The federal government finances its operations with taxes, fees, and other receipts collected from many different sectors of the economy. In 2018, total federal receipts were $3.3 trillion, about 16.5 percent of GDP. The largest sources of tax revenues are the individual income tax and payroll taxes, followed by the corporate income tax, the excise tax, and estate and gift taxes. Absent changes in tax laws, the total amount of revenues generally increases along with the economy. Individuals ultimately bear the burden of all taxes no matter how they are imposed.
Sources of Federal Revenue

- **Individual Income Taxes**: The federal government collects taxes on the wages and salaries earned by individuals, income from investments (e.g., rent, interest, dividends, and capital gains), and other income. Individual income taxes constitute about half of total revenues and are the largest single source. As a percentage of GDP, individual income taxes have ranged from 6 percent to 10 percent of GDP over the past 50 years, averaging approximately 8 percent. Total tax liabilities among individuals vary considerably by income. In 2018, the top quintile of earners paid 87 percent of all individual income taxes, while people in the lowest income quintiles had negative income tax liabilities (that is, on average, they received more in refundable tax credits than they owed in income taxes).

- **Payroll Taxes**: Both employers and employees contribute payroll taxes, also known as social insurance taxes. Such taxes are the second largest component of federal revenues and account for approximately one third of total federal revenues. Payroll taxes help fund Social Security, Medicare, and unemployment insurance. For Social Security, employers and employees each contribute 6.2 percent of every paycheck, up to a maximum amount ($128,400 in 2018, and adjusted for average wage growth thereafter). For Medicare, employers and employees each contribute an additional 1.45 percent with no limit. The Affordable Care Act added another 0.9 percent in payroll tax on earnings over $200,000 for individuals, or $250,000 for couples. Employers also pay the federal unemployment tax, which finances state-run unemployment insurance programs. Total revenue from payroll taxes is approximately 6 percent of GDP.

- **Corporate Income Taxes**: The government collects taxes on the profits of corporations. In 2018, most corporate income was taxed at 21 percent at the federal level. When combined with state and local corporate taxes, the average statutory tax rate was 25.7 percent. Corporate taxes amount to approximately 6 percent of all tax revenues, or approximately 1 percent of GDP.

- **Excise Taxes**: Taxes on certain goods such as tobacco, alcohol, and motor fuels also contribute to federal revenues. Those excise taxes are imposed at the point of sale and add to the prices that consumers pay for such goods. Revenues from excise taxes are approximately 0.5 percent of GDP.

- **Estate and Gift Taxes**: Total estate and gift tax revenues are approximately 0.1 percent of GDP. In 2018, only estates over $11.18 million were subject to federal taxes. The maximum tax rate on estates above that level is 40 percent. Individuals who give large gifts of property (including money) to other individuals may also be subject to a gift tax. In 2018, donors may exclude gifts up to $15,000 per donee each year. (Separate rules govern charitable contributions to qualified organizations.)

Understanding Who Pays Taxes and How

To assess whether the tax system is fair or not, it is important to look at all of the taxes that people pay, not just one particular form of taxation.

For example, while it is true that many people owe little or no individual federal income tax, there are many other kinds of taxes that apply to individuals. In fact, taxpayers whose incomes are in the bottom 90 percent of all incomes pay, on average, more in payroll taxes than in income taxes. At the other end of the spectrum, high-income Americans receive a significant amount of their incomes from capital gains and dividends, which are taxed at lower rates than wages and salaries. However, wealthier taxpayers also face higher tax rates on their other income, and indirectly bear a greater share of the corporate income tax, which significantly raises their overall effective tax rates.
In aggregate, our federal tax system is structured to be generally progressive, with higher-income taxpayers paying a larger share of their income in taxes. However, the composition of taxes paid is very different for taxpayers at different ends of the income distribution. For low-income Americans, payroll taxes and excise taxes are the major forms of taxation; for high-income Americans, individual and corporate income taxes comprise most of their tax burden.

The U.S. tax system is progressive, with higher-income taxpayers facing higher tax rates

Effective Federal Tax Rate By Type (% of Cash Income In 2018)

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**Tax Expenditures**

The income tax code also contains provisions that allow individual and corporate taxpayers to reduce their tax bills. Such special provisions — deductions, exemptions, deferrals, exclusions, credits, and preferential rates — are known as tax expenditures. While the Tax Cuts and Jobs Act made changes to some tax expenditures, many of the largest ones remain in place. In 2018, tax expenditures totaled approximately $1.5 trillion. That enormous amount equals nearly 90 percent of the revenue that the federal government actually collected in income taxes and exceeds what was spent by any single agency or spending program, including the Department of Defense and Social Security.
Tax expenditures work in various ways and take many forms, including:

- **Tax deductions**, which are expenses that can be subtracted from income that is taxed. The interest paid on home mortgages (subject to certain limitations), for example, can be deducted from taxable income.
- **Preferential rates** that apply to certain types of income, such as capital gains and dividends.
- **Tax credits**, which are subtracted from a taxpayer’s total tax liability. For example, businesses can claim a tax credit for making investments in hybrid solar lighting systems.
- **Exclusions** that reduce the amount of total income subject to taxation. The single largest tax expenditure is the exclusion from taxable income of payments for health insurance made by employers on behalf of their employees.

For individuals, just six tax expenditures amounted to $749 billion in 2018 — half the cost of all expenditures combined.
Tax expenditures are often referred to as "spending in disguise," because lawmakers use the tax code to direct subsidies to specific constituencies and activities. Policymakers also use tax expenditures to influence consumer and business behavior. The mortgage-interest deduction, for example, encourages taxpayers to buy homes instead of renting. Similarly, depreciation provisions for businesses encourage new purchases of equipment. In addition, because tax expenditures subsidize "favored" activities, they can distort economic decisions in ways that reduce the productivity of our economy.

Tax expenditures generally receive less scrutiny than spending programs. Most do not need annual review and approval, and therefore often remain in place for many years. With few opportunities for review and consideration, they are harder to control and less transparent than line-item spending programs. Many tax expenditures are also more valuable for people at higher marginal tax rates, so the benefits of tax expenditures often skew toward those with higher incomes.

**Six popular tax provisions accounted for a large majority of annual tax expenditures for individuals**

<table>
<thead>
<tr>
<th>Major Individual Tax Expenditures</th>
<th>Budgetary Costs (2018)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exclusion of pension contributions and earnings**</td>
<td>$251 billion</td>
</tr>
<tr>
<td>Exclusion of employer contributions for medical insurance and care*</td>
<td>$146 billion</td>
</tr>
<tr>
<td>Preferential treatment of dividends and capital gains</td>
<td>$129 billion</td>
</tr>
<tr>
<td>Child Tax Credit</td>
<td>$104 billion</td>
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<tr>
<td>Earned Income Tax Credit (EITC)</td>
<td>$70 billion</td>
</tr>
<tr>
<td>Subsidies for insurance purchased through health benefit exchanges</td>
<td>$49 billion</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$749 billion</strong></td>
</tr>
</tbody>
</table>


NOTE: *Estimate includes employer-provided health insurance purchased through cafeteria plans and TRICARE medical insurance. **Includes defined benefit plans, defined contribution plans, plans covering partners and sole proprietors, and IRA’s.

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