TAX REFORM TO PROMOTE ECONOMIC GROWTH AND ECONOMIC OPPORTUNITY FOR ALL

Statement of

Leonard E. Burman*

Institute Fellow, Urban Institute

before the

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Committee on Ways and Means,

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TAX POLICIES TO EXPAND ECONOMIC GROWTH AND INCREASE PROSPERITY FOR AMERICAN FAMILIES

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500 L'Enfant Plaza SW
Washington DC 20024
urban.org

Chairman Kelly, Ranking Member Thompson, and members of the subcommittee. Thank you for inviting me to share my views on "Tax Policies to Expand Economic Growth and Increase Prosperity for American Families."

My name is Len Burman, and I am an Institute Fellow at the Urban-Brookings Tax Policy Center and Paul Volcker Professor Emeritus in public administration at the Maxwell School of Syracuse University. The views expressed in this testimony are my own.

I applaud the committee for taking on this important topic. Figuring out how to spur economic growth while sharing the gains broadly is more challenging and important than ever. It is possible to design pro-growth policies that advance economic opportunity for all, but some attractive sounding options would be inequitable and ineffective while others could have undesirable unintended consequences. To advance growth and opportunity while avoiding pitfalls, I suggest we focus on four goals.

First, I think it imperative that we find a way to support work when unprecedented technological change is suppressing wage growth for many workers. The tax code plays a small part in supporting wages for low-wage workers through the EITC. It could do much more. This might not sound like a pro-growth policy, but if working-class people continue to feel left behind by the modern economy, they may resist changes that boost growth overall but provide no benefits to, or even harm, them.

Second, both tax policy and spending policy should do much more to support children. Investing in children may be the single best investment that we can make because it boosts their productivity throughout their lives. Yet, only a fraction of the budget goes toward children while a growing share is supporting older Americans.

Third, we should avoid attractive-sounding but unproductive—or even counterproductive—tax reforms.

Fourth, Congress should consider setting up a regular process to evaluate all tax subsidies and eliminate or reform those found to be ineffectual or counterproductive. This would simplify the tax code and reduce the opportunities for tax evasion and avoidance. It would raise revenues that could be used to cut tax rates, finance critical investments, or reduce the deficit.

I elaborate on each of these objectives below.

Enact Tax and Spending Policy to Share the Benefits of Economic Growth

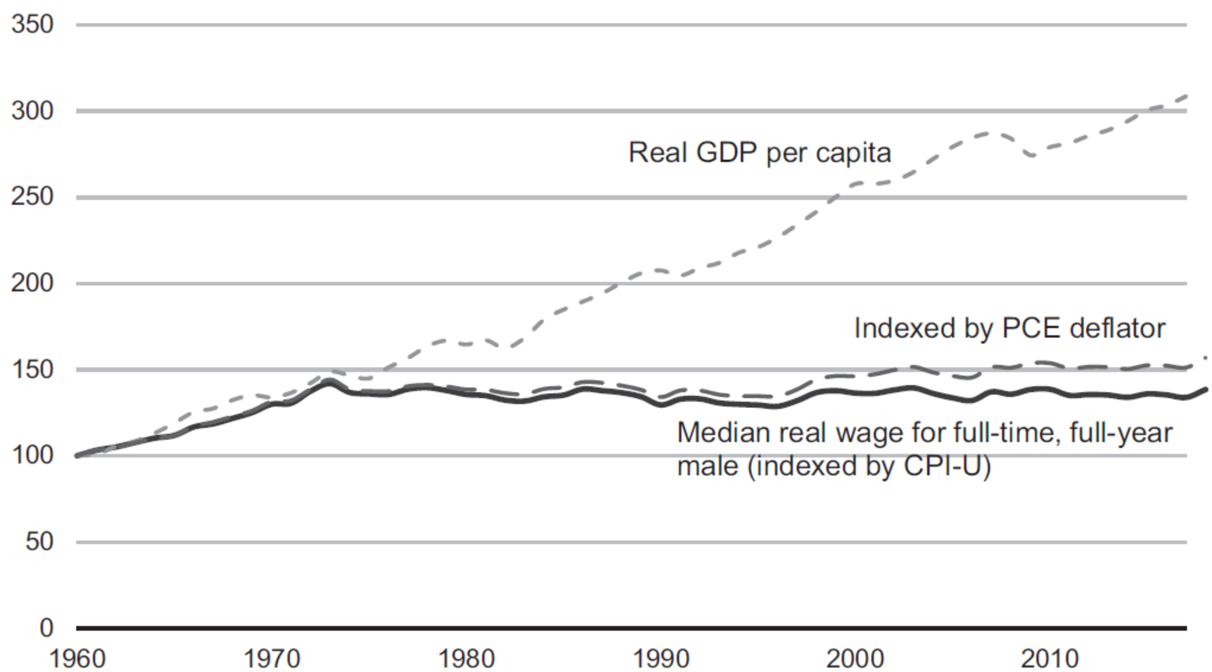
For most of our country's history, economic growth has provided benefits for workers on all steps of the economic ladder. But several factors, especially unprecedented technological change, have helped increase economic concentration at the top. Real inflation-adjusted wages have barely kept pace with inflation for the past half-century, despite a doubling of real GDP per capita over the same period (figure 1).[1] Median wages understate compensation because of the exclusion of fringe benefits, especially the value of

[1] Taken from Leonard E. Burman, "A Universal EITC: Making Work Pay in the Age of Automation," *National Tax Journal* 73, no 4 (2020): 1187–1218.

employer-sponsored health insurance.[2] However, it is scant consolation to the typical worker that all pay increases since the 1970s have gone to cover the cost of increasingly expensive health insurance.

Figure 1

Real Median Earnings and Economic Growth, 1960–2017
(Indexed to 100 in 1960)



Sources: Real wages, U.S. Census Bureau, Table P-38, https://www.census.gov/data/tables/time-series/demo/income-poverty/historical-income-people.html.
Real GDP per capita, https://fred.stlouisfed.org/series/A939RX0Q048SBEA.

It's possible that the economy will adapt so all workers eventually gain from technology, but the increasing ability of artificial intelligence and robots to substitute machines for human labor makes that adaptation an increasingly remote possibility. I believe that wage stagnation is a significant factor behind the discontent of many workers across the political spectrum, even as the United States remains the richest country in the world. Unless we can find a way to share the gains from growth more broadly, there will be increasing political resistance to pro-growth policies. We have already seen that backlash in increased hostility to free-trade policies and immigration, which boost growth but produce losers as well as winners.[3] History dating back at least as far as the Industrial Revolution suggests that workers will resist

[2] Sylvester J. Schieber and Steven A. Nyce, *Health Care USA: A Cancer on the American Dream* (London: Willis Towers Watson, 2018). http://dx.doi.org/10.2139/ssrn.3410449.

[3] Kimberly Clausing, *Open: The Progressive Case for Free Trade, Immigration, and Global Capital* (Cambridge, MA: Harvard University Press, 2019).

mechanization when it is perceived as a threat to their livelihood. Populist attacks on robots and AI are only a matter of time if wage stagnation continues or accelerates.

Therefore, finding a way to share the gains of economic growth is not only an ethical imperative, but possibly a necessity to sustain pro-growth policies.

Policymakers have long recognized that the tax code can be an effective tool to make work pay. I proposed a new universal earned income tax credit (UEITC) that would provide a 100-percent wage subsidy on the first $10,000 of earnings.[4] The maximum credit would be indexed to GDP growth so low-skilled workers would be guaranteed a share in the benefits of economic growth even if their wages do not increase. This would end poverty for almost all full-time workers and propel two-earner families solidly into the middle class, even if they are in relatively low-wage service jobs.

The drawback of my proposal is that it would be expensive, requiring substantial new taxes or expansions in existing taxes. A more modest option would be to expand the existing EITC, which largely leaves out low-wage workers without children. Increasing the EITC for adults who do not have children living with them has bipartisan support and would produce several salutary benefits. First, by making low-wage work more lucrative, it would encourage many low-skilled young men to enter the workforce and stay there. Second, many of these men have noncustodial children. Helping them to earn a decent wage (including the EITC) would make them less likely to resort to more lucrative illegal activities and make it possible for them to sustain their child support obligations and remain connected with their children.[5] This produces long-lasting benefits for their children as they grow up, especially for their sons.

Of course, adapting to technological change isn't solely a tax problem. Investing in education and training will help workers adapt to rapid technological change. Community colleges have been shown to play a critical role in helping workers develop skills required by local employers. For example, investing in community colleges and career and vocational education programs can help train, or retrain, workers with skills that local employers demand.[6,7]

Invest in Children

Investing in children is one of the most productive investments we can make. Yet, spending on children represents less than 10 percent of the federal budget, and its share is falling.[8] Economists Nathaniel

[4] Leonard E. Burman, "A Universal EITC: Making Work Pay in the Age of Automation."

[5] Peter B. Edelman, Harry J. Holzer, and Paul Offner, *Reconnecting Disadvantaged Young Men* (Washington, DC: Urban Institute Press, 2006).

[6] Shayne Spaulding and Madeleine Sirois. "Designing Career and Technical Education Programs that Help Students Get Good Jobs." (Washington, DC: Urban Institute, 2022). https://www.urban.org/sites/default/files/2022-12/Designing%20Career%20and%20Technical%20Education%20Programs%20that%20Help%20Students%20Get%20Good%20Jobs_0.pdf.

[7] Shayne Spaulding, Ian Hecker, Emily Bramhall. 2022. "Expanding and Improving Work-Based Learning in Community Colleges: Better Data and Measurement to Realize Goals for Students and Employers." (Washington, DC: Urban Institute, 2022). https://www.urban.org/sites/default/files/publication/101781/expanding20and20improving20work-based20learning20in20community20colleges.pdf.

[8] Cary Lou, Heather Hahn, Elaine Maag, Hannah Daly, Michelle Casas, and C. Eugene Steuerle, *Kids' Share 2023: Report on Federal Expenditures on Children through 2022 and Future Projections* (Washington, DC: Urban Institute, 2023). https://www.urban.org/research/publication/kids-share-2023.

Hendren and Ben Sprung-Keyser have documented that investments in young children pay the highest social returns of any public investments.[9] My colleague Elaine Maag explained in congressional testimony that child poverty costs the US as much as $1 trillion a year. "The largest cost is reduced productivity later in life. Children experiencing poverty tend to earn less and pay less in taxes as adults, and they are more likely to require public supports later in life." [10]

Increasing the child tax credit (CTC) and making it fully refundable so the full benefits go to all low- and middle-income families with children, as was done in 2021, is an especially productive way to invest in children. The American Rescue Plan Act of 2021 made the CTC fully refundable—eliminating the phase-in of the refundable CTC with earnings and its $1,400 cap—and increased the maximum credit from $2,000 to $3,000 ($3,600 for children under age 6). Expanding access for low-income families and increasing the maximum credit cut the child poverty rate nearly in half in 2021.[11] If sustained, that policy would dramatically improve educational, health, and employment outcomes for those children as they grow up, and significantly reduce incarceration rates.[12,13]

Making it possible for all kids to grow up to be healthy, educated, and productive adults not only helps children, but is good for the economy.

Avoid Unproductive Tax Reforms

I understand that this committee is considering the FairTax—a national retail sales tax similar to the tax imposed by many states and localities—as a fair and simple pro-growth tax reform. It certainly sounds fair, but it's not. It would be remove almost all of the progressivity of the current tax system because it would exempt from tax most of the income of high-income people. The proposal is designed to hold households below the poverty threshold harmless by virtue of a "family consumption allowance"—a universal cash transfer equal to the amount of sales tax that would be owed, on average, at that income level. Meanwhile, because high-income households spend only a fraction of their income, they would get a large tax cut if the progressive income tax were replaced with the FairTax. Middle-income households would end up with a huge tax increase if the plan were to raise as much revenue as the taxes it would replace.

FairTax proponents reach a different conclusion because they calculate that existing taxes could be replaced by a 23-percent FairTax rate. If that sounds too good to be true, it is. First, the 23-percent rate is measured on a tax-inclusive basis—that is, the tax as a share of sales price, including the tax. Measured the

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[9] Nathaniel Hendren and Ben Sprung-Keyser, "A Unified Welfare Analysis of Government Policies," *Quarterly Journal of Economics* 135, no. 3 (2020): 1209–1318.

[10] Elaine Maag, "Understanding How the Expanded Child Tax Credit Reduced Poverty and Hardship in 2021," testimony before the Work and Welfare Subcommittee of the Ways and Means Committee, US House of Representatives, October 24, 2023, pages 3–4. https://www.taxpolicycenter.org/publications/understanding-how-expanded-child-tax-credit-reduced-poverty-and-hardship-2021/full

[11] Elaine Maag, "Understanding How the Expanded Child Tax Credit Reduced Poverty and Hardship in 2021."

[12] Elaine Maag, Cary Lou, Michelle Casas, Hannah Daly, Gabriella Garriga, and Lillian Hunter, *The Return on Investing in Children* (Washington, DC: Urban Institute, 2023). https://www.urban.org/research/publication/return-investing-children.

[13] Irwin Garfinkel, Laurel Sariscsany, Elizbeth Ananat, Sophie M. Collyer, Robert Paul Hartley, Buyi Wang, and Christopher Wimer, "The Benefits and Costs of a U.S. Child Allowance," Working Paper 29854 (Cambridge, MA: National Bureau of Economic Research, 2022).

way state sales taxes are—as a percentage of the pretax price—the rate is 30 percent. More important than the semantic distinction, a 23-percent FairTax (or 30-percent sales tax) would not come close to replacing existing taxes. The analysis assumes that state and local governments would be subject to the tax, which would require them to raise their own taxes or slash government services. It assumes an impossibly broad base. States all exempt at least some goods and services, such as food and medicine, from their taxes. And the analysis assumes zero tax evasion, even though it would be easy to avoid this tax because it only applies at the retail level.

Economist Bill Gale of the Brookings Institution and Kyle Pomerleau of the American Enterprise Institute recently calculated that, after correcting math errors, assuming a tax base similar to that applied at the state level, and assuming a modest level of evasion, the FairTax could increase deficits by $27.7 trillion over the next decade—or more.[14]

If the errors identified by Gale and Pomerleau are corrected, the top rate (measured the same way state sales taxes are) would have to exceed 80 percent. This would provoke a lot more tax evasion than Gale and Pomerleau assume, even assuming we don't eliminate the IRS (another part of the proposal). Americans have been extremely upset about price increases of 5 to 10 percent. A revenue-neutral FairTax could raise prices (including tax) by more than 80 percent!

This is why President George W. Bush's tax reform commission rejected a national retail sales tax. And why no country in the world relies on a retail sales tax as its only or primary source of revenue. It is why University of Michigan economist Joel Slemrod and I put the FairTax in a chapter titled "Snake Oil" in our book, *Taxes in America.* It is not a serious solution.

Other ostensibly pro-growth income tax policies are not snake oil but are still counterproductive. For example, lower tax rates on capital gains, combined with the capital gains tax exemption for assets held until death, are probably the single biggest factor in individual tax shelters as rich people alter their behavior to try to convert highly taxed wages and salaries into lightly taxed—or never taxed—capital gains. The brilliant people who design and implement tax shelters might otherwise be doing economically productive work if we had a better tax code.[15]

More generally, tax subsidies distort economic behavior. This may be intended, but there are often unintended consequences. The biggest problem is that taxpayers have an incentive to try to recharacterize unfavored activities into the favored category to qualify for deductions or tax credits.

Regularly Reevaluate Tax Expenditures and Simplify the Tax Code

Voters like tax breaks, but just like appropriations, these policies add to deficits. As noted above, they can create opportunities for tax sheltering. And they make the tax code more complex. Some tax expenditures are worth the money. (I am a fan of the EITC and CTC.) But some aren't.

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[14] William G. Gale and Kyle Pomerleau, "Proposed FairTax Rate Would Add Trillions to Deficits Over Ten Years," *TaxVox* (blog), Tax Policy Center, March 1, 2023, https://www.taxpolicycenter.org/taxvox/proposed-fairtax-rate-would-add-trillions-deficits-over-ten-years.

[15] Leonard E. Burman, *The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed* (Washington, DC: Brookings Institution Press, 1999).

Promoting tax shelters is wasteful and inequitable. While the time people waste on a needlessly complex tax system may not show up in GDP, it's an economic loss, nonetheless. Simplification is a major rationale for the FairTax, but it's not the solution.

One promising solution is the experiment started in Minnesota, where its tax expenditure review commission is required to submit a report every year evaluating the purpose and cost of each tax expenditure.[16] The original proposal was much more expansive, requiring that all tax expenditures sunset after eight years unless policymakers opt for extension or a revenue-neutral replacement.[17]

The Ways and Means Committee evaluates tax expenditures on an ad hoc basis, but a systematic periodic review of all tax expenditures would be ideal. The Congressional Budget Office and Congressional Research Service both provide periodic reports on tax expenditures and the Joint Committee on Taxation and Office of Management and Budget compile lists of tax expenditures and estimates of their cost, but most tax expenditures continue with little or no systematic evaluation of their effectiveness. If Congress followed the Minnesota model, you could ask CBO to evaluate all tax expenditures on an eight-year cycle (i.e., one-eighth of them every year) and, if a program doesn't meet its goals or isn't worth the cost, recommend repeal or lay out options for reform.

I understand that it is easy for think tank and academic researchers to propose eliminating ineffective tax subsidies but hard for elected officials to repeal subsidies that may have large constituencies. But Congress has, on occasion, come up with mechanisms to tackle politically challenging but fiscally necessary options. The Base Realignment and Closure process comes to mind.

Conclusion

Expanding economic growth and increasing prosperity for American families are crucial for the continued economic health of our country. To meet this moment, we could better support America's low-wage workers and children, avoid unproductive tax reforms, and set up a regular process to evaluate all tax subsidies.

For questions, or to request a follow-up discussion, please contact Sarah Trumble at STrumble@urban.org.

[16] Tax Expenditure Review Commission, *Annual Legislative Report* (St Paul: Minnesota Legislature, 2022). https://www.lrl.mn.gov/docs/2022/mandated/221558.pdf.

[17] Minnesota Department of Revenue, Marsha Blumenthal, Laura Kalambokidis, P. Jay Kiedrowski, John Spry, Judy Temple, and Jenny Wahl, *Tax Expenditure Review Report: Bringing Tax Expenditures Into the Budget Process* (St Paul: Minnesota Department of Revenue, 2011) https://www.revenue.state.mn.us/sites/default/files/2018-12/TE_Review_Report_02_15_11.pdf