# Key Elements of the U.S. Tax System



Why are taxes so complicated?

## Q. Why are taxes so complicated?

**A. Our tax system could be simple if its only purpose were to raise revenue. But it has other goals, including fairness, efficiency, and enforceability. And Congress has used the tax system to influence social policy as well as to deliver benefits for specific groups and industries.**

Almost everyone agrees that the current tax system is too complicated, yet almost every year the system gets more complex, not less. Why? Tax simplicity almost always conflicts with other policy goals.

For example, the simplest—and least distorting—tax is a head tax, a fixed-dollar tax on everyone. But a head tax would be unfair, taking no account of differences in the incomes and needs of individuals, families, and businesses.

### COMPETING GOALS FOR A TAX SYSTEM

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 individual taxpayers' characteristics. That can make taxes fairer, but 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 expenditures or income, have to be reported and documented. These conflicting objectives appear to be especially relevant in the current tax code, where the desire to reduce tax burdens for particular groups have added significant complexity.

### POLITICS OF TAX POLICY

Politics compounds complexity. Interest groups—and thus politicians—support tax subsidies for particular activities. And these targeted subsidies inevitably complicate the tax system by creating distinctions among taxpayers with different sources and uses of income.

### EFFECTS OF INCREMENTAL LEGISLATIVE CHANGES

The current tax law was not enacted all at once but is a result of numerous provisions added or subtracted in multiple tax bills. Often Congress designs legislation under self-imposed constraints, such as short-term revenue goals or effects on the distribution of tax burdens among income groups. The result is that tax incentives are often designed in complex ways to limit the revenue losses or benefits to high-income taxpayers or to prevent their use by unintended beneficiaries.

The result of this process is a set of very complex provisions that appear to have no overall logic if the tax law were being designed from scratch. These include phaseouts of certain tax benefits at high incomes, multiple incentives for higher education and retirement savings, multiple benefits for taxpayers with dependents with different eligibility definitions, and an entirely separate tax schedule, the individual alternative minimum tax, that applies to certain taxpayers using selected tax preferences. The Tax Cuts and Jobs Act of 2017 substantially reduced the number of taxpayers subject to the alternative minimum tax through 2025 and, by raising the standard deduction and capping the state and local tax deduction, reduced the number of taxpayers who benefit from itemized deductions. But it left many other complex benefits in the tax law largely unchanged and added a new deduction for business income, with its own complex limits to minimize abusive transactions.

Annual reports by the National Taxpayer Advocate have presented proposals for simplifying the tax code, including reforms of education incentives, retirement incentives, child benefits, and the alternative minimum tax.

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What are the benefits of simpler taxes?

## Q. What are the benefits of simpler taxes?

## A. Simpler taxes have lower compliance costs—in both time and money—and may encourage taxpayers to use tax provisions aimed at helping people pay for socially desirable activities.

Simplification could improve the tax code in at least two important ways. First, simplicity would lower taxpayers' costs of complying with the tax system in time, money, and mental anguish. Second, simpler tax provisions are more likely to be used. Provisions aimed at encouraging specific activities, such as saving for college, would be more effective if people understood how they work.

Making taxes simpler could improve compliance by reducing inadvertent nonpayment of taxes. To some (uncertain) extent, people do not pay taxes because they do not understand the tax law. Evidence also suggests that people are more likely to evade taxes they consider unfair. People who cannot understand tax rules may question the fairness of the tax system and feel that others are reaping more benefits than they are.

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What policy reforms could simplify the tax code?

## Q. What policy reforms could simplify the tax code?

## A. Reducing the number of distinctions among economic activities and taxpayers' characteristics would simplify the code, reducing both taxpayers' compliance costs and governmental administrative costs. Some distinctions among taxpayers promote fairness, so there are trade-offs among goals, but the tax law could be simplified without compromising equity.

The key to tax simplification is to make fewer distinctions across economic activities and taxpayers' characteristics. This would not only reduce compliance costs, but would also allow for simpler administration. For example, allowing taxpayers who itemize their deductions to deduct charitable contributions requires administrative resources to determine which organizations are eligible to receive charitable contributions, and to ensure that taxpayers make the contributions they claim on their tax returns. This also imposes record-keeping costs on taxpayers.

A simple tax system would generally be structured with 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 do now), a basic exemption amount, and the choice of tax base (income, consumption, or another measure), rather than through specific provisions that treat different levels of income and consumption differently. Universal exemptions, deductions, or credits are much simpler to administer than targeted ones.

The tax law could be made even simpler if all income were taxed at a single rate. Then, all taxes on earnings, interest, and dividends could be collected by withholding from employers and financial institutions without many taxpayers needing to file returns. But such a tax system would conflict with the goal of progressivity—imposing higher tax rates on those with a greater ability to pay—and many would regard that as unfair.

Some other provisions that add complexity are nonetheless necessary for tax fairness and economic efficiency. For example, self-employed taxpayers who use a personal automobile in their business must keep records to distinguish between personal and business uses of their car. Nonetheless, a fair and efficient income tax requires that business costs should be deductible, while personal consumption expenses should not.

Several modest changes could make the current tax system simpler without compromising fairness or reducing incentives to work, save, and invest. One option would be to coordinate the phaseout of tax credits. Specific tax credits phase out across different income ranges, so that claiming each credit requires a separate worksheet and tax calculation. The phaseouts also create hidden taxes over the phaseout range and diminish the credits' effectiveness in encouraging the activities they are designed to spur.

Numerous provisions—each with its own rules—apply to the same general activity. Coordinating or consolidating these provisions could simplify tax-return preparation and reduce tax-planning costs with little or no change in revenue or the distribution of tax burdens. Examples include the various provisions related to families with children (the earned income tax credit, the child tax credit, and the child and dependent care tax credit), tax subsidies for education (the American Opportunity and Lifetime Learning credits, and the deductibility of tuition and fees), and saving incentives (traditional individual retirement accounts, Roth IRAs, education IRAs, and Keogh plans).

Yet another simplification would tax capital gains at the same rate as ordinary income in return for reduced top tax rates. This was a main feature of the 1986 Tax Reform Act, although the 1986 reform also retained a limitation on capital losses to prevent selective realization of losses by taxpayers with gains on their investment portfolios. Returning to this approach would reduce incentives for complex tax-planning strategies that recharacterize ordinary income as capital gain. Yet a higher capital gains rate would increase incentives to delay or wholly avoid realizations of capital gains and put new pressure on rules, such as those for like-kind exchanges, that define when a realization event has occurred.

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TAX COMPLEXITY

## What policy reforms could simplify the tax code?