The Impact of Complexity in the Tax Code on Individual Taxpayers and Small Businesses
Testimony before the House Committee on Ways and Means, Subcommittee on Oversight
C. Eugene Steuerle

Thank you for the opportunity to testify on tax simplification on behalf of the National Tax Association (NTA). Founded in 1907, NTA is the leading association of tax professionals dedicated to advancing understanding of the theory and practice of public finance. The Association is the premier forum for debating complex and controversial public finance issues; testing new tax theories, practices, and policies; and disseminating impartial, nonpartisan research of the highest quality. NTA is a tax-exempt 501(c)(3) organization and does not promote any particular tax program or policy. NTA’s diverse membership brings together government, corporate, academic, and independent tax professionals: a rich mix of federal and state legislators and administrators; taxpayer representatives; tax lawyers and accountants; professors, librarians, and other scholars; and students and interested citizens.

With its long history of exploring tax issues, and its broad membership, the Association will be pleased to assist the Subcommittee in its discussion of tax simplification. Most recently, NTA convened the major national project on taxation of communications and electronic commerce, which is sorting out issues facing governments, industry, and users of these services.

Principles of tax law often conflict. For example, taxing all income on an equal basis is generally considered to promote both a more efficient and fair tax system, but carried to an extreme it can add to complexity. In achieving a balance among principles, however, almost everyone would agree that simplicity has been given far too little weight in the legislative process. There are many items in the tax law that add significant complexity with little gain in some other area like equity or efficiency. Almost no one would introduce many provisions now in current law, if designing a Code from scratch. Once there, however, these complexities are hard to remove. My congratulations go out to the members of this subcommittee who are willing to tackle these problems.

Complexity creates waste, not merely cost. One must distinguish between costs that might provide benefits and those that do not. A transfer of $1 from me to you may cost me $1, but there is an offset in the $1 that you pick up. Economists often focus on the distortions that this transaction might bring about, such as changes in behavior. However, among the most important distortions are the extra time and effort involved. Joel Slemrod of the National Tax Association has made special efforts over time to study this issue and has concluded that administrative costs are significant. If it now costs me $1.10 to transfer $1 to you—$1 in cash and 10 cents in human resources—then that 10 cents is lost to society as a whole.

Another cost, although more subtle, may be even more important. Many people do not mind paying their fair share of the cost of government, but they highly resent it when they see needless waste—including waste of their time in filling out an unreasonable number of forms. They gradually lose respect for government and its functions. I do not mean to imply that tax complexity is the only, or even the primary, factor at play in the public’s increasing cynicism toward government—a cynicism that goes well beyond the healthy skepticism that Americans have always had. But needless tax complexity does serve as one of the important barriers to a healthy relationship between a citizenry and its government.

A Few Candidates for Reform

Included among the many items of needless complexity today are the following:

- An alternative minimum tax that treats items such as dependent exemptions as tax shelters, thereby threatening to tax millions who were never meant to be affected;
- Phase-out after phase-out of such allowances as itemized deductions, earned income tax credits, personal exemptions, eligibility for IRAs, eligibility for other saving incentives, eligibility for educational tax breaks—each of which is like an additional mini-tax system all to itself;
- Pension and saving incentives that add administrative costs and possibly even reduce net saving by providing different rules for withdrawals, penalties, Social Security tax treatment, allowable amounts of exclusion or deduction, and so on;
- A tax treatment of dependent children that needlessly causes millions of unnecessary tax returns to be filed;
- A capital gains tax law with at least seven different tax rates and that requires taxpayers to fill out pages of forms even when they have only a few dollars of gains;
- Multiple educational tax breaks that are poorly coordinated with each other and with direct educational expenditures, thus requiring duplicate administration and creating complexity for students, parents, educators, and the IRS;
- Complicated rules for charitable deductions and charities, including multiple limits on giving as a percent of income and a perverse excise tax on foundations that actually discourages charitable giving;
- Child credits and dependent exemptions that could easily be folded into one; and
- Unnecessarily strict estimated tax rules that pick up very little extra revenue for all the complexity they introduce.

In the appendix to this testimony, I elaborate a bit on the first three of these items. My purpose here, however, is not to go through a laundry list of provisions in need of reform. Instead, I would like to concentrate the remainder of my testimony not on particular proposals but on a broader issue. I believe that the complexity of the tax law is at its heart a failure of process. This process failure could be mitigated through the adoption of certain procedures that I have suggested for both the Executive Branch and Congress. The purpose of these procedures is simply to grant simplicity a higher priority in the policy process.

The issue, however, is not whether simplification should receive the top priority in every tax bill. It should not. There are often equally important, or more important, principles and issues at stake, such as financing government activity or providing equal justice to citizens in equal circumstances. After all, the government doesn’t collect taxes merely to simplify its tax system. The issue, instead, is that simplification receives too little weight, especially given how complex the tax system has already become. Indeed, the good news in this bad news is that there are so many opportunities now for simplification that only a modest effort is required to ensure that most new tax enactments achieve net tax simplification.

Process

When I speak of process reform, I refer partly to the fact that no one in the Executive Branch or in the Congress is responsible for reporting on the consequences of tax law. I believe the way to alleviate this situation would be to assign this fiduciary-like responsibility and to formalize it in some very specific procedures. Below I list two types of process reforms: (1) those that would involve periodic reporting on existing law; and (2) those that would apply to new legislation.

Periodic Reports

- My first suggestion is that Treasury or the Joint Committee on Taxation should publish a formal study year after year listing tax simplification options. This would be similar to the package of potential expenditure cuts and tax increases prepared by the Congressional Budget Office and the tax expenditure

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list prepared by Treasury and the Joint Committee on Taxation. I have become convinced that it is only through the publication of such a list that tax simplification is liable to get the greater attention it deserves, especially on an ongoing basis.

Note, by the way, that the tax expenditure list is not sufficient for this purpose. Among the many reasons are that not all tax expenditures are complex, or more complex than direct expenditures. The purpose of the tax expenditure list is not to provide ideas for simplification, but to give tax programs a budgetary weight that is equivalent to the expenditure programs that they might replace.

Some simplification options can be taken from Joint Committee on Taxation studies such as its recent overviews of individual income tax provisions on April 14, 1999 and of employer-sponsored retirement plans on March 22, 1999. The Treasury often makes some suggestions each year, especially at budget time, but they are worth the trouble not just because of the number of programs, but also because of the comprehensiveness of the list. Moreover, the Joint Committee on Taxation does not approach the problem of simplification from a purely economic perspective. It does not have to make final judgment; it does have responsibility for better development and dissemination of the information it acquires in administering programs.

IRS is also scared to put out reports on administrative effectiveness. In reporting on the EITC during the 1990s, for instance, it has faced the political constraint that both President Bush and President Clinton favored an increase in the grants made under this program. Unless a regular schedule of reporting is established, IRS will fear that the timing of release of any report will appear to be politically motivated by one side or the other.

**Reporting on New Legislation**

Here are some methods for giving simplicity greater weight in the legislative process:

- **Testimony on proposed bills should always include at least some witnesses who focus solely on the simplification and administration issues.** Although affected persons should be invited, some of these witnesses should not represent anyone with a significant stake in the outcome.
- **When the markup of a bill occurs, one individual at the witness table should have the sole assignment of providing information on the administrative aspects of the bill.** This individual might be from the IRS, the Treasury’s Office of Tax Policy, or the Joint Committee on Taxation, but the assignment must be separated from other issues so as to ensure that simplification concerns are not ignored.
- **Before going to conference, the IRS should produce mock tax forms showing exactly what has been wrought from bills produced in both houses.** Changes in number of users of forms and line items should also be provided, when possible.
- **In conference committee, one person at the witness table should be held responsible for providing information only on the simplification aspects of the bills before Congress.**
- **The National Commission on Restructuring the IRS suggested that a tax complexity assessment accompany future tax changes.** If interpreted in too legalistic a fashion, the requirement may be hard to implement, but the spirit of the suggestion could be met in a variety of ways. Last year the Joint Committee on Taxation prepared a simplification analysis of a House bill at the request of Chairman Archer, even though it was not required for that year. I am hopeful that this subcommittee will continue some effort to make sure the right precedents continue to be set and to guaranteeing that these analyses are given significant weight in future legislative efforts.

Of course, none of these process reforms guarantee that simplification will occur. Nor, as I noted at the beginning of my testimony, should simplification be the only factor under consideration. Nonetheless, a combination of some, if not all, of these procedures could serve as a major deterrent to new sources of unnecessary complexity and as a spur toward achieving the types of simplifications sought by this subcommittee.

**APPENDIX**

### Three Major Areas of Complexity

**Alternative Minimum Tax**

Many efforts at reforming the AMT deal with the failure to index the system over time, so that more and more taxpayers would not be forced to pay this tax. Under current law, for instance, many married couples with two children, aver 40,000, and no more deductions than their state and local taxes are scheduled to pay AMT in the future. As their income and state and local taxes—which are counted as preference items—grow with normal inflation and economy-wide growth, these taxpayers are less likely to be excluded from the AMT. But while a reform that indexes the AMT is worthwhile, it still ignores whether or not the tax makes sense, whether its base includes items that should not be subject to taxation, and whether the administrative hassle and complexity are worth the trouble in the first place.

A few of the preference items in the AMT have attributes associated with preferential treatment, such as generous depletion allowances or the tax exemption for interest received on private activity bonds. In those cases the taxpayer may be excluding from taxable income a significant portion of real income received. But most of these items are not large in terms of alternative minimum tax collections. Other items included at different times, such as an alternative depreciation schedule, are more debatable since they seem to deny to some taxpayers even those deductions that would be allowed if economic income were calculated accurately. Some of these provisions are enormously complex, as well, for they require the taxpayer to keep multiple records for years under alternative methods of calculation.

There is little excuse for inclusion of items that are legitimate deductions reflecting a lower ability to pay tax. The standard deduction allowed to nonitemizers is treated as a preference item under the AMT. So also are extraordinary and legitimate work expenses when deducted as miscellaneous itemized deductions. The inclusion of personal exemptions as a preference item implies Congress believes that a dependency exemption is not an appropriate adjustment to ability to pay tax, but instead accords the taxpayer special treatment. In effect, for AMT purposes, the law implies that a family of four has the same ability to pay tax as a family of two with equal income.

Finally, there are those items that under some theories might not be deductions under an income tax, but under other theories are quite reasonable. It is inconsistent and arbitrary to try to tax them through an AMT. These include state and local tax deductions and those few medical deductions allowed for regular tax, but not minimum tax purposes. If there is a rationale for further limiting these deductions, it should be applied directly in the normal income tax, not through the more complex AMT.

**Tax System after Tax System & the High Implicit Marginal Tax Rates**

In recent decades the tax and expenditure laws have witnessed the establishment of one new tax system after another. These tax systems derive from attempts to cut back or pare various "benefits" as income increases. As a consequence, they create a strange tax rate schedule with a number of side effects such as rising and increasing marriage penalties on individuals.

The difficulty is that the tax systems are created in happenstance manner. They derive from nothing more than a glance at what might look politically palatable when each part of a bill is up for adoption. For example, child credits are meant to apply to the middle class, so they will at least be limited for those with incomes of, say, $75,000 or $110,000 or more. Yet almost every one of these phase-outs has its own set of rates, base, and phase-out region. Should one of these income taxes apply at one level and the next at a very different level? Maybe, but no rationale is or has been provided. Moreover, granting some benefit at high income levels is not necessarily regressive if those individuals have more than paid for the benefit with their taxes.
Meanwhile, there are now multiple tax systems implicit in expenditure programs as well. Consider all the possible interactions among the following: a federal income tax, a state income tax, the phaseout of an earned income tax credit, phaseouts of the benefits of nontaxation of social security income, phaseouts of personal exemptions, phase-ins of limits on itemized deductions, phase-ins of alternative minimum taxes, phaseouts of existing higher educational benefits like Pell grants, and phaseouts of various welfare benefits like Temporary Assistance to Needy Families, food stamps, Supplemental Security Income, and various forms of housing subsidies.

For low and moderate income taxpayers—the primary group for which simplified filing at one time seemed possible—earned income tax credits, child credits, dependent care deductions, educational credits, and presidential campaign check-offs, among others, have been added to returns. Unlike the traditional personal exemption and standard deduction, these various provisions often require additional information by the taxpayer. Whatever their other merits, therefore, they have complicated filing significantly. To top matters off, the IRS has discovered that many of the errors in EITC filing and other allowances are related to claiming children incorrectly, especially when the parents of children are separated, divorced, or never married. To deal with this problem, the IRS has sought additional information from taxpayers to verify their eligibility for different allowances related to children.

Most of the allowances for low and average income individuals, ranging from the EITC to child credits and dependent exemptions, could be combined or simplified significantly, even if some variations had to be eliminated. For example, there’s little reason that the personal exemptions for dependents couldn’t be folded into the child credit.

**Pension and Saving Plan Simplification**

The number of rules and regulations applying to pension and saving plans is overwhelming (see attached table). This derives from an extraordinary number of so-called saving and retirement incentives in the tax code, each with its own separate limits, exceptions, and requirements on both individual taxpayers and employers. The consequent complexity reduces the net rate of return available to saving, in part because of the very large expenditure of time and paid labor that must be employed to interpret, administer, and seek to understand this universe. Thus, the issue is not whether there should be rules regarding eligible deposits, discrimination among employees, penalties for withdrawals, and so on, but whether there needs to be so many inconsistent rules and regulations across so many different plans.

One type of reform does not address how many incentives might be offered, but, whatever their number, seeks to apply a more common set of rules on as many of them as possible. For example, there might be a single, common limit on deductible contributions for all types of employer-provided plans and a common income eligibility standard for individual plan options such as individual retirement accounts. The limit might be expressed simply as a dollar amount, rather than as percent of income. For withdrawals, a common but limited set of exceptions might be established, and a common penalty for early withdrawal might be applied. A simple standard could be adopted as to whether contributions are subject to social security tax or not.

More complicated to design, but highly desirable, would be a simpler rule or set of rules regarding when plans “discriminate” against lower-paid workers in labor that must be employed to interpret, administer, and seek to understand this universe. Thus, the issue is not whether there should be rules regarding eligible deposits, discrimination among employees, penalties for withdrawals, and so on, but whether there needs to be so many inconsistent rules and regulations across so many different plans.

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### Table: Private Pension Plans

<table>
<thead>
<tr>
<th>Plan Characteristics</th>
<th>Individual Accounts</th>
<th>Small Business Plans</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Non-Qualified Deferred Annuity</td>
<td>Roth IRA</td>
</tr>
<tr>
<td>Eligibility</td>
<td>Top hat only*</td>
<td>All taxpayers</td>
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<tr>
<td>Overall Dollar Limit</td>
<td>None</td>
<td>$2,000 reduced by other IRAs</td>
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<tr>
<td>Overall Maximum % of Pay</td>
<td>NA</td>
<td>100%</td>
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<tr>
<td>Employer Limits</td>
<td>None</td>
<td>NA</td>
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<tr>
<td>Employee Limits</td>
<td>None</td>
<td>$2,000</td>
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<tr>
<td>Aggregate Employer Deduction Limits</td>
<td>None</td>
<td>NA</td>
</tr>
<tr>
<td>Exclusion from SS Tax</td>
<td>No (except after vesting)</td>
<td>No</td>
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<tr>
<td>Subject to Early Withdrawal Penalty Tax(6)</td>
<td>No (unless annuity purchased)</td>
<td>Yes</td>
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<tr>
<td>Distributions</td>
<td>Penalty Tax Exceptions (7)</td>
<td>None</td>
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<tr>
<td>Conditions for In-service Withdrawl</td>
<td>No Additional Limitations</td>
<td>No Additional Limitations</td>
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<tr>
<td>Loans Available</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Nondiscrimination</td>
<td>None</td>
<td>None</td>
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<tr>
<td>Salary Cap for Nondiscrimination testing</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Integrated with Social Security</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Complicating Factors</td>
<td>Spousal Protection</td>
<td>None</td>
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<tr>
<td>Vesting</td>
<td>Immediate for employee; deferred for employer</td>
<td>Immediate</td>
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<tr>
<td>Special Restrictions and Benefits</td>
<td>Taxed when paid or made available (or when vested for tax-exempts) May be DC or DB</td>
<td>None</td>
</tr>
</tbody>
</table>

Note: All dollar values are indexed, and the given figures are as of 1997. Sources: Harry Conaway, WILLIAM M. MERCER, and C. Eugene Steuerle and Andrea Barnett, THE URBAN INSTITUTE, 1997. For footnotes see end of second table.

*Funding is required for a pension plan that is not limited to a select group of officers or highly compensated employees. (This does not apply to certain section 415 benefit plans or church or government plans.)

### Private Pension Plans
#### Plan Characteristics

<table>
<thead>
<tr>
<th>Defined Contribution Plans</th>
<th>Defined Benefit</th>
</tr>
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<tbody>
<tr>
<td><strong>Plan Characteristics</strong></td>
<td><strong>Eligible 457 Plans</strong></td>
</tr>
<tr>
<td><strong>Eligibility</strong></td>
<td>Employees of state and local government and officers of tax-exempt organizations</td>
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<tr>
<td><strong>Overall Dollar Limit</strong></td>
<td>$7500 ($15,000 limit for last 3 years before retirement as catch-up allowance) Reduced by contributions to 403(b), SEP and 401(k) plans</td>
</tr>
<tr>
<td><strong>Overall Maximum % of Pay</strong></td>
<td>33 1/3%</td>
</tr>
<tr>
<td>Contribution Limits</td>
<td>Employer Limits</td>
</tr>
<tr>
<td>---------------------</td>
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This table does not include education IRAs because they are not properly viewed as retirement vehicles.

Private Pensions: Plan Characteristics - Footnotes

1) IRA phase-out schedule: in 1997 $25,000 to $35,000 for individuals and $40,000 to $50,000 for married couples filing together. These phase-outs are scheduled to increase to $50,000 to $60,000 for individuals and $80,000 to $100,000 for joint filers by 2007 with incremental increases starting in 1998. There are also special limits for non-working spouses.

2) The phase-out schedule for Roth IRAs is $95,000-110,000 for individuals and $150,000-160,000 for married couples filing jointly.

3) Public sector employees and employees of tax-exempt organizations are not allowed to make elective deferrals into a SEP.

4) Deposit limits for contributions to Roth IRAs actually have a greater value than traditional IRAs because it is an after tax contribution.

5) The $30,000 overall dollar limit is a cumulative limit for employers and employees across all qualified plans.

6) The general exceptions to the standard IRS 10% penalty for early withdrawal include death, disability, separation from service and plan termination.

7) Withdrawals for medical expenses in excess of 7.5% of AGI are exempt from the IRS penalty for all plans.

8) State and local plans are exempt from all nondiscrimination tests.

9) The 125% HCE rule says that a Highly Compensated Employee (HCE), which are defined under the IRC to include employees who are 5% owners during the current or preceding year or who received compensation in excess of $80,000 in the preceding year, may not defer more than 125% of the average deferral of all Non-Highly Compensated Employees (NCHEs).

10) Under the Taxpayer Relief Act of 1997 the 150% limit for Defined Benefit plans will be increased to 170% by 2005 with incremental increases starting in 1999.

11) There is an additional combined deduction limit of the greater amount of the maximum funding limit for defined plans and 25% of compensation, when an employee participates in both a defined benefit and a defined contribution plan.

12) Since the employees contributions are only after-tax contributions that are not excludable from Social Security tax.

13) Financial Hardship is defined as, immediate and heavy financial need where the funds are not available from other sources. The need may be either foreseeable or voluntarily incurred. The distribution cannot exceed the amount required to meet the immediate financial need created by the hardship.

14) Unforeseeable emergencies are defined as severe financial hardship to the participant as a result of sudden illness or accident to the participant or a dependent, property loss due to casualty or other extraordinary and unforeseeable circumstances beyond the control of the participant. No payment will be made if there are other ways to satisfy the financial need. Specifically not included: college and home purchase.

15) The general nondiscrimination rule says that no HCE may receive a contribution or benefit that is a higher percentage of pay than the contribution or benefit of any NHCE.

16) The Aggregate Contribution Percentage test (ACP) applies to employer and after-tax employee contributions. It requires that either (1) the ACP for the group of HCEs is not more than 125% of the ACP for all other eligible employees or (2) the excess of the ACP for the group of HCEs in not more than 2 times the ACP of all other eligible employees. The Actual Deferral Percentage test (ADP) applies to elective employee contributions and is designed to limit the contributions of HCEs based on the average deferred percentages of NCHEs. It requires that:

   FOR ADP of NCHEs: ADP of HCEs may be:
   Less than 2%: 2 times the ADP of the NCHEs
   2% to 8%: ADP of the NCHEs + 2%
   8% or greater: 1.25 times the ADP of the NCHEs

   Additionally, the 401(k) ADP test is based on an aggregate average of deferrals and therefore allows a higher disparity than the 125% HCE rule for SEP plans.

17) Unless the plan offers an annuity, the death benefit provides the remaining value of the plan to the widow or widower in a lump sum payment unless the spouse consents to another distribution. (This assumes the plan is subject to ERISA and not a church or government plan).

Other Publications by the Authors

• C. Eugene Steuerle