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The Cost of Tax Compliance

House Ways & Means Committee Testimony

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Mr. Chairman, Members of the Committee, it is with great pleasure that I appear before this Committee to testify about the cost to taxpayers of our tax code's complexity.

I am a senior economist at the Tax Foundation, a 64-year-old non-profit, non-partisan research institution that receives no federal funds. Our goal is to explain as precisely and as clearly as possible the current state of fiscal policy in light of established tax principles, so that you, the policy makers, have the information to make informed decisions.

One such principle of taxation is that a good tax system should be as simple and stable as possible. Therefore, the Tax Foundation has worked on estimating how much it costs both individuals and businesses to read the rules, fill out the forms, and do all the other things necessary to comply with the nation's tax laws in time for the April 15th tax filing deadline.

The economy is dramatically affected by the state of tax law. If lawmakers create an Internal Revenue Code that is terribly complex or that changes rapidly, taxpayers may not be able to obtain a reasonably certain conclusion about how taxation will affect a business plan or investment.

My testimony will provide the results of our work to date on the cost of tax compliance.

It is important for the public to have an estimate of this cost because the performance of the economy is dramatically affected by the state of tax law. If lawmakers create an Internal Revenue Code that is terribly complex or that changes rapidly, taxpayers may not be able to obtain a reasonably certain conclusion about how taxation will affect a business plan or investment. When the tax consequences of various economic activities are unpredictable, then tax policy is handicapping the growth and dynamism of the U.S. economy.

As if the complexities inherent in taxing income did not pose a sufficiently daunting challenge to the writers and administrators of the tax code, political and social demands have also been taken into account. In particular, two goals for the code that contribute to complexity are "fairness" and social utility. They come into play when determining how much individual taxpayers should owe, the "ability-to-pay" principle, and when providing incentives for socially beneficial activities.

Many studies of the tax code find that our system, particularly the income tax code, is excessively complex. This study concurs, quantifying the code's complexity in a way that makes clear how unnecessary much of it is. In 2001 individuals and businesses will spend an estimated 4.6 billion hours complying with the federal income tax, with an estimated cost of compliance of over $140 billion. This amounts to imposing a 12-cent administrative burden for every dollar the income tax system collects.

If the high cost of complying with the federal income tax were a necessary price to pay for a fair and effective tax system, perhaps there would be little room for complaint, but in fact the complaints are justified.

The Complications of the Federal Income Tax

Most Americans naturally think of their

income tax burden simply as the amount at the bottom line of their 1040 form. Economists, on the other hand, may express Americans' tax burden as a percentage of GDP or even as a date on the calendar, such as Tax Freedom Day. But such measures fail to register another cost to taxpayers: the cost of complying with the tax system.

Experts complained about the complexity of the federal income tax system as early as 1914, the year immediately following the adoption of the 16th Amendment to the Constitution which authorized the income tax. Since then, the quest for tax simplification has waxed and waned with generally little progress over the years and the tax code has grown in complexity. Veteran tax professionals commonly point to the Tax Reform Act of 1969 as the legislation that infused much needless complexity into the income tax code. But they say nothing in that Act came anywhere near the bewildering complexities that were introduced by the tax enactments of the 1980s.

Within a three-year period in the first half of the 1980s, the income tax code was subjected to three massive pieces of legislation. First was what became known as "the Reagan tax cut," the Economic Recovery Tax Act of 1981. This was followed immediately by the Tax Equity and Fiscal Responsibility Act of 1982, and soon thereafter came the Deficit Reduction Act of 1984. However, the tax drama had not yet reached its climax, which occurred in 1986 with the enactment of the Tax Reform Act of 1986 (TRA'86).

TRA'86 was meant to make a clean break from the past complexity and instability in the tax code. The primary goal of its authors was tax simplification, and toward that end, the act reduced the number of rates and expanded the tax base (through the elimination of numerous tax preferences). While the goal was laudable, the nation did not end up with a simpler tax code, especially from the perspective of businesses. Previous research by the Tax Foundation has found that there is near unanimity among senior corporate tax officers that TRA'86 brought tax complexity to an unprecedented level. They point to the alternative minimum tax, inventory capitalization rules, and foreign income rules as the main culprits.

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The Complex Job of Taxing Income

In 1927, the Joint Committee on Internal Revenue Taxation (Vol. 1, p. 5) reported that: "It must be recognized that while a degree of simplification is possible, a simple income tax for complex business is not." This early recognition of how difficult it is to tax income bears repetition and elaboration.

The Problem of Defining Income

Income tax complexity is almost wholly related to tax base questions, that is, questions or uncertainty about the timing or definition of taxable transactions. The inherent complexity of an income tax results from the difficulty of defining income and determining when and to whom to recognize income and expense for tax purposes. Over time, the political process of give-and-take has made these difficult tax base questions inordinately complex. The definition of taxable income has not only expanded dramatically, but it has undergone chronic change.

Non-Economic Demands on the Code

In addition to the inherent complexities of taxing income, an important political goal of our tax system is to ensure that the income tax code is both fair and equitable. This goal comes into play in two important areas of the tax code that contribute to complexity: (1) determining how much individual taxpayers should owe — the "ability-to-pay" principle, and (2) providing incentives for socially beneficial activities.

Ability to Pay

From an economic perspective, the most efficient way to levy taxes is with a head tax. In other words, every person would pay an equal lump-sum tax. According to recent Tax Foundation research, if such a head tax were instituted today, every man, woman and child in the nation would have to pay $11,116 to fund the government at current levels. The federal government alone would account for almost 70 percent ($7,754) of the tax bill with state and local governments accounting for the remainder ($3,362).

Economists would call such a head tax efficient because it is economically neutral,

avoiding all distortion of the free-market process. In other words, the burden of a head tax does not fall on any particular economic activity, so taxpayers' economic decisions would be completely unaffected by the tax system. Even the simplest income tax could never be 100 percent economically neutral precisely because the burden of the tax falls on income-producing activity, inevitably persuading some taxpayers in some circumstances to earn less income.

Obviously, such a head tax would be administratively efficient as well, as neither taxpayers nor the government would need to document taxpayers' income. However, the head tax is politically troublesome, to put it mildly. Taxation anywhere near the current level would constitute an insuperable burden for low-income citizens. If television stars and day laborers must pool their resources to fund government operations that consume roughly one third of the nation's income, as they now do, then devising a tax system that takes "ability to pay" into account becomes inevitable, even if it does lead to a much more complex tax code.

Today the tax code includes a multitude of provisions to adjust the tax burden according to this "ability-to-pay" principle. The most obvious application of this principle is the graduated rate structure which increases a taxpayer's liability as a percentage of income as income rises. Other provisions adjust for the number of children in the family, family status (single, married, head of household), etc.

Promoting Socially Useful Activities

In addition to making allowances for the poor, today's income tax code includes numerous provisions to encourage activities that are deemed "socially beneficial." In the personal code, taxpayers are allowed various credits and deductions such as home mortgage interest, health care expenditures and the child tax credit, to name a few. On the business side, there are various credits, such as the investment tax credit, and preferential depreciation rules. As a result, the income tax code today is a hodgepodge of deductions and credits that have nothing to do with raising the revenue needed to fund government operations. In fact, these tax code items not only reduce revenues but at the same time dramatically increase the complexity of the tax code.

Unfortunately, once inserted into the code, these preferential tax provisions become entrenched over time as various groups lobby for their protection and expansion.

To economists this is known as rent-seeking. Such lobbies have a strong interest in maintaining the tax preference because they have usually spent substantial resources obtaining it. Also, the general public usually mounts little opposition since the benefits are concentrated on a relatively small group of taxpayers while the costs are spread amongst everyone else.

For example, let's look at the tax complexity caused by the ever-popular deduction for charitable contributions. As for any itemized deduction, taxpayers must keep an accurate accounting of their charitable contributions. If the value is over $250, the taxpayer also needs a statement from the charitable organization. While such recordkeeping does not appear overly onerous, just look at some of the problems lurking in the background.

For one, charitable contributions are a significant source of "tax leakage," a term the Internal Revenue Service uses when it refers to the loss of tax revenue caused by under-reported income or over-reported deductions. For instance, a phantom donation of $25 a week would lead to a deduction of $1,300 a year. Obviously, if a significant number of taxpayers did this, the revenue loss would be quite significant. Not all tax evaders are as blatant as the tax lawyer who was recently caught claiming to have given his church $500 every Sunday. When the IRS inquired, the pastor of the taxpayer's church was not obliged to keep his parishioner's sin a secret. Such over-reporting of deductions leads to higher compliance costs for all taxpayers as the IRS has to resort to increased auditing and/or the addition of more rules and regulations.

Charitable organizations have to go through an approval process administered by the IRS before a contribution by an individual can be legally declared as a charitable deduction. The burden of this process is not a one-time cost because every approved charity has to be aware at all times that even the slightest change in its mission could nullify its charitable status according to the IRS. Of course, this process is costly, in time and money, for the charities and the IRS.

The rules and regulations governing the deduction not only add to the complexity in the tax code, but naturally, the deduction also lowers government revenue, forcing everyone else to pay higher tax rates. However, while there are a multitude of organizations that stand ready to defend the deductibility of charitable contributions, there are no large groups of taxpayers that oppose its complexity.

The complexity caused by this one popular deduction is like the proverbial tip of

the iceberg. There are literally thousands of similar special preferences written into the tax law that promote various activities or benefit a group of taxpayers. These groups of taxpayers stand ready to defend their tax preferences with economic and emotional arguments that relate to the taxpayers' ability to pay or the social benefits of the activity in question. This organized resistance to simplification has been phenomenally successful over many years, causing many legislators to despair of piecemeal efforts at tax simplification.

Fundamental Tax Reform

One way to get around the problems caused by rent-seeking, thereby reducing complexity and its attendant costs in the income tax code, is to reform the entire federal income tax system. Reform proposals are currently on the table that attempt to make simplification and the promotion of economic growth the principal strategies of tax policy. These include the national sales tax sponsored by Rep. Billy Tauzin and the flat income tax proposal sponsored by Rep. Dick Armey.

The national sales tax takes the direct approach and moves away from the concept of taxing income completely, taxing consumption instead. The flat tax, on the other hand, moves to cash flow as the tax base, rather than accrued income. A cash flow tax, as it applies to business, totals business receipts and then subtracts purchases from other businesses. On the individual level, the approach resembles a universal IRA.

Both proposals would boost economic performance by eliminating the double tax on savings, and both promise huge reductions in the complexity of the tax code. As of this writing, however, neither plan has garnered widespread support. Even if a plan to fundamentally simplify the tax system did gain momentum, the possibility exists that provisions would be added during the legislative process that would add new complexity, such as happened in 1986.

The Growth and Instability of the Income Tax Code

Despite decades of concern over its undue complexity, the income tax was formally placed at the core of the federal tax system by the Internal Revenue Act of 1954. Overall, two important measures of tax complexity have climbed dramatically since then: the size and the instability of the tax code.

The Growth of the Code

Table 1, Figure 1 and Figure 2 chart the dramatic growth over the past 40 years in the

Table 1
Growth of the Number of Words in the Internal Revenue Code
Thousands of Words
Selected Years 1955-2000

	1955	1965	1975	1985	1995	2000
Internal Revenue Code						
Income Taxes Only	172	243	395	645	881	982
Entire Tax Code	409	548	758	1,107	1,488	1,670
Period-to-Period Percent Growth						
Income Taxes Only	*	41.4%	62.8%	63.2%	36.6%	11.5%
Entire Tax Code	*	33.8%	38.3%	46.0%	34.5%	12.2%
Internal Revenue Code Regulations						
Income Taxes Only	572	1,715	2,571	3,762	4,880	5,947
Entire Tax Code	1,033	3,098	3,295	4,613	6,135	7,307
Period-to-Period Percent Growth						
Income Taxes Only	*	199.6%	49.9%	46.3%	29.7%	21.8%
Entire Tax Code	*	199.9%	6.4%	40.0%	33.0%	19.1%
Internal Revenue Code and Regulations						
Income Taxes Only	744	1,957	2,966	4,406	5,761	6,929
Entire Tax Code	1,442	3,646	4,053	5,720	7,623	8,976
Period-to-Period Percent Growth						
Income Taxes Only	*	163.1%	51.5%	48.6%	30.8%	20.3%
Entire Tax Code	*	152.8%	11.2%	41.1%	33.3%	17.7%

Source: Tax Foundation calculations based on the annual publications of "Internal Revenue Code" and "Federal Tax Regulations" from West Publishing Company.

combined number of words that define the body of both the federal income tax laws and their attendant regulations. Since 1954, the estimated number of words in the entire tax code devoted to the income tax has grown from 42 percent to 59 percent, more than a 40 percent increase over the last four decades. The volume of income tax regulations has grown even more. In 1954, income tax regulations represented 55 percent of the body of tax code regulations. Today, that figure has grown to 81 percent, an increase of more than 47 percent over the past four decades.

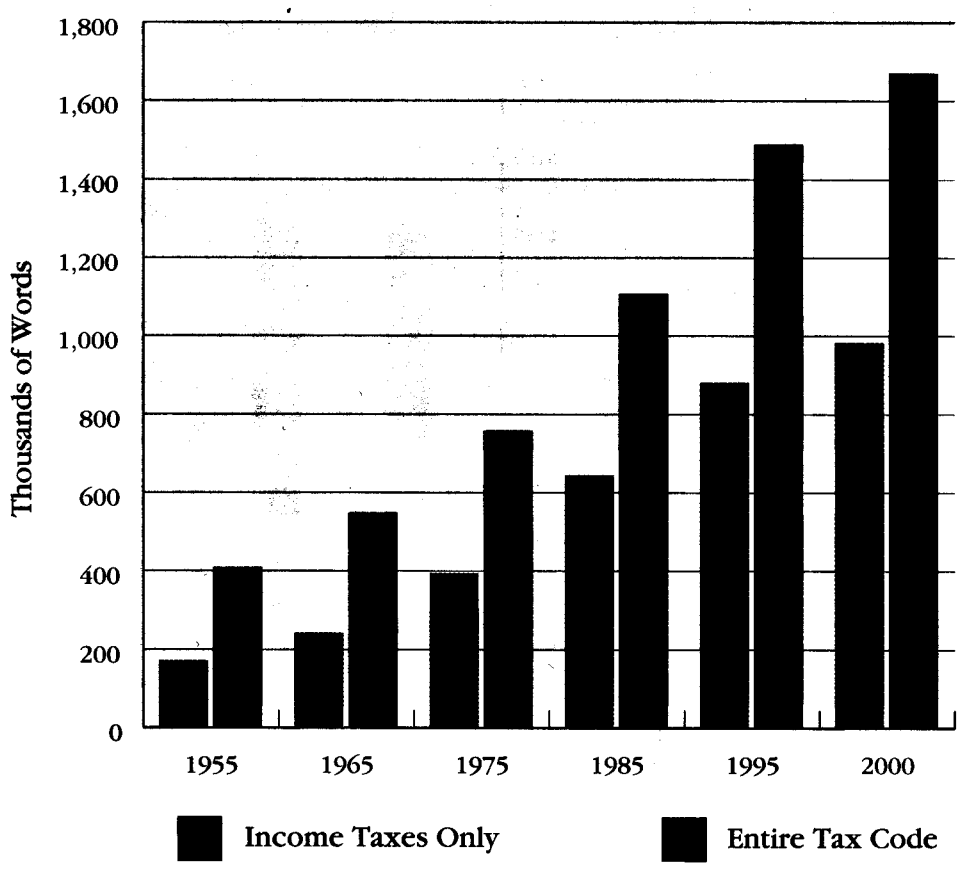
The Tax Foundation has determined that over the past 45 years the number of words detailing the income tax laws has grown from 172,000 words in 1955 to 982,000 today, an increase of 472 percent. Income tax regulations, which provide taxpayers with the "guidance" they need to calculate their taxable income, have grown at an even faster pace from 572,000 words in 1955 to 5,947,000 words today, an increase of 939 percent. Combined, the federal income tax code and regulations grew from 744,000 words in 1955 to 6,929,000 today-an increase of 831 percent.

Growth of the Code by Subject Area

Perhaps a more revealing measure of tax code complexity is the multiplication of the subchapters and subsections that comprise the Internal Revenue Code. In 1954, federal income tax law was comprised of 103 code sections. Today, there are 725 income tax code sections, a 604 percent increase. (See Table 2.)

Almost all of the growth relates to tax base questions. For example, since 1954, the number of sections dealing with the "Determination of Tax Liability" has grown 1,150 percent; the number of sections dealing with "Capital Gains and Losses" has grown 1,300 percent; the number of sections dealing with "Deferred Compensation" (e.g., pension plans) has grown 1,450 percent; and the number of sections dealing with the "Computation of

Figure 1
Growth of the Number of Words in the Internal Revenue Code
Selected Years 1955-2000



Taxable Income" has grown by more than 1,589 percent.

The growth in the volume of the income tax laws and regulations is a direct result of the 32 significant federal tax enactments that have taken place since 1954, or approximately one every 1.4 years. Previous Tax Foundation research (based on a sample of one-fifth of the core sections of the income tax code) found that these enactments have not only increased the volume of the tax code, but resulted, on average, in the amendment of each section once ever four years (as of 1994). This instability has been much more pronounced in the past 20 years than it was during the 20 years immediately following the 1954 Act.

Quantifying the Cost of Tax Compliance

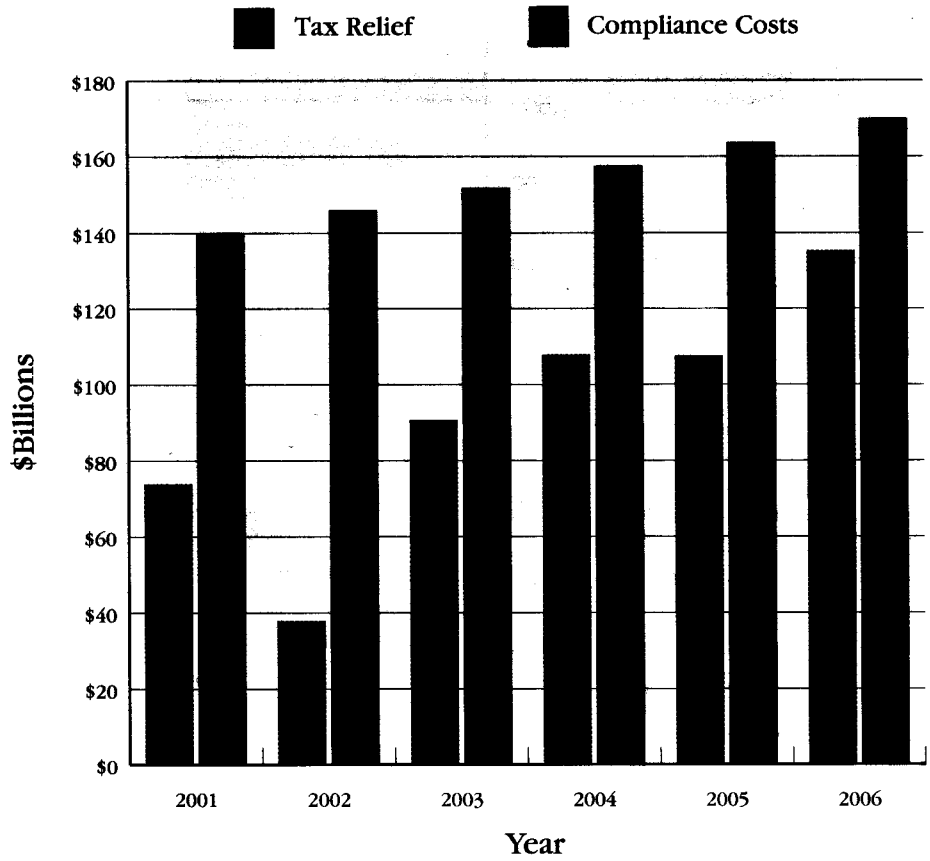
The complexity generated by the growth and constant change of the tax code creates two general types of economic cost: overhead and opportunity cost. Overhead can be divided into three principal activities: the economically sterile exercises of tax planning, compliance, and litigation, all of which act like tax surcharges on taxpayers.

- The first type of overhead is tax planning, which in this context refers to all the economic decisions that individuals and firms make because of the tax code.
- The second type of overhead, tax compliance, refers here to the basic actions required to comply with the federal income tax, including record keeping, education, form preparation and packaging/sending.
- The third type of overhead is litigation, referring to the cost of the IRS and the Tax Court, as well as all the legal costs that taxpayers incur while dealing with these two government institutions.

Of these three costs, the second, tax compliance, is the only one estimated in this report. It is for this reason that the data presented here should be viewed as extremely cautious estimates of the federal income tax compliance burden on taxpayers.

For example, a company plans to build a

Figure 2
Economic Impact of Income Tax Compliance Costs vs. the Tax Relief Act of 2001
2001-2006



manufacturing facility. However, after tax planning, the decision is reached to build a slightly different facility in a different location. The company later files a tax return on the activities of the facility, but the IRS objects to some aspect of the tax return, and after some legal wrangling, the return is finalized. In this case, only the firm's costs of actually calculating and filing its tax return are part of the Tax Foundation's estimate of the "cost of compliance."

As for the second general type of economic cost caused by the tax system — opportunity costs — they are also excluded from Tax Foundation estimates of the compliance burden. Arriving at an estimate of opportunity costs is a much more difficult and speculative task.

For instance, imagine a software developer who has to spend time complying with the tax code. Data are available to compute an estimated value of the tax work he accomplishes, and this report does that. But it is not possible to estimate with any precision the value of the work that the taxpayer might have accomplished had tax compliance not replaced entrepreneurial effort. This time may have been spent working on a new idea that one day blossomed into the next Microsoft — creating tens of billions of dollars in wealth. And even if phenomenal wealth would not have been created in that time, it is still true that every hour or dollar spent complying with the tax code represents resources that could have been spent tending to business problems, adding value to the economy while doing the work that the taxpayer is good at.

As shown in Tables 3 and 4, the Tax Foundation estimates that in 2001 individuals and businesses spent over 4.6 billion hours complying with the federal income tax. Using an hourly cost of $25.21 for individuals and $36.20 for businesses, the estimated cost of compliance in 2001 is $140 billion. (See Methodology section for details about how the hours and wages were determined.) Therefore, the overall compliance cost surcharge alone amounts to nearly 12 cents for every $1 collected by the federal income tax.

To put the tax compliance burden into perspective, the $140 billion tax surcharge is greater than the combined revenue of Sears

Table 2
Comparison of 1954 Code and 2000 Code

Subchapter of Income Tax Code	Number of Sections in Subchapter 1954	Number of Sections in Subchapter 2000	Percentage Growth
Determination of Tax Liability	4	50	1150%
Computation of Taxable Income	9	152	1589%
Corporate Distributions and Adjustments	14	35	150%
Deferred Compensation	2	31	1450%
Accounting Periods and Methods	6	33	450%
Tax-Exempt Organizations	4	19	375%
Corporations Used to Avoid Income Tax on Shareholders	4	27	575%
Banking Institutions	3	8	167%
Natural Resources	3	10	233%
Estates, Trusts, Beneficiaries, Etc.	7	32	357%
Partners and Partnerships	7	36	414%
Insurance Companies	5	30	500%
Regulated Investment Companies, Etc.	1	22	2100%
Tax Based on Income from Within or Without the United States	9	79	778%
Gain/Loss on Disposition of Property	7	40	471%
Capital Gains and Losses	4	56	1300%
Readjustment of Tax Between Years and Special Limitations	6	7	17%
Tax Treatment of S Corporations	0	14	NA
Other (a)	8	44	450%
TOTAL	103	725	604%

(a) Includes all subchapters not explicitly listed as well as Chapters 2-6 of Subtitle A of the Internal Revenue Code.

Source: Tax Foundation computations from Internal Revenue Code.

($40.9 billion), Walt Disney ($25.4 billion), Microsoft ($22.9 billion), Rite Aid ($14.7 billion), McDonalds ($14.2 billion), 3 Com ($5.4 billion) and Radio Shack ($4.8 billion). Put another way, 4.6 billion hours per year represents a work force of over 2,235,000 people, larger than the populations of Dallas (1,076,000) and Detroit (965,000) combined, and more people than work in the auto industry, the computer manufacturing industry, the airline manufacturing industry, and the steel industry combined. This is also more people than would reside in four Congressional districts.

In addition, the Tax Foundation has projected future compliance costs out to 2006. These projections are based on estimates published by the Internal Revenue Service (see Methodology section). As Shown in Figure 2, compliance costs will grow by almost $30 billion from $140 billion in 2001 to $170 billion in 2006.

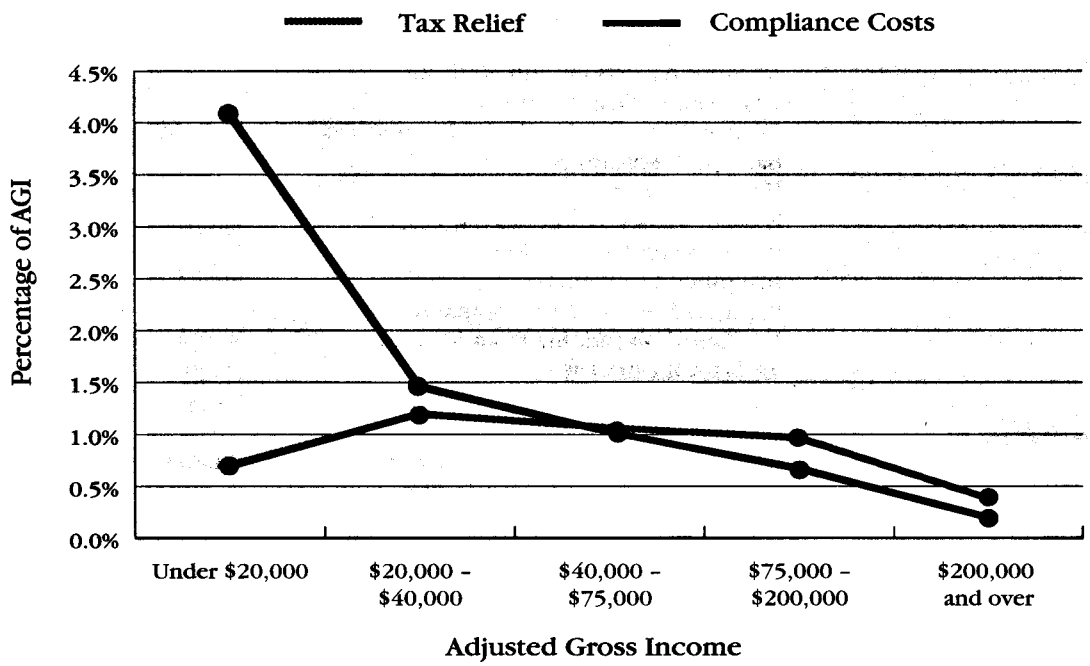
To illustrate the magnitude of these compliance costs, Figure 2 also compares the year-to-year compliance cost with that of the recently enacted tax reduction. In every year between 2001 and 2006, the total tax compliance cost is greater than the tax reduction. So from the taxpayer's perspective, the recent tax cut represents only a partial refund of their total tax compliance burden. The cumulative compliance cost over the 2001-2006 period will come to almost $930 billion while the cumulative tax reduction over the same period will only cover a little more than half the compliance costs at $550 billion.

Who Bears the Burden of Tax Compliance

Because complying with tax laws represents a fixed cost for many individuals, it seems likely that lower income individuals would bear a greater relative compliance burden than higher income individuals. In previous research, the Tax Foundation has found this to be true in corporate compliance costs. In fact, in 1996, small corporations — those with less than $1 million in assets — spent at least 27 times more on compliance costs as a percentage of assets than the largest U.S. corporations. New research by the Tax Foundation finds the same is true for individuals.

As shown in Figure 3, the compliance cost on individuals is quite regressive (see Methodology section). In other words, the compliance cost hits lower income individuals harder than higher income individuals. In fact, taxpayers with less than $50,000 of adjusted gross income (AGI) pay almost 60 percent of the total compliance cost for individuals—$37

Figure 3
The Income Distribution of Income Tax Compliance Costs vs. the Tax Relief Act of 2001
2001-2006



billion of the total $65 billion compliance cost imposed on individuals.

As a percentage of AGI, taxpayers with AGI of less than $20,000 are hit the hardest. They pay a compliance tax surcharge of over 4 percent of their AGI. Because compliance costs are essentially a fixed cost, the compliance tax surcharge falls as AGI increases. For taxpayers with $40,000-$75,000 in AGI, their surcharge consumes a much lower 1 percent of their AGI. The surcharge drops to 0.2 percent for taxpayers with an AGI of over $200,000.

This result occurs for two reasons. First, 75 percent of all returns are filed by taxpayers with less than $50,000 in AGI. Secondly, taxpayers with less than $50,000 in AGI only account for 33 percent of total AGI. Therefore, the fixed cost nature of tax compliance has a larger negative impact on lower income individuals.

Again, for illustrative purposes, the distribution of the individual compliance costs is compared to the distribution of the recent tax reduction. This comparison is made for year 2001 which is an appropriate comparative year because the majority of the tax cuts where aimed at individuals — particularly lower income taxpayers with the retroactive implementation of the lower 10 percent bracket.

Figure 3 reveals that a more effective way to provide tax relief to lower income taxpayers is via tax simplification. In fact, nearly half of all the tax surcharge savings resulting from tax simplification would go to taxpayers with less than $40,000 in AGI. For example, Form 1040 — which accounts for almost half of the tax compliance burden on individuals — takes nearly 13 hours to complete. Every hour shaved off the 1040 would save taxpayers over $2 billion. A mere 3 hour savings would net a ten-year $60 billion windfall for taxpayers at zero cost to the U.S. Treasury. Every hour shaved would also save taxpayers some 80 million hours a year, time better spent with family or tending to business.

Measures to Reduce the Cost of Compliance

What can be done to reverse the current situation? To reduce tax compliance costs, lawmakers and regulators must focus on the causes of tax complexity. One set of causes is economic and the other set is political.

As explained earlier, the economic causes of complexity are inherent in an income tax itself. The tax base questions, "What is income?" and "When is it income?" are difficult to answer, especially on the corporate side. The inherent difficulty of these questions explains why, for example, the rules of depreciation and the rules of transfer pricing associated with foreign-source income create such mindboggling tax code complexity.

However, the political process, particularly the politics the deficit/surplus debate, has made an inherently complex tax system worse. To a vast degree, the complexity of the current tax code is a by-product of the era of chronic federal budget deficits. The drive to balance the budget placed a policy emphasis on increasing on increasing government revenue, rather than on refining and promulgating consistent definitional answers about income. In this sense, tax policy has become tactical rather than strategic. Tax policy has no unifying theme. Instead, the budgetary aspects of dealing with the tax system are generally controlling the policy process.

This past budgetary dynamic has combined with the issue of tax fairness and the normal course of lobbying to accelerate the trend of "created complexity" and the artificial expertise that necessarily accompanies it. And this artificial expertise creates its own problems with regard to tax code complexity.

The interplay of these forces works something like this: Under budgetary rules, nothing can be done unless it is paid for. To date, however, cutting spending has rarely been a realistic political option, so inventive ways are found to raise revenue. Often, such revenue-raising exercises amount to broadening the tax base in some ad hoc or indirect way, like the AMT, since raising rates or removing tax preferences in a straightforward manner would face clear and powerful opposition.

Naturally, when the individuals or businesses that will be affected by the tax changes get wind of the proposals, they lobby to change the proposal, or shift the tax burden altogether. These activities may further contort the tax proposals.

When the final provisions are passed into law, the regulating agencies must devise ways to administer them. When the regulations are drawn up so as to be comprehensive — that is, when they attempt to cover every contingency while attempting to assure a zero possibility that a taxpayer can avoid taxation — the result is complex regulation superimposed on complex (or vague) legislation.

The net result of this process over time, is that few if any of the tax writers — the "artificial" experts — understand the mechanics of the entire tax code. The tax writing specialists

become comfortable in dealing only with their own narrow specialty. Tax specialists begin writing detailed rules with other tax specialists in mind. This narrow focus explains why, on occasion, there are complete inconsistencies in the Internal Revenue Code. No one person is capable of grasping the entire body of law. In this way, complexity seems to beget further complexity.

Short of overhauling the entire federal tax system, Congress can work to reduce the complexity of the current tax system (and, therefore, its high compliance costs) through two courses of action. First, Congress should strive to achieve a much larger measure of tax stability. Although not measured in this testimony, the taxpayer uncertainty that results from frequent tax law changes is a key source of complexity. Second, legislators and regulators should place a larger emphasis on tax simplicity. There exists an inherent trade-off between completeness and simplicity. In their steady pursuit of tax revenue and tax "fairness," legislators and regulators have emphasized completeness by trying to shut off all avenues of tax avoidance without regard to the incremental costs or unintended consequences of such an approach to governance.

Conclusion

Current forecasts of compliance costs on taxpayers reveal a large and growing tax compliance surcharge over the next few years, from $140 billion in 2001 to $170 billion in 2006. In 2001 alone, this surcharge amounted to nearly 12 percent of all income tax revenue collected.

In addition to the tax surcharge, the tax complexity due to the size and instability of the tax code creates two other types of economic costs, costs not measured in this testimony but significant enough to keep in mind. One is the overhead cost associated with the economically sterile exercise of tax planning, compliance and litigation. The second cost results from the economic oppor-

Table 3
Estimated Cost to Individuals of the Federal Income Tax System
Hours Per Return in 2001

Individual Forms and Schedules	Number of Returns	Record-keeping	Education Stage	Form Preparation	Packaging/ Sending	Total	Total Hours
Forms							
1040 (a)	77,914,480	2.8 hrs	3.4 hrs	6.3 hrs	0.6 hrs	13.0 hrs	1,014,186,815
1040A (b)	14,702,000	2.3	3.5	6.5	2.0	14.3	209,993,567
1040EZ (c)	16,660,000	0.1	1.6	1.8	0.3	3.9	64,696,333
1040ES	43,251,000	1.3	0.3	0.8	0.2	2.6	111,731,750
1040X	3,274,000	1.3	0.5	1.2	0.6	3.6	11,622,700
4868 (Extension of Time) (d)	8,333,000	0.4	0.2	0.3	0.2	1.1	9,027,417
2688 (Extension of Time) (e)	3,066,000	0.0	0.2	0.3	0.3	0.8	2,350,600
1041 (Estates and Trusts)	3,670,000	46.6	18.5	35.0	4.3	104.4	383,025,667
1041ES	2,017,000	0.3	0.3	1.5	1.0	3.1	6,252,700
1040 Schedules							
Sch A	52,017,347	3.1 hrs	0.7 hrs	1.6 hrs	0.3 hrs	5.6 hrs	292,164,098
Sch B	53,939,047	0.6	0.1	0.4	0.3	1.4	77,312,634
Sch D	35,277,366	1.5	3.1	1.8	0.6	7.0	245,765,650
Sch E	21,135,796	3.1	1.0	1.4	0.6	6.1	127,871,564
Sch EIC	23,026,802	0.0	0.0	0.2	0.3	0.6	13,048,521
Sch H	436,280	1.6	0.5	0.9	0.6	3.6	1,563,337
Sch R	592,602	0.3	0.3	0.5	0.6	1.6	967,917
Estate and Gift							
706 and 706NA (Estate)	121,000	12.4 hrs	7.6 hrs	14.6 hrs	10.6 hrs	45.3 hrs	5,477,267
709 (Gift)	300,000	0.7	1.1	1.9	1.1	4.7	1,410,000
Total (Forms + Schedules)	359,733,721	NA	NA	NA	NA	NA	2,578,468,537

(a) Includes 1040PC and electronically filed 1040 forms.
(b) Schedules 1-3 are included in the average time.
(c) Includes Telefiled 1040EZ forms.
(d) Application for automatic extension of time in which to file the individual income tax return.
(e) Application for additional extension of time in which to file the individual income tax return.

tunities that are foregone because of taxpayer uncertainty.

In conclusion, the benefits of reducing the tax complexity burden would dramatically benefit lower income taxpayers since they bear a disproportionate amount of the burden. In essence, taxpayers could enjoy a tax reduction via tax simplification, at zero cost to the U.S. Treasury. This could be done under a comprehensive revision of the tax code guided by established tax principles, such as those supported by the Tax Foundation. In addition, such tax reform would diminish the need for corrective tax legislation in the future and thereby increase the stability in the tax code and regulations.

Methodology

The federal income tax compliance cost estimate is based on data from the Internal Revenue Service. Table 3 compiles a list of the core individual income tax forms along with both the estimated paperwork-burden calculation (in hours of compliance time) generated

Table 4
Estimated Cost to Business of the Federal Income Tax System
Hours Per Return in 2001

Business Forms and Schedules	Number of Returns	Record-keeping	Education Stage	Form Preparation	Packaging/ Sending	Total	Total Hours
Sole Proprietorships							
Form 1040	19,775,520	2.8 hrs	3.4 hrs	6.3 hrs	0.6 hrs	13.0 hrs	257,411,352
Sch C	15,488,696	6.0	1.4	2.3	0.7	10.4	160,824,293
Sch C-EZ	2,535,193	0.8	0.1	0.6	0.3	1.7	4,352,081
Sch F	1,751,631	3.5	0.5	1.4	0.3	5.8	10,203,253
Sch SE	19,245,221	0.3	0.3	0.4	0.3	1.3	24,216,903
Partnerships							
Form 1065	2,132,000	39.9 hrs	22.2 hrs	37.8 hrs	4.0 hrs	104.0 hrs	221,656,933
Schedules							
Sch D	2,132,000	6.9 hrs	2.2 hrs	2.4 hrs	0.0 hrs	11.5 hrs	24,518,000
Sch K-1	2,132,000	27.0	10.1	11.0	0.0	48.2	102,762,400
Sch L	2,132,000	15.5	0.1	0.4	0.0	16.0	34,112,000
Sch M-1	2,132,000	3.4	0.2	0.3	0.0	3.8	8,137,133
Sch M-2	2,132,000	2.9	0.1	0.2	0.0	3.1	6,644,733
Corporations							
Forms							
1120	2,270,000	71.5 hrs	42.0 hrs	73.0 hrs	8.0 hrs	194.5 hrs	441,590,667
1120A	259,000	44.2	23.6	41.1	4.6	113.5	29,387,867
1120S	2,856,000	63.4	21.4	39.2	4.6	128.4	366,805,600
1120X	14,000	12.4	1.4	3.6	0.5	18.0	251,533
1120F	23,000	107.6	40.5	70.1	7.5	225.8	5,192,250
1120FSC	6,000	94.0	18.5	36.4	0.0	148.9	893,300
1120POL	5,000	17.0	5.1	12.1	1.9	36.0	179,750
1120RIC	11,000	56.9	18.5	34.2	4.0	113.7	1,250,700
7004 (Extension of Time) (a)	2,900,000	5.7	1.4	2.5	0.3	9.8	28,468,333
4626 (AMT)	363,200	18.2	12.2	13.1	0.0	43.4	15,774,987
4562 (Depreciation)	2,529,000	37.3	5.2	6.0	0.0	48.5	122,572,200
1120 Schedules							
Sch D	2,270,000	7.2 hrs	4.1 hrs	6.3 hrs	0.5 hrs	18.1 hrs	41,011,333
Sch H	227,000	6.0	0.6	0.7	0.0	7.3	1,649,533
Sch PH	113,500	15.3	6.2	8.6	0.5	30.6	3,474,992
1120S Schedules							
Sch D	2,856,000	10.5 hrs	4.6 hrs	9.7 hrs	1.3 hrs	26.1 hrs	74,636,800
Sch K-1	2,856,000	15.5	10.4	2.1	1.1	29.1	83,062,000
Total (Forms + Schedules)	91,146,961	NA	NA	NA	NA	NA	2,071,040,927
GRAND TOTAL (Table 3+ Table 4)	450,880,682	NA	NA	NA	NA	NA	4,649,509,464

(a) Application for automatic extension of time in which to file the corporate income tax return.
Source: Tax Foundation, using Internal Revenue Service data and estimation methods.

by the Internal Revenue Service. It also reports IRS projections for 2001 of the number of tax returns by type. Table 4 compiles a similar list for the business sector. These lists are far from exhaustive. Not only are many obscure forms and schedules left out, but the lists are also incomplete to the degree that adequate tax return information could not be obtained or estimated for the many schedules and forms that are common auxiliary components of the core forms.

The benefits of reducing the tax complexity burden would dramatically benefit lower income taxpayers since they bear a disproportionate amount of the burden. In essence, taxpayers could enjoy a tax reduction via tax simplification, at zero cost to the U.S. Treasury.

One trend in tax filing has been the growth in alternative methods of filing, the tele-file and the e-file. These filing methods primarily affect the delivery of the tax filings rather than the filings themselves. In the case of the tele-file, the 1040EZ must be used in order to file over the phone. As such, all tele-filed forms were counted under the 1040EZ form. In the case of the e-file, both the 1040 and 1040A forms can be filed electronically. Unfortunately, no data is available to break down the types of e-filings. In order to keep the time estimates on the conservative side, all e-files were counted as 1040 filings (as the 1040 requires less time to file than the 1040A).

Once the total number of hours spent on compliance has been determined, an hourly rate is then applied in order to determine the cost of compliance. This hourly rate was determined in one of two ways.

First, for individuals who filed themselves, the report uses their hourly compensation rate (wages and salary plus benefits) as a proxy for their "tax surcharge." Some may argue that individuals would value their time more highly than their hourly salary rate since it is their leisure time (time not spent in formal work) that is given up to file taxes. However, to avoid speculation, we believe that the hourly compensation rate represents the best estimate of a minimum compliance cost level for individuals.

Utilizing data from the National Compensation Survey and Employment Cost Index published by the Bureau of Labor Statistics, the Tax Foundation estimates a national hourly wage and salary rate of $16.22. In addition, utilizing data from the National Income and Product Accounts published by the Bureau of Economic Analysis, the Tax Foundation estimates that benefits increase total compensation by 18.4 percent, for a total hourly compensation rate of $19.20.

Second, for filings made by tax professionals, the report uses the average compensation rate for tax accountants. Unfortunately, the National Compensation Survey does not list "tax accountants" as a separate occupation. Therefore, the Tax Foundation estimates their rate by averaging "accountants and auditors" and "lawyers" together, since tax accountants must be adept not only in accounting procedures, but also in interpreting tax law and court rulings. This yields an hourly wage and salary rate of $29.27. After adjusting this wage to include benefits, a final hourly compensation rate of $34.66 is reached.

To derive the final average compensation cost for individual filings, the report also takes into account the number of forms prepared by individuals and those prepared by tax professionals. The latest IRS data shows that 56 percent of all forms are prepared by tax professionals. Using a weighted average, the final compensation cost is $24.14. For businesses, the average compensation cost is the rate derived for the average tax accountant: $34.66.

The compensation cost was initially derived for 1999. In order to project the compensation cost out to 2006, the cost was conservatively scaled up by the estimated rate of inflation as published by the Congressional Budget Office. The projections for the number of forms filed by type were taken from the Internal Revenue Service's own estimates. The hourly estimates for the projections were taken from the 2000 forms and held static throughout the projected time span; therefore, recent policy changes are not incorporated into the hourly form estimate.

The income distribution of income tax compliance costs is the result of an allocation model developed by the Tax Foundation utilizing data published by the Internal Revenue Service - Individual Income Tax Returns, 1998. Utilizing this data, the model allocates every IRS form examined in the compliance study by income cohort. ●

TAX FOUNDATION

SPECIAL BRIEFS are based on congressional testimony presented by the staff of the Tax Foundation, an independent 501(c)(3) organization chartered in the District of Columbia.

The Tax Foundation, a nonprofit, nonpartisan research and public education organization, has monitored tax and fiscal activities at all levels of government since 1937.

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About the Tax Foundation

Our Mission

The mission of the Tax Foundation is to educate taxpayers about sound tax policy and the size of the tax burden borne by Americans at all levels of government. From its founding in 1937, the Tax Foundation has been grounded in the belief that the dissemination of basic information about government finance is the foundation of sound policy in a free society.

What Do We Stand For?

As a nonpartisan educational organization, the Tax Foundation has earned a reputation for independence and credibility. However, it is not devoid of perspective. All Tax Foundation research is guided by the following principles of sound tax policy, which should serve as touchstones for good tax policy everywhere:

> *Simplicity*: The tax system should be as simple as possible, and taxes should be easy to understand and comply with.
>
> *Transparency*: Taxes should be as visible as possible to taxpayers, and should make clear who and what is being taxed.
>
> *Stability*: Tax law should not change continually, and changes in tax law should not be retroactive.
>
> *Neutrality*: Taxes should aim to raise revenue with a minimum of economic distortion, and should not attempt to micromanage the economy.
>
> *Growth-Promotion*: Taxes should raise revenue for programs while consuming as small a portion of national income as possible, and should interfere with economic growth, trade and capital flows as little as possible.

How Should Journalists Describe Us?

The Tax Foundation is a nonpartisan tax research group based in Washington, D.C.

The Tax Foundation Story

The year was 1937, the heart of the Great Depression. During the previous decade, first under Herbert Hoover, then under Franklin Roosevelt, federal spending had climbed 170 percent; over the previous five years internal revenue collections had risen 198 percent.

Concerned about the effect such expansion might have on private sector growth, a small group of business executives gathered in New York City to discuss how they could monitor fiscal activities at all levels of government and convey the information to the general public. They decided to launch an organization which, through research and analysis, could inform and educate Americans using objective, reliable data on government finance.

In the subsequent seven decades, the Tax Foundation has been a national leader in promoting a sense of "tax consciousness" in the public. Its distribution of information has helped provide policy makers with the lay of the land in the ongoing debate over tax and budget policies, as well as with a greater understanding of the policies proposed.