TAX FOUNDATION

PRINCIPLES OF SOUND TAX POLICY

As a nonpartisan, educational organization, the Tax Foundation has earned a reputation for independence and credibility. All Tax Foundation research is guided by the principles of sound tax policy—simplicity, transparency, neutrality, and stability—which should serve as touchstones for policymakers and taxpayers everywhere.

Below, we define our four principles and, for each, outline four real-world policies—two that embody our ideals and two that do not. These examples are illustrative and intended to make each concept more tangible. They only represent a small fraction of the tax policies we delve into every day. For more information about our principles and how they can be applied in practice, please contact us here.

SIMPLICITY

Tax codes should be easy for taxpayers to comply with and for governments to administer and enforce.

Complex Tax Policy	Simple Tax Policy
Itemized Deductions	**The Standard Deduction**

Tax code complexity can create real costs for taxpayers in the form of compliance burdens. Individuals spent 2.6 billion hours complying with IRS tax filing requirements in 2016.

The Tax Cuts and Jobs Act of 2017 simplified the federal tax code by doubling the standard deduction, which the Joint Committee on Taxation (JCT) estimated has resulted in nearly 30 percent fewer filers itemizing.

This has reduced complexity for filers who have decided they no longer need to track itemized deductions, which add significant time and complexity to the filing process.

Complex Tax Policy	Simple Tax Policy
Current U.S. Savings Account System	**Universal Savings Accounts**

The sheer complexity of the American savings account system is astounding. As of 2020, there were 15 types of retirement accounts, each with an array of unique restrictions and requirements, including contribution limits, tax deduction limits, and guidelines for when savers can or must make withdrawals.

By increasing the complexity of the tax code, the web of requirements and restrictions across these accounts complicates saving decisions and disincentivizes saving altogether.

A simpler alternative would be the creation of universal savings accounts (USAs), which are simple, all-purpose accounts available to anyone, with no restrictions on either the timing or purpose of withdrawals. Savings are taxed only once, at the time of either contribution or withdrawal, and contributions are invested in assets such as bonds and equities, providing a return over time.

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. Additionally, any changes to the tax code should be made with careful consideration, input, and open hearings.

Nontransparent Tax Policy **Gross Receipts Taxes**	Transparent Tax Policy **Retail Sales Taxes**

Gross receipts taxes (GRTs) cause "tax pyramiding," meaning the same good is taxed multiple times in the process of being produced. Products with longer production chains are thus taxed more.

This disguises the burden of the tax, hiding it in the final price of goods. The "sticker rate" of a GRT—the rate set by law that policymakers advertise—is always lower than the "effective" rate, what consumers actually pay, after the tax has been shifted down the production chain.

A traditional retail sales tax, on the other hand, is only added to the final price of a good or service and is usually clearly delineated at the bottom of a receipt or invoice.

Nontransparent Tax Policy **Employer-side Payroll Taxes**	Transparent Tax Policy **Employee-side Payroll Taxes**

In the U.S., half of payroll taxes are remitted directly by employers ("employer-side" payroll taxes) while the other half are taken out of workers' paychecks ("employee-side" payroll taxes).

Employee-side payroll taxes are relatively transparent: If you pull out your latest pay stub, you will likely see lines for two federal programs, Social Security (sometimes called FICA) and Medicare (MEDFICA), along with the amount that was taken out of your wages to fund each. Added together, these figures represent your total payroll tax liability for that pay cycle.

"Employer-side" payroll taxes, however, can be misleading. While remitted by businesses, they are almost entirely passed on to employees in the form of lower wages. This obscures who bears the burden of the tax and masks the cost to taxpayers of the programs it funds.

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. Minimizing tax preferences broadens the tax base, so that the government can raise sufficient revenue with lower rates.

Non-Neutral Tax Policy	Neutral Tax Policy
Digital Services Taxes	**Broad-based Consumption Taxes**

Recently, several countries, U.S. states, the EU, and the OECD have looked at ways to tax the digital economy via digital services taxes (DSTs).

These taxes can be discriminatory as they often single out specific industries and even specific business models through narrowly defined tax bases and arbitrary thresholds.

A more neutral approach would be to tax digital services like other goods and services, through value-added taxes (VATs) and retail sales taxes. Such broad-based consumption taxes that apply to all final consumption are neutral because they have little effect on consumer behavior and apply to all business models the same.

Non-Neutral Tax Policy	Neutral Tax Policy
Preferential Tax Credits and Exemptions	**Full Expensing for All Capital Investments**

The principle of neutrality dictates that tax codes not pick winners and losers. Preferential tax credits and exemptions like those offered for purchasing electric vehicles, building sports arenas, or even filming movies in certain jurisdictions, do just that—they promote certain industries and activities over others.

A much more neutral, pro-growth solution to encouraging economic growth is what's called "full expensing" by which all businesses, regardless of industry, are able to deduct the cost of all capital investments from their taxable income immediately.

Not only is full expensing for all investments non-distortionary, but when paired with the elimination of preferential credits, it can also result in a broader, simpler tax base overall, allowing governments to raise revenue more efficiently.

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.

Unstable Tax Policy	Stable Tax Policy
Cigarette Excise Taxes	**Broad-based Consumption Taxes**

Cigarette taxes have been a source of state revenue for decades but face consistent erosion as consumption declines. In most states, cigarette tax hikes are met with a momentary bump in revenue, followed by a drop-off in future years.

Conversely, one of the advantages of a broad-based consumption tax is its stability. All tax revenue is subject to economic cycles and changing taxpayer behavior, but broad-based consumption taxes experience considerably less volatility than taxes that target a narrow tax base, such as cigarette use.

Unstable Tax Policy	Stable Tax Policy
Temporary Policies in the Tax Cuts and Jobs Act of 2017	**Permanent Policies in the Tax Cuts and Jobs Act of 2017**

Permanent tax policies promote stability and, in turn, lead to more pronounced economic effects than temporary policies. The Tax Cuts and Jobs Act (TCJA) of 2017 is a good case study for understanding the real-world implications of this.

The TCJA *permanently* reduced the corporate income tax rate from 35 percent to 21 percent but only *temporarily* allowed businesses to fully and immediately deduct their capital investments (what's called "full expensing").

While both policies increase economic growth by incentivizing investment, our modeling shows that the corporate income tax cut will have a significantly larger, positive effect on GDP in the long run, while full expensing will result in a short-term boost to GDP, followed by a dramatic drop-off as the policy expires.

Even the most pro-growth policies can have muted effects when implemented on a temporary basis. That's because businesses make investment decisions by looking far into the future—much further than five years. The possibility that taxes on investment may increase in the near future will make businesses less likely to pursue big, long-term projects that often require years of sustained investment.