Steven Rattner
Chairman and Chief Executive Officer, Willett Advisors LLC
Testimony Before House Ways and Means Committee
May 18, 2017

No one can doubt the need for comprehensive tax reform. It has now been more than 30 years our revenue code was last thoroughly overhauled. Since that time, many loopholes and methods of achieving avoidance have crept into the system. And the policies and practices of our global competitors have also evolved, in many cases to our detriment.

However, any major tax legislation should meet several important tests:

1) It should be deficit neutral, given projections for rising fiscal gaps

2) It should be fair and certainly not diminish the progressivity of our system

3) It should be growth and investment enhancing

4) It should improve our international competitive position

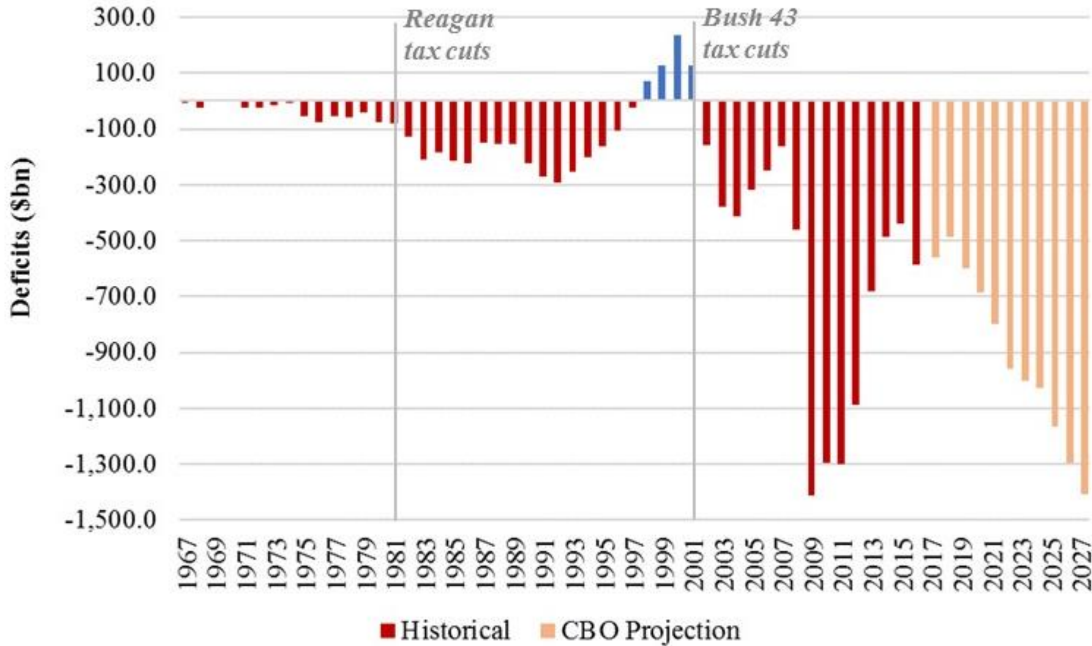
On that basis, the proposal by President Trump falls short in several important respects.

1) It should be deficit neutral, given projections for rising fiscal gaps

While the President's focus on tax reform is laudatory, his one-page plan includes far more detail on how the administration would cut taxes than on how it would pay for those reductions. Based on the information provided, non-partisan researchers have estimated that its net cost could be $5 trillion to $6 trillion over the next decade. Without adequate offsets, these tax cuts would drive up interest rates, the deficit and the federal debt.

Even before incorporating the administration's tax proposals, the federal deficit – after having declined dramatically since the financial crisis – is again on the march upward, as a result of entitlement spending and interest costs rising faster than revenues.

Deficits Are Rising

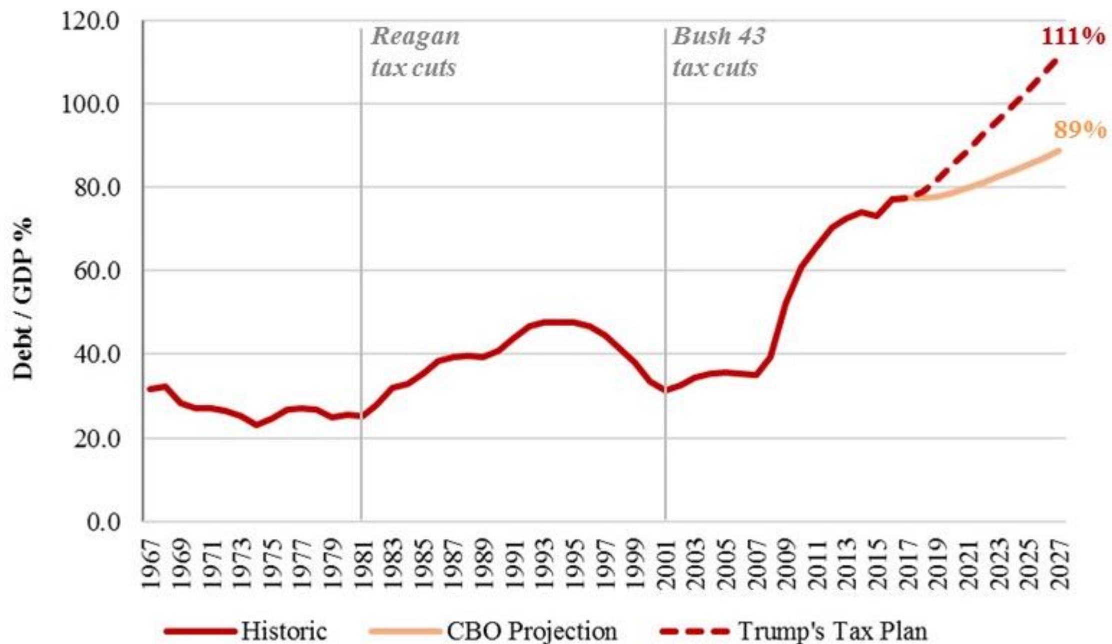


Source: Congressional Budget Office

These projected deficits would be substantially exacerbated by the Trump plan. Again before incorporating the administration's plan, the Committee for a Responsible Federal Budget forecasts that the ratio of debt to Gross Domestic Product – already at an historic high of just under 80% would rise sharply and could reach 89% by 2027, above every previous high except for a short period after World War II.

The Trump plan would drive this ratio to an astounding 111% by 2027, even as we continue to deal with the effects of an aging population.

Debt is Exploding



Source: Congressional Budget Office, Committee for a Responsible Federal Budget

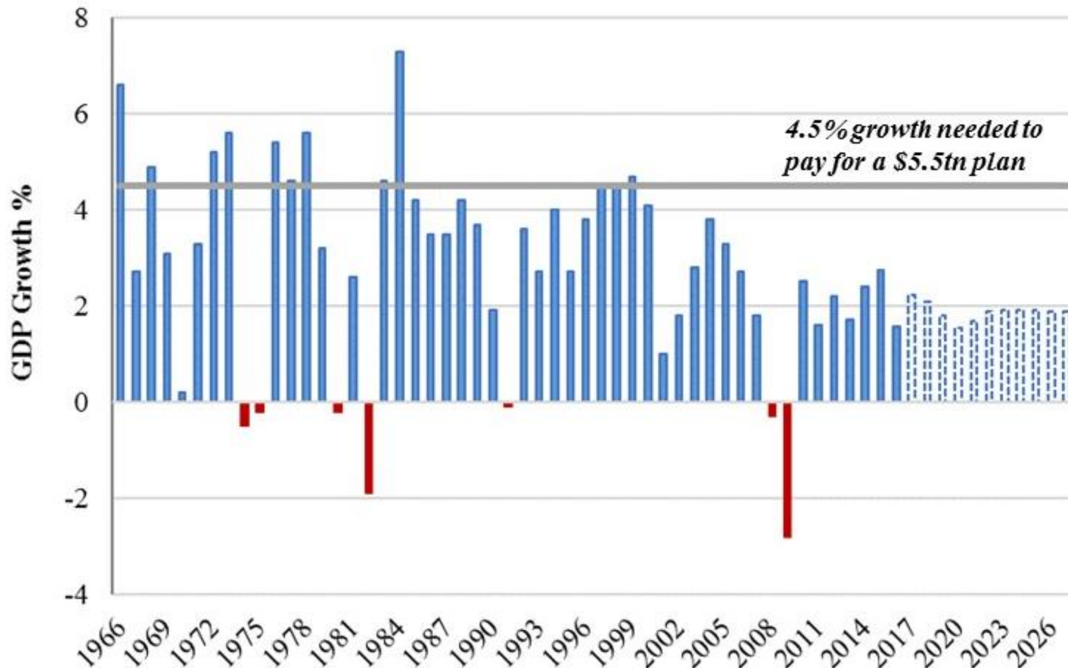
To counter these concerns, the Trump administration and its supporters appear to be resurrecting the discredited supply side theory that high deficits resulting from tax cuts don't matter because faster economic growth will quickly close the gap.

That's not what happened following the Reagan tax cut of 1981 (and by the end of Reagan's tenure, roughly two-thirds of his tax reductions had been reversed). Nor is it our experience following the tax cuts pushed through by President George W. Bush in 2001 and 2003.

To pay for the Trump plan, we would need average growth of 4.5% per year. That hasn't happened on a sustained basis in modern history and is highly implausible in the future given our current aging and productivity trends.

For its part, the non-partisan Congressional Budget Office projects approximately 2% growth for the next decide.

Treasury Secretary Steven Mnuchin believes that annual growth of 3% is attainable from the Trump plan. I know of no independent economist who thinks that is possible. And even if it were, the result would be about $2 trillion of additional revenues, far short of what is needed.



2) It should be fair and certainly not diminish the progressivity of our system

Given the economic strains on middle and working class Americans with which we are all familiar, it is critical that any tax reform plan be focused on helping these Americans.

However, the details of the Trump plan unassailably contradict Secretary Mnuchin's assertions that there would be no net tax cut for the rich. This includes lowering the top rate on earned income, eliminating a 3.8% levy on investment income, and doing away with the estate tax and the alternative minimum tax.

Yes, some deductions are to be eliminated, most notably for state and local taxes, but when the Trump administration provides enough information for experts to "score" the proposal, I have no doubt that the rich will be the big winners.

Gary Cohn, director of the National Economic Council, has argued that the increase in the standard deduction qualifies Mr. Trump's plan as a "middle-class tax cut."

The problem is that a family of two or more pays less tax under current law than it would under Mr. Trump's plan because of the availability of both a standard deduction and personal exemptions, which Mr. Trump said in the campaign he would end.

3) It should be growth and investment enhancing

While large tax cuts could be viewed as enhancing short-term growth, the size of Mr. Trump's tax cuts and lack of progressivity will quickly overwhelm the positive benefits.

Most importantly, rising interest rates will soon squeeze out private investment. Last year, for example, the Tax Policy Center estimated Mr. Trump's $6 trillion campaign tax plan would reduce the GDP by 0.5% after a decade and 4% after two.

The lack of progressivity in President Trump's proposal will also affect growth. In 2015, a study on income inequality by the International Monetary Fund found that increasing the income share of the top 20% results in lower growth because of the propensity of the wealthy to save rather than spend. Furthermore, a study by Brookings Institute last year found there is no guarantee tax cuts will increase long-term economic growth.

4) It should enhance our international competitive position

The need for corporate tax reform is without question.

While the stated corporate rate for U.S. companies is 39% (including state and local taxes), many pay far less because of the use of avoidance techniques. As a result, the average corporate tax rate is 10 to 15 points lower than the statutory rate.

That is unfair to many stakeholders. What should be done is a thorough elimination of abusive practices (such as transfer pricing) in return for a lowering of the stated rate to 25%, which is in line with the OECD's unweighted average.

The President's proposal, on the other hand, again goes way too far and gives up too much revenue for too little. His proposal to cut the corporate tax rate from 35% to 15% alone would cost us $2.2 trillion over the next 10 years.

The administration has proposed extending the corporate rate to the so-called "pass throughs," corporate entities that are taxed as individuals. While I am sympathetic to the goal of having all true business activities pay the same rate, I am not aware of any effective method of avoiding the creation of yet another loophole, the ability of high-income individuals to convert what should be wage income taxed at full ordinary rates into business income that would be taxed at a lower rate.

Three last points on business and investment income taxation:

To ensure deficit neutrality, I would not lower levies on interest, dividends and capital gains as the administration has proposed but would raise them as it is these individuals who will indirectly benefit most from a reduction in corporate tax rates.

In 1986, President Reagan equalized the top marginal and capital gains rates. This prevented the wealthy from getting special treatment and did not cause investment to fall.

The Trump administration also wants to move to a territorial tax system, in line with most other developed countries. There are certainly benefits associated with such a step but it could also inadvertently create more incentives for companies to move offshore. It is a complicated issue that deserves further study.

Finally, much attention has been focused on the $2.6 trillion of profits earned by American corporations but "trapped" overseas. While we should not be overly optimistic about the economic benefits of repatriation, I would be supportive of allowing repatriation at a modest tax rate if those revenues were used to address our critical infrastructure needs.

Conclusion

As I said at the outset, a comprehensive tax bill is long overdue. However, in my opinion it should be deficit neutral using conventional scoring methodologies. It should focus on reforming and simplifying our excessively complicated system while enhancing our international competitiveness.