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Income Tax Rife with Complexity and Inefficiency

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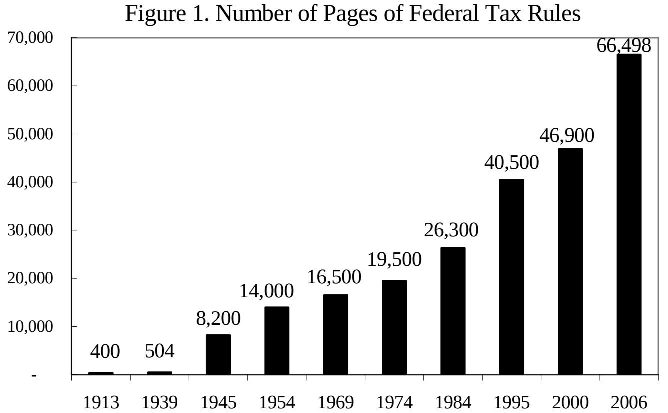
Despite recent tax cuts, the federal income tax code remains terribly complex and inefficient. Last November's report from the President's Advisory Panel on Federal Tax Reform sounded the alarm regarding the need for a major tax overhaul.[1] Congress should consider the panel's reform proposals and craft legislation to cut rates, end special breaks, and reduce tax barriers to savings and investment.

Major tax reforms are long overdue. Figure 1 shows that the number of pages of federal tax rules has increased 42 percent since 2000. The complex alternative minimum tax will hit about 30 million taxpayers by 2010 if not repealed. The high-rate U.S. corporate income tax is under growing pressure in the competitive global economy.

Figure 1. Number of Pages of Federal Tax Rules



Source: CCH, www.cch.com/wbot2006. Includes the tax code, regulations, and IRS rulings.

The Costs of Tax Complexity

Table 1 shows that taxpayers face rising compliance costs, more tax forms, longer instructions, and tax returns that are increasingly cluttered with credits and other special breaks. The number of tax breaks for education and energy has soared in the last decade. Sadly, the political impulse for social engineering has created a mess in the tax code and rising tax inequities between Americans.

Tax complexity imposes at least four types of cost on society. First, it creates annual compliance costs of about $265 billion for record keeping, learning tax rules, and related activities. Rising complexity has driven growth in the tax industry, which employs the nation's brightest minds in business tax planning, designing tax shelters, and battling the Internal Revenue Service.

Second, complexity impedes efficient economic decisionmaking. For businesses, complex rules for depreciation, capital gains, and other items interfere with such decisions as investments, mergers, and acquisitions. For individuals, tax complexity confuses important life decisions such as planning for retirement and starting a small business. A survey in 2005 found that two-thirds of taxpayers could not correctly answer basic questions about the tax rules on home sales, education incentives, retirement savings, and other items.[2]

Table 1. Rising Tax Complexity

	Item	Initial Year	Recent Year
a.	Total pages of federal tax rules (code, regulations, IRS rulings)	1995 40,500	2006 66,498
b.	Federal income tax compliance costs	1995 $112 billion	2005 $265 billion
c.	Number of IRS tax forms	2000 475	2006 582
d.	Percent of tax filers using paid tax preparers	1995 50%	2005 61%
e.	Pages in Form 1040 instruction book	1995 84	2005 142
f.	Number of income tax breaks for education	1995 7	2006 16
g.	Number of income tax breaks for energy	1995 11	2006 26
h.	Hours Americans spend on tax compliance	1995 5.3 billion	2005 6.4 billion
i.	H&R Block revenues from U.S. tax preparation	1996 $740 million	2005 $2.2 billion

Sources: CCH (a), Tax Foundation (b), IRS (c, d, e), Office of Management and Budget (f, g, h), H&R Block (i).

Third, tax complexity promotes an invasion of privacy by the government. The IRS needs to hunt for volumes of documentation to enforce all of the code's special breaks, such as those for housing and education. Also, because of the complex treatment of capital income under the income tax, the IRS accesses a vast range of personal financial data. By contrast, under a consumption-based flat tax, capital income would be taxed at the business level, which would increase privacy and simplify personal finances.[3]

Fourth, complex and unclear tax rules cause frequent errors by the IRS and taxpayers, and they exacerbate noncompliance with the law. A recent report found that the gap between federal taxes owed and taxes actually paid is about $345 billion annually.[4] Complexity coupled with high rates has fostered aggressive tax avoidance, as we saw with the Enron scandal. On the business side, the solution should be to either repeal the corporate income tax or replace it with a low-rate cash-flow tax system.[5]

Reducing Tax Distortions to Boost Growth

Simplifying the tax system goes hand in hand with reducing tax distortions and boosting economic growth. The tax code's inefficiency can be reduced in three ways. First, tax rules that treat different industries and business structures unequally should be ended. All types of investment should face the same low marginal tax rate. That would allow markets to direct resources to their highest-value uses and increase the nation's output.

Second, inefficiency can be reduced by ending the tax code's bias against saving and investment. One reform idea is to replace business depreciation with immediate deduction of capital purchases. That would simplify the code and likely increase investment, productivity, and wages, thus creating a win-win for business and labor.

Third, cutting marginal income tax rates would directly reduce the tax system's inefficiency. As tax rates are cut, taxpayers reduce their unproductive activities, such as tax avoidance and loophole lobbying, and increase their productive activities, such as working and investing.

These types of gains have inspired a flat tax revolution in Eastern Europe and Russia. Nine countries have enacted individual income taxes with low, flat rates.[6] The gains from cutting corporate tax rates are particularly large, a fact that nearly all our major trading partners have figured out. Reforms in recent years have reduced the average top corporate tax rate in Europe to 27 percent, compared with the U.S. federal and average state rate of 40 percent.[7]

Tax rates are important because they drive taxpayer behavior. As marginal rates are reduced, economic activity increases and reported incomes rise. The responsiveness of taxpayers to rates was demonstrated by the dividend tax cut in 2003. Congress cut the top rate on dividends from 35 to 15 percent in an effort to spur investment and improve capital market efficiency. Businesses responded strongly—the average per-share dividend payout for corporations in the Standard & Poor's 500 has increased 50 percent since the tax cut passed in early 2003.[8]

Transparent and Limited Government

A final goal of tax reform is to create a system that is more transparent and equal so that the public better appreciates the high cost of government. Under a flat-rate system with few deductions, people would more clearly understand how much they owed, and they could be sure that their neighbors faced a similar burden.

One problem with the federal tax system is that 37 percent of current taxes are not visible to average citizens.[9] The result is that people perceive the "price" of government to be artificially low, which in turn causes the "demand" for government to be too high. Thus, reforms should aim for taxes that are not only simple, but visible.

If done correctly, major tax reforms would leave all Americans better off. In today's competitive global economy, we cannot afford to have a second-rate tax system, especially given the rising burden the economy will face from a rapidly growing number of retirees. With the administration currently dithering on tax reform, it is up to Congress to forge ahead in 2006.

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1 President's Advisory Panel on Federal Tax Reform, "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System," November 2005.
2 CCH, "*CompleteTax* Survey Suggests Taxpayers Confused by Tax Code Complexity," March 16, 2005.
3 Chris Edwards, "Options for Tax Reform," Cato Institute Policy Analysis no. 536, February 24, 2005.
4 Government Accountability Office, "Tax Gap," GAO-06-453T, February 15, 2006.
5 Chris Edwards, "Replacing the Scandal-Plagued Corporate Income Tax with a Cash-Flow Tax," Cato Institute Policy Analysis no. 484, August 14, 2003.
6 Chris Edwards, "Catching Up to Global Tax Reforms," Cato Institute Tax & Budget Bulletin no. 28, November 2005.
7 Ibid.
8 Standard and Poor's Investment Services, www.standardandpoors.com/indices. For background, see U.S. Department of Treasury, "Investing in America's Future," March 14, 2006, and see www.americanshareholders.com.
9 The primary hidden taxes are the corporate income tax and the "employer" half of the federal payroll tax.