AN ACT OF DEFIANCE

Review of the New Republican Tax Cuts and Jobs Act
By Herman Greene

Naomi Klein in *This Changes Everything* identified three pillars of the corporate globalization process: "privatization of the public sphere, deregulation of the corporate sector, and lower corporate taxation, paid for with cuts to public spending." And she wrote, "Granting the corporate wish list, we were told, would fuel economic growth, which would trickle down to the rest of us eventually." The new Republican tax act was molded out of this framework. The Act is called the "Tax Cuts and Jobs Act," with the implication that if we cut taxes, especially on corporations, the economy will grow and produce jobs. For some time the Republicans have distinguished between the job creators (the wealthy, the corporations) and the job takers (the rest of us) and provide incentives for the former allegedly for the benefit of the latter. There is some logic to this: No doubt if I were a billionaire, I would employ more people!

The act will have a longstanding effect on the US and global economy. The tragedy is that in this time of the "long emergency," the greatest change in the US tax code in 30 years has been developed out of the same pro-growth, pro-business mindset that brought us to this point. The act will increase inequality and cut public spending at the federal, state, and local levels. It will balloon the US deficit, which could have consequences not only for the United States but for the world as this puts pressure on the US currency and its standing in the world. Compared with the current tax law, the act hurts the environment, though it could have been worse. Little thought was given to the kind of tax changes and government spending that will be needed to deal with climate change and other long-term challenges.

The act may sustain the current economic bubble for a while, and, thus, appear to validate its promoters. But it is a move in the wrong direction. We are in a gilded age. Neo-liberalism reigns supreme.

Environment

Let's start with the environment. To get Alaskan Senator Lisa Murkowski's vote and to obtain tax revenue to offset some of the reduction in tax revenues that will result from the act, the act opens up the 1002 area, about 1.5 million acres of the Arctic National Wildlife Refuge to oil & gas drilling.

Map from the US Fish and Wildlife Service

The 1002 area, i.e. the coastal plain area, is the "biological heart of the refuge. See Defenders of Earth fact sheet on the effects of drilling in this area. According to the December 1, 2017, Final Report of Conservation Science Partners, 98% of the crucial habitat in the refuge is in the 1002 area. It "hosts one-third of all polar bear denning habitat in the United States and one third of the migratory birds that come to the Arctic Refuge. It is also considered sacred to the indigenous Gwich'in people, who sustain themselves from the caribou that migrate there" (ecowatch.com).

On another matter concerning fossil fuels, there was talk of taking out special provisions in the current tax code that benefit fossil fuels, but they were not changed. The special provisions "include the expensing of exploration, development, and intangible drilling costs; the use of percentage depletion instead of cost depletion to recover drilling and development costs of oil and gas wells and coal mining properties; and numerous smaller incentives for production and distribution of oil, coal, and natural gas" (taxpolicycenter.org). In addition fossil fuels will benefit from the lower taxes on earnings of pass-through entities, discussed below, as many aspects of the industry are conducted through partnerships, and also by the faster expensing of capital investments in the act.

There is some good news in terms of environmental impact and that is the final act largely preserves the incentives for wind and solar power. Tax credits can cover up to 30% of the cost of these projects and these credits. The House bill had rolled back these credits, but the final act leaves them intact. Further the tax credit of up to $7,500 on the purchase of an electric vehicle was preserved. The act does limit “tax-equity” financing which is used in financing renewable energy projects (nytimes.com).

The huge growth in size of houses and housing stock in the United States, discussed in Alice’s Blog in this issue, is a misallocation of resources, and the larger buildings increase energy costs. The act will reduce incentives to buy houses, both small and large. At present homeowners can deduct their interest on home mortgages of up to $1 million and also their property taxes. As a result, for roughly half of homeowners, it pays to itemize deductions under current law. The tax act reduces the mortgage limit to $750,000 and also, as discussed below, limits property tax deductions. With the increase of the standard deduction to $24,000, only about 15% of new home purchasers will have enough itemized deductions to benefit from itemizing over taking the standard deduction. Those who don’t itemize will be put on the same tax footing as renters. In other words home ownership for most people under the new law will provide no tax benefits for homeowners over renters, both will take the standard deduction. Owners of high priced houses may see the value of their properties fall as much as 10% under the new law because of the limits on mortgage interest deductibility and property taxes (nytimes.com).

The bill has a slight disincentive for having children. Under current law a family’s standard deduction is based on the number of dependents. In the new act the standard deduction will be a flat amount regardless of the number of dependents. On the other hand, the tax credit for the children under 18 increases from $1,000 to $2,000.

Health Care

No doubt the individual mandate is one of the most disliked parts of Obama’s Affordable Care Act. Yet, in the logic of the Act it was necessary. The purpose of the ACA was to extend health coverage to the approximately 43 million uninsured Americans at the time the ACA was adopted. Some near the poverty level were to receive coverage through an expansion of Medicaid (government health insurance). Others at higher income levels were to receive coverage through private health plans and many of those people were to receive government subsidies to pay for their health plans. A problem before the ACA was that preexisting conditions would sometimes make applicants for health insurance uninsurable or insurable only at prohibitive rates. The ACA mandated that applicants not be penalized on insurance rates for their preexisting conditions. The insurance companies said they could go along with this if the applicant pool was expanded to include more healthy people, especially young people who tended to forego coverage. The answer was the health insurance mandate, a tax penalty on those who did not sign up for the ACA insurance policies.

The new tax act repeals the insurance mandate. According to the Congressional Budget Office this will lead to 13 million more uninsured people a decade from now than would be the case

with the mandate. Further premiums for those covered by the ACA plans will increase by 10% or more. Ironically one of the reasons for dropping the insurance mandate was to cover the shortfall in government revenues resulting from the tax cuts in the act. The fewer the number or people insured by ACA plans, the lower the government subsidies will be. Thus the government will save money by having fewer people insured.

There is another potential health impact of the tax act. The Statutory Pay-As-You-Go Act passed in 2010 (the Paygo Act) requires legislation that increases the federal deficit to be paid for by spending cuts or increased revenues or other offsets. The act will increase the federal deficit by $1.5 trillion dollars over 10 years and under the Paygo Act this would trigger automatic cuts in Medicare (limited to 4%) and other programs (most with no ceiling on the amount of cuts). "In 2018, for example, the law would claim $14 billion in various farm aid programs, $1.7 billion for Social Services block grants, which states use to help fund foster care, Meals on wheels and other programs, and $69 million for the Black Lung Disability Trust Fund" (nytimes.com).

Business

The last time there was a major reform of the tax code was in 1986. At that time rates were reduced so that the top rate was lowered from 50% to 38.5% with a plan to lower the top rate to 28% over time. At the same time as rates were lowered, many deductions were eliminated and the code was revised to more truly reflect income. Capital gains were taxed at the same rate as ordinary income in the 1986 Act. Over time many new deductions were added to the code and long-term capital gains rates were reduced to 15% for most taxpayers and to 20% for the highest earners. The top tax rate on ordinary income was eventually increased to 39.6%.

One of the most egregious loopholes in the present tax code is the "carried-interest deduction." This deductions allows managers of investment funds to pay tax on the earnings of the funds at the 20% capital gains rates, rather than the normal top rate for earned income of 39.6%. These managers, e.g. hedge fund managers, are the highest earners in America. Many earn millions each year and some earn more than a billion dollars in a single year. In Trump's presidential campaign he pledged to end the carried-interest deduction, but the act preserves it. Heads of these investment funds are large campaign contributors.

Businesses are taxed as C corporations—a non-pass through entity, or as S corporations, partnerships or sole proprietorships—all three are pass-through entities. With a C corporation, earnings are taxed at the corporate level. Taxed earnings may be retained by the business or be distributed to shareholders. If they are distributed to shareholders, the shareholders pay a tax on the dividend. The complaint about C corporations has been "double taxation." Under present law, earnings of C corporations are taxed at rates up to 35% and dividends at rates up to 20%. So C corporation earnings can carry a total tax burden of as much as 48%. Under the new tax act, the top tax rate for C corporation earnings will be 21% and the top rate on dividends will be 20% for a total tax burden of as much as 36.8%, which is in line with the new top individual rate of 37%. While this reduction of the C corporation tax rate aligns the total tax burden of C corporation earnings with the new individual tax rate, and makes the US corporate

tax rate competitive with tax rates of other countries, the lower tax rate will greatly reduce government revenues on C corporation taxes. That shortfall ultimately will have to be paid for somewhere else.

A feature of the new act that hasn't received as much comment as it deserves is that US corporations will no longer be taxed on their worldwide income, they will only be taxed on their US income. This provides an incentive of US multinational corporations to move more of their operations outside of the United States. The lower C corporation tax rates provides an incentive for the companies to stay in the US, but lack of taxation on worldwide income provides an incentive to move operations out of the United States. While there is no international regulation of taxation by various nations, the fact that US corporations were taxed on their worldwide income provided some indirect US oversight of a world filled with tax havens and national competition for international businesses.

S corporations, partnerships or sole proprietorships are pass-through entities. They are not taxed at the entity level, rather the earnings of the entities are taxed to their owners in proportion to their ownership at the tax rate of each owner. This would have meant under the new law that the top tax rates on these earnings would have been 37%, which appears to be higher than the 21% rate of tax on C corporation earnings. But With pass-through entities there is no tax on distribution of their earnings making the total tax burden in pass-through entities as high as 37%, which is in line with the total tax burden on C corporation earnings. Senator Ron Johnson of Wisconsin said he wouldn't vote for the act, however, unless it "did more for small businesses." What he actually meant was "did more for owners of pass-through business," entities which can be very, very large. For example, President Trump runs his real estate business using pass-through entities and, as Trump would be quick to say, that's no small business. Under the new tax act, lawyers, accountants, and other owners of pass-through entities will receive a 20% deduction on the earnings of the entity, meaning the owners of these businesses would pay a top tax rate of 29.6% rather than 37%. (For owners of certain service businesses, like accountants and lawyers, the 20% deduction would phase out, after, if they file joint returns, $315,000 of earnings.) So under the new tax act there is two-tier tax rate for on earnings just based on the form of doing business and nothing else. Owners of pass-through entities will receive a 10% reduction in their top tax rate, not just the 2% reduction that other top earners will receive.

Inequality

According to the nonpartisan Tax Policy Center, 65% of the tax savings from the Act will go to the top 20% of income earners. In 2018, taxes will be reduced by $1,600 on average, but this is very unevenly distributed. For people in the lowest 20% of earners the average tax cut will be $60. People in the 95th to 99th percentile with incomes between $308,000 and $733,000 will receive an average tax cut of $13,500 and people in the top 1%, those with incomes about $733,000, will receive an average cut of $51,000. (taxpolicycenter.org)

There are many provisions of the Act that benefit the wealthy. As previously mentioned there is a reduction of the top tax rate on ordinary income from 39.6% to 37%, and for those who operate through pass-through entities from 39.6% to 29.6%. This is offset in some cases by the loss of the ability to deduct state and local taxes as discussed below. Further the wealthy benefit from a change in the amount that is exempted from estate tax. For married couples the exempt amount doubles from $11.2 million to $22.4 million.

This act creates more tax shelter opportunities for the wealthy than any tax legislation since the mid-1980s. Income can be moved to lower tax jurisdictions by doing business outside the United States. People can operate through pass-through entities to take advantage of the 29.6% rate. The 21% tax rate for C Corporations gives an opportunity for deferral of taxes. Current income in C Corporations will be taxed at much lower rate than the individual tax rate. So owners of C corporations can keep more after-tax earnings in the corporation and invest it inside the corporation until they need to take it out. Helaine Olen's op-ed in the *Washington Post* explains how the new code can be gamed (washingtonpost.com), and a detailed report by thirteen tax attorneys and tax law professors explains the tactics that can be used for tax avoidance under the Act (papers.ssrn.com). As a result of these opportunities for tax avoidance, I believe the federal revenue loss from the Act will exceed the projected $1.5 trillion.

Funding of Government at All Levels

The income tax is a tax imposed on income. For businesses this means that prior to computing taxable earnings, business deductions are allowed. For individuals this means that prior to computing taxable income, certain individual deductions are allowed. Some of the individual deductions are policy oriented, such as the ability to deduct interest on home mortgages, but one arguably is like a business deduction and that is the state and local tax deduction. If a person makes $100, but $8 of that is used to pay state and local income or property taxes, then arguably the $8 used to pay the state and local income and property taxes is not income and should not be taxed as such. Under the new tax law, though, the deductions for state and local income and property taxes will be limited to $10,000 in total. There are two effects of this, higher income earners will lose part of their tax deduction, and perhaps more importantly state and local governments will be pressured to keep their tax rates and spending low.

This corresponds to the increased pressure on the federal government to keep spending low as a result of the increased deficits that will result from the tax cuts in the new tax act. Fareed Zakaria has a good op-ed in the *Washington Post* that discusses the impact of the tax cuts on federal government spending, especially on discretionary items, such as "spending on roads and airports, training and apprenticeship programs, health care research and public-health initiatives [and environment]. . . . . Combined nondefense, public investment by federal, state and local governments is at its lowest point in six decades, relative to GDP" (Washington Post).

The Middle Class, the Poor, and Immigrants

Middle income taxpayers will see a reduction in their tax rates and the standard deduction for these tax payers will double. Some of these tax savings will be offset by the reduction of itemized deductions in the tax act such as the state and local tax deduction and unreimbursed business expenses. People who are insured in the Affordable Care Act may see increases in their premiums and losses in other government services that will more than offset any gains they realize from tax cuts under the tax act. As previously stated millions more will be uninsured, leaving their families in a highly vulnerable position. The poor will benefit from the larger standard deduction and the increase of the child tax credit to $2,000 with $1,400 of that being a refundable credit. Undocumented immigrants will be penalized in regard to the refundable child tax credit by the requirement that they will need to provide Social Security numbers for each child for which they claim the credit.

Final Note

So the Tax Cuts and Jobs Act is now a reality. Republicans insist it will boost economic growth. Democrats say it is a scam. The public at present sees it unfavorably, with only 33% approving of it. The act will have intended and many unintended consequences and will have significant political effect as well. The tax act will be a central issue in the 2018 elections.

From my standpoint, the act is a missed opportunity and parts of it, such as the repeal of the health mandate, are wrong. The Republicans were desperate for a “win” and they got what they asked for. Be careful what you ask for.

The provisions in the act, aside from the repeal of the health insurance mandate which had no place in a tax act, are not, however, off the wall. There is a logic to them and I have tried to explain the reasoning behind the provisions in this article. Watch what happens as these provisions are enacted. They have changed the world.