DATE: September 14, 2017

FROM: Casie Daugherty, Prime Policy Group

SUBJECT: Senate Finance Committee Hearing on Tax Reform

Today, the Senate Finance Committee held a hearing entitled "Individual Tax Reform."

The hearing covered issues ranging from the "head of household" filing, expanding the child tax credit, eliminating the state and local income tax deduction, and how best to help middle class families. One of the most bipartisan issues was the Committee's (and the panelists) concerns about the "Roth-ificiation" of retirement savings, which many Senators felt would disincentivize savings. Notably there were no questions specifically addressing passthroughs, though some of the panelists touched on it tangentially.

Committee Members' Opening Statements

Committee Chairman Orrin Hatch (R-UT)

In his opening statement, Chairman Hatch made several clarifications on the plan for tax reform. He stated that it was true that leaders have been discussing proposals but tax writing committees, not another group, will write the final bill. The Big 6 WILL NOT dictate the direction, and the upcoming documents (set to be released the last week of September) will only be "signposts." The goal will be a document that passes the Senate Finance Committee (you need 14 votes). The Senate Finance Committee is NOT a rubber stamp. Additionally, the Chairman intends to work closely with committee members, and the bill that comes to the Committee will reflect the consensus of the Committee. He emphasized that his commitments are not limited to Republicans, and he will work with any Democrat that comes to the table without a list of demands. Once again, he stressed that his preference is to move tax reform with bipartisan support.

Ranking Member Ron Wyden (D-OR)

Ranking Member Wyden, in his opening statement, emphasized that the Committee should not consider anything that is put together in secret but should be focused of a bipartisan product done in an open process. He pointed to the "lunar crater-sized loophole" in the president's plan that would allow the wealthiest people to dodge paying their fair share by taking advantage of the pasthrough status that is meant for small businesses. He also spoke out against eliminating the state and local tax deduction and taxing retirement savings.

Witnesses' Opening Statements

Lily Batchelder, Professor of Law and Public Policy At New York University School of Law And Affiliated Professor at New York University Wagner School Of Public Service

Alex Brill, Research Fellow at the American Enterprise Institute

Iona Harrison, Senior Vice President at Pioneer Realty

Ramesh Ponnuru, Visiting Fellow at the American Enterprise Institute

Q&A Round 1:

Chairman Hatch: Would repealing the federal itemized deduction for state and local income taxes be a shift in a progressive direction?

> **Ms. Batchelder:** It depends on how the revenue is used. In the current proposals, the repeal is used for highly regressive tax cuts. If you repeal the deduction in isolation and used that money for an EITC or a Child Tax Credit, that would be progressive.
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> **Mr. Brill:** The repeal is a progressive change in isolation. In the context of reform, we would have to look at all the changes.

Chairman Hatch: In your testimony, you say that the benefits for real property taxes go to middle class families. We have statistics from JCT that the vast majority of benefits from the state and local tax deduction goes to people with an income over $200,000 per year. So, there is a difference in who benefits from real property taxes and state and local deductions. Am I right on that? Am I correct that your testimony is more focused on preserving the real property tax deduction than the deduction for state and local taxes?

> **Ms. Harrison:** Not being a tax expert, my information in my testimony is based on our PriceWaterhouseCoopers study. As with the mortgage interest deduction, 75% of the value of real property tax deductions went to taxpayers with income of less than $200,000, and the real estate deduction is usually claimed by households with an adjusted gross income of slightly less than $50,000. State and local tax deductions are a lifetime benefit, where the mortgage interest deduction is only good until the mortgage is paid off.

Chairman Hatch: You suggest a higher tax credit for children. This will cost a lot in the ten-year window, but you make the point that it will pay for itself over the long run- today's children will be tomorrow's Social Security taxpayers. Correct?

> **Mr. Ponnuru:** I propose that an expansion of the child tax credit be financed in the way that other tax relief is, with the familiar list of payfors. Whatever portion of a tax cut is paid for, we should be consistent and this credit shouldn't be treated any different than any other.

Chairman Hatch: You have made the point repeatedly that the tax code reform needs to be progressive. At what point is it too progressive? In that case, why don't we just tax Bill Gates and the rest of us pay nothing.

> **Ms. Batchelder:** There is a point that the code is too progressive or targeted. However, we are very far from that point.
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> **Mr. Brill:** My personal view is that it is good that the current system is progressive. However, I would caution against the approach that every new change needs to be progressive.
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> **Mr. Ponnuru:** I do think there are concerns on excessive progressivity because it can lead to a volatile tax base.

Ranking Member Wyden: Can you contrast what the president said yesterday (there won't be any tax breaks for the wealthy) to what is on offer?

> **Ms. Batchelder:** When you look at his statement, it is hard to square with the plans that he has put out. I can't think of a credible analysis of his plans that says they don't cut taxes for the wealthy. Sooner or later the revenue loss of his plan will have to be paid for. It is likely that low and middle income families will likely be left holding the bag.

Ranking Member Wyden: As you know, the Committee made the child tax credit permanent. You say that we will pay for the expansion by changes in Medicare and Social Security. It is going to take a lot of money to do what you are talking about. How will you find the revenue?

> **Mr. Ponnuru:** I support the idea of dynamic scoring but when you are talking about something like the child tax credit, the revenue is so far in the future, it is subject to even more uncertainty than the usual exercise in dynamic scoring. My own views on how to pay for tax reform would include some long-term restructuring of entitlements. I also think that ending some credits and deductions, like a scaling back or elimination of the state and local deduction, or the mortgage interest deduction is a good idea. I also think that expanding the width of the top tax brackets make sense.

Sen. Johnny Isakson (R-GA): One of the most significant disadvantages of the 1986 reform was the clawback of passive loss. When Congress did this, it actually put people out of business. Your testimony addresses that. Do you agree that we should avoid a clawback on any investment that was made before the time the tax law was changed?

> **Mr. Brill:** The transition issues are very important and can be very tricky. Business owners are going to see retroactive changes as a drag because they made these decisions under a different set of laws. We want to make these changes on a prospective basis.

Sen. Isakson: One of the things I've worked hardest on is an incentive for Americans to save for their future. Do you consider a deferral of tax liability on an IRA investment as a benefit for the rich or a commonsense incentive?

> **Mr. Brill:** JCT and Treasury will identify these policies as tax expenditures. However, these are policies that promote savings and are critical for the long-term economic viability of our country. These policies can lead to positive economic growth.

Sen. Isakson: This also applies to the collection of 1031, isn't that correct? It isn't a matter of collecting the tax, it is only a matter of when.

> **Ms. Harrison:** Absolutely. 1031 exchanges are utilized throughout my profession and can range from very small properties to large commercial properties. Deferral doesn't mean you aren't paying, it just means you aren't paying now.

Sen. Isakson: I also want to make the point on low and middle class housing credits. They will be vital to the hurricane recovery efforts that we will be going through. It's important that when we label things, we don't lose sight of the fact that they don't just benefit the rich. Wouldn't you agree?

> **Ms. Harrison:** Labels can be very dangerous because they lead us to not examine the underlying things we are discussing.

Sen. Ben Cardin (D-MD): What would the impact be on retirement security if we used timing issues for rate reductions and what would the impact be on overall fiscal responsibility.

> **Ms. Batchelder:** Some have advanced the idea of making decisions on a Roth basis, which means that they are after tax. Right now, people can choose before or after. The problem is, if a lot of people switch to this, you would raise a lot of money within the budget window but lose an even greater amount outside the budget window.

Sen. Bill Cassidy (R-LA): Mr. Ponnuru advocates for increasing the child deduction. Your testimony compares two families with the same number of children but have different ages. You are implicitly criticizing the credit. I want to see how your testimony plays together, so can you expand on your position?

> **Mr. Brill:** I would note that there is a wide disparity currently based on family size. This is part of the horizontal inequity that I describe. Mr. Ponnuru makes an argument for that disparity. I would not promote a larger tax credit, but I respect his arguments.

Sen. Cassidy: Ms. Batchelder cites you in her testimony saying that our taxes should be an increased size of GDP. Implicitly, you are criticizing dynamic scoring. Thoughts on that?

> **Mr. Brill:** With respect to dynamic scoring, I think some tax changes can lead to dynamic effects, but not every tax policy change does that. We should recognize that. With respect to her testimony, I did coauthor the change she references, among many others. If we can find efficient ways to raise revenues, it is a reasonable part of a fiscal solution.

Sen. Sherrod Brown (D-OH): What would be the impact of raising the eligibility age of Social Security, coupled with cutting Medicare and changing the way that retirement savings are taxed to middle class families?

> **Ms. Batchelder:** Medicare and Social Security are programs that low and middle class families rely on immensely. I am deeply concerned about the retirement change as simply a timing gimmick. Roth-ification would be a dramatic change in retirement policy. There are very different rules on withdrawal and contribution limits.

Sen. Dean Heller (R-NV): The average median household income in Nevada is about $55,000. Most of the plans we have seen include a reduction in the number of brackets, as well as a significant reduction in rates. If we were to be successful, how much would the average family keep?

> **Mr. Brill:** I would note that matter to median households: what their tax bill is, what their marginal tax rate is, and the cost associated with complying with the code.

Sen. Heller: What is your biggest concern in any tax bill moving forward?

> **Ms. Harrison:** The first thing would be to do no harm. For many Americans, wealth-building starts with the equity in their home.

Sen. Tom Carper (D-DE): When I look at tax reform, I focus on four key questions: is it fair; does it foster economic growth; does it simplify the tax code or make it more complex; and how does it affect the deficit. Are those four good questions to ask?

> **Mr. Brill:** Yes
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> **Ms. Harrison:** Absolutely essential
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> **Ms. Batchelder:** Yes
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> **Mr. Ponnuru:** Yes

Sen. Carper: We are always looking for consensus. Give me one idea where you think you all agree.

> **Mr. Brill:** I would associate myself with Ms. Batchelder's comments on the Roth-ification of retirement savings, especially as it relates to timing and the potential impacts.
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> **Ms. Harrison:** We agree that the tax code should be fair.
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> **Ms. Batchelder:** I agree with Mr. Ponnuru that we should be seriously considering expanding the child tax credit, particularly for the lowest income families.
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> **Mr. Ponnuru:** I agree with the comments on Roth-ification and agree with Ms. Batchelder's testimony that eliminating the dependent exemption and increasing the standard deduction would be a bad trade-off.

Sen. Claire McCaskill (D-MO): Do you believe that clearing up some of the complexity could be as important as some of the other things that are sucking up all the oxygen in the room?

Mr. Brill: Complexity is a cost separate from the rates. Compliance costs from itemizing are significant. It is reasonable and appropriate to address that now.

Sen. McCaskill: I understand that the mortgage interest deduction is a behavior-modifying provision when it relates to people buying their first home. Do you have any data that when a family buys their 2nd, 3rd, 4th, home that somehow these buyers are considering going back to an apartment if they don't get a mortgage interest deduction?

Ms. Harrison: The short answer is, I don't think so.

Sen. Bob Casey (D-PA): Can you discuss what the President's past proposals on child care have looked like, and why a credit is preferable to a deduction?

Ms. Batchelder: The president last fall came out with some proposals, and I applaud him for that. The problem is that they didn't address the problems. They give more benefits to higher income families, even though lower income families spend a greater portion of their income. A more thoughtful approach would require that the tax credit be refundable.

Sen. Debbie Stabenow (D-MI): What lessons can we take from other tax reform efforts?

Ms. Batchelder: Working on a bipartisan basis is one of the most enduring lessons. There can be pitfalls is you don't release legislative language well ahead of time. The second would be to work with the revenue and distributional effects.

Sen. Stabenow: I'm concerned about not creating new loopholes. How can we assure that we are closing loopholes and not opening new ones?

Ms. Batchelder: The most important is to "flag" the rate cap on pass-through income. The estimates are it would cost trillions of dollars, mostly from people avoiding their tax burdens.

Sen. Pat Toomey (R-PA): You make a point that itemized deductions, and the state and local deduction in particular, have some unintended features in that they disproportionately benefit higher income earners. Would it be fair to characterize your view as states with higher taxes are subsidized by states with lower taxes? That the effect is it keeps federal rates higher?

Mr. Brill: That is true. Statutory rates could be lowered if the base was broadened.

Sen. Toomey: Does lowering marginal rates have an almost immediate outcome of changing incentives and encouraging economic growth?

Mr. Brill: I have a somewhat nuanced view. Lowering effective tax rates will increase the incentives to work, save and invest. It becomes a little bit trickier when you are simultaneously broadening the base and lowering the marginal rates. It can sometimes neutralize the effects.

Sen. Maria Cantwell (D-WA): Would incentivizing worker retraining be helpful? What else can we do for the middle class?

Ms. Batchelder: One of the most important things is to expand the Child Tax Credit and the EITC. Job training could be worth considering as part of education, but I tend to think direct benefits work better. Increasing the low-income housing tax credit is also worth expanding.

Sen. Michael Bennet (D-CO): What would your opinion be of phasing the child credit in at a faster rate and at the first dollar instead of where we do it today.

Mr. Ponnuru: I support those changes today. An expanded tax credit, especially one made refundable against payroll taxes, would lift even more children out of poverty.

Sen. Bennet What are your thoughts on a universal child allowance?

Mr. Ponnuru: I think an expanded child tax credit would have many of the same benefits that you are talking about. Many of the things that you've talked about at this hearing (affordable housing, paid leave, etc.) could be solved by an extended credit.

Ms. Batchelder: It is important to look at increasing the refundability rate.

Mr. Brill: One thing to think about is as it phases out, it would affect more people.

Sen. Rob Portman (R-OH): In recent efforts, base broadening and rate lowering efforts have been coupled with a standard deduction. Do you see any benefit from reducing the number of taxpayers that have to itemize?

Mr. Brill: There are a number of benefits, including lowering the compliance costs and tackling the horizontal equity issue.

Sen. Portman: Do you think the Roth-ification of retirement would create a disincentive to save? Less than 5% of people currently take advantage of a Roth account. What is the incentive to save?

Mr. Brill: I am concerned. What matters is the real-world evidence. There is a fair amount of uncertainty when you take away the choice. Policymakers should be cautious.

Ms. Batchelder: As a matter of theory, you could argue either way. You would want a group like JCT to model what would actually happen.