Taxes

In December 2017, lawmakers enacted the Tax Cuts and Jobs Act, which included significant changes to both individual and corporate taxes. The legislation lowered income tax rates for most individuals while modifying a number of deductions, credits and exemptions. The bill also lowered the corporate tax rate and made changes to the way worldwide income of U.S. corporations is subject to taxation.

The changes implemented by the 2017 tax act, however, yielded a tax system that remains complex, confusing, inefficient, and, some would say, unfair. The tax code is still riddled with tax expenditures, or "tax breaks," including loopholes, deductions, exemptions, credits, and preferential rates. Because such tax breaks provide financial assistance to specific activities and groups, many are actually a lot like government spending in disguise. Worse, they create market distortions that are damaging to economic growth and productivity. Finally, because the tax code raises less revenue than it did before the tax act, it increased annual deficits and added to our long-term fiscal challenges.

Many economists believe it would help the economy to do away with some or all of those tax breaks to make the code more efficient and reduce the deficit. Tax reform done right would promote economic growth, make our fiscal outlook more sustainable, reduce the complexity and burden of compliance, and increase the system’s transparency and fairness by treating individuals and businesses in similar circumstances more equally. For more background about the tax system, see Revenues.

Many worthwhile ideas have been proposed for reforming individual and corporate income taxes, in addition to proposals for new types of tax regimes.

Policy Options

Individual Income Tax Reform

One prominent reform strategy is to eliminate most or all of the individual income and payroll tax expenditures. In the current system, two taxpayers with the same level of income could face very different tax bills because one taxpayer takes advantage of more tax breaks — or tax expenditures — than the other. While the Tax Cuts and Jobs Act eliminated certain tax expenditures, many of the largest remain. Some of the most expensive tax expenditures are also the most popular, including tax breaks that cover employer-provided health benefits, retirement plans, and mortgage interest. For that reason, major changes to our tax code should be phased-in gradually to give people time to adjust.
Eliminating the remaining individual tax expenditures could allow for a number of other changes to the tax system, while producing additional revenues to improve our long-term fiscal outlook. It could also improve the efficiency of our economy and improve taxpayers’ confidence in the fairness of the overall system.

**Corporate Income Tax Reform**

The Tax Cuts and Jobs Act also made a number of changes to the way in which the corporate income tax is administered. Corporate tax expenditures implicitly subsidize some economic activities and sectors of the economy at the expense of others and thereby distort economic decision-making. For example, businesses are taxed differently based upon how they are organized (i.e., as corporations, Subchapter S corporations, limited liability companies, partnerships, etc.). Many have suggested that an ideal system would do away with some or all of corporate tax breaks, thereby avoiding distortions generated by special provisions and instead promoting economic growth.

**Other Tax Reform Proposals**

Other proposals would create new types of taxes to replace existing taxes or to supplement them. Two prominent examples include:

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### 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>
</tr>
<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>

**SOURCE:** The Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2018–2022, October 2018. Compiled by PGPF. **NOTE:** **Includes defined benefit plans, defined contribution plans, plans covering partners and sole proprietors, and IRAs.** *Estimate includes employer-provided health insurance purchased through cafeteria plans and TRICARE medical insurance.*

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Consumption taxes: One major reform would replace the current income tax system with one that taxes consumption. There are many forms that a consumption tax could take. Most proposals exempt income used for savings and investments. To protect lower-income taxpayers, some proposals would exempt income used for housing, food, medical care and other defined purposes up to a specified level. Other proposals would tax the consumption by lower-income families at reduced rates.

Carbon taxes: Some have suggested introducing carbon taxes to achieve two goals: raising revenue and discouraging the use of carbon-intense energy, which would ultimately have positive environmental effects. A carbon tax could also enable the government to reduce other taxes, such as the corporate income tax, the payroll tax, or individual income taxes, while still generating additional revenue for deficit reduction.

Who Pays Taxes?

Additional resources:

- Center for American Progress, The Growing Consensus to Improve Our Tax Code, September 2014
- Congressional Budget Office, Options for Reducing the Deficit: 2017 to 2026, December 2016
- Mercatus Center, “Fixing” the Tax Code: Key Principles for Successful, Sustainable Reform, May 2016
- Committee for a Responsible Federal Budget, “Principles for Responsible Tax Reform”, April 2017
- Peterson Foundation, “Key Principles to Achieve Tax Reform that Grows the Economy, Not the National Debt”