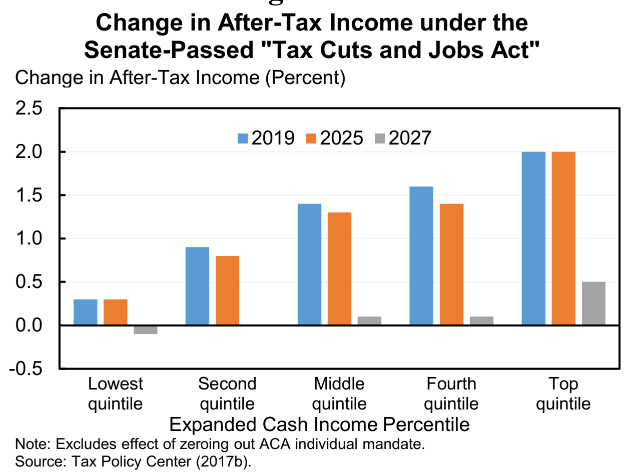


Figure 1b



Based on the Joint Committee on Taxation, in 2025 the House and Senate bills would raise taxes by more than $100 on 36 million and 22 million households making less than $200,000 a year respectively. If most of the individual tax changes expire, as is legislated in the Senate bill, the number facing a tax increase of $100 or more would rise to 38 million in 2027 under the Senate bill. Genuine tax reform inevitably has winners and losers, but what is so troubling about this bill is that all of these tax increases are despite the fact that the bill includes nearly $1.5 trillion in tax cuts.

Moreover, under the House bill, looking just at individual income taxes that people would pay on their 1040s—and ignoring the effects of the corporate tax reductions which are discussed from a macroeconomic perspective in the second part of this testimony—households making $10,000 to $40,000 would see a net tax increase starting in 2023 and by 2027 households making $10,000 to $50,000 would see a net tax increase. Under the Senate bill, households making up to $40,000 would see a net tax increase starting in 2023 and, if all the tax cuts expire as they would under the legislation, then all income groups would see net individual tax increases in 2027. (These estimates are from slightly earlier versions of the bills before the amendments and final passage.)

The skewed impact of the tax changes in the bills reflect policy choices. For example, both the House and Senate bills expand the child tax credit. But under the House bill lower-income households would not get anything because the refundability is not expanded and under the

Senate bill these households would only get $75. In contrast, higher-income households—those making between about $200,000 and $500,000—would get a $2,000 tax cut per child under the Senate passed bill, twice as large as what middle-class households get. Other choices, like repealing the estate tax (House bill) or cutting it (the Senate bill) would also provide very skewed benefits that would only go to 2 out of every 1,000 decedents.

Advocates for the TCJA rest their arguments less on the direct tax benefits and more on the argument that the corporate tax cuts it includes would generate large increases in economic growth, wages, and jobs that would benefit middle-class households. The next section of my testimony evaluates these claims.

2. The Tax Cuts and Jobs Act would have a very small effect on growth over the next decade and could be negative thereafter

A wide range of analyses are consistent with the estimate that the TCJA would raise GDP annual growth 0.1 percentage point per year or less as shown in Table 1. Moreover, even this very small estimate overstates the benefits the bill would actually have because it does not factor in that the bill would increase foreign borrowing which would need to be repaid and that some of this growth comes at the cost of reductions in consumption and leisure.

Table 1

Estimated Growth Effects of Republican Tax Reform Proposals Through 2027

	Change in Real GDP Growth Rate (Percentage Point per Year)
Joint Committee on Taxation	
House Bill	~0.1
Senate Bill	~0.1
Penn Wharton Budget Model	
House Bill	0.04 to 0.09
Senate Bill	0.05 to 0.10
Moody's Analytics	
House Bill	0.03
Senate Bill	0.02

Source: Joint Committee on Taxation (2017a; 2017b); Penn Wharton Budget Model (2017a; 2017b); Zandi (2017); author's calculations.

The most comprehensive and disinterested analysis was done by the Joint Committee on Taxation and found that the additional growth under the Senate Finance Committee reported bill would be less than 0.1 percentage point per year and under the House passed bill would be about 0.1 percentage point per year (2017a; 2017b). The Penn Wharton Budget Model, which is headed by a former political official in the George W. Bush Treasury, found similar results—a growth increase of 0.04 to 0.10 percentage point annually under these bills (PWBM 2017a; 2017b). Private forecasters have also reached similar conclusions, with Moody's Analytics finding a 0.02 to 0.03 percentage point increase in the annual growth rate (Zandi 2017).

Economists coming from a conservative perspective have reached similar conclusions. Researchers at the American Enterprise Institute (AEI) recently estimated that the business provisions of the House and Senate bills would add between 0.05 and 0.1 percentage point to the annual growth rate over the next decade (Mathur and Kallen 2017). A group of leading Republican economists also sent a letter to Secretary Mnuchin that estimated that over the long run output would expand by 3 percent which, translated over a decade using a standard rate of convergence some of the signatories of the letter have found in their previous research, would also translate into about a 0.1 percentage point increase in the annual growth rate over the next decade (Barro et al. 2017). Even models from conservative organizations like the Tax Foundation and the Heritage Foundation have found that the growth associated with the tax cuts would fall well short of paying for their costs.

The reasons that so many of these growth estimates are so low is that even well-designed tax reform provides only a modest economic boost. Moreover, the House and Senate bills are not well designed in a number of respects including the fact that they would substantially increase the debt; make key provisions, like expensing, only temporary; include anti-growth revenue-raising provisions, like raising taxes on R&D expenditures; substantially increase marginal tax rates on some activities, in some cases, potentially above 100 percent; create new sources of complexity and distortion around choices about how to organize businesses; and include international base erosion provisions that are very weak and would encourage gaming.

I have spent substantial time analyzing some of the claims that the growth effect would be higher and have found that they generally derive their misleading and inaccurate conclusions from a combination of errors. These errors include, but are not limited to, failing to model the actual details of the legislation, using long-run estimates without adjusting for the length of the transition period to arrive at the "long run", ignoring the negative impact of the additional debt, and using overly optimistic economic parameters.

All of the estimates I have been discussing are for the next decade. Over the longer-run the results are likely to be even smaller and, most likely, would eventually be negative. The fundamental reason for this is that the debt would grow under the legislation—reaching nearly 100 percent of GDP after a decade and rising steadily thereafter. This debt increase would partly crowd out private capital accumulation, reducing the size of GDP. The debt increase would also partly be financed by additional foreign borrowing, which would have to be repaid in the future—reducing GNP. Either way, the amount of income the economy produces for the benefit of Americans would be reduced over time—in the case of the Senate bill this would especially be true if all the expiring individual tax cuts were made permanent.

3. The Tax Cuts and Jobs Act would have additional indirect effects that would be further deleterious to middle class households

The direct effects of the TCJA on economic growth are so small that they can largely be ignored in analyzing the impact of the legislation on middle-class households. However, a number of other indirect effects of the legislation would be much larger and more consequential. I discuss three of them here.

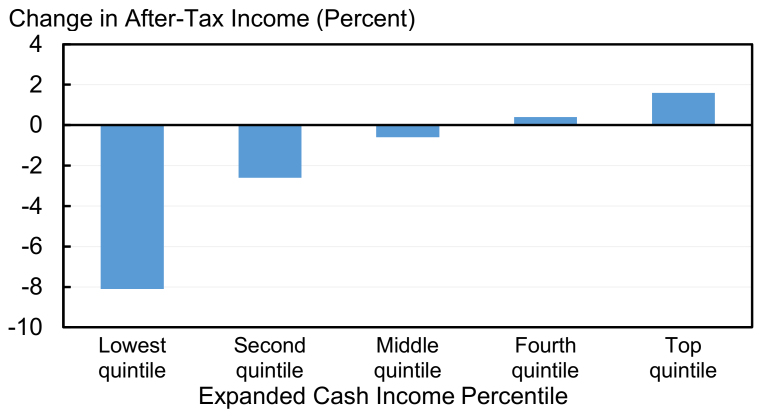
Paying of the tax cuts would likely eventually hurt middle class families even more

All of the major analyses of the tax bills have been incomplete because the bills themselves are incomplete. Specifically, the bills will eventually need to be paid for and any estimate of their impact on households should include not just the bills themselves but also how they would eventually be financed—whether through future spending cuts or tax increases. The President's Budget and the Congressional Budget Resolution, for example, both envision ultimately paying for the cost through reductions to programs like Medicaid and nutritional assistance. As a result, to understand the impact on households it is necessary to include these changes as well.

William Gale, Surachai Khitatrakun and Aaron Krupkin (2017) analyzed several different possible ways to eventually finance the tax bills. Here I show results that assume the tax cuts are paid for with equal amounts on each household. Under this financing assumptions 72 percent of households would see their taxes go up using the 2019 parameters for the bill and even higher fractions in future years. As is shown in Figure 2, taxes would go up for households at the bottom and down for households at the top.

Figure 2

Change in After-Tax Income under the Senate-Passed "Tax Cuts and Jobs Act" with Equal-per-Household Financing, 2019



Note: Excludes effect of zeroing out ACA individual mandate and certain other provisions.
Source: Gale, Khitatrakun, and Krupkin (2017).

Repealing the individual mandate would reduce health insurance coverage and raise premiums

Including the individual mandate in the Affordable Care Act was based on the fact that especially with no ability to deny coverage to people with pre-existing conditions, the market for health insurance would be undermined by a market failure called adverse selection—people who were healthier than average could opt out of coverage, driving up costs for others, and leading more people in turn to drop out of coverage. In addition, establishing a norm of responsibility for purchasing insurance would help many people, including those entitled to free insurance through Medicaid but who might otherwise not complete the necessary steps to take it up. For these reasons, an individual mandate was pioneered by the Heritage Institute and has long been included in conservative health proposals.

The Senate passed bill would effectively repeal the individual mandate by setting the penalty to zero. The Congressional Budget Office (2017) projects that this would increase the number of uninsured by 13 million and raise premiums in the individual market by about 10 percent. The reduction in the uninsured is a combination of people who are now priced out of coverage and also people who would fail to sign up, in many cases for free or heavily subsidized coverage. Other outside estimates forecast lower coverage losses, but even these estimates are in the millions. It is notable that if these estimates of more modest coverage losses are true the repeal of the mandate will save less than estimated and the cost of the bill will be commensurately higher. There is a substantial body of research that finds that lacking health insurance worsens both self-reported health outcomes and also objective measures of health. In fact, the number of premature deaths would increase by thousands per year if the individual mandate is effectively repealed.

Repealing or limiting the State and local tax deduction could limit State and local services

Currently State and local taxes are deductible against Federal taxes. Part of the rationale for this provision is preventing a race to the bottom in State and local taxes whereby jurisdictions that might collectively want to have a robust tax base to support services would end up with inefficiently low taxes as they competed with each other to get a small number of very high-income and highly-mobile people to locate in their jurisdictions. Eliminating or limiting this deduction would both put downward pressure on State and local taxes and also shift States and localities to less progressive methods of revenue raising. Given that most States have balanced budget requirements, any reductions in revenue would come out of their programs. With more than half of State spending currently being on education and healthcare, these areas would likely face significant reductions in many States—compounding the direct harms from the tax bills.

4. A better tax bill than the TJCA could both do more for economic growth and for middle-class families

The tax code should be reformed. The United States currently has a very high statutory corporate rate but also a very narrow corporate base. The tax code is unnecessarily inefficient, complex and unfair in many ways. But tax *reform* is very different than a tax *cut*. Given that revenues are currently well short of our spending commitment and our debt is relatively high as a share of GDP compared with the last two major tax cuts as shown in Table 2, now is not the time for tax cuts. Moreover, in many important ways the TCJA would compound the current inefficiencies, complexities, and unfairness in the tax code today.

Table 2
Revenue and Debt as a Share of GDP At Time of Previous and Proposed Tax Cuts

	1981	2001	2017
Revenue (% of GDP)	19.1	18.8	17.3
Debt (% of GDP)	25.2	31.4	76.7

Source: Congressional Budget Office.

An alternative approach to tax reform that would genuinely improve the system could have the same starting point as President Reagan's 1986 reform: revenue neutrality and distribution neutrality. Revenue neutrality was, in fact, the stated goal of Republican leaders and the Treasury Secretary has reiterated his commitment to distribution neutrality.

Moving the tax bills to achieve President Reagan's principals would require major changes. On the business side this would mean reducing the rate as far as would be affordable, potentially to 28 percent, while also making permanent and expanding pro-growth provisions in the legislation, like expensing, while making further reducing the tax preference for borrowing. It would also mean having much tougher rules to prevent the territorial tax system at the heart of the bill from eroding our domestic tax base. Finally, it would mean dropping the new loophole that was created for certain types of passthrough income.

On the individual side, it would mean a much larger increase in the refundable portion of the child tax credit, an expansion in the Earned Income Tax Credits for childless workers along the lines of what Speaker Ryan proposed in the past, and modifications to the individual provisions in the bills, including retaining the State and local tax deduction.

These are just a few of the changes that would be required in these bills. More fundamentally, it would require a change in process—a commitment to holding hearings, releasing and respecting expert nonpartisan analysis, and engaging in a bipartisan process designed to improve the tax code rather than just to pass any bill.

Thank you and I look forward to your questions.

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