TESTIMONY OF AARON HEDLUND
BEFORE THE HOUSE COMMITTEE ON SMALL BUSINESS

TAX DAY: EXPLORING THE ADVERSE EFFECTS OF HIGH TAXES AND A COMPLEX TAX CODE

APRIL 10, 2024

Good morning, Chairman Williams, Vice Chairman Luetkemeyer, Ranking Member Velázquez, and Members of the Committee. It is truly a privilege to engage with you today on such a timely and important topic as the federal tax code and its impacts on the broader economy.

My name is Aaron Hedlund, and I have been an economics professor for more than a decade. In that capacity, I regularly publish rigorous, peer-reviewed studies from my own analysis of the data, and I also have the opportunity to engage with some of the brightest minds in economics on pressing policy-relevant questions. From 2020 to 2021, I had the privilege to serve as the Chief Domestic Economist and Senior Advisor at the White House Council of Economic Advisers.

The Current Economic Context

Before delving into the specific issue of taxes, it is important to establish the economic context for our discussion today. Put simply, America is in the midst of a self-inflicted cost-of-living crisis that is causing upheaval for family and small business budgets. By self-inflicted, I of course do not mean to suggest that it is the fault of everyday Americans. To the contrary, blame largely rests at the feet of bad federal policy over the past three years. It is not my aim today to litigate the decision to repeatedly flood an already rapidly recovering economy with trillions of dollars of debt-fueled stimulus. I leave that job to Larry Summers, former Clinton Treasury Secretary and President Obama's National Economic Council Director, who was characteristically blunt in his early 2021 assessment when he critiqued the current administration's approach as the "least responsible macroeconomic policy" he had seen in 40 years. Inflation would go on to validate these criticisms by reaching a 40-year high in 2022.

Although the Federal Reserve has made progress in reducing the rate of inflation over the past year, the result is simply a slowing of further price increases. Prices remain 20% higher than they were a few years ago, and as a result, family incomes have fallen by thousands of dollars in purchasing power terms. In fact, the official inflation statistics do not even tell the full story of the cost-of-living crisis, because they do not account for the dramatic rise in mortgage rates that have driven housing affordability to record lows. In fact, a recent academic paper by Larry Summers and co-authors finds that the already-high inflation rate over the past couple of years would be over twice as high if the government were to include borrowing costs in its inflation calculations in the way that it used to before 1983. Their findings explain the not-so-mysterious mystery why people remain pessimistic: shrinking real paychecks spur economic discontent.

The current economic predicament serves as an important backdrop for today's tax discussion both because it underscores the urgent relief Americans need from the cost-of-living crisis and because it highlights two very different paths to bring about that relief. If one conceptualizes inflation as too much money chasing too few goods, the first approach is the painful medicine approach of taking some of that money back out of the economy by slamming the brakes on economic demand. The Federal Reserve's interest rate hiking campaign follows this approach, and it is essentially the only option available to the Federal Reserve, setting aside misguided advice by some to simply let inflation run hot out of the incorrect belief that workers benefit.

If the first approach is aimed at reversing "too much money" by slowing demand, the second approach seeks to reverse "too few goods" by expanding supply. The advantage of a supply-expansion approach to ending the cost-of-living crisis is that it does so by creating affordable abundance and raising economic growth. This recipe has succeeded in the past, most notably when the 1980s "supply-side revolution" of simpler, lower, and fairer taxes and pairing back of excess regulation put an end to stagflation.

The 2017 Tax Cuts and Jobs Act and the Blue-Collar Boom

As fellow Missourian Mark Twain reportedly once said, "History does not repeat itself, but it often rhymes." Coming on the heels of the 2007-09 financial crisis, the early to mid-2010s was another era of widespread economic discontent in the midst of what ultimately came to be the weakest economic recovery in modern American history, as shown in figure 1. Persistent efforts to stimulate the economy failed to create robust growth in the face of supply-constraining work disincentives. The eventual expiration of misguided stimulus policies created some momentum for the recovery, but by 2016, the Federal Open Market Committee and Congressional Budget Office (CBO) were forecasting the labor market recovery to stall and unemployment to flatten. In 2017, the Trump Administration and Congress took a different view of fiscal policy than their predecessors. Instead of pursuing stimulus-driven growth, they unleashed the beginnings of a blue-collar supply-side revolution by passing the 2017 Tax Cuts and Jobs Act (TCJA) and rolling back excessive regulation. TCJA contained a number of important provisions to make the U.S. more competitive on the world stage, to boost productivity-enhancing investment, to free up resources and level the playing field for small businesses, and to lift the burden of government for families who had not seen any gain in living standards between 2007 and 2015.

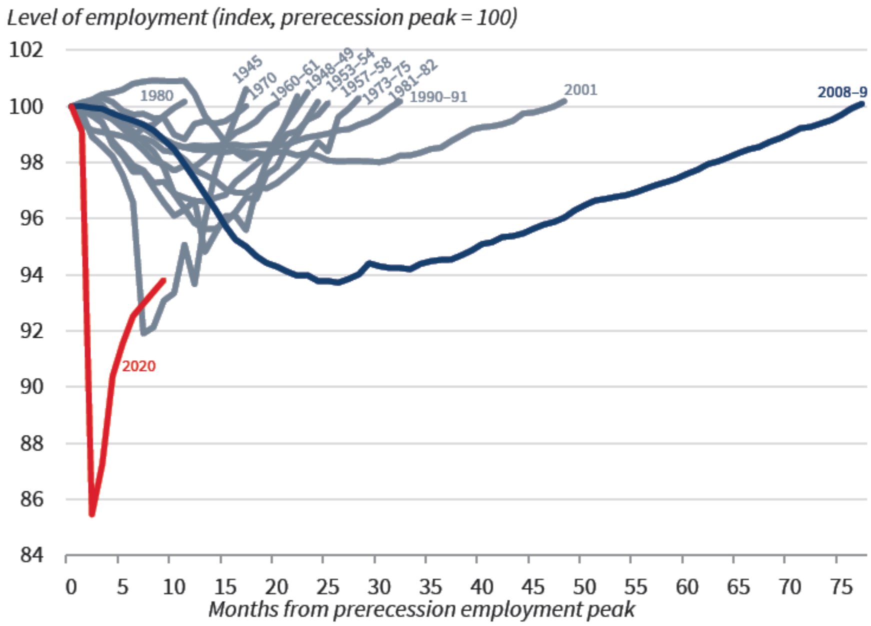

Figure 1: Comparison of Economic Recoveries (Source: Figure I-7, 2021 Economic Report of the President)

Before delving into some of the most important components of TCJA, it is worth remarking on the [stellar performance] of the U.S. economy in the years that ensued as it eclipsed the earlier forecasts. Instead of stagnating, the labor market attained unparalleled strength while GDP surpassed expectations, as shown in figures 2 and 3. Headline unemployment fell to 50-year lows, and a more inclusive measure—one that captures discouraged workers on the sidelines and part-time workers who prefer to have a full-time job—reached an all-time low in December 2019. Labor market opportunity reached every corner of America. The unemployment rate for African Americans and Hispanics fell to record lows, and Americans with lower levels of formal education experienced plummeting joblessness.

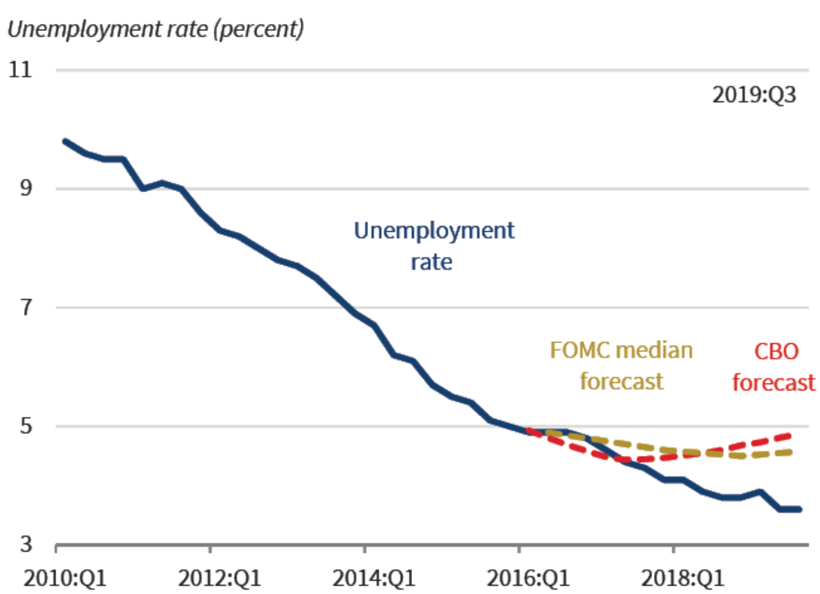

Figure 2: Actual vs. Forecasted Unemployment. (Source: Figure 1-3, 2021 Economic Report of the President)

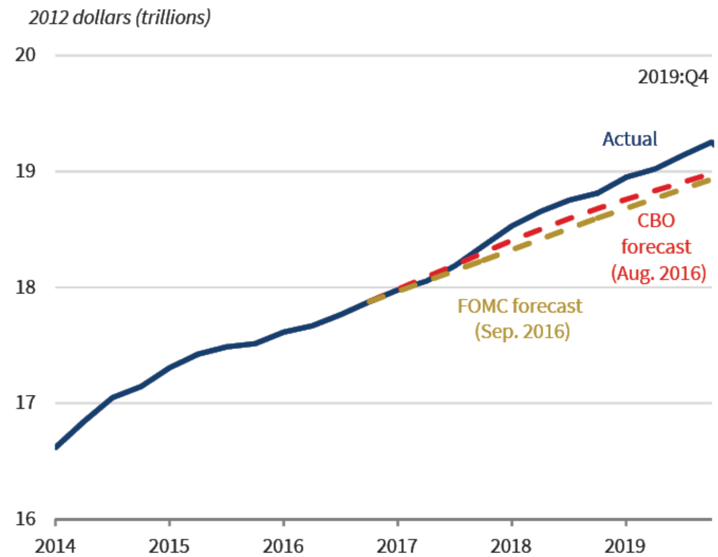

Figure 3: Actual vs. Forecasted GDP. (Source: Figure 1-7, 2021 Economic Report of the President)

America was in a full-scale blue-collar boom. While worker earnings overall grew at more than a 40% faster rate from January 2017 to February 2020 compared to the period from July 2009 to December 2016, the acceleration in earnings was 130% for workers without a bachelor's degree and 158% for the bottom 10% of wage earners. Workers in the top 10% also saw their earnings rise, albeit at a slower pace than for workers at the bottom who disproportionately benefited from a historically strong labor market. This robust employment and wage growth manifested itself in record-low poverty rates and the largest household income gains in history. As shown in figure 4, real (inflation-adjusted) median household income rose by over $6,000 post-2016 and by a record $4,400 in 2019 alone—more than in the entire 16-year period from 2000 to 2016. These outcomes were not some narrow *political* victory—they were an *economic* victory for the country, and especially for the forgotten Americans who had been left to languish on the sidelines and were largely written off as forever consigned to government dependency.

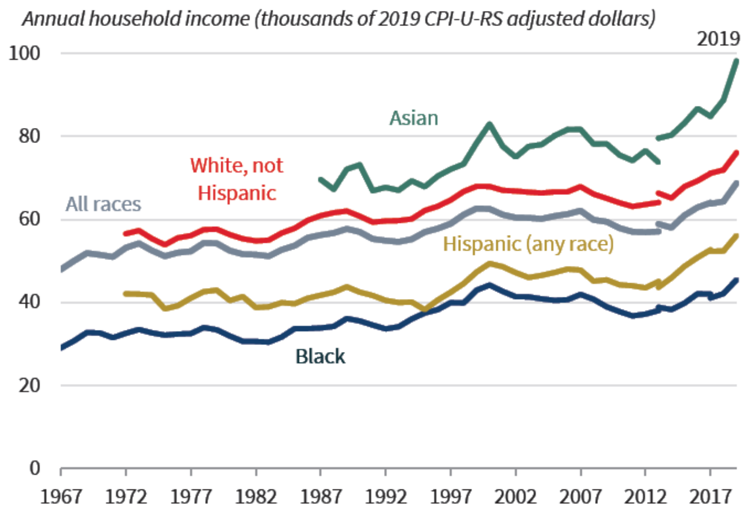

Figure 4: Real Median Household Income. (Source: Figure 1-4, 2021 Economic Report of the President)

The robust prosperity of 2017 to 2019 made the economy both stronger and more *resilient*, enabling it to better weather adverse shocks. Unfortunately, COVID-19 brought that adversity in force, causing GDP to experience its sharpest contraction in modern history in the second quarter of 2020. Decisive action by the federal government in spring 2020 proved critical to saving the economy and initiating the fastest recovery on record, but the pre-existing resilience of the economy was also an essential ingredient. Analysis by the Council of Economic Advisers has found that, if COVID-19 had occurred in 2016 under the weaker economic conditions that prevailed at the time instead of during 2020, millions more would have lost their jobs, and the unemployment rate would have taken considerably longer to recover.

The Ingredients Behind TCJA's Success

The blue-collar boom described above did not emerge by happenstance. TCJA helped pave the way with the pro-growth reforms it made to the tax code. For individuals and families, TCJA simplified taxes by doubling the standard deduction and raised disposable income by lowering marginal rates, letting people keep more of the fruits of their hard work. TCJA also expanded the Child Tax Credit while keeping in place critical work requirements so as to not discourage labor force participation. In terms of simplicity, nearly 50% of joint filers in 2017 itemized their deductions prior to the implementation of TCJA. In 2021, only 12% of joint filers itemized, with the vast majority of filers saving time and money by taking the generous standard deduction. It also improved fairness and economic efficiency by reducing the federal tax penalty for moving to lower tax locales and for making a larger down payment on a house. TCJA has been a boon for small businesses by cutting rates, creating the section 199A 20% deduction of pass-through income, and implementing full expensing for capital investment. All of these changes make it more viable and attractive for small businesses to increase hiring, wages, and investment.

If TCJA made substantial incremental improvements on the individual side, it made even more fundamental and necessary changes to corporate taxation. Prior to TCJA, U.S. businesses were at a significant competitive disadvantage on the global stage because of America's burdensome corporate rate of 35% and practice of taxing worldwide income once repatriated. This system encouraged U.S. multinationals to shift income overseas instead of reinvesting in America. TCJA dramatically improved the corporate tax code by cutting the rate from the highest rate in the developed world to a rate closer to the median—21%—and shifting to a territorial system. In 2017, the Council of Economic Advisers noted the extensive literature linking corporate tax rate cuts to higher wages and estimated that TCJA could boost household income by $4,000 to $9,000—predictions that proved remarkably prescient and accurate. Also, since the passage of TCJA, at least $1.76 trillion has been repatriated from foreign subsidiaries back to U.S. shores.

TCJA also recognized that, while every community stands to benefit from the macroeconomic improvements of higher aggregate wages and investment, distressed communities face unique challenges to partaking in that prosperity. With that understanding in mind, TCJA harnessed the power of private capital by enacting the Opportunity Zone program, which created dramatic tax benefits for investing in high-poverty areas. In an initial assessment, the Council of Economic Advisers estimated that, by the end of 2019, $52 billion in net new investment had flowed into designated Opportunity Zone tracts that would not have otherwise occurred, consistent with figure 5. Subsequent rigorous studies have also found strong positive effects of the Opportunity Zone program, with one recent study finding that the program increased employment growth by between 3 and 4.5 percentage points, with the effects proving persistent. Opportunity Zone investment has occurred in a diverse array of sectors, but arguably no sector may need it more at the moment than real estate. Already, there is compelling evidence that Opportunity Zones are an important vehicle for alleviating the current crisis in housing affordability.

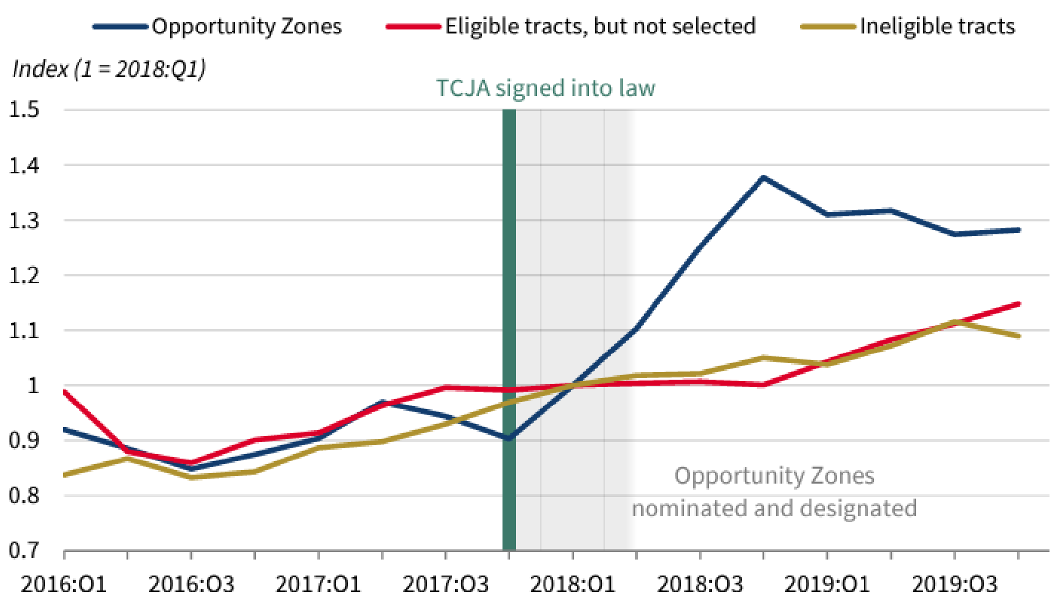

Figure 5: Private Equity Investment, 2016-2019 (Source: Figure 9, "The Impact of Opportunity Zones: An Initial Assessment")

Myths and Truths of Pro-Growth Tax Policy

Looking beyond the specific provisions, TCJA was rooted in well-established principles of sound, pro-growth taxation. Unfortunately, political rhetoric often perpetuates myths that obscure the underlying truth about the impact of taxes on the economy.

Myth: Tax Cuts are a Giveaway to the Rich
Truth: Tax Cuts Boost Wages, and Inequality Narrowed After TCJA
This myth is rooted in several fallacies. First, tax cuts do not "give away" money to anybody. They prevent the government from taking away as much to begin with. Tax cuts increase the reward to productive activity, whereas government handouts are disconnected from effort and productivity (in fact, often times subsidizing the opposite). Second, the entity signing the check sent to the IRS is often times not the ultimate bearer of the *burden* of taxation. Businesses are not passive in the face of taxes, and corporate CEOs are not cutting personal checks to pay their company's tax bill. Instead, taxes affect job creation, wages, investment decisions, and beyond. Research has found that workers and consumers bear much or even most of the burden of corporate taxes, with effects coming through lower earnings and higher prices. Thirdly, the share of the tax burden paid by the top 1% has *increased* over time, not decreased. In 2017, the top 1% of earners paid 39% of income taxes, and that share increased to 42% in 2020—nearly double their 22% contribution to aggregate income. Also, simply measuring the change in tax liability is not an accurate way of assessing the distributional consequences of tax cuts, because they also impact *pre-tax income*. As discussed earlier, household income surged after TCJA, with the largest gains accruing to the lower end of the income distribution. Wealth inequality also narrowed after TCJA, not because of declines at the top, but because of disproportionate gains at the bottom. In addition, there is an extensive body of academic research that finds negative economic effects of high taxes. In particular, tax increases reduce investment, impede innovation, and undermine productivity growth, which is the foundation of rising living standards over time. Even when the revenue from tax increases is redistributed to lower-income households, those households end up worse off because of lower overall incomes caused by the adverse response of the economy. In other words, class warfare is worse than zero-sum redistribution. It actively destroys economic prosperity.

Myth: Tax Cuts Starve the Government of Needed Resources
Truth: Tax Revenues are Above their Historic Average
Opponents of tax cuts assert that allowing Americans to keep more of their hard-earned money deprives the government of funds needed to fund ongoing operations. The numbers challenge this false narrative. For one thing, as of fiscal year 2022, federal receipts as a share of GDP were at their second highest since World War II, and the sum of payroll and income taxes as a share of the economy are projected to be almost a percentage point higher in 2024 compared to the average from 1994 to 2023. On the flip side, government spending as a share of the economy has skyrocketed in recent years. Prior to COVID-19, spending averaged around 20% of GDP over the fifty-year period from 1968 to 2019. While a temporary spike in spending was merited in

2020 to combat the unique circumstances of COVID-19, government has instead permanently expanded over the past three years. The CBO is forecasting spending to be 23% to 24% of GDP over the next 10 years, and rising further beyond that. The goal of tax policy should not be to accommodate an expansion of government by siphoning an ever-growing share of resources from families and small businesses already reeling from the burden of the cost-of-living crisis.

The Path Forward: Building Upon the Success of TCJA

The federal tax code is overly burdensome. Taxes are higher than they ought to be and more complex than they ought to be. Estimates put the amount of money that the American people spend just on *tax accounting* at between $67 billion and $378 billion per year. The burden of compliance with IRS regulations causes economic losses of another $148 billion to $609 billion annually. The antidote is for taxes to be simple, low, and fair. The Tax Cuts and Jobs Act of 2017 made tremendous progress when it transformed the corporate side of the tax code and made a significant down payment on reform of individual taxes. The most critical step the government can take is to extend TCJA and prevent the American people from experiencing a massive tax hike, especially after they have already been taxed by high inflation. The economy will benefit from the predictability of continued lower rates, small business relief, immediate expensing of investment and R&D, and other key pillars of the law. Going forward, here are some principles and priorities to have in mind to further realize simple, low, and fair taxes.

*Tax Simplification *Is* Deregulation*

As previously mentioned, IRS regulations impose substantial costs on the economy. Increasing the standard deduction in TCJA caused a dramatic decline in the share of households itemizing their tax returns, causing fewer of them to have to wade through IRS regulations on what can and cannot be deducted and under what conditions. Further base broadening efforts would allow for an even larger standard deduction. It is also worthwhile pursuing avenues to build upon the section 199A deduction to reduce small business compliance and accounting costs. Ultimately, the biggest source of complexity in the tax code is not the number of tax rates, but rather the many different types of income definitions and complicated carve-outs in the code.

Tax Fairness Advances Equality of Opportunity, Not Class Warfare

This testimony has already provided clear data to refute the idea that high-income Americans are paying less than their proportionate share of the tax burden. In fact, they are paying a higher share in taxes than is their contribution to aggregate income. One can debate the ideal degree of progressivity in the tax code, but starting with the false premise that the tax code is regressive is unhelpful. Genuine tax fairness aims to spread opportunity, not to spread others' wealth and pursue income leveling through class warfare redistribution.

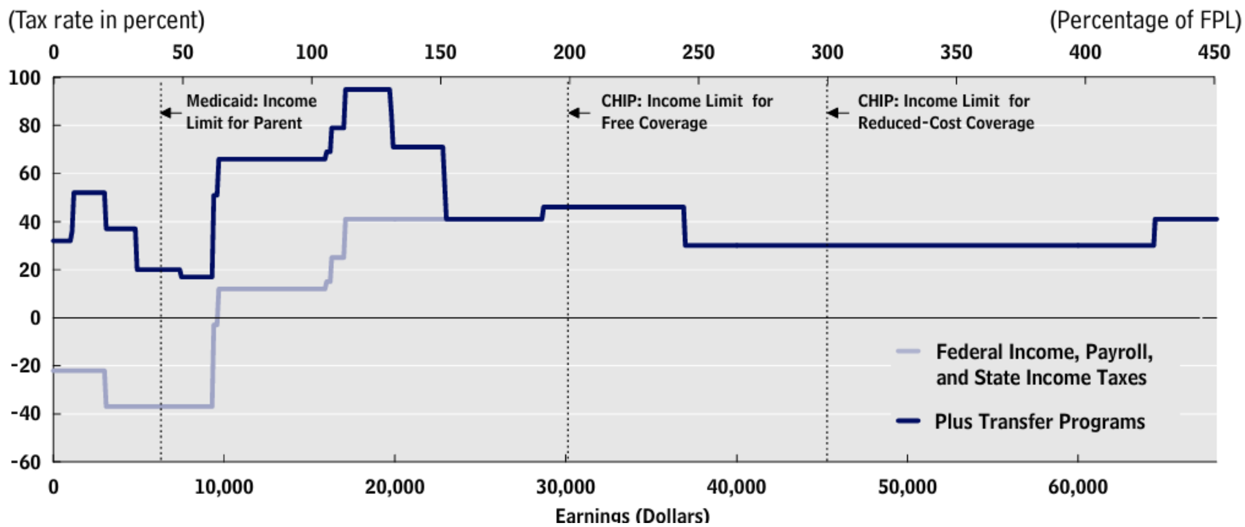

Figure 6: Marginal Tax Rates for a Single Parent with One Child (Source: Figure 2, "Effective Marginal Tax Rates for Low- and Moderate-Income Workers", CBO)

Aspiring Middle Class Families Experience Some of the Most Punitive Effective Tax Rates

There are two ways to measure the burden of a tax: how much of a person's total income it takes away (the average tax rate) and how much it penalizes someone in the form of a higher tax bill after they receive a raise at work, find a higher-paying job, or invest in themselves to switch to a more lucrative career. As a whole, high-income Americans undoubtedly pay the highest average tax rates. However, Americans looking to climb into or stay in the middle class face marginal tax penalties that in many cases are at least as high, if not higher, once one also accounts for the effects of means-tested provisions of federal taxes and transfers, as shown in figure 6. Put another way, for too many struggling and striving Americans on the edges of the middle class, earning higher pre-tax income can result in a minimal gain in take-home pay or even an outright decline. In this way, many Americans are penalized and disincentivized from trying to climb the economic ladder. The problem is compounded for second earners in two-earner families, with the second earner often facing extremely high penalties from entering or staying in the labor market. Addressing all of these defects is the supply-side issue of our time.

In addition to reducing effective marginal tax rates on struggling and striving Americans, it is worth exploring ways to extend and expand the Opportunity Zone program to allow people to receive favorable tax treatment when they invest paycheck income into an Opportunity Zone. At present, only capital gains income receives favorable treatment. Responsibly expanding the incentive would open the floodgates of potential investment into struggling pockets of America, allowing residents of limited means to invest directly in businesses in their own communities.

Improve the Treatment of Human Capital Investment

Enduring economic prosperity requires continual gains in productivity fueled by investment and innovation. This well-established fact explains why the tax code contains provisions favorable to the treatment of capital investment, such as immediate expensing and low capital gains rates. It is important to remember, however, that physical and financial capital are not the only sources of capital. For most people, their greatest asset is their own human capital—their accumulated skills and capacities acquired during their childhood, formal education, workplace training, and experience on the job. In this vein, work is more than just a means to earn today's paycheck. It is also a way for people to invest in their own future earnings capacity, prepare themselves for tomorrow's more rewarding job, and perhaps to even start their own business. Sadly, when people invest in their own human capital, they can expect the tax code to significantly bite into their return on such investment or even erase it entirely.

Currently, the main way that the tax code seeks to incentivize human capital formation is to subsidize spending on specific government-approved human capital *inputs* like education while still taxing the *returns* on such investment, like a raise in pay, at high rates. Lawmakers should instead think more creatively and comprehensively about equalizing the priority the tax code places on encouraging broad human capital investment to that of other types of investment. For example, it is important to recognize that not all human capital investment takes place in formal education institutions, and it is worth evaluating how the tax code can better treat wage gains and losses as an analogy to how it treats other investment gains and losses. More broadly, the importance of human capital for economic prosperity raises the stakes for bringing about simpler, lower, and fairer taxes, because the cost of inaction is not just smaller paychecks today, but also less investment in the skills and knowledge that will fuel individual opportunity and America's economic strength for years to come.

Conclusion

TCJA extension is critical and ought to serve as the foundation upon which tax reform efforts continue to build. Simple, low, and fair taxes are not just about "putting money in peoples' pockets." They are about unleashing America's full economic potential and creating affordable abundance for current and future generations. Thank you for affording me the opportunity to speak with you about this important matter, and I look forward to answering your questions.