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Hearing Entitled "Incentivizing Economic Excellence Through Tax Policy"

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Chairman Arrington, Ranking Member Boyle, and Members of the Committee, thank you for having me here today to discuss this important topic concerning the Federal Tax Code.

The Federal Tax Code, administered by the Internal Revenue Service (IRS), is responsible for raising over $4.5 trillion per year, which helps pay for the goods and services that the Federal government provides to the Nation.

When evaluating any tax system, there are four main criteria: revenue adequacy, efficiency, equity, and simplicity. Revenue adequacy simply means raising the revenues necessary to support all the activities of the Federal government. Efficiency means raising the desired revenue in ways that minimize the economic distortions that accompany tax systems. Equity means treating similarly situated taxpayers in a similar fashion (horizontal equity) and ensuring that those with the greatest means to do so contribute a larger share of their resources to funding the government (vertical equity). Finally, simplicity (while in the eye of the beholder) means creating a tax system where taxpayers know their obligations and the rules and can comply without excessive administrative burden.

These are the ideals that the Federal government should aim for in developing tax policy. Unfortunately, as a Nation, we fall short across all these dimensions.

Revenue Adequacy

The last time the Federal government had a balanced budget was in the late 1990s/early 2000s, when revenue raised totaled approximately 20 percent of Gross Domestic Product (GDP). Given the changes in the U.S. economy, in the Nation's demographics, and in fiscal policy – namely greater investments in national defense and a growing share of retirees who rely on Social Security and Medicare -- we should probably be aiming for a revenue share that is a couple percentage points higher than it was over two decades ago. This means revenues should be significantly over 20 percent of GDP in order to balance the Federal budget this decade or even to stabilize Federal debt as a share of GDP.[1]

Revenues have generally declined as a share of the economy over the past 25 years for a variety of reasons. Taxes on capital income are lower due to reduced corporate income tax rates, preferential tax

[1] In Fiscal Year 2022, Federal revenues reached 19.6 percent of GDP, a result that appears to represent a one-time confluence of events, including a bounce-back from a pandemic-induced economic contraction and the impact of Federal government spending to combat the effects of the pandemic. The Congressional Budget Office forecasts that Federal revenues will decline by 1-2 percentage points of GDP in the next couple years.

rates on capital gains and dividend income, and reduced taxes on estates and gifts. The last 25 years also have seen greater use of tax incentives, a substantial rollback of the Alternative Minimum Tax (AMT), stagnant or reduced excise taxes, and a reduction in individual income tax rates across the board, with effectively larger reductions for those with higher incomes.

While I was at the Urban-Brookings Tax Policy Center, I wrote about my own personal income tax history. I compared my Federal income tax burden in 2018 with that for 1988 (the first full year of implementation after the 1986 Tax Reform Act). In both years, I had similar household composition, but my income in 2018 was substantially higher, about 50 percent higher in inflation-adjusted terms. However, my effective Federal income tax rate (income tax paid divided by adjusted gross income) was about 19 percent in 2018, a full 2 percentage points lower than my 21 percent effective tax rate for 1988. How did this occur? Well, Congress cut taxes for households like mine in 2001 and 2003, and largely continued those tax cuts in 2012. And in 2017, the Tax Cuts and Jobs Act further reduced my taxes (though there were provisions going in both directions). Overall, these tax cuts far outweighed the tax increases on households like mine from the 1993 tax legislation and the 2010 Affordable Care Act.[2]

Over the same 30 year time frame, Federal spending bounced around a bit but has averaged around 20 percent of GDP. So while I benefitted about the same amount from the various public goods provided by the Federal government over three decades, my relative contribution declined even while my ability to pay increased. And this simple example helps illustrate one of the reasons we struggle with revenue adequacy as a Nation.

Tax Incentives

In general, tax incentives attempt to shift taxpayer behavior in a way that Congress desires. Also in general, tax incentives are inefficient policy tools. This is because tax incentives, unless very well-designed, will subsidize many taxpayers for doing what they would have done even in the absence of the tax incentive. To put it another way, for most tax incentives the amount of behavior that is changed as a result of the incentive tends to be very small compared to the amount of tax benefit that accrues to taxpayers who do not change their underlying behavior.

The list of inefficient tax incentives is large. Bonus depreciation largely rewards firms for making the investments necessary for an ongoing business to become and remain profitable. When bonus depreciation was first enacted, it may have helped accelerate investment into a year prior to when it would have ordinarily occurred, but that effect has largely gone away as Congress has made some form of bonus depreciation routine. Section 529 accounts (to promote saving for higher education) are intended to encourage parents (and grandparents) to save for the college education expenses of their children by allowing accumulated earnings on these accounts to escape taxation if the distributions from these accounts are used for a wide range of expenses associated with higher education. There may have been some taxpayers who would have foregone saving for college expenses except for the creation of these tax-preferred accounts. But a much, much greater number of taxpayers moved investment funds from a fully-taxable investment account to a tax-preferred Tuition Saving Program (Section 529

[2] Since 2018, my income has dropped a bit but so has my effective tax rate, so the situation is about the same.

account). Opportunity Zones have rewarded real estate investors who have long made use of a technique to defer taxes on the capital gains generated by real estate investments called "like-kind exchange". Under the provisions of the Opportunity Zone legislation, future gains on these properties can be reduced or even eliminated, a benefit much greater then deferral, provided the property is located in an area designated as an Opportunity Zone. And the process for designating Opportunity Zones provides these benefits to many fast-growing areas in the country, meaning that the benefits can accrue to real estate investors who are merely following their traditional business behavior. Even the excise tax reductions that Congress has provided to support craft brewers apply to a portion of the production of extremely large brewing companies, such as Anheuser-Busch, an obvious design flaw if the goal is to encourage small brewers to enter the business and expand.

The list of inefficient tax preferences is long and covers a wide range of activities. Here are just a few more: preferential tax rates on capital gains from assets held over 1 year, preferential tax rates on dividend income, the home mortgage interest deduction, a zero capital gains tax rate applied to certain "Small Business" stock, the deduction for a portion of income from pass-through businesses, and Roth IRAs. In all these cases, the desired behavioral change generated is relatively small compared to the revenue foregone from the tax preference.

There also are tax incentives which reward prior behavior, where taxpayers can claim a tax benefit a year or two after filing an initial tax return covering the period where the tax-preferred expenditure was made. Cottage industries have cropped up to help taxpayers make these delayed claims for things like the Research and Experimentation (R&E) Tax Credit or the Employee Retention Credit based on expenditures made in prior years. Obviously, these tax benefits go to firms that already made decisions and investments regarding their operations a year or two ago, and so the prospect of tax benefits did not figure into their decisions. Claiming the tax benefits on an amended return does not change the firm's underlying behavior, but does add to the cash flow of the firm (and the companies who help the firms file their belated claims for the tax benefits).

There are some tax incentives, however, that do appear to encourage the desired behavior to an extent greater than the total cost of the tax subsidy. Research on the R&E Tax Credit has shown that it can be cost-effective in generating additional research investments. The original design of the R&E credit rewarded research investments above a prior year baseline, encouraging firms to continually increase their research investments. Congress over time has essentially removed this feature, blunting, but not entirely eliminating the effectiveness of this tax credit at changing firm behavior in the desired direction. That is, the credit still seems to generate a bit more than $1 of additional research investment for each $1 of foregone tax revenue.

The point of effective tax incentives is to encourage desired behavior that would not otherwise occur. And the value of the changed behavior should exceed the cost of the tax expenditure over the life of the program, not just over the traditional 10-year budget window. The goal should be to enact only those tax incentives that have a return on investment substantially greater than $1 for each $1 of foregone tax revenue. Given that the cost in foregone tax revenue from existing tax expenditures probably exceeds $1 trillion per year, adding new tax expenditures should be a rare occurrence.

High ROI Investments

When looking at Federal Government expenditures, it is important to fund necessary ongoing operations as well as to meet the service expectations of citizens. In addition, it is also key to support outlays with a high rate of return on investment (ROI).

For example, well-considered investments in transportation infrastructure can have high returns that accrue to travelers, shippers and consumers, covering just about the entire population. Well-chosen projects that have significant and widespread benefits exist in every state and lead to a high aggregate ROI. That is why the recently enacted infrastructure bill is so important. The funding it makes available can be put to good use all across the country, repairing and upgrading existing infrastructure, relieving bottlenecks through new approaches, and adding new capacity where needed. Congress missed an opportunity, however, to fund part of this investment package by increasing motor fuels excise taxes which act as a user fee for many of those who utilize transportation assets. These taxes were last raised nearly three decades ago.

There also are important investments that can help government work better. Congress used to have its own Office of Technology Assessment, which provided independent and objective expertise on a wide range of complex technological matters. It was abolished in 1995. And now Congress learns about topics such as artificial intelligence, advanced battery and storage technology, privacy in electronic communications, and new approaches to health care from industry representatives and other interested parties instead of from its own set of objective experts.

Another important investment with a large return is the multi-year funding provided to the IRS in the Inflation Reduction Act last year. Traditional estimates are that the IRS generates a 4:1 or a 5:1 return on its investments in enforcement activities. In a recent working paper, Professor Natasha Sarin and I argue that this is a substantial under-estimate. Once the benefits of deterrence and better technology and resource allocation are incorporated, the returns could be twice the traditional estimates.[3] This work implies that the recent reduction of IRS funding contained in the debt-limit agreement is both short-sighted and counter-productive. The Congressional Budget Office estimated that the $21.4 billion reduction in IRS funding would reduce tax collections by around $40 billion over the current 10-year budget window. Our estimate would be at least twice that amount, meaning that this rescission of funds would leave the accumulated Federal budget deficits at least $60 billion larger than would otherwise be the case. This is counter-productive to the goal of moving toward a more balanced Federal budget.

Another benefit from the multi-year investment in the IRS is a potential improvement in taxpayer morale. While few people enjoy paying taxes, we all know that we should make our best efforts to comply. The multi-year IRS funding will allow for improved services, making it easier for taxpayers to meet their tax obligations. And increased scrutiny applied to high-income taxpayers and corporations

[3] A recent paper by a team of economists examined IRS audit results to compile costs and additional tax collections. The paper concluded that once deterrent effects were factored in, the rate of return on resources devoted to auditing high-income individuals could exceed 10:1.

will help convince people that the Nation does not have a two-tier tax system, with one set of rules for ordinary wage earners and another set for everyone else.

Summary

The Federal Tax Code is primarily about raising the resources to fund the goods and services provided by the Federal government. Key features of a desirable tax system are revenue adequacy, efficiency, equity, and simplicity. Our Tax Code falls short on all these dimensions and the large ongoing Federal budget deficits are indicative that the revenues generated are inadequate, given the economic and demographic changes we have experienced.

When designing tax incentives, it is important to focus on the effectiveness at generating the desired behavioral changes compared to the cost of the foregone tax revenue. In this regard, most of the existing tax incentives are quite inefficient.

In running a government enterprise, it is important to fund activities with high rates of return on the investments. The recent infrastructure bill has the potential for being evaluated by future policy analysts as a desirable set of investments and good fiscal policy. The recent agreement to rescind part of the multi-year funding for the IRS is a step in the opposite policy direction.