

The time, money, and aggravation that tens of millions of Americans expend to understand and comply with the income tax is, it turns out, nothing new. In his 1776 *The Wealth of Nations*, Adam Smith noted that “subjecting the people to the frequent visits and the odious examination of the tax gatherers...may expose them to much unnecessary trouble, vexation, and oppression: and though vexation is not, strictly speaking, expence, it is certainly equivalent to expence at which every man would be willing to redeem himself from it.” For Americans today, the “expence” includes maintaining records, learning the law, preparing the return or hiring a preparer, corresponding with the IRS, and learning how to reduce (or cheat on) taxes.

How Bad Is It?

For low-income households, headaches can arise from issues regarding filing status, abandoned spouses, dependency tests, the child and dependent care tax credit, and the earned income tax credit. For individuals with higher income, complexity arises in itemizing deductions, the treatment of capital income (particularly capital

gains, interest deductions, and passive losses), and the alternative minimum tax. For small business owners, issues relating to inventory, depreciation, and distinguishing various expenses can be complicated. For large corporations, tax complexity is centered on depreciation, international income, the alternative minimum tax, and coordinating with state taxes. In



William Gale is the Joseph A. Pechman fellow in the Brookings Economic Studies program. He is the co-editor, with Henry Aaron, of Effects of Fundamental Tax Reform (Brookings, 1996). This article is based on a recent study, “The Role of Administrative Factors in Tax Reform,” that is co-authored with Janet Holtzblatt of the Treasury Department.

WHY ARE TAXES SO COMPLICATED?

AND WHAT CAN WE DO ABOUT IT

addition, large firms are almost continually audited; one tax expert has described the basic corporate tax return as nothing more than an “opening bid.”

Stories of income tax complexity are legion. The internal revenue code contains more than five million words. In *Money Magazine's* recent surveys, every one of 40 to 50 tax preparers came up with a different estimate of the tax liability due on a complex, hypothetical return. The share of taxpayers who pay tax professionals to complete their tax returns rose from 42 percent in 1981 to 51 percent in 1997.

Yet the costs can easily be overblown or distorted. For many people, the tax system is not that complicated. Almost 40 percent file simplified 1040A or 1040EZ forms, and about 18 percent file the 1040 but have no itemized deductions or business income. Many people go to preparers to expedite refunds or because they prefer to spend their time on other things rather than on preparing taxes. Marsha Blumenthal and Joel Slemrod found that while the average taxpayer spent 27.4 hours on filing income tax returns and related activities, 30 percent spent less than 5 hours, and another 15 percent spent between 5 and 10 hours. About 11 percent spent 50–100 hours, and 5 percent spent more than 100 hours. About half had no out-of-pocket expenses, and 17 percent paid less than \$50. Costs were highest among high-income and self-employed taxpayers.

Estimates of the total cost of complying with and running the individual and corporate income tax systems in 1995 go as high as \$600 billion, but the most reasonable estimates range between \$75 billion and \$150 billion, or about 10–20 percent of income tax revenue. Even at \$75 billion—or \$386 per adult per year—tax complexity imposes significant costs. Resources lost to compliance and administrative costs could be productively devoted to other activities. Complexity also generates confusion and aggravation among taxpayers, which can reduce confidence in the system. Thus, *other things equal* social welfare would be improved by having a tax system that is simpler to comply with,

administer, and enforce. Of course, other things are never equal.

Tax Trade-offs

Since virtually everyone agrees that taxes should be easy to understand, administer, and enforce, why are taxes so complicated? The answer is that people also agree that taxes should be fair, should be conducive to economic prosperity, should raise sufficient revenue to finance government spending, and should respect individuals' privacy. Many people also think tax incentives should be used to pursue social or economic policies for the poor, housing, health, the environment, and small businesses.

Trading off these goals is difficult. Sometimes the meaning of a goal is unclear. Fairness, for example, is clearly “in the eyes of the beholder.” Sometimes people differ about the best way to reach a goal. Is it best to help the poor via cash payments, tax incentives to work, direct provision of health care and education, or some other way? Finally, and most importantly, the goals are mutually inconsistent, and people disagree about which goals deserve the greatest weight.

As a result, tax policy involves trade-offs—and complexity is the result. In the end, complexity resembles pollution. Some of it is undoubtedly unnecessary, but much of it is the unfortunate byproduct of the production of goods that many people want.

For reasons of fairness, most tax systems tailor tax burdens to depend on individual characteristics. This creates complexity in several ways. It requires tracing income from the business sector to individuals. It requires reporting and documenting individual characteristics such as marital status, dependents, each person's level and composition of income and spending, and so on. And it requires tax rates that vary with individual characteristics, creating incentives to shift income to other people with lower income, such as children, or to other time periods when income might be lower.

Complexity also derives from using the tax system to house social programs that subsidize what Congress and a

significant portion of the population consider to be desired activities: housing, charity, health insurance, higher education, child care, state and local governments, retirement saving, entrepreneurial activity.

Closing tax loopholes also increases complexity. Any time a provision for special treatment or social engineering arises, it must be limited. If the child care credit, for example, is not intended to subsidize ski lessons in Aspen, some line has to be drawn concerning what is allowed and what is not. The taxation of financial income is particularly difficult in this regard.

Clamping down on tax evasion often increases complexity. Given the opportunity, people sometimes cheat on their taxes. Taxes on income from wages, for example, are withheld and sent to the government by the employer. The evasion rate is around 1 percent. Taxes on income from sole proprietorships are neither withheld nor sent in by a third party. The evasion rate here exceeds 30 percent. Many tax complexities exist to limit opportunities to cheat. In the late 1980s, a new law required people who claimed the child care credit to provide the Social Security number of the care provider. This both reduced the number of child care credit claims and raised by 65 percent the amount of income reported by child care providers.

While trade-offs among consensus policy goals are an important source of complexity, political factors are another. That is, complexity can also be the result of the production of goods that only a few of us want. Politicians and interest groups have a vested interest in certain types of subsidies that reduce taxes on favored constituencies. The lavish campaign contributions received by members of the House Ways and Means Committee do not come from lobbyists deeply respectful of a tax code clean of special subsidies. There is no lobby for simplicity.

Sometimes the tax code is used to hide subsidies that would not be supported as outright spending. Consider a “homeowner welfare program” in which taxpayers earned an entitlement to help pay their mortgages. The entitle-

ment grew in proportion to mortgage size, interest rate, and tax rate, but anyone whose entitlement was less than \$6,000 received nothing from the program. Obviously, not a very appealing idea, but not that different from the mortgage interest deduction.

And let's face it: taxpayers *like* complexity that reduces their taxes. It's just complexity that raises taxes that annoys. Thus, people will grump about the new filing requirements for capital gains or child credits, but few will volunteer to give up those cuts.

The real question is not the total amount of compliance costs, but whether society gets good value for income tax complexity. My view is that, generally, we do not. The economy-wide perspective is important here. Suppose people had to fill out ten extra lines of the tax form to receive a \$1,000 tax cut. Each might regard that as "good complexity," well worth the added cost of providing a few extra pieces of information. But in the aggregate, the revenues would have to be raised from taxpayers, so everyone's tax "cut" would be from a higher initial tax liability and net taxes would be the same. Thus, from a social perspective, the sum of all individuals' "good complexity" would be zero or negative.

Many existing provisions designed to encourage certain activities end up either largely subsidizing activity that would have occurred anyway or creating new problems. Many of the reasons for complexity are completely inappropriate: hiding unpopular programs, special loopholes that fuel campaign contributions. It is hard to see any impact on economic growth, and the "fairness" that occurs is a very strange kind. The subsidies help one group, but at the expense of all others.

Fundamental Tax Reform and Simplicity

The complexity of existing taxes is a powerful force behind the movement to replace the income tax with a flat tax or sales tax. The new systems would shift the tax base to consumption, rather than income, flatten tax rates, eliminate all deductions and credits, and collect most or all taxes at the business level. Plan advocates promise great simplification, and it is clear that pure versions of either plan would be much simpler than the existing system. But, well, it's not that simple.

Just as the income tax has deviated from a low-rate tax, with a one-page form and three pages of instructions, the flat tax or sales tax would also be under pressure to depart from its pure form. The thousands of lobbyists now working in Washington are unlikely to pack up and go home. In short, you can repeal the tax code, but you can't repeal politics.

On paper, for example, the sales tax would be vastly simpler than the current system. But the 45 existing state sales taxes are nothing like the single-rate, no-exemption sales tax that is proposed at the national level. The states feature numerous exemptions for goods and especially services, as well as different rates for different goods.

Moreover, as Joel Slemrod has shown, it is inappropriate to analyze simplicity independently of evasion and enforcement. The sales tax rate required to replace federal taxes would be well above the 23 percent rate claimed by advocates. After correcting for mistakes in the way the proposal treats government spending, and adjusting for political factors that would erode the tax base and for a reasonable amount of tax avoidance activity, a federal sales tax could result in mark-ups at the cash

register in excess of 70 percent. At these rates, the incentive to evade sales taxes (which, unlike the income tax, feature no third-party withholding to aid in compliance) and the political pressure to exempt certain goods from taxes would be strong.

No country has ever successfully run a high-rate national retail sales tax. Many have tried to implement some variant of a sales tax and have given up.

European governments, and numerous conservative and liberal scholars, have concluded that sales taxes at the required rates would be unworkable.

How about the flat tax? Under such a tax, businesses pay taxes on gross sales minus the cost of materials, services, capital goods, wages, and pension contributions. Individuals pay taxes on wages and pensions, less personal exemptions. No other income is taxed, and no other deductions are allowed. Flat tax advocates claim that individual and business returns will fit on a post card. In theory, the flat tax promises to be as simple as the sales tax.

But flat tax proponents have already acknowledged the need to provide transition relief to businesses that bought assets under the old system. Various flat tax plans include deductions for mortgage interest, charity, and payroll taxes. Deductions for health insurance and state and local taxes, the earned income credit, and graduated tax rates on wage income cannot be far behind. Allowing for these items would raise the required flat tax rate to about 32 percent and complicate taxes.

More fundamentally, the flat tax makes different distinctions than the existing system does. This will create new "pressure points," and so could create a host of new compliance and sheltering issues and accentuate problems created by existing regulations. For example, the differential treatment of "interest income" and "sales" under the flat tax has led tax experts



Charles McLure and George Zodrow to conclude that the business tax “contains unacceptable opportunities for abuse.” As attorney Alan Feld notes, the flat tax will either generate complicated business transactions (to skirt the simple rules) or complicated tax laws (to reduce the gaming possibilities), or both.

The flat tax would cause huge changes in tax liabilities for businesses across the country. It would create situations where some businesses with large economic profits would pay no taxes and others with economic losses would face steep taxes. Amending the tax to address these issues would create complexity.

At the individual level, the flat tax would renegotiate every alimony agreement in the country. Under the flat tax, alimony payments would no longer be deductible and receipts would no longer be taxable. Another difficulty would arise from earnings that are subsequently stolen. Under the flat tax, a robbery victim is still liable for taxes—and the robber is not. Under the income tax, it is the other way around. Additional anomalies will no doubt be discovered. Each of these problems with the individual tax could be fixed—but each solution would require a bigger postcard. Even a flat tax modified along these lines would be simpler than the current system. But with a rate of 30 percent or more, a realistic flat tax may not be politically appealing.

Simplifying the Income Tax

What about tax simplification options in the existing system? To begin with, procedural changes could raise the visibility and explicit consideration of simplicity and enforcement issues in the making of tax policy. For example, the recent IRS restructuring legislation requires the IRS to report to Congress each year regarding sources of complexity in the administration of federal taxes. The Joint Committee on Taxation is required to prepare complexity analysis of new tax legislation that affects individuals or small businesses.

It is also possible to eliminate the need for certain taxpayers to file tax returns. Thirty-six countries already use a return-free system for some of their taxpayers, replacing end-of-year filing requirements with withholding throughout the year and end-of-year reconciliation by the tax agency. In recent work, Janet Holtzblatt of the Treasury Department and I found that 52 million U.S. taxpayers could be placed on a return-free system with minor changes in the structure of taxes. These families have income only from wages, pensions, Social Security, interest, dividends, and unemployment compensation; they do not itemize deductions; and they face at most a 15 percent tax rate. Although the net compliance and administrative savings may not be great (because these people already have simple returns), a return-free system could reduce the psychic costs (fear and aggravation) associated with tax filing for the affected taxpayers.

Structural reforms could also reduce complexity. Broadening the tax base by eliminating deductions and preferences and taxing capital gains as ordinary income directly removes complexity. Increased standard deductions remove many people from the tax system. Lower tax rates would

reduce the value of sheltering and cheating. Increasing the number of people who face the same “basic” rate facilitates the withholding of taxes on interest and dividends at the source, further simplifying taxes and increasing compliance. In short, broadening the base and reducing the rates can be revenue-neutral, fair, and efficient, as well as simplifying. Such reforms make taxes simpler for many taxpayers and could reduce compliance costs by 10–15 percent.

Getting Serious about Simplicity

We could have much simpler taxes if we were willing to change our preferences and forgo common notions of fairness, reduce our concern with tax evasion and loopholes, eliminate a raft of targeted social and economic incentives, and reduce the extent to which taxes depend on individual characteristics. Retaining those preferences, however, does not condemn us to much of the seemingly needless complexity of the current code. While the goal of fundamental tax reform is both more distant and less likely to resolve current problems than its advocates might care to admit, the existing system could be improved and simplified with a concerted effort to take simplicity seriously as a distinct policy goal. ■

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