Testimony

Testimony on The Tax Code, High Earners, and Tax Planning: Policy Considerations

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Chairman Wyden, Ranking Member Crapo, and members of the committee, thank you for the privilege of appearing today to discuss issues related to the tax code, high-income individuals, and tax planning strategies.

I hope to make the following three main points:

- The two most pressing policy problems are the poor pace of economic growth and the unsustainable federal budget outlook; these interact as deficits are a headwind to growth, but faster growth would improve the fiscal outlook.
- Deficit reduction should be dominated by slowing the growth of mandatory spending, while tax policy should be pro-growth with low taxes on saving, investment, and innovation.
- Differential taxation of alternative forms of capital income offers the greatest opportunities for tax avoidance and evasion; a pro-growth tax stance reduces risks of these behaviors.

Let me discuss these in turn.

The Twin Challenges of Economic Growth and the Federal Fiscal Outlook

The most pressing economic policy issues are interrelated: the need for faster economic growth and a fiscal stance that reduces deficits and controls the federal debt. The record on growth is striking. From 1960 through 2000, the average pace of growth in real gross domestic product (GDP) per capita was 2.4 percent. At this pace, GDP per capita – a rough measure of the standard of living – would double every 29 years. Thus, in roughly one working career, growth would double the standard of living, giving American families the opportunity to pursue their economic dreams.

Since then, from 2001 to 2022 the average pace of growth has been a full percentage point slower: 1.4 percent. At this pace the standard of living will double only every 56 years. There is the palpable sense that access to the American Dream is disappearing over the horizon.

The implications are enormous. Had the pace of growth been maintained in the 21st century, real GDP (in 2017 dollars) would have been $6.3 trillion higher in 2022, translating into additional real income of nearly $19,000 per capita. There is no government transfer program that can compete with the power of compound economic

growth.

The budget consequences would be enormous as well. Assuming federal revenues are roughly 19 percent of GDP, a faster pace of growth would mean that revenues would be $1.2 trillion higher than at present. At a time when the Congressional Budget Office (CBO) projects $20 trillion in federal deficits over the next 10 years, having $12 trillion less in deficits would make the job of controlling the federal debt much more manageable.

Federal fiscal policy is contributing to the slower pace of economic growth. It is widely recognized that borrowing trillions of dollars when the economy is at full employment competes with private sector demands for capital. Reduced access to capital diminishes private-sector investment, thereby reducing growth in productivity and the standard of living.

Note, however, that *how* federal deficits will evolve is especially anti-growth. The CBO baseline anticipates that the unified deficit will rise from 5.8 percent of GDP in 2024 to 7.3 percent of GDP in 2033, a 1.5 percentage point rise. Social Security spending will rise by 0.7 percentage points (from 5.3 percent to 6.0 percent of GDP) and Medicare spending will rise by 1.6 percentage points (from 3.7 percent of GDP to 5.3 percent of GDP). Thus, the combined growth of these two large mandatory spending programs will exceed the increase in the deficit by 0.8 percentage points.

If resources are transferred from private-sector investment to federal subsidies to consumption, each dollar transferred reduces the growth in productivity, real wages, and the standard of living. Notice that this is true regardless of whether that transfer comes via taxes or deficit finance, but deficit finance is more likely to come at the expense of private investment. Past chronic federal deficits have already been a headwind to growth; the evolution of deficits over the next decade is an even greater threat to growth.

The Role of Tax Policy

In the face of the rising debt and fiscal outlook, one might be tempted to focus tax policy on raising revenue, especially from the affluent. But many have observed that there is not enough potential revenue in such an approach and a recent study by Brian Reidl summarizes the evidence. He notes:

"This report models an aggressive tax-the-rich agenda that pushes tax rates for corporations and wealthy families toward revenue-maximizing levels. It shows that such policies could raise, at most, 2% of GDP—and likely far less, when accounting for the macroeconomic losses that would result from layering so many new taxes on top of one another. Consequently, a sustainable economic and tax agenda would limit upper-income-tax increases to 1% of GDP."

A focus on taxing the affluent to "solve" the budget challenge will fail. A strategy more likely to succeed would be to focus tax policy on growth, keeping taxes on the return to saving, investment, and innovation as low and uniform as possible. As noted above, better growth has beneficial impacts on the budget outlook. Moreover, focusing deficit reduction on slowing the growth of mandatory spending programs will have a beneficial impact on growth.

To the extent that raising revenue is necessary, it would be better to focus on consumption-based changes to the tax base. Indeed, a dramatic reform would be to transition the tax code toward a personal consumption tax as the foundation of a pro-growth strategy.

The Role of Anti-Avoidance and Anti-Evasion Policies

People should pay their legally owed taxes and the Internal Revenue Service (IRS) should be adequately staffed, funded, and mission-focused to enforce a high level of compliance. Such efforts should be pursued across the income distribution. I am troubled by the notion that recent additional funding to the IRS should be exclusively focused on the tax compliance of the affluent. The president's campaign promise was to not raise taxes on those making under $400,000. He did not promise that those individuals would be allowed to cheat on their taxes, and there is ample evidence of a substantial middle-income tax gap that bears scrutiny.

Tax avoidance, in contrast, is the legal pursuit of tax reduction by taking advantage of features of the tax code. Stripped to the basics, the heart of tax avoidance is to transform one type of income (e.g., interest) to a less heavily taxed form of income (e.g., capital gains). The tax code should be structured to keep the undesired behavioral responses to a minimum by keeping tax rates as low as possible and uniform across sources of income. The tax strategy for growth pairs nicely with reducing the incentives for avoidance, especially among the affluent who have concentration of capital income.

Thank you and I look forward to your questions.