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Tax Reform for Economic Growth

Testimony to the Committee on Ways and Means

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Thank you, Mr. Chairman. I am pleased to appear before this committee. I will focus my remarks on some of the contributions that tax reform can make to increasing economic growth, creating better jobs, and raising the standard of living of the American people.

Higher real GDP in the future would allow not only increased personal spending but would also provide greater resources for public spending on national security and on domestic programs for education, poverty reduction, and an improved environment.

Tax reform can be the major driver of faster GDP growth. Fortunately, the American tax code is now better in many ways than it was when I first appeared before this committee back in the 1970s. We now have lower tax rates on personal incomes, on capital gains, and on corporate profits. That improves incentives and contributes to faster growth and better jobs.

But there has also been some backsliding in tax rates since the tax reform act of 1986. Remedying this should be an important goal of tax reform.

There are many high priority tax reforms that can strengthen growth and reduce our fiscal deficits. Because my time is very limited, I will focus on a few things that receive less attention than they should.

Increasing employment among women

I will start with tax reforms that can increase the employment of women and raise their after-tax incomes.

Current tax and Social Security rules penalize married women more than other individuals. The federal government taxes a wife's first dollar of earnings at the same rate as her husband's last dollar of earnings. Other countries tax each individual on their own earnings, giving married women a greater incentive to work and to work at jobs that pay higher wages. The U.S. can achieve that improvement in fairness and in incentives without abandoning the system of joint filing.

Social Security now taxes a woman on her full earnings but often provides no extra benefit. She receives an incremental benefit in return for her taxes only to the extent the benefit based on her own earnings would exceed 50 percent of her husband's benefit while he is alive and 100 percent after he dies.

Reforming these tax and Social Security rules would increase women's labor force participation and the nation's GDP.

Increasing employment among seniors

I'll turn now to increasing employment among seniors.

The labor force participation rate now declines from 64 percent among 60 year olds to only 32 percent among individuals 65 through 69. As you know, Congress in 1983 raised the age for full Social Security benefits from 65 to 67, with a delay and gradual phase in. As a result, the labor force participation rate among those age 65 to 69 rose from 21% to 32%.

Life expectancy at age 67 has increased by three years since 1983. Raising the age for full benefits in line with that increase in life expectancy would expand the labor force and raise real GDP.[1]

Raising the national saving rate

I turn now from policies designed to increase employment to policies that can raise our nation's rate of saving and therefore our nation's stock of capital. More capital investment increases productivity and output directly and by introducing new technology. Better policies can increase the volume of capital and the way that it is deployed.

Household saving – i.e., the net personal income that is not spent on consumption – fell from 9 percent of after-tax incomes in the 25 years from 1960 to 1985 to about a third of that now.[2] A variety of public policies contributes to the low rate of saving and the high rates of dissaving. These include the deductibility of mortgage interest and the level of unfunded Social Security benefits.

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[1] Since the increased life expectancy has been less for individuals with lower average earnings, the increase in the age for full benefits could be related to lifetime average earnings.

Automatic enrollment IRA plans and a shift of Social Security to a mixed system with investment based personal retirement accounts would increase national saving and would therefore increase business investment that would raise real incomes and create better paying jobs.

Unfortunately, most of household saving is now absorbed by the federal budget deficit. The resulting national debt has increased from less than 40 percent of GDP a decade ago to 75 percent now, with the prospect that it will rise to more than 100 percent unless Congress takes action to raise revenue and slow the growth of entitlements.

The good news is that small reductions in the annual deficits can prevent the rising debt level and bring it back to lower levels. Reducing the annual deficit from today's three percent of GDP to two percent would put us on a path to a debt ratio of less than 50 percent. That should be a basic goal for Congress in the next few years.

Reducing the annual deficits requires a combination of slower growth of government spending and increased tax revenue. Because the annually appropriated spending for defense and non-defense programs is already being squeezed to historically low levels, controlling government spending requires slowing the growth of the middle class programs for seniors – Social Security and Medicare.

Tax revenue can be raised without increasing marginal tax rates by limiting the ability of taxpayers to use the tax expenditure features of the tax code to reduce their tax liabilities. These tax expenditures are a major form of government spending. Capping the use of these tax subsidies could also simplify the tax process by inducing taxpayers to use the standard deduction rather than itemizing deductions. My written testimony provides a reference to a recent study of how such a cap on tax expenditures might be implemented.[3]

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[2] The current household saving rate of 4.7 percent reflects a change in the definition that raised the measured level by about 1.5 percentage points relative to the old definition.

[3] See Martin Feldstein, "Raising Revenue by Limiting Tax Expenditures," NBER Working Paper 20672, forthcoming in Tax Policy and the Economy, volume 29, University of Chicago Press, 2014

Reforming the corporate income tax

Tax reform can also improve the way that our nation's saving is used. A key element of that is corporate tax reform: reducing the corporate tax rate – now the highest in the industrial world – and shifting to the type of international tax rule (the territorial system) that is used by every other industrial nation.

Thank you again for the opportunity to summarize my views. I look forward to your questions.