Overview of the Federal Tax System

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Summary

The individual income tax is the major source of federal revenue, followed closely by Social Security taxes. As a revenue source, the corporate income tax is a distant third. Federal estate and gift and excise taxes play only minor roles as revenue sources.

In 2004, individual income taxes accounted for 43% of total federal revenue. Social security taxes accounted for 39%. Corporate income taxes accounted for 10%; excise taxes accounted for 4%; and estate and gift, customs, and miscellaneous taxes accounted for the remaining 4% of total revenue. Over time, corporate income tax has become much less important as a revenue source while social security taxes have become much more important.

In 2000, total receipts were 20.8% of gross domestic output (GDP), which represented a post World War II high. By 2003, federal receipts had fallen to 16.5% of GDP, the lowest level since 1959. Most of this reduction was attributable to legislated tax cuts. Taxes (including all levels of government) in the United States are low compared to those in most other developed countries.

There are four individual income tax filing categories: married filing jointly, married filing separately, head of household, and single individual. The individual income tax base is wages, salaries, tips, income from investments and, business income. The base is reduced by certain adjustments, such as contributions to traditional IRAs, producing adjusted gross income (AGI). Standard or itemized deductions and personal exemptions reduce AGI to taxable income, which is taxed at graduated rates of 10%, 15%, 25%, 28%, 33%, and 35%. Preliminary tax liability is then reduced by tax credits to arrive at a taxpayer’s final income tax liability.

Corporate taxable income is subject to a set of graduated rates: 15%, 25%, 34%, and 35%, but most income is taxed at the top rate. The base is approximately earnings from equity investments.

Social Security and Medicare tax rates are, respectively, 12.4% and 2.9% (half paid by the employer and half by the employee). In 2004, Social Security taxes were levied on the first $90,000 of wages, with the wage cap adjusted annually for increases in average wages in the economy. Medicare taxes are assessed against all wage income.

The major federal excise taxes are levied on transportation fuels, alcohol, tobacco, telephones, and domestic air transport.

This report will be updated on enactment of major changes in the federal tax system.
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Overview of the Federal Tax System

The sources of federal tax revenue are individual income taxes; Social Security and other payroll taxes; corporate income taxes; excise taxes; and estate and gift taxes. This report describes the federal tax structure and provides some tax statistics.

Federal Taxes: A Description

The individual income tax is the major source of federal revenues, followed closely by Social Security and other payroll taxes. As a revenue source, the corporate income tax is a distant third. Estate and gift and excise taxes play only minor roles as revenue sources.

The Structure of the Federal Individual Income Tax

There are four main filing categories under the individual income tax: married filing jointly, married filing separately, head of household, and single individual.

The individual income tax base is composed of wages, salaries, tips, taxable interest and dividend income, business and farm income, realized net capital gains, income from rents, royalties, trusts, estates, partnerships, taxable pension and annuity income, and alimony received.

The tax base is reduced by adjustments to income, including contributions to Keogh and traditional IRAs, some interest paid on student loans, and alimony payments made by the taxpayer. This step of the process produces adjusted gross income (AGI), which is the basic measure of income under the federal income tax.

The tax base is further reduced by certain deductions. Taxpayers can take a standard deduction or they may itemize their deductions. The elderly and blind are allowed an additional standard deduction. Itemized deductions are allowed for home mortgage interest payments, state and local income taxes, state and local property taxes, charitable contributions, medical expenses in excess of 7.5% of AGI, and a few other items. As a temporary measure in 2005, state and local sales taxes can be deducted as an alternative to state and local income taxes.

The tax base is reduced further by subtracting personal and dependent exemptions. Personal exemptions are allowed for the taxpayer, his or her spouse, and each dependent. For taxpayers with high levels of AGI, the personal and dependent exemptions are phased out.
Taxable income equals AGI reduced by either the standard deductions or itemized deductions and personal and dependent exemptions. Taxable income is the base on which federal income tax is assessed.

The individual income tax has six marginal income tax rates: 10%, 15%, 25%, 28%, 33%, and 35%. These marginal income tax rates are applied against taxable income to arrive at a taxpayer’s gross income tax liability.

Long-term capital gains — that is, gain on the sale of assets held more than 12 months — and qualified dividend income are taxed at lower tax rates.

Tax credits are subtracted from gross tax liability to arrive at a final tax liability. The major tax credits include the earned income tax credit, the child tax credit, the education tax credit, the tax credit for the elderly and the disabled, and the credit for child and dependent care expenses. (See CRS Report RL30110, *Federal Individual Income Tax Terms: An Explanation*, by Louis Alan Talley and Pamela J. Jackson, for a further discussion of tax terms.)

**Base and Adjustments.** The tax base for the individual income tax approximates the sum of labor and capital income and thus, bears a resemblance to national income as measured by economists. There, are, however, a number of exclusions; in addition, certain income transfers are subject to tax.

Wage income of employees is taxed, although most contributions to employee pension and health insurance plans and certain other employee benefits are not included in wages subject to income tax. Employer contributions to Social Security are also excluded from wages. When pensions are received, they are included in income to the extent that they represent contributions originally excluded. If the taxpayer has the same tax rate when contributions are made and when pensions are received, this treatment is equivalent to eliminating tax on the earnings of pension plans. Some Social Security benefits are also subject to tax.

Passive capital income, in the form of interest, dividends, and capital gains on financial instruments, is also taxed, although the tax base excludes gains that are unrealized and interest on tax-exempt securities issued by state and local governments.

Income from operating a business through a proprietorship, partnership, or small business corporation that elects to be treated similarly to a partnership (Subchapter S corporation), or through rental property (which reflects returns to both investment and effort) is also subject to tax, although it is always difficult to measure such income precisely. This income is the net of gross receipts reduced by costs such as payments to labor, depreciation, costs of goods acquired for resale and other inputs, interest, and taxes. Some investment income of small businesses is subject to favorable treatment through provisions that allow costs of capital equipment to be expensed when incurred. Other income such as miscellaneous income, gambling winnings, and royalties is also included in the tax base.

Transfers are sometimes included in income of the recipient and sometimes not. Among those subject to tax are pension earnings, a portion of Social Security benefits
for higher-income individuals, unemployment compensation, alimony, and the portion of scholarships and fellowships not used for tuition and books.

There are several adjustments to this income base to yield adjusted gross income. Probably the most well known of these are deductions for individual retirement accounts and self-employed pension plans, interest on student loans, alimony, certain education expenses, and moving expenses.

**Deductions and Exemptions.** Individuals subtract from their adjusted gross income either the standard deduction or itemized deductions, along with an exemption for each family member. Extra standard deductions are allowed for the blind and elderly. These statutory components of the income tax are indexed for inflation.

Individuals may elect to itemize their deductions; these itemized deductions include deductions for excess medical expenses, mortgage interest, state and local income taxes (or, alternatively, state and local sales taxes), state and local property taxes, charitable contributions, and certain miscellaneous deductions.

Personal exemptions and itemized deductions are limited for certain high-income taxpayers.

**Table 1. Statutory Personal Exemptions and Standard Deductions**

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Personal Exemptions</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$2,900</td>
<td>$3,000</td>
<td>$3,050</td>
<td>$3,100</td>
<td>$3,200</td>
</tr>
<tr>
<td><strong>Standard Deductions</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>— Joint</td>
<td>$7,600</td>
<td>$7,850</td>
<td>$9,500</td>
<td>$9,700</td>
<td>$10,000</td>
</tr>
<tr>
<td>— Single</td>
<td>$4,550</td>
<td>$4,700</td>
<td>$4,750</td>
<td>$4,850</td>
<td>$5,000</td>
</tr>
<tr>
<td>— Head of Household</td>
<td>$6,650</td>
<td>$6,900</td>
<td>$7,000</td>
<td>$7,150</td>
<td>$7,300</td>
</tr>
<tr>
<td><strong>Add. Standard Deductions for the Elderly and the Blind</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>— Joint</td>
<td>$900</td>
<td>$900</td>
<td>$950</td>
<td>$950</td>
<td>$1,000</td>
</tr>
<tr>
<td>— Single/Head of Household</td>
<td>$1,100</td>
<td>$1,150</td>
<td>$1,150</td>
<td>$1,200</td>
<td>$1,200</td>
</tr>
</tbody>
</table>

There are also limitations on allowances for children and students filing their own tax returns, while claimed on someone else’s returns. (See CRS Report RS20072, *Standard Deduction and Personal/Dependency Amounts for Children 14 and over and Students*, by Pamela J. Jackson and Louis Alan Talley.)

**Tax Rates.** Tax rate schedules for individuals include joint returns for married couples, head of household returns for single individuals with dependents and single returns. (Married couples can file separate returns; the brackets in these schedules are half as wide as brackets in the joint return, so there is no tax rate advantage in filing
such a return.)  The individual income tax rate schedules are shown below in Table 2.

**Table 2. Statutory Marginal Tax Rates for 2005**

<table>
<thead>
<tr>
<th>If taxable income is:</th>
<th>Then, tax is:</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Joint Returns</strong></td>
<td></td>
</tr>
<tr>
<td>$0 - $14,600</td>
<td>10% of the amount over $0</td>
</tr>
<tr>
<td>$14,600 - $59,400</td>
<td>$1,460 + 15% of the amount over $14,600</td>
</tr>
<tr>
<td>$59,400 - $119,950</td>
<td>$8,180 + 25% of the amount over $59,400</td>
</tr>
<tr>
<td>$119,950 - $182,800</td>
<td>$23,318 + 28% of the amount over $119,950</td>
</tr>
<tr>
<td>$182,800 - $326,450</td>
<td>$40,916 + 33% of the amount over $182,800</td>
</tr>
<tr>
<td>$326,450 +</td>
<td>$88,321 + 35% of the amount over $326,450</td>
</tr>
<tr>
<td><strong>Single Returns</strong></td>
<td></td>
</tr>
<tr>
<td>$0 - $7,300</td>
<td>10% of the amount over $0</td>
</tr>
<tr>
<td>$7,300 - $29,700</td>
<td>$730 + 15% of the amount over $7,300</td>
</tr>
<tr>
<td>$29,700 - $71,950</td>
<td>$4,090 + 25% of the amount over $29,700</td>
</tr>
<tr>
<td>$71,950 - $150,150</td>
<td>$14,653 + 28% of the amount over $71,950</td>
</tr>
<tr>
<td>$150,150 - $326,450</td>
<td>$36,549 + 33% of the amount over $150,150</td>
</tr>
<tr>
<td>$326,450 +</td>
<td>$94,728 + 35% of the amount over $326,450</td>
</tr>
<tr>
<td><strong>Heads of Households</strong></td>
<td></td>
</tr>
<tr>
<td>$0 - $10,450</td>
<td>10% of the amount over $0</td>
</tr>
<tr>
<td>$10,450 - $39,800</td>
<td>$1,045 + 15% of the amount over $10,450</td>
</tr>
<tr>
<td>$39,800 - $102,800</td>
<td>$5,448 + 25% of the amount over $39,800</td>
</tr>
<tr>
<td>$102,800 - $166,450</td>
<td>$201,198 + 28% of the amount over $102,800</td>
</tr>
<tr>
<td>$166,450 - $326,450</td>
<td>$39,020 + 33% of the amount over $166,450</td>
</tr>
<tr>
<td>$326,450 +</td>
<td>$91,820 + 35% of the amount over $326,450</td>
</tr>
</tbody>
</table>

Long term capital gains and dividend income are taxed at lower rates: 5% for those in the 10% and 15% brackets, and 15% for those in higher brackets. (See also CRS Report RL30007, *Individual Income Tax Rates: 2005*, by Gregg Esenwein.)

Many tax provisions are phased out as income increases, which has the effect of increasing marginal tax rates.
Income may also be taxed under the alternative minimum tax (AMT), whose rates are set at 26% and 28% on an expanded base (see below).

The current tax rates, which were reduced by the 2001 tax cut are technically scheduled to return to their prior values after 2010, although they may be extended or made permanent. The lower rates on dividends and capital gains expire after 2008; if not extended, dividends will be taxed at ordinary rates and long-term capital gains tax rates will rise (although they will still be subject to favorable rates).

**Tax Credits.** Tax credits offset tax liability on a dollar-for-dollar basis and have become an increasingly popular method of providing tax relief and social benefits in general. If a tax credit is refundable and it exceeds tax liability, a taxpayer receives a payment from the government. If credits are not refundable, then they provide no benefit to many lower income individuals who have no tax liability. The earned income credit is refundable, and the child tax credit is refundable for all but very low income families. Many credits are phased out as income rises and thus do not benefit higher income individuals; these phase-out points vary considerably. There are credits for a variety of purposes; the major individual income tax credits are described below.

**Child Tax Credit.** This credit for children under 17 was adopted in 1997 and was originally set a $400 for each qualifying child. Subsequent legislation in 2001, 2003, and 2004 increased the credit to $1,000 and extended its refundability. (See CRS Report RS21860, *The Child Tax Credit*, by Gregg Esenwein.)

**Child and Dependent Care Credit.** This credit is provided for the costs of paid care for dependents, mostly children. The maximum credit is 35% of costs up to $3,000 for one individual, $6,000 for two or more individuals. The rate is reduced when the taxpayer’s adjusted gross income (AGI) exceeds $15,000, but is no less than 20%. The credit is nonrefundable.

**Earned Income Credit.** The earned income credit is allowed against wages for lower-income families and individuals and is designed to supplement wages so that working families can have sufficient resources to stay out of poverty. The EIC is refundable (otherwise, it could not fulfill its function) and is phased out at lower and moderate income levels. (See CRS Report RS21477, *The Earned Income Tax Credit (EITC): Policy and Legislative Issues*, by Christine Scott.)

**Hope and Lifetime Learning Credits (Education Credits).** These credits, enacted in 1997, provide benefits for post-secondary education. A credit of 100% of a portion of tuition and 50% of an additional portion (varying by year) applies for the first two years of undergraduate tuition. There is also a lifetime learning credit of 20% that applies to all education and to a larger base. This credit is not refundable. (See CRS Report RL32507, *Higher Education Tax Credits: An Economic Analysis*, by Pamela Jackson.)

**Alternative Minimum Tax.** Individuals may also pay tax under the alternative minimum tax (AMT). Under current law, to calculate the AMT, an individual first adds back various tax items, including personal exemptions and certain itemized deductions, to his regular taxable income. This grossed up amount
becomes the income base for the AMT. Next, an exemption of $58,000 for joint returns and $40,250 for single and head of household returns is subtracted from this income base to obtain AMT taxable income. (These exemption levels are temporary and are scheduled to revert to their prior law levels of $45,000 for joint returns and $35,750 for unmarried taxpayers in 2006.) The basic exemptions are phased out for taxpayers with high levels of AMT income. A two-tiered rate structure of 26% and 28% is then assessed against AMT taxable income. The taxpayer compares his AMT tax liability to his regular tax liability and pays the greater of the two.

Even though a taxpayer may not actually pay any AMT, it can affect his regular tax liability because nonrefundable tax credits under the regular income tax are limited to the excess of regular income tax over AMT liability. Thus, a taxpayer who has a net $4,000 regular income tax liability ($5,000 tax liability less $1,000 in nonrefundable tax credits) but has an AMT liability of $4,300 will, effectively, see his regular income tax credits reduced by $300. Temporary provisions, first enacted in 1998, that allow individuals to use all personal tax credits against both their regular and AMT tax liabilities. This change is effective through December 31, 2005.

Although the AMT was originally designed to prevent high-income taxpayers from escaping what was perceived to be their fair share of the income tax burden, there will be a significant increase in the number of middle- to - upper -middle-income taxpayers affected by the AMT. (See CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, for further information).

### The Corporate Income Tax

Corporate taxable income is subject to a set of graduated rates: 15%, 25%, 34%, and 35%, with the lower rates applying to firms with lower taxable incomes. Since smaller firms tend to have smaller profits, small firms benefit more often from the 15% and 25% rates. And since the bulk of corporate income is earned by large firms, most corporate income is subject to either the 34% or 35% rate. The benefits of the lower rates are phased out, and during the phase out range, marginal tax rates are actually higher because an additional dollar of income not only has a direct tax rate but also reduces the benefit of lower rates.

The base of the corporate income tax is net income, or profits, as defined by the tax code. In general this is gross revenue minus costs. Deductible costs include materials, interest, and wage payments. Another important deductible cost is depreciation — an allowance for declines in the value of a firm’s tangible assets, such as machines, equipment, and structures.

In broad economic terms, the base of the corporate income tax is the return to equity capital, as follows. Wages are tax-deductible, so labor’s contribution to corporate revenue is excluded from the corporate tax base. Income produced by corporate capital investment includes that produced by corporate investment of borrowed funds, and that produced by investment of equity, or funds provided by stockholders. Profits from debt-financed investment are paid out as interest, which is deductible; thus, the return to debt capital is excluded from the corporate tax base. Equity investments are financed by retained earnings and the sale of stock. The income equity investment generates is paid out as dividends and the capital gains that
accrue as stock increases in value. Neither form of income is generally deductible. Thus, the base of the corporate income tax is the return to equity capital.

Because of the nature of its base, the corporate income tax has several broad effects on the allocation of capital investment. First, it favors non-corporate investment — for example, unincorporated business and owner-occupied housing — over corporate investment. Second, it favors corporate debt over corporate equity investment since the former is not subject to the tax. However, while the base of the tax is equity income, the flow of capital out of the corporate sector and other economic adjustments probably cause the burden of the tax to spread to all owners of capital: owners of unincorporated business, bondholders, and homeowners. The tax can also shift from capital income to labor income, or even benefit labor income (with capital bearing more than 100% of the tax). The government agencies that provide distributional analysis allocate the corporate tax to capital in general.

A question that economists find is reasonable to ask is: why tax corporate profits at all? Corporate equity profits are taxed twice, once at the corporate level and once under the individual income tax when they are received by stockholders as dividends or capital gains. As a consequence, taxes tend to steer investment away from the corporate sector. Further, corporations are not persons who can bear the burden of taxes, but merely legal entities through which individuals earn income. From this point of view it is misleading to compare the tax burden of a corporation with that of an individual. The corporate tax, some argue, should be combined ("integrated") with the individual income tax in some manner. Some of the reasons that have been put forward for having a separate corporate tax are: it discourages the use of corporations as shelters from the individual income tax; it probably adds to the tax system’s progressivity; integration of the individual and corporate taxes would present administrative difficulties; and the corporate tax has a degree of public support. It also raises significant revenue.

In 2003, the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) took a step in the direction of relieving the double-taxation of corporate income by reducing the tax rate individuals pay on corporate-source dividends and capital gains to 15% for 2003 to 2008. For more information, see CRS Report RL31597, *The Taxation of Dividend Income: An Overview and Economic Analysis*, by Gregg Esenwein and Jane Gravelle. For a discussion of who bears the burden of corporate (and other capital) income taxes, see CRS Report RL32517, *Distributional Effects of Taxes on Corporate Profits, Investment Income, and Estates*, by Jane G. Gravelle.

**Payroll Taxes**

Payroll taxes are used to fund specific programs, largely Social Security and Medicare.

Social Security and Medicare taxes make up the largest share of federal payroll taxes by a wide margin. Social Security and Medicare taxes are paid at a combined rate of 15.3% of wages, with 7.65% being paid by the employee and employer alike. In 2005, the Social Security part of the tax (6.2% for both employees and employers) is only levied on the first $90,000 of wages, with the cap adjusted
annually for increases in average wages in the economy. The Medicare portion (1.45%) is applied to all wages.

The other categories of federal payroll taxes are unemployment insurance taxes (FUTA) and employees’ contributions to the federal retirement system. The federal portion of the unemployment tax is applied at a 6.2% rate to the first $7,000 of wages. However, the states apply the tax at a 5.4% rate that is credited against the federal tax so that the net federal rate is 0.8%.

**Estate and Gift Tax**

The federal estate tax is imposed when property is transferred at death. The taxable unit is the estate, in contrast to an inheritance tax, which is levied on heirs. The base of the federal estate tax is property transferred at death, less allowable deductions and exemptions. The base is subject to graduated rates that rise from 18% to 48% as estate size increases. (The top rate is scheduled to fall over the period 2002-2009 as the tax is gradually phased out.) An unlimited marital deduction is allowed for property transferred to a surviving spouse. Other allowable deductions include estate administration expenses, transfers to charity, and certain other items. A tax credit (the unified credit) is allowed against the tentative estate tax liability, which has the effect of exempting the first $1.5 million of an estate from tax. Under the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA; P.L. 107-16), the estate tax is repealed in 2010.

The federal gift tax operates alongside the estate tax to prevent individuals from avoiding the estate tax by transferring property to heirs before dying. (Note that the first $11,000 of gifts from one individual to another is excluded from taxation. Thus, a married couple could each give a child $11,000 each for a total gift of $22,000 every year.) The gift and estate taxes are unified because the same rates and unified credit amount apply to the cumulative taxable transfers over an individual’s lifetime and at death. For example, a gift tax credit of $25,000 claimed during a person’s lifetime reduces the credit that can be claimed at death under the estate tax by $25,000. The rate bracket that applies to a transfer at death is based on cumulative gifts over the decedent’s lifetime as well as the size of the estate. EGTRRA gradually reduces the top rate of the gift tax parallel to the estate tax reductions. The gift tax will remain in place after 2010; its top rate will be the top individual income tax rate applicable under EGTRRA.

The estate and gift tax occupies a minor role in the federal fiscal structure, accounting for only 1.3% of gross federal tax collections in FY2004.1 Further, because of the exemption (the unified credit) and deductions, few estates pay the tax. In 2001, only 2.2% of all deaths of those 25 years old and older resulted in estate tax liability.

Aside from raising revenue, the estate tax has been defended as a means of increasing the overall progressivity of the tax system. The tax falls on those with the

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greatest wealth, and wealth is widely regarded as a good measure of an individual’s ability to pay. Some have argued, however, that the tax impairs operation of the economy by discouraging lifetime saving and capital formation. Whether the estate tax does so, however, is unclear.

The possible impact of the estate tax on small business and farms has often been the subject of debate. Some have argued, for example, that the tax inhibits the transfer of farms and small businesses to heirs and prevents them from staying in the decedent’s family. As a result of such concerns, the estate tax currently has a number of special rules designed to ease its burden on farms and small businesses. However, tax return data show that the farm and business estates most likely to dispose of assets to pay the estate tax tend to be larger estates.


**Excise Taxes**

Excise taxes are a form of consumption tax — levies on the consumption of goods and services rather than income. Unlike sales taxes, they apply to particular commodities, rather than to broad categories. While the federal government has left sales taxes to the states as a revenue source, it levies a variety of excise taxes. Federal excise tax revenues are small compared to other federal taxes. In FY2004, $70.0 billion in excise taxes were collected, amounting to 3.7% of total federal receipts and 0.6% of Gross Domestic Product.

Federal excise taxes are levied on a variety of products; their collection point varies, ranging from the production level to retail sales. In terms of receipts, the single largest tax is the excise tax on gasoline, which made up 30.4% of all excise tax receipts in FY2003. Other prominent excise taxes are those on diesel fuel, domestic air passengers, distilled spirits, beer, cigarettes, and telephone services.

Most federal excise taxes are paid into trust funds devoted to various federal activities rather than remaining in the federal budget’s general fund. In FY2003, almost two-thirds (65%) of excise tax receipts went into trust funds. The largest amount went into the Highway Trust Fund, and consisted of highway motor fuels taxes (including the gasoline tax), retail sales taxes on tractors and heavy trucks and trailers, and an annual heavy vehicle use tax.

Excise taxes serve a variety of fiscal purposes. Some were enacted simply to raise revenue (for example, the telephone tax and fuel taxes enacted for deficit reduction). The taxes linked with trust funds serve to fund expenditure programs by taxing their beneficiaries, or by taxing those responsible for certain problems.

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addressed by expenditure programs. Some excise taxes adjust for the effects of negative externalities — that is, they seek to ensure that the price of products that produce side-effects like pollution reflects their true cost to society. Other purposes of excise taxes include: adjusting the price of imports to reflect domestic taxes, regulation of certain activities, and regulation of activities thought to be undesirable.

The burden of excise taxes is thought to fall on consumption and more heavily on individuals with lower incomes. The tax is believed to be usually passed on by producers to consumers in the form of higher prices. And because consumption is a higher proportion of income for lower-income persons than upper-income individuals, excise taxes are usually considered regressive. However, the incidence of excise taxes in particular cases depends on the market conditions, and how consumers and producers respond to price changes. Further, some economists have argued that consideration of the incidence of excise taxes over an individual’s lifetime reduces their apparent regressivity. The effects of excise taxes on economic efficiency vary, depending on the particular tax. For example, taxes that counter negative externalities probably enhance economic efficiency; others may hamper efficiency and reduce economic welfare by distorting prices and consumption choices.


Tax Statistics

Composition and Size of the Federal Tax System

The federal tax system is composed of five major sources of tax revenue. In FY2004, the individual income tax accounted for 43% of total federal revenue, the Social Security tax for 39% of total revenue, the corporate income tax for 10% of the total, and excise taxes for approximately 4% of the total.4 The remaining 4% of revenue was collected through the estate and gift tax, customs duties, and other miscellaneous taxes.

Since 1960, total federal revenues have fluctuated between 16.5% and 20.8% of Gross Domestic Product (GDP), with the average over the period equal to 18.2% of GDP. After reaching a post-World War II peak of 20.8% of GDP if FY2000, federal receipts measured as a percentage of GDP declined to a historic low of 16.3% of GDP in FY2004. Approximately 39% of this decline was a result of a downturn in the economy, while about 61% of the decline in federal revenues was the result of policy changes (tax cuts). For more information on this recent trend see CRS

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Since the mid-1940s, the individual income tax has been the most important source of federal revenue. Over time, the corporate income tax has fallen from the second to the third most important source of revenue. In the late 1960s, corporate income taxes were replaced by social security taxes as the second most important source of revenue for the federal government.

### Table 3. Composition and Size of U.S. Tax Receipts

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Individual Income Taxes</th>
<th>Corporate Income Taxes</th>
<th>Social Security Taxes</th>
<th>Excise Taxes</th>
<th>Other Taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960</td>
<td>17.8</td>
<td>44.0</td>
<td>23.2</td>
<td>15.9</td>
<td>12.6</td>
</tr>
<tr>
<td>1965</td>
<td>17.0</td>
<td>41.8</td>
<td>21.8</td>
<td>19.0</td>
<td>12.5</td>
</tr>
<tr>
<td>1970</td>
<td>19.0</td>
<td>46.9</td>
<td>17.0</td>
<td>23.0</td>
<td>8.1</td>
</tr>
<tr>
<td>1975</td>
<td>17.9</td>
<td>43.9</td>
<td>14.6</td>
<td>30.3</td>
<td>5.9</td>
</tr>
<tr>
<td>1980</td>
<td>18.9</td>
<td>47.2</td>
<td>12.5</td>
<td>30.5</td>
<td>4.7</td>
</tr>
<tr>
<td>1985</td>
<td>17.7</td>
<td>45.6</td>
<td>8.4</td>
<td>36.1</td>
<td>4.9</td>
</tr>
<tr>
<td>1990</td>
<td>18.0</td>
<td>45.2</td>
<td>9.1</td>
<td>36.8</td>
<td>3.4</td>
</tr>
<tr>
<td>1995</td>
<td>18.5</td>
<td>43.7</td>
<td>11.6</td>
<td>35.8</td>
<td>4.3</td>
</tr>
<tr>
<td>2000</td>
<td>20.8</td>
<td>49.6</td>
<td>10.2</td>
<td>32.2</td>
<td>3.4</td>
</tr>
<tr>
<td>2004</td>
<td>16.3</td>
<td>43.0</td>
<td>10.1</td>
<td>39.0</td>
<td>3.7</td>
</tr>
</tbody>
</table>


Further information on the level of federal taxes since 1940 is contained in CRS Report RS20087, *The Level of Taxes in the United States, 1940-2003*, by David L. Brumbaugh and Don C. Richards.

### The U.S. Fiscal Position Compared to Other Nations

Given congressional interest in the fiscal position of the federal government, the question of how the U.S. public sector compares to other nations often arises. Using aggregate budget data for all levels of government relative to economic output (budget aggregates as a percentage of gross domestic product, GDP) as one measure of the size of public sectors, several observations can be made.
• Compared with the other major industrialized nations, the public sector (including all levels of government) in the United States is relatively small.

• In terms of revenue, Japan and the U.S. public sectors collect the least amount of revenue relative to their economic output.

• In terms of outlays, the U.S. public sector has the lowest level of outlays relative to its economic output.

• The United States, Japan, Germany, France, Italy, and the United Kingdom are all estimated to run a public sector deficit in 2003.

The following table presents Organization for Economic Co-Operation and Development (OECD) estimates of government receipts, outlays, and deficits/surpluses as a percentage of GDP for the seven major industrialized countries in 2003.

Table 4. U.S. Fiscal Position Compared to Other Industrialized Nations in 2003

<table>
<thead>
<tr>
<th></th>
<th>Receipts as a % of GDP</th>
<th>Outlays as a % of GDP</th>
<th>Surplus/Deficit as a % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>30.9</td>
<td>35.7</td>
<td>-4.8</td>
</tr>
<tr>
<td>Japan</td>
<td>29.8</td>
<td>37.7</td>
<td>-7.9</td>
</tr>
<tr>
<td>Germany</td>
<td>45.0</td>
<td>48.9</td>
<td>-3.9</td>
</tr>
<tr>
<td>France</td>
<td>50.4</td>
<td>54.5</td>
<td>-4.1</td>
</tr>
<tr>
<td>Italy</td>
<td>46.4</td>
<td>48.9</td>
<td>-2.5</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>39.3</td>
<td>42.6</td>
<td>-3.3</td>
</tr>
<tr>
<td>Canada</td>
<td>41.3</td>
<td>40.1</td>
<td>1.2</td>
</tr>
</tbody>
</table>

Source: OECD.

Distribution of the U.S. Federal Tax Burden Across Income Classes

The distribution of the federal tax burden is a perennial topic of concern and debate. Tax burdens could be distributed such that all taxpayers pay the same percentage of their income in taxes regardless of their income level, a proportional distribution. Alternatively, the tax burden could be distributed such that lower income taxpayers pay a higher percentage of their income in taxes than do upper-income taxpayers, a regressive distribution. Or the tax burden could be distributed progressively such that taxes as a percentage of income increase as incomes increase.
Economic theory does not provide an answer as to how the tax burden should be distributed among people with unequal incomes. While few would argue that the tax system should be regressive, the degree to which it should be progressive involves subjective value judgements. A consensus seems to have evolved that the federal tax system should be progressive, a goal that, over time, has been achieved.

Studies by the Congressional Budget Office (CBO) show that while there have been some fluctuations in the distribution of the tax burden over the last 20 years, the largest fluctuations have been concentrated at the ends of the income spectrum. Families in the middle of the income spectrum have experienced a stable level of federal taxes over the period. Tax law changes in the early 1980s tended to increase federal taxes on low-income families while reducing taxes on upper-income families. These trends were reversed in the early 1990s when tax law changes raised federal taxes on upper-income families and reduced taxes for families at the lower end of the income spectrum. Changes in 2001 and 2003 provided significant tax reductions for middle- to upper-income families filing joint returns. The following table shows average federal tax rates for 1996 and 2001.

### Table 5. Average Federal Tax Rates for All Households: 1996 and 2001

<table>
<thead>
<tr>
<th>Income category</th>
<th>1996</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lowest quintile</td>
<td>5.6</td>
<td>5.4</td>
</tr>
<tr>
<td>Second quintile</td>
<td>13.2</td>
<td>11.6</td>
</tr>
<tr>
<td>Middle quintile</td>
<td>17.3</td>
<td>15.2</td>
</tr>
<tr>
<td>Fourth quintile</td>
<td>20.3</td>
<td>19.3</td>
</tr>
<tr>
<td>Highest quintile</td>
<td>28.0</td>
<td>26.8</td>
</tr>
<tr>
<td>Top 10%</td>
<td>30.1</td>
<td>28.6</td>
</tr>
<tr>
<td>Top 5%</td>
<td>32.0</td>
<td>30.1</td>
</tr>
<tr>
<td>Top 1%</td>
<td>36.0</td>
<td>33.0</td>
</tr>
</tbody>
</table>


Selected Tax Concepts

Tax Expenditures

Tax expenditures are revenue losses from special tax deductions, credits, and other tax benefits. The Joint Committee on Taxation lists revenue losses from these tax provisions by functional spending categories. The table below reports the mathematical sums of tax expenditures. While it is not precisely correct to add up all tax expenditures, which are estimated individually and have some interactive effects, these totals provide some notion of the magnitude of these provisions. In FY2005, individual income taxes are projected to yield $227 billion.\(^5\) Thus, these tax expenditures are large relative to total receipts.

Table 6. Sum of Tax Expenditure Items by Type of Taxpayer, Fiscal Years 2005-2009 (in billions of dollars)

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Individuals</th>
<th>Corporations</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>812.3</td>
<td>85.8</td>
<td>898.1</td>
</tr>
<tr>
<td>2006</td>
<td>845.4</td>
<td>75.9</td>
<td>921.3</td>
</tr>
<tr>
<td>2007</td>
<td>884.4</td>
<td>82.6</td>
<td>967.1</td>
</tr>
<tr>
<td>2008</td>
<td>935.6</td>
<td>86.1</td>
<td>1021.7</td>
</tr>
<tr>
<td>2009</td>
<td>926.0</td>
<td>91.6</td>
<td>1017.6</td>
</tr>
</tbody>
</table>

Source: U.S. Congress, Senate, Committee on the Budget, Tax Expenditures — Compendium of Background Material on Individual Provisions, S.Rept. 108-54, December 2004, p. 7; updated biennially based on data provided by the Joint Committee on Taxation.

Tax expenditures measure the revenue effects of provisions on a cash flow basis, so they may not reflect the true benefit to the taxpayer (e.g., when the value of a benefit arises from a deferral of taxes). The initial revenue effects of a repeal of a provision may differ from the costs reflected in the tax expenditure budget. For example, a new depreciation scheme usually applies only to new investments, while the tax expenditure reflects effects on old assets.

For lists of tax expenditures see OMB’s Analytical Perspectives on the Budget and the Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2005-2009.

Capital Gains

Under current income tax law, a capital gain or loss is the result of a sale or exchange of a capital asset. If the asset is sold for a higher price than its acquisition price, then the sale produces a capital gain. If the asset is sold for a lower price than

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its acquisition price, then the sale produces a capital loss. Capital gains taxes were reduced in 1997, and the holding period to qualify for long-term capital gain tax treatment was reduced in 1998. Under current law, capital assets held longer than 12 months are considered long-term assets, while assets held 12 months or less are considered short-term assets. Capital gains on short-term assets are taxed at regular income tax rates. In 2003, the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) reduced the maximum tax rate on long-term capital gains income to 5% (0% for 2008) for taxpayers in the 10% and 15% marginal income tax brackets. JGTRRA reduced the maximum capital gains tax rate to 15% for taxpayers in marginal income tax brackets exceeding 15%. These changes are effective for assets sold or exchanged on or after May 6, 2003, and before January 1, 2009.

Some economists argue that lowering capital gains taxes would significantly reduce “lock-in” effects and make resource allocation more efficient. Taxes on increased capital gains realizations would offset some of the initial cost of cutting capital gains taxes. However, there is considerable uncertainty about the magnitude of this unlocking effect. Alternatively, lock-in could be reduced by taxing capital gains on an accrual basis or by taxing capital gains passed on at death. These alternative solutions, however, face a variety of technical problems, and the idea of taxing gains at death has been unpopular.

Arguments have also been made that cutting capital gains taxes would increase savings and stimulate economic growth. While evidence on the effect of tax cuts on savings rates and, thus, economic growth is difficult to obtain, most evidence does not indicate a large response of savings to an increase in the after-tax rate of return.

A case might be made for cutting capital gains taxes on corporate stock since corporate equity capital is subject to taxation both under the corporate and individual income taxes. This double taxation encourages corporations to take on too much debt and directs too much capital to the non-corporate sector. On the other hand, reducing the capital gains tax would increase the relative penalty that applies to dividends and introduce tax distortions into the decisions of firms to retain earnings.

A major complaint made by some is that cutting capital gains taxes would primarily benefit very high-income individuals. Capital gains are concentrated among higher-income individuals both because these individuals tend to own capital and because they are especially likely to own capital that generates capital gains income.

Some argue that taxes on capital gains income should be reduced as a means of simplifying the tax code. Part of the problem with taxing capital gains income has always been the trade-off between taxing capital gains more efficiently and equitably and the added complexity in the tax code that this would entail.

Finally, many economists argue that a capital gains tax appears unlikely to provide much stimulus to the economy in the short run.

For more information, see CRS Report RS20250 Capital Gains Tax Rates and Revenues, by Gregg Esenwein; CRS Report 96-769. Capital Gains Taxes: An
Marriage Penalties and Bonuses

Defining the married couple as a single tax unit under the federal individual income tax violates the principle of marriage neutrality. Some married couples pay more income tax than they would as two unmarried singles (a marriage tax penalty) while other married couples pay less income tax than they would as two unmarried singles (a marriage tax bonus).

The most important structural factors affecting the marriage neutrality of the income tax are the earned income tax credit (EITC), the standard deductions, and the tax rate schedules. Under the current tax system, single individuals, heads of households, and married couples are subject to different standard deductions and tax rate schedules. In addition, the EITC amounts and phase-out ranges vary based on the number of dependents claimed. These differences give rise to structural marriage tax bonuses and penalties.

Generally, the more evenly divided the earned income of the two spouses, the more likely they are to have a structural marriage tax penalty. Hence, married couples in which each spouse earns 50% of the total earned income have the largest marriage tax penalties. On the other hand, married couples where one spouse earns all the earned income have the largest marriage tax bonuses.

The actual determination of whether any given married couple has a marriage tax penalty or bonus depends on how their income, deductions, and personal/dependent exemptions are split between the two spouses for calculation purposes. It also depends on the filing status under which each spouse’s tax liability is computed — single or head of household. CBO uses assumptions that some economists believe may overstate marriage tax penalties. However, even under these assumptions, CBO estimated that in 1999, only 43% of married couples incurred a tax penalty, while 52% experienced a marriage tax bonus.

It is a widely accepted goal that the individual income tax should not influence the choice of individuals with regard to their marital status. Marriage neutrality, however, conflicts with two other widely accepted concepts of equity: progressivity and the equal income taxation of couples with equal incomes.

Regardless of how these three concepts of equity are juggled, under current definitions an income tax can achieve only two of the goals; it cannot simultaneously achieve all three. The current income tax has chosen progressivity and equal taxation of couples with equal incomes at the expense of marriage neutrality. A critical point in this debate is that there are no unambiguous right or wrong answers to the question of which of these three competing goals of equity is the most important.

Legislation in 2001, 2003, and 2004, addressed marriage tax penalties by increasing the standard deduction for couples to twice that of singles and broadening


**Tax Deferral**

One perplexing problem associated with taxing income involves the issue of tax deferral. Ideally, a tax levied on income should be assessed when the income accrues to the taxpayer. However, as a result of many factors (some income is taxed when it is realized rather than when it accrues, there can be a mismatch between income and the expense of earning it, or the tax code specifically permits it), taxes are often deferred into the future. Since money has a time value (a dollar today is more valuable than a dollar in the future), tax deferral effectively lowers the tax rate on the income in question.

Illustrating the benefits of tax deferral is the case of income from capital gains in which the tax is assessed when the gain is realized rather than as it accrues. If a capital asset is acquired for $100 and appreciates at a rate of 10% per annum, by the end of the first year it has appreciated in value to $110 and by the end of the second year it is worth $121. Assuming a marginal tax rate of 15% (the top marginal tax rate on long-term capital gains), if the gain were realized at the end of the second year, then a tax of $3.15 ($21 times 15%) would be levied on the realized appreciation. The after-tax return would be $17.85.

In contrast is the case of a $100 investment in an interest-bearing account earning a 10% rate of return. At the end of the first year, the account would yield $10 in interest. Tax on the interest, assuming a 15% marginal income tax rate, would be $1.50, leaving $108.50 in the account. By the end of the second year, the account would yield $10.85 in interest. Tax on the second year’s interest would be $1.63, leaving $117.72 in the account, for an after-tax return over the two-year period of $17.72.

It is apparent from the examples above that the investment in the asset producing a capital gain earns a higher after-tax return than the comparable investment in an interest-bearing account. In essence, the reason for this result is simply that, for the asset producing a capital gain, the tax on the appreciation in the first year was deferred, with the deferred tax remaining in the account and earning interest. The benefits of tax deferral increase the longer an asset is held and tax can be deferred.

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6 The acts were the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16), the Jobs and Growth Tax Relief and Reconciliation Act of 2003 (P.L. 108-27), and the Working Families Tax Relief Act of 2004 (P.L. 108-311).
(It should also be noted that the top marginal tax rate on long-term capital gains income is currently capped at 15%, while the top marginal tax rate on interest income can reach 35%.)

Tax deferral not only affects the taxation of assets producing capital gains income, but also is of concern in other areas of tax policy, such as the taxation of contributions to retirement accounts and depreciation allowances.

**Depreciation**

When a business purchases a tangible asset such as a machine or structure, it is not incurring a cost; it is simply exchanging one asset — for example, cash — for another. The full purchase price of an asset is therefore usually not tax deductible in the year the asset is bought. Assets do, however, decline in value as they age or become outmoded; this decline in value (depreciation) is a cost. And because assets gradually depreciate until they are worthless, the tax code permits firms gradually to deduct the full acquisition cost of an asset over a number of years.

The tax code contains a set of rules that govern the rate at which depreciation deductions can be claimed. The rules determine the tax depreciation rate by specifying a *recovery period* and a *depreciation method* for different types of assets. An asset’s recovery period is the number of years over which deductions for the asset’s full cost must be spread; the applicable depreciation method determines how depreciation deductions are distributed among the different years of the recovery period. The slowest method is straight-line, in which equal deductions are taken each year. Declining balance methods, in which a fixed fraction of the cost less prior depreciation is deducted, cause larger shares to be taken in earlier years.

Importantly, a tax deduction of a given dollar amount is worth more to a business the sooner it can be claimed; the sooner a tax deduction can be claimed, the sooner the tax savings it generates can be invested and earn a return. It follows that the tax rules governing when depreciation deductions can be claimed are quite important to businesses. If depreciation deductions can be claimed faster than an asset actually declines in value, a tax benefit exists; depreciation is said to be *accelerated*. If, on the other hand, depreciation deductions can be claimed more slowly than the corresponding asset actually depreciates, a tax penalty occurs. Only if depreciation deductions are claimed at the rate an asset actually depreciates do taxes confer neither a tax benefit nor a tax penalty.

According to some estimates, current tax depreciation for some types of equipment is somewhat accelerated compared to economic depreciation. “Bonus” depreciation allowances that recent tax acts have provided for temporary periods may have further accelerated depreciation for certain equipment. (See, for example the depreciation provisions of the Jobs and Growth Tax Relief and Reconciliation Act of 2003, P.L. 108-27.) Depreciation for most structures is probably not accelerated. Thus, firms have a tax incentive to use more equipment and fewer of other types of assets in their production process than they otherwise would. This influence of taxes in the allocation of capital probably reduces economic efficiency.
Forms of Business Organization

The Internal Revenue Code recognizes several different forms of business organization; their tax treatment varies. The principal forms are C corporations, S corporations, partnerships, and sole proprietorships.

Apart from taxes, corporations are a legally defined form of business organization, with ownership stakes represented by shares that may or may not be publicly traded. Shareholders’ liabilities are limited to their stake in the corporation. The Internal Revenue Code normally subjects corporate profits to the corporate income tax under its subchapter C; corporations subject to income tax are thus often referred to as “C corporations.” As explained more fully above, in the report’s section on the corporate income tax, the part of C corporation income generated by equity investment is subject to two layers of tax: the corporate income tax and the individual income tax. In contrast, corporations that qualify as “S corporations” are not subject to the corporate income tax. Instead, their net profits are passed on a pro rata basis through to the individual shareholders who are taxed on the profits under the individual income tax. To qualify, S corporations may have no more than 75 shareholders.

Taxes aside, partnerships are like corporations in that they have multiple owners. In contrast to corporations, some partnerships convey a liability for debts that is not limited to partners’ contributions to the enterprise. Partnerships are also less likely than corporations to be publicly traded, although some forms of partnerships (“master limited partnerships”) are. Like S corporations, partnerships are not subject to the corporate income tax; partners are subject to their share of partnership earnings under the individual income tax.

Limited liability companies (LLCs) have some of the characteristics of both partnerships and corporations. Under IRS “check the box” regulations, LLCs can elect to be taxed either as corporations or as partnerships. Other specially defined business entities include real estate investment trusts (REITs), which are required to engage primarily in passive investment in real estate and securities. Qualifying REITs are permitted to deduct dividends they pay to shareholders, which effectively exempts REITs from the corporate income tax. Regulated investment companies (RICs), who invest primarily in securities and distribute most income, are also permitted to deduct dividends. The simplest forms of business organization are sole proprietorships. Sole proprietorships have only one owner; there is no legal distinction between the business and the business’s owner. For tax purposes, business profits earned by a sole proprietor are taxed to the owner under the individual income tax. The corporate income tax does not apply.

For more information, see CRS Report RL31538, *Passthrough Organizations Not Taxed as Corporations*, by Jack H. Taylor.

Taxes and Competitiveness

Competitiveness can be defined in a variety of ways (indeed, some would argue that it has no concrete meaning at all, at least at the national level). But regardless
of how competitiveness is defined, standard economic analysis suggests that most tax measures can do little to enhance it. Indeed, some observers argue that many of the tax provisions designed to improve U.S. performance in the world economy actually reduce U.S. economic welfare, world economic welfare, or both.

An individual firm or its employees might defend competitiveness as its ability to withstand the threat of foreign competition. If asked, they might recommend some manner of tax benefit targeted at their industry: perhaps favorable depreciation rules or tax credits for consumers who buy their product. Economic analysis predicts that such measures might well improve the position of the targeted industry: its costs would fall because its taxes have fallen, introducing the possibility of reduced prices, larger market shares, and more jobs.

But economic theory also predicts that the effects of a targeted tax benefit will ripple through the economy and ultimately confound the policy’s competitiveness goals for the economy as a whole. Because the nation’s resources are limited, the theory holds, a narrowly targeted tax benefit will simply reshuffle the way resources are employed, drawing them into the favored industry and away from alternative uses. And while exports in the favored sector may rise (or imports fall), the theory predicts that the performance of other sectors will decline. Further, economics predicts that the effect of taxes on how the economy’s resources are deployed diminishes the nation’s economic vitality: market forces, not tax rules, this theory holds, are usually the best way to guarantee that resources are used efficiently.

Policymakers or others at the national level may take a broader view of competitiveness and define it as the ability of the country as a whole to sell its exports — not just the performance of one sector. Such a view might recommend, for example, a tax incentive for exporting, regardless of the product. But in this case, economic theory suggests that exchange rate adjustments will stymie any effect the export subsidy may have in improving the trade balance. Although implementation of an export subsidy may initially increase exports, the increase in exports raises the price of the dollar in currency markets, which, in turn, makes U.S. exports more expensive and imports cheaper. As a result, exports are predicted to fall and imports increase until any initial improvement in the balance of trade that may have occurred disappears. Further, to the extent that part of the export tax benefit is passed on to foreign consumers as lower prices, this analysis indicates that the measure transfers economic welfare from U.S. taxpayers to foreign persons.

Many economists would argue that taxes can alter the balance of trade in the short and medium term, but not in the way that is perhaps commonly thought. If a country runs a trade deficit, it is using more than it produces, and to do so, it must, in effect, borrow from abroad, importing the foreign investment that finances the deficit. The trade balance thus mirrors the balance on capital account, and it follows that taxes alter the trade balance not by their direct application to exports or imports, but by altering capital flows. For example, a cut in taxes on business investment in the United States increases the U.S. appetite for investment; foreign capital inflows accordingly increase and net U.S. exports (imports minus exports) fall. Or, a tax cut that increases the federal budget deficit can be expected to exert upward pressure on real interest rates, thereby attracting additional foreign capital and expanding the
trade deficit. Conversely, a tax increase that reduces the budget deficit can also reduce the trade deficit.

What of taxation of capital flows rather than trade? For example, can taxes improve the economy by making U.S. firms that operate abroad more competitive, cutting their costs and helping them compete more effectively against foreign firms? Again, economic theory is doubtful, holding that economic performance is enhanced by a neutral tax policy that neither discourages nor encourages overseas investment.