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A Golden Opportunity to Simplify the Tax System

Most of the debate about President Bush's tax proposals and Democratic alternatives has focused on the highly contentious issues of size and fairness. The effects on tax complexity have been largely ignored, despite widespread consensus that taxes are too complicated. With both parties interested in tax cuts of some kind, this is a prime opportunity to simplify the tax system. In this brief, we discuss why taxes are complicated, examine how the Bush administration's and the Democrats' proposals would affect tax complexity, and present options for simpler taxes.

Tax complexity is like the weather: everyone talks about it but nobody does anything about it. This year's debate is no exception. The way things are going, taxes will end up more complicated after the next round of "reform." Unlike the weather, though, policymakers can do something about complexity. And if they do not simplify the tax system now, when there are surplus funds to pay for simplification, they will have lost a golden opportunity.

Simpler taxes are needed for many reasons. First and foremost, tax complexity creates headaches for almost all taxpayers. Complex taxes are difficult to comply with and to administer. Provisions aimed at encouraging certain activities—such as saving for college—will be less effective if people cannot understand how they work. People who do not understand tax rules may also question the fairness of the tax system, feeling that others are receiving more benefits than they are. As a result, these taxpayers may be less apt to comply with the law.

Why Are Taxes So Complex?

Any plea for simpler taxes has to start by addressing a basic problem: If everyone thinks taxes should be simple, why are taxes so complicated? We believe five factors help explain why taxes get complicated and suggest keys to making taxes simpler.

First, simplicity often conflicts with other tax policy goals. Most people believe taxes should be fair, conducive to economic prosperity, and enforceable, as well as simple. 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 competing goals. For example, most countries tailor tax burdens to the characteristics of individual taxpayers. That can make taxes fairer, but also 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 conflicts appear to have been especially relevant in the Clinton administration, where

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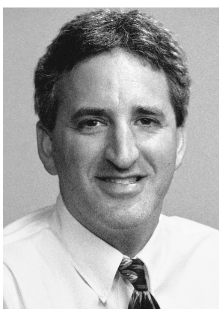

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Options for Reforming

desires to channel tax cuts to particular groups added significant complexity to tax rules especially for middle-income households.

Second, the political process creates complexity. Politicians and interest groups support tax subsidies for particular groups or activities. Targeted subsidies inevitably complicate the tax system by creating distinctions among taxpayers and among sources and uses of income.

Third, some complexity is necessary to deter tax avoidance. Taxpayers have every right to reduce their taxes by any legal means. But this activity inevitably raises questions about whether particular activities or expenditures qualify for tax-preferred status. The Treasury Department responds with complex rules designed to limit avoidance. Taxpayers in turn respond by inventing complex transactions to skirt the new rules. This can create a vicious cycle that leads to more and more complex rules and increasingly sophisticated and complex avoidance strategies.

Fourth, many complicated provisions were enacted to raise revenue or limit revenue losses during times of rampant budget deficits. For example, the landmark Tax Reform Act of 1986 (TRA)—a remarkable accomplishment in many respects—fell short of its goal of simplicity in order to meet the requirement of "revenue neutrality." TRA created several complicated phase-outs and hidden taxes in order to raise revenue and meet distributional targets.

Lastly, complexity is hard to quantify. If members of Congress knew that a particular provision would raise compliance costs by a particular number of dollars, they could more easily evaluate the trade-offs between complexity and other goals.

Insofar as complexity has arisen from efforts to limit revenue loss, the surplus and the political consensus in favor of tax cuts creates an opportunity to simplify taxes. But simplification will not prove easy. Trade-offs among policy goals, political haggling, and taxpayer avoidance will affect any tax system and will limit how simple taxes can be.

Given the policy trade-offs, the fundamental question is not the overall level of complexity, but whether its benefits—in terms of achieving other policy goals—are worth the costs of complexity. This assessment can be tricky. Most people don't mind complexity that directly reduces their taxes, but that does not necessarily make such complexity a good idea from society's point of view. For example, suppose every taxpayer had to complete five extra lines of the tax form in order to receive a $1,000 tax cut. Each person filing might regard that as "good complexity," worth the cost of providing extra information. But, if the intent is for revenues to remain constant, the funds would still have to be raised from somewhere, so the average taxpayer would receive no benefit from the good complexity. Thus, on balance,

a Complex Tax Code

individuals' tax bills are not lower, but taxpayers would have to work a lot harder to figure out what they owe. So, even what seems to be "good" complexity from the individual's point of view can be an illusion, and an unambiguous loss for society.

Simplification in the President's Plan

President Bush's proposed tax cut is dominated by four main components: reductions in the marginal income tax rates, creation of a new 10-percent income tax bracket, expansion of the child credit, and abolition of the estate tax. But for issues of simplification, the devil is almost always in the details, and the president also offers a large set of additional proposals (see chart). Would taxes be simpler under the president's plan? Probably not.

Simplicity often conflicts with other tax policy goals. Although taxes should be simple, most people also believe taxes should be fair, conducive to economic prosperity, and enforceable.

Income Tax Rate Cuts Contrary to some claims, reducing the number of tax brackets does not simplify compliance. Taxpayers will continue to look up their tax liability in a tax table. But lower tax rates simplify tax compliance indirectly by reducing the incentive to avoid taxes or find tax shelters. They are one way to break the vicious cycle described earlier.

Alternative Minimum Tax Any gains in simplicity arising from lower rates would be offset several times over because lower rates would subject millions of taxpayers to the individual alternative minimum tax (AMT). The AMT is a parallel tax system that was created to prevent high-income taxpayers from aggressively using tax shelters and deductions to eliminate their tax burdens. Taxpayers must pay the AMT if their regular income tax liability is less than their AMT liability. The AMT is quite complex and requires tax filers to make many detailed calculations. Currently, fewer than 2 million taxpayers face the AMT.

By lowering income tax rates but not the AMT, the president's proposal would raise the number of people subject to the AMT. By 2011, 36 million people—more than one quarter of taxpayers—would face the AMT. Most would be middle- and upper-middle-income taxpayers who must complete the AMT merely because they have large families or live in a high-tax state. These families are hurt most because the AMT does not provide exemptions for children or deductions for state and local taxes. Of course, having children and living in a high-tax state hardly represent the egregious sheltering activities that the AMT was intended to capture. To be sure, the AMT would be a very serious problem even with no change in tax law; about 21 million people are slated to face the levy by 2011. But the administration's plan would increase the number of AMT payers by 70 percent, according to the Joint Committee on Taxation.

Estate Tax Abolition Reforming the estate tax could simplify tax compliance for some wealthy taxpayers. For example, exempting $2.5 million per person—rather than the current $675,000—would reduce the number of estate tax payers by about 85 percent and substantially reduce the amount of estate tax planning those households have to do. (Under current law, the exemption is scheduled to increase to $1 million by 2006, and is $1.3 million for individuals with family-owned businesses and farms.)

Any plea for simpler taxes has to start by addressing a basic problem: If everyone thinks taxes should be simple, why are taxes so complicated?

Outright repeal of the tax—as proposed by the administration—would probably be more complex than raising the exemption. Repeal would eliminate tax planning for all estates, but estate planning would still be necessary, since much of it occurs for reasons other than taxes. And repeal would also create new complexities. For example, under current law, when an heir receives an asset from an estate, the basis price is "stepped up" (i.e., changed) from its original purchase price to its current value. If step-up survives after abolition of the estate tax, it would create gaping loopholes in the treatment of gifts and bequests that could be profitably exploited by the very wealthy. For example, the Joint Committee on Taxation recently estimated that, although the estate tax itself is slated to raise a little over $400 billion over the next 10 years, abolishing it immediately would cost much more—about $660 billion—because of the shelters it would create in the *income* tax. Although this problem would also arise with a $2.5 million exemption, it would be much more severe if the tax is repealed altogether because the extremely wealthy have the most to gain from aggressive tax shelters and are thus more likely to take advantage of loopholes.

An alternative approach—passed by Congress in 2000—is to couple estate tax abolition with "basis carryover," under which heirs inherit an asset's original basis price. Implementing carryover raises vexing issues. For example, some families would have to keep records for generations to track asset purchase prices and increases. Carryover basis would raise taxes on many heirs compared with current law unless modest gains are excluded from the new rule. But exempting a portion of capital gains would create a great deal of complexity. For example, under current law, it is easy for a parent to split an estate equally among his or her children. Under basis carryover, the estate would have to decide how to allocate a capital gain exclusion among the children. The assets inherited by children who received equal bequests, but different exclusion amounts, would be worth different amounts on an after-tax basis.

A carryover basis provision was enacted in the late 1970s, but was repealed before it took effect because taxpayers complained about the new complexities and problems in implementation. There is no reason to think these issues would be any easier to deal with now.

Targeted credits and deductions Given his critique of Al Gore's targeted proposals, a surprising feature of the president's proposal is the panoply of targeted tax incentives (see chart). The president wants to subsidize everything from health care to teachers' out-of-pocket classroom expenses, to alternative fuels and conservation, and more. These programs would complicate taxes. Each program would require precise definitions of eligible taxpayers, income levels, and qualifying expenses. Many of the proposed incentives would require separate worksheets or tax forms. The possibility of honest mistakes or fraud would rise commensurately. The government would need to spend more on monitoring or auditing taxpayers, and the programs would likely send more lower- and middle-income households to paid tax preparers.

Charitable deduction for non-itemizers The president would allow taxpayers who do not itemize to deduct charitable contributions up to the amount of the standard deduction. This proposal could simplify matters for the 2 percent of taxpayers who currently itemize, but whose deductions other than charity are less than the standard deduction. But for the roughly 70 percent of taxpayers who take the standard deduction, the change would add complexity. They would need to keep records of contributions, which might be difficult if the contributions are small or in cash. A similar deduction in the early 1980s created serious compliance problems, with many taxpayers claiming undocumented deductions. Both the cap on non-itemized charitable deductions and the interaction of this provision with the phase-out of itemized deductions for high-income taxpayers would complicate choices for some taxpayers and require more auditing and monitoring by the IRS.

Elements of President Bush's Tax Plan

1. Reduce individual income tax rates
2. Create new 10-percent bracket
3. Increase the child credit
4. Phase out and repeal estate tax
5. Establish second-earner deduction
6. Institute charitable deduction for non-itemizers
7. Allow tax-free withdrawals from IRAs for charitable contributions
8. Raise cap on corporate charitable contributions
9. Allow farmers to reserve a portion of their farm income in a tax deferred Farm and Ranch Risk Management (FARRM) account
10. Expand education savings accounts
11. Exempt qualified state prepaid tuition plans from tax and expand to include private plans
12. Provide an exclusion from income for National Health Service Corps scholarships
13. Allow a tax deduction of up to $400 for teachers' out-of-pocket classroom expenses
14. Allow state private activity bonds to be used for school construction and repair
15. Permanently extend research and experimentation tax credit
16. Provide a tax credit for individuals and families who do not have access to employer-sponsored health insurance
17. Extend and expand medical savings accounts
18. Allow an additional personal exemption for caretakers of elderly family members
19. Allow additional tax subsidies for health flexible spending accounts
20. Provide a tax credit to financial institutions that match private contributions to individual development accounts to save for a first home, start a business, or pay for education
21. Provide a 50-percent tax credit for rehabilitation and construction of homes in distressed areas
22. Make the adoption tax credit permanent and increase it from $5,000 to $7,500
23. Clarify that a company's contributions of computers and Internet access for home use by employees with disabilities are tax-free benefits
24. Provide a tax credit for the installation of rooftop solar equipment
25. Extend the tax credit for fuel produced from renewable sources
26. Provide a 50 percent capital gains tax exclusion to private landowners who voluntarily sell their land or water for conservation purposes
27. Extend permanently favorable tax treatment of the costs of cleaning up contamination at abandoned waste sites known as "brownfields"

Simplification Under Democratic Alternatives

Although there is no official Democratic plan, House Ways and Means Committee Ranking Member Charles Rangel (D-NY) has proposed four items: a new 12 percent bracket, an expanded standard deduction for married couples, an increase in the estate tax exemption, and expansion and simplification of the earned income tax credit (EITC).

This package is less expensive and more tilted toward lower-income households than President Bush's plan, and it would be simpler. As noted, raising the exempt amount on the estate tax creates fewer complexities than abolishing the tax. Raising the standard deduction would reduce complexity by lowering the number of households that itemize their deductions. The proposed reform of the EITC would simplify rules governing who is eligible for the credit—currently a significant source of confusion. Rangel's proposals do nothing to alleviate the coming AMT problem discussed above, but they do not make it worse either.

Making Taxes Simpler

The key to tax simplification is to make fewer distinctions across economic activities and personal characteristics. Taxes should be imposed on a broad base at relatively low rates that do not vary by income source or expenditure type. Progressivity should be embodied in the rate structure and the tax base, not in the design of specific provisions. Universal exemptions, deductions, or credits are much simpler than targeted ones. The following types of reforms are examples of options that could make the tax system simpler as well as fairer and more conducive to economic growth.

Reform the Individual AMT To spare middle-income people who were never its target, the AMT should be indexed for inflation, deductions should be allowed for dependents and state and local taxes, and all personal credits should be available against the AMT. Any proposal that cuts regular income tax liabilities should be required to make conforming adjustments to the AMT so that more taxpayers are not subjected to the alternative tax. Some would argue that the AMT should be eliminated altogether. But a reformed AMT would prevent the very wealthy from eliminating their tax liability, and legislators will probably want to be spared the embarrassment of seeing how successfully the well-advised can exploit loopholes.

Repeal Limits on Personal Exemptions and Itemized Deductions The personal income tax contains several "take back" provisions—hidden taxes designed to raise revenue from upper-income people in an obscure fashion. Personal exemptions are phased out for high-income taxpayers, creating a secret family surtax on high-income taxpayers. Another provision reduces itemized deductions by 3 percent of households' income above certain thresholds. Taken together, these provisions can raise effective tax rates by four or more percentage points for a family of four (and more for larger families). They constitute surcharges on upper-middle income families that are not directly reflected on any tax table.

Eliminate Credit Phase-Outs A number of credits phase out across different income ranges. Each credit requires separate worksheets and tax calculations. The phase-outs create hidden taxes over the phase-out range, and diminish the effectiveness of the credits in encouraging the activities they are designed to spur.

Coordinate and Consolidate Provisions with Similar Purposes In a number of areas, numerous provisions—each with slightly different rules—apply to the same general activity. Coordinating or consolidating the following provisions would simplify taxes, often with little or no forgone revenue:

EITC, Dependent Exemption, and Child Credit Several recent proposals would combine features of the tax code that deal with families with children. Coordinating the three tax subsidies—and adopting a common definition of "qualifying child"—could make taxes much simpler for low-income households.

The main reason to focus on simplification now is that the budget surplus and the consensus in favor of some kind of tax cut offer a rare opportunity to address the problem.

Education Subsidies Choosing among the alternative tax subsidies for college education requires college algebra and a lawyer's attention to detail. These choices could be made far simpler through consolidation into two subsidies, one focusing on saving incentives for education, and one on either deductions or credits for current educational expenditures.

Saving Incentives Independent of employer-provided accounts, households may save in Individual Retirement Accounts (IRAs), Roth IRAs, educational IRAs, and Keogh plans. Rules concerning contribution limits and withdrawal patterns vary by program. Consolidating these options into one or two non-overlapping options with simple and broad rules on eligibility, contribution, and withdrawal rules would simplify tax planning for retirement.

Capital Gains Capital gains will eventually be taxed at up to eleven different rates, depending on the asset, the owner's income, when the asset was purchased, and how long it was held. It would be much simpler to replace this confusing hodge podge with an exclusion of a set fraction of capital gains from taxable income—say 50 percent—as was done prior to 1987.

Simplify Filing and Record-Keeping Thirty-six countries administer some sort of "return-free" tax system. Under such a system, the taxpayer or the taxpayer's employer supplies a few information items to the tax authorities, which calculates the tax due and bills the taxpayer. Up to 52 million taxpayers (and many more if the standard deduction were significantly increased) could be placed on a return-free system with relatively minor changes in the structure of the income tax. These include filers who have income only from wages, pensions, Social Security, interest, dividends, and unemployment compensation; who do not itemize deductions or claim credits other than the EITC or the child credit; and who are in the zero or 15-percent tax bracket. Raising the standard deduction significantly would curb administrative costs by reducing the number of itemizers and removing millions of households from the tax rolls altogether. It would also provide a tax cut for many low- to middle-income households.

Fix the Income Tax Although not likely any time soon, the best option would be broad-based income tax reform. Broadening the base by eliminating targeted preferences and taxing capital gains as ordinary income would remove major sources of complexity and major incentives for sheltering. The revenue raised could be used to increase the standard deduction—removing millions from the tax system—and to reduce tax rates—thereby reducing the incentive to shelter funds and encouraging compliance.

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Why Now?

Tax simplification can benefit both low- and high-income households and make taxes fairer and more efficient. But that has always been true. Why focus on simplification now?

Recent events suggest an increased willingness to focus on simplification in some circles. The IRS's Office of the National Taxpayer Advocate, for example, listed complexity as the most difficult problem facing taxpayers, and now-retired Senator Daniel Patrick Moynihan (D-NY) and others have proposed establishing a national commission on tax simplification. Leading tax professional groups, including tax lawyers and accountants, have advanced their own simplification proposals.

But the main reason to focus on simplification now is that the budget surplus and the momentum behind tax cuts create a rare opportunity to address this problem. Simplification in the past seemed impossible because eliminating loopholes and preferences in a "revenue-neutral" package raises taxes on some people, who naturally object. Achieving simplification in a tax cut package, however, can avoid the politically difficult offsetting revenue increases. For once, everyone could have lower and simpler taxes, if politicians decide to put their money where their rhetoric is.

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