



JOINT ECONOMIC COMMITTEE

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RESEARCH REPORT #109-23
November 2005



Individuals and the Compliance Costs of Taxation

Taxes impose many costs. It would be easy to view the costs as simply the amount of money a person gives to the tax collector. However, the economic effects go beyond simply transferring money from one party to another. Since Adam Smith, economists have been concerned with the costs of taxation and have developed several different measurements of the economic costs.

First, as Smith pointed out, taxes can change or alter behavior. This may or may not be intentional. For example, taxes on cigarettes have the stated purpose of reducing smoking. Likewise, tax incentives to attend school may lead to an increase in the demand for schooling. However, there are other costs that are not intentional. One set of costs is the amount of time people spend complying with the tax code, known as compliance costs.

Compliance costs are a measure of the time and monetary costs borne by individuals as a result of paying their income taxes. These include record keeping, learning about specific laws and forms, preparation time, remittal time. They also include any monetary costs such as seeking assistance from an accountant, tax lawyer, or tax preparer (such as H&R Block) or buying computer programs or books. It is a measure of the opportunity cost of complying with the tax code.

Cost of Compliance

There is an extensive literature that examines the compliance costs of taxation. A number of recent studies estimate compliance costs at between \$67 and \$99 billion per year. A reasonable estimate would be \$83 billion. Given high compliance costs, it is important to understand how people respond.

Substitution Effect

Because taxpayers have some understanding of the time costs of preparing their taxes, many will choose to forgo the process entirely and have someone else do the work. About half of all taxpayers purchase assistance from an accountant or other tax professional. Those who purchased assistance spent about \$158 (1995 dollars) on average, although the amounts varied widely depending on the complexity of the return.

While seeking assistance will reduce the time costs of taxation, records still need to be kept, and the individual must invest some time and effort. Nevertheless, because tax preparers have developed a high level of expertise, they will be more efficient and will lower the time requirements, but not necessarily the monetary costs, to comply with the tax code.

Taxpayer Confusion

For those who file themselves, complexity can create confusion. People may intentionally take conservative filing positions when faced with a complex area of the tax code that seems to offer no clear

answers. Alternatively, some people may want to “roll the dice” and try a more aggressive approach in the hope that complexity may protect them in case of an audit.

In other cases, complexity may induce changes in behavior even when the tax law is clear and there is little chance of confusion. The tax law may be clear in some cases but involve a large number of steps or calculations that could be intimidating. This would not result in confusion or uncertainty, but might still alter behavior. For example, the Government Accounting Office (GAO) estimated that in tax year 1998, approximately 510,000 individuals did not itemize their deductions and may have overpaid their taxes by \$311 million.

One possible reason for this apparently irrational behavior is that the GAO only considers the accounting costs involved. Itemizing may save a taxpayer money, but the economic costs, such as the lost time, may not be worth the accounting profit.

Lack of Transparency

Complexity in the tax laws obscures the actual tax base and can, over time, increase the tendency of people to feel that the tax system is not fair. Survey results show that people frequently underestimate the tax shares paid by high income filers. As a result, people may call for marginal tax rates to increase, so a higher percentage of the

burden of taxation will fall on the wealthier individuals in society. Or, it can breed cynicism among taxpayers, which can ultimately lead to intentional noncompliance. Over time, this could make the collection duties of the IRS increasingly difficult.

Complexity Creep

One lesson of economics is that legislation can have unintended consequences. In tax law, one problem is that complexity sometimes does not become evident until many years after a legislated change. Consider the alternative minimum tax (AMT). In tax year 1990, only 132,000 people paid the AMT for individuals (there is also an AMT for corporations). By 2000 that number rose to 1.3 million and by 2010 the number is projected to rise to nearly 35 million, unless the current law is changed.

Conclusion

The Internal Revenue Code now consists of more than 1.4 million words and the result is complexity and taxpayer confusion. Tax reform is necessary and worthwhile. However, for tax reform to be successful, legislators should keep filing and administrative costs to a minimum and they should apply low marginal tax rates to a broad economic base. These simple guidelines should ensure that tax reform reduces disincentives to work, save, and invest.

This Research Report is based in part on the Joint Economic Committee study *Individuals and the Compliance Costs of Taxation* (October 2005). For a copy of this study, contact the JEC at (202) 226-3234 or visit the website www.house.gov/jec.

Additional JEC Reports of interest are also available on the website and include:

- *Reforming the U.S. Corporate Tax System to Increase Tax Competitiveness* (May 2005)
- *A Brief Explanation of the Economic Burden Imposed by Federal Taxes* (April 2005)
- *How Competitive is the U.S. Tax System?* (April 2004)
- *Near-Term Stimulus and Long-term Growth* (May 2003)
- *Federal Tax Policy, Near-Term Stimulus and Long-Term Growth* (March 2003)
- *Tax Reduction and Economic Welfare* (April 1999)
- *Some Underlying Principles of Tax Policy* (September 1998)