Heather Boushey
Washington Center for Equitable Growth
Testimony Before the House Committee on Ways and Means Tax Reform Forum
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Thank you for the opportunity to speak to you today about tax reform. In my testimony, I will first set the stage for the tax reform debate by reviewing the longer-term economic challenges facing American families, including slow income growth and rising inequality. I will then turn to the substance of tax reform. My comments will be motivated by a simple idea: the focus of reform should be the living standards of American families, particularly middle-class families and families striving to reach the middle class. This simple idea leads me to three key points:

- **Tax reform should raise revenue and – at a bare minimum – should not lose revenue.** The purpose of the tax system, as with public policy in general, is to support the living standards of American families. Core to this purpose is raising the revenues necessary to finance the investments in children and families, the social insurance programs, and the many other basic governmental functions that support our quality of life. Indeed, with an aging population, government revenues will need to increase. If tax reform becomes tax cuts, Congress will need to reverse those cuts in the future or the resulting revenue losses will force cuts to core programs.

    - When tax cuts are financed by higher deficits, the consequences for the programs and services that we rely on are obscured because the cuts are not immediate. However, unless Congress reverses the cuts, in which case it would make more sense simply not to enact them in the first place, the bill will eventually come due in the form of Medicaid cuts, Medicare or Social Security cuts, reductions in discretionary spending, or some combination of the above.

    - In addition, if the cost of tax cuts is obscured by adding to the deficit rather than identifying programmatic cuts to finance them, most economic models suggest that they will impose an additional cost on the economy: increasing interest rates and crowding out private-sector investment. Note that this cost is in addition to the eventual need for spending cuts or tax increases; it does not eliminate the need for those offsets.

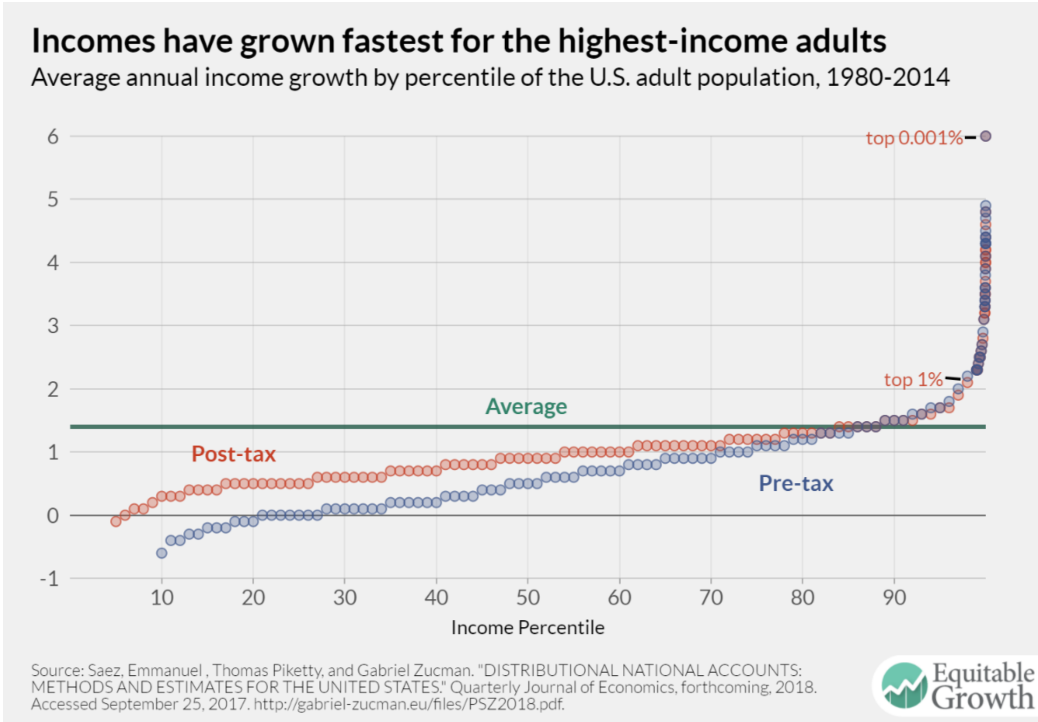
- **Given the dramatic divergence of income growth between families with the highest incomes and those below them, tax reform should provide no net tax cut for the most fortunate Americans and any economic gains realized from reform should benefit working and middle-class families, not the wealthy.** Well-designed, revenue-neutral and revenue-raising tax reform can generate economic gains with which to improve the standard of living for American families. Congress will determine which families see an increase in their standard of living and how large that increase is by the choices members make in designing reform. Evaluating potential reforms thus requires serious estimates of the impact of reform on after-tax incomes across the income distribution from nonpartisan analysts. It should be a condition of reform that the economic gains benefit working and middle-class families, not the wealthy.

- **Tax reform should preserve and expand the evidence-backed refundable tax credits that help working families, while realizing that these do not eliminate the need for direct investment in programs and services that help these families thrive.** Tax reform that helps working families will maintain and expand investments in the Child Tax Credit and the Earned Income Tax Credit, but Congress still needs to invest in other programs and services that help children thrive and help families stay attached to the labor force. Moreover, as noted above, if included in a revenue-losing package, tax cuts for working and middle-class families may offer an apparent boost, but the spending cuts or tax increases necessary to finance them will most likely make these families worse off on net, particularly if the price of expanded benefits for working and middle-class families is additional benefits for higher-income families.

Reform that meets these requirements would increase living standards for working and middle-class families and thus deliver equitable growth. Adequate revenues to meet the government's spending commitments would ensure that Americans continue to benefit from essential government programs. Eliminating wasteful loopholes in the tax system and using the resulting economic gains to benefit working and middle-class families would provide a much-needed lift to those whose incomes have grown the least in recent decades.

The Context for Tax Reform: Rising Inequality and Slow Growth in Incomes

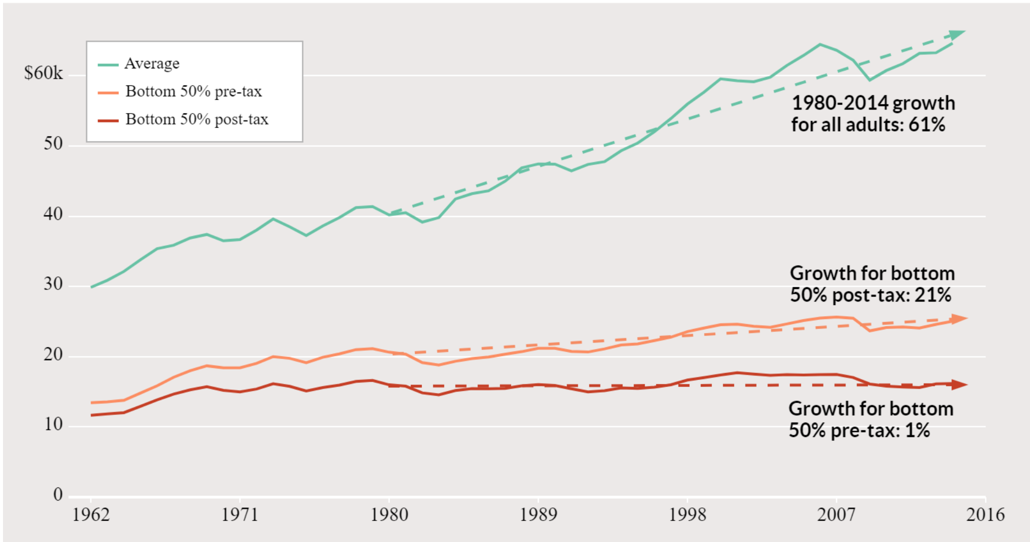
The story of recent decades is rapidly increasing incomes at the top of the income distribution, slow growth in incomes in the middle, and very little growth at the bottom. The economists Thomas Piketty, Emmanuel Saez, and Gabriel Zucman estimate that average annual pre-tax income growth for the top 0.001 percent of the population has been 6 percent per year since 1980 while incomes have fallen outright for the bottom 20 percent of the population. After taxes, average annual income growth for the top 0.001 percent of the population was still about 6 percent, while roughly the bottom half of the distribution experienced growth of less than 1 percent per year (Figure 1).



Compounded over time these growth rates correspond to radically different income levels. Since 1980, overall incomes have grown 61 percent while pre-tax incomes for the top 0.001 percent have grown 636 percent and pre-tax incomes for the top 1 percent (including the top 0.001 percent) are up 204 percent. After taxes, growth rates are nearly as high. Incomes for the top 0.001 percent are up 616 percent and incomes for the top 1 percent are up 194 percent. The flip side of the faster-than-average growth at the top is slow growth at the bottom (Figure 2). Incomes for the bottom 50 percent of adults are up 1 percent before tax and only 21 percent after tax.

Healthy national income growth has not been shared by the bottom 50% of earners

Average national income for all adults and adults in the bottom 50% of the income distribution, 1962-2014 (thousands of 2014 dollars)



Source: Saez, Emmanuel , Thomas Piketty, and Gabriel Zucman. "DISTRIBUTIONAL NATIONAL ACCOUNTS: METHODS AND ESTIMATES FOR THE UNITED STATES." Quarterly Journal of Economics, forthcoming, 2018. Accessed September 25, 2017. http://gabriel-zucman.eu/files/PSZ2018.pdf.

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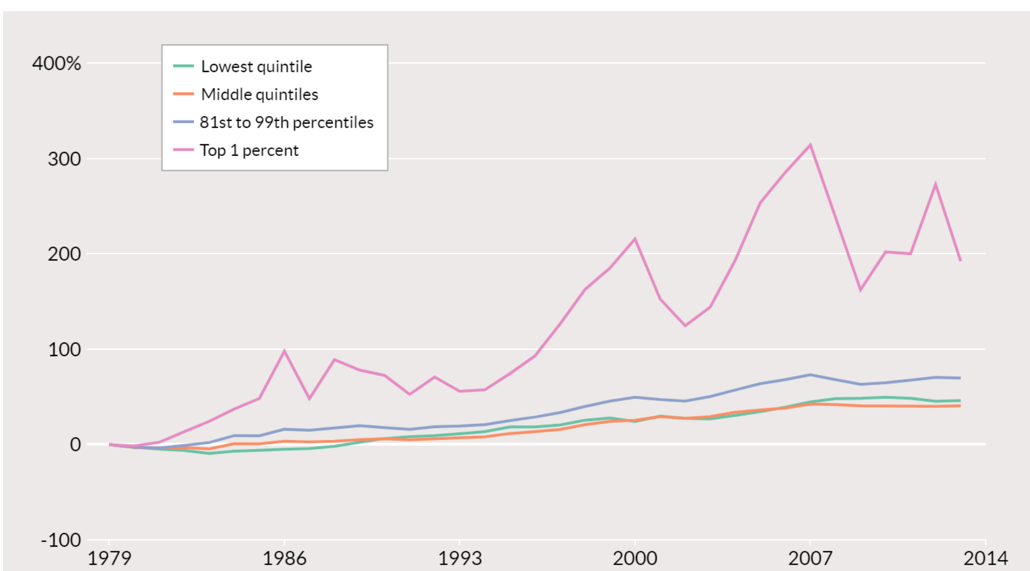
These findings are broadly similar to estimates produced by the Congressional Budget Office, though these estimates do not provide the same level of detail in the extreme upper tail (Figure 3). After-tax incomes increased 192 percent between 1979 and 2013 according to CBO while incomes for the middle-three quintiles of the distribution increased 41 percent. CBO shows somewhat faster growth for the very bottom than do the Piketty-Saez-Zucman estimates, at 46 percent.

Cumulative Growth in Average Inflation-Adjusted After-Tax Income

by Before-Tax Income Group, 1979 to 2013



Source: "The Distribution of Household Income and Federal Taxes, 2013." June 2016. Accessed September 25, 2017. https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51361-householdincomefedtaxesonecol.pdf.

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These estimates highlight the sharp increase in income inequality in recent decades. However, there is little reason for us to accept the level of inequality that prevailed around 1980 as the ideal level. In 1979, the average income for the top 1 percent was $355,000 (in 2013 dollars) and the average income for the middle quintile of the population was $45,000, according to the CBO estimates. An equal percentage point increase in income that preserved the level of inequality that existed in 1979 would still have implied real income growth for the top 1 percent that exceeded that of the middle quintile by a factor of seven.

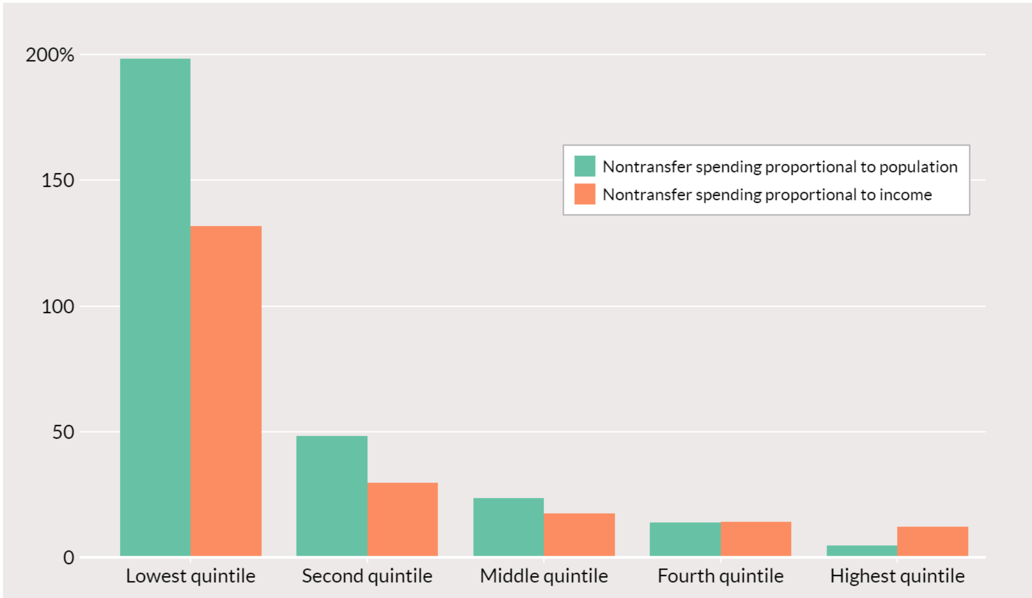
In 2013, the last year available in the CBO data, the average income for the top 1 percent was over $1 million and the average income of the middle quintile was $61,000. This high level of inequality is harmful for our society, and we should not accept it. Tax reform should reduce inequality. The last thing we should do is increase inequality by giving large tax cuts to the fortunate few whose incomes have increased so much in recent decades.

Tax reform should raise revenue and – at a bare minimum – should not lose revenue.

The purpose of the tax system, as with public policy more broadly, is to support the living standards of American families. Core to this purpose is raising the revenues necessary to finance the social insurance programs, the investments in children and families, and the other spending commitments that support our quality of life. Indeed, with an aging population, government revenues will need to increase.

The distribution of federal spending is highly progressive. Though dated, a Congressional Budget Office analysis of federal spending in 2006 concluded that nonelderly families in the bottom income quintile benefitted from federal spending equal to either 130 or 200 percent of income depending on the methodology used while families in the top quintile benefitted from spending equal to either 5 or 12 percent of income (Figure 4). CBO did not conduct an analysis of elderly households across the income distribution. However, while spending on the elderly is likely to be less progressive than spending on the nonelderly it would almost certainly be progressive overall.

Federal spending as percent of income for the non-elderly by income quintile, 2006



Source: "The Distribution of Federal Spending and Taxes in 2006." November 2013. Accessed September 25, 2017. https://www.cbo.gov/sites/default/files/113th-congress-2013-2014/reports/44698-distribution11-2013.pdf.

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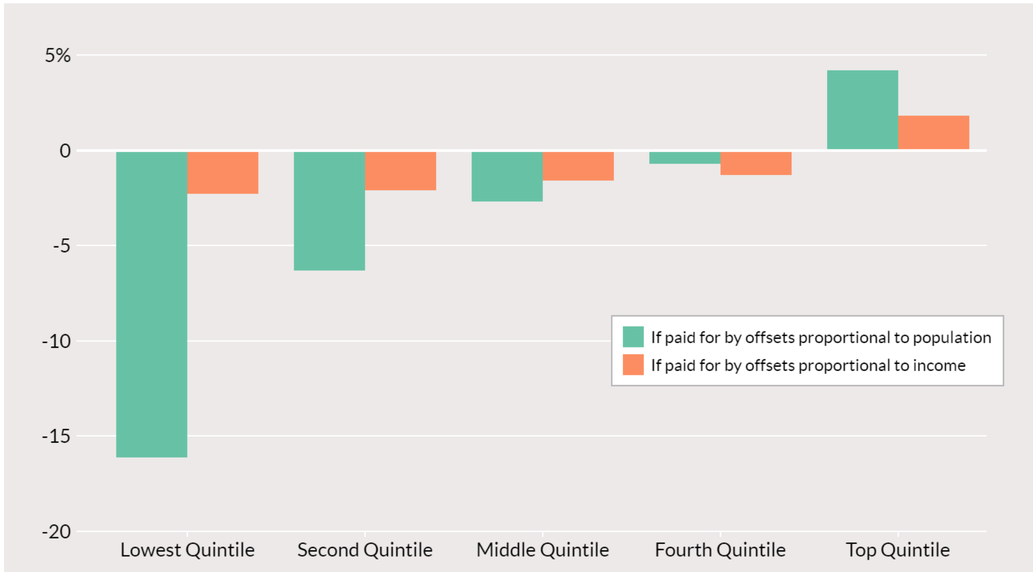
Deficit-financed tax cuts obscure their true cost by avoiding an explicit statement of what the spending cuts or tax increases required to pay for them will be. However, if tax reform becomes tax cuts, Congress will need to reverse those cuts in the future or the resulting revenue losses will force cuts to core programs. Given the strongly progressive nature of federal spending, spending cuts will disproportionately harm working and middle-class families.

To illustrate the hidden harms of deficit-financed tax cuts, consider the estimates from the Tax Policy Center showing possibilities for how the deficits resulting from the April version of the Trump administration's tax plan could be offset. If tax cuts are paid for by imposing an equal cost, in dollars, on all households, families in the bottom quintile would see their incomes decrease by more than 15 percent, families in the middle-quintile would see their incomes decrease by 3 percent, and families in the top quintile would see their incomes go up by 4 percent (Figure 5). The impact could be even more regressive if, for example, tax cuts are paid for by the kinds of severe Medicaid cuts reflected in each version of Republican health care legislation considered this year.

Even if we assume that the ultimate costs of tax cuts will fall on families in proportion to their incomes, the ultimate impact of the tax cut will be to reduce incomes on average in each of the bottom four quintiles and to increase incomes in the top quintile.

Trump tax plan would make most families worse off accounting for higher deficits
Percent change in after-tax income under two different assumptions about financing



Source: "Cutting Taxes and Making Future Americans Pay for It: How Trump's Tax Cuts Could Hurt Many Households." August 15, 2017. Accessed September 25, 2017. https://www.brookings.edu/wp-content/uploads/2017/08/cutting-taxes-and-making-future-americans-pay-for-it.pdf.

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In addition, if the cost of tax cuts is obscured by adding to the deficit rather than identifying programmatic cuts to finance them, most economic models suggest that they will impose an additional cost on the economy: increasing interest rates and crowding out private-sector investment. This is a real issue that should be included in the dynamic analysis of deficit-financed tax cuts. However, the central role this issue has taken on reflects a misguided emphasis resulting from the increased use of dynamic scoring. By way of analogy, it is like borrowing $1 million from the bank and worrying not about whether you can pay back the $1 million, nor whether you can pay back the interest on the $1 million, but whether your loan will cause the bank to increase the interest rate it charges on other loans.

Congress should ensure that there is no net tax cut for the most fortunate Americans and that the economic gains from tax reform are realized by working and middle-class families.

Well-designed tax reform can generate improvements in the standard of living for American families. Congress will determine which families see an increase in their standard of living and how large that increase is by the choices members make in designing reform. Evaluating potential reforms thus requires serious estimates of the impact of reform on after-tax incomes across the income distribution from nonpartisan analysts.

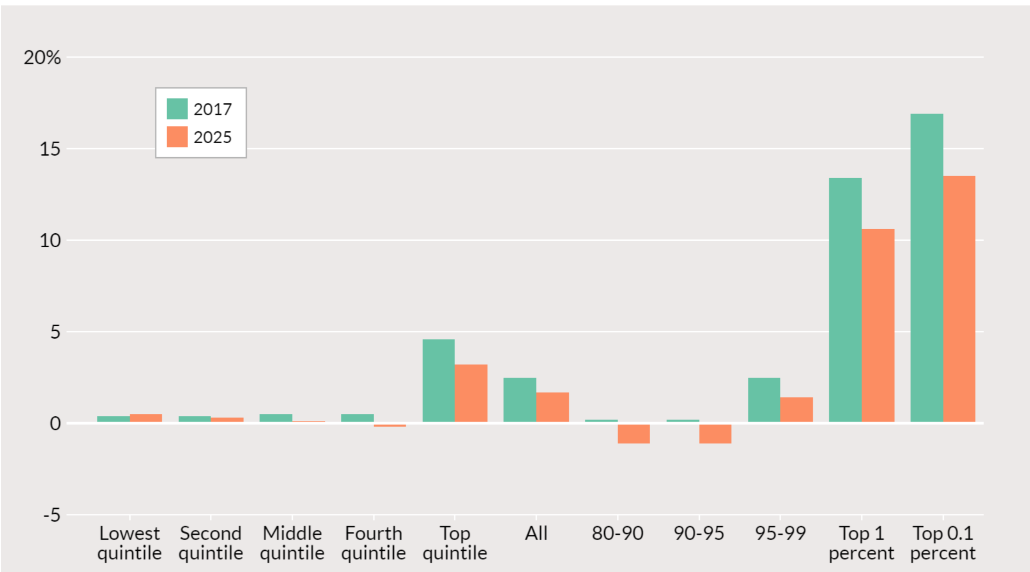
The criterion by which tax reform should be judged is that there is no net tax cut for the most fortunate Americans and that any efficiency gains from tax reform are used to benefit working and middle-class families. To determine whether reform meets this criterion will require distribution tables that show the impact of potential reforms on after-tax incomes. These tables must be free of the impact of gimmicks and exclude gains attributable to increased federal borrowing.

Unfortunately, no tax reform plan put forward by House Republicans or the Trump administration to this point would meet this test. Every plan has provided large gains to the most fortunate, little or nothing to working and middle-class families, and relied on higher deficits to generate even these modest gains.

The blueprint for tax reform released by House Republicans in 2016, for example, would have boosted incomes for the top 1 percent by 13 percent in the year after enactment while increasing incomes for the bottom 95 percent of families by less than half of one percent (Figure 6). In subsequent years, high-income families would benefit somewhat less, but many families outside the top 5 percent would be made worse off. Moreover, as noted above, most families would be worse off in all years after accounting for spending cuts or offsetting tax increases to eliminate the deficits.

House blueprint would be severely regressive

Percent change in after-tax income by income percentile, 2017 and 2025



Source: "Dynamic Analysis of the House GOP Tax Plan: An Update." Tax Policy Center. June 30, 2017. Accessed September 25, 2017. http://www.taxpolicycenter.org/publications/dynamic-analysis-house-gop-tax-plan-update.

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These estimates of the impact of the House blueprint report the percent change in after-tax income. However, an equal percent change in after-tax income across the income distribution would mean that the gains for the top 1 percent of families are more than 20 times the gains for middle-class families. Indeed, expressed in dollars the disparity in the benefits of the House blueprint is even more striking (Table 1). Families in the top 1 percent would see their after-tax incomes increase by more than $200,000 while families in the middle quintile of the income distribution would see them increase by $260.

Distribution of Federal Tax Change

By expanded cash income percentile, 2017[a]

TPC

Expanded cash income percentile[b,c]	Percent change in after-tax income (%)[d]	Share of total federal tax change (%)	Average federal tax change ($)	Average Federal Tax Rate[e]	
				Change (% points)	Under the proposal (%)
Lowest quintile	0.4	0.8	-50	-0.4	3.4
Second quintile	0.4	1.4	-120	-0.3	8.1
Middle quintile	0.5	2.8	-260	-0.4	13.2
Fourth quintile	0.5	3.7	-410	-0.4	17.0
Top quintile	4.6	89.0	-11,760	-3.4	22.7
All	2.5	100.0	-1,810	-2.0	18.0
Addendum					
80–90	0.2	1.2	-310	-0.2	20.0
90–95	0.2	0.7	-370	-0.2	22.0
95–99	2.5	11.0	-7,690	-1.9	23.6
Top 1 percent	13.4	76.1	-212,660	-8.9	24.5
Top 0.1 percent	16.9	46.5	-1,262,530	-11.1	23.4

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).

Notes: Number of Alternative Minimum Tax (AMT) taxpayers (millions): Baseline: 4.8; Proposal: 0.

The benchmark for tax reform should not be that a family with after-tax income of $6 million receives a benefit of $60,000 for every $600 received by a family with income of $60,000. Instead, Congress should enact reform that directs all of the efficiency gains realized to the benefit of working and middle-class families thus reducing inequality and fulfilling the promises made by officeholders across the ideological spectrum that the focus of their efforts while in office will be the economic fortunes of the American middle-class.

It is worth comparing this focus on after-tax incomes with a focus on economic growth or GDP, which is also frequently used. As an economic matter, measures of total economic output and total income should be equal. Thus, using an output-based measure of economic growth as the measure of reform rather than incomes is not primarily about the difference between output and income.

The most important impact of focusing on economic growth rather than the change in incomes across the distribution is that it implicitly adopts the perspective that a policy that increases the income of a household making $1 million by $11,000 is more valuable than one that doubles the income of a household making $10,000. It does this not by directly asserting this value judgment, but by adopting a summary metric that uses this weighting.

In fact, a measure of the level and distribution of after-tax incomes across the distribution provides far more information than knowledge of the level of output. Focusing on output growth is thus akin to putting on blinders that obscure the broader picture. When incomes have grown by about 600 percent in the last three-plus decades at the very top of the distribution but by only 21 percent in the bottom half, there is no reason to choose an objective that does not focus on increasing the living standards of working and middle-class families.

There is nothing controversial about the economic claims I am making. While there are numerous disagreements about the right way to measure the distribution of taxes and about what kinds of tax reform will boost growth and how large any growth effects will be, there is no disagreement that the distribution of the benefits from tax reform will be determined by the structure of the tax reform, and that if Congress chooses to enact reform that directs the benefits to working and middle class families it can do so. Put simply, if tax reform directs far greater benefits to the wealthy than it does to the working and middle-class families, it will be because Congress chose to do so.

Tax reform should preserve and expand the evidence-backed refundable tax credits that help working families, while realizing that these do not eliminate the need for direct investment in programs and services that help these families thrive.

Congress should preserve and expand evidence backed refundable tax credits like the Earned Income Tax Credit and the Child Tax Credit, while evaluating these expansions in the context of the broader tax package in which they are a part. However, expanding these credits would not take the place of desperately needed increases in investments in child care, paid family leave, and job training.

The Earned Income Tax Credit is designed to encourage and reward work, reduce poverty, and provide assistance to struggling families. The credit is refundable, which means the many families whose incomes are too low to generate substantial federal income tax obligations can still benefit. According to the Center on Budget and Policy Priorities, the Earned Income Tax Credit lifted 6.5 million people, including 3.3 million children, out of poverty in 2015. The Child Tax Credit, which is only partially refundable, also provides families with a significant economic boost. It provides workers with children a tax credit of up to $1,000 per child and lifted about 2.8 million people out of poverty, including about 1.6 million children, in 2015.

One potential component of a tax package this fall would be a CTC expansion that focuses on helping low- to moderate-income families. These improvements should include measures such as allowing families to receive a CTC refund from the first dollar of income and substantially increasing the phase-in rate or making the credit fully refundable. Any CTC expansion should include a particular focus on the poorest families and the youngest children given the evidence that suggests that the benefits of additional income—including improved health outcomes, increased educational attainment, and higher expected earnings as adults—are clearest for that group.

However, the reality is that improving the EITC and CTC would not take the place of desperately needed increases in investments in child care or paid family leave. With average childcare costs ranging from $3,000 to $17,000 per year, expanded tax credits are not the best approach to deal with this expense. For example, a CTC expansion or other attempts to make childcare more affordable through the tax code would not address issues with access to high quality reliable childcare. Addressing families' child care needs requires significant public investments in the childcare system as a whole.

Another potential component of a tax package would be a tax credit for businesses that offer paid leave. These kinds of tax credits can be ineffective at increasing the number of employers offering paid leave, especially for low-wage workers, and thus serve to provide tax cuts to employers that already do. However, even while ineffective in increasing access to paid leave, the cost of the tax cuts would still require cuts in other services or offsetting tax increases to pay for them. Proposals like these may only exacerbate inequality by offering tax credits to employers who have already acknowledged that there is value offering paid leave.

Moreover, as noted above, if included in a revenue-losing package, tax cuts for working and middle-class families may offer an apparent boost, but the spending cuts or tax increases necessary to finance them will most likely make these families worse off, particularly if the price of expanded benefits for working and middle-class families is additional benefits for higher-income families.