Radical Simplification of the Income Tax: Issues and Options

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Introduction

Taxes have always been “too complicated”
- Adam Smith
- 1913 income tax
- Jimmy Carter
- William Simon

This is a good time to talk about simplification
- Tax season
  - 2025 right around the corner

Spoiler Alert: No magic bullet

Brookings and TPC do not take Institutional positions
Outline

• Four overarching themes

• Four caveats

• Four questions

• Four proposals

• Four conclusions
Four Overarching Themes

• Massive potential for simplification

• No such thing as “just” simplifying the system

• Simplifying “taxes” versus “interactions with the government”

• Key question: Marginal (social) value of complexity
Four Caveats

Focusing on simplification related to

- Federal taxes, not state
- Individual income tax, not corporate
- Costs for individuals, not the IRS
- Most people, not all
Question 1: Why are taxes complex?

• Why don’t we just have the simplest system – a head tax?

• Trade-offs among policy goals
• Lobbying process
• Hard to measure
• The world is complicated (Finance, Childcare)
Question 2: How should we measure complexity?

- Standard metrics
  - Sum of administrative and compliance costs (Slemrod 1984)
  - Number of words in the code (Benzarti)

- Conventional and useful measures, but not ideal
Question 2: How should we measure complexity? (continued)

• Unconventional metric

• A survey by Cash App shows that 54% of Generation Z and 38% of Millennials report that the stress of filing taxes has either brought them to tears in the past or they expect tears this year.

• One in four Gen Z-ers reported a need for help from a therapist to recover from the experience.
Question 3: Why is complexity a problem?

- Imposes tangible costs on individuals
  - 3-17% of income tax revenues
  - Regressive, but larger absolute costs among high-income households
  - Higher in the US than other countries (b/c of social policy in the tax code)

- Creates intangible costs
  - Can facilitate avoidance and evasion (and reduce ability to achieve policy goals)
  - Can make people think that others are (unfairly) avoiding and evading

- People are willing to pay for simpler taxes, but not that much
  - $130, on average, about what a commercial tax preparer charges (Benzarti)
Question 4: Which features of the code affect complexity?

• Structural
  • Base – Broad versus Narrow
  • Rates – Flat versus Graduated
  • Deductions, credits – Universal versus Targeted

• Administrative
  • Withholding at source
  • Filing practices – pre-populating or no-return systems
Four proposals

• Apples-to-apples comparison with the current system
  • Each option is revenue- (or budget) neutral relative to 2023 system

• Each is more progressive than the 2023 system

• Good ideas, hopefully; but not cure-alls
  • Help illustrate the trade-offs
  • Meant to be a menu of options
Proposal 1 – Simplified Income Tax

Repeal
• All itemized deductions
• All preferential rates – capital gains, dividends, section 199a
• Alternative minimum tax
• All credits
• Head of household filing status

Introduce
• Personal credit – $1,000 per person, including children
• Work credit – 20% of one’s earnings up to 20k, phased out by $40k
• Both are fully refundable
Simplified Income Tax – Continued

• The tax calculation process is simplified
  • Choose filing status – Married or Not
  • Report sources and amounts of income
  • Claim standard deduction, personal credit(s), and (if applicable) work credits
  • Look up tax amount

• Notes
  • Still a progressive income tax
  • Still provides support for low-income HH, HH with children, and work
  • Still “high end” complexity
Itemized deductions

- The higher standard deduction introduced in 2017 means that ID are used predominantly by high-income households.

- Mortgage Interest:
  - Mainly raises prices not homeownership rates
  - If structured as a “homeowner welfare” spending program, it would be embarrassing

- Charitable contributions:
  - Hardest call, could consider modification
Preferential rates

• Capital gains
  • Lower CG rates are the mother of all tax shelters
  • Revenue estimates include change in realization behavior
  • Broader reform could include taxing capital gains at death

• Section 199a
  • Intended to create parity with respect to corporate rate but is:
    • Expensive
    • Extremely regressive
    • Complex
    • Inconsistent with horizontal equity with respect to wages
Head of household/EITC/CTC

• HOH benefit structure rises with income

• EITC
  • Comingles work and child benefits
  • Complex rules and phaseout
  • Low benefits for childless workers

• CTC does not reach many families because their income is too low
The new personal credit and work credit

Personal credit
• $1,000 per person (including children) in Proposal 1
• Fully refundable / mini version of Universal Basic Income (UBI)

Work credit
• Depends only on individual earnings
• Could be administered entirely outside the income tax
• But some high-income households would receive it
Simplified Income Tax: Effects on All Filers

Percent Change in ECI

Expanded Cash Income Bracket

- Less than 10
- 10-20
- 20-30
- 30-40
- 40-50
- 50-75
- 75-100
- 100-200
- 200-500
- 500-1,000
- More than 1,000
Simplified Income Tax: Effects on Filers with Children

Percent Change in ECI

Expanded Cash Income Bracket
Proposal 2 – Modified, Simplified Income Tax

• Same as Proposal 1, except

• Personal credit is $2,000 per person
  • Phase out starts at 72k married (36k single) at a rate of 0.4
  • E.G., phase out is complete at 92k (married, two kids)

• Trade-offs
Modified Simplified Income Tax: Effects on Filers with Children

Percent Change in ECI

Expanded Cash Income Bracket

Simplified

Modified Simplified
Proposal 3 – Back to the Future (based on Graetz 1997)

• Same changes as in Proposal 1

• Raise the standard deduction to $100k married ($50k single)
• Create a 10% VAT

• To make those changes work, in terms of revenue and distribution:
  • Raise all <25% tax rates to 25% (to apply to income above 100k/50k)
  • Raise the personal credit to $2,800
Raising the Standard Deduction

• A simple way to remove many people from the need to file tax returns
  • Filing requirements typically key to SD amount
  • TCJA raised the standard deduction and substantially reduced the probability of itemizing
• With an SD of $100k / $50k, almost two-thirds of all tax filing units would not need to file
  • Would make the income tax a levy on middle- and upper-income households
  • More like what it used to be (hence “Back to the Future”)
Value-Added Tax (VAT)

• Sales tax collected in chunks at each stage of production (rather than all at the retail stage)
• In place everywhere except the US
• Substantial revenue
• Does not distort saving, investment choices
• Administrable, enforceable
• Needs to have a broad base to remain simple (New Zealand, not Europe)
Proposal 4 – “UBI”

• Same as Proposal 3, except

• Don’t raise the standard deduction

• Instead, raise the personal credit to $3,900
  • (compared to $2,800 in Proposal 3)
Universal Basic Income

• All the proposals contain refundable credits, which are UBI’s, so it is a matter of degree to call this proposal a UBI.

• Under Proposal 4, a family of four would receive $15,600 per year before having to pay income tax and VAT.

• UBIs have attracted support from the right and the left

• Supported by many recently in the context of using carbon tax revenues
Four proposals

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<tr>
<th>Repeal itemized deductions</th>
<th>Simplified Income Tax</th>
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</thead>
<tbody>
<tr>
<td>Repeal section 199a deduction for business income</td>
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<td>Repeal preferential rates for capital gains and dividends</td>
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<td>Repeal all personal income tax credits</td>
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<td>Repeal head of household filing status</td>
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<td>Repeal individual alternative minimum tax</td>
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<td>Introduce refundable work credit</td>
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<tr>
<td>Introduce refundable personal credit</td>
<td>$1,000</td>
<td>$2,000 but phased out</td>
<td>$2,800 to $100k for couples</td>
<td>$3,900</td>
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<td>Increase the standard deduction</td>
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<td>Introduce 25% minimum tax rate bracket</td>
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<td>Introduce a 10% value-added tax</td>
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Simplified Income Tax

Modified Simplified Income Tax

Back to the Future

Simplified Income Tax, VAT, UBI
Effects of All Simplification Proposals

Expanded Cash Income Bracket

Percent Change in ECI

Simplified
Modified Simplified
Back To The Future
UBI
Effects on complexity

• Filing requirement – if income is above the standard deduction
  • About 22% of tax units avoid having to file under current law
  • Under proposal 3, about 64% would avoid having to file

• Record-keeping requirements
  • A major part of compliance costs (Slemrod, Benzarti)
  • Would be reduced substantially under all four proposals

• Ability to have return “successfully” pre-populated would rise dramatically
  • People are willing to pay for pre-populated returns (about $77)
  • Both liberals and conservatives willing to pay (Benzarti and Wallossek)
Four Conclusions

• We know how to do simplify taxes

• Simplification (and Direct File) would help a lot of people

• If simplification were easy politically, it would already have been done

• But everything is on the table in 2025 and simplification is a better idea than many others floating around.
Some Resources

• TAX CALCULATOR:
  • https://tpc-tax-calculator.urban.org/

• PAPER:
  • https://www.brookings.edu/articles/radical-simplification-of-the-income-tax-issues-and-options/
Calculating Income Tax

1. Select Filing Status
2. Calculate AGI
3. Subtract Adjustments and Deductions
4. Taxable Income

Taxable Income
5. Apply Tax Rate Schedule
6. Gross Tax Liability
7. Subtract Credits
8. Net Tax Liability