

Written Testimony before the U.S. Senate Committee on Finance

Hearing Title: “Examining How the Tax Code Affects High-Income Individuals and Tax Planning Strategies”

November 9, 2023

William McBride

Vice President of Federal Tax Policy and Stephen J. Entin Fellow in Economics, Tax Foundation

The Size and Distribution of the Federal Tax Burden

Chairman Wyden, Ranking Member Crapo, and distinguished members of the Senate Finance Committee, thank you for the opportunity to provide testimony on the distribution of the federal tax burden. I am William McBride, Vice President of Federal Tax Policy and Stephen J. Entin Fellow in Economics at the Tax Foundation, where I focus on how we can improve our federal tax code.

Today, my testimony will focus on four points. First, I will describe the current federal tax system, showing that tax collections in recent years are well above historical averages and the burden is highly progressive. Second, I will describe how the tax code’s increasing complexity adds to this burden, raising compliance costs for taxpayers and administrative costs for the Internal Revenue Service (IRS). Third, I will describe the economic costs of the tax code’s high marginal income tax rates, which slow economic growth and reduce living standards.

Finally, I will recommend ways to reform the federal tax code to reduce complexity and improve economic incentives, grow the economy, benefit low- and middle-income workers, and raise sufficient revenues at or above current levels.

Recent Federal Tax Collections Are Above Average and Set to Go Higher

As a result of the economic recovery coming out of the pandemic and surging inflation, federal tax collections hit an all-time high of \$4.9 trillion in fiscal year (FY) 2022, topping the prior year's record collections by \$850 billion.¹ As a share of gross domestic product (GDP), federal tax collections in FY 2022 reached a multi-decade high of about 19.4 percent, up from 17.6 percent in the prior fiscal year and near the last peak of 20.0 percent set during the dot-com bubble in FY 2000.²

Only two other years in U.S. history saw federal tax collections as a share of GDP exceed the FY 2022 level, both during World War II: in 1943, federal tax collections reached 20.5 percent of GDP before falling to 19.9 percent in 1944. FY 2022 tax collections exceeded the post-war average of 17.2 percent of GDP by 2.2 percentage points.

In FY 2022, individual income tax collections contributed the most to the surge in federal tax collections, growing 29 percent to \$2.6 trillion in FY 2022 from \$2.0 trillion in FY 2021. Payroll taxes grew 13 percent to \$1.5 trillion in FY 2022 from \$1.3 trillion in FY 2021, while corporate taxes grew 14 percent to \$425 billion from \$372 billion, and other revenues grew 13 percent to \$356 billion from \$316 billion.

Individual income tax collections reached 10.4 percent of GDP in FY 2022, the highest level on record. That level substantially exceeded the prior record of 9.9 percent of GDP set in FY 2000 as well as the World War II-era record of 9.2 percent of GDP set in FY 1944.³

The surge in individual income tax revenue is partly attributable to growth in capital gains revenue due to booming stock and housing markets in 2021, itself a function of inflationary fiscal and monetary stimulus during the pandemic.⁴ The Congressional Budget Office (CBO) estimates that capital gains realizations and revenue roughly doubled during the pandemic years: realizations grew to \$2.0 trillion in 2021 and \$1.7 trillion in 2022 from \$881 billion in 2019 while revenues grew to \$304 billion in FY 2021 and \$378 billion in FY 2022 from \$169 billion in FY 2019.⁵

As the inflationary boom of 2021 turned into a bust in 2022, and as the Federal Reserve raised interest rates to fight the inflation, federal tax collections dropped about 9 percent to \$4.4 trillion in FY 2023, or about 16.5 percent of GDP.⁶ The largest decline was for individual income taxes, which fell \$456 billion, or 17 percent, to \$2.2 trillion, apparently due in large part to a drop in revenue as the stock and housing markets deflated. CBO's preliminary analysis also points to "higher-than-anticipated claims" of the Employee Retention Credit, a pandemic-era program that spawned a cottage industry until the IRS recently halted

1 William McBride, "Inflation is Surging, So Are Federal Tax Collections," Tax Foundation, Oct. 13, 2022, <https://taxfoundation.org/federal-tax-collections-inflation-surging/>; Congressional Budget Office, Budget and Economic Data, <https://www.cbo.gov/data/budget-economic-data>.

2 Because the Bureau of Economic Analysis recently revised GDP up considerably for several recent years including 2022, tax revenue as a share of GDP has come down relative to earlier estimates.

3 Office of Management and Budget, Historical Tables, Table 2.3-Receipts by Source as Percentages of GDP: 1934-2028, <https://www.whitehouse.gov/omb/budget/historical-tables/>; A similar measure from the Bureau of Economic Analysis (BEA) indicates federal and state individual income taxes as a share of personal income reached an all-time high of 14.4 percent in calendar year 2022. See BEA, National Income and Product Accounts, Table 2.1 Personal Income and Its Disposition, <https://www.bea.gov/itable/national-gdp-and-personal-income>.

4 William McBride, "Inflation is Surging, So Are Federal Tax Collections," Tax Foundation, Oct. 13, 2022, <https://taxfoundation.org/federal-tax-collections-inflation-surging/>.

5 Congressional Budget Office, "The Budget and Economic Outlook: 2023 to 2033," February 15, 2023, <https://www.cbo.gov/publication/58848>; CBO, Budget and Economic Data, Revenue Projections, by Category, <https://www.cbo.gov/data/budget-economic-data#7>

6 Congressional Budget Office, "Monthly Budget Review: September 2023," Oct. 10, 2023, <https://www.cbo.gov/publication/59544>; William McBride, "Federal Deficit Grew to \$2 Trillion in FY 2023," Oct. 12, 2023, <https://taxfoundation.org/blog/federal-budget-deficit-2023/>

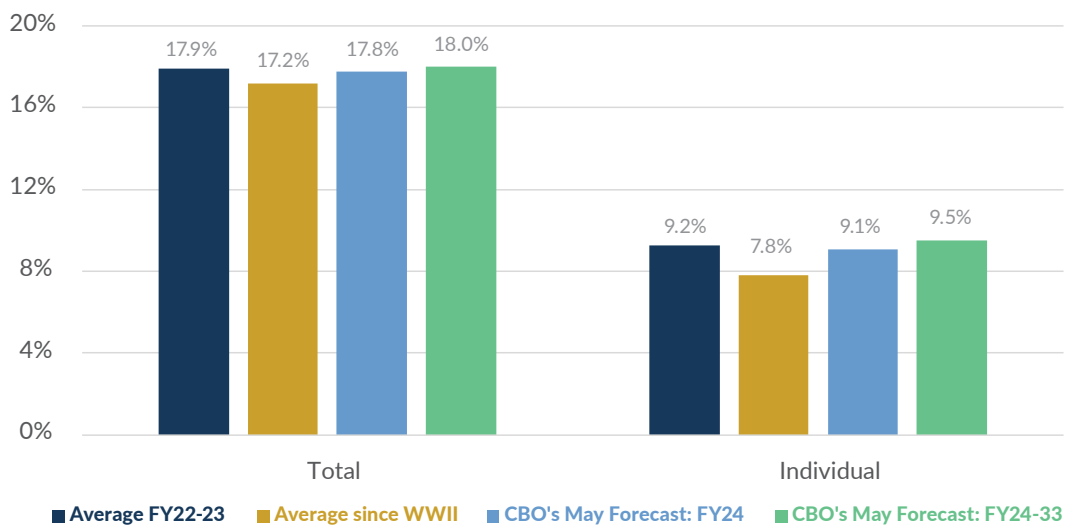
new claims due to rampant fraud. Individual income tax refunds were \$129 billion higher this year than last, a 52 percent increase. Another factor behind the decline, as noted by the CBO, is that the IRS postponed the filing deadline for taxpayers affected by natural disasters, including most taxpayers in California, until October 16 or later.

In contrast, payroll taxes grew 9 percent to \$1.6 trillion in FY 2023, reflecting growth in wages and jobs. Corporate income taxes were roughly flat, falling \$5 billion, or 1 percent, to \$420 billion, despite the introduction of the new minimum tax on corporate book income and the stock buyback tax, both part of the Inflation Reduction Act (IRA) enacted last year. Other receipts dropped \$124 billion, or 35 percent, to \$232 billion in FY 2023, primarily reflecting a near-zeroing out of remittances from the Federal Reserve as higher interest rates caused the central bank's interest expense to offset its income.

The extreme volatility in revenue collections over the last two years, marked by extraordinary capital gains in 2021 and most likely heavy losses in 2022, reflects a federal tax system that is heavily reliant on high-income investors (where capital gains and losses are concentrated), as we will see in more detail in the next section. It also means that future tax collections will depend a great deal on fluctuations in the economy, including the ups and downs of the stock market. As one indicator, the S&P 500 rose about 27 percent in 2021, dropped about 19 percent in 2022, and is up about 14 percent this year. This, and other one-time factors mentioned above, suggests FY 2024 collections may be closer to FY 2022 levels than FY 2023 levels.

Federal Tax Revenue above Historical Averages in Recent Years and Expected to Remain So under Current Law

Federal Tax Revenue as a Share of GDP



Source: CBO, OMB, BEA.

Simply averaging FY 2022 and FY 2023 together yields total federal tax collections of 17.9 percent of GDP, which is 0.7 percentage points above the historical average since WWII. Individual income tax collections average to 9.2 percent of GDP over the last two years, which is about 1.4 percentage points above the historical average. In addition, federal tax collections exhibit an upward trend resulting from many of the provisions of the Tax Cuts and Jobs Act (TCJA), including the phaseout of bonus depreciation that is set to occur over the next five years and the expiration of the individual income tax provisions at the end of 2025, as well as the permanent features that boost economic growth, especially the lower corporate tax rate.⁷ As such, under a current law baseline, we expect federal tax collections over the next several years to trend upwards towards 18 percent of GDP or higher, whereas full or partial extension of TCJA's expiring provisions would reduce revenue to a range of about 17 to 18 percent of GDP.⁸ Under current law, the CBO projects total collections of 18.0 percent of GDP and individual income tax collections of 9.5 percent of GDP on average from FY 2024 to FY 2033.⁹

Most of the Federal Tax Burden Is Paid by High Earners

By any objective measure, the U.S. tax code is extremely progressive and very redistributive. According to the latest IRS data for 2020, the top 5 percent of taxpayers (about 7.9 million filers who earn more than \$220,521) paid in aggregate \$1.1 trillion in income taxes, amounting to 62.7 percent of all income taxes paid that year.¹⁰ The top 1 percent of taxpayers (about 1.6 million filers who earn more than \$548,336) paid \$723 billion in income taxes, or 42.3 percent of all income taxes paid—a larger share than the bottom 95 percent of taxpayers combined.

The share of federal income taxes paid by the top 1 percent is higher than it has been in at least 20 years, according to IRS data.¹¹ In 2001, the top 1 percent's share of income taxes paid was 33.2 percent, then fluctuated with the business cycle and the ups and downs of the housing and stock markets, before rising steadily to its current high of 42.3 percent in 2020. The top 1 percent's share of income taxes could well go higher in 2021 and 2022 due to growth of capital gains revenue, which is paid primarily by high earners.

High income taxpayers also pay the highest tax rates, according to the IRS. The average income tax rate in 2020 was 13.6 percent. The top 5 percent of taxpayers paid a 22.4 percent average rate while the top 1 percent of taxpayers paid a 26.0 percent average rate—more than eight times higher than the 3.1 percent average rate paid by the bottom half of taxpayers. The top 0.001 percent, or the richest 1,575 tax returns filed in 2020, paid nearly \$71 billion in income taxes and had an average tax rate of 23.7 percent.

7 Tax Foundation, "Preliminary Details and Analysis of the Tax Cuts and Jobs Act," Dec. 18, 2017, <https://taxfoundation.org/research/all/federal/final-tax-cuts-and-jobs-act-details-analysis/>; William McBride and Alex Durante, "New Study Finds TCJA Strongly Boosted Corporate Investment," Tax Foundation, Oct. 21, 2023, <https://taxfoundation.org/blog/tcja-corporate-tax-economic-effects/>.

8 Our recent modeling of potential extensions of TCJA expiring provisions indicates full extension of all provisions as they were in 2021, including individual, estate, and business provisions, would reduce revenue to about 17 percent of GDP on average from FY 2024 to FY 2033 (dynamically scored, i.e., accounting for the policy's impacts on economic growth) whereas extension of only the business provisions would reduce revenue to about 17.7 percent of GDP.

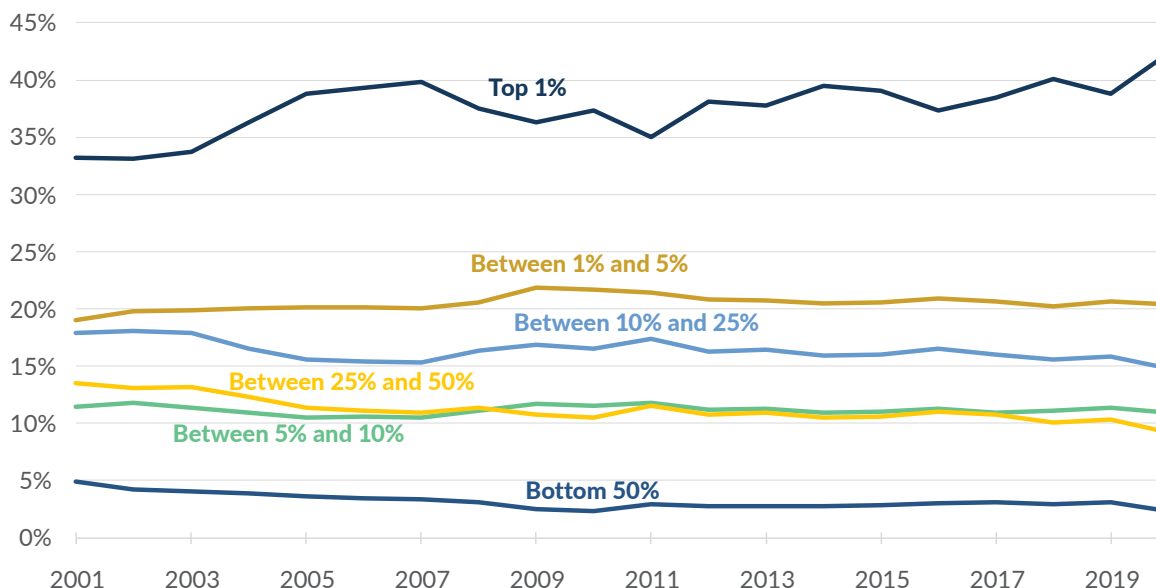
9 CBO, "An Update to the Budget Outlook: 2023 to 2033," May 12, 2023, <https://www.cbo.gov/publication/59096>.

10 Internal Revenue Service, *Statistics of Income*, "Number of Returns, Shares of AGI and Total Income Tax, AGI Floor on Percentiles in Current and Constant Dollars, and Average Tax Rates," Table 1, and "Number of Returns, Shares of AGI and Total Income Tax, and Average Tax Rates," Table 2, <https://www.irs.gov/statistics/soi-tax-stats-individual-income-tax-rates-and-tax-shares>; Erica York, "Summary of the Latest Federal Income Tax Data, 2023 Update," Tax Foundation, Jan. 26, 2023, <https://taxfoundation.org/publications/latest-federal-income-tax-data/>.

11 Erica York, "Summary of the Latest Federal Income Tax Data, 2023 Update," Tax Foundation, Jan. 26, 2023, <https://taxfoundation.org/publications/latest-federal-income-tax-data/>.

The Top 1 Percent's Share of Income Taxes Has Increased Over Time

Shares of Income Taxes by Income Group, 2001-2020



Source: IRS, Statistics of Income, Individual Income Rates and Tax Shares.

The average tax rate for the top 0.001 percent is slightly lower than that of the top 1 percent because a larger share of the top 0.001 percent's income is capital gains, which face a lower rate schedule. One justification for the lower rate is that capital gains income is earned in an environment where other taxes have already been applied. In particular, shareholder taxes on capital gains and dividends essentially apply on top of the corporate income tax of 21 percent. That is, the same dollar of corporate income is first taxed by the corporate income tax and then taxed again when distributed to shareholders in the form of capital gains and dividends. Note that the shares and average tax rates cited above do not reflect the additional burden of the corporate income tax.¹²

Analysis from the CBO provides a more complete picture of the distribution of the federal tax burden. When accounting for individual income taxes—including the outlay portion of refundable tax credits—corporate income taxes, payroll taxes, estate taxes, and excise taxes, CBO finds that the federal tax system, as a whole, is progressive.¹³ The latest data indicates that households in the highest income quintile paid about 69 percent of all federal taxes in 2019, and the top 1 percent of households paid about 25 percent of all federal taxes.¹⁴ In contrast, the bottom quintile of households paid about 0.1 percent of all federal taxes.

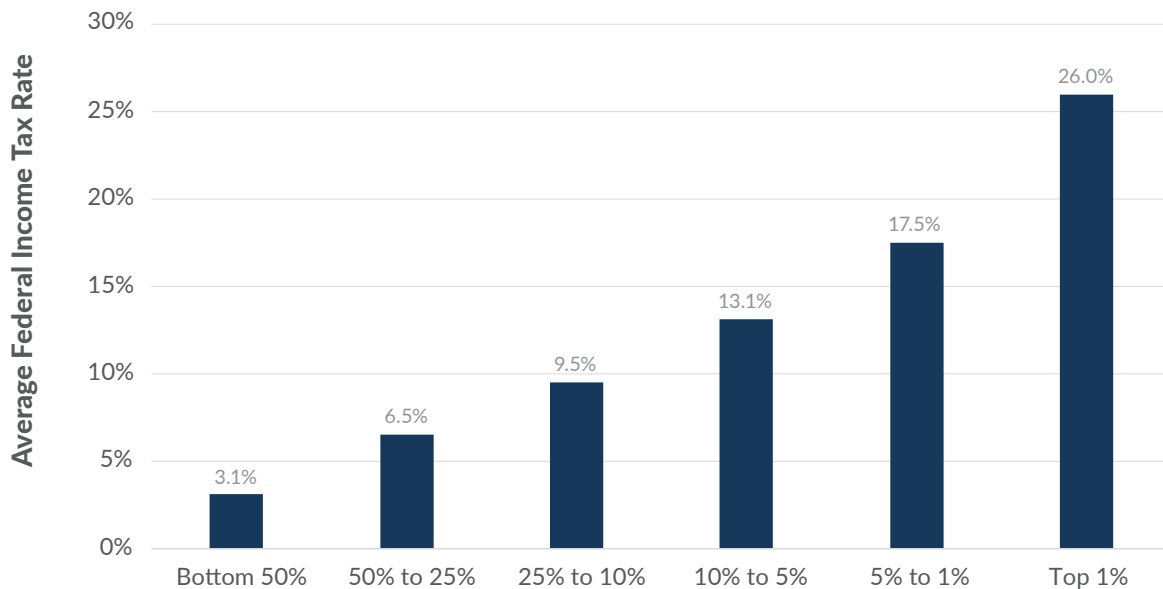
¹² The IRS statistics on shares and average tax rates also do not include the outlay portion of refundable tax credits, such as the Earned Income Tax Credit (EITC) and the Child Tax Credit (CTC), which if included would reduce further the average tax rates paid by low-income filers and increase the share of federal income taxes paid by high-income filers.

¹³ Congressional Budget Office, "The Distribution of Household Income 2019," Nov. 15, 2022, <https://www.cbo.gov/system/files/2022-11/58353-HouseholdIncome.pdf>; Garrett Watson, "CBO Analysis Finds Income Growth and Progressive Tax Code in 2019," Tax Foundation, Jan. 10, 2023, <https://taxfoundation.org/us-income-growth-progressive-tax-code/>.

¹⁴ In CBO's analysis, the top 1 percent income group represents about 1.2 million households. Income thresholds defining each income group vary by household size. For example, a one person household in the top 1 percent of income earns more than \$447,200 in 2019 while a four person household in the top 1 percent earns more than \$894,400.

High-Income Taxpayers Paid the Highest Average Income Tax Rates

Average Federal Income Tax Rate by Income Group, 2020

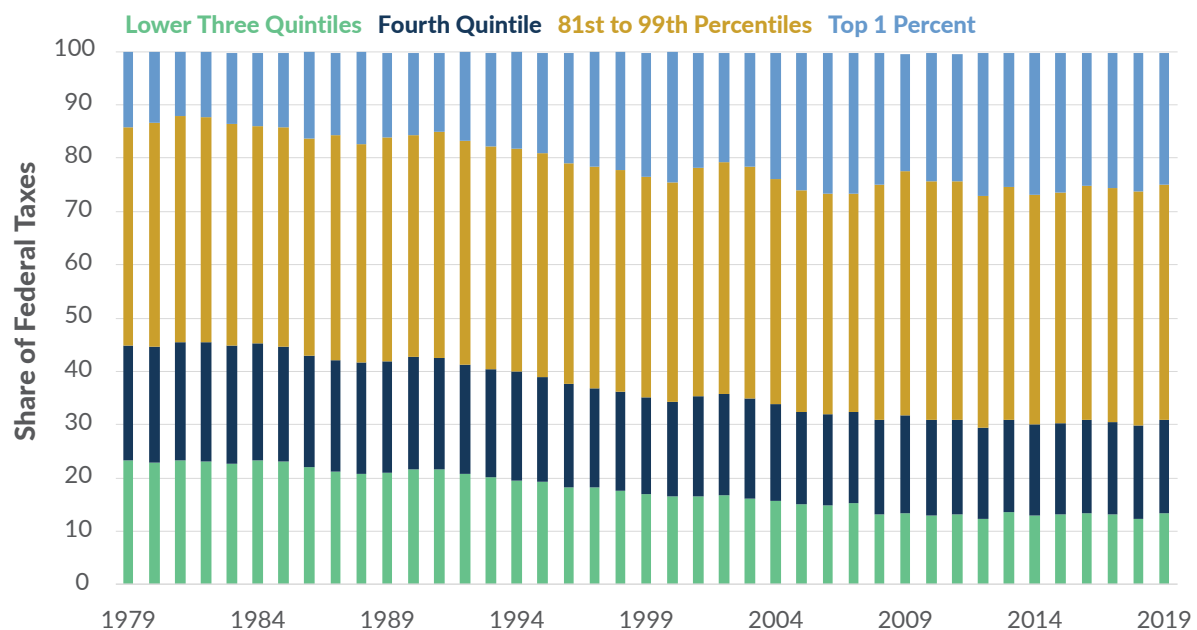


Source: IRS, Statistics of Income, Individual Income Rates and Tax Shares.

Like the IRS data on federal income taxes, the CBO analysis indicates the share of all federal taxes paid by high earners has grown over time. For example, the share of federal taxes paid by households in the top 1 percent has approximately doubled to about 25 percent in 2019 from roughly 12 percent in the early 1980s.

The Top 1 Percent Pays About 25 Percent of All Federal Taxes

Shares of Federal Taxes, 1979 to 2019



Source: Congressional Budget Office, "The Distribution of Household Income, 2019," Exhibit 16

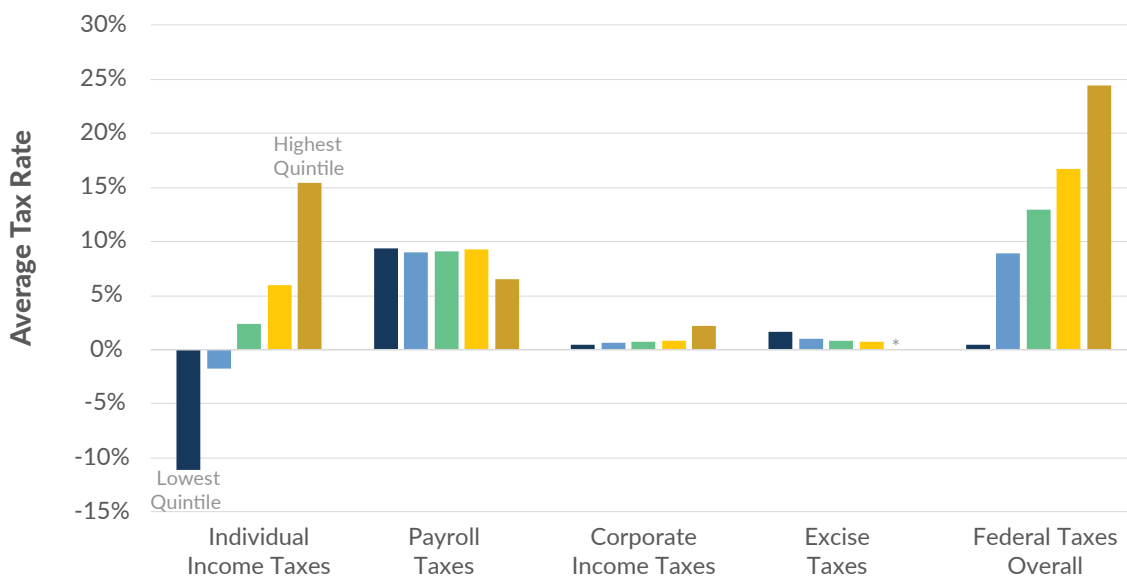
Furthermore, the CBO analysis indicates that average federal tax rates increase substantially with income. For example, the top quintile of households paid an average federal tax rate of 24.4 percent in 2019 and the top 1 percent of households paid an average federal tax rate of 30.0 percent. In contrast, the bottom quintile paid an average federal tax rate of 0.5 percent, reflecting the fact that refundable tax credits for this group almost entirely offset payroll taxes and other federal taxes.

The CBO notes that within the top 1 percent's average federal tax rates are relatively flat at about 30 percent, as the effect of lower capital gains tax rates are offset by higher average corporate tax rates.¹⁵ For example, the top 0.01 percent of households paid an average federal tax rate of 30.2 percent in 2019.

Over time, the average federal tax rate paid by the top 1 percent has remained within a range of about 25 to 35 percent since 1979, and as of 2019 is about in the middle of that range and close to the average of 30.5 percent over the period 1979 to 2019. However, the average federal tax rate for the bottom quintile has declined substantially, to nearly zero in 2019 due to the introduction and expansion of refundable tax credits from a high of about 12 percent in 1984.

Average Federal Tax Rates Vary Highly by Tax Type and Income Level and are Progressive Overall

Average Federal Tax Rates by Tax Source, 2019



* The highest quintile has an effective federal excise tax rate between 0 and 0.5 percent.
Source: Congressional Budget Office, "The Distribution of Household Income, 2019," Exhibit 13

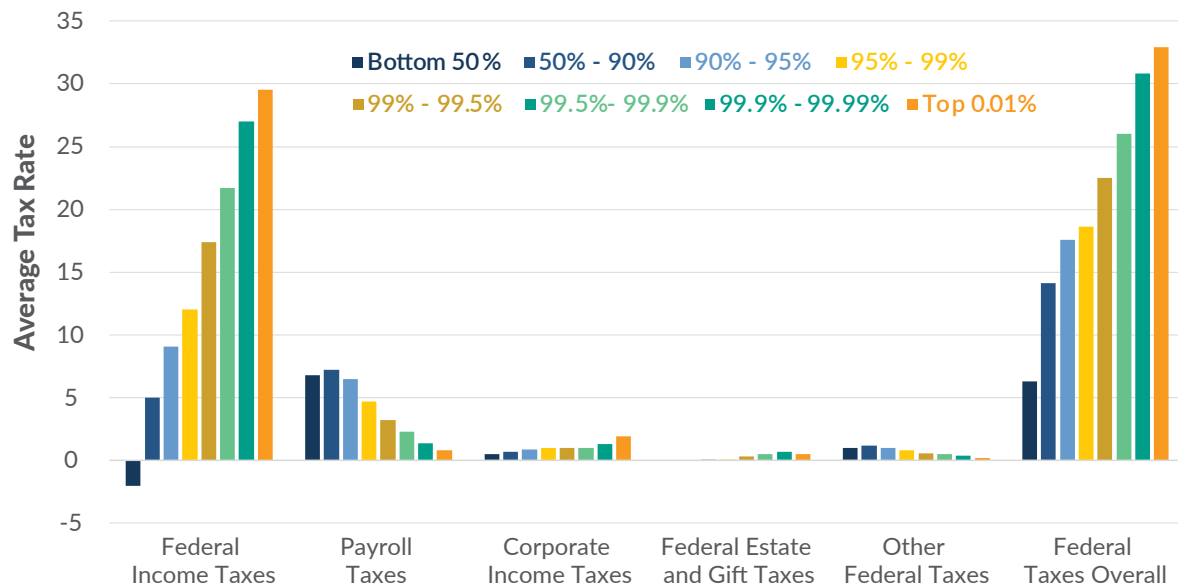
Data from the Joint Committee on Taxation (JCT) confirms that average federal tax rates consistently rise with income. When including all federal taxes, the bottom 50 percent of taxpayers face an average federal tax rate of 6.3 percent, compared to an average rate of 24.8 percent for the top 1 percent of taxpayers. The federal income tax is the most progressive of the federal taxes, with corporate income taxes and estate and gift taxes also adding to federal progressivity. The progressive tax sources more than offset

¹⁵ In CBO's analysis, 75 percent of corporate income taxes are allocated to owners of capital in proportion to their income from interest, dividends, rents, and adjusted capital gains, and 25 percent to workers in proportion to their labor income.

payroll taxes and excise taxes that apply higher average tax rates to lower income groups. The JCT data also shows average federal taxes rise within the top 1 percent, from an average tax rate of 22.6 percent for those in the 99th to 99.5th percentiles of income to 32.9 percent for the top 0.01 percent of earners, representing about 15,000 taxpayers in the United States.

Average Federal Tax Rates Vary Highly by Tax Type and Income Level and are Progressive Overall

Average Federal Tax Rates by Tax Source and Income Group by Percentile, 2018



Source: JCT; Other federal taxes are mostly excise taxes and customs duties.

Tax Code's Complexity Adds to the Burden

By any measure, the federal tax code is extremely complex. Totalling more than 6,000 pages and about 4 million words (plus about 15,000 pages of associated tax law interpretations), no taxpayer can reasonably be expected to fully comprehend it.¹⁶ The complexity derives in part from the basic challenge of defining and taxing income, an endeavor the country embarked on more than 100 years ago. Every Congress and administration since has revised and added to an accumulating pile of deductions, credits, and special provisions. By official measures, there are now more than 200 such special provisions known as “tax expenditures,” costing about \$2 trillion annually. In the last three years alone more than 100 tax expenditures have been created or amended.¹⁷

¹⁶ Demian Brady, “Tax Complexity 2021: Compliance Burdens Ease for Third Year Since Tax Reform,” NTU, April 15, 2021, <https://www.ntu.org/foundation/detail/tax-complexity-2021-compliance-burdens-ease-for-third-year-since-tax-reform>.

¹⁷ The Joint Committee on Taxation, “Estimates of Federal Tax Expenditures for Fiscal Years 2022-2026,” Dec. 22, 2022, <https://www.jct.gov/publications/2022/jcx-22-22/>; Treasury Department, “Tax Expenditures,” <https://home.treasury.gov/policy-issues/tax-policy/tax-expenditures>.

While some tax expenditures are important structural elements of the tax code, many are complicated and disproportionately benefit specific industries or types of households.¹⁸ The CBO finds about half of the total income tax benefits of expenditures go to high-income households.¹⁹

The Inflation Reduction Act (IRA), enacted last year, adds several complicated provisions to the tax code, including a book minimum tax, a stock buyback tax, and more than 20 different tax subsidies for green energy. All of these require extensive regulatory guidance which continues to roll out even as much of the law took effect at the beginning of this year.²⁰ Taxpayers, too, have highlighted several remaining concerns and ambiguities in the law (e.g., reporting requirements and applicable financial statements for the book minimum tax, and domestic content rules for the green energy tax credits).²¹

The uncertainty in the law also translates into uncertainty about the budgetary costs and distributional impacts. For example, researchers now estimate the budgetary cost of the IRA's green energy credits and subsidies will exceed \$1 trillion over a decade, three times the original cost estimated by the CBO and the JCT, with the benefits accruing mainly to high earners.²²

In the same month the IRA was enacted, Congress passed the CHIPS and Science Act, which provides billions of dollars of targeted (and complex) incentives and investment tax credits for semiconductor manufacturing, along with a variety of eligibility and reporting requirements.²³

In 2022 (before the IRA or the CHIPS Act), Americans spent more than 6.5 billion hours trying to comply with the tax code, according to the latest estimates from the White House Office of Information and Regulatory Affairs (OIRA).²⁴ Based on wage and benefit estimates for tax preparers and certified public accountants, we estimate the hourly compliance costs of the tax code equates to about \$313 billion each year in lost productivity, or 1.4 percent of GDP.²⁵ The compliance burden for individual taxpayers is nearly \$74 billion annually, while the burden on corporate entities of complying with just their income tax returns is more than \$60 billion. Much of the remaining \$179 billion of costs comes from complying with hundreds of other business tax forms and regulations, such as those relating to depreciation and amortization. Compliance with income tax returns for estates and trusts costs \$18 billion a year, approaching the amount of tax revenue raised by the estate tax.

18 Alex Muresianu, "JCT Tax Expenditure Report: Not All Expenditures Are Created Equal," Tax Foundation, Feb. 13, 2023, <https://taxfoundation.org/largest-tax-expenditures-saving-investment-tax/>; Erica York and William McBride, "Lawmakers Could Pay for Reconciliation While Improving the Tax Code," Tax Foundation, Oct. 25, 2021, <https://taxfoundation.org/pay-for-reconciliation-tax/>.

19 Congressional Budget Office, "Distribution of Major Expenditures in 2019," October 2021, <https://www.cbo.gov/system/files/2021-10/57413-TaxExpenditures.pdf>.

20 William McBride, Alex Muresianu, Erica York, and Michael Hartt, "Inflation Reduction Act One Year After Enactment," Tax Foundation, Aug. 16, 2023, <https://taxfoundation.org/research/all/federal/inflation-reduction-act-taxes/>; Internal Revenue Service, "Latest Updates on the Inflation Reduction Act of 2022," <https://www.irs.gov/inflation-reduction-act-of-2022>.

21 William McBride, Alex Muresianu, Erica York, and Michael Hartt, "Inflation Reduction Act One Year After Enactment," Tax Foundation, Aug. 16, 2023, <https://taxfoundation.org/research/all/federal/inflation-reduction-act-taxes/>.

22 Ibid; John Bistline, Neil Mehrotra, and Catherine Wolfram, "Economic Implications of the Climate Provisions of the Inflation Reduction Act," Brookings Papers on Economic Activity, March 2023, https://www.brookings.edu/wp-content/uploads/2023/03/BPEA_Spring2023_Bistline-et-al_unembargoedUpdated.pdf; Jason Furman, "Comment on 'Economic Implications of the Climate Provisions of the Inflation Reduction Act,'" Mar. 30, 2023, https://www.brookings.edu/wp-content/uploads/2023/02/2b_20230330-BPEA-climate-furman-comment.pdf; Christine McDaniel, "The Cost of Battery Production Tax Credits Provided in the IRA," Forbes, Feb. 1, 2023, <https://www.forbes.com/sites/christinemcdaniel/2023/02/01/the-cost-of-battery-production-tax-credits-provided-in-the-ira/?sh=362fc62279ef>; Christine McDaniel, "The Costs of Wind Production Tax Credits Provided in the IRA," Forbes, Mar. 8, 2023, <https://www.forbes.com/sites/christinemcdaniel/2023/03/08/the-costs-of-wind-production-tax-credits-provided-in-the-ira/?sh=7cd6f4295ff7>; Goldman Sachs, "Carbonomics: The Third American Energy Revolution," Mar. 22, 2023.

23 Erica York, "Careful What You Wish For: CHIPS Subsidies Require 'Excess Profits' Sharing," Tax Foundation, Mar. 2, 2023, <https://taxfoundation.org/biden-semiconductor-chips-act-subsidies/>.

24 White House Office of Information and Regulatory Affairs, Information Collection Review, <https://www.reginfo.gov/public/do/PRAMain>.

25 Scott Hodge, "The Tax Compliance Costs of IRS Regulations," Tax Foundation, Aug. 23, 2022, <https://taxfoundation.org/tax-compliance-costs-irs-regulations/>.

Our estimate of compliance costs does not include the cost of tax planning, which is a significant industry on its own. Nor does it include the cost of uncertainty in the law for taxpayers, which makes planning for taxes as well as investment and other economic activities difficult and costly.

The majority of the compliance burden is from the complex taxing of business income, which involves tracking and reporting multiple items of income and expense to arrive at net taxable income and allowing offsets from net income to account for past losses (in a typical year roughly 40 percent of companies are in a loss position).²⁶ In addition, the U.S. tax code contains several business credits, exclusions, and other special provisions that increase compliance costs. Multinational corporations face a slew of complex provisions that subject various types of foreign income and cross-border transactions to tax, including Subpart F, Global Intangible Low-Taxed Income (GILTI), Foreign-Derived Intangible Income (FDII), and Base Erosion and Anti-Abuse Tax (BEAT).²⁷

For individual filers, compliance costs generally increase proportionally with income, such that most of the compliance burden is borne by high earners.²⁸ High earning individuals typically have multiple sources of income beyond wages, including capital gains, dividends, rents, royalties, and pass-through business income from partnerships and S corporations (income from these business forms is subject to individual income tax rather than corporate income tax).

Another aspect of the tax code's complexity is the administrative costs and challenges for the IRS, an agency whose responsibilities have grown well beyond simple revenue collection to include administration of subsidies and benefits relating to children, health care, education, housing, energy, the environment, economic stimulus, and more.²⁹ Pursuant to its expanded role, in FY 2021 the IRS processed some 261 million returns and forms and received some 4.7 billion pieces of information, detailing the composition and activities of nearly every American household and business.³⁰ In recent years, the IRS has found itself literally buried in paperwork, resulting in processing delays, millions of returns backlogged, and poor customer service.³¹ Last year, for instance, the IRS answered only about 13 percent of the 173 million phone calls it received from taxpayers asking for help; those who got through waited an average of 29 minutes.³²

IRS customer service improved considerably this filing season, due partly to reduced demand as many complicated pandemic-era policies expired, such as the 2021 expanded child tax credit, as well as new funding from the IRA and a shift in resources towards phone service.³³ For example, call volume dropped by more than half, returning to "normal" levels seen pre-pandemic in which the IRS received some 30

26 Arthur P. Hall, "House Way & Means Committee Testimony: Compliance Costs of Alternative Tax Systems II," Tax Foundation, March 1996, https://files.taxfoundation.org/legacy/docs/8926e37c5827f958604933276fcb4864.pdf?_gl=1*1bocc81*_ga*MijkNjU2MTcuMTY4MDg2NjcyOA.*_ga_FP7KWDV08V*MTY4M-TI5MzY4Ni40LjEuMTY4MTI5MzcwNy45LjAuMA.

27 Kyle Pomerleau, "A Hybrid Approach: The Treatment of Foreign Profits under the Tax Cuts and Jobs Act," Tax Foundation, May 3, 2018, <https://taxfoundation.org/treatment-foreign-profits-tax-cuts-jobs-act/>.

28 Daniel Berger, Eric Toder, Victoria Bryant, John Guyton, and Patrick Langetieg, "Estimating the Effects of Tax Reform on Compliance Burdens," Urban Institute, May 19, 2018, <https://www.urban.org/research/publication/estimating-effects-tax-reform-compliance-burdens>.

29 Alex Muresianu and Garrett Watson, "Chaotic IRS Filing Season Shows the Perils of Running Social Policy Through the Tax Code," Tax Foundation, Apr. 18, 2022, <https://taxfoundation.org/irs-filing-season-2022/>.

30 Internal Revenue Service, Data Book 2021, May 2022, <https://www.irs.gov/statistics/soi-tax-stats-irs-data-book>; Joseph Bishop-Henchman, "Transforming the Internal Revenue Service," Cato Institute, Apr. 11, 2023, <https://www.cato.org/policy-analysis/transforming-internal-revenue-service/>.

31 Internal Revenue Service National Taxpayer Advocate, "2022 Annual Report to Congress," Jan. 11, 2023, <https://www.taxpayeradvocate.irs.gov/news/national-taxpayer-advocate-delivers-2022-annual-report-to-congress/>; Joseph Bishop-Henchman, "Transforming the Internal Revenue Service," Cato Institute, Apr. 11, 2023, <https://www.cato.org/policy-analysis/transforming-internal-revenue-service/>.

32 Internal Revenue Service National Taxpayer Advocate, "2022 Annual Report to Congress," Jan. 11, 2023, <https://www.taxpayeradvocate.irs.gov/news/national-taxpayer-advocate-delivers-2022-annual-report-to-congress/>.

33 Erin Collins, "Objectives Report to Congress, Fiscal Year 2024," National Taxpayer Advocate, June 2023, <https://www.taxpayeradvocate.irs.gov/reports/2024-objectives-report-to-congress/>; William McBride, Alex Muresianu, Erica York, and Michael Hartt, "Inflation Reduction Act One Year After Enactment," Tax Foundation, Aug. 16, 2023, <https://taxfoundation.org/research/all/federal/inflation-reduction-act-taxes/>.

million to 40 million calls from taxpayers during the filing season. The IRS answered about 34 percent of calls this filing season and substantially reduced wait times. In addition, the IRS was able to significantly reduce its backlog of returns.

However, other performance metrics worsened, including longer processing delays for taxpayer correspondence and amended returns. As well, the number of backlogged identity theft cases increased 46 percent to about 465,000 as of April, requiring about 15 months to resolve on average.³⁴ Making matters worse, some aspects of the tax code became more complex, consuming more IRS resources and detracting from other core duties. For instance, earlier this year, the IRS requested an additional \$3.9 billion in funding to further implement the IRA's green energy tax credits.³⁵ Clearly, there is room for further improvement, as an overly complex tax code presents ongoing administrative challenges at the IRS that are also problematic for taxpayers.

A report from the Government Accountability Office (GAO) sheds light on the challenges faced by the IRS and taxpayers as a result of the increasing complexity of the code.³⁶ The report finds that the average number of hours the IRS spends per audit has increased about 30 percent in recent years, to 6.5 hours in 2021 from 5.0 hours in 2010. The increase is concentrated in high-income returns. Average hours per audit increased 209 percent for incomes of \$5 million and above, to about 58 hours in 2021 from about 19 hours per return in 2010. Average hours per audit increased 118 percent for incomes between \$500,000 and \$5 million, to 34 hours from about 16, and 103 percent for incomes between \$200,000 and \$500,000, from about 10 to 21 hours. In contrast, audits for incomes below \$200,000 took considerably less time—about 2 hours on average for incomes below \$25,000, and 6 hours for incomes between \$25,000 and \$200,000, and this remained stable over this period.

The GAO report notes that IRS officials attribute the increase in average audit hours to “greater complexity of higher-income audits and increased case transfers due to auditor attrition.” The GAO report mentions several legislative changes that have added to the IRS's responsibilities in recent years, including the Patient Protection and Affordable Care Act, the Foreign Account Tax Compliance Act, the TCJA, as well as some 496 million stimulus payments totaling \$837 billion as part of the CARES Act and other pandemic relief packages. (Note the GAO report was published before enactment of the IRA or CHIPS Act.)

As a measure of the efficiency of audits, or the “bang for the buck,” the GAO compared the recommended additional tax with hours spent on audits. The GAO found that audits of the highest income returns—those with income of \$5 million or more—resulted in the highest amounts of recommended additional tax per audit hour (\$4,880 in 2021), followed by audits of those claiming the EITC (\$3,130) and those reporting less than \$25,000 of income (\$2,120). In aggregate, the majority of the total recommended additional tax came from audits of taxpayers with income below \$200,000. On average, roughly half of recommended additional amounts are ultimately collected, however the collection rate for EITC returns exceeds 70 percent since these audits are typically done prior to issuing refunds.

34 Erin Collins, “Objectives Report to Congress, Fiscal Year 2024,” National Taxpayer Advocate, June 2023, <https://www.taxpayeradvocate.irs.gov/reports/2024-objectives-report-to-congress/>.

35 Internal Revenue Service, “Inflation Reduction Act Strategic Operating Plan,” Apr. 5, 2023, <https://www.irs.gov/pub/irs-pdf/p3744.pdf>.

36 Government Accountability Office, “Tax Compliance: Trends of IRS Audit Rates and Results for Individual Taxpayers by Income,” May 17, 2022, <https://www.gao.gov/products/gao-22-104960>.

Lastly, the GAO report documents that audit rates for individual income tax returns have decreased for all income levels, dropping to 0.25 percent in 2019 from an average of 0.9 percent in 2010, which IRS officials attribute mainly to reduced staffing as a result of reduced funding. Audit rates decreased the most for high earners because, according to IRS officials, these audits are generally more complex and require more staff time to complete.

Simplifying the tax code would reduce IRS resources required to more effectively administer it, including by reducing the time needed to audit the currently complex returns of high earners. A simpler tax code would also reduce taxpayer confusion so that there would be less need for the IRS to produce volumes of guidance and respond to millions of taxpayer calls for assistance. Less confusion on the part of taxpayers would also boost compliance.³⁷ As the IRS Taxpayer Advocate explains: “Simplifying the Code and eliminating complexities in the IRS’s procedures would reduce taxpayer compliance burdens by making it easier for taxpayers to understand their filing and payment obligations, and it would also make it easier for the IRS to administer the tax laws. Thus, simplification is essential to the integrity of the U.S. tax system and will enhance voluntary compliance.”³⁸

The Economic Cost of High Marginal Income Tax Rates

Decades of economic research amply demonstrates the steep cost of high marginal income tax rates that arises from disincentives to work, save, and invest.³⁹ The economic harm of income taxes increases with the square of the tax rate, meaning high income tax rates come with a disproportionately large additional excess burden. This burden is over and above the tax revenue collected, manifesting itself over the course of several years as a drag on economic growth through less investment, less innovation, fewer jobs, and lower wages.⁴⁰

A study based on postwar tax reforms in the United States found that reducing marginal tax rates on individual income for the top 1 percent of earners leads to increases in real GDP and declines in unemployment, with a 1 percentage point cut in the tax rate increasing real GDP by 0.78 percent by the third year after the tax change.⁴¹ Given the size of the U.S. economy today, that equates to about \$204 billion in additional GDP for each 1 percentage point cut in the marginal tax rate on individual income earned by the top 1 percent. The study shows the benefits of the resulting economic growth would be felt throughout the economy.

In looking at the experience of developed countries over the period 1971 to 2004, researchers at the Organisation of for Economic Co-operation and Development (OECD) concluded that “a reduction in the

37 Garrett Watson, “Closing the Tax Gap and Improving the Tax Code Are Complementary Goals,” Tax Foundation, November 21, 2019, <https://taxfoundation.org/closing-tax-gap-improving-tax-code/>.

38 Erin Collins, “Objectives Report to Congress, Fiscal Year 2024,” National Taxpayer Advocate, June 2023, <https://www.taxpayeradvocate.irs.gov/reports/2024-objectives-report-to-congress/>.

39 N. Gregory Mankiw, Matthew Weinzierl, and Danny Yagan, “Optimal Taxation in Theory and Practice,” *Journal of Economic Perspectives* 2009, volume 23(4), <https://eml.berkeley.edu/~yagan/OptimalTaxation.pdf>; William McBride, “What Is the Evidence on Taxes and Growth,” Tax Foundation, Dec. 18, 2012, <https://www.tax-foundation.org/what-evidence-taxes-and-growth/>; Alex Durante, “Reviewing Recent Evidence of the Effect of Taxes on Economic Growth,” Tax Foundation, May 21, 2021, <https://taxfoundation.org/reviewing-recent-evidence-effect-taxes-economic-growth/>; Timothy Vermeer, “The Impact of Individual Income Tax Changes on Economic Growth,” Tax Foundation, June 14, 2022, <https://taxfoundation.org/income-taxes-affect-economy/>.

40 Robert Carroll, “The Excess Burden of Taxes and the Economic Cost of High Tax Rates,” Tax Foundation, August 2009, <https://files.taxfoundation.org/legacy/docs/sr170.pdf>; Martin Feldstein, “Tax Avoidance and the Deadweight Loss of the Income Tax,” *The Review of Economics and Statistics* 81:4 (November 1999): 674-680, <https://www.jstor.org/stable/2646716>.

41 Karel Mertens and José Luis Montiel Olea, “Marginal Tax Rates and Income: New Time Series Evidence,” *The Quarterly Journal of Economics* 133:4 (November 2018), <https://academic.oup.com/qje/article-abstract/133/4/1803/4880451?redirectedFrom=fulltext>.

top marginal [individual] tax rate is found to raise productivity in industries with potentially high rates of enterprise creation. Thus, reducing top marginal tax rates may help to enhance economy-wide productivity in OECD countries with a large share of such industries.”⁴²

The CBO modeled three types of tax increases to fund a permanent increase in government spending of 10 percent of GDP annually: a flat labor tax, a flat income tax, and a progressive income tax. The CBO found that a progressive income tax is the most economically damaging of the three options, reducing GDP by 10 percent after 10 years, and reducing lifetime consumption and hours worked, especially for younger households.⁴³

Corporate income taxes are generally more economically damaging than individual income taxes, since they make investment opportunities less profitable on an after-tax basis for corporations, reducing the likelihood that marginal investments will be pursued. In most countries including the U.S., business investment makes up the bulk of all private sector investment; more uniquely in the U.S., about half of business investment is done by corporations and the other half by pass-through businesses subject to individual income taxes.

An OECD study examining data from 63 countries concluded that corporate income taxes are the most economically damaging way to raise revenue, followed by individual income taxes, consumption taxes, and property taxes.⁴⁴ A study on taxes in the United Kingdom found that taxes on consumption are less economically damaging than taxes on corporate and individual income.⁴⁵ A study of U.S. tax changes since World War II found that a 1 percentage point cut in the average corporate tax rate raises real GDP per capita by 0.6 percent after one year, a somewhat larger impact than a similarly sized cut in individual income taxes.⁴⁶ Based on U.S. state taxes, a study found that a 1 percentage point cut in the corporate tax rate leads to a 0.2 percent increase in employment and a 0.3 percent increase in wages.⁴⁷

Furthermore, several studies demonstrate that the corporate tax is borne in part by workers.⁴⁸ For instance, a study of corporate taxes in Germany found that workers bear about half of the tax burden in the form of lower wages, with low-skilled, young, and female employees disproportionately harmed.⁴⁹

The corporate tax is also borne by owners of shares, including retirees earning considerably less than \$400,000. In the short run, the JCT assumes owners of capital bear all of the corporate tax, yet that includes more than 90 million tax filers earning less than \$200,000. In the long run, the JCT assumes

42 Åsa Johansson, Christopher Heady, Jens Arnold, Bert Brys, Cyrille Schwellnus, & Laura Vartia, “Taxation and Economic Growth.”

43 Congressional Budget Office, “The Economics of Financing a Large and Permanent Increase in Government Spending: Working Paper 2021-03,” Mar. 22, 2021, <https://www.cbo.gov/publication/57021>; see also Garrett Watson, “Congressional Budget Office and Tax Foundation Modeling Show That Some Tax Hikes Are More Damaging Than Others,” Tax Foundation, Mar. 26, 2021, <https://www.taxfoundation.org/tax-hikes-are-more-damaging-than-others-analysis/>.

44 Åsa Johansson, Christopher Heady, Jens Matthias Arnold, Bert Brys, and Laura Vartia, “Taxation and Economic Growth,” Organisation for Economic Co-Operation and Development Working Paper No. 620, July 3, 2008, https://www.oecd-ilibrary.org/economics/taxation-and-economic-growth_241216205486.

45 Ahn D. M. Nguyen, Luisanna Onnis, and Raffaele Rossi, “The Macroeconomic Effects of Income and Consumption Tax Changes,” *American Economic Journal: Economic Policy* 13:2 (May 2021), <https://www.aeaweb.org/articles?id=10.1257/pol.20170241&&from=f>.

46 Karel Mertens and Morten O. Ravn, “The Dynamic Effects of Personal and Corporate Income Tax Changes in the United States,” *American Economic Review* 103:4 (June 2013), <https://www.aeaweb.org/articles?id=10.1257/aer.103.4.1212>.

47 Alexander Ljungqvist and Michael Smolyansky, “To Cut or Not to Cut? On the Impact of Corporate Taxes on Employment and Income,” National Bureau of Economic Research Working Paper No. 20753 (October 2018), https://www.nber.org/system/files/working_papers/w20753/w20753.pdf.

48 Stephen J. Entin, “Labor Bears Much of the Cost of the Corporate Tax,” Tax Foundation, Oct. 24, 2017, <https://www.taxfoundation.org/labor-bears-corporate-tax/>; and Alex Durante, “Who Bears the Burden of Corporate Taxation? A Review of Recent Evidence,” June 10, 2021, <https://www.taxfoundation.org/who-bears-burden-corporate-tax/>.

49 Clemens Fuest, Andreas Peichl, and Sebastian Sieglöckh, “Do Higher Corporate Taxes Reduce Wages? Micro Evidence from Germany,” *American Economic Review* 108:2 (February 2018): 393–418, <https://www.doi.org/10.1257/aer.20130570>.

workers bear a portion of the corporate tax, such that the burden falls on more than 150 million tax filers earning less than \$200,000.⁵⁰

Another factor to consider regarding the corporate tax in particular is competitiveness with respect to our major trading partners, as corporate investment is highly mobile internationally and will flow to lower tax locations all else equal. The corporate tax rate reduction from the TCJA brought the U.S. closer to the average among developed countries accounting for federal and state level taxes, though it remains slightly above average. The U.S. combined federal-state corporate tax rate in 2022 was 25.8 percent, compared to 21.2 percent in the average EU country and 23.6 percent in the average OECD country.⁵¹

Lastly, one of the most problematic and economically destructive aspects of the U.S. tax code is the double taxation of corporate income by the corporate income tax (and now also the book minimum tax) and shareholder taxes on capital gains and dividends. Accounting for federal and state corporate and individual incomes taxes, the top integrated tax rate on corporate income distributed as dividends is about 47 percent in the U.S., compared to an OECD average of about 42 percent.⁵² Several OECD countries have integrated corporate and individual tax codes to eliminate or reduce the negative effects of double taxation of corporate income. In the U.S., after decades of double taxing corporate income, a large share of business activity has migrated to pass-through form, which has only one layer of income tax as owners report pass-through profits on their individual income tax returns.⁵³

Recommendations for Reform

For several years, the Tax Foundation has observed and analyzed tax systems from around the world and evaluated them based on the principles of sound tax policy.⁵⁴ Most tax policy experts agree that taxes should be simple, transparent, and stable over time so they are easy to understand, comply with, and administer. Another element of sound tax policy is neutrality: the tax code should generally treat taxpayers equally with minimum preferences, which extends to equal treatment of immediate versus delayed consumption via saving. A tax code that embodies these principles naturally supports economic flourishing, including plentiful jobs, growing wages, upward mobility, innovation, progress, and higher standards of living.

In our annual ranking of the most competitive tax systems, we found for the 10th year in a row that Estonia has the best tax code in the OECD.⁵⁵ This is in part because it has a fully integrated income tax system that avoids double-taxing corporate income through taxes at both the entity and shareholder levels. Instead of a complicated corporate income tax and separate rules that apply to passthrough businesses, all businesses are subject to a simple 20 percent tax on distributed profits (including dividends and stock

50 Joint Committee on Taxation, "Revenue Estimates and Distributional Analyses," Aug. 3, 2021, https://www.finance.senate.gov/imo/media/doc/jct_analysis_on_corporate_tax_increase.pdf.

51 Cristina Enache, "Corporate Tax Rates around the World, 2022," Tax Foundation, December 13, 2022, <https://taxfoundation.org/corporate-tax-rates-by-country-2022/>.

52 OECD, Tax Database Table II.4. Overall Statutory Tax Rates on Dividend Income, <https://www.oecd.org/tax/tax-policy/tax-database/>; Elke Asen, "Double Taxation of Corporate Income in the United States and the OECD," Tax Foundation, January 13, 2021, <https://taxfoundation.org/double-taxation-of-corporate-income/>.

53 Scott Eastman, "Corporate and Pass-through Business Income and Returns Since 1980," Apr. 23, 2019, <https://www.taxfoundation.org/pass-through-business-income-since-1980/>.

54 TaxEDU, "Principles of Sound Tax Policy," Tax Foundation, <https://taxfoundation.org/principles/>.

55 Alex Mengden, "International Tax Competitiveness Index, 2023," Tax Foundation, Oct. 18, 2023, <https://taxfoundation.org/research/all/global/2023-international-tax-competitiveness-index/>.

buybacks). At the individual level, a simple flat tax of 20 percent applies to all individual income except dividends, since they are already taxed by the distributed profits tax. Capital gains are taxed as ordinary income at 20 percent. Rather than a complicated estate tax like ours that taxes accumulated savings at death, bequeathed assets are simply taxed as capital gains when sold by the heir with deductible basis determined only by costs incurred by the heir.⁵⁶

Simplicity and neutrality are the hallmarks of the Estonian income tax system.⁵⁷ Taxes are so simple in Estonia that they can typically be filed in five minutes, and the cost of compliance for businesses is among the lowest of any country.⁵⁸ Estonia's tax system is also very pro-growth, increasing small business entrepreneurship, investment, labor productivity and thereby wages.⁵⁹ Estonia's income tax system does all of this while generating substantial revenue comparable to other developed countries.⁶⁰

We recently analyzed the effect of a revenue-neutral reform of the U.S. tax code along the lines of the Estonian income tax system, keeping only certain features of the current code that benefit low-income households (such as the EITC and Child Tax Credit) and support saving (such as 401ks).⁶¹ By greatly simplifying the federal tax code, these reforms would substantially reduce compliance costs, potentially saving U.S. taxpayers more than \$100 billion annually, comprised of more than \$70 billion in reduced compliance costs for businesses and more than \$30 billion in reduced compliance costs for individuals related to individual income and estate tax returns.

In addition to compliance cost savings, our modeling of the reform's impacts on the U.S. economy indicates it would increase GDP by 2.5 percent in the long run, grow the capital stock by 3.4 percent, add 1.3 million full-time equivalent jobs and raise wages by 1.4 percent. By increasing GDP, we estimate the reform would reduce the debt burden as measured by the debt-to-GDP ratio by 9.2 percentage points over the long run.

Distributionally, we find the reform would increase after-tax income overall by 3.5 percent in the long-run, accounting for improved economic growth, with a larger boost of 4.3 percent for the bottom quintile of earners and 4.7 percent for the second quintile.

56 William McBride, "Biden's New Tax Proposals are Complicated and Rife with Double Taxation," Tax Foundation, Mar. 13, 2023, <https://taxfoundation.org/biden-tax-fairness/>.

57 Estonia's simple approach to taxing business and individual income has also been implemented in Latvia and Georgia. Daniel Bunn, "Better than the Rest," Tax Foundation, Oct. 9, 2019, <https://taxfoundation.org/estonia-tax-system-latvia-tax-system/>; Gia Jandieri, "Tax Reform in Georgia 2004-2012," Tax Foundation, July 17, 2019, <https://taxfoundation.org/tax-reforms-in-georgia-2004-2012/>.

58 Kyle Pomerleau, "The Best Part of the Estonian Tax Code Is Not 5 Minute Tax Filing," Tax Foundation, Jul. 21, 2015, <https://taxfoundation.org/best-part-estonian-tax-code-not-5-minute-tax-filing/>; William McBride, Garrett Watson, Erica York, "Taxing Distributed Profits Makes Business Taxation Simple and Efficient," Tax Foundation, Mar. 1, 2023, <https://taxfoundation.org/distributed-profits-tax-us-businesses/>.

59 Jaan Maaso, Jaanika Meriküll, and Priit Vahter, "Gross Profit Taxation Versus Distributed Profit Taxation and Firm Performance: Effects of Estonia's Corporate Income Tax Reform," The University of Tartu Faculty of Economics and Business Administration Working Paper No. 81-2011, March 23, 2011, <https://ssrn.com/abstract=1793143> or <http://dx.doi.org/10.2139/ssrn.1793143>; Jaan Masso and Jaanika Meriküll, "Macroeconomic Effects of Zero Corporate Income Tax on Retained Earnings," *Baltic Journal of Economics*, 11:2 (2011): 81-99, <https://www.tandfonline.com/doi/pdf/10.1080/1406099X.2011.10840502>; Aaro Hazak, "Companies' Financial Decisions Under the Distributed Profit Taxation Regime of Estonia," *Emerging Markets Finance & Trade* 45:4 (2009): 4-12, <https://www.jstor.org/stable/27750676>; Eduardo Davila and Benjamin Hebert, "Optimal Corporate Taxation under Financial Frictions," NBER Working Paper No. 25520, October 2021, <https://www.nber.org/papers/w25520>.

60 Over the last 10 years, Estonia's central government tax collections from income and profit amount to about 7.4 percent of GDP, compared to 7.3 percent for the median OECD country and 8.4 percent averaged across OECD countries. See OECD Tax Revenue Statistics, <https://stats.oecd.org/Index.aspx>

61 William McBride, Huaqun Li, Garrett Watson, Alex Durante, Erica York, and Alex Muresianu, "Details and Analysis of a Tax Reform Plan for Growth and Opportunity," Tax Foundation, Jun. 29, 2023, <https://taxfoundation.org/growth-opportunity-us-tax-reform-plan/>

More generally, the U.S. could learn from the experience of other countries in the OECD, which rely more heavily on consumption taxes than the U.S. does.⁶² Value-added taxes (VATs) are a major source of revenue in virtually every developed country except the U.S., and as the literature cited above indicates, VATs and other taxes on consumption are among the least economically harmful ways to raise revenue.⁶³

OECD countries have also tended to abandon more complicated means of taxing high earners such as wealth taxes due to their administrative and economic challenges.⁶⁴ Rather than high capital gains taxes, or any attempt to tax unrealized capital gains, most OECD countries have lower capital gains tax rates than the U.S., and tax capital income overall at lower average tax rates.⁶⁵

Consumption taxes can be designed to progressively tax the consumption of higher earners without the administrative complexity and compliance costs of our current progressive income tax system. For example, by splitting the VAT base in two, businesses would pay taxes on their cash flow (sales less purchases and compensation paid), while households would pay taxes on compensation received. Applying a progressive rate schedule at the household level, with the top rate matching the rate on business cash flow, is a relatively simple way to achieve progressivity within a consumption tax.⁶⁶ Under a more standard value-added tax, the most efficient way to increase progressivity would be to offer targeted relief to lower- and middle-income households.⁶⁷

We have recently modeled specific reforms that would shift the U.S. tax system towards taxing consumption rather than income while simplifying the tax code's various anti-poverty programs, including an option that combines a cash flow tax with a progressive household compensation tax and per person credit. We find these reforms would lead to higher economic output and higher after-tax income for lower-income households while raising roughly the same amount of tax revenue for the federal government.⁶⁸

Conclusion

We as a country have built a federal tax system that is inherently complex, costly, and controversial, one that is centered on taxing both individual and business income at progressive tax rates and littered with various preferences. To the extent it is comprehensible at all, taxpayers do not perceive it as fair. The IRS has real challenges administering such a complicated tax system, but boosting the IRS budget will not fix the underlying problem that causes taxpayers to call the IRS millions of times per year asking for help filling tax forms that take them more than 6.5 billion hours to complete.

-
- 62 Daniel Bunn and Cecilia Perez Weigel, "Sources of Government Revenue in the OECD," Tax Foundation, Feb. 23, 2023, <https://taxfoundation.org/oced-tax-revenue-by-country-2023/>.
- 63 William McBride, "What Is the Evidence on Taxes and Growth," Tax Foundation, Dec. 18, 2012, <https://www.taxfoundation.org/what-evidence-taxes-and-growth/>.
- 64 Daniel Bunn, "What the U.S. Can Learn from the Adoption (and Repeal) of Wealth Taxes in the OECD," Tax Foundation, Jan. 18, 2022, <https://taxfoundation.org/wealth-taxes-in-the-oced/>.
- 65 Daniel Bunn and Elke Asen, "Savings and Investment: The Tax Treatment of Stock and Retirement Accounts in the OECD," Tax Foundation, May 26, 2021, <https://taxfoundation.org/savings-and-investment-oced/#Capital>; Jacob Lundberg and Johannes Nathell, "Taxing Capital—An International Comparison," Tax Foundation, May 11, 2021, <https://taxfoundation.org/tax-burden-on-capital-income/>.
- 66 This design is known as the "X Tax," developed by the late economist David Bradford. See Robert Carroll and Alan D. Viard, *Progressive Consumption Taxation: The X Tax*, (Washington, D.C.: The Rowman & Littlefield Publishing Group, 2012).
- 67 See Rita de la Feria and Michael Walpole, "The Impact of Public Perceptions on General Consumption Taxes," *British Tax Review* 67:5 (Dec. 4, 2020), 637-669, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3723750 for a discussion on how other approaches, such as exemptions or reduced rates can, counterintuitively, increase regressivity by providing more benefits to higher-income households.
- 68 Erica York, Garrett Watson, Alex Durante, and Huaqun Li, "How Taxing Consumption Would Improve Long-Term Opportunity and Well-Being for Families and Children," Tax Foundation, Oct. 12, 2023, <https://taxfoundation.org/research/all/federal/us-consumption-tax-vs-income-tax/>.

As top priority, lawmakers should simplify the tax code so that taxpayers can understand the laws and the IRS can administer them with minimum cost and frustration. As the IRS's National Taxpayer Advocate states in their most recent report to Congress, "Simplifying the Code is the most important step Congress can take to reduce taxpayer compliance burdens. Simplification is essential to the integrity of the U.S. tax system and will enhance voluntary compliance."⁶⁹ We have outlined reforms that would reduce taxpayer compliance burdens by at least \$100 billion per year.

Second, lawmakers should reduce the economic drag caused by the tax code, particularly in the current environment of high interest rates and still-too-high inflation reducing living standards and prosperity. The tax code is one of the most effective levers available to lawmakers to strengthen the economy, but it should not be done through preferences that are targeted and complicated. Rather, lawmakers should broadly improve incentives to work, save, and invest by lowering marginal tax rates on individual and corporate income.

We have shown that revenue-neutral tax reform can greatly improve economic growth, increasing GDP by 2.5 percent in the long run, adding 1.3 million jobs, and raising wages by 1.4 percent such that after-tax incomes for the bottom 40 percent of earners increase by more than 4 percent on average. Additionally, the experience of other countries shows that taxing consumption as opposed to income raises substantial revenue in a more economically efficient way. To address distributional concerns, lawmakers can design consumption taxes to progressively tax the consumption of higher earners without the administrative complexity and compliance costs of our current progressive income tax system.

Contact

William McBride

Vice President of Federal Tax Policy and Stephen J. Entin Fellow in Economics
wmcbride@taxfoundation.org

The Tax Foundation is the nation's leading tax policy research organization. Since 1937, our research, analysis, and experts have informed smarter tax policy at the federal, state, and global levels. We are a 501(c)(3) nonprofit organization.

⁶⁹ Internal Revenue Service National Taxpayer Advocate, "2022 Annual Report to Congress," Jan. 11, 2023, <https://www.taxpayeradvocate.irs.gov/news/national-taxpayer-advocate-delivers-2022-annual-report-to-congress/>.