Simplify, Simplify, Simplify: The First Principle of Tax Reform

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JULY 2013

PPI believes we need a federal tax system that is simpler and more progressive.

Overhauling the federal tax system is one of the most important steps U.S. political leaders can take to promote economic growth and fairness. It is also that rarest of issues in today's Washington—one that commands broad support on both sides of the political aisle. For these reasons, the Progressive Policy Institute urges the White House and Congress to give top priority to fixing our broken tax system over the next 12 months.

Everyone knows our tax code is too complicated, too inefficient and too riddled with preferences for special interests. Americans deserve better. PPI believes we need a federal tax system that is simpler and more progressive; that steers investment into productive, job-creating activity; that enables U.S. workers and companies to compete on an even footing in world markets; and, that serves the most basic purpose of any tax system—raising enough revenue to finance the government while ensuring fairness to taxpayers.

Comprehensive tax reform obviously poses daunting political obstacles. Nevertheless, it's a goal Democrats and Republicans share. The Senate Finance Committee has published 10 papers on various options while the House Ways and Means Committee has organized 11 subgroups to consider different areas of the tax law. Over 1000 comments have been filed. With Sen. Max Baucus retiring this year, and Rep. Dave Camp term-limited as chair of the House Ways and Means Committee, the two most important players on tax policy are strongly motivated to get something done.

This paper will not offer a sweeping blueprint for reform. Instead it focuses on one crucial aspect of reform: Simplification. PPI has long argued that our tax system is too complex and ill-fitted to the needs of middle-class families and small entrepreneurs. They benefit little from the existing array of incentives and loopholes, which are mainly targeted on special interests or people with a level of income and wealth they can only dream about. The code's byzantine complexity also costs business and individuals hundreds of billions in compliance. In a recently released annual report to Congress, the IRS's National Taxpayer Advocate, Nina Olson, estimated that individual and business taxpayers spent 6.1 billion hours to complete filings. The bloated federal code contains almost four million words and on average has more than one new provision added to it daily.[1]

The code is so complex that nearly 60 percent of taxpayers hire paid preparers and another 30 percent rely on commercial software to prepare their returns.[2]

In fact, according to PricewaterhouseCoopers, only four nations have more pages of "primary tax legislation" than does the United States. And the World Bank's www.doingbusiness.org ranks 61 nations as having tax systems friendlier to business than does the United States, while the World Economic Forum puts the U.S. tax system in 107th place in a ranking of the efficiency of 117 national tax regimes.

Congress perennially fiddles with the code, and it takes a full-time army of lobbyists to keep track of all the changes: the Treasury Department reports that there have been more than 14,400 revisions since 1986. It is imperative, then, that any comprehensive overhaul of the federal tax system not make the code even bigger and more complicated. Tax reform without dramatic simplification should not be considered genuine reform.

What is Simplification?

We often hear talk about simplification from both sides of the political aisle. But there is a lot of confusion about what constitutes tax simplification and how to ensure the vast majority of Americans will benefit. In fact some reform plans that claim they would simplify the tax code and the process of filing taxes would actually make the current system worse in several important ways.

Simplification should never leave most Americans, particularly low- and middle-income families, worse off than the current system nor should it abandon the principle of progressive taxation. One example of such an approach is the so-called 'flat tax' that would collapse the current 5 marginal rates into one. The flat tax sounds simple, but in order to ensure the government doesn't worsen our already historically high federal deficit, the rate would be considerably higher than the 15 percent rate most taxpayers pay today. That means the vast majority of Americans would be saddled with a substantial tax hike all in the name of creating a tax code with a single rate.

Just as problematic are political gimmicks that would pretend to simplify while in actuality maintain the current system of excess complexity. For example, 'return free filing' has been proposed as a solution to taxpayer woes. Under this proposal, the Internal Revenue Service would just calculate your taxes for you—no fuss, no muss.

However beguiling that might sound to some, there are several big problems with this idea. First, you can't change an old jalopy into a sports car simply by painting it red—under the hood the tax system would be just as complex, hard to understand, and dysfunctional. Indeed, return-free can actually hide tax dysfunctionality and inefficiency by making it invisible to citizens, which would work at cross-purposes to the long-term improvements and reform of the tax system that are long overdue.

Second, there's the inherent conflict of interest in having the taxman do your taxes. If there's any question about how to apply the tax code, the IRS is likely to choose the interpretation that brings in more taxes. Finally, to the degree that the IRS actually tries to figure out the right level of taxes due—rather than simply charging the highest number—return free filing is likely to be expensive to implement. Indeed, there's already free solutions for tax return preparation—IRS Free File—that relies on the private sector without costing taxpayers a dime. And, this idea has been tried in the United States. Under California's Ready Return, of the millions of taxpayers offered the government-prepared returns, less than a hundred thousand taxpayers a year have taken up the State's offer which would be sent to them just like their real estate or property tax bills. At the end of the day, Ready Return was an experiment that failed to persuade taxpayers that government revenue agencies should be their tax preparer.

But there is a more positive reason why it is in the nation's interest to keep the citizen directly engaged in their own tax compliance obligations. The annual tax ritual is for some individuals and families the one time when they take stock of their complete financial situation. It represents a teachable moment in financial literacy, which should not be lost. Instead, we should seek to drive greater positive benefit from that moment. Today taxpayers can choose to split their tax refund up to three ways by direct deposit when filing their returns. Affirmative initiatives should seek to help make opening a 529 Education Plan for a child, or an IRA for retirement easier and more understandable. Even a small percentage of such savings from the average tax refund could make a real difference over time. We should be encouraging citizens to pay more attention to their personal financial health before and after taxes, not less.

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PPI supports a real drive to truly simplify our tax system, not a fig leaf. Not only would a simpler code reduce red tape and save taxpayers hours of wasted time pouring over forms and filing multiple documents and at multiple times and places, it would also level the playing field, create a better economic environment for businesses of all shapes and sizes, maintain progressivity, and raise revenues for both deficit reduction and urgent investments in our nation's future.

If Congress and the Administration are serious about simplifying the tax code for the vast majority of taxpayers, tax reform must achieve the following goals:

1. **Promote economic efficiency and growth.** We need a tax code that allocates personal and business investment more efficiently, into activities that will create new jobs and companies. Pro-growth tax reform will help us speed economic recovery, bring unemployment down, and shrink the national debt. Many economists believe that reform plans that close

tax incentives and lower rates (so long as they do not add to the deficit) can substantially improve economic growth. For example, some studies have suggested that the last major tax reform in 1986 added 1 percent to GDP.[3] And the Joint Committee on Taxation has determined that the effect of generic base-broadening reforms to the individual code (and corporate side if Congress was so inclined), could increase national output by anywhere from 1.2 percent to 2.0 percent in the second five years after enactment.[4]

2. **Reduce the number of tax incentives to lower rates and rebuild the nation's revenue base.** The tax code now contains more than $1 trillion in tax incentives. Many economists believe tax breaks distort economic behavior and misallocate investment. Furthermore, many of these incentives are simply a form of spending. The Simpson-Bowles plan, the Rivlin-Domenici Commission, and the Wyden-Coats legislation have all suggested cutting all or many of the tax incentives currently embedded in the code and use the savings to lower marginal income rates and to cut the deficit. Others, like House Budget Chairman Paul Ryan have proposed similar ideas.

   Each tax loophole is fiercely guarded by the special interests who benefit from it. Closing tax breaks en masse will not be easy, but it is essential both to lower tax rates for middle class families today, and to whittle down public debts that imply crippling tax burdens on tomorrow's taxpayers—aka our children.

   Of course it is naïve to think that any tax reform plan would eliminate every tax preference. The Modified Zero Plan proposed by the Simpson-Bowles Commission in fact included a number of tax incentives, some altered and some not. But even with those incentives added back in, the modified Zero plan would cut the deficit by $1 trillion, lower the top rate to 29 percent, cut the corporate tax rate, and move the U.S. to a territorial tax system, so that over $1 trillion currently held by U.S. corporations overseas could be brought back home to create jobs here in this country.

   Of course, elected officials may have other good reasons for preserving some tax breaks. For example, policymakers might want to maintain certain tax incentives for industries that won't benefit from a lower corporate tax rate or moving to a territorial system. But these choices should be made in the overall context of lowering marginal rates and hitting certain revenue targets.

3. **Maintain Progressivity.** Most tax incentives in the code today make it less progressive, not more. The Earned Income Tax Credit (EITC) is a major exception. This is true for a number of reasons, including that higher earners participate more in tax-favored activities (like retirement savings and mortgages) and are more likely to be able to itemize their deductions.

In addition, for many tax expenditures, the more you earn the more you get; someone at the 15 percent rate gets a 15 cent subsidy for spending a dollar on the same activity for which a high earner may get a 35 cent subsidy.

An analysis from the Tax Policy Center has found that the top quintile pays 11 percent less of their income in taxes thanks to tax expenditures, while the bottom quintile pays only 6.5 percent less. If you exclude the effects of the child tax credit and EITC, the bottom quintile pays only 1 percent less as a result of tax incentives, compared to 11 percent at the top.[5]

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What this means is that eliminating many tax incentives and using the savings for lower rates, can, in conjunction with maintaining (and maybe even expanding) the EITC, maintain or improve progressivity in the tax code.

4. **Reduce Errors and Avoidance.** Tax law complexity often leads to perverse results. On the one hand, taxpayers who honestly seek to comply with the law often make inadvertent errors, causing them to either overpay their tax or become subject to IRS enforcement action for mistaken underpayments. On the other hand, sophisticated taxpayers often find loopholes that enable them to reduce or eliminate their tax liabilities. And, all this complexity has contributed to the Federal net tax gap, which now totals $385 billion, according to the Internal Revenue Service.[6]

Besides eliminating tax incentives, there are additional ways to clean up the federal tax code. A number of tax credits phase-out across different income ranges, so that claiming each credit requires a separate worksheet and tax calculation. The phase outs also create hidden taxes over the phase-out range and diminish the effectiveness of the credits in encouraging the very activities they are designed to spur.

Another reform that PPI has long championed is to consolidate redundant tax incentives, such as tax breaks for retirement and higher education. In a number of areas, numerous provisions—each with slightly different rules-applies to the same general activity. These technical differences in real life tax situations touch so many lives (retirement and education) but the choices are mind-numbing for most people. Coordinating or consolidating these provisions would simplify taxes, reduce confusion, and increase take-up rates for those healthy economic behaviors Congress is seeking to encourage. Presently, there are some 14 different incentives for college, 11 types of IRAs, and 3 major incentives to help parents defray the cost of raising children.[7] Such complexity works against the achievement of the intended objectives. Common sense simplification would make tax reform work for average working families.

Tax simplification has been labeled one of the most effective ways of closing the tax gap. The tax gap is defined as the difference between what is owed in taxes and what is not collected. According to the most recent IRS estimate, the "net tax gap" is $385 billion annually. Generally speaking there are three ways to reduce the tax gap:

First, hire more IRS enforcement personnel. According to Internal Revenue Service internal studies, each dollar spent on an additional examiner brings in on average 4 to 5 dollars of additional revenue.[8] But given the recent IRS scandal and our nation's general contempt for the IRS, this proposal is a political non-starter.

Second, increase the amount of third party reporting. Unlike wages paid by an employer, not all forms of income are reported by a third party. However, much has been done to increase third party reporting in recent years and a number of obstacles exist to further reforms. But there is still more that could be achieved by applying modern data-driven innovation to improve the quality of returns. Government needs more complete and accurate returns to help close the tax gap. Today many taxpayers can already electronically download financial information such as W-2s and 1099s directly into their tax returns from their original sources, such as payroll service providers and financial institutions. Such modern data-driven innovation should be the standard way most returns are prepared and filed, delivering higher quality returns, with validated data and taxpayer identity. Government should work with the private sector, much as it did in creating the IRS Free File program, to leverage private sector investment and innovation to achieve a leap forward in tax return accuracy and completeness, without adding new costs to IRS budgets.

Third, radically simplify the tax code. According to the General Accounting Office (GAO), "a broader opportunity to address the tax gap involves simplifying the Internal Revenue Code, as complexity can cause taxpayer confusion and provide opportunities to hide willful noncompliance. Fundamental tax reform could result in a smaller tax gap if the new system has fewer tax preferences or complex tax code provisions, reducing IRS's enforcement challenges and increasing public confidence in the fairness of the tax system."[9]

Making taxes simpler would probably raise compliance rates, by reducing both inadvertent and intentional nonpayment of taxes and illegal tax evasion. To some (uncertain) extent, people do not pay taxes because they do not understand the tax law. Clarifying and simplifying tax rules can only help to make people understand the tax law better and would likely make it easier to enforce the law as well. Evidence also suggests that people are more likely to evade taxes that they consider unfair. People who cannot understand tax rules may also question the fairness of the tax system and feel that others are reaping more benefits than they are. This may make them more likely to evade taxes.

Clarifying and simplifying tax rules can only help to make people understand the tax law better and would likely make it easier to enforce the law as well.

Former Treasury Secretary Larry Summers, in testimony before the Joint Economic Committee in early 2007, listed assuring the fair collection of taxes as the first of three policy recommendations to help the middle class. He estimated that making a serious assault on the tax gap could raise about $50 billion per year.[10] Even more skeptical analysts acknowledge simplification could raise some additional revenue.[11]

5. **Better Align State and Federal Rules.** One tax simplification concept that has been largely overlooked by national policymakers, in large part because of the complex issues of federalism that are involved, is the growing divergence between federal and state tax systems and rules.

   Forty-three states and the District of Columbia impose individual income taxes. The definition of taxable income varies by state (for example, New Hampshire and Tennessee tax only income from dividends and interest), but most states generally follow the federal definition, except that taxpayers may not deduct state income taxes paid.

   However, a growing number of states apply different rules than the Internal Revenue Service for other types of income and have differing tax rates. Nine states apply a single tax rate to all incomes, while the rest have multiple tax brackets and rates. Top marginal rates for state income tax in 2008 ranged from 3 percent in Illinois to 10.3 percent in California.[12]

   For a company, or an individual who conducts business in a number of states, the growing divergence between federal and state rules exacerbates the complexity of filing taxes.

   While federal tax reform is probably a heavy enough lift for this Congress, simplification will never be maximized unless federal and state governments can come together to better align their tax systems so as to reduce paperwork, streamline the filing process, and create less opportunity for tax arbitrage. That is why federal tax reform legislation should begin the process for a better coordination of federal and state tax rules and procedures.

Conclusion

Simplicity and its many benefits are often overlooked in the tax reform debate, which typically centers on economic and redistributive issues. Simplification should be considered a goal of equal importance and should be made a fundamental test of comprehensive tax reform. A democracy should strive to make tax policy transparent and user-friendly to ordinary citizens, so that it becomes an instrument for promoting common prosperity rather than special privilege.

Fortunately, the good news is that policymakers do not have to choose among economic growth, progressivity, and simplification when it comes to tax reform. There are a number of plans that would incorporate all three principles and would put our nation on a path to prosperity for everyone, not just a select few. There is a moment of opportunity in this Congress and this Administration to do great good in making our tax system more rational and understandable and effective. We need to seize the moment.

Endnotes

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