# Key Elements of the U.S. Tax System



What policy reforms could simplify the tax code?

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**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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