FEDERAL TAX REFORM

Congress should

- cut individual income tax rates to 10 and 25 percent;
- repeal nearly all individual deductions and credits;
- create universal savings accounts to encourage families to build wealth;
- cut the top dividend and capital gains tax rates to 15 percent;
- cut the corporate income tax rate to 15 percent;
- replace depreciation deductions with capital expensing;
- repeal the estate tax; and
- cut spending to reduce pressure to raise taxes.

At the beginning of the 20th century, federal tax revenues were 3 percent of gross domestic product (GDP), and federal tax rules filled just a few hundred pages. Today, federal tax revenues are 18 percent of GDP, and federal tax rules span about 75,000 pages.

The federal government will extract $4.8 trillion in taxes from families and businesses in 2022. Individuals will be left with less income to buy food, clothing, and other needed items, while businesses will be left with less income to hire workers and build factories.

Federal taxation is costly in other ways. The tax code's complexity creates a compliance burden on individuals and businesses, and it makes financial and investment planning more difficult. Tax complexity is partly driven by special-interest breaks, which create unequal treatment and breed a distrust of government.

Another cost of the tax system is the damage to economic growth. High tax rates reduce productive activities, such as working and investing, and the unequal treatment of different industries and activities steers resources into lower-valued uses. The 2017 Tax Cuts and Jobs Act (TCJA) slashed the corporate tax rate and trimmed individual tax rates, but it did not do enough to simplify the tax code.

Looking ahead, Congress should reform the tax code with three goals in mind: simplification, transparency, and increased economic growth.

Simplification

In 1976, president-to-be Jimmy Carter called for "a complete overhaul of our income tax system. I feel it's a disgrace to the human race." Since that call for reform, the number of pages of federal tax rules has tripled, according to the tax information firm CCH. Congress continues to create new credits and other narrow breaks, while the Treasury Department churns out an endless stream of tax regulations. Tax complexity generates at least five costs.

1. Compliance and administrative burdens. Americans spend more than six billion hours annually filling out tax forms, keeping records, and learning tax rules, according to the Office of Management and Budget. The paperwork for a corporate tax return can be tens of thousands of pages in length. In addition to the costs of filing, taxpayers face a burden from audits, notices, liens, levies, seizures, and millions of penalties assessed each year by the Internal Revenue Service (IRS). Complying with the federal tax code costs the economy hundreds of billions of dollars annually in the value of lost time and the expenses for accounting and legal services.

The IRS has been overwhelmed in recent years, not only because the pandemic slowed the agency's workflow but also because Congress has added and expanded numerous breaks, such as child tax credits and recovery rebate credits. Millions of unprocessed tax returns have piled up at IRS facilities, taxpayer phone calls to the IRS for help have skyrocketed, and IRS computers are generating automated notices to taxpayers that are outdated or in error. The recent IRS mess illustrates that the tax code has become so complicated it is becoming impossible to properly administer.

2. Errors. Tax complexity and constantly changing rules cause taxpayers to make frequent and costly errors. In recent years, less than one-third of the taxpayers calling the IRS with questions have gotten through, and those that do often receive inaccurate answers. The error and fraud rate on the complex $70 billion earned income tax credit has long been above 20 percent. The IRS makes many mistakes as well, and the number of disputes between the IRS and taxpayers has been rising. In its 2021 report to Congress, the National Taxpayer Advocate found that only 73 percent of people "trust the IRS to fairly enforce the tax laws" and that only 69 percent "trust the IRS to help them understand tax obligations."

3. Economic decisionmaking. Tax complexity and frequent rule changes impede efficient decisionmaking. For individuals, choosing the wrong savings vehicle may result in higher taxes, lower returns, less liquidity, or penalties on withdrawals. For businesses, tax complexity injects uncertainty into hiring, capital investment, and other important decisions.

4. Inequality and unfairness. Although equality under the law is a bedrock principle of justice, taxpayers can pay greatly different tax rates. Households with similar incomes are often treated unequally as a result of exemptions, deductions, and credits related to such factors as education, homeownership, and children. Households are also subject to different tax rates because of their different incomes. IRS data for 2019 show that income taxes averaged 26 percent of adjusted gross income for the top 1 percent of households, but just 6 percent for households in the middle of the income distribution. It is true that middle-income households pay heavy payroll taxes, but households at the top still pay much higher overall effective tax rates. Looking at all federal taxes, the Congressional Budget Office found that the top fifth of households had an average tax rate of 24 percent in 2018, compared with 13 percent for the middle fifth of households.

5. Avoidance and evasion. Some members of Congress want to increase IRS powers to try to reduce avoidance and evasion. They want to expand mandatory information collection and reduce procedural safeguards for taxpayers to defend themselves against the IRS. But such policies would undermine civil liberties, and they are not needed in order to improve compliance. Instead, Congress should simplify the tax code and eliminate special-interest provisions, which are often manipulated and used in unplanned ways. The Low-Income Housing Tax Credit, for example, is intensely complicated and difficult for the IRS to oversee, and that has led to its being riddled with fraud by housing developers. The credit is unneeded and should be repealed.

Cutting overall tax burdens would also reduce avoidance and evasion. In a study using data across 157 countries, Mai Hassan and Friedrich Schneider noted: “It is widely accepted in the literature that the most important cause leading to the proliferation of the shadow economy is the tax burden. The higher the overall tax burden, the stronger are the incentives to operate informally in order to avoid paying the taxes.” With lower taxes and a simpler tax base, individuals and businesses would focus more on productive activities and less on tax avoidance and evasion.

Transparency

A simple and transparent tax system would give citizens a clear picture of the burden of government. If the federal government imposed a single tax at a single rate, it would be easy for people to compare the cost of government with the costs of other items in their budget, such as food and housing.

However, policymakers use many techniques to hide the burden of government. They run deficits, which defer taxes until the future. They collect income and payroll taxes through employer withholding to make paying taxes less obvious. And they conceal the size of the overall tax load by spreading the burden across multiple tax bases.

Policymakers also hide the tax burden from individuals by imposing taxes on businesses. The largest hidden tax is the employer half of the 15.3 percent payroll tax that funds Social Security and Medicare. This tax is not reported on worker pay stubs, but economists agree that the burden falls on workers in the form of lower wages. Another hidden tax is the corporate income tax, which is passed through to individuals in the form of higher prices, lower wages, and reduced returns on savings.

When tax burdens are hidden, people perceive the price of federal spending to be artificially low, and they demand too much of it. A major thrust of tax reform should be to make taxes simpler and more transparent so that people better understand the cost of government. For the payroll tax, one reform would be to show the entire tax on worker pay stubs and IRS W-2 forms so that the costs of Social Security and Medicare are more visible. For the income tax, the number of rate brackets should be reduced and as many deductions and credits eliminated as possible.

Economic Growth

American incomes would be higher and growth more robust if the size of the federal government was reduced. But it is also true that for any particular size of government, the economy would be stronger if marginal tax rates were lower and the tax base simpler and more neutral. Such reforms would minimize tax distortions that undermine working, saving, investing, and entrepreneurship.

The income tax distorts individual and business activities, which creates losses to the economy and individual welfare called "deadweight losses." The size of these losses rises rapidly as marginal tax rates rise. Harvard University's Greg Mankiw explains: "It is a standard proposition in economics that the deadweight loss of a tax rises approximately with the square of the tax rate. . . . If we double the size of a tax, the deadweight loss increases four-fold." Thus, a high-rate tax structure is much more damaging than a low-rate structure.

The highest rates are typically paid by individuals with the highest incomes, many of whom have unique and valuable skills. If higher tax rates induce doctors, for example, to work fewer hours and retire earlier, it would impose harm on patients and the overall economy. Or consider the effects of taxes on entrepreneurs. More than four-fifths of the top 0.1 percent of federal taxpayers report small-business income, and those taxpayers respond to tax changes by adjusting their working, hiring, and investing activities.

For every $1 billion tax increase, the harm to the private economy is more than $1 billion because of deadweight losses created by these taxpayer responses. The Congressional Budget Office found that "typical estimates of the economic [or deadweight] cost of a dollar of tax revenue range from 20 cents to 60 cents over and above the revenue raised." Former Harvard University professor Martin Feldstein estimated that deadweight losses from a marginal tax rate increase "may exceed one dollar per dollar of revenue raised, making the cost of incremental governmental spending more than two dollars for each dollar of government spending."

Tax reforms should reduce tax rates, but they should also reduce the tax code's bias against savings and investment. If individuals use their after-tax earnings for consumption, they pay no further income tax, but if they save their earnings for future consumption, they will pay further taxes on their returns to saving. To the extent this tax code bias reduces savings and investment, it reduces economic growth and, ultimately, worker incomes. Tax reforms should transition the tax code from an income tax base to a consumption base, which would make it neutral with respect to savings and investment.

For individuals, the tax code should be moved toward a consumption base by enacting universal savings accounts (USAs). Contributions to USAs would come from after-tax income, but all account earnings would be tax free. Individuals could withdraw funds tax free at any time for any reason, which would increase liquidity and encourage saving. Both Canada and the United Kingdom have enacted such accounts, and they have been hugely popular with individuals at all income levels. USAs would encourage people to build larger nest eggs and increase their personal financial security.

For businesses, the tax code should be moved toward a consumption base by substituting capital expensing for depreciation. Under expensing, businesses immediately deduct the costs of equipment and structures they purchase, rather than deducting the costs over a period of years. The TCJA allowed for full expensing of machinery and equipment but not structures, and the provision is only effective for five years before phasing out.

Tax Reform Steps

Simplify the tax-rate structure. Congress should reduce the number of tax-rate brackets and lower rates. A good initial goal would be to collapse the seven current rates to two rates of 10 and 25 percent. The long-term goal should be a tax code with a single rate and a neutral base that treats all economic activities equally.

Cut dividend and capital gains rates. Corporate equity is currently taxed at both the corporate and individual levels, which biases the tax code in favor of debt. To alleviate this distortion and encourage investment, Congress should cut the top individual tax rates on dividends and capital gains to 15 percent.

End most deductions and credits. Repeal narrow and special-interest tax breaks, including the mortgage interest deduction, the state and local tax deduction, the exemption for interest on state and local bonds, and virtually all tax credits.

Cut the corporate tax rate. The U.S. corporate tax rate—including the 21 percent federal rate and the average state rate—is 27 percent. The average global rate in 2021 was 24 percent, according to accounting firm KPMG, so the United States is higher than average even after the TCJA reforms. We should aim to have the best climate in the world for investing and hiring, so Congress should cut the federal corporate tax rate to 15 percent. Governments and the private sector can both win from corporate tax-rate cuts. The average corporate tax rate among high-income countries today is only about half the average rate in the early 1980s, yet corporate tax revenues have risen as a share of GDP since then.

Extend capital expensing. Congress should make the expensing reforms in the TCJA permanent and extend expensing to structures in addition to machinery and equipment. The goal is to increase investment and productivity, which in turn raises worker wages. Also, since innovations are embodied in new machinery and equipment, cutting taxes on capital investment supports technological advances.

Enact universal savings accounts. Congress should enact these all-purpose savings accounts, which could be used to save for medical costs, college expenses, buying a home, covering spells of unemployment, starting a business, or any other purpose. All personal savings—not just retirement savings—should be encouraged.

Repeal the estate tax. The federal estate or death tax has a top rate of 40 percent. It raises just half a percent of federal revenues but creates substantial economic harm. It reduces savings and creates a wasteful estate planning industry to help people avoid it. The death tax may not raise any money for the government overall because it likely suppresses income tax collections by reducing earnings incentives and depressing growth.

Enact a consumption-based flat tax. In recent decades, proposals to replace the federal income tax with a consumption-based flat tax have gained support because such reforms would simplify taxation, increase savings and investment, and spur growth. The reform steps discussed here would move toward such a system. About two dozen nations have enacted tax systems with single rates, as discussed in the Cato book *Global Tax Revolution* and at https://flattaxes.blogspot.com.

Major tax reforms will be harder to implement if Congress does not get spending under control. Rising spending pushes up budget deficits and creates pressure to reverse the TCJA tax reforms and to increase taxes in damaging ways, such as by raising taxes on capital and raising marginal rates. Spending cuts not only would reduce pressure for tax increases, but also would spur growth by retaining more resources in the productive private sector.

Suggested Readings

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