

# Five Rules for Fiscally Responsible, Pro-Growth Tax Reform

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## KEY TAKEAWAYS

The looming 2025 expiration of the individual tax cuts in the Tax Cuts and Jobs Act sets up a major inflection point on tax policy.

The deficit is unsustainable, so tax cuts that do not grow the economy would lead to higher inflation, future tax increases, or both.

Net tax cuts designed to spur economic growth can be fiscally responsible, because the nation's ability to service the debt depends on the size of the economy.

Fiscal conservatives generally support reducing the size and scope of the federal government, but few would have any qualms with acknowledging that *certain* federal spending is beneficial and warranted. Conservatives should also recognize that the details matter when it comes to tax cuts. Tax cuts can be highly beneficial, but certain tax cuts in certain situations can be counterproductive. With the United States facing a \$2 trillion annual deficit (and growing) and already having accumulated \$34.6 trillion of debt, a poorly designed tax cut could do more harm than good. A deficit-financed tax cut that fails to spur economic growth would exacerbate America's fiscal situation and ultimately lead to future tax increases, higher inflation, or both.

On the other hand, a well-designed tax reform could dramatically improve the economy *and* the

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federal budget, especially over the long run. By spurring investment, innovation, higher employment, and increased productivity, strongly pro-growth tax reform can reduce the nation's debt burden as a share of the economy. Advocates of higher taxes often ridicule the notion of tax cuts paying for themselves, but all that they can refute is the generalized statement that tax cuts always, unequivocally *do* pay for themselves. However, the idea that tax cuts *never* pay for themselves is equally absurd. Clearly, when tax rates are sufficiently high, they discourage productive activity so much as to become utterly counterproductive to the goal of deficit reduction.<sup>1</sup> No serious policymaker would advocate a 99 percent income tax bracket. People would not continue working and taking entrepreneurial risks if the government confiscated 99 cents for every additional dollar they earned. Such a tax would cost taxpayers dearly and destroy the federal budget in the process. However, a tax need not have a 99 percent rate to worsen the budget situation. Look no further than the spate of wealth taxes that European countries have tried and abandoned, and it becomes clear that poorly conceived taxes can be economic and budgetary disasters even with low statutory tax rates of 1 or 2 percent of wealth.<sup>2</sup>

For tax reform to be economically beneficial *and* fiscally responsible, policymakers should mitigate the parts of the tax code that are especially anti-growth. Fiscally responsible, pro-growth tax reform improves incentives to work, save, invest, and innovate and removes unnecessary distortions and complications. It also makes the tax system simpler and fairer by repealing unjustifiable tax carveouts such as tax credits for politically favored businesses or activities.

This report briefly describes how the looming expiration of the 2017 Tax Cuts and Jobs Act (TCJA) will bring tax reform discussions to the forefront in 2025. It then explains why fiscally responsible tax reform should be strongly pro-growth, providing five basic rules for evaluating whether a tax-reform package would mostly spur a larger economy or just a larger deficit. It includes some recommendations and specific examples of tax changes that would satisfy these rules. However, the purpose of this report is not to provide a specific blueprint for the ideal tax reform but rather to describe general principles that should underlie effective reform.

## Tax Reform and the Looming Tax Cliff

The next Congress will have to grapple with whether to extend some or all the provisions of the 2017 TCJA. Most of the TCJA will expire after December 31, 2025. Some of the provisions have already begun phasing

out. If Congress fails to act, the expiration of the tax cuts would result in a large tax increase for most Americans. Alternatively, Congress may plot a different course for federal taxes by passing an altogether new reform.

How Congress decides to act will have important implications for the American people, the economy, and the federal budget. The TCJA included some very strong, pro-growth elements. It reduced excessively high taxes on businesses and corporations, which faced among the highest tax rates in the developed world. The improvements to the business tax code spurred job growth and higher wages.<sup>3</sup> The tax cuts also simplified and reduced the cost of capital investments by businesses through the allowance of full and immediate expensing of equipment and machinery. With expensing, businesses can simply deduct valid business expenses instead of using complicated, drawn-out depreciation schedules that diminish the value of tax deductions before they are claimed.

The TCJA was strong overall, but it was not perfect. Important pro-growth provisions, including expensing, were made temporary instead of permanent. The reforms added to the complexity of the international tax code and small business taxation. They increased the tax code's use of refundable tax credits—payments to individuals with no net income tax liability. They left many problems in the tax system unaddressed, including many unjustifiable tax breaks. All this leaves an opportunity for further improvements in 2025.

## Responsible Tax Reform Should Drive Economic Growth

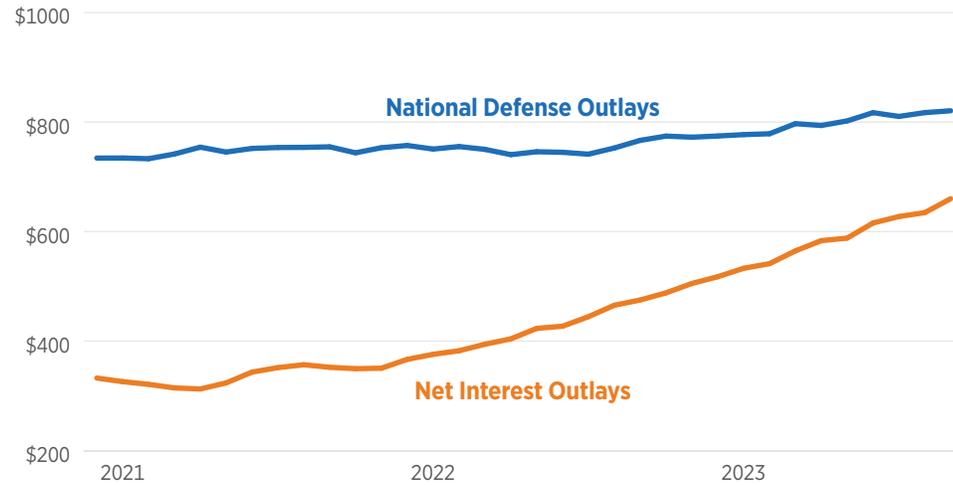
Because of an explosion of federal spending after the outbreak of COVID-19, since 2020 the national debt has soared by \$10 trillion, up to an incredible \$34.6 trillion today.<sup>4</sup> That is more than a quarter-million dollars per American household.<sup>5</sup> Massive deficits that are not accompanied by increased output typically lead to higher inflation, higher economy-wide interest rates, or both. This has certainly been true of the most recent bout of spending. At the height of the spending spree, year-over-year inflation surpassed 9 percent, four-and-a-half times the Federal Reserve's target.<sup>6</sup> To tame inflation, the Federal Reserve has ratcheted up interest rates, driving up the cost of investment in the private economy as well as the cost of servicing the national debt. If interest rates remain high, this would have serious long-term ramifications.

Net interest payments in the first six months of the 2024 fiscal year (October 2023–March 2024) were 194 percent higher than the last six months of the 2020 fiscal year, rising from \$146 billion to \$429 billion.<sup>7</sup> In other words, the average

CHART 1

## Annual Federal Outlays on Net Interest and National Defense

IN BILLIONS OF DOLLARS



**NOTE:** Outlays are by expenditure type in previous 12-month period December 2020-September 2023.

**SOURCE:** Bureau of the Fiscal Service, "Monthly Treasury Statements," <https://www.fiscal.treasury.gov/reports-statements/mts/> (accessed August 17, 2023).

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U.S. household owes about \$6,500 per year just on net interest payment on the federal debt. These payments, for which taxpayers receive no government service or benefit in return, act as a constant drain on capital out of private markets, making it harder for businesses to get the funds they need to operate and harder for homebuyers to afford mortgages. Without course correction, the burden of interest payments will get far worse in the decades to come.<sup>8</sup>

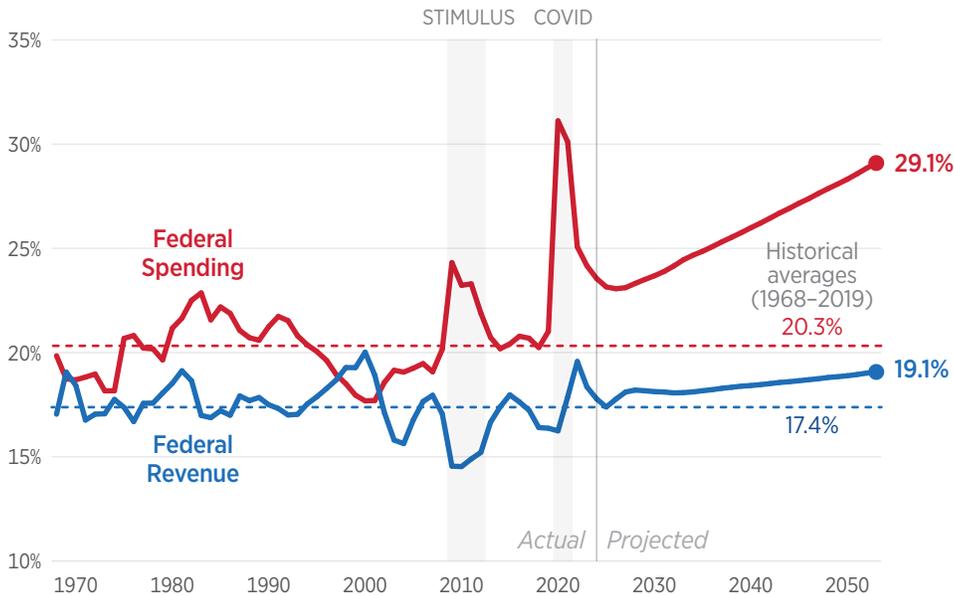
Unless addressed, the skyrocketing debt will be a millstone around the necks of future generations of Americans, sapping the economy of vitality, inhibiting innovation, and leaving the nation ill-equipped to tackle the unforeseen challenges that it will inevitably face. Excessive federal spending, not a lack of tax dollars, created the nation's huge deficits.<sup>9</sup> However, until Congress can tame spending, tax writers should avoid adding to the growing and unsustainable debt problem.

Tax reform should prioritize growing the economy to ensure that America's economic engine is powerful enough to pull the nation out of its gaping fiscal hole. Just as someone earning \$1 million per year can afford higher monthly mortgage payments than someone earning \$50,000 per year can,

CHART 2

## Growing Spending Is the Problem

PERCENTAGE OF GDP



**SOURCES:** Congressional Budget Office, Historical Budget Data, February 2023, Table 1a, <https://www.cbo.gov/data/budget-economic-data#2> (accessed November 29, 2023), U.S. Congressional Budget Office, The Long-Term Budget Outlook, June 2023, Table 1, <https://www.cbo.gov/publication/59014> (accessed November 29, 2023).

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the nation's creditworthiness and ability to service the national debt depend on the size of the economy. That is why strongly pro-growth tax reform can be fiscally responsible, even if it may add to *short*-term deficits.

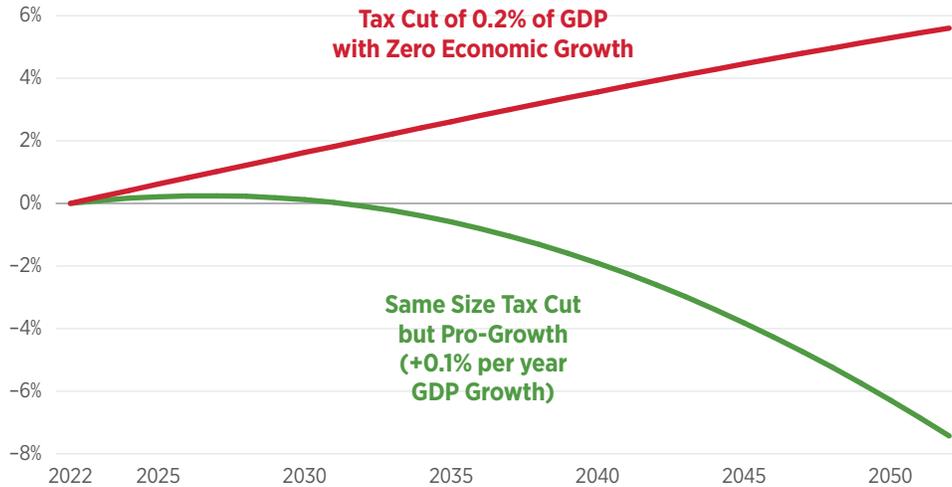
For example, if Congress passed a tax reform that permanently reduced federal taxes as a share of gross domestic product (GDP) by 0.2 percent but added 0.1 percent to annual GDP growth rates, it would add about \$400 billion to 10-year deficits, but it would still manage to reduce the debt as a share of the economy. Therefore, such a tax reform would leave the country *better* positioned to manage the debt, not worse. (To be clear, this is not true of tax cuts generally and a 2025 tax package that does not prioritize economic growth will not improve America's fiscal position.)

The positive budget effects of economic growth are much more dramatic if sustained over a long period. Between the effect of higher tax revenues reducing the deficit and a larger GDP reducing the debt-to-GDP ratio, a persistent 0.1 percent increase in economic growth rates maintained over

CHART 3

## Pro-Growth Tax Cuts Can Reduce Debt as Share of GDP

EFFECT ON DEBT AS A PERCENTAGE OF GDP



**NOTES:** This chart shows the estimated effect on the national debt as a percentage of GDP of two hypothetical tax cuts. Both tax cuts lead to a direct decrease in revenues of 0.2 percent of GDP per year, but it is assumed that the second tax cut leads to a permanent 0.1 percent increase in annual GDP growth rates.

**SOURCE:** Author's calculations based on data from Congressional Budget Office, "The Budget and Economic Outlook: 2023 to 2033," February 15, 2023, <https://www.cbo.gov/publication/58848> (accessed August 17, 2023).

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30 years would reduce the debt-to-GDP ratio by as much as a one-time \$10 trillion debt reduction at the end of the period.<sup>10</sup>

## Principles That Should Underlie Pro-Growth, Fiscally Responsible Tax Reform

Tax and fiscal reform should leave the country in as good or better position to handle the nation's debt, and that requires solidly pro-growth policies. Below are five principles for tax reform that would grow the economy and be fiscally responsible.

### 1. Tax Reform Should Improve Incentives, Not Merely Stimulate Demand

During the 110-year history of the federal income tax, there have been a few strong, pro-growth tax reforms. Such reforms spurred long-term

growth by paring back astronomical tax rates or reducing the multiple layers of taxation that impede entrepreneurship, investment, and work.

The tax reforms designed by Treasury Secretary Andrew Mellon under President Calvin Coolidge in the 1920s, the JFK tax cuts in the early 1960s, the Reagan tax cuts of the early 1980s, and the business tax reforms in the 2017 TCJA all grew the American economy and made Americans more prosperous.<sup>11</sup>

Some other tax cuts did little for the economy besides stimulating short-term demand. They briefly boosted consumer spending, but because they failed to improve incentives, they did not bring lasting economic gains for Americans. For example, a series of tax bills that passed under Presidents Gerald Ford and Jimmy Carter between 1975 and 1978 were heavy on short-term stimulus and light on pro-growth reforms. They greatly expanded the standard deduction, enacted and extended temporary general tax credits, and provided rebates for previous taxes paid.<sup>12</sup> At the same time, inflation and “bracket creep” during this period drove more taxpayers into an excessively high top tax bracket.

The centerpiece of the 2001 George W. Bush tax cuts was a \$300–\$600 one-time tax rebate check for most households that did nothing to improve incentives for work or investment.<sup>13</sup> Now, since 2008, whenever the economy goes into a recession, Republicans and Democrats alike have increasingly tasked the Internal Revenue Service (IRS) with sending out *refundable* tax-credit checks, meaning the IRS makes payments to both taxpayers *and* nontaxpayers.<sup>14</sup> In 2021, even though the economy was already bouncing back from pandemic-related lockdowns, President Joe Biden’s “American Rescue Plan” blanketed the economy with inflation-inducing \$1,400 per-person “economic income payments.” The law also temporarily increased the child tax credit amount while removing work requirements.

When federal deficits fund fiscal policies that “put more money in people’s pockets” but do not grow the economy, the temporary boost in wealth eventually gives way to inflation. A standalone tax reduction (with no corresponding reduction in spending or regulations) can leave Americans with more *real* income in the long run only *if* it causes Americans to produce more goods and services or higher value products (by improving incentives to invest, for example). If a deficit-funded tax cut causes consumption to rise by more than production does for a period, then national savings and investment would fall, and there would be less growth and less to consume in future periods. Reductions in saving and investing make nations poorer in the long run, not richer.<sup>15</sup>

**Guidelines for Tax Reform That Improves Incentives Instead of Stoking Short-Term Demand.** Pro-growth tax reform should remove barriers that stand in the way of a more vibrant economy. To improve economic incentives through tax reform, Congress should:

- **Reduce taxes on productive activities such as investing and entrepreneurship.** Tax cuts are often viewed in distributional terms—*who* gets a tax cut and how big? Such analyses can be misleading as they ignore how people are affected by economic effects of the fiscal changes, such as changes in wages, unemployment, or inflation.<sup>16</sup> Congress should focus on the underlying activities being taxed and should concentrate tax reductions on productive, beneficial activities. Removing disincentives against saving, investing, and entrepreneurship is especially critical for long-term growth.
- **Avoid expanding refundable tax credits, rebates, and general relief.** Pro-growth tax reform should *not* increase government outlays through the expansion of refundable tax credits.<sup>17</sup> It should also avoid using rebates or retroactive changes and should *not* create or expand credits or deductions that are nearly universal or targeted based on taxpayers' inherent and unchanging characteristics.

## 2. Tax Reform Should Broaden the Tax Base, Not Protect the Tax Code's Carveouts

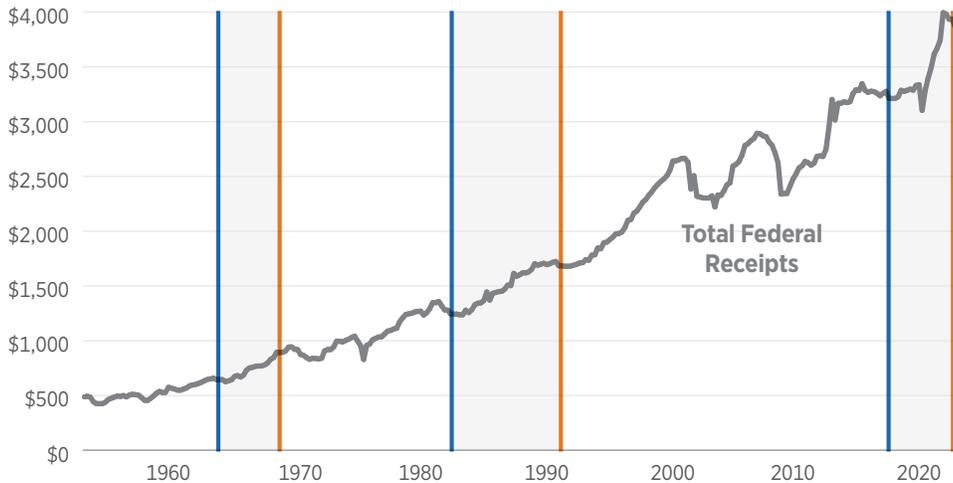
Instead of accepting large deficit increases or resorting to budgetary gimmicks, lawmakers should eliminate or trim the wide array of inefficient carveouts in the tax code. Such base-broadening serves at least three purposes. First, repealing unwarranted carveouts can allow more pro-growth reductions in tax rates or improvements in the tax treatment of productivity-enhancing investments in things such as factories and equipment.<sup>18</sup> Second, repealing tax preferences reduces the federal government's biasing influence in favor of certain activities, limiting its distortion of prices in private markets. Third, it reduces wasteful and disreputable industry lobbying to protect existing tax preferences or to gain new ones.

Tax receipts remained high after the TCJA in part because the 2017 reform paired pro-growth tax cuts with certain reductions in some of the tax code's unjustifiable tax breaks (though much more could have been done). By far the largest revenue-raiser used in the TCJA was temporarily

CHART 4

## Total Federal Receipts

IN 2012 DOLLARS



**NOTES:** This chart shows total federal receipts, adjusted to 2012 dollars using the GDP deflator.

**SOURCE:** Author's calculations based on data from Bureau of Economic Analysis, "National Data," Tables 1.1.4 and 3.2, <https://apps.bea.gov/iTable/?reqid=19&step=2&isuri=1&categories=survey> (accessed August 17, 2023).

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capping individual tax deductions for state and local taxes (SALT) at \$10,000 through 2025. The SALT deduction acts as a subsidy to high-tax state governments, incentivizing state lawmakers to increase spending and raise taxes, because their residents can deduct state and local taxes paid when calculating their federal tax bills.<sup>19</sup>

A note of caution is warranted on the topic of base broadening. Many tax provisions that are labeled "tax breaks," "tax carveouts," or "tax expenditures" are justifiable because they remove duplicative taxation as opposed to providing a subsidy. The Joint Committee on Taxation (JCT) and the Treasury Department, for example, prepare annual lists of tax expenditures including estimates of how much revenue is lost from their presence in the tax code. These lists, though, are loosely based on a flawed concept of income known as "Haig-Simons income" that accepts the punitive double taxation of saving and investment as a normal matter of course.<sup>20</sup>

For example, under the current income tax system, if a worker has a 401(k), he owes income tax on the full value of his income (labor and capital income) at his ordinary tax rate when he receives an income distribution during retirement. Yet because the tax is deferred until the distribution

occurs, these lists wrongly treat this deferral as a tax expenditure instead of relief against double taxation. On the business side, these lists also wrongly treat expensing provisions as tax expenditures. About half of the \$1.8 trillion per year of income tax provisions that the JCT lists as tax expenditures are not loopholes but relief against double taxation.<sup>21</sup>

In some cases, lawmakers can justifiably accept some economic inefficiency in tax expenditures if those tax expenditures advance a critical societal good. For example, the adoption tax credit is justifiable on the grounds that adoption is a selfless, life-changing act that the public has an interest in encouraging, and the adoption tax credit has a relatively minor budget impact. However, all too often, Congress has created new tax expenditures with little regard to the costs to society at large because they provide a concentrated benefit to a politically influential constituency.

**Base-Broadening Tax Reform Options.** Realistically, for conservatives to make the TCJA permanent, the existing cap on SALT deductions should be made permanent or reduced, and ideally Congress would eliminate the SALT deduction altogether to make room for more pro-growth provisions in the 2025 tax package.

Another ripe target for repeal is the federal tax exclusion for interest income earned on state and local municipal bonds.<sup>22</sup> In the current income tax system, interest income is usually taxable. The tax code, however, allows an interest income exclusion for municipal bond holders, rewarding city, county, and state governments that use large amounts of publicly issued debt to finance projects. Because public-sector bond holders can avoid federal taxes on bond interest, they are willing to accept a lower interest rate compared to what they would accept for private-sector bonds carrying a comparable level of risk. The exclusion of interest income on municipal bonds ultimately forces private companies to pay higher interest rates to secure financing. It also places private providers of services at a competitive disadvantage when competing with local governments providing goods and services such as recreation facilities, trash collection, water, electricity, and others. Eliminating the municipal bond exclusion would be doubly beneficial to private capital markets, both by reducing the crowd-out of federal deficits and by leveling the playing field for businesses seeking new financing. This would boost the private economy and enable companies to invest more in things such as new factory equipment, product research, and other initiatives that expand worker productivity, wages, and consumer choice.<sup>23</sup>

Congress should also put a cap on the amount of most employee benefits that companies are permitted to deduct depending on their number of full-time-equivalent employees plus their dependents.<sup>24</sup> (Basing the cap on

the number of employees *plus covered dependents* would be relatively more favorable for family insurance plans.) When companies decide on wage-benefit packages for their employees, current policy encourages companies to provide extra benefits instead of paying higher wages to their employees. Federal and state income taxes apply to wages, along with the 15.3 percent payroll tax paid by employers and employees. Most employee benefits, on the other hand, are untaxed. A reasonable limitation on the deductibility of benefits would reduce this bias against higher wages. Companies that provide the most luxurious employee benefits would have to bear the incremental costs of providing the benefits, which would put healthy competitive pricing pressure on health insurers and other firms that sell and package employee benefits. As a result, companies would offer higher wages and benefit packages that are more targeted to meeting the needs of employees instead of being shaped by the tax code.<sup>25</sup>

The Heritage Foundation's "Budget Blueprint for Fiscal Year 2023" lists numerous other potential repeals of tax preferences.<sup>26</sup> Congress should also repeal most or all of the green energy and climate-related tax credits that recently became law as part of the August 2022 Inflation Reduction Act.<sup>27</sup>

### 3. Tax Reform Should Be Permanent, Not Temporary

If a tax policy change is worth doing, it is worth making permanent. Tax reforms that are permanent are more economically beneficial, are administratively simpler, encourage less lobbying, and are less prone to budget gimmicks.

Tax policy should not drive business decisions or individual economic decisions. However, when tax policies change dramatically from year to year, businesses' finance departments respond by engaging in tax planning. If they expect their tax rates to rise next year, they may push more taxable income into the current year. If they expect a tax credit or deduction to sunset or reemerge, they may plan the timing of business purchases or investments accordingly. The more companies change their business activities (or resort to lobbying) in reaction to a constantly evolving tax code, the more resources are diverted away from serving their customers well and using investors' capital optimally.

Lawmakers frequently set up expiring tax provisions to make bills appear more fiscally responsible than they are. A bill that offsets three years of tax cuts or spending increases with 10 years of revenue raisers can create large immediate deficits while still scoring as producing a 10-year surplus. This practice may be politically convenient and may help comply with budget

reconciliation rules (refer to the section “A Note on Fiscal Scoring” below), but it often helps facilitate fiscal recklessness.

One major flaw in the otherwise pro-growth business provisions of the TCJA was that many of the most important provisions in the legislation—most notably the expensing provisions—were made temporary.<sup>28</sup> Businesses should be able to generally know what the tax rules are in advance without having to speculate about what a future Congress may do.

**Permanent Tax Reforms.** Tax reform should simplify matters for businesses and individuals, but temporary, expiring measures do the opposite. To give taxpayers a stable, predictable tax environment, Congress should:

- **Make full and immediate expensing permanent.** The TCJA’s failure to make full and immediate expensing permanent was one of its biggest missed opportunities. Congress should rectify that mistake and give businesses the certainty they need by making full and immediate expensing permanent for capital equipment and for research and development.
- **Avoid new expiring tax provisions.** Congress should maximize the positive impact of future tax reforms, minimize lobbying, and provide a stable, certain tax environment by not enacting expiring tax provisions.

#### 4. Tax Reform Should Reduce High Combined Marginal Tax Rates

People make most economic decisions at the margins. Companies decide how much to spend on new investments such as factory equipment or technical research based on the expected return on investment. A business invests only up to the point that it expects the return to outweigh the cost. Because the cost of additional financing rises as borrowing increases, a business always reaches a point where another dollar of investment is not worthwhile.<sup>29</sup>

Part of the danger of poorly designed tax policies is that they can distort price signals and the normal operation of markets, depriving worthwhile projects of required capital, discouraging entrepreneurs from innovating, and dulling people’s motivation to work and save.<sup>30</sup> The size of the distortion depends on the amount of tax imposed on the *next* dollar of investment, the *next* hour of work, or the *next* product purchased. When seeking pro-growth tax policies, Congress should be mindful of how taxes affect prices at the margins. By reducing taxes where total combined marginal tax rates are

the highest, Congress can minimize the weight of the federal government's thumb on the economic scales.<sup>31</sup>

Note that reducing excessive marginal tax rates on an activity may not necessarily involve lowering a statutory tax rate at all. Expensing provisions, for example, reduce the distortion of taxes on businesses' decisions about how to spend their limited resources. Because gradual depreciation schedules effectively deny companies from deducting a portion of their capital investment costs, allowing companies full and immediate expensing helps ensure that companies do not effectively face a special tax that applies only to such capital investment expenditures.

**Adding Up Taxes Across Labor and Capital.** Both labor and capital are typically subject to multiple layers of taxation, so it is important that lawmakers consider the combined marginal effect of all relevant taxes, not just each tax in isolation.

Labor is subject to two main layers of federal taxation: payroll taxes and individual income taxes on wages. To fund the Social Security and Medicare trust funds, employers and employees split a 15.3 percent payroll tax on wage earnings (up to the individual payroll tax cap of \$168,600 per year).<sup>32</sup> The federal income tax layers on an additional 0 percent to 37 percent in taxes, with rates rising with incomes (though refundable tax credits cause many low-income taxpayers to have negative effective tax rates).<sup>33</sup> Residents of a typical state are also subject to a top state individual income tax rate of about 5 percent.<sup>34</sup>

Lower combined labor tax rates increase people's incentive to work and earn income. The reduced revenues from individual tax deductions, exemptions, and tax credits, on the other hand, ultimately lead to higher marginal tax rates to compensate. The tax code should use individual tax credits and exemptions sparingly except when dealing with double taxation. *Deductions* are important for ensuring that business income is taxed only after subtracting costs. On the other hand, most business tax *credits* are unjustifiable unless they deal with taxes already paid (e.g., foreign tax credits).

Capital income is subject to additional federal taxes: business-level taxes, investor-level taxes, and in some cases both. The money that people invest generally originates as labor income, and, accordingly, the amount invested typically already faced labor taxes. A person who saves and invests his after-tax wages will generally pay more federal taxes in the long run than if he simply spent his wages when he received them.

For example, an individual who invests \$100,000 of *after-tax* wage income into a closely held business will face another layer of taxation as he earns income from his ownership stake in the company. Under a typical tax

structure for a small business, he would pay tax on his share of the company profits (based on the size of his ownership stake) through the individual income tax.<sup>35</sup> Such investments generally do not have the benefit of allowing the deferral of labor taxes in tax-advantaged savings accounts.<sup>36</sup> Indeed, part owners of closely held pass-through businesses must pay tax on their share of the company profits even if their full initial investment remains tied up in the company and they have yet to receive any actual distribution or dividend.<sup>37</sup>

If instead he invests in corporate stock, the business will first pay tax on any profits earned from his investment at the corporate level. (The federal corporate tax rate is 21 percent, and the median state imposes a 6.5 percent corporate tax.<sup>38</sup>) Then, as the individual realizes income from his investment—whether in the form of dividends, distributions, or capital gains from the sale of the stock—he will pay tax on that investment income. The federal government taxes most qualified dividends and long-term capital gain income at a 15 percent to 23.8 percent tax rate, and most states tax investment income at their ordinary income tax rates.<sup>39</sup>

While investments in corporate stock face an extra layer of taxation above and beyond most capital investments, a significant portion of corporate investments are facilitated through:

- **Traditional IRA-style retirement accounts**, which allow taxpayers to deduct contributions from taxable income, deferring taxes on labor income and capital returns until money is withdrawn; or
- **Roth IRA-style accounts**, which do not allow taxpayers to deduct contributions but *do* allow any subsequent capital returns to accrue untaxed.<sup>40</sup>

The tax code's lower rates on corporate and capital gains taxes help ensure that combined tax rates on capital income earned through "tax-advantaged" accounts are not dramatically overtaxed compared to labor income. There are two problems, though:

1. Americans earn a large share of their capital income outside the confines of these retirement accounts, which act as limited refuges from the overtaxation of capital income. The tax system systematically disincentivizes investments that cannot be made through these accounts.<sup>41</sup>

2. Restrictive, complicated rules governing things such as retirement accounts, capital gains taxation, and qualified dividends lock people into bad investments. Withdrawing funds from a retirement account or selling a capital asset often triggers a tax liability (and sometimes a tax penalty) even if the funds are reinvested elsewhere. To avoid tax issues, people routinely hold onto assets they would prefer to sell. This distorts prices and interrupts the proper functioning of financial markets.

**Tax Reforms to Deal with Discrepancies in Marginal Rates.** The federal tax system distorts marginal tax rates in many ways. These include but are not limited to (1) a highly progressive income tax rate structure; (2) high combined tax rates on capital; (3) lack of double-taxation relief for certain types or amounts of investment; (4) bias against equity financing; (5) bias against depreciable assets; and (6) rapid phaseouts of tax credits.

Congress has many options to alleviate such biases, only a couple of which are described below. Congress should:

- **Create flexible universal savings accounts to expand double-taxation relief for investments.** Congress should streamline the complicated web of IRS-approved investment vehicles and enact highly flexible universal savings accounts to allow for a freer flow of individual investments and penalty-free withdrawals.<sup>42</sup> More fundamental reform could ultimately solve the uneven tax treatment of different investments in businesses by eliminating the capital gains tax and moving to a system with a single flat rate applied at the business level.
- **Smooth combined income and payroll tax rates.** Congress should flatten or smooth combined individual marginal tax rates factoring in income tax rates, the payroll tax income range, and tax-credit phaseouts. This could be done in numerous ways that do not necessarily involve moving to a single flat rate. For example, combined marginal rates could be flattened by setting the largest income tax bracket rate increase at a taxable income amount that coincides with taxpayers reaching the payroll tax cap (past which they owe no further Social Security tax).

## 5. Tax Reform Should Simplify Taxes

The complexity of the tax system imposes a heavy cost on Americans and the U.S. economy, consuming the equivalent of the output of 3.3 million full-time jobs each year.<sup>43</sup> The IRS paperwork burden comprises about 63

percent of total federal government-wide paperwork compliance.<sup>44</sup> This is an enormous deadweight loss.<sup>45</sup> A major simplification of the tax code could free up billions of hours for more worthwhile activities, such as starting a business or simply raising or providing for a family.

A simplified tax code would also increase voluntary compliance with the tax code. The simpler the tax code is, the more likely taxpayers will pay what they owe (no more and no less), and the fewer resources the IRS will require for enforcement. Tax simplification would allow Congress to scale back the IRS's budgetary resources, which are set to soon surpass \$20 billion per year.<sup>46</sup>

The vast economic resources that go into dealing with the complexity of the tax code do not contribute to higher standards of living or higher investment. Quite the opposite is true. Yet government statistics count most tax compliance activities—from tax preparation services to government audits to business overhead spent on their tax departments—as contributions to economic output. Regardless of the shortcomings of economic measurements, lawmakers should not underestimate the importance of simplifying the tax code for improving Americans' standard of living, economic growth, and the federal government's fiscal trajectory.

**Simplifying Tax Reforms.** Tax simplification goes hand-in-hand with many of the other tax reforms described in this report: Expensing is simpler than forcing businesses to follow convoluted depreciation schedules. A code with fewer tax credits is simpler than one with many distorting tax credits. A permanent tax system is easier to comply with than one that is constantly evolving with many expiring tax provisions. Universal savings accounts are simpler than the tangled web of retirement, health, and education accounts the tax code has now.<sup>47</sup>

Tax reform, taken as a whole, should make the tax system simpler. In addition to the simplifying tax reforms already described, Congress should:

- **Reduce the number of ways Americans are taxed.** Although income taxes and payroll taxes account for almost 93 percent of federal revenues, the many ways Americans are taxed within the income tax are too numerous to describe.<sup>48</sup> The pace of new taxes such as minimum taxes and taxes on financial transactions has accelerated in recent years. Instead of creating yet more categories of different tax treatments, Congress should simplify and consolidate the tax system.
- **Close opportunities for IRS interpretation.** Lawmakers should write tax reform legislation that is clear, specific, and complete, leaving

TEXT BOX 1

## A Note on Fiscal Scoring

Any tax reform would have to comply with the rules of the annual budget resolution and—assuming the next major tax bill passes through the budget reconciliation process to avoid the Senate filibuster—follow reconciliation instructions passed in the budget resolution. Furthermore, the Byrd rule prevents legislation passed through reconciliation from adding to scored deficits or reducing scored revenues outside the budget window. (The number of years in the budget window is set in the budget resolution.<sup>1</sup>)

The Congressional Budget Office (CBO) and the tax scorekeepers at the JCT calculate legislation's fiscal scores.<sup>2</sup> The official government scorekeeping is based on static scoring, which ignores the economic impacts of legislation. This, regrettably, leads to bias against fiscal reforms with pro-growth “dynamic” effects. For procedural reasons, lawmakers involved in tax reform must pay heed to the static budget scores provided by the JCT. However,

of greater concern is their duty to the American people—particularly future generations—to consider any fiscal reform's *true* impact on America's large and unsustainable deficits.

Congress should set reconciliation instructions as part of the annual budget resolution with this dynamic in mind. It may, for example, consider setting a longer budget window to provide more leeway in the timing of reconciliation legislation. It should also consider legislative changes that require the CBO and the JCT to use more accurate scoring that accounts for growth effects. Instead of preventing increases to the deficit in years outside the budget window, it would be more appropriate to prevent increases in the deficit as a share of GDP. The reconciliation rules should also *not* prevent revenue reductions outside the budget window, as tax cuts that are fully offset by spending cuts typically improve fiscal matters.

1. Matthew D. Dickerson, “Consequential Decisions on Reconciliation and the Byrd Rule,” Heritage Foundation *Backgrounders* No. 3583, February 4, 2021, <https://www.heritage.org/budget-and-spending/report/consequential-decisions-reconciliation-and-the-byrd-rule>.
2. James V. Saturno and Megan S. Lynch, “Changes to House Rules Affecting the Congressional Budget Process Included in H.Res. 5 (118th Congress),” Congressional Research Service *Report for Congress*, January 12, 2023, <https://crsreports.congress.gov/product/pdf/R/R47384> (accessed August 3, 2023).

little room for alternative interpretations. New tax legislation typically gives the IRS some discretion to write new regulations that essentially fill in the gaps of details left out of the law, often with undesirable consequences. Language such as “[t]he Secretary shall provide for such regulations and other guidance as necessary to carry out the purposes of this section” gives significant authority to the IRS and should be avoided. Key undefined terms are also problematic.<sup>49</sup>

## The Road to Real Reform

The stakes of the coming tax reform debate are enormous. The economy and real wages is sputtering as inflation ravages Americans' wealth. The

economy can scarcely afford for Congress to sit by and allow a tax hike of over \$3 trillion as TCJA expires.<sup>50</sup>

However, because of the fiscal time bomb, America also cannot afford short-sighted tax cuts. America's fiscal situation is dire and will only continue to worsen as the population ages and the share of Americans on Social Security and Medicare expands.<sup>51</sup> The path that Congress should take is a fiscal reform package that balances strongly pro-growth tax cuts with thoughtful and fiscally responsible base-broadening measures and spending cuts that together reduce the role of the federal government and ultimately allow American workers, families, and businesses to lift themselves up. The only way to release the federal government's stranglehold on the American economy is to allow the private economy to grow more quickly than the federal leviathan.

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## Endnotes

1. Arthur Laffer, "The Laffer Curve: Past, Present, and Future," Heritage Foundation *Backgrounders* No. 1765, June 1, 2004, <https://www.heritage.org/taxes/report/the-laffer-curve-past-present-and-future>.
2. Preston Brashers, "Why Congress Shouldn't Rush to Enact Poorly Conceived New Taxes to Fund Spending Spree," *The Daily Signal*, October 28, 2021, <https://www.dailysignal.com/2021/10/28/why-congress-shouldnt-rush-to-enact-poorly-conceived-new-taxes-to-fund-spending-spree/>, and Andrew Wilford, "Norway Provides a Stark Reminder of the Wealth Tax's Folly," *RealClear Markets*, June 15, 2023, [https://www.realclearmarkets.com/articles/2023/06/15/norway\\_provides\\_a\\_stark\\_reminder\\_of\\_the\\_wealth\\_taxes\\_folly\\_940719.html](https://www.realclearmarkets.com/articles/2023/06/15/norway_provides_a_stark_reminder_of_the_wealth_taxes_folly_940719.html) (accessed August 14, 2023).
3. Adam Michel, "An Economic History of the Tax Cuts and Jobs Act: Higher Wages, More Jobs, New Investment," Heritage Foundation *Backgrounders* No. 3592, March 16, 2021, <https://www.heritage.org/taxes/report/economic-history-the-tax-cuts-and-jobs-act-higher-wages-more-jobs-new-investment>.
4. Treasury Department, "Debt to the Penny," <https://fiscaldata.treasury.gov/datasets/debt-to-the-penny/debt-to-the-penny> (accessed April 26, 2024).
5. The Census Bureau estimated there were 131.4 million U.S. households as of 2022. U.S. Census Bureau, "Historical Households Tables, Table HH-1," <https://www.census.gov/data/tables/time-series/demo/families/households.html> (accessed April 26, 2024).
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7. U.S. Department of the Treasury, Bureau of the Fiscal Service, "Monthly Treasury Statement," March 2020–March 2024, <https://fiscal.treasury.gov/reports-statements/mts/> (accessed April 26, 2024).
8. Preston Brashers, "From Concerning to Terrifying: 7 Horrible Milestones on Horizon for Bloated Federal Budget," *The Daily Signal*, March 2, 2023, <https://www.dailysignal.com/2023/03/01/from-concerning-to-terrifying-7-horrible-milestones-on-horizon-for-federal-budget/>.
9. David Ditch, "These 7 Charts Show Why Congress Must Get Spending Under Control Immediately," *The Daily Signal*, July 5, 2022, <https://www.dailysignal.com/2022/07/05/7-charts-show-why-congress-must-get-spending-under-control-immediately-if-not-sooner/>.
10. Estimate based on author's calculations using Congressional Budget Office forecasts of 10-year Treasury note interest rates. In practice, it would be uncommon for a tax reduction to lead to such a persistent increase in the economic growth *rate* if for no other reason than because fiscal policy is unlikely to remain fixed for such a long period. However, this example illustrates how the positive fiscal effect of economic growth builds over time.
11. Daniel J. Mitchell, "Time for Lower Income Tax Rates: The Historical Case for Supply-Side Economics," Heritage Foundation *Backgrounders* No. 1253, February 19, 1999, <https://www.heritage.org/taxes/report/time-lower-income-tax-rates-the-historical-case-supply-side-economics>. The Tax Reform Act of 1986 also had many strongly pro-growth elements. In particular, it dramatically reduced the top marginal tax rate on labor income and greatly simplified the tax code. However, it went too far in broadening the tax base by eliminating certain deductions that prevent double taxation, including deductions related to individual retirement accounts and depreciation.
12. Tax Foundation, "Historical U.S. Federal Individual Income Tax Rates and Brackets," August 24, 2021, <https://taxfoundation.org/data/all/federal/historical-income-tax-rates-brackets/> (accessed August 3, 2023); Tax Policy Center, "Standard Deduction Amount, 1970–2021," <https://www.taxpolicycenter.org/statistics/standard-deduction> (accessed August 3, 2023); Tax Reduction Act of 1975, Public Law 94–12; Tax Reform Act of 1976, Public Law 94–455; Tax Reduction and Simplification Act of 1977, Public Law 95–30; and Revenue Act of 1978, Public Law 95–600.
13. Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107–16. The second round of Bush tax cuts in 2003 included more pro-growth elements, including a reduction in the capital gains tax rate.
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19. Preston Brashers, "SALT Deduction: Debunking the 'Moocher State' and Cost-of-Living Justifications," Heritage Foundation *Backgrounders* No. 3685,

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20. Haig-Simons income is defined as consumption plus changes in net wealth. See Henry Calvert Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (Chicago: University of Chicago Press, 1938), p. 50; Robert Murray Haig, "The Concept of Income: Economic and Legal Aspects," reprinted in Richard A. Musgrave and Carl S. Shoup, eds., *Economics of Taxation*, Vol. IX (Homewood, IL: Richard D. Irwin, 1959). A better definition of *income* is the Fisher-Ture definition: current income minus all outlays made for the purpose of earning future income. See Irving Fisher, "Income in Theory and Income Taxation in Practice," *Econometrica* (January 1937); Irving Fisher, "The Double Taxation of Savings," *American Economic Review*, Vol. 29, No. 1 (March 1939); Irving Fisher, "The Unperceived Double Taxation of Income, Answers to Those That Deny Its Existence," 1946, previously unpublished manuscript published in William J. Barber, ed., *The Works of Irving Fisher*, Vol. 12 (London: Pickering and Chatto, 1997); Irving Fisher, "Paradoxes in Taxing Savings," *Econometrica* (April 1942); Irving Fisher and Herbert Fisher, *Constructive Income Taxation* (New York: Harper and Brothers, 1942); Norman B. Ture, "Supply Side Analysis and Public Policy," in David G. Raboy, ed., *Essays in Supply Side Economics* (Washington, DC: Heritage Foundation and Institute for Research on the Economics of Taxation, 1982), <http://iret.org/pub/SupplySideBook.pdf> (accessed August 3, 2023); and Norman B. Ture, "The Inflow Outflow Tax—A Saving-Deferred Neutral Tax System," Institute for Research on the Economics of Taxation, 1997, [http://iret.org/pub/inflow\\_outflow.pdf](http://iret.org/pub/inflow_outflow.pdf) (accessed August 3, 2023).
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  22. Taxing income from state and local bonds is constitutionally permissible. See *South Carolina v. Baker*, 485 U.S. 505 (1988).
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  24. Employer contributions to some forms of benefits could be exempt from the benefit cap. For example, to encourage employer adoption of health savings accounts that give employees more ownership and agency over their health spending, Congress could make employer contributions to health savings accounts not subject to the cap.
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  26. The Heritage Foundation, "Budget Blueprint for Fiscal Year 2023," July 2022, <https://www.heritage.org/budget/pages/policy-proposals.html>.
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  31. Federal interference in markets through tax policy seldom, if ever, results in a more industrious, prosperous, or virtuous people.
  32. U.S. Social Security Administration, "Contribution and Benefit Base," <https://www.ssa.gov/oact/cola/cbb.html> (accessed April 26, 2024).
  33. 26 U.S. Code § 1.
  34. Timothy Vermeer, "State Individual Income Tax Rates and Brackets for 2023," Tax Foundation, February 21, 2023, <https://taxfoundation.org/data/all/state/state-income-tax-rates-2023/> (accessed August 3, 2023).
  35. Most small businesses are organized as partnerships, sole proprietorships, or pass-through businesses where the business income "passes through" and is taxed at the individual level instead of the business level.
  36. Holly Eve, "Venture Capital Is Not the Funding Reality of Most Startups—Here's What Is," *Forbes*, July 6, 2020, <https://www.forbes.com/sites/hollyeve/2020/07/06/venture-capital-is-not-the-funding-reality-of-most-startups-heres-what-is/?sh=7378c14865ea> (accessed August 3, 2023).
  37. 26 U.S. Code § 702, and 26 U.S. Code § 1366.
  38. Janelle Fritts, "State Corporate Income Tax Rates and Brackets for 2023," Tax Foundation, January 24, 2023, <https://taxfoundation.org/data/all/state/state-corporate-income-tax-rates-brackets-2023/> (accessed August 3, 2023).
  39. The federal government taxes dividends and capital gains on short-term investments at the higher ordinary income tax rates.
  40. Adam Michel, "Universal Savings Accounts Can Help All Americans Build Savings," Heritage Foundation *Backgrounders* No. 3370, December 4, 2018, <https://www.heritage.org/taxes/report/universal-savings-accounts-can-help-all-americans-build-savings>.
  41. Americans invest in many ways, including by investing in or purchasing real estate, certificates of deposit, individual stocks, commodities, precious metals and cryptocurrencies, and ownership shares in closely held businesses. Many such investments do not receive the double-taxation relief of "tax-advantaged accounts." In addition, annual contribution limits restrict how much Americans can invest in various accounts.

42. Michel, "Universal Savings Accounts Can Help All Americans Build Savings."
43. This assumes a full-time worker works 2,000 hours per year (e.g., 40 hours a week for 50 weeks of the year). Americans spent approximately 6.55 billion hours complying with their federal taxes and IRS paperwork burden in 2022. Demian Brady, "6.5 Billion Hours, \$260 Billion: What Tax Complexity Costs Americans," National Taxpayers Union Foundation, April 17, 2023, <https://www.ntu.org/foundation/tax-page/complexity-2023-65-billion-hours-260-billion-what-tax-complexity-costs-americans> (accessed August 11, 2023).
44. *Ibid.*
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46. The IRS's fiscal year 2024 budget request included \$20.6 billion (though IRS outlays for the year will likely end up being somewhat lower). IRS annual outlays are set to expand significantly in the coming years. The IRS received \$79 billion of supplemental appropriations over 10 years (on top of regular annual appropriations) in the 2022 Inflation Reduction Act, which will allow for rapid growth in the IRS unless Congress rescinds most of the new funding.
47. There are some exceptions where otherwise pro-growth reforms add some degree of complexity to the tax code. Sometimes, provisions that add to complexity are worthwhile because they are sufficiently pro-growth, such as indexing capital gains to account for inflation.
48. The broad category of income taxes includes, for example, distinct taxes or distinct rules for estates and gifts, investment income, the net investment income surtax, partnership income, corporate income, subpart F income, the stock buyback tax, the global intangible low-taxed income, income subject to the individual alternative minimum tax, the base erosion anti-abuse tax, and the new "book minimum tax."
49. For example, one of the reasons that the expected cost of the clean vehicle tax credits in the Inflation Reduction Act have ballooned in the year since the bill's passage is that the IRS took a very broad interpretation of the phrase *free trade agreement*. As a result, vehicles with batteries made using critical minerals from many countries qualified for the credits, but Congress had intended the credit to be more limited.
50. Kyle Pomerleau, "The Costs of Extending the Tax Cuts and Jobs Act," American Enterprise Institute, May 18, 2023, <https://www.aei.org/economics/the-costs-of-extending-the-tax-cuts-and-jobs-act/> (accessed August 3, 2023).
51. With the U.S. national debt looking increasingly unsustainable, Fitch downgraded American debt from a AAA rating to AA+ on August 1, 2023. Matt Grossman, "Fitch Downgrades U.S. Credit Rating," *Wall Street Journal*, August 1, 2023, <https://www.wsj.com/articles/fitch-downgrades-u-s-credit-rating-56c73b89> (accessed August 3, 2023).