Testimony Before the Senate Finance Committee
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Chairman Hatch, Ranking Member Wyden, and Members of the Committee, I thank you the opportunity to come here to discuss the recent tax bill.

The 2017 tax act is a lost opportunity to overhaul the tax code for the better. A flawed framework and rushed process produced a law that is likely to leave typical Americans worse off in the end. Our tax system had a number of significant flaws before this bill, but, while the legislation makes some worthwhile targeted improvements, its overall thrust is to go in the wrong direction along some of the most important dimensions.

- **The legislation is expected to add $1.9 trillion to the deficit over the next decade.** With the federal budget already on an unsustainable fiscal course, this legislation makes the situation significantly worse. The law adds $1.9 trillion to the deficit through 2028 according to the latest Congressional Budget Office (CBO) estimate—and at a time when the economy does not need such fiscal stimulus.[1] To put this in perspective, these tax cuts are expected to result in a 70 percent larger rise in federal debt as a share of the economy than we would have otherwise had through 2025 (the point at which the individual income tax cuts in the bill expire). We simply cannot run a 21st century government and care for an aging population when revenue in the next few years is expected to be below the historical average of the last several decades, as is the case because of this bill.

- **The legislation provides the largest benefits to the highest income Americans and likely leaves typical families worse off in the end.** The tax cuts concentrate their benefits among those who are doing the very best in this economy. As a share of income in 2018, this bill gives an average tax cut to the top five percent that is over twice as large as for a typical middle-class family and over nine times as large as for a typical low-income family.[2] That doesn't even count the negative effects of millions of low- and middle-income Americans no longer having health insurance as a result of the bill's repeal of the individual mandate—which is used to help partially finance these tax cuts disproportionately for the top. Further, the legislation is likely to look even worse once it is fully paid for, as it eventually must be. As a result, this bill is likely to leave a typical American family worse off in the end, as key programs and investments are threatened to pay for tax cuts which we know give outsized benefits to those with high incomes.

- **The legislation is a bonanza for tax planning by preferentially taxing certain kinds of income and drawing complex, arbitrary, and unfair lines.** The new reform fundamentally undermines the integrity of the income tax by expanding preferential taxation

[1] Congressional Budget Office, The Budget and Economic Outlook: 2018 to 2028 at 129 tbl.B-3 (2018).
[2] Author's calculations based on Tax Policy Center, Table T18-0025 (2018), available at http://www.taxpolicycenter.org/model-estimates/individual-income-tax-provisions-tax-cuts-and-jobs-act-tcja-february-2018/t18-0025.

of income earned in certain ways but not others.[3] Corporations can now be used as tax shelters to avoid the top individual rate. Alternatively, people in the right sectors or with good enough tax counsel can take advantage of the new deduction for certain kinds of "pass-through" businesses—but only very certain kinds. This pass-through deduction represents the very worst kind of tax policy, picking winners and losers haphazardly in a complex tax provision, and then generating significant incentives for people to rearrange their businesses to try to get on the right side of the line. And these kinds of tax-planning opportunities throughout the bill mean the legislation seems likely to lose even more revenue—and give even more benefits to the best off—than initial estimates suggest.

- **We can and must do better.** Tax reform should raise more revenue, not less; ask more especially from the top, not less; reduce arbitrariness and complexity to create an even playing field across people and businesses, rather than adding a maze of rules that haphazardly pick winners and losers; and reduce unnecessary distortions and preferences that hold back the economy. The 2017 law made some targeted changes that went in the right direction, such as limiting the corporate preference for debt financing, limiting business deductions for entertainment expenses, and attacking ways that certain U.S. and foreign corporations strip profits out of the United States that should be taxable here. But, the plan overall fails to meet the most important goals we should have for our tax system. It means true tax reform should continue be on the agenda—a reform that undoes the damage of this bill and takes our tax system in the right direction.

Revenue to Finance Our Country's Commitments, Investments, and Public Services

The federal government needs more revenue to meet the country's commitments, make worthwhile investments, and provide needed services. We have long known that, with the retirement of the baby boomers, spending would rise in Social Security and Medicare, and that is happening now. Containing health care cost growth, building on the accomplishments of recent years, is of key importance. If that is done, then the costs for Social Security and Medicare are eventually expected to level out as a share of the economy—at a new, somewhat higher level.[4] We can successfully finance the increase in costs from the aging of the population, and also the many other investments and services that our government should provide. But, we need more revenue to do that, and

[3] For a more complete discussion of the kinds of tax planning opportunities created by the act, see a report released by thirteen tax scholars, including me, in the immediate lead up to passage of the bill. *See* Avi-Yonah et al., The Games They Will Play: An Update on the Conference Committee Bill (draft Dec. 2017), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3089423.

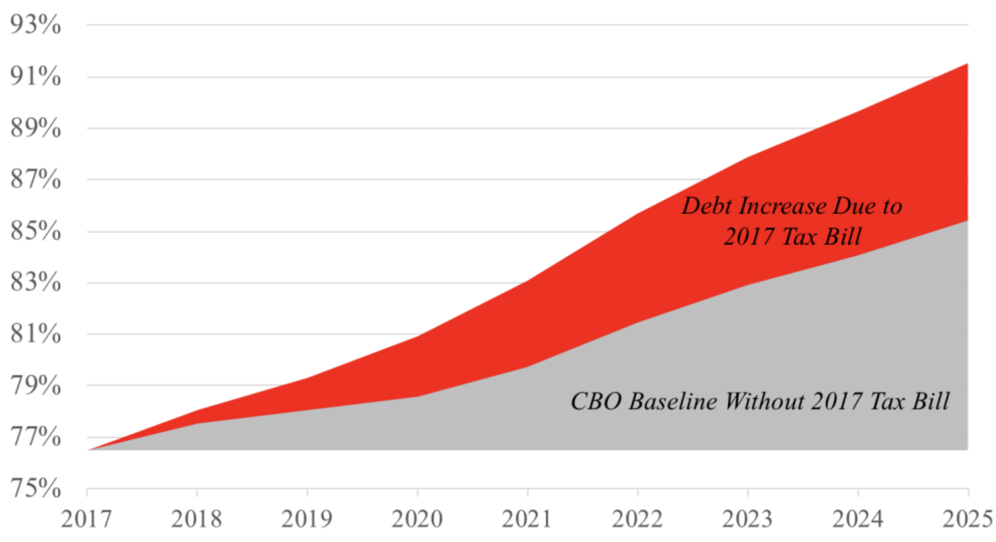
[4] For instance, the Social Security Trustees project Social Security costs rising from about four percent of GDP as of the early 2000s to around six percent of GDP as of 2030—with costs then stabilizing at that level. *See* Social Security Trustees, 2017 OASDI Trustees Report, Table VI.G4 Single Year Table, available at https://www.ssa.gov/oact/tr/2017/lr6g4.html. For a projection following a broadly similar pattern, see Congressional Budget Office, The 2017 Long-Term Budget Outlook, Supplemental Information, tbl.1 (2017), available at https://www.cbo.gov/sites/default/files/recurringdata/51119-2017-03-ltbo_1.xlsx. For Medicare, the trajectory depends on health care costs and whether we can build on the reforms in recent years that have helped to contain cost growth. If there is zero "excess cost growth" (spending per capita in Medicare rises with GDP), then Medicare spending, like Social Security spending, would increase as the baby boomers retire but then stabilize as a share of the economy. If excess cost growth is positive, then the program would continue to grow as a share of income—a trend that would eventually have to end. *Id*. at tbl.4.

certainly cannot do it when tax cuts are driving revenue below the historical average of the last several decades—as will be the case in the next few years.[5]

An unsustainable fiscal trajectory has been made significantly worse by these tax cuts. In dollar terms, these tax cuts will add $1.9 trillion to the deficit through 2028, according to CBO's latest projections.[6] This is a significant blow to the country's fiscal trajectory. To give a sense for the magnitude:

- *A 70 percent larger rise in debt through 2025 as a share of the economy.* The debt-to-GDP ratio should generally be stable or falling when the economy is strong. Even absent these tax cuts, the federal government's debt-to-GDP ratio would have been on an unsustainable upward trajectory, expected to rise by 9 percentage points from the end of 2017 through 2025—going from about 76 percent of GDP to 85 percent based on the latest data from CBO. But, as shown in Figure 1, with the tax cuts in place and fully taking into account potential macroeconomic feedback, that increase is now expected to be about 70 percent larger through 2025 according to CBO (at which point all of the individual income tax cuts are scheduled expire). In other words, as a result of the tax cuts as enacted, the debt-to-GDP ratio is projected to rise around 15 percentage points rather than 8 percentage points, and reach 92 percent of GDP as of 2025.[7]

Figure 1
Projected Increase in U.S. Debt-to-GDP Ratio Relative to 2017 (Including Macroeconomic Feedback Effects)



Source: Author's calculations based on CBO data.

[5] Through 2025 (when the individual income tax cuts expire), revenues are projected to average 16.9 percent of GDP assuming continued growth. Congressional Budget Office, *supra* note 1, at 67 tbl.3-1. That's as compared to an average of 17.4 percent over the last forty years (including recessions) and a high in that period of 20.0 percent in 2000.
[6] *Id.* at 129 tbl.B-3.
[7] Author's calculations based on CBO data.

- *When fully in effect, a deficit of roughly similar magnitude as the long-term shortfall in the entire Social Security system.* People often cite to the long-term shortfall in Social Security as a key fiscal challenge, and it is—though one that can be addressed readily if there were political will, especially to raise revenue. Notably, these tax cuts are of about the same magnitude as the entire shortfall in the Social Security system. In the years that they are fully in effect, the tax cuts amount to about 1 percent of GDP. The Social Security Trustees estimate that the Social Security shortfall is also about 1 percent of GDP over the next 75-years.[8] CBO puts the Social Security gap as somewhat larger than that, about 1.5 percent of GDP.[9] So, these tax cuts alone, when fully in effect, are between two-thirds and 100 percent as large as the 75-year Social Security shortfall, depending on which estimates are used. Of course, if many of the tax cuts expire as scheduled as of 2025, then they would not have a long-term deficit effect; this illustrates how big they are if they remain in place.

Put simply, this tax bill fails a very basic test. Does it give us a tax system that generates enough revenue? The answer is "no." Either the tax cuts must be reversed and then some, or key commitments, investments, and services will have to give.

To be sure, there are times that deficit financing can be wise—in fact, urgently needed. That is particularly the case when the economy is weak, with high unemployment, and especially if the Federal Reserve has cut interest rates to the "zero bound" and so has limited ability to stimulate the economy. In those times, deficits can save jobs and raise living standards. We are not now in that environment, since the Federal Reserve is in fact moving to raise interest rates. There were serious mistakes made in fiscal policy several years ago, when Congress insisted on austerity that was premature. Congress is now engaged in a mistake of the opposite kind—deficit financing unsustainably and without the justification of serious economic weakness.

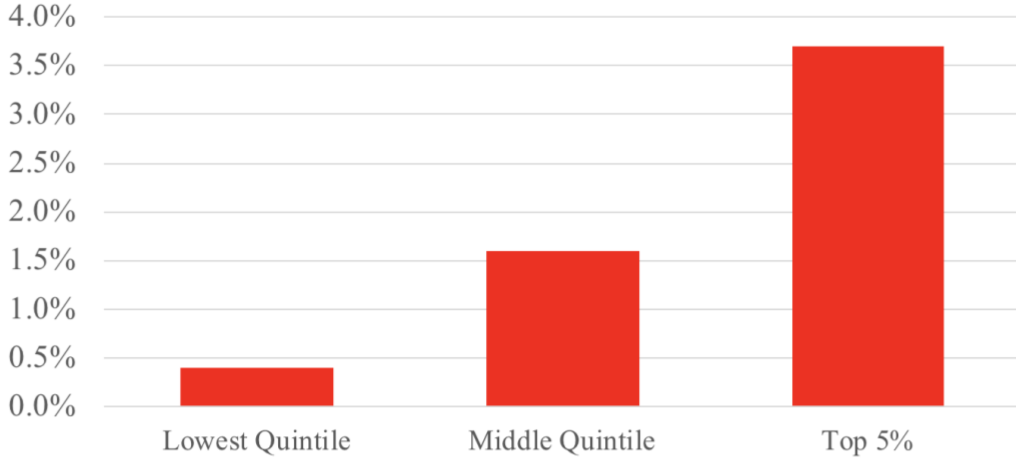
Concentrating the Benefits at the Top, with Typical Families Likely Left Worse Off

Who wins from these tax cuts? Disproportionately, it is those who have done best in this economy, aggravating the already wide gap between the living standards of those at the top and everyone else. In 2018 and based on Tax Policy Center data:[10]

- Top 5 percent: An average family in the top 5 percent gets a tax cut of about 3.7 percent of after-tax income (or $20,890).
- Middle quintile: An average family in the middle quintile gets a tax cut of 1.6 percent of after-tax income (or $930).
- Bottom quintile: An average family in the bottom quintile gets a tax cut of 0.4 percent of after-tax income (or $60).

[8] Social Security Trustees, *supra* note 4, at Table VI.G4, https://www.ssa.gov/oact/tr/2017/VI_G2_OASDHI_GDP.html#200732.
[9] Congressional Budget Office, Changes to CBO's Long-Term Social Security Projections Since 2016, at 2 tbl.1 (2017), available at https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/53209-ltbossprojections.pdf.
[10] Author's calculations based on Tax Policy Center, *supra* note 2.

Figure 2
Distribution of Bill in 2018
(% Change in After-Tax Income)



Source: Tax Policy Center, Table T18-0025.

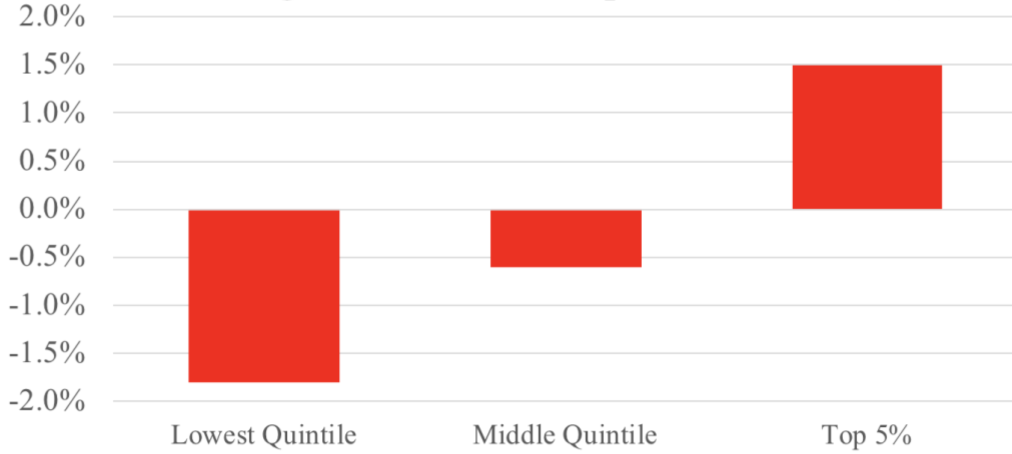
In other words, the average tax cut for the top 5 percent is more than double that for a typical middle-income family as a share of income and nine times that for a low-income family. This distribution comes as a result of a series of policy choices. That includes expanding the Child Tax Credit but then failing to enhance it in such a way that the tax cut would give anything but a symbolic benefit to millions of low-income working families and not expanding the Earned Income Tax Credit at all. It also includes a series of large tax cuts disproportionately benefiting the top and which are significantly larger than the base-broadening measures that the bill enacts. That includes the large corporate rate cut, the new deduction for pass-through businesses, the cuts to the top individual income tax rates, further reductions in the estate tax, and so on.

In fact, this distributional estimate is misleadingly optimistic. First, that's because it doesn't include the losses to low- and middle-income Americans coming from health insurance increasing and millions dropping health insurance as a result of the repeal of the individual mandate. Second, because these tax cuts are deficit financed, there will come a day when they do get paid for, as services are cut (or taxes increased) to finance them.

Who will be the winners and losers then? Well, of course, we don't know until it happens. That is part of the problem with deficit financing a tax cut like this. It hides who actually pays for the tax cuts.

If one were to perhaps optimistically assume that the eventual financing for these tax cuts is distributed in proportion to income (that is, households across the income distribution see spending cuts and/or tax increases that reduce their income by the same percent), the picture becomes one of tax cuts that leave the top ahead and everyone else worse off. In short, these tax cuts come with the very real risk, and I'd argue likelihood, that a typical family will be left worse off as a result. This is shown in Figure 3.

Figure 3
Distribution of Bill in 2018 with Financing
(% Change in After-Tax Income with
Financing Distributed in Proportion to Income)



Source: Author's calculations based on Tax Policy Center, Table T18-0025.

And, that distribution of financing may well be too optimistic, certainly if the budget choices advocated by many tax cut supporters were pursued. Some indication can perhaps be taken from budgets like those from the Trump Administration and Congressional Republicans. These budgets aim to slash the kinds of benefits, investments, and services that are especially important for many lower- to middle- income families in order to help finance tax cuts like these. For instance, the Center on Budget and Policy Priorities has found that about 50 percent of the non-defense cuts in last year's congressional budget framework would come from programs particularly benefiting low-income Americans.[11]

Another indication of what the future might hold can be taken from what Congress chose to make permanent and what it did not in this very legislation. In order to meet the constraints set by the budget rules, the writers of this legislation chose to allow all of the individual tax cuts expire after 2025. The corporate rate reduction continues but in significant part financed through provisions affecting low- and middle-income Americans—a slowdown in inflation adjustments that gradually increases taxes over time and, also, the repeal of the individual mandate likely leading to millions more uninsured. Thus, after 2025 and even putting to the side the effects of getting rid of the mandate, this tax bill would, if nothing changes, produce modest tax cuts for the top and tax *increases* for the rest.[12]

Those expirations may or may not happen as scheduled. But, we do live in a world of constraints. Choices will have to be made, and these expirations apparently reflect the priorities of the writers of this legislation when faced with constraints, even if the constraints now might be the budget rules.

[11] Isaac Shapiro et al., Center on Budget and Policy Priorities, House GOP Budget Cuts Programs Aiding Low- and Moderate-Income People by $2.9 Trillion Over Decade (2017), available at https://www.cbpp.org/research/federal-budget/house-gop-budget-cuts-programs-aiding-low-and-moderate-income-people-by-29.
[12] *See* Tax Policy Center, Table 17-0136 (2017), available at http://www.taxpolicycenter.org/model-estimates/conference-agreement-tax-cuts-and-jobs-act-dec-2017/t17-0316-conference-agreement.

The trade-offs they made show the danger that this tax bill poses to low- to middle- income Americans when it is eventually paid for.

A Tax Planning Bonanza and Complexity Galore

Unfortunately, this tax bill's flaws are not fully captured by these revenue and distributional estimates. These measures do not show the harm that comes from the wasteful and unfair tax planning that this bill will prompt. Moreover, these tax planning games could well lead to even more revenue loss and bigger wins for the top than official estimates suggest; I believe that is in fact the likelihood.

Tax planning, complexity, and unfairness often go hand-in-hand. This bill increases all of those by allowing certain kinds of income—if earned in the right forms or in the right sectors—to be preferentially taxed in ways they hadn't been before. These preferential rates are given for income earned through corporations and for certain kinds of pass-through businesses. The result is a system in which many of the most sophisticated and highest income Americans will be able to avoid the new (reduced) top individual income tax rate on substantial shares of their income if they do enough planning, even as those in some lines of business will win more than others for no particularly good reason.

To the degree there is a logic behind this mess, it might be that "business income" deserves a special break as compared to income earned from "work."[13] I would question that choice from the start. Why should someone working as an independent contractor or business owner get a tax break that someone doing the same work as an employee does not? That is apparently the position of the writers of this legislation. And, the administrative mess that this bill creates in trying to draw such a distinction helps demonstrate the profound lack of wisdom in this policy approach.

A number of tax scholars and practitioners pointed out some of the deep flaws in the legislation in the lead up to its enactment, but the flaws still remained and they are already being exploited according to news reports.[14]

Corporations as Tax Shelters

One of the central elements of the 2017 reform is a large cut in the corporate tax rate. The corporate rate falls from 35 percent to 21 percent. However, the legislation does nothing effective to address

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[13] There is greater logic to applying different tax rates to normal returns to capital versus other returns (such as returns to labor). For instance, consumption tax approaches, which can be progressive depending how they're structured, involve not taxing normal returns to capital but then taxing all other returns (including extraordinary returns to capital and returns to labor). I tend to support taxing all of these returns (including the normal return to capital), but there are reasonable disagreements among tax policy experts on that score. The new tax rates on business income, however, do not represent any kind of defensible quasi-consumption tax style model. Under this new system, top income earners can now manage to characterize all kinds of returns—including returns to their own labor—as "business income" and effectively get special, low tax rates.

[14] *See, e.g.*, Ruth Simon and Richard Rubin, "Crack and Pack: How Companies Are Mastering the New Tax Code," Wall Street Journal, April 3, 2018, available at https://www.wsj.com/articles/crack-and-pack-how-companies-are-mastering-the-new-tax-code-1522768287; Ben Steverman and Patrick Clark, "Here's the Trump Tax Loophole Your Accountant Can Blow Right Open," Bloomberg, February 5, 2018, available at https://www.bloomberg.com/news/articles/2018-02-05/here-s-the-trump-tax-loophole-your-accountant-can-blow-wide-open.

the problem that this creates for the individual income tax system and the kind of avoidance this will generate.

In particular, with this large cut in the corporate rate, high-income individuals can avoid the progressive individual income tax. They can do so by stuffing income into the corporation. Taking into account self-employment and surtaxes, the top individual rate is around 40 percent—now, a far cry from the top corporate rate of 21 percent. That generates a potentially powerful incentive to earn income through the corporation rather than any form that would be subject to the 40 percent rate. (Also, for corporations, state and local income taxes remain fully deductible whereas, for individuals, the deduction is subject to a low cap, adding to the preference for earning income through a corporation.)

Corporate income is potentially subject to a second layer of tax, which can reduce this incentive. Qualified dividends and capital gains are taxed at up to a rate of 23.8 percent. However, the second level of tax can be deferred and potentially even eliminated. Owners of corporations can choose not to distribute funds from the corporations, and, while there are existing provisions meant to limit such build ups, those limits are widely understood to have been ineffective in decades past when the tax code created similar incentives—and are unlikely to be effective now.[15] The deferral of the second level of tax effectively reduces its value, and, if deferred until the corporate shares are given to heirs at death, the second level of tax can be entirely eliminated via step-up-in-basis at death.

Further, there are ways for owners of such corporations to essentially use the income in the corporation for other means and without triggering the second layer of tax. They can do so by borrowing and even potentially using the corporate stock to secure such loans, and, again, without triggering that tax.

Prior to the 1986 tax reform, there were somewhat similar incentives to stuff income into corporations. However, one notable difference between that environment and the current one is that, unlike anytime before this in the post World War II-era, someone can now earn income in the corporation, have it subject to the top corporate rate, distribute the income and immediately subject it to the second layer of tax, and still come out ahead as compared to earning that income as an individual. Thus, if the current rate structure holds, using a corporation to earn income as opposed to earning it as an individual subject to the top rate will, for many types of income, be superior irrespective of whether the second level of tax is deferred—with the question only being how much better.

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[15] On some of the history of corporations serving as tax shelters, the restrictions that apply, and those restrictions' ineffectiveness, see generally Steven A. Bank, From Sword to Shield: The Transformation of the Corporate Income Tax, 1861 to Present (2010); Edward Kleinbard, "Corporate Capital and Labor Stuffing in the New Tax Rate Environment" (March 21, 2013), https://ssrn.com/abstract=2239360. A number of other tax experts have also described how corporations will now act as tax shelters with the new, much lower corporate rate. *See, e.g.*, Shawn Bayern, An Unintended Consequence of Reducing the Corporate Tax Rate, 157 Tax Notes 1137 (Nov. 20, 2017); Michael L. Schler, Reflections on the Pending Tax Cut and Jobs Act, 157 Tax Notes 1731 (Dec. 18, 2017); Adam Looney, Brookings Institution, The Next Tax Shelter for Wealthy Americans: C-Corporations, Up Front Blog, (Nov. 30, 2017), available at https://www.brookings.edu/blog/up-front/2017/11/30/the-next-tax-shelter-for-wealthy-americans-c-corporations/.

A Deduction for Certain Pass-Throughs That Is Tax Policy at Its Worst

Perhaps in response to this preference for income earned through corporations, the designers of the legislation decided to also create a special deduction for certain kinds of pass-through income. This applies to income earned through non-corporate businesses that are taxed at the individual level ("passed through" to the individual). The twenty percent deduction essentially reduces the individual income tax rates applied to this income by twenty percent.

However, in trying to avoid a substantial shift into corporations, the designers of this tax legislation set up something even worse than simply allowing that shift to happen—or, better yet, not allowing corporations to be used so easily as tax shelters. The deduction is a provision of substantial complexity, real unfairness, and subject to significant gaming.[16] Further, it will tend to most benefit those with the higher incomes—since such pass-through income is concentrated at the top and a deduction like this most benefits those being taxed at the highest rates. For those who say the provision is needed to help true small businesses, I say there are much better ways.

To briefly summarize the bevy of rules that apply here:

- *Not to employees.* The one group that cannot get the deduction at all are employees. Irrespective of income level, employees are barred from enjoying the deduction's benefits.

- *Yes, to independent contractors and other business owners, sometimes.* For those who aren't employees, such as independent contractors and other business owners, much turns on whether other restrictions—on those with higher incomes—apply. For those with taxable income below $315,000 for a married couple (and half that for a single individual), what matters is whether one is an employee or not. If someone is an independent contractor, for instance, that person apparently gets the deduction, based on guidance so far.[17] This is true even if the person were doing similar work as an employee—just without employee benefits and somewhat less supervision, for instance (some of the criteria that differentiate employees from independent contractors). There is no good reason to preference independent contractor status—but that is the result of this provision. And it sets up a

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[16] Daniel Shaviro has a particularly incisive discussion of how the pass-through deduction came to be and its deep flaws. In his words, "[It] function[s] as incoherent and unrationalised industrial policy, directing economic activity away from some market sectors and towards others, for no good reason and scarcely even an articulated bad one." *See generally* Daniel Shaviro, "Evaluating the New U.S. Pass-Through Rules," British Tax Review (2018).

[17] 199A—the provision creating the 20 percent deduction—does impose a potential restriction on independent contractors and others irrespective of income level. Specifically, three types of payments in exchange for services are not eligible for the 20 percent deduction: (1) reasonable compensation, (2) guaranteed payments, and (3) payments to partners not acting in their capacity as partners. The last two restrictions are specific to partnerships (and, as it happens, are easy for partners working at a partnership to avoid). The first—the restriction making "reasonable compensation" ineligible for the deduction—is potentially broader and could apply across-the-board. However, the concept of "reasonable compensation" has, up until now, only been used to attack tax avoidance among S-corporation owners, and statements from then-Deputy Assistant Secretary Dana Trier suggest that Treasury does not plan to use the "reasonable compensation" standard to restrict deductibility for other forms of businesses, including independent contractors. *See* Matthew R. Madara, "ABA Section of Taxation Meeting: No Plans to Apply Reasonable Compensation Beyond S Corps," Tax Notes, February 19, 2018, available at https://www.taxnotes.com/tax-notes/partnerships/aba-section-taxation-meeting-no-plans-apply-reasonable-compensation-beyond-s-corps/2018/02/19/26wcl. In that case, an independent contractor—below the income threshold—would be able to take full advantage of the deduction, even as an employee doing very similar work could not.

complicated trade-off for workers to assess: weighing the now larger tax savings from being an independent contractor to the detriments of leaving behind employee benefits.

- *Cracking, packing, and the many games to be played.* Above that $315,000 threshold, a set of other restrictions are meant to apply (phasing in over a $100,000 income range above the threshold), but they are haphazard and create the kinds of lines that tax lawyers and accountants get paid to manipulate. Certain lines of work—such as providing legal, medical, or consulting services, or any business in which the employer's or employees' reputation or services is the principal asset—are not supposed to get the deduction. (And, architects and engineers got a last-minute reprieve removing them from the list of barred service providers, further illustrating the haphazard nature of this line drawing exercise. Why architects but not doctors and so on?) Also, a business owner must either pay enough in wages to employees or have enough tangible property (or some combination) in order to fully qualify. So, some business owners—such as real estate developers, owners of oil and gas firms, and retailers—seem to squarely fall within the benefits of the provision. For everyone else, it is a question of trying to squeeze within the lines and to identify themselves as a "winner" (under the provision) to the extent they can.

  For some businesses trying to take advantage of the deduction, it might mean "cracking" apart lines of business to try to remove as much activity from the prohibited service businesses as possible and maximize what would be eligible. A law office might, for instance, try to crack apart its real estate and some support staff into a separate entity—potentially eligible for the 20 percent deduction—and then rent it back to the "law office" at the maximum possible amount that they can get away with.

  For other businesses, it might mean "packing" businesses together to achieve eligibility. That is the case if a business would otherwise not have enough tangible property or employee wages to fully take advantage of the deduction. It might also be a way to avoid the restriction on businesses in which the owners' or employees' services or reputation would otherwise be the principal asset; they should try to pack in some other big asset, such as intellectual property or real estate or anything else.[18]

  This is not to mention that the IRS will surely find itself challenged defining what exactly it means to provide a legal, medical, consulting, or other prohibited service—and fighting off aggressive maneuvers by taxpayers to avoid those categories.

  I'd urge the IRS to try to reduce such gaming to the degree it can by, among other things, limiting ways businesses can choose what is counted as part of the business and what isn't for purposes of this provision, whether via an economic substance test or some other approach. But, this will be an uphill battle for the IRS, and make no mistake—this provision is fundamentally flawed from the start.

[18] Writing before the 2017 law was even passed by Congress, a number of us borrowed the "cracking" and "packing" terminology from gerrymandering jurisprudence to describe the kinds of games that would be played under this provision. *See* Avi-Yonah et al., *supra* note 3. Unfortunately, reports suggest our theories are becoming reality, and the "crack" and "pack" terminology has now entered the lexicon of tax planning maneuvers. Simon and Rubin, *supra* note 14.

Pick Your Own Adventure – With Lots of Advice from Tax Lawyers and Accountants

The point is that, for some, it will make sense to stuff income into a corporation. For others, it will make sense to be a pass-through business with planning to fit into the complex lines of the 20 percent deduction. Which route is better and how to achieve it will be the province of tax lawyers and accountants. And, using either route, the top individual income tax rate can be avoided.

That planning is in itself wasteful, and the disparate effects are unfair. I also strongly suspect that the official estimates of the 2017 legislation under-estimated the amount of such planning and, thus, both the cost and regressivity of these tax cuts. I believe that is also the case when it comes to other forms of planning as well that I and others have discussed. To take one other example: one of the largest revenue raisers in the legislation is the limitation on the deductibility of state and local income taxes. However, as was clear even before the legislation was signed into law, states could potentially make changes that would effectively preserve deductibility and limit the revenue raised by this provision,[19] and a number of states are now enacting or considering just such steps.[20] This should have been more seriously considered as the law was designed, but it wasn't—and official estimates do not seem to reflect this likely outcome.

Small, Additional Economic Growth Does Not Justify This Legislation

Supporters of the tax legislation will often justify the bill in terms of a rise in economic growth. But, that effect is very small, could be better achieved other ways, and does not change the core conclusions: that the legislation is fiscally unsustainable and disproportionately helps those at the top, likely at the expense of low- and middle-income workers.

Credible estimators find only very modest growth effects from this legislation:

- **0.1 percentage points per year or under.** Credible estimators find an annualized increase in GDP growth across the decade of 0.1 percentage point per year or under—with most estimates well under that.[21] See Figure 4. The growth effect as estimated by CBO is in fact already taken into account in the deficit figures cited earlier, with the tax legislation projected to add $1.9 trillion to the deficit in the coming decade including the macroeconomic feedback. This overview of estimates leaves aside the Tax Foundation, whose model has serious shortcomings including not incorporating any negative effects from deficit-financing.[22]

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[19] *See* Avi-Yonah et al., *supra* note 3.

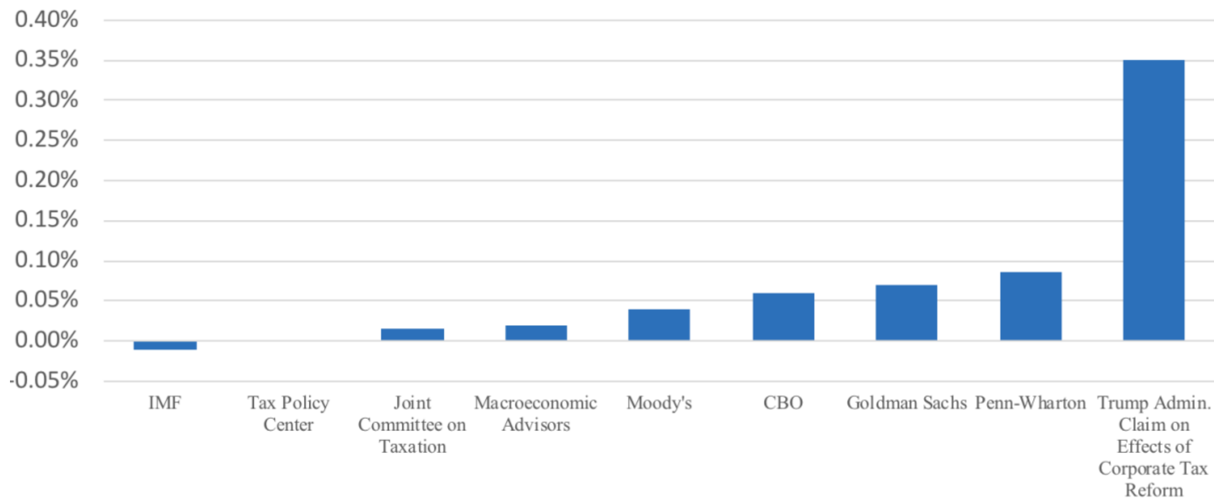
[20] New York State, for instance, enacted two measures in its recent budget deal that are aimed at reducing the effects of the 2017 tax bill's limitation on deductibility of income taxes.

[21] The Congressional Budget Office helpfully compiled estimates of the macroeconomic effects of the tax legislation. *See* Congressional Budget Office, *supra* note 1, at 117 tbl.B-2. For the figures here, I have used the annualized growth rate based on how much higher (or lower) GDP is as a result of the tax changes in the tenth year. An alternative is to look at the average level effect of the tax legislation across the period (figures CBO also provides). The benefit of the latter is that it captures gains in GDP in the interim years, some of which dissipates over time; on the other hand, looking at average level effects—as opposed to annualized growth—doesn't convey the degree to which those effects are temporary. Looking at it either way, effects are small, and I have chosen to focus on the annualized growth rate since those have frequently been used in the debate over the tax bill including by the administration to which I compare.

[22] *See, e.g.*, Matt O'Brien, "Republicans Are Looking for Proof Their Tax cuts Will Pay for Themselves. They Won't Find It." Washington Post Wonkblog, December 1, 2017, available at https://www.washingtonpost.com/news/wonk/wp/2017/12/01/republicans-are-looking-for-proof-their-tax-cuts-will-pay-

- **Trump administration's out-sized claims.** All of these estimates can be contrasted with the Trump administration's claim of a 0.7 percentage point annual increase in the growth rate from the totality of its policies in the coming decade and its claim of a 0.35 percentage point increase from corporate tax reform alone and which it said would generate $1 trillion of additional revenue to offset the cost of the tax cuts[23]—which all credible estimators agree is highly unlikely to happen.

<u>Figure 4</u>
Estimates of Effect on Annual Growth
(Annualized Growth Across Decade Based on Effect in 10th Year)



Source: As compiled by CBO. Note that Penn-Wharton gives a "high" and "low" estimate. The high is an increase of 0.1 percentage points per year, and the low is an increase of 0.06 percentage points per year. This figure shows the average.

Further, there are other, far less costly ways to achieve this kind of increase in growth via tax reform. For instance, an analysis by Robert Barro and Jason Furman suggests that simply making "bonus depreciation" permanent, at *one-sixth* the cost of this tax bill, would have had the roughly same growth effect as the 2017 tax legislation.[24]

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for-themselves-they-wont-find-it/?utm_term=.6065fa73ff12. Greg Leiserson, Center for Equitable Growth, "Measuring the Cost of Capital and Estate Tax in the Taxes and Growth Model," November 21, 2017, available at https://taxfoundation.org/measuring-the-cost-of-capital-and-estate-tax-in-the-taxes-and-growth-model/.

[23] Department of the Treasury, Analysis of Growth and Revenue Estimates Based on the U.S. Senate Committee on Finance Tax Reform Plan, December 11, 2017, available at https://www.treasury.gov/press-center/press-releases/Documents/TreasuryGrowthMemo12-11-17.pdf.

[24] Barrow and Furman find that, under the assumption that all tax cuts are paid for via cuts elsewhere, the enacted bill has a slightly larger growth effect than simply making bonus depreciation permanent; however, if they are not paid for and instead deficit financed, the opposite is the case. *See* Robert J. Barro and Jason Furman, "The Macroeconomic Effects of the 2017 Tax Reform," Brookings Papers on Economic Activity 41 tbl.11, 42 tbl.12, 48 (2018), available at https://www.brookings.edu/wp-content/uploads/2018/03/4_barrofurman.pdf. Barro and Furman also find overall growth effects for the legislation as enacted that is in the range of other credible, independent estimates—they find between 0.02 percentage points and 0.04 percentage points higher annualized growth across the decade as a result. *Id.* at 41 tbl. 11 and 49 tbl.14.

Finally, these growth rates are not only modest; they are often misunderstood as implying that the legislation is significantly better for Americans than shown in the traditional distributional tables cited earlier. That's wrong for several reasons. First, these GDP estimates measure the effects on "domestic" product rather than "national" product. It is "national" product that matters more for the living standards of Americans since that subtracts payments to foreigners like interest payments on debt (from which Americans don't benefit). CBO has found the effect on "national product" to be 40 percent smaller than that on "domestic product," on average, across the coming decade.[25] Second, both GDP and GNP measure increases in production rather than people's actual welfare—as in how much better people's lives really are—and effects on welfare are likely even smaller. Put simply, the modest, estimated growth effects don't change the fundamental conclusions described earlier—this is a bill that does little for low- and middle-income Americans now and seems likely to leave them worse off in the long-run.[26]

Reform to Fix a Newly Broken System

To be sure, the 2017 tax bill took some discrete steps in the right direction. The tax system has long generated a preference for debt over equity in the corporate sector that misaligned incentives and caused corporations to leverage more than they would otherwise; that has been ameliorated to some degree in the new legislation. The legislation cracks down on business deductions for entertainment and food in ways that I think are wise. It tries to take on problems with stripping of the U.S. tax base by both U.S. and foreign corporations, and this is an area very much deserving of attention and reform.

But, in terms of overall thrust, the tax system has ended up more broken than it was before because of this tax bill. Tax reform should remain on the agenda. But, it should now be tax reform that addresses the key problems created by this bill and beyond. That means generating significantly more revenue and in a progressive way; eliminating provisions like the 20 percent deduction that are complicated, unfair, and arbitrary; taking steps to prevent, or at least reduce, people using corporate form to avoid individual income taxation, for instance, by ending step-up in basis at death or taxing using a mark-to-market system; working toward a system that doesn't pick winners and losers in the economy like this latest legislation does too often; and building on the reforms in this bill while working with other countries to more effectively tax capital income that has too often escaped to tax havens.

There is much work to be done in overhauling the U.S. tax system, and this recent bill made the project much greater and more urgent.

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[25] Congressional Budget Office, Letter to the Honorable Chris Van Hollen, April 18, 2018, available at https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/53772-2017taxacteffectsonincome.pdf.
[26] I am grateful to Greg Leiserson for sharing his views on the issue of the relationship between growth effects, distributional tables, and welfare.