TAX FOUNDATION

Analyzing the Effects of U.S. Federal Tax Policy

Or, Taxes Matter, But Probably Not For The Reasons You Think

Erica York

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Areas of Focus

- About me
- About Tax Foundation
- National accounting and a model of the economy
- How taxes affect the economy
- Some illustrations
- Questions

About me

- B.S. in Business Administration/Economics from Sterling College
- M.A. in Economics from Wichita State

- Research director and senior economist at Tax Foundation
  - Started as an intern
  - And we are hiring for summer interns!

Principles of Sound Tax Policy

Simplicity	• Tax codes should be easy for taxpayers to comply with and for governments to administer and enforce.
Neutrality	• Taxes should neither encourage nor discourage personal or business decisions. The purpose of taxes is to raise needed revenue, not to favor or punish specific industries, activities, and products.
Transparency	• Tax policies should clearly and plainly define what taxpayers must pay and when they must pay it. Hiding tax burdens in complex structures should be avoided.
Stability	• Taxpayers deserve consistency and predictability in the tax code. Governments should avoid enacting temporary tax laws, including tax holidays, amnesties, and retroactive changes, and strive to establish stable revenue sources.

Basics of National Accounting

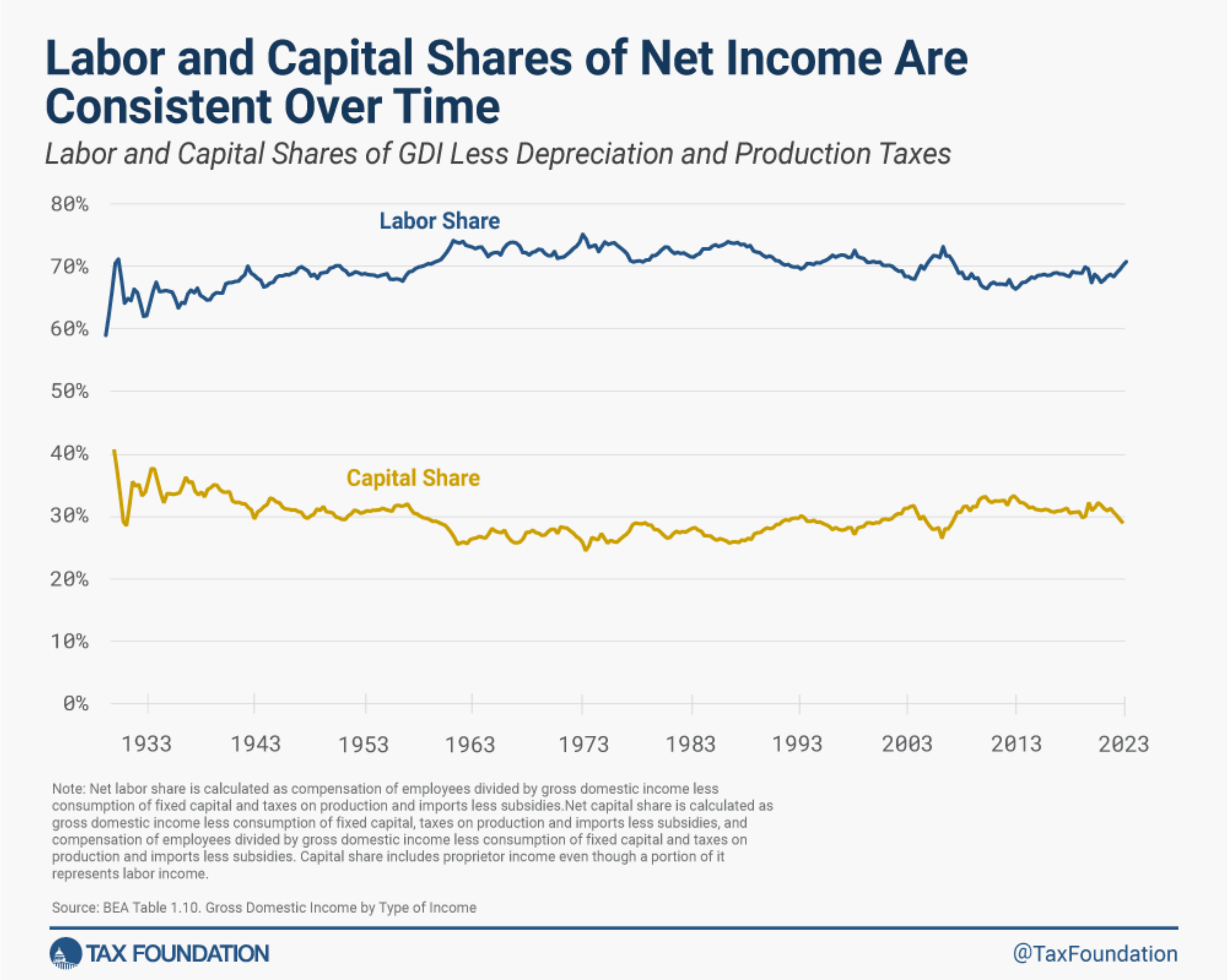
- Gross Domestic Product—total market value of all the final goods and services produced in a country in a given year
  - Personal Consumption
  - Gross Investment
  - Government Consumption Expenditures
  - Net Exports (total value of all goods and services exported minus the total value of all goods and services imported)
- Y = C + I + G + NX

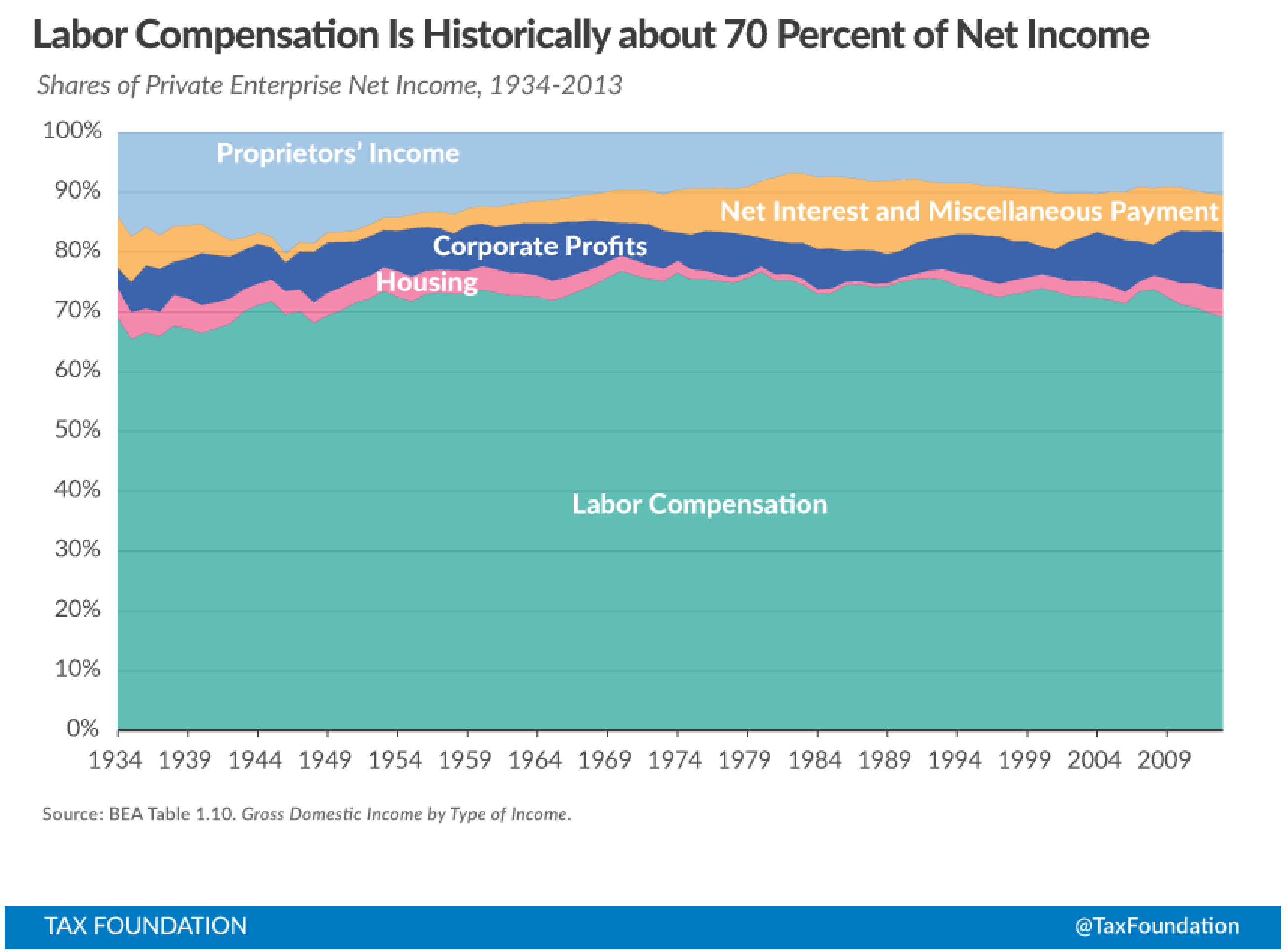
- Gross Domestic Income—total value of all income earned by the factors of production in the United States in a given year
  - Compensation of Employees
  - Gross Operating Surplus
  - Taxes on Production and Imports (minus subsidies)
- GDI = Wages +Gross Profits + Taxes - Subsidies
- Equal in principle: Income = Expenditures!

A Basic Model of the Economy

- National Accounts tells us what, but doesn't tell us why.
- We need a model to explain why GDP is a certain level at any points
- Most models of GDP start with what is called the "Cobb-Douglas Production Function."
- Total GDP is a function of the amount of labor (workers) and capital (productive stuff).
- Y (GDP) = ALbK(1-b)

A Basic Model of the Economy





How do taxes impact the economy?

- Important to distinguish between legal incidence and economic incidence—or, who pays and who really pays
- The total cost of a tax is the revenue raised by the government **plus** the economic damage (“deadweight loss”)
- **Measuring the economic cost** helps guide policymakers to design a better tax system that minimizes damage to economic growth, improves competitiveness, and raises living standards

How do taxes impact the economy?

Impact on incentives

- The impact on incentives is through marginal tax rates
  - How does a tax impact an individual's incentive to do one more unit of some activity?
  - It has little to do with how high taxes are
- Labor: the benefit of an additional hour of work, or whether to work at all
- Saving: the benefit of an additional dollar of saving
- Investment: the return to an additional unit of capital
- Each behavior responds differently to taxation!

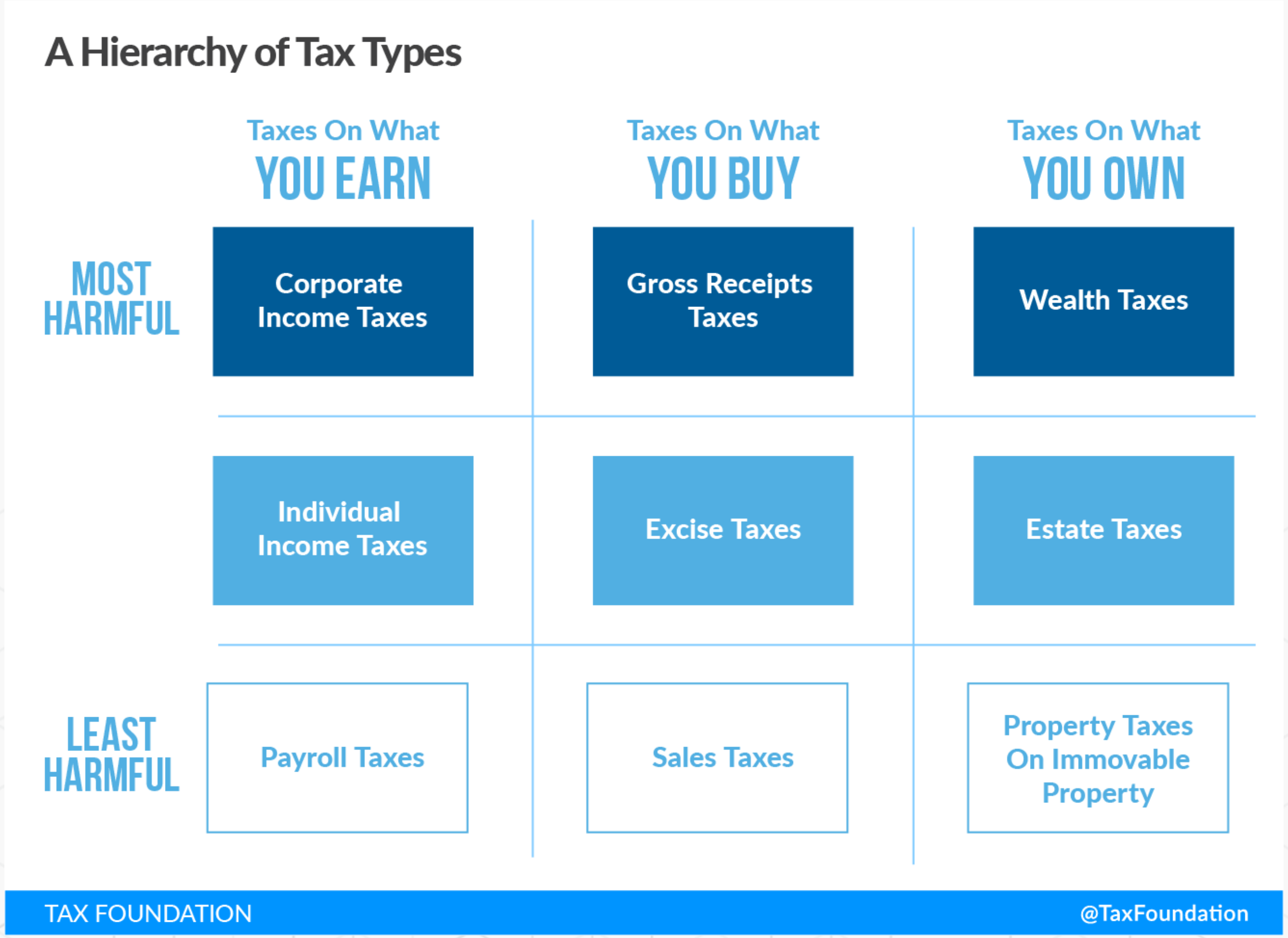
Taxes Matter, But Maybe Not for the Reasons You Think

Comparing Two Approaches to the Economics of Tax Reform

	Folk Theory of Taxes and the Economy	Neoclassical Theory of Taxes and the Economy
Retroactive tax cuts	Leads to economic growth by putting money in the pockets of households and businesses	Does not lead to long-run growth, because taxpayers cannot change past decisions about work and investment
Temporary tax cuts	Leads to economic growth by putting money in the pockets of households and businesses	Does not lead to long-run growth, because decisions about investment are made on long time horizons
Revenue-neutral tax reform	Does not lead to economic growth, because it simply increases taxes on some taxpayers and decreases taxes on others, without lowering the overall level of taxes	Can lead to economic growth by removing or lessening structural biases in the federal tax code, and by lowering marginal tax rates on work and investment

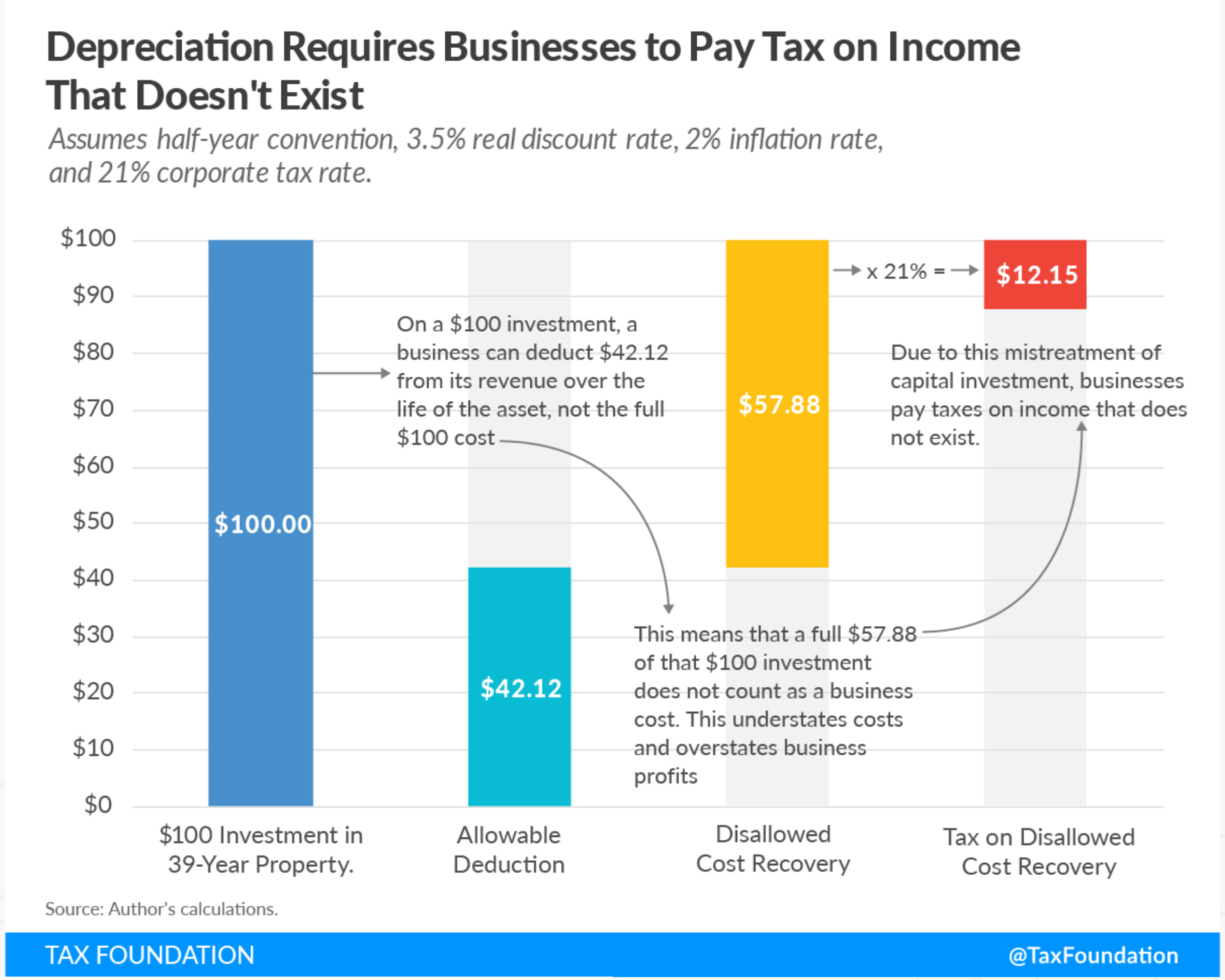
Not All Taxes are Created Equal

- Taxes have differing impacts
- Factors of production have different responses
- Some taxes are more distortionary, and thus have a larger economic cost, than others



Examples – Corporate Tax Base

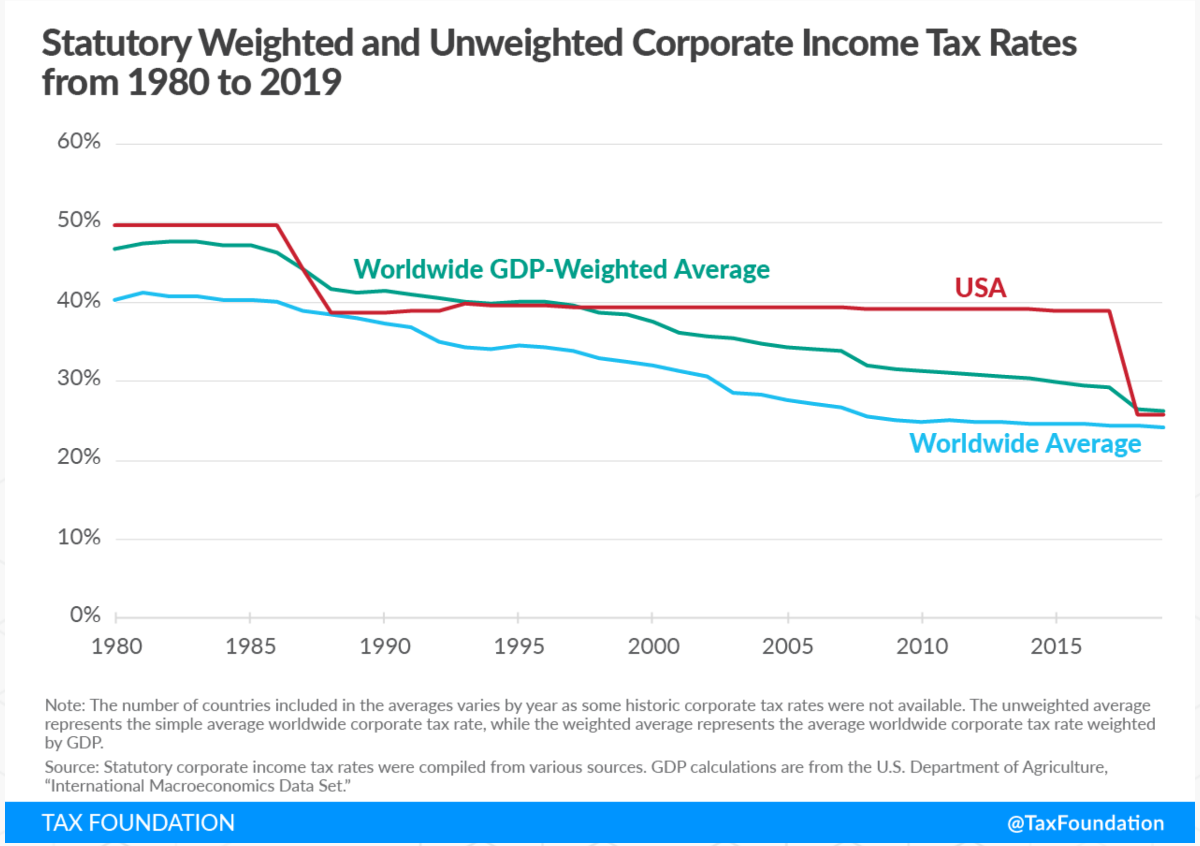
- Profits = revenue minus expenses, except for capital investments
  - Capital investments must be depreciated over time
  - Depreciation artificially increases taxable income and the cost of capital



Provision	Change in GDP	Change in GNP	Change in Capital Stock	Change in Wages	Change in Full-time Equivalent Jobs
Allow full expensing for short-lived assets	0.4%	0.3%	0.7%	0.3%	73,000

Examples – Corporate Tax Rate

- Current combined statutory tax rate is 25.8%, near worldwide average
- Prior to the 2017 tax reform, it was 38.9%, an international outlier
- Applying the tax rate to the tax base results in a corporation’s tax liability



Tariff Example

- 2018-2019 trade war
- Tariffs could reduce U.S. output through a few channels
  - Higher costs of production
  - Higher prices for consumers
  - USD appreciates

Tracking the Economic Impact of U.S. Tariffs and Retaliatory Actions

July 7, 2023 · 12 min read

By: Erica York

IMPOSED TARIFFS

10-Year Revenue (Billions)	Long-run GDP	Long-Run Wages	Long-Run FTE Jobs
$73.9	-0.21%	-0.14%	-166,000

RETALIATORY TARIFFS

10-Year Revenue (Billions)	Long-run GDP	Long-Run Wages	Long-Run FTE Jobs
$0	-0.04%	-0.02%	-29,000

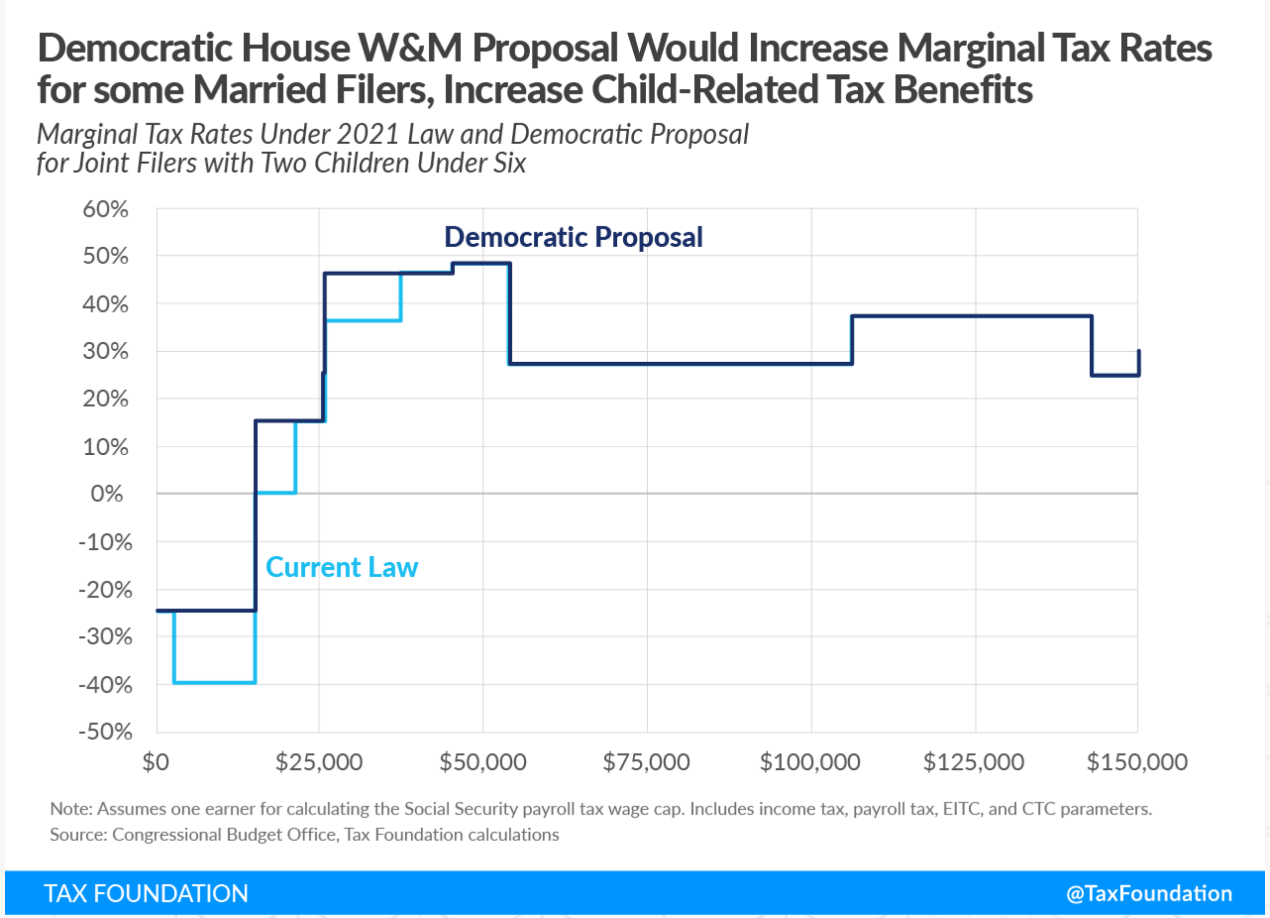
Source: Tax Foundation Taxes and Growth Model, March 2018

Questions?

Erica York
eyork@taxfoundation.org
@ericadyork

Extra slides if needed for Q&A

Individual Tax Example



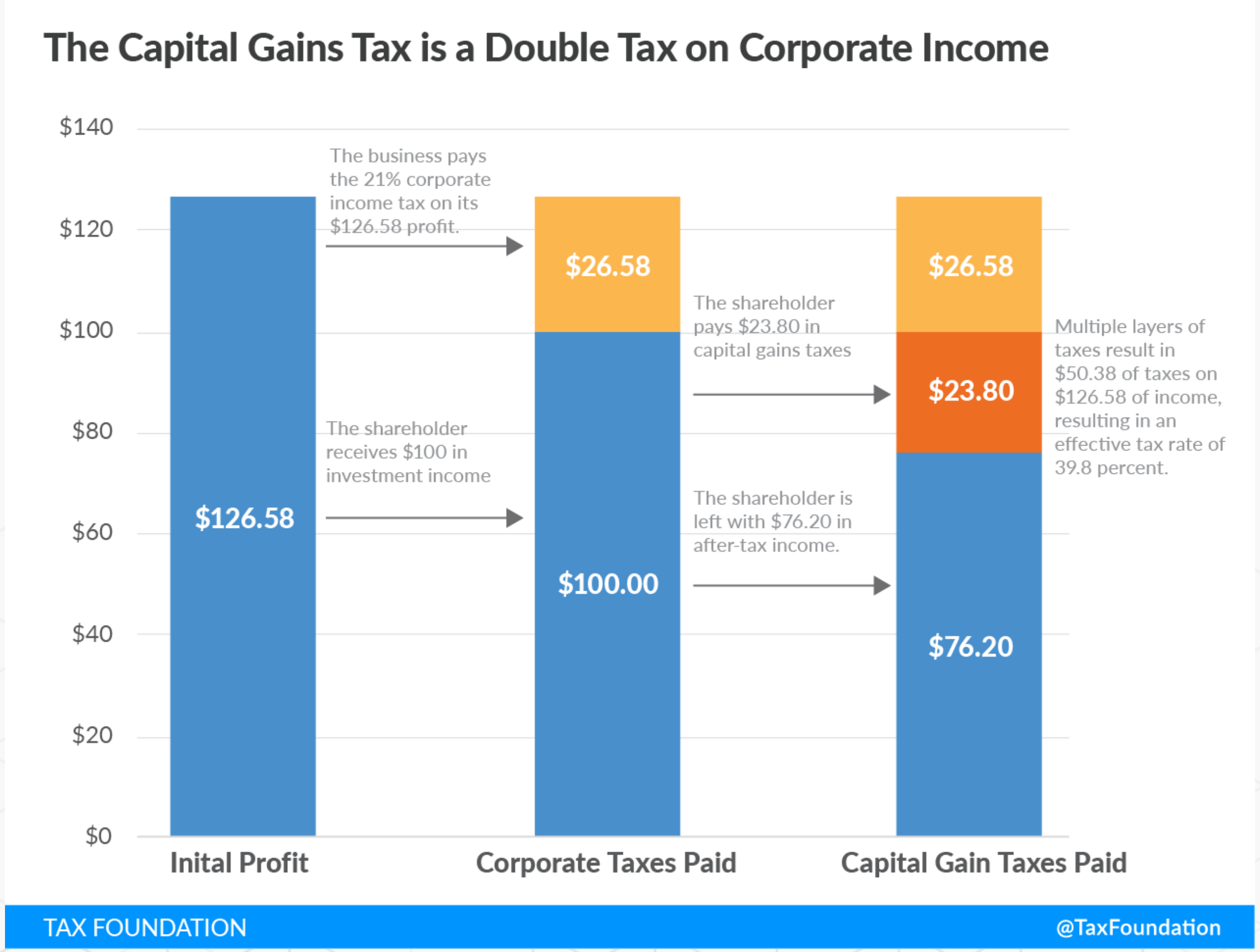
- Background on child tax credit
- Substitution effects and income effects
- Change in marginal tax rates versus average tax rates

Do Corporations Pay $0 in Federal Taxes?

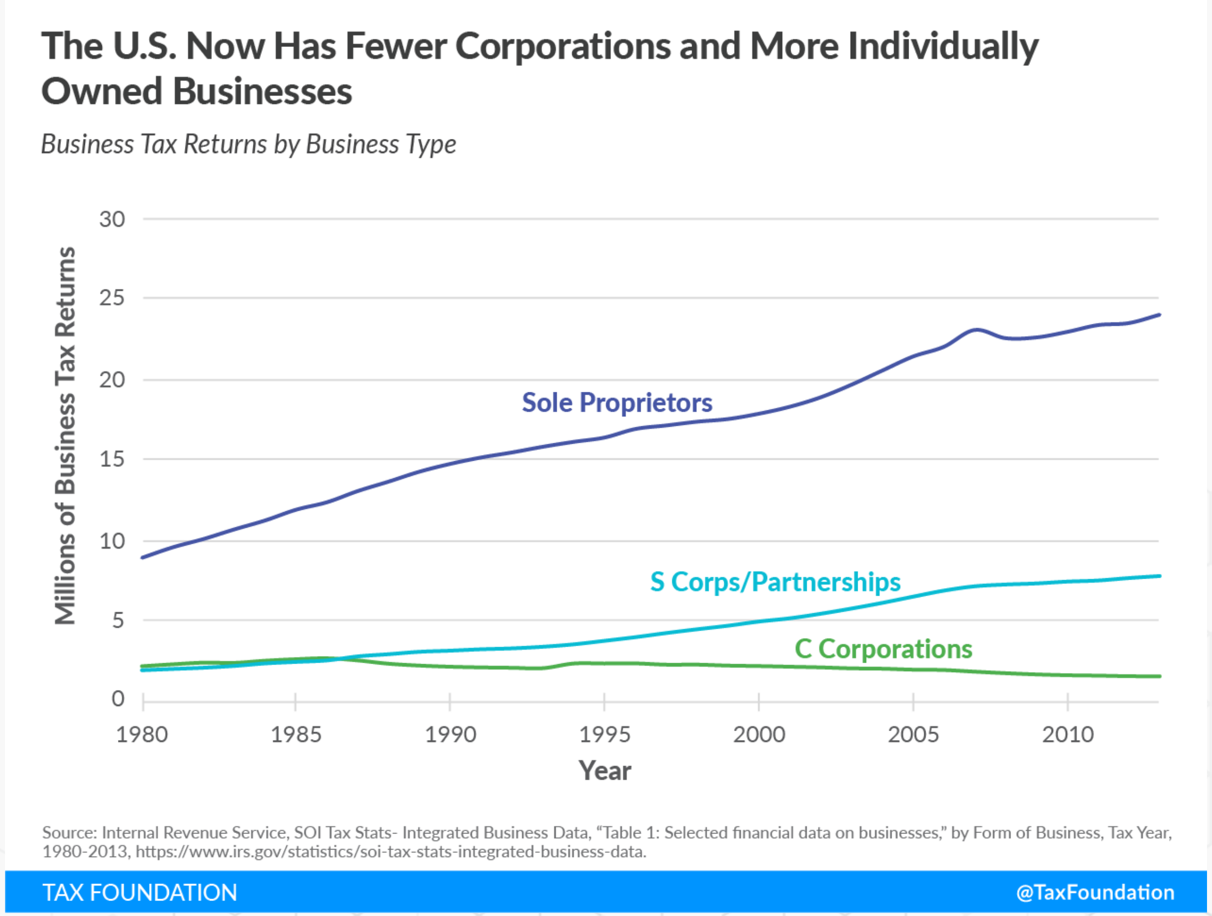
- Taxable profits and losses are determined by tax laws
- Book profits and losses are determined by accounting standards
- Real, legitimate reasons explain why tax laws differ from accounting standards

Corporate Income Taxes – Shareholder Level

- Corporate profits are **taxed at the entity level** – that's the tax we just reviewed
- And corporate profits are **taxed at the shareholder level** when distributed as dividends or realized as capital gains
- Remember the two layers of tax whenever you hear about corporate taxes or capital gains taxes, together they make up the **integrated rate on corporate income**

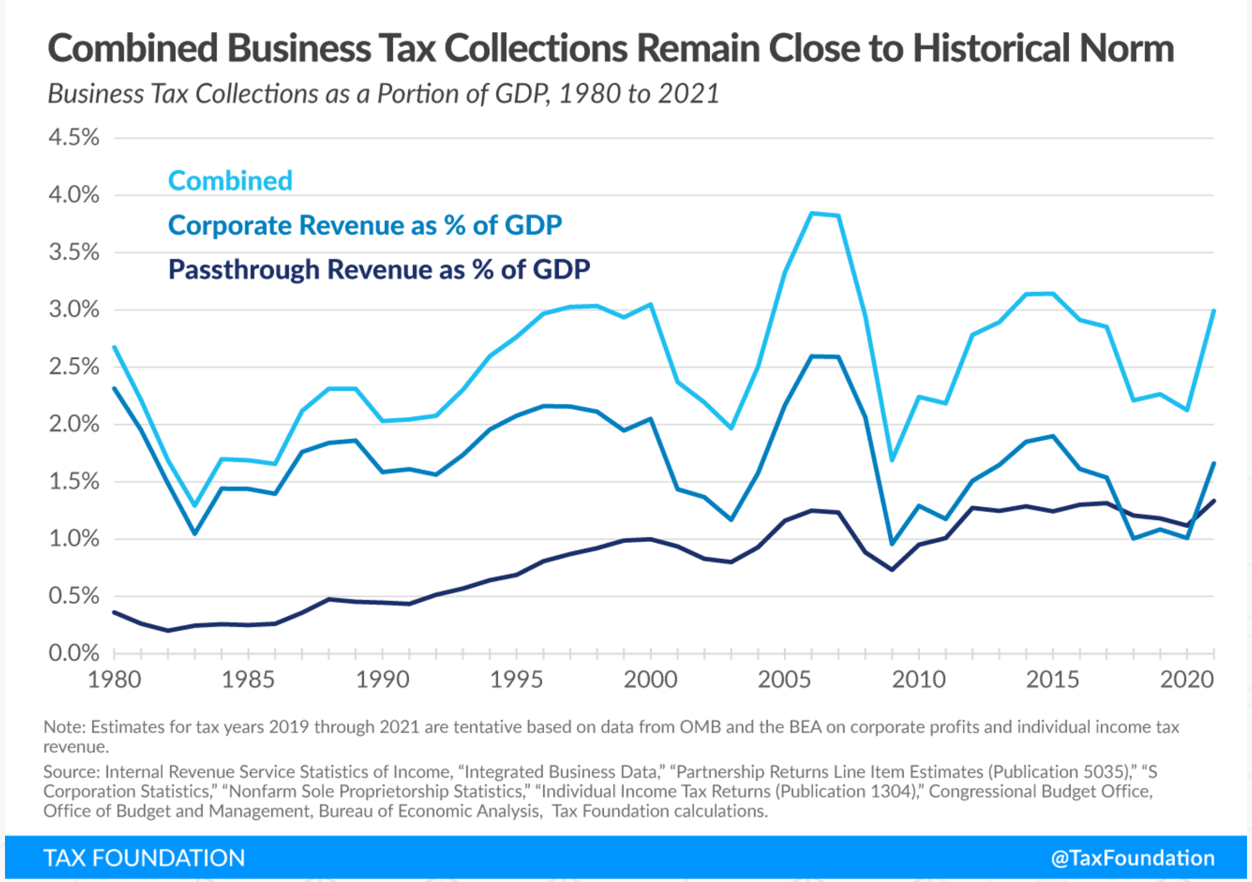


Noncorporate Income Taxes



- Pass-through entities pass profits (or losses) directly to individual owners, no double taxation
- Taxed at personal tax rates
- Owners take deductions, such as Section 199A and Section 179
- Vast majority of U.S. companies are pass-throughs

Business Tax Revenue



- Decline in number of corporations has led to a decline in corporate tax revenue as share of GDP
- FY2023 corporate tax revenues totaled $420 billion out of $4.4 trillion in total taxes
- Combining corporate and noncorporate tax revenues, total business tax revenue in the U.S. is near historical norms

Impact of Corporate Taxes on Investment

- Three rates to pay attention to
- **Statutory tax rates** affect location of profits; at the margin, a higher statutory tax rate encourages profit shifting to jurisdictions with lower statutory tax rates (impact location of profits)
- **Marginal effective tax rates** are an indicator of marginal investment incentives within a jurisdiction (impact the level of investment)
- **Average effective tax rates** are an indicator of asset-location incentives (impact location of investment)

	METR	AETR
United States, maintain TCJA biz policies	11.2%	21.5%
United States, current law	18.3%	23.4%
OECD average	15.5%	22.9%

Note: Estimates do not account for R&D tax credits.
Source: Kyle Pomerleau, "The tax burden on corporations: A comparison of Organisation for Economic Co-operation and Development countries and proposals to reform the US tax system," American Enterprise Institute, Oct. 13, 2021, https://www.aei.org/research-products/report/the-tax-burden-on-corporations-a-comparison-of-organisation-for-economic-co-operation-and-development-countries-and-proposals-to-reform-the-us-tax-system/.

Impact of Corporate Taxes on Workers

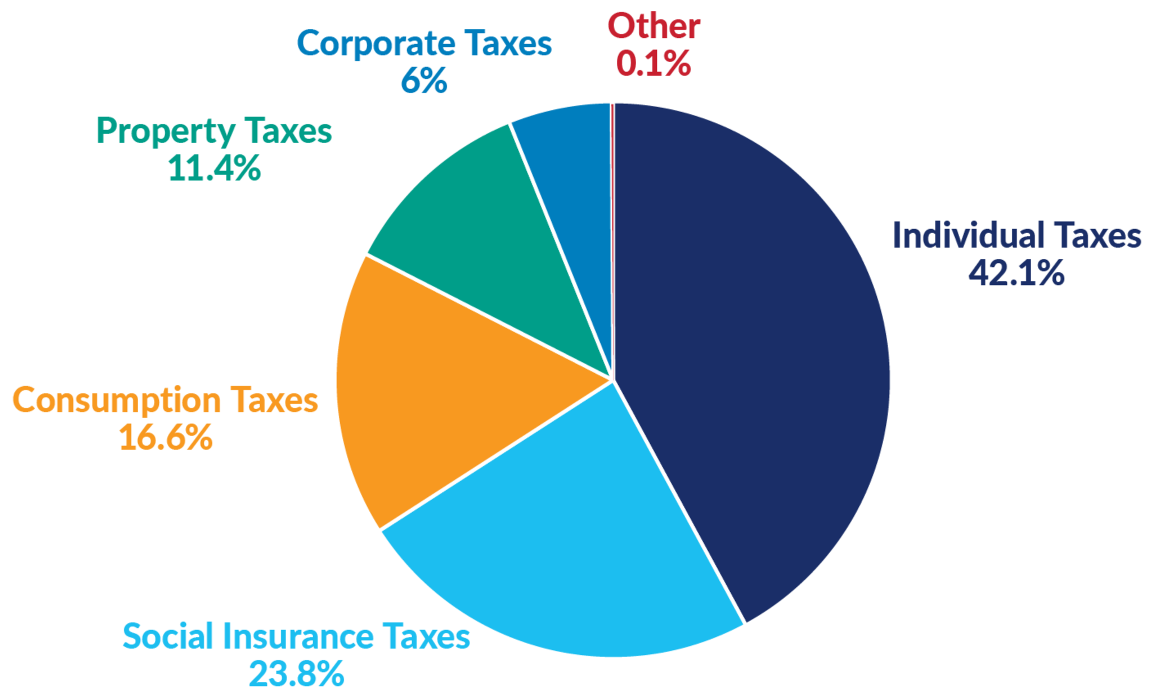
- Legal incidence says, “Corporations pay the taxes!”
- Economic incidence asks, “But who bears the burden?”
  - JCT: 75% of the burden falls on capital, 25% of the burden falls on labor
  - Tax Foundation: 50% on capital and 50% on labor
  - Range in literature suggests in some cases, labor bears 70% to 100%
- Fuest et al find corporate taxes reduce wages more for young workers, the low-skilled, and women
- Most economists, including at the OECD, find the corporate income tax is the most harmful and least efficient way to fund priorities

Do Corporations Pay $0 in Federal Taxes?

- Misunderstanding the differences between book income and taxable income leads to bad policy
- Corporate Alternative Minimum Tax enacted in IRA, not as simple as it sounds
- Applies to AFSI for corporations with profits over $1 billion, effective for tax years beginning after December 31, 2022
  - Adjustments include using tax depreciation instead of book depreciation, allowing tax credits, adjustments for ambiguities between book and tax rules, etc.
- But… CAMT payments have been deferred until 2024 as the IRS needed more time to finalize guidance and regulations

Individual Taxes Are the Most Important Tax Revenue Source for the United States

Sources of Tax Revenue in the United States, 2021

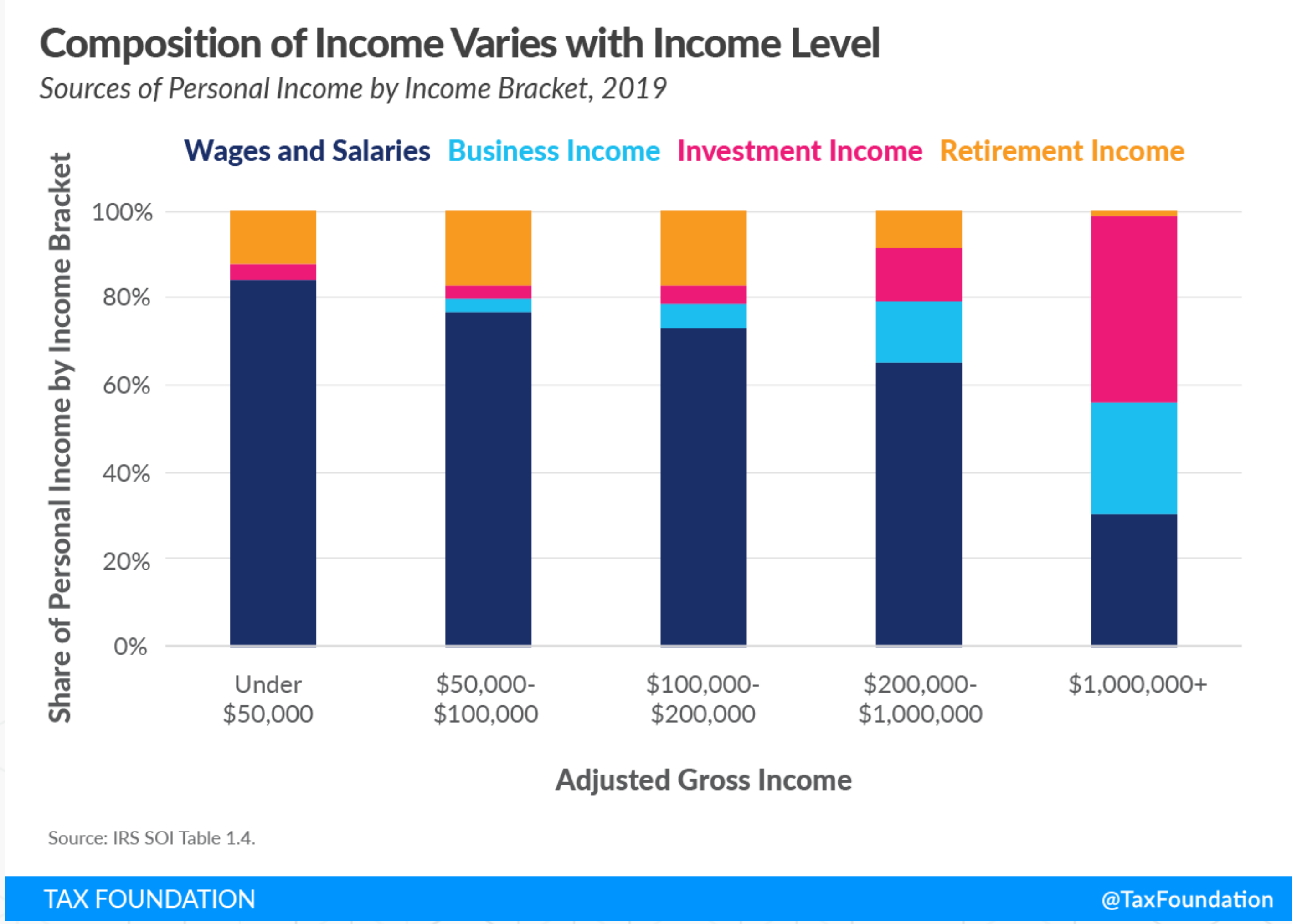


Source: OECD, Revenue Statistics- OECD Countries: Comparative Tables."

- The income tax raised $2.6 trillion of $4.9 trillion of revenue in 2022

- Income on 2019 tax returns
    a. 68% was wages and salaries
    b. 12% was retirement income
    c. 10% was investment income
    d. 9% was business income

- Approximately 158 million tax filers in 2020



The double taxation of saving

Reducing the Four Layers of Tax on $1 of Income

Current Law with Biden Proposals Compared to Tax Foundation's Growth and Opportunity Reform

Current Law with Biden Proposals	Growth and Opportunity Reform
1. Individual income tax on wages:	
Top rate of 37% under current law plus Medicare taxes of 3.8%. Biden proposals: 39.6% top rate plus 5% Medicare tax	Individual income tax on wages of 20% plus Medicare taxes of 3.8%
2. Corporate taxes on wages saved and invested in corporate equities:	
Corporate income tax of 21%, book minimum tax of 15%. Biden proposals: 28% corporate rate	No annual corporate income tax
3. Taxes on corporate earnings distributed to shareholders:	
Long-term capital gains and dividend taxes at a top rate of 20%, plus 3.8% NIIT and 1% stock buyback tax. Biden proposals: 39.6% top tax rate on capital gains and dividends, 4% stock buyback tax, 5% NIIT, and 25% minimum tax on income including unrealized capital gains for high-net-worth individuals	Dividends, buybacks, and capital gains taxed at 20%
4. Taxes at death on accumulated savings:	
Estate tax with top rate of 40% under current law	Death is not a taxable event, full value of assets taxable to the heir upon sale at 20% income tax rate

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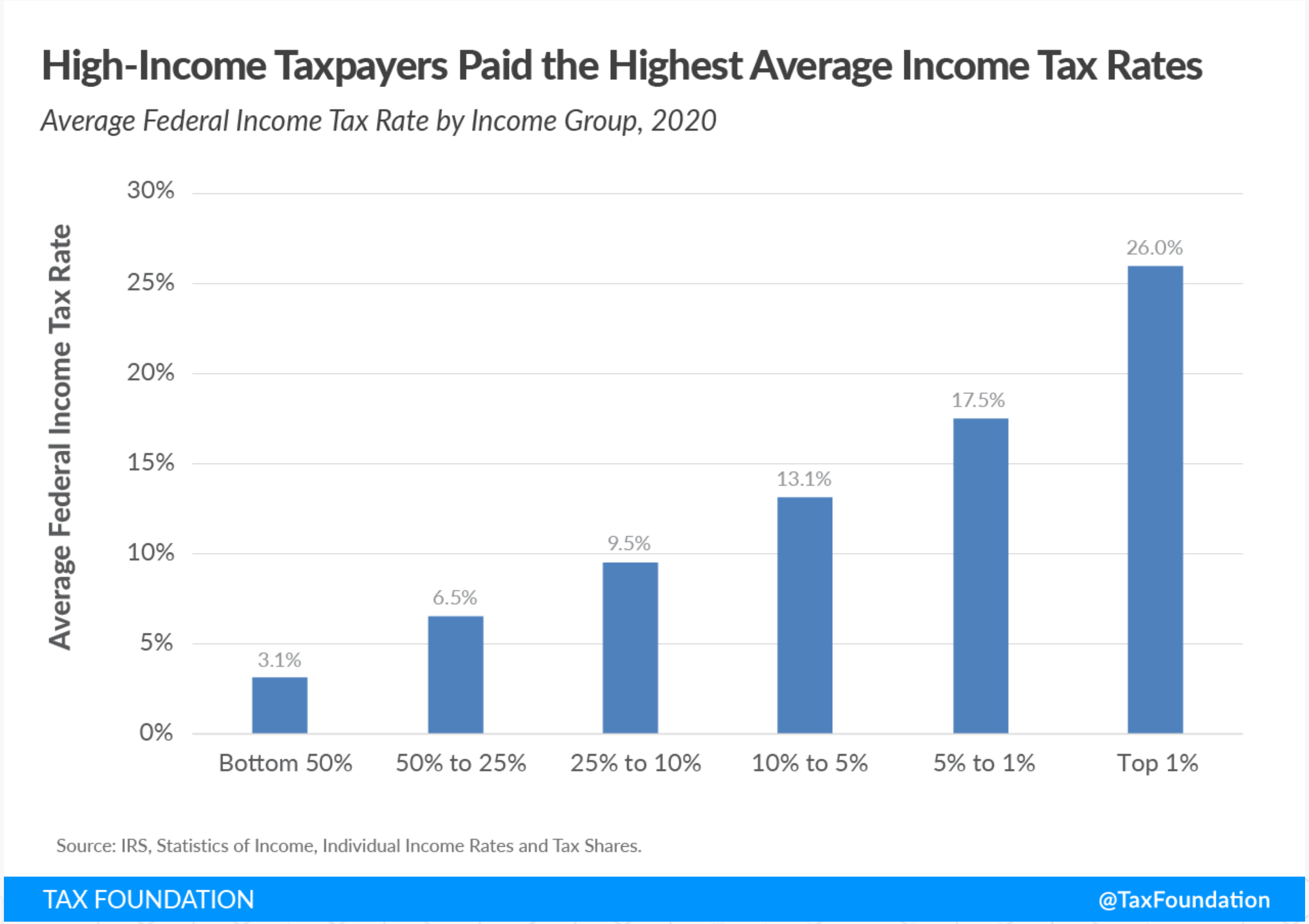
The double taxation of saving

Income Elements

- Ordinary taxation of saving: taxing both the amounts saved and returns on saving
- Depreciation and amortization in accordance with "economic depreciation"

Consumption Elements

- Tax-deferred or Roth-style pensions and retirement plans
- Tax-exempt bonds
- Treatment of owner-occupied housing
- Accelerated depreciation or expensing provisions



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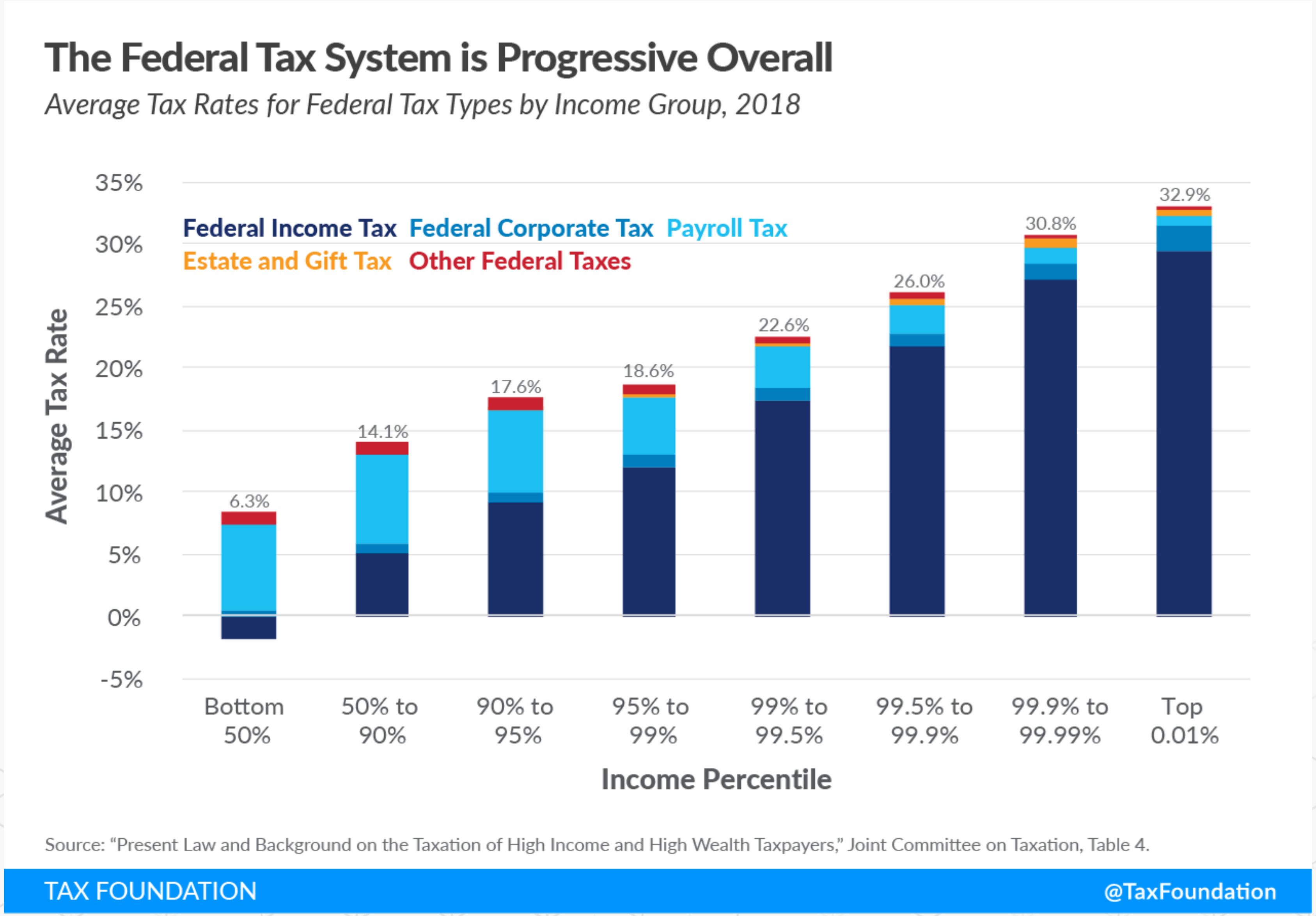
Progressivity



Tax Rates and Brackets