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Heading off a Cliff? The Tax Reform Man Cometh, and Goeth

Michael J. Graetz

The coming tax "reform" cannot possibly be the great and simplifying stimulus to economic growth its proponents claim.

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President Trump has recently been taking breaks from tweeting and golfing to travel around the country promoting his ideas for "tax reform." On September 27, for example, he traveled to Indiana to promote his tax plan, which he described as "historic tax relief for the American People." "We are going to cut taxes for the middle class, make the tax code simpler and more fair for everyday Americans, and we are going to bring back the jobs and wealth that have left our country," he said. "There's never been tax cuts like what we're talking about," he bragged. "Our explicit commitment," he promised, is "that tax reform will protect low-income and middle-income households, not the wealthy and well-connected."

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But just a few weeks later, Trump's tax plan is heading toward a precipice. Everyone knows that tax reform is easier than health care reform: No one is going to stand up in a town hall and claim that he will die if the legislation is enacted. But that doesn't make enacting tax legislation easy.

Both the White House and congressional Republicans are desperate for a "win"—any win—but they don't have a lot of votes to spare. If three Republican Senators vote "no," Trump's promises of "tremendous" tax cuts will slip away. Bob Corker, the retiring Senator from Tennessee, has said that if the tax legislation adds even one penny to the deficit, "There is no way in hell, I'm voting for it." Arizona's John McCain, like Corker, has frequently feuded with Trump, and he says that he wants to see "regular order" and some Democratic votes. That's a long shot. And more than a few other Republican wild cards occupy the Senate: Susan Collins of Maine and Kentucky's Rand Paul are two. And on December 12, the wildest card of all, Roy Moore of Alabama may take the seat now held by Luther Strange, a sure "yes" vote.

With only a handful of "legislative" weeks remaining before year's end, no one knows exactly what a new tax law might contain. In April, President Trump gave us one page of principles and another half page that outlined some specific goals. Three months later, at the end of July, the so-called Big Six—Secretary of the Treasury Steven Mnuchin, National Economic Council (NEC) Director Gary Cohn, Senate Majority Leader Mitch McConnell, Senate Finance Committee Chairman Orrin Hatch, Speaker of the House Paul Ryan, and Ways and Means Chairman Kevin Brady—who had been meeting regularly, released a statement repeating their goals for more economic growth through lower tax rates on businesses and individuals, a reform of international tax rules, greater fairness (principally through lower tax rates on families), and, of course, less complexity.[1] Shortly thereafter, 45 of the 48 Senate Democrats sent Senator McConnell a letter containing their three principles for tax reform, two of which were that it neither "benefit the wealthiest individuals" nor "increase the deficit." McConnell rejected those constraints in a Kentucky minute.

Then, during the first week of September, Secretary Mnuchin announced that the group of six had a "detailed" tax reform plan. The next day NEC Director Cohn described it as a "skeleton" plan—by which he surely meant to suggest that it needed some flesh, not that it had died and was awaiting burial. On September 15, Chairman Brady said that the tax plan—scheduled for release during the week of September 25—would not say exactly what the new business tax rate would be. Secretary Mnuchin then immediately said the plan would announce the tax rate. Meanwhile, Donald Trump said that the business rate would be 15 percent—which everyone knows is lower than it will actually be, by at least 5 and maybe 10 percentage points. So things were going very smoothly, just like the GOP effort to "repeal and replace" the Affordable Care Act.

Then, on September 27, the day of Trump's Indiana speech, the Sixers released their "Unified Framework for Fixing our Broken Tax Code." In its nine pages (about one-third of which was blank space) they set forth a list of their proposed tax changes. The proposals include a corporate tax rate of 20 percent and a special 25 percent tax rate for partnerships and Subchapter S corporations, labeled a special tax rate for small businesses—even though nearly two-thirds of the net income of partnerships is earned by the largest 1 percent of firms with more than $50 million in assets.[2] On the individual side, the Sixers' framework was especially vague. It announced an "aim to reduce the current seven tax brackets, which range from 10 percent to 39.6 percent, to three tax brackets, ranging from 12 to 35 percent." But the framework failed to say at what levels of income these brackets would kick in. The framework also promised to double the standard deduction and replace personal exemptions with tax credits for children and other dependents. The Sixers told us that the credit for dependents other than children would be $500, but it left to Congress the amount for child credits. One large New York law firm aptly told its clients that the Sixers had handed us a frame without a picture.

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The President and congressional leaders tell us that the forthcoming tax legislation will be a once-in-a-generation event—on a scale equaling or surpassing the Tax Reform Act of 1986. But it won't. Just as the health care debate hasn't really been about care but about how to pay for health insurance, the tax debate is liable to be mostly about numbers, not about the structure and function of the tax code as it bears on the American political economy.

The 1986 Tax Reform Act spent 53 weeks in the Congress. Two years before, the Treasury had released more than 600 pages analyzing the various tax reform ideas that led to the landmark 1986 legislation, and in May 1985 President Reagan had released nearly 500 pages detailing his proposals. Compared to that, the nine pages we have gotten so far from President Trump and the Sixers can only be described as anorexic.

While they have been very forthcoming in parading apparitions of large tax cuts, so far it's been all ponies and no manure—with the notable exception of their intention to repeal the deduction for state and local taxes. Some of the ponies are not even real. Donald Trump has insisted that there will be no tax cut for the wealthy. But fewer than the richest half of 1 percent of people who die in any year pay the estate tax, which he and congressional Republicans seem determined to repeal. And President Trump surely knows from his own taxes who will benefit from lowering the tax rate on partnership income.

It is not surprising that our political leaders are urging that the 1986 tax reform should be the playbook for tax legislation now. The crowning domestic policy achievement of Reagan's presidency, that legislation was widely heralded as the most important tax legislation since the income tax was converted into a tax on the masses during World War II. Since some pundits and many politicians from across the political spectrum are now calling for a replay, it is worth reviewing what happened then, and soon thereafter.

The 1986 reform increased the permissible amount of tax-free income; lowered and flattened income tax rates; shut down mass-marketed tax shelters for high-income individuals; curtailed the ability to shift income to lower-income, lower-rate family members; and taxed capital gains at the same rate as ordinary income. By shutting down tax shelters for individuals and repealing tax breaks for investments in equipment and real estate, Congress not only financed a reduction in the corporate tax rate (from 46 to 34 percent) but also paid for some of the individual rate reductions.[3]

The corporate changes also made the income tax considerably more neutral across industries. Soon thereafter, the law's rate-reducing and base-broadening reforms were mimicked throughout the OECD. And in the years since, other OECD countries have continued to lower tax rates, especially corporate tax rates, while the United States has largely stood pat.

But the reforms wrought by the 1986 Act proved neither revolutionary nor stable. The 1986 tax law resulted from an uneasy, temporary marriage between the forces of "justice" and "virtue." The conventional Democratic tax reformers, who were principally interested in improving tax equity by broadening the income tax base so that income would be taxed similarly regardless of its source, joined together with Republican supply-siders and deregulators, who were most concerned about incentives and wanted to enact lower tax rates "to get government off the backs" of the American public and American businesses. The ink was hardly dry on the 1986 Act before the divorce proceedings started. Thousands of pages of legislation in the years since 1986 have narrowed the income tax base, while the top tax rate has crept upward.

Even though deficits were becoming a serious concern by the mid-1980s, the linchpin of the 1986 Act was revenue neutrality. By insisting that the new law not reduce government revenues, the Reagan Administration and the congressional leadership ensured that amendments to the tax bill could be offered only if any revenue losses were offset by revenue gains. Legislators behaved better when to pay Peter they had to be explicit about just how they intended to rob Paul. The 1986 Act was not only revenue neutral but also roughly distributionally neutral: The new law was not an occasion for shifting the distribution of tax burdens down the income scale to less wealthy families.

The coming tax legislation is unlikely to be either revenue or distributionally neutral. There is no revenue pot of gold like the investment tax credit and individual tax shelters valuable enough to finance tax cuts today. Nor are we going to raise business taxes to finance individual tax cuts, as happened in 1986. This time our leaders seem determined to cut both business and individual taxes. Donald Trump, who as we know sometimes exaggerates, says that this is going to be "the biggest tax cut ever." That is a high hurdle indeed: Reagan's tax cut of 1981 was more than 2 percent of GDP, and

George W. Bush's tax cuts of 2001 and 2003 amounted to about 2.5 percent of GDP.

Unfortunately, given our deficits and large debt, the coming tax legislation will resemble the 1981 or 2001/2003 tax cuts more than the 1986 tax reform. So the Sixers are fooling themselves—or they're trying to fool us.

Alas, given the size of the Federal debt and the promises for retirement income and health insurance coverage that have been made to the now retiring Baby Boom generation, we cannot afford a tax reduction anywhere close to the level of the Bush tax cuts. We have never in modern times faced such a dangerous imbalance between the levels of Federal spending and revenues. The Federal debt as a percentage of U.S. economic output is now greater than it has been at any time since the end of World War II.

And back then we had all the money: Europe and Japan were in shambles, and China was entering a dark communist era. No matter how bad our tax system may have been, our economy was poised to grow for decades at an unprecedented pace. And the U.S. government then owed 98 percent of the money it had borrowed to finance the war to Americans. Now our national debt is rapidly approaching $20 trillion—more than three-quarters of GDP—with about half owed to foreigners, some of whom we cannot rely on to be our friends. At a 5 percent interest rate, interest on Federal debt alone would cost more than $1 trillion a year. If we fail to get control of the Federal budget, rising interest costs will devour an ever-larger share. Public debt growing to such levels will also lead to new challenges to the dollar's role as the world's reserve currency. Our growing national debt thus increases the likelihood of substantially higher interest rates, inflation, and another financial crisis. Over time, it can threaten the living standards of the American people.

The major tax policy challenge of the 21st century is the need to address the nation's fiscal condition fairly and in a manner conducive to economic growth. But since California adopted Proposition 13 nearly forty years ago, antipathy to taxes has served as the glue that has held the Republican coalition together. Even though our taxes as a percentage of our economy are low by OECD standards and low by our own historical experience, anti-tax attitudes have become even more important for Republicans politically, since they now find it hard to agree on almost anything else. So revenue-positive, or even revenue-neutral, forms of tax reform—at least as long as the GOP maintains its legislative majority—are politically impossible.

One thing we can be sure of is that Congress and the White House will go to extraordinary lengths to disguise the size and the implications of the tax reductions they intend to enact. The Senate Budget Committee passed a budget resolution that requires tax cuts not to exceed $1.5 trillion over ten years to allow them to be enacted through "reconciliation," a procedure that allows tax legislation to pass the Senate with only 51 votes (including that of Vice President Pence). The House Budget Committee initially insisted that tax legislation not lose any revenue, but the House will certainly accept the Senate's number. The Tax Policy Center, however, estimates that the changes announced in the Sixer's framework will cost at least $2.4 trillion and their largest revenue raiser—repeal of the deduction for state and local taxes—has already provoked vigorous opposition from quite a few Republican representatives. Republican deficit hawks quickly transmogrify into hummingbirds when tax cuts hit the table.

Some Senators, most notably Pat Toomey of Pennsylvania and Ted Cruz of Texas, have called for lengthening the budget window from ten years to 25 or even thirty years—not because the ten-year projections have been so spot on—but to allow tax cuts *not* to expire in a decade, as George W. Bush's did, because the Republicans will not be able to muster the sixty votes in the Senate required to avoid a termination date a decade hence. That particular gambit will not succeed, but other sleights of hand are ready. The President and his Treasury Secretary have already made clear that this legislation will produce great optimism about its effects on economic growth. So we will see "dynamic scoring" that will understate the revenue costs of the legislation; let us just hope that it falls short of turbo-dynamic scoring.

We will also undoubtedly see the kinds of phase-ins and sunset provisions that characterized the 2001 law and combined to dramatically understate its real revenue costs. When the 2001 Bush tax cuts were enacted, moderate Democrats in the Senate achieved a "victory" by insisting on reducing the cuts' projected costs over a ten-year period from $1.6 trillion to $1.3 trillion. But the bill was festooned with so many phase-ins and phase-outs that the actual cost over the past 15 years has been far closer to $3 trillion than to $1.3 trillion.

And beware manipulations of the budget baseline to make the cuts seem smaller than they really are; using "current policy" rather than the traditional current law baseline is one possible trick. To understand the importance of the baseline, consider the following exchange between a police inspector and Johnny Depp from *The Tourist*:

> **Inspector:** Now you wish to report a murder?
> **Depp:** No, some people tried to kill me.
> **Inspector:** I was told you were reporting a murder.
> **Depp:** Attempted murder.
> **Inspector:** Ah, that is not so serious.
> **Depp:** No, not when you downgrade it from murder. When you upgrade it from room service, it is quite serious.[4]

Beware of budget baseline scorekeeping games.

But at least baseline games don't change people's behavior. The newest and riskiest funny-money game is what's become known inside the beltway as "Rothification"—that is to convert 401(k) and other similar retirement saving plans from deductible plans taxable on withdrawal to nondeductible, nontaxable plans similar to Roth IRAs. While this idea has to lose revenue in present value and may cause uncertain, largely uninvestigated consequences on retirement savings behavior, it would shift at least $1 trillion into the budget window so that Congress could use the money to "pay for" tax cuts despite their long-term revenue costs. Of all the budget gimmicks now being bandied about in Washington, this one is the most distressing.

With an aging population, rising health care and education costs, and the extraordinary costs of fighting terrorism and preventing war, we cannot afford large tax cuts like those of 2001 and 2003. So, as already suggested, the new law will be disguised to make us think it more closely resembles 1986. Former Republican deficit hawks can barely be heard anymore, now that the politics have shifted from "shaft Obama" to "support Trump" (which speaks volumes about their former sincerity). And they believe they need a legislative "win" before the 2018 midterms no matter what its fiscal costs.

That, of course, is hardly a surprise. The real question is what will the coming revenue costs produce in terms of the U.S. economy. It's not an easy question to answer; as that well-known tax philosopher Yogi Berra once said: "It's tough to make predictions, especially about the future." But we can try.

First, we seem certain to get a corporate rate cut. After the 1986 Act, we had the lowest statutory tax rate in the OECD; now we have the highest. In today's global economy, where capital moves around the world with the click of a mouse, this creates nearly irresistible incentives for both U.S. and foreign multinationals to locate their deductions here and their income in a low- or zero-tax jurisdiction. So the corporate rate will be lowered—how low it will go depends on whether the tax base is expanded and by how much. The 20 percent rate of framework seems very optimistic, and Donald Trump's 15 percent rate is unreal.

While many smaller breaks will probably exit the tax code, the big questions concern whether there will be faster write-offs or "expensing" for capital investments and whether there will be serious restrictions on interest deductions. The Sixers' framework calls for the immediate write-off (or expensing) of purchases of equipment during the next five years. It also says that interest deductions of taxable corporations will be "partially limited." The framework says nothing about limiting the interest deductions of partnerships, no matter how large the partnership. The problem—which is well understood by tax professionals but not at all by the public—is that expensing of assets that are debt-financed leads to negative tax rates, or large subsidies, to investments that would not be made absent the excessive tax breaks. The interest deduction coupled with expensing of assets will be one of the most contentious issues of business tax reform, and how these issues are resolved will not only tell us how low the corporate rate will go, but also whether the investment incentives of the new law will be rational or horribly distortive.

Congress will also abandon our foreign tax credit system in favor of an exemption system for dividends from foreign subsidiaries and impose a low-rate one-time transitional tax on the $2 to $3 trillion of foreign earnings of U.S. multinationals that have not been repatriated—almost certainly with a higher rate on cash than on foreign investments in plant and equipment. The big question for international tax changes will be what kinds of measures are enacted to prevent base erosion in a territorial system, an esoteric subject we don't have space to detail here. Many options are being considered, some with vigorous opposition from multinational businesses, and no one knows yet which will emerge.

Of course, the new tax law will provide an increase in the credits for children. What Ivanka wants, Ivanka gets.

There also seems to be an emerging consensus for a special lower tax rate on certain partnership and proprietorship business income, as the framework proposes. Along with the tremendous increase in the importance of international income tax rules (which has occurred almost everywhere), there has been a uniquely American transformation of the composition of business income. The rise of sovereign wealth funds, private equity, and business investments by large university endowments and pension funds has allowed businesses to amass large amounts of capital without going to the public capital markets. This, in turn, has permitted the creation of very large business partnerships not subject to the corporate tax.

About two-thirds of business income is now earned by partnerships and other flow-through entities such as Subchapter S corporations. By comparison, in the early 1980s taxable corporations accounted for about three-quarters of the net income of businesses. This transformation has produced the Sixers' call for a lower rate of tax on partnership income—something that President Trump has a large personal stake in. In fact, partnership and other pass-through business income is especially concentrated among high earners, with nearly 70 percent accruing to the top 1 percent. One careful study by Treasury and university economists has estimated that more than 40 percent of the increase in the top 1 percent share in income between 1980 and 2013 is due to higher pass-through business income.[5] This makes it very difficult, if not impossible, to reduce the tax rate on partnership income from a top rate of 39.6 percent to 25 percent and fulfill the oft-repeated promises of President Trump that this tax legislation will not reduce taxes on the wealthy. As to whether these business tax cuts actually produce more jobs and higher wages for middle-class workers, as they also claim, we will have to wait and see.

On the individual side, the rates will of course become an important issue. For more than two decades now, Republicans and Democrats have fought *Game of Thrones*-style battles, as if our nation's destiny turned entirely on whether the top individual tax rate is 35 percent or 39.6 percent. This struggle echoes the comment about faculty politics attributed to Columbia University professor Wallace Sayre that politics in the academy are so bitter and rancorous "because the stakes are so low."

The framework would also double the standard deduction. Doubling the standard deduction will, of course, do nothing to promote economic growth or increase wages; it is being recommended simply to enable our politicians to claim that most folks will be able to file their tax returns on a postcard. As all income tax history demonstrates, however, postcard returns won't last long. If they happen, Congress's taste for using tax deductions and credits as if they were credible solutions to all our nation's economic and social ills will transform that postcard into a booklet.

A large expansion of the Earned Income Tax Credit, for both single workers and those with children, would be far better policy. It could make work pay better and eliminate debilitating marriage penalties for low- and moderate-income workers.

To pay for at least some of their tax cuts, the Sixers are planning to repeal the deduction for state and local taxes, but we will see whether that actually happens. There are nearly sixty Republican Representatives from high-tax districts, so the political costs of repealing the deduction for state and local income taxes and property taxes could prove very high. Once they learn about this idea, homeowners everywhere will squeal. A cap on such tax deductions—perhaps limited to state income taxes—may prove more likely.

Of course, the new tax law will provide an increase in the credits for children. That is Ivanka Trump's domestic policy priority. And what Ivanka wants, Ivanka gets.

Finally, there is repeal of the estate tax, which kicks in only for a married couple with more than $11 million of wealth and is estimated to apply this year to only about 5,200 of the 2.7 million people who will die. Despite all the attention in recent years to the growing inequalities of income and wealth, this most progressive piece of our Federal tax system is again in peril. Virtually every Republican candidate for President in this century has supported repeal. Despite the truth of the country song refrain: "I've never seen a hearse with a luggage rack," the opponents of repeal have been unable to convince the public that this "death tax" is a tax on *recipients* of inherited wealth—a tax on Paris Hilton, not Conrad Hilton.

Enough predictions. I told the *Wall Street Journal* in 2009 that Congress would never allow the one-year estate tax repeal of 2010 to take effect—that it would be malpractice to allow the tax to expire for just that one year. I was only half right: It was malpractice, but 2010 became the year, as Paul Krugman put it, to "throw mama from the train." The Tax Policy Center estimated that about 25,000 people who would have been subject to the estate tax died that year. And billions of dollars were also spared future estate and generation-skipping taxes that year—eliminating taxes on the transmission of wealth to remote generations long into the future. So as malpractice goes, this example was quite dazzling.

Well...maybe just one more prediction: Tax legislation that is this controversial, and that benefits high-wealth individuals and multinational corporations, will open up great opportunities for the Democrats to demagogue—and not just about the estate tax. The corporate tax is the worst tax economically: it burdens productive investments and inspires all sorts of distortions and chicanery for only 7 percent of the revenue pie. But it is the most popular tax politically. So, if the coming tax legislation is passed with no or only a few Democratic votes, we will certainly hear a lot in the 2018 and 2020 campaigns about plans to "repeal and replace" it. And as everyone knows, repealing and replacing legislation on taxes is far easier than it is on health insurance.

The sad truth, of course, is that the coming tax cuts cannot possibly be the great and simplifying tax reform that the President and Sixers claim and that our nation so badly needs. We are hobbling our nation in today's competitive global economy by relying so heavily on an income tax. How have other countries managed to get their business tax rates so low? By raising their value-added taxes—taxes on consumption now used by every other country in the OECD and by more than 160 countries worldwide.

By enacting a value-added tax of around 12 percent we could eliminate more than 150 million people from income taxation with a $100,000 family exemption; lower income tax rates for everyone; reduce the corporate rate to 15 percent; and protect low- and moderate-income families from any tax increase through payroll tax credits and expanded refundable tax credits for children administered through government-issued debit cards.[6] Senator Ben Cardin of Maryland has introduced legislation along these lines. But that legislation is now going nowhere because most of our politicians believe they can avoid any political heat by insisting on tax cuts alone. Our politicians simply refuse to tell the truth to the American people.

In 1990, when I was serving at the Treasury Department, George H.W. Bush came to believe that the nation's fiscal situation required serious deficit reduction. And when George

Mitchell, then the Democratic Senate Majority Leader, made clear that he would not consider significant spending cuts or new tighter budget rules without tax increases, Bush agreed to increase taxes, violating his famous "Read my lips: No new taxes" pledge, because he believed it was the right thing to do for the country. He knew it might cost him re-election, and it did—in no small part because of the betrayal of Newt Gingrich, who was far more interested in his own ambitions to be Speaker of the House than in what was good for the country.

Five years later Gingrich did become Speaker of the House after Bill Clinton had raised taxes in 1993—again to address the deficit—this time with only Democratic votes. In the 1994 election, the Republicans captured the House of Representatives for the first time since 1954. After that, political courage over the necessary level of taxes became scarce. Political courage: that was *so* 20th century.

But not all the news is bad. The budget legislation of the 1990s, along with the economic growth unleashed by the information technology revolution of the late 1990s, completely eliminated the projected deficits by the year 2000 and produced a Federal surplus for the first time since 1969. Indeed, the budget surpluses projected by the Congressional Budget Office were so large that, in March 2001, then-Chairman of the Federal Reserve Alan Greenspan told Congress that the Federal government would soon pay off all of the national debt and would have to begin investing its surplus revenues in corporate stocks, a prospect he abhorred. The good news is that this problem has been solved.

When talking about enacting tax legislation that they can call "tax reform," Republicans keep insisting that "failure is not an option." But when it comes to creating a new tax law that will ably serve the American economy, enhance the living standards of the American public, and ensure our nation's fiscal health in the 21st century, failure is not just an option. It's the *only* option.

Endnotes

[1]That statement was more notable for what the Sixers said they *weren't* going to do: enact a new consumption-based tax system with border adjustability. This system, they said, had too "many unknowns associated with it." With that, they threw overboard the novel consumption tax House Republicans had proposed in the summer of 2016, when they, like everyone else, thought Hillary Clinton would be President. Throwing this so-called BAT tax overboard was a message to its opponents—notably retail importers like Amazon and Walmart, as well as the Koch Brothers—that they had won. I published a widely circulated paper detailing the "known unknowns" of this proposal. Graetz, "The Known Unknowns of the Business Tax Reforms Proposed in the House Republican Blueprint," *Columbia Journal of Tax Law* (2017).

[2]Staff of the Joint Committee on Taxation, "Present Law and Data Related to the Taxation of Business Income," September 15, 2017, p. 56.

[3]Before 1986, the use of pre-tax loss real estate investments as tax shelters contributed to a massive market distortion in commercial real estate, leading to wasteful oversupply and misallocation of capital. Today we still have an oversupply of commercial real estate—and a greater oversupply than other OECD countries—but that is for other reasons. See "What's Ahead for Retail Landlords," Cohen & Steers (June 2017).

[4]I am grateful to Donald Marron for this illustration.

[5]Michael Cooper, John McClelland, James Pearce, Richard Prisinzano, Joseph Sullivan, Danny Yagan, Owen Zidar, and Eric Zwick, "Business in the United States: Who Owns It and How Much Tax Do They Pay?" NBER Working Paper No. 21651 (2015).

[6]This plan was detailed in my 2010 book *100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States* (Yale University Press) with updated estimates in my article "The Tax Reform Road Not Taken—Yet," *National Tax Journal* (2014). I presented a briefer version of the plan in these pages as well. See "How to Shrink the IRS and Grow the Economy," *The American Interest* (November/December 2011).