



**Tax Policy Center**  
Urban Institute and Brookings Institution

## THE TAX POLICY

### BRIEFING BOOK

*A Citizens' Guide for the  
2008 Election and Beyond*

# INCREMENTAL REFORM

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## Tax Simplification: Why are taxes so complicated?

Almost everyone agrees that the current tax system is too complicated, yet almost every year the system gets more complex, not less. Why? The reason is that simplicity almost always conflicts with other tax policy goals. Most people believe taxes should be fair, conducive to economic prosperity, and enforceable, as well as simple. But even people who agree on these goals often disagree about the relative importance of each. As a result, policies usually represent a balance among competing goals, and simplicity often loses out to other priorities. For example, most countries tailor tax burdens to the characteristics of individual taxpayers. That can make taxes fairer but also more complex. Income has to be traced from businesses to individuals. Individual characteristics such as marital status and number of dependents, as well as the composition of expenditure or income, have to be reported and documented. These conflicts appear to have been especially relevant in the current tax code, where desires to channel tax cuts to particular groups have added significant complexity.

- The political process creates complexity. Politicians and interest groups support tax subsidies for particular groups or activities. Targeted subsidies inevitably complicate the tax system by creating distinctions among taxpayers and among sources and uses of income.
- Some complexity is necessary to deter tax avoidance. Taxpayers have every right to reduce their taxes by any legal means. But their doing so inevitably raises questions about whether particular activities or expenditures qualify for tax-preferred status. The Treasury Department responds with rules designed to limit avoidance. Taxpayers in turn respond by inventing transactions to skirt the new rules. This can create a vicious cycle that leads to more and more complex rules and increasingly sophisticated and complex avoidance strategies.
- Many complicated provisions were enacted to raise revenue or limit revenue losses during times of rampant budget deficits. For example, the landmark Tax Reform Act of 1986, although a remarkable accomplishment in many respects, fell short of its goal of simplicity in order to meet the requirement of revenue neutrality. The 1986 act created several complicated phase-outs and hidden taxes in order to raise revenue and meet distributional targets.

### See Also

Tax Simplification: What are the benefits of simpler taxes?

Tax Simplification: How costly is complexity?

Authors: William Gale and Benjamin Harris  
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### Further Reading

Gale, William G., and Janet Holtzblatt, "The Role of Administrative Issues in Tax Reform: Simplicity, Compliance, and Administration," in *United States Tax Reform in the 21st Century*, edited by George Zodrow and Peter Mieszkowski (Cambridge, U.K.: Cambridge University Press, 2000).

Steuerle, C. Eugene, "Tax Simplification," Testimony Before the United States' House of Representatives Subcommittee on Oversight Committee on Ways and Means (July 2001).





## Tax Simplification: How costly is complexity?

If policymakers knew how much a given change in the tax code would raise or lower taxpayers' compliance costs (and government's administrative costs), they could more easily evaluate the trade-offs between complexity and other goals. But complexity and its costs are hard to quantify. Calculating the total resource costs of the current tax system requires dividing those costs into several components: the value of the time it takes individuals and businesses to comply with the tax system, the out-of-pocket costs they incur (for recordkeeping, outside tax preparation, and the like), and the administrative costs borne by government. A number of surveys have tried to measure the burden of tax compliance. Although results vary, most surveys find that the average taxpayer devotes relatively little time to paying taxes, but that a small subset of taxpayers (many of them high-income and self-employed individuals) devote much more.

- One recent study estimated that taxpayers spent 3.2 billion hours and \$18.8 billion preparing and paying taxes in 2000. These figures correspond to an average of 25.5 hours and \$149 per taxpayer, although these estimates varied by complexity of tax form. Taxpayers filing a 1040EZ, a simplified tax form, spent an average of just 8.1 hours and \$17 per return, while taxpayers filing the more complex 1040 form spent an average of 33.8 hours and \$205 per return.
- In 1998, 38 percent of taxpayers filed a simplified version of the standard 1040 form, either the 1040A or the 1040EZ. Another 8 percent were eligible to file using these simple forms but elected to file a 1040 form instead. Another 6 percent had to use the 1040 but did not itemize deductions, claim capital gains or losses, or have business income.
- Another study found that although the average taxpayer reported spending 27.4 hours on filing income tax returns and related activities, 30 percent spent less than 5 hours, and 15 percent spent between 5 and 10 hours. At the high end, 11 percent spent 50 to 100 hours, and 5 percent spent more than 100 hours. Out-of-pocket costs averaged \$111 (in 2007 dollars), but 49 percent of filers had no such costs, and another 17 percent had costs below \$84 (in 2007 dollars). Slightly over 7 percent of taxpayers spent more than \$337 (in 2007 dollars). High-income and self-employed taxpayers spent the most time and money preparing their taxes.
- Information on the use of paid preparers gives further hints about how complex individuals find the system to be. In 1998, 53 percent of tax filers used paid preparers. Among those who filed the 1040, 64 percent used preparers. Even among 1040A and 1040EZ filers, 35 percent used preparers. It is unclear, however, whether these figures indicate that individuals are using paid preparers because they cannot navigate the tax code themselves, or whether they simply prefer to pay others to do their taxes.
- The IRS currently uses the ADL models to estimate the time required to complete forms and schedules. These estimates are published with the tax forms as part of the Paperwork Reduction Act Notice. For fiscal 1997, the Office of Management and Budget estimated that taxpayers needed 5.3 billion hours to comply with the requirements of all tax forms and Internal Revenue Service regulations. This estimate applies to both businesses and individuals and includes all federal taxes, not just income taxes.

- Using these and other estimates of hours spent, several notable studies have placed the dollar cost of taxpayer time within a range of \$103 billion to \$380 billion (in 2007 dollars), although the higher end of the range likely overstates the true cost. Adjusting for methodological issues and indexing for inflation yields a realistic range of taxpayer compliance costs of between approximately \$105 billion and \$175 billion annually, in 2007 dollars. New developments in taxpayer compliance, such as electronic filing, suggest that a new survey is needed to accurately measure the cost today of complying with the tax code.

Surveys of Individual Taxpayer Time			
Survey	Arthur D. Little	Slemrod and Sorum	Blumenthal and Slemrod
Data source	National random survey of 6,200 individuals <sup>a</sup>	Random survey of 2,000 Minnesota residents	Random survey of 2,000 Minnesota households
Response rate (percent)	65.3	32.7	43.4
Sample size <sup>b</sup>	3,750	600	708
Types of returns	1983 federal income	1982 federal and state income	1989 federal and state income
Aggregate hours per activity (billions)			
Record keeping	0.7	1.3	1.7
Learning	0.3	0.2	0.4
Time with preparer	-	0.4	0.2
Preparing return	0.5	0.1	0.5
Sending	0.1	-	-
Rearranging financial affairs	-	-	0.3
Total hours	1.6	2.1	3.0
Cost to taxpayer <sup>d</sup>			
Value of time spent (per hour)	-	\$13.69	\$10.09
Out-of-pocket costs (per return)	-	\$57.00 <sup>c</sup>	\$66.00
Total costs for individuals	-	\$34.1 billion	\$37.6 billion
Adjustments to survey	Survey results were used to obtain models for estimating taxpayer burden. Estimates above from models.	Weighted nationally. Estimates subject to accounting biases; authors suggest true figure could be as low as \$17 billion.	Weighted nationally.

Notes:

(a) Arthur D. Little also surveyed 4,000 corporations and partnerships, with a response rate of 36.8 percent. Businesses were found to spend 1.6 billion hours on record keeping, 0.1 billion hours on learning, 0.1 hours on obtaining materials, 0.1 billion on finding and using a preparer, 0.7 billion hours on preparing the return, and 0.1 billion hours on sending the return, for a total of 2.7 billion hours.

(b) Sample size was reduced by incomplete or inconsistent responses as well as nonrespondents.

(c) Blumenthal and Slemrod report that the average out-of-pocket expenditure for 1982 taxpayers (in 1989 dollars) was \$45. This appears inconsistent with the estimate shown in the Slemrod and Sorum study, which found an average out-of-pocket expenditure in 1982 dollars that would be consistent with \$56.50 in 1989 dollars.

d. Cost to payer is represented in 1989 dollars.

Source: Gale and Holzblatt (2000), from data in Arthur D. Little (1988), Slemrod and Sorum (1984), and Blumenthal and Slemrod (1992).

## See Also

Tax Simplification: What are the benefits of simpler taxes?

Tax Simplification: Why are taxes so complicated?

## Data Sources

Gale and Holzblatt (2000), from data in Arthur D. Little (1988), Slemrod and Sorum (1984), and Blumenthal and Slemrod (1992).

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## Further Reading

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U.S. Government Accountability Office, "Summary of Estimates of the Costs of the Federal Tax System," Report to Congressional Requesters (August 2005).

U.S. Treasury Department, "Return-Free Tax Systems: Tax Simplification Is a Prerequisite," Report to Congress (Washington, 2003).

## Tax Simplification: What are the benefits of simpler taxes?

Simpler taxes could improve the tax code in at least two important ways. First, simpler taxes would lower taxpayers' costs of complying with the tax system in terms of time, money, and mental anguish, thus reducing the overall burden of taxation. Second, tax provisions that are simpler are more likely to be used. Provisions aimed at encouraging certain activities, such as saving for college, will be less effective if people cannot understand how they work and therefore do not use them.

- Making taxes simpler would probably raise compliance rates, by reducing both inadvertent and intentional nonpayment of taxes, and illegal tax evasion. To some (uncertain) extent, people do not pay taxes because they do not understand the tax law. Clarifying and simplifying tax rules can only help to make people understand the tax law better and would likely make it easier to enforce the law as well. Evidence also suggests that people are more likely to evade taxes that they consider unfair. People who cannot understand tax rules may also question the fairness of the tax system and feel that others are reaping more benefits than they are. This may make them more likely to evade taxes.

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Graetz, Michael J., *The Decline (and Fall?) of the Income Tax* (New York: W.W. Norton and Co., 1997). Steuerle, C. Eugene, "Tax Simplification," Testimony Before the United States' House of Representatives Subcommittee on Oversight Committee on Ways and Means (July 2001).

## **Tax Simplification: What policy reforms could simplify the tax code?**

The key to tax simplification is to make fewer distinctions across economic activities and taxpayers' personal characteristics. Doing so would not only reduce compliance costs, given current administrative structures, but also allow for simpler administration. For example, if everyone paid the same tax rate on dividends, the tax could be collected at the firm level, without having to trace the dividend payments to individuals. The general structure of a simple tax system would be a broad tax base with rates that are the same across different income sources or types of expenditure. Progressivity could be embodied in the rate structure (with rates rising with income, as they are now), the initial exemption amount, and the choice of the tax base, rather than in the design of specific provisions. Universal exemptions, deductions, or credits are much simpler than targeted ones.

- Several reforms could make the current tax system simpler as well as fairer and more conducive to economic growth. One reform would be to resolve the uncertainty created by the sunset, phase-in, and phase-out provisions of the 2001 and 2003 tax acts. Having numerous tax provisions dangle for an indefinite period does not simplify the tax code. (It would also make sense to decide whether to keep permanently or to abolish the entire set of temporary tax provisions that existed even before 2001.)
- Another option would be to reform the individual alternative minimum tax (AMT). To spare the middle-income taxpayers who were never its target, the AMT should be indexed for inflation, deductions should be allowed for dependents and for state and local taxes, and all personal credits should be available against the AMT. Any new proposal that cuts regular income tax liabilities should be required to make conforming adjustments to the AMT so that more taxpayers are not subjected to it.
- A third option would be to coordinate credit phase-outs. A number of tax credits phase-out across different income ranges, so that claiming each credit requires a separate worksheet and tax calculation. The phase-outs also create hidden taxes over the phase-out range and diminish the effectiveness of the credits in encouraging the very activities they are designed to spur.
- In a number of areas, numerous provisions—each with slightly different rules—apply to the same general activity. Coordinating or consolidating these provisions would simplify taxes, often with little or no forgone revenue. Examples include the various provisions relating to families with children (the earned income tax credit, the dependent exemption, and the child credit), tax subsidies for education (the Hope and Lifetime Learning credits and the deduction for tuition and fees), and saving incentives (traditional Individual Retirement Accounts (IRAs), Roth IRAs, educational IRAs, and Keogh plans), and the plethora of different tax rates for capital gains.
- One could also reduce the top tax rates and tax capital gains as ordinary income. This was the cornerstone of the deal struck in 1986 that allowed substantial simplification of the individual income tax. It would massively reduce incentives to create tax shelters and the need to engage in complex tax planning.

**See Also**

Tax Simplification: What are the benefits of simpler taxes?

Tax Simplification: How costly is complexity?

**Data Sources**

Tax Policy Center Table T04-0174, "Repealing the AMT and Disallowing the Deduction for State and Local Taxes."

Tax Policy Center Table T07-0212, "Tax Capital Gains and Qualified Dividends as Ordinary Income."

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**Further Reading**

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Steuerle, C. Eugene, "Candidates for Tax Simplification Reform," Tax Analysts (July 1999).