Updated: **July, 2022**

Taxes

Summary and Key Talking Points

Policy Proposals

1. Make the Tax Cuts and Jobs Act permanent and expand expensing.

2. Enact universal savings accounts (USAs) to encourage saving.

3. Cut tax subsidies; eliminate all individual and corporate deductions, credits, exclusions, and exemptions that are not economically justified; and lower tax rates.

4. Ensure permanent tax relief by pairing further tax reductions with spending cuts that are as large as or larger than any tax cuts.

Quick Facts

1. The federal government collected $3.4 trillion in revenues in 2020. Combined with $1.6 trillion in state and local taxes, the payment of taxes consumes about one-quarter of U.S. economic production.

2. Americans spend over 6.2 billion hours a year complying with the tax code and other Treasury Department information collection requirements.

3. In 2018, because of the Tax Cuts and Jobs Act, households saved an average of $1,400 in taxes, and married couples with two children saved an average of $2,900.

Power Phrases

A Necessary Evil

- Our tax system should be simple, transparent, and fair. Even after the historic 2017 tax cuts—which benefited all Americans—the tax code is still complex, unjust, and a threat to growth and prosperity.

- Taxes that are too high or poorly designed can destroy wealth, discourage investment, and stifle economic opportunity.

The Tax Cuts and Jobs Act of 2017

- The Tax Cuts and Jobs Act of 2017 (TCJA) simplified tax paying for many Americans, reduced taxes on individuals and businesses, and updated the business tax code.

Opportunity for Permanent Relief

- Tax reform gives American families much-needed relief, with larger paychecks and more jobs.

- Tax reform makes the U.S. more competitive, encouraging companies to move jobs and investment to the U.S.
- In 2025, most of the individual tax cuts will expire. Congress should take this opportunity to revisit the tax code and make many of the cuts permanent.

The Issue

As the federal government has expanded, taxes have assumed an oversized role in American life. Taxes influence how much Americans work, what they produce, what they buy, how much they save, and when they retire. It is therefore critical that policymakers design a tax system that minimizes the negative impact of taxes on the economy and people's lives.

Federal taxes in America are largely paid in three ways. The individual income tax, including taxes paid on investments (capital gains and dividends) and taxes on business profits paid directly by the owners on their individual tax return, raises 49.6 percent of federal revenue; payroll taxes account for 35.9 percent; and the corporate income tax accounts for 6.6 percent. Investors, workers, and consumers pay business taxes like the corporate income tax. Workers shoulder the largest burden through lower wages.

Taxes often determine winners and losers in the economy. Under a well-designed revenue system, taxes would be neutral. If taxes are applied consistently and evenly, they are less likely to be the driving factor in economic decisions. All too often, America's tax system favors certain industries over others, incentivizes consumption over saving, and discourages work and entrepreneurship. Different tax treatment of different activities acts like a wedge that drives individuals and businesses away from the most economically beneficial activities.

Federal taxes should be low. When taxes are low, they cause less harm and smaller distortions in the economy. However, taxes are directly tied to how much the government spends, and the federal government has a spending problem. Partly in response to the coronavirus outbreak, the federal government spent $13.4 trillion in 2020 and 2021 and racked up over $5.9 trillion of new debt. Since the United States is obligated to pay its debts, Congress must dramatically reduce spending to avoid painful future tax increases.

Taxes should be simple and transparent. The Tax Cuts and Jobs Act of 2017 (TCJA) simplified taxpaying for individual Americans and lowered taxes, but the U.S. tax code is still far too complex. A vast array of subsidies and carve-outs for the politically connected add to complexity and economic distortions. Based on government estimates, Americans dedicate over 6.2 billion hours a year to complying with the tax code and other Treasury Department information collection requirements. Business taxpayers especially must dedicate vast amounts of time and money to comply with the tax code, IRS regulations, and official guidance. Small businesses often lack the resources to devote to this time-consuming process. Under a simpler tax system, most of these resources could be put to better use.

The biggest distortion in the tax code is caused by the hidden double tax on savers, who face a tax on wages and a second tax on any earnings if the wages are saved and invested. The lower tax rate on capital gains and dividends (with a top rate of 20 percent on long-term capital gains versus a 37 percent top marginal rate on income) helps to move the income tax toward a more neutral treatment of saving but is still an example of double taxation.

Americans benefitted from many pro-growth provisions in the TCJA. In 2019 and early 2020, the unemployment rate was at a 50-year low, wage growth was at a 10-year high, labor force participation had reversed a 20-year downward trend, inflation was low, and the poorest Americans were benefitting the most from the thriving economy. (State-mandated economic shutdowns erased these gains in many parts of the country in 2020 and 2021.) Most of the TCJA's individual tax cuts are set to expire in 2025. This deadline gives Congress an opportunity to revisit the tax code, prevent tax increases by making much of the TCJA permanent, and address many remaining issues not included in the 2017 tax bill.

Ultimately, the tax system should use the least economically destructive forms of taxation to raise the revenue necessary to fund a limited government that carries out its constitutionally delegated powers. To this end, Congress needs to make pro-growth features of the TCJA permanent and lower taxes on saving while simultaneously eliminating tax subsidies and cutting spending.

Recommendations

Make expensing permanent and extend it to long-lived assets. The U.S. tax code generally imposes years of delay between the moment businesses pay for an investment and the point at which they can deduct the full cost of that investment on their taxes. This raises the cost of the investment, which in turn slows gains to future worker productivity and shrinks incomes. The TCJA temporarily fixed this problem for some short-lived investments through "expensing," allowing businesses to write off some new investments immediately. Congress should prioritize making these pro-growth provisions permanent.

While the TCJA reduced the tax code's bias against investing in short-lived assets, this provision was too limited. Buildings, such as new manufacturing floor space and storefronts, still must use the costly and complicated pre-TCJA system, characterized by arbitrary depreciation schedules concocted by federal bureaucrats who often have little or no business experience. The budgetary impact of expanding expensing to all investments would be high in the first few years because of transition costs, but the economic benefits would be huge. Alternatively, an intermediate approach with a smaller upfront budget impact would allow neutral cost recovery for buildings. Inflation makes delayed expensing especially harmful, because by the time taxpayers can fully claim deductions, the value of the dollar has fallen, reducing the value of the deduction compared to the real cost of the investment. A neutral cost recovery system allows taxpayers to adjust deductions to account for inflation and a real rate of return, providing an economic benefit that is similar to expensing.

Prevent tax increases and make the Tax Cuts and Jobs Act permanent. The 2017 tax cuts reduced federal income tax rates, increased the standard deduction, doubled the child tax credit, repealed the personal and dependent exemptions, and capped the state and local tax (SALT) deduction, among many other reforms. Most of the law's individual tax provisions expire at the end of 2025, and taxes are scheduled to increase beginning in 2026.

Although most media attention surrounding the TCJA centered on lower tax rates for individuals and businesses, the TCJA's adjustments to investment rules, such as expensing, had important benefits for American workers, supporting higher wages and more jobs. A permanent version of the 2017 tax cuts could increase the size of the economy and further boost Americans' paychecks, and permanent tax cuts and expanded expensing could boost the size of the economy by 4.3 percent over the pre–tax cuts baseline. That would more than double the economic benefits that are expected to result from the temporary provisions under current law.

Congress should resist proposals to increase Americans' tax burden or to create new taxes. Americans already pay federal individual income taxes (including capital gains), corporate income taxes, payroll taxes, estate taxes, tariffs, and excise taxes like those on gasoline, tobacco, alcohol, firearms, and sporting goods. There is no need to add a new revenue source, whether it is a value added tax, a border adjustment tax, or a tax on carbon, wealth, unrealized capital gains, or financial transactions. Adding yet another federal revenue source would add needless complexity and make it easier for elected officials to collect more revenue to fund an already bloated federal government. Rather than thinking of new sources of revenue, policymakers should consider eliminating or consolidating revenue sources.

Pair tax reductions with spending cuts. The federal government needs to get spending under control. By allowing deficits to rise, Congress makes future tax increases inevitable. Moreover, any increase in the debt will create an imbalance between tax rates now and tax rates in the future, which in turn can create harmful economic distortions by causing people to avoid activities that might lead to future taxes on, for example, entrepreneurship and saving. Therefore, any further tax reductions should be offset by spending cuts that are as large as or larger than any tax cuts. In addition, there are many tax subsidies that could be removed from the tax code to pay for pro-growth reforms that make the code simpler and fairer.

Enact universal savings accounts. The current tax code discourages most forms of savings compared to consumption. People's paychecks are subject to individual income tax (and payroll tax), but no further tax is due on the portion of one's paycheck that is spent. However, if an individual puts a portion of the paycheck into savings or investments (except tax-preferred forms), the individual will face additional tax on any interest or capital gains earned. This is an additional layer of tax. Individual retirement accounts (IRAs), Roth IRAs, 401(k)s, and defined contribution plans allow investors to save limited amounts while avoiding this double taxation. Such plans, however, restrict the use of funds and penalize early withdrawal. This lack of flexibility especially discourages less wealthy Americans from using tax-preferred savings.

Universal savings accounts (USAs) would reduce taxes on savings for all Americans and help families build their own financial security through a single, simple, and flexible account. Unlike holders of existing retirement savings accounts, USA holders would not be bound by limits on when savings can be withdrawn or for what purpose people may use their personal savings. Individuals would contribute post-tax earnings, and all withdrawals from a USA would be excluded from taxable income; any gains accrued would thus be tax-free. USAs would allow Americans at all income levels to save more of their earnings with fewer restrictions on where and when they can spend their own money.

Index capital gains for inflation. For purposes of capital gains taxes, the tax base is the difference between the value of the asset upon sale (or other taxable event) compared to the basis of the asset (usually its value when purchased). Part of the increase in asset values over time is offset by general economy-wide inflation, but the full increase in asset prices is subject to capital gains tax, so investors are subject to tax both on real gains and on inflation. This inflation tax is higher and more distortionary the longer capital assets are held and, of course, the higher inflation rises.

This defect in the tax code is especially harmful because taxes on investments already represent a second layer of taxation. Taxpayers can avoid the tax on real capital gains and inflation by simply spending wage income rather than investing, but this perverse incentive reduces Americans' savings and deprives businesses of the capital funding they need to grow and innovate. Congress can stimulate economic growth and create a more neutral tax system by indexing the tax basis of capital gains for inflation.

Cut tax subsidies. Each year, the tax code is used to hand out billions of dollars in subsidies to politically connected interests, thereby picking winners and losers and distorting market outcomes. Future tax reform should eliminate all individual and corporate deductions, credits, exclusions, and exemptions that are not economically justified. Some of the most egregious tax subsidies are the wide range of tax breaks for the production and consumption of politically favored types of energy and energy-efficient products that distort energy markets, making them less efficient and more dependent on government subsidies. Other examples include tax credits for college expenses that contribute to the inflated cost of college for every American student, the research and development tax credit that is an inefficient subsidy for an activity in which most companies would engage anyway, and the low-income housing tax credit that creates incentives for local government corruption and primarily subsidizes developers, not renters.

The 2017 tax reform introduced new tax preferences that should be rolled back, like the temporary tax credit for paid family leave, the new 20 percent deduction for pass-through businesses, and place-based opportunity zone credits. The bill also did not fully eliminate existing subsidies like the newly capped state and local tax (SALT) deduction, which should be zeroed out as it is harmful for individuals and businesses. Each of these tax preferences and many others add unnecessary complexity to the tax code and reduce economic growth because they cause individuals and businesses to rely on government subsidies rather than market signals when making decisions about where to live or what to produce. The TCJA's provisions that eliminate double taxation on savings and investments are sound tax policies and should not be viewed as "tax expenditures."

Limit the power of the Internal Revenue Service. The U.S. Constitution delegates the power to lay and collect taxes to Congress, but Congress has ceded much of this power to the IRS and, more broadly, the Department of the Treasury and the executive branch. When Congress writes tax laws, those laws are typically riddled with instructions for the Secretary of the Treasury to issue new regulations covering various aspects of the law. If these occurrences were limited to mere administrative issues, this would not be especially problematic, but the tens of thousands of pages of IRS regulations and other official guidance meaningfully shape tax law and add significantly to the burden imposed on taxpayers. Businesses often must wait a year or more for IRS regulations to be published before they can really understand how a new tax law affects them. Congress should avoid relying on the IRS to issue highly consequential tax regulations.

The IRS's power in setting tax policy is also problematic at a time when global taxation is in vogue. As the Organisation for Economic Co-operation and Development (OECD) develops proposals to institute a more globalized tax system, Americans should be wary of too much power resting in the executive branch. Under the Constitution, the President can sign international treaties but cannot circumvent Congress in making laws. Limiting the IRS's regulatory power will help to ensure that constitutional checks remain in place.

Facts + Figures

FACT: High-income taxpayers already pay the lion's share of federal income taxes, and the 2017 tax cuts made the tax code more progressive.

- Households in the bottom half of income earners paid 3 percent of the federal income taxes and earned 12 percent of the income in 2018 (the most recent year for which tax data are available).
- The top 1 percent of income earners paid 40 percent of federal income taxes and earned 21 percent of the income.
- The 2017 tax cuts made the tax code more progressive by reducing taxes paid by the lowest-income taxpayers more than it reduced taxes paid by high-income taxpayers as a percentage of the income taxes they would otherwise have owed.
- It is mathematically impossible for the rich to pay for all of the government spending proposed by progressives.
- In 2018, an income tax of 100 percent on all individuals earning more than $1 million would have increased tax collections by $1.3 trillion. In 2020, Medicare for All would have required $2.8 trillion of new federal funding.

FACT: Uncontrolled government spending, not tax cuts, drives U.S. deficits.

- Federal revenues as a percentage of GDP have been near the historical average since 1968 and are projected to rise.
- The Congressional Budget Office projects that by 2050, federal spending will be 80 percent higher as a percentage of GDP than it was in 2000.
- A tax environment that rewards hard work and innovation is critical to the long-term growth of the economy, which is necessary if America is to pay down its debts.

FACT: The complexity of the tax code drains the economy of productive resources.

- The Internal Revenue Code was 6,859 pages long as of November 2021.
- The IRS has 14,312 pages of regulations and since 2000 has issued at least 48,895 pages of official guidance with which individuals and business must comply. Together, this amounts to 70,066 pages of rules—roughly the size of 58 King James Bibles.
- Government estimates show that Americans dedicate more than 6.2 billion hours a year to complying with the tax code and other Treasury Department information collection requirements.
- Despite improvements in accounting software, employment of accountants and auditors is projected to grow by 7 percent per year from 2020 to 2030. The population, by contrast, grows less than 1 percent per year.

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