United States Government Accountability Office

GAO

Testimony

Before the Committee on Finance, U.S. Senate

For Release on Delivery
Expected at 10:30 a.m. EDT
Thursday, August 3, 2006

INDIVIDUAL INCOME TAX POLICY

Streamlining, Simplification, and Additional Reforms Are Desirable

Statement of David M. Walker
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August 3, 2006

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Highlights

Highlights of GAO-06-1028T, a testimony before the Committee on Finance, U.S. Senate

INDIVIDUAL INCOME TAX POLICY

Streamlining, Simplification, and Additional Reforms are Desirable

Why GAO Did This Study

The federal government currently relies heavily on the individual income tax and payroll taxes for about 80 percent of its total annual revenue. Long-range projections show that without some form of policy change, the gap between revenues and spending will increasingly widen. The debate about the future tax system is partly about whether the goals for the nation's tax system can be best achieved by reforming the current income tax so that it has a broader base and flatter rate schedule, or switching to some form of consumption tax.

This testimony reviews the revenue contribution of the current individual income tax as well as its complexity, economic efficiency, equity, and taxpayer compliance issues; discusses some common dimensions to compare tax proposals; and draws some conclusions for tax reform.

This statement is based on previously published GAO work and reviews of relevant literature.

www.gao.gov/cgi-bin/getrpt?GAO--06-1028T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact James White at (202) 512-9110 or whitej@gao.gov.

What GAO Found

The United States faces a large and growing structural budget deficit as current projected revenues are not sufficient to fund projected spending. The individual income tax has long been the largest source of federal revenue—amounting to $927 billion (7.5 percent of Gross Domestic Product (GDP)) in 2005. (Total revenues that year amounted to 17.5 percent of GDP.) Income tax policy, including existing tax expenditures, such as the exclusion of employer-provided health insurance from individual income, and enforcement approaches, need to be key elements of a multipronged approach that reexamines federal policies and approaches to address our nation's large and growing long-term fiscal imbalance.

Concerns regarding the complexity, efficiency, and equity of the individual income tax have contributed to calls for a substantial restructuring of the individual income tax or its full or partial replacement with some form of consumption tax. The widely recognized complexity of the tax results in (1) significant compliance costs, frustration, and anxiety for taxpayers; (2) decreased voluntary compliance; (3) increased difficulties for the Internal Revenue Service (IRS) in administering the tax laws; and (4) reduced confidence in the fairness of the tax. The tax also causes taxpayers to change their work, savings, investment, and consumption behavior in ways that reduce economic efficiency and, thereby, taxpayers' well-being.

Taxpayer noncompliance with the current individual income tax is another factor that could motivate reform. For tax year 2001, IRS estimated that noncompliance with the individual income tax accounted for about 70 percent of the $345 billion gross tax gap, which is the difference between the taxes that should have been paid voluntarily and on time and what was actually paid. Reducing this gap can improve the nation's fiscal stability, as each 1 percent reduction in the tax gap would likely yield about $3 billion annually. Reducing the tax gap within the current income tax structure will require exploring new and innovative administrative and legislative approaches.

In moving forward on tax reform, policymakers may find it useful to compare alternative proposals along some common dimensions. These include, in part, whether proposed tax systems over time will generate enough revenue to fund expected expenditures, whether the base is as broad as possible so rates can be as low as possible, whether the system meets our future needs, and whether it has attributes that promote compliance. Our publication, *Understanding the Tax Reform Debate* (GAO-05-1009SP), provides background, criteria, and questions that policymakers may find useful.

Mr. Chairman and Members of the Committee:

I appreciate this opportunity to contribute to your consideration of fundamental tax reform by discussing the individual income tax. Although the focus of my statement is the individual income tax, it clearly makes sense to consider a broader reform encompassing both the individual and corporate income taxes and much of my message is applicable to broad reforms.[1]

As the Committee is well aware, two fundamental objectives of a tax system are (1) to raise revenue sufficient to fund projected spending and (2) to do so in a manner that is fair, relatively easy to administer, and minimizes negative effects on the economy. Unfortunately, over time, the accumulated changes to our individual tax system have not been consistent with these objectives and, not surprisingly, there is a growing debate about the fundamental design of the current tax system.

The debate about the future tax system is partly about whether the goals for the nation's tax system can be best achieved by reforming the current income tax so that it has a broader base and a flatter rate schedule, or switching in whole or in part to some form of a consumption tax. The President's Advisory Panel on Federal Tax Reform has taken a major step in beginning this debate.[2] The Panel suggested two alternative proposals for coordinated reform of the individual and corporate income taxes and thereby advanced the public debate over how best to simplify these taxes and their proposals include the desirable combination of broader tax bases and lower tax rates.

My statement reviews the revenue contribution of the current individual income tax as well as its complexity, economic efficiency, equity, and taxpayer compliance issues. It also draws some conclusions regarding the need for tax reform. My statement today makes the following points:

- The debate about the fundamental design of the tax system is occurring at a time when the nation also faces a large and growing structural budget

[1]I addressed a number of issues relating to the corporate income tax in a statement before this committee several weeks ago. See GAO, *Tax Compliance: Challenges to Corporate Tax Enforcement and Options to Improve Securities Basis Reporting*, GAO-06-851T (Washington, D.C.: June 13, 2006).

[2]President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, (Washington, D.C.: November 2005).

deficit, as under current policy, the gap between revenues and spending will widen over the next few decades. The individual income tax has long been the single largest source of federal tax revenue—amounting to $927 billion in 2005. Individual income tax policy, including existing tax expenditures and enforcement approaches, needs to be an element of a multipronged approach that reexamines existing federal policies and approaches to address the nation's large long-term fiscal imbalance.

- Concerns regarding the complexity, economic efficiency, and overall equity of the individual income tax have contributed to calls for a substantial restructuring of the individual tax or its full or partial replacement with some form of consumption tax. The widely recognized complexity of the tax results in (1) significant compliance costs, frustration and anxiety for taxpayers; (2) decreased voluntary compliance; (3) increased difficulties for the Internal Revenue Service (IRS) in administering the tax laws; and (4) reduced confidence in the fairness of the tax. As discussed in our publication, *Understanding the Tax Reform Debate*[3] the individual income tax also causes taxpayers to change their work, savings, investment, and consumption behavior in ways that reduce economic efficiency and taxpayers' well-being.

- Taxpayer noncompliance with the current individual income tax is another factor that could motivate reform. For tax year 2001, IRS estimated that noncompliance with the individual income tax accounted for about 70 percent of the $345 billion gross tax gap, which is the difference between the taxes that should have been paid voluntarily and on time and what was actually paid. Reducing this gap can improve the nation's fiscal stability, as each 1 percent reduction in the tax gap would likely yield about $3 billion annually. Given its persistence and size, reducing the tax gap within the current income tax structure will require exploring new and innovative administrative and legislative approaches.

- In moving forward on tax reform, policymakers may find it useful to compare alternative proposals along some common dimensions. Among these are whether a proposed tax system will generate sufficient revenue over time to fund whatever spending path is chosen, whether the base is as broad as possible so rates can be as low as possible, and whether it has attributes that promote compliance. Our publication, *Understanding the*

[3]GAO, *Understanding the Tax Reform Debate: Background, Criteria, & Questions*, GAO-05-1009SP (Washington, D.C.: September 2005).

Tax Reform Debate, provides background, criteria, and questions that policymakers should find useful.[4]

My statement today is drawn from previous GAO reports and testimonies, which were done in accordance with generally accepted government auditing standards, as well as reviews of relevant literature.

Background

The base of the individual income tax covers income paid to individuals, such as wages, interest, dividends, realized net capital gains, various forms of business income, and income from pensions, annuities, trusts and estates. This tax base is reduced by personal exemptions for taxpayers and their spouses and children, as well as by numerous preferences—statutorily defined as tax expenditures—such as the deduction for mortgage interest, the earned income tax credit, and the exclusion of the value of employer-provided health insurance from individuals' taxable income and taxable wage base. The statutory rates of tax on net taxable income range from 10 percent to 35 percent. Lower rates (5 percent and 15 percent, depending on taxable income) apply to long-term capital gains and dividend income.

Individuals may also pay tax under the alternative minimum tax (AMT). The base of this tax equals regular taxable income, plus the value of various tax items, including personal exemptions and certain itemized deductions that are added back into the base. This AMT income base is then reduced by a substantial exemption and then taxed at a rate of 26 percent or 28 percent, depending on the taxpayer's income level. Taxpayers compare their AMT tax liabilities to their regular tax liabilities and pay the greater of the two.

Although the income tax applies to all who have taxable income, nearly all workers pay social insurance taxes to fund retirement, disability and retiree health programs. According to Congressional Budget Office estimates, in 2000 over 40 percent of households paid more in just their portion of social insurance taxes than they paid in income taxes. Further, when both their contribution and their employers' is counted, over 70 percent of households paid more in social insurance taxes than they did in income taxes. The consensus among economists is that the employees ultimately bear the entire social insurance tax burden. In 2005 workers

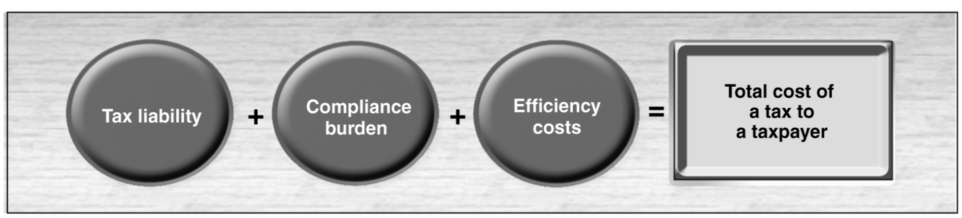
[4]GAO-05-1009SP.

paid a total of $794 billion in social insurance taxes to fund federal social insurance, retirement, disability, and retiree health programs. This amount was in addition to their income tax liabilities. From the taxpayers' view, these taxes may not appear significantly different than income taxes. They reduce the workers' take-home pay each pay period and, although the taxes are set aside in a separate account to fund specific benefits, the portion of these taxes not immediately needed for current beneficiaries goes to fund current government expenses just like income taxes.

Three long-standing criteria—equity; economic efficiency; and a combination of simplicity, transparency, and administrability—are typically used to evaluate tax policy. These criteria are often in conflict with each other and, as a result, there are usually trade-offs to consider and people are likely to disagree about the relative importance of the criteria.

To the extent that a tax is not simple and efficient, it imposes costs on taxpayers beyond the payments they make to the U.S. Treasury. As shown in figure 1, the total cost of any tax from a taxpayer's point of view is the sum of the tax liability, the cost of complying with the tax system, and the economic efficiency costs that the tax imposes. In deciding on the size of government, we balance the total cost of taxes with the benefits provided by government programs.

Figure 1: Components of the Total Cost of a Tax to Taxpayers



Source: GAO.

The United States Faces a Large and Growing Structural Budget Deficit

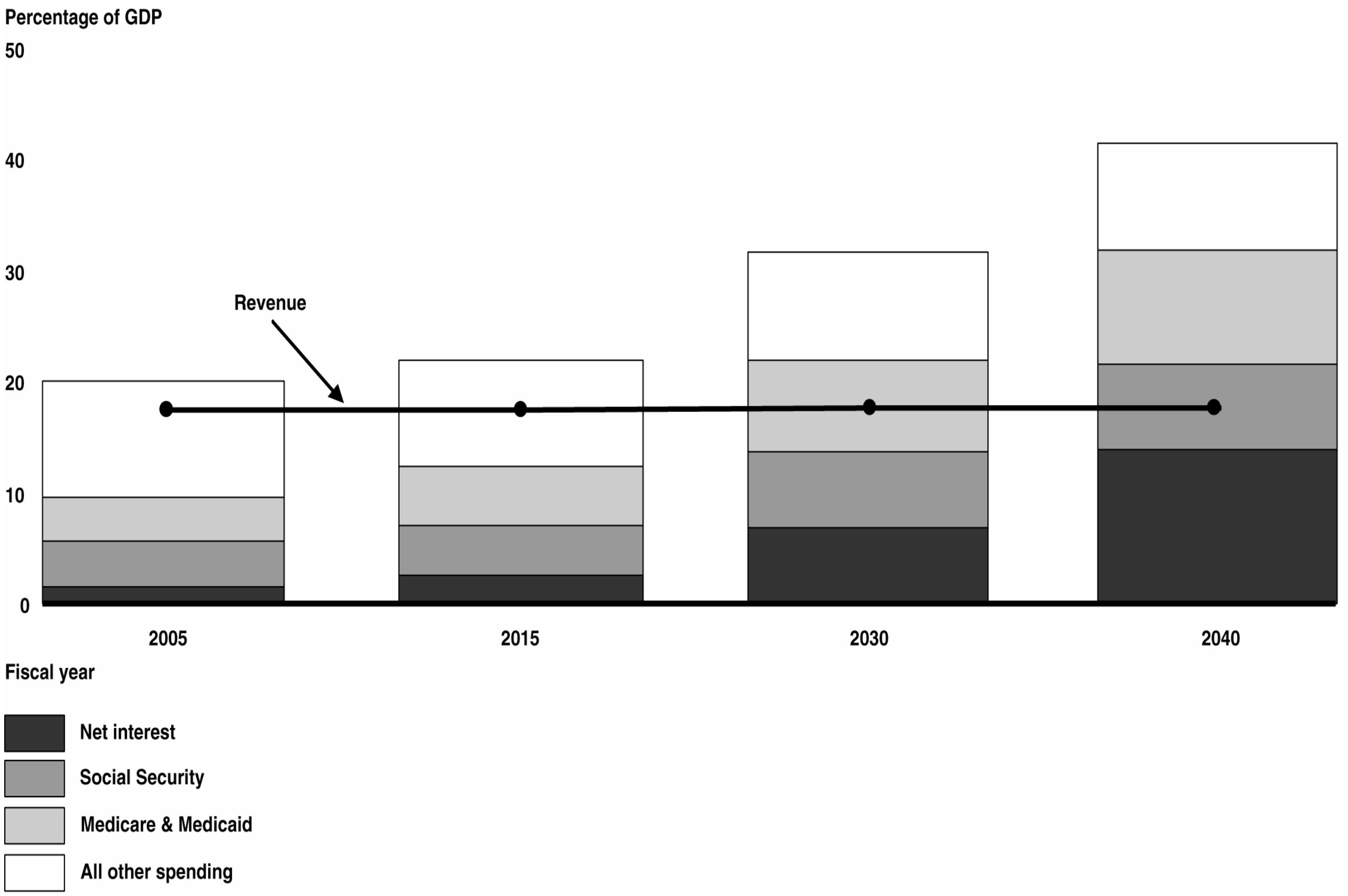
Over the long term, the United States faces a large and growing structural budget deficit primarily caused by known demographic trends and rising health care costs, and this deficit is exacerbated over time by growing interest on the ever larger federal debt. Continuing on this imprudent and unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security. Addressing the nation's long-term fiscal imbalances constitutes a major transformational challenge that may take a generation or more to resolve.

Fiscal necessity may prompt a fundamental review of major program and policy areas. Many current federal programs and policies—including tax policies—were designed decades ago to respond to trends and challenges that existed then but may no longer suit our 21st century needs. Clearly, the individual income, social insurance, and corporate income taxes, which have been the federal government's three largest sources of revenue, will need to be considered in any plan for addressing the nation's long-term fiscal imbalance.

Revenues from the Current Tax System Are Not Sufficient to Fund Projected Spending

Over the next few decades, as the baby boom generation retires, federal spending on retirement and health programs, such as Social Security, Medicare, and Medicaid, will grow dramatically and bind the nation's fiscal future. Absent policy changes on the spending and/or revenue sides of the budget, a growing imbalance between federal spending and tax revenues will mean escalating and ultimately unsustainable federal deficits and debt. In simple terms, the gap between projected spending and expected revenues grows larger every year. For example, as figure 2 indicates, if discretionary spending grows at the same rate as the economy, all expiring tax provisions are extended, and then federal revenues are held as a constant share of the economy, revenues could be adequate to cover little more than interest on the federal debt by 2040.

Figure 2: Composition of Federal Spending as a Share of GDP, Assuming Discretionary Spending Grows with GDP after 2006 and That Expiring Tax Provisions Are Extended



Source: GAO's May 2006 analysis.

Note: The revenue projection in this figure includes certain tax provisions that expired at the end of 2005, such as the increased alternative minimum tax exemption amount.

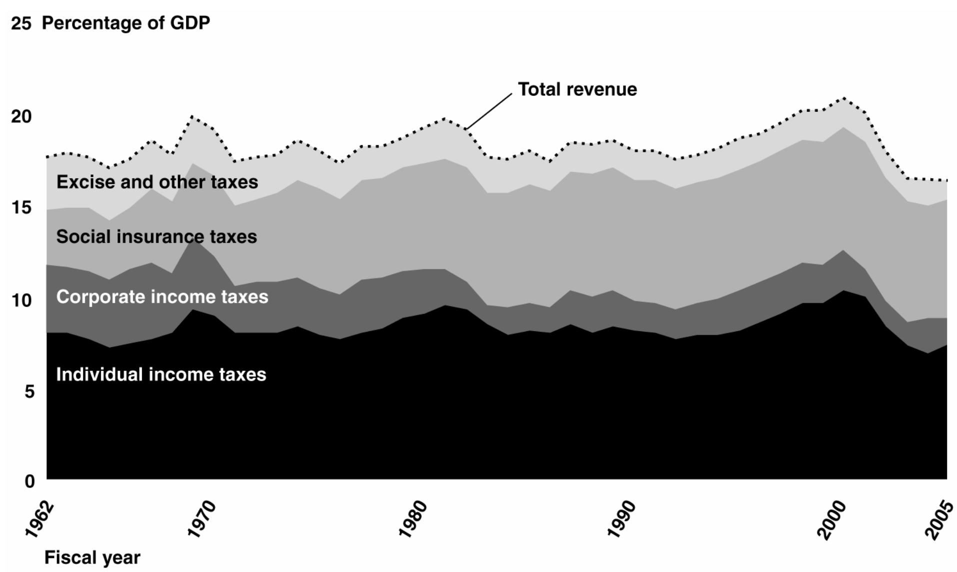
We cannot grow our way out of this long-term fiscal challenge because the imbalance between spending and revenue is so large. We will need to make tough choices using a multipronged approach: (1) revise budget processes and financial reporting requirements; (2) restructure entitlement programs; (3) reexamine the base of discretionary spending and other spending; and (4) review and revise tax policy, including tax expenditures and tax enforcement programs. Individual income tax policy, tax expenditures, and enforcement need to be key elements of the overall tax review.

One promising—and perhaps necessary—approach to tackling both the tax and entitlements part of our long-term fiscal challenge is a credible, capable, and bipartisan Tax and Entitlements Reform Commission. Such an approach would help ensure that any decisions made on taxes and spending are well coordinated and will produce a sustainable fiscal system that meets agreed-upon objectives.

The Individual Income Tax Is the Largest Single Source of Federal Revenues

The individual income tax has long been the single largest source of federal tax revenue. In 2005, individual taxpayers paid $927 billion in income taxes. Figure 3 shows the relative importance of federal taxes. Since 1962, the individual income tax has ranged between a low of 7 percent (in 2004) and a high of 10.3 percent (in 2000) of gross domestic product (GDP). Over the same period, social insurance taxes have grown considerably in importance—from 3 percent of GDP in 1962 to 6.5 percent of GDP (or $794 billion) in 2005. Revenue from the individual income tax has historically accounted for between 40 percent and 50 percent of total federal tax revenue. In contrast, in the early 1960s, social insurance taxes accounted for less than 20 percent of the total; however, they have grown to represent 37.1 percent of revenue in 2005.

Figure 3: Federal Revenues as a Percentage of GDP, 1962 to 2005



Source: GAO represenation of Office of Management and Budget (OMB) data.

Individual Income Tax Complexity, Compliance, and Efficiency Costs and Equity Concerns Contribute to Calls for Reform

Concerns about the complexity, efficiency, and equity of the individual income tax have motivated calls for a substantial restructuring of the tax or its replacement with some form of consumption tax. The widely recognized complexity of the tax results in (1) significant compliance costs, frustration, and anxiety for taxpayers; (2) decreased voluntary compliance; (3) increased difficulties for IRS in administering the tax laws; and (4) reduced confidence in the fairness of the tax. The individual income tax also causes taxpayers to change their work, savings, investment, and consumption behavior in ways that reduce their well-being.[5] These reductions in well-being, known to economists as efficiency costs, are likely to be large—perhaps on the order of 2 percent of GDP or more. The success of our tax system hinges very much on the public's perception of its fairness and transparency. There are differences of opinion about the overall fairness of the individual income tax and concerns have been expressed about the equity of many specific features of the tax.

Important Sources of Complexity Are Income Documentation Requirements and Tax Expenditure Rules

If they are to take advantage of the many tax benefits in the tax code, virtually all taxpayers must familiarize themselves with, or pay someone to advise them on, the sometimes complex rules for determining whether they qualify (and, if so, to what extent). Moreover, in cases where multiple tax expenditures have similar purposes, taxpayers may have to devote considerable time to learn and plan in order to make optimal use of these tax benefits. For example, the IRS publication *Tax Benefits for Education*[6] outlines 12 tax expenditures, including 4 different tax expenditures for educational saving. The use of one of these tax expenditures can affect whether (or how) a taxpayer is allowed to use the other tax expenditures. Adding to the taxpayer's challenge to select the best educational tax benefit, the use of one of these tax expenditures may affect a student's

[5]GAO-05-1009SP.

[6]Department of the Treasury, IRS, Publication 970, *Tax Benefits for Education*, 2004.

eligibility for other forms of federal assistance for higher education, such as Pell grants and subsidized loans.[7]

The tax benefits, or tax expenditures, available under the income tax are usually justified on the grounds that they promote certain social or economic goals. They grant special tax relief (through deductions, credits, exemptions, etc.) that encourages certain types of behavior by taxpayers or aids taxpayers in certain circumstances. Tax expenditures can promote a wide range of goals, like encouraging economic development in disadvantaged areas, financing postsecondary education, or stimulating research and development. For example, a wide range of tax provisions are intended to help individuals save for their retirement. These include traditional and Roth Individual Retirement Accounts (IRA) and various plans administered by employers or available to self-employed individuals. Again, individuals face complex choices to select the best options as well as complex rules to stay in compliance once they select a retirement savings option. From a public policy perspective, all of this complexity and the burden it imposes on taxpayers would most likely be worthwhile if the tax incentives are successful in achieving their intended purposes. However, in many cases this is questionable or unknown. Although research results vary, many studies suggest that IRAs result in little actual increase in retirement saving. One concern is that individuals can take a lump sum withdrawal and, depending on how the sum is used, the individual may not have a sufficient stream of income over his/her remaining lifetime.

Tax Expenditures Have Been Growing

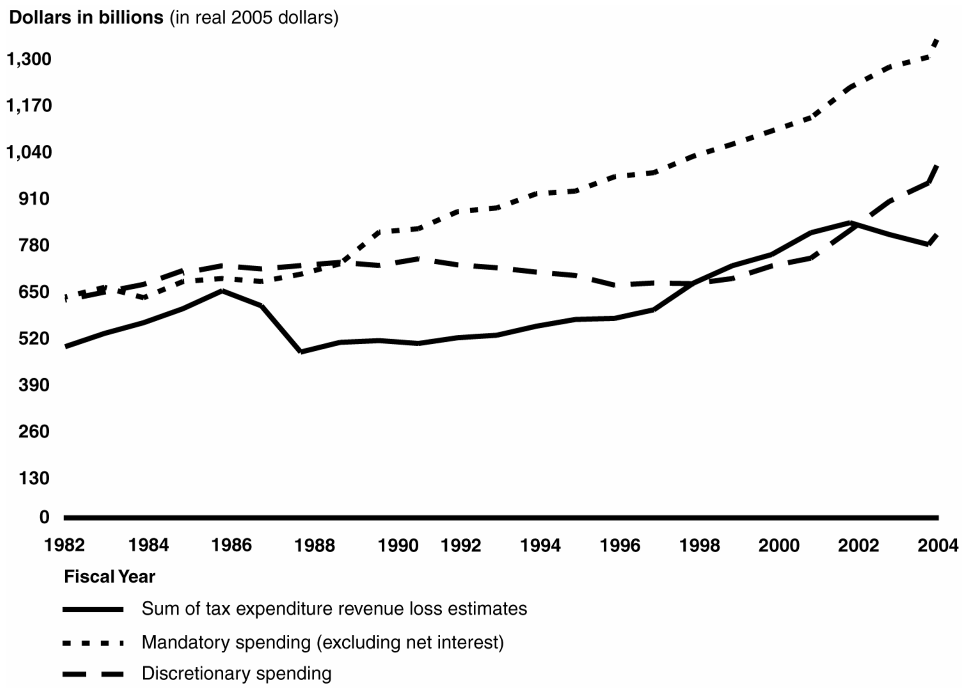
The sum of the revenue loss estimates associated with tax expenditures was more than $775 billion in 2005 and the vast majority of this loss was for tax expenditures provided to individuals, rather than to corporations.[8]

[7]Three of the tax incentives for saving—Coverdell Education Savings Accounts, Qualified Tuition Programs, and U.S. education savings bonds—differ across more than a dozen dimensions. Similarly, three other tax expenditures, all of which help students meet current costs—the Hope credit, Lifetime Learning credit, and the tuition deduction—differ in terms of eligibility criteria, benefit levels, and income-related phase-outs. For a fuller discussion, including estimates of the number of taxpayers who made suboptimal choices in selecting among three tax provisions, see GAO, *Student Aid and Postsecondary Tax Preferences: Limited Research Exists on Effectiveness of Tools to Assist Students and Families through Title IV Student Aid and Tax Preferences*, GAO-05-684 (Washington, D.C.: July 29, 2005).

[8]Summing the individual tax expenditure estimates is useful for gauging the general magnitude of the federal revenue involved, but it does not take into account possible interactions between individual provisions.

As the data in figure 4 indicate, revenue losses due to tax expenditures exceeded discretionary spending for half of the last decade.

Figure 4: Trends in Spending and Tax Expenditure Revenue Losses, 1982-2005

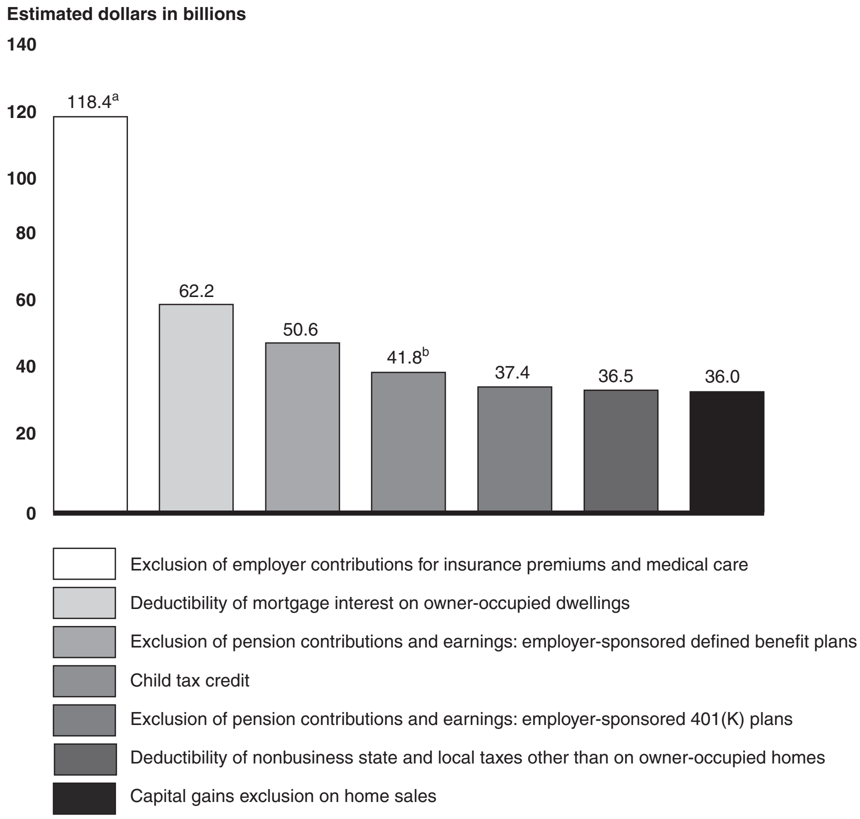


Source: GAO analysis of OMB budget reports on tax expenditures, fiscal years 1976-2007.

Note: Summing the individual tax expenditure estimates is useful for gauging the general magnitude of the federal revenue involved, but it does not take into account possible interactions between individual provisions.

Much of the revenue loss due to individual income tax expenditures is attributable to a small number of large tax expenditures. The seven tax expenditures shown in figure 5—each with an annual revenue loss estimated at $36 billion or more—accounted for about half of the sum of revenue losses for all tax expenditures for fiscal year 2005. With revenue losses estimated at $4.9 billion, the earned income tax credit (EITC) does not appear on this list. The EITC has both revenue losses and outlays when a taxpayer's refund exceeds their tax liability. If $34.6 billion in associated outlays were included, this refundable credit would rank among the largest tax expenditures.

Figure 5: Revenue Loss Estimates for the Seven Largest Reported Tax Expenditures for Individuals, Fiscal Year 2005



Source: OMB, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2007.*

[a]If the payroll tax exclusion were also counted here, the total tax expenditure for employer contributions for health insurance premiums would be about 50 percent higher or $177.6 billion.

[b]This is the revenue loss and does not include associated outlays of $14.6 billion.

Although Difficult to Measure, Compliance Burden Is Likely a Significant Cost to Taxpayers

The costs of complying with the individual income tax are large but unclear. IRS's most recent estimates suggest that these costs are roughly on the order of ½ to 1 percent of GDP. These costs include the time and money spent complying with the computational, reporting, planning, and recordkeeping requirements of the tax system. Estimates of compliance costs are uncertain because taxpayers generally do not keep relevant records documenting their time and money spent complying with the tax system and many important elements of the costs are difficult to measure because, among other things, federal tax requirements often overlap with recordkeeping and reporting that taxpayers do for other purposes.

The available compliance cost estimates do not represent the potential cost savings to be gained by replacing the current federal individual income tax. Any replacement tax system will impose significant compliance costs of its own. Moreover, given that many state and local government income taxes depend upon the same compliance activities as the federal income tax does, taxpayers would still bear the costs of those activities unless those other governments replaced their own taxes to conform to the new federal system. In addition, if some of the subsidies, such as the earned income tax credit and child tax credit, which are provided by the current federal tax system, are replaced by spending programs under a reformed system, tax compliance costs may be reduced, but only as a result of their being shifted to those new programs. Similarly, if a replacement tax system no longer requires individuals to compute and document their incomes, individuals will still need to document their incomes for borrowing and other purposes, and government statistical agencies will incur expenses to replace the data that they currently obtain from income tax returns.

Taxes Generally Reduce Economic Efficiency

Taxes impose efficiency costs by altering taxpayers' behavior, inducing them to shift resources from higher valued uses to lower valued uses in an effort to reduce tax liability. This change in behavior can cause a reduction in taxpayers' well-being that, for example, may include lost production (or income) and consumption opportunities. One important behavioral change attributable to the income tax arises from the fact that investment in housing is given more favorable treatment than investment in business activities. Economists generally agree that this differential tax treatment reduces the amount of money available to businesses for investment in productivity-enhancing technology. This in turn results in employees receiving lower wages because increases in wages are generally tied to increases in productivity. The tax exclusion for the exclusion of employer-provided health insurance from individuals' taxable income, discussed in text box 1, is another example of an income tax provision that clearly reduces economic efficiency. The exclusion encourages more extensive insurance coverage, but introduces a well-known problem with health insurance. Because much of the cost of medical treatment is paid for by the insurer, patients and doctors are generally unaware of, or disconnected from, the total costs of health care and have little incentive to economize on health care spending.

Efficiency costs, along with the tax liability paid to the government and the costs of complying with tax laws, are part of the total cost of taxes to taxpayers. However, this does not mean that taxes are not worth paying. One reason people bear taxes is they desire the benefits of government programs and services. (The government does deliver some services effectively and often provides services that otherwise would not be available.) Taxpayers implicitly or explicitly balance the costs of taxes with the benefits of government.

Nevertheless, minimizing efficiency costs is one criterion for a good tax. Economists agree that taxes with broad bases and low rates generally cause lower efficiency costs than do taxes with narrow bases and high rates. The goal of tax policy is to design a tax system that produces revenue needed to pay current bills and deliver on future promises while at the same time balancing economic efficiency with other objectives, such as equity, simplicity, transparency, and administrability. Moreover, as noted earlier, the failure to provide sufficient tax revenues to finance the level of spending we choose as a nation gives rise to deficits and debt. Large, sustained deficits could ultimately have a negative impact on economic growth, productivity, and potentially our national security. Large structural deficits also raise serious stewardship and intergenerational equity issues.

Text Box 1: Tax Expenditure for Employer-Provided Medical Insurance Premiums and Medical Care

The current U.S. tax system excludes employer-provided health insurance from individuals' taxable income even though such insurance is a form of income (noncash compensation). The Department of the Treasury estimates that the tax exclusion for employer-provided health insurance resulted in $118.4 billion in lost revenue during 2005, not including forgone social insurance taxes and state taxes. Including forgone federal social insurance taxes, an estimated $177.6 billion in revenue was forgone due to this exclusion.

The tax exclusion increases the proportion of the population covered by health insurance. In 2004, nearly 46 million Americans were without health insurance. The tax exclusion encourages employers to offer and employees to participate in health insurance plans, increasing the proportion of workers covered. Because individuals may be better able to anticipate their health care needs than insurers, health care plans may attract customers with higher risk of poor health, resulting in higher premiums. By encouraging the pooling of high-and low-risk individuals, the tax exclusion may help to reduce premiums below those that individuals would face if they purchased insurance on their own.

However, some question whether the tax subsidy for health insurance is the best way to increase health insurance coverage. For example, the tax exclusion provides the most assistance to taxpayers who have high marginal tax rates (those with high incomes)—the exclusion saves those taxpayers more in taxes owed than it saves those with lower marginal tax rates.

The tax exclusion for health insurance also contributes to higher health care costs. The exclusion, by lowering premiums, encourages more extensive insurance coverage, which compounds another well-known problem with health insurance. Because much of the cost of medical treatment is paid for by a third party (the insurer), patients and doctors are generally unaware of, or disconnected from, the total costs of health care and have little incentive to economize on health care spending.

Unlike the tax exclusion for employer-provided health insurance, an ideal health care payment system would foster the delivery of care that is both effective and efficient, resulting in better value for the dollars spent on health care.

Efficiency Costs Resulting from the Individual Income Tax Are Likely to Be Large but Can Only Be Estimated with Considerable Uncertainty

Estimating the efficiency costs of the federal tax system is an enormous, complicated, and uncertain task, given the complexity of existing tax rules, the breadth and diversity of the U.S. economy and population, and the limited empirical evidence available on how individuals and businesses change their behavior in response to tax rules. In practice, researchers have not been able to obtain and analyze all of the detailed data they need to produce efficiency cost estimates that are free from a large degree of uncertainty.

The two studies that have made the most comprehensive estimates of the efficiency costs arising from the individual income tax in the past two decades suggest that those costs are considerable. The first study, which examined the combined efficiency costs of the individual income and payroll taxes, estimated those costs to have been on the order of 2 to 5 percent of GDP in 1994.[9] Estimates from the second study indicate that the efficiency cost of the individual income tax was on the order of 2 percent of GDP in 1997.[10] Efficiency cost estimates such as these are often quite sensitive to the assumed magnitude of key behavioral responses and those assumptions are often based on empirical research that continues to evolve over time or, in other cases, has yet to be undertaken. For example, the consensus of recent research is that individuals are less responsive to changes in taxes than the first study assumed them to be.

The extent to which efficiency gains could be realized by switching to an alternative tax system depends critically on the detailed characteristics of the alternative. All of the alternative tax system proposals that have received serious consideration in recent decades would have imposed significant efficiency costs. Moreover, in assessing the potential efficiency gains from any tax reform proposal it is also important to consider compensating changes that may be made on the spending side of the federal budget. For example, if any tax expenditures in the current federal income taxes are replaced by grants, spending programs, regulations, or other forms of nontax subsidies, those subsidies can result in efficiency costs similar in magnitude to those associated with the tax expenditures they replaced.

Perceptions of Inequities in the Tax System Can Undermine Its Success

The success of our tax system hinges very much on the public's perception of its fairness and transparency. The myriad of tax deductions, credits, special rates, and so forth cause taxpayers to doubt the fairness of the tax

[9]Martin Feldstein, "Tax Avoidance and the Deadweight Loss of the Income Tax," *The Review of Economics and Statistics* (1999).

[10]Dale Jorgenson and Kun-Young Yun, *Investment Volume 3: Lifting the Burden: Tax Reform, the Cost of Capital, and U.S. Economic Growth* (Cambridge, Ma.: MIT Press), 2001.

system because they do not know whether those with the same ability to pay actually pay the same amount of tax. Fairness is ultimately a matter of personal judgment about issues such as how progressive tax rates should be and what constitutes ability to pay.

Public confidence in the nation's tax laws and tax administration is critical because we rely heavily on a system of voluntary compliance. If taxpayers do not believe that the tax system is credible, easy to understand, and treats everyone fairly, then voluntary compliance is likely to decline. The latest available IRS estimates indicate that about 84 percent of total taxes due for tax year 2001 were paid voluntarily and on time. Complexity and the lack of transparency it can create exacerbate doubts about the current tax system's fairness.

There are differences of opinion about the fairness of the individual income tax. Likewise, concerns have been expressed about the equity of many specific features of the tax, such as:

- marriage penalties (and bonuses) built into the tax under which the combined tax liabilities of two individuals differ, depending on whether or not those individuals are married;
- the inconsistent treatment between taxable wages and salaries and other components of total employee compensation, such as employer-provided health benefits that are not taxed;
- the fact that many low-income individuals face high effective marginal tax rates over certain income ranges as the benefits of tax preferences, such as the earned income tax credit, phase out;
- the provision of certain tax benefits in the form of deductions, which are more valuable to taxpayers in higher income brackets, rather than as tax credits;
- the requirement that a taxpayer must own a home in order to receive the significant advantage of tax-preferred borrowing; and
- the greater ease with which self-employed individuals can underreport income, compared to employees whose incomes are subject to withholding and third-party reporting.

Judging the equity of the individual income tax can depend substantially on the frame of reference used. For example, for many, a progressive tax code is considered to be more equitable. When looked at in isolation, the individual income tax system is somewhat progressive. If the frame of reference is expanded, however, and payroll taxes are also taken into account, total progressivity drops.[11] As mentioned earlier, more than 70 percent of taxpayers are estimated to pay more in payroll taxes than individual income taxes when the combined employee and employer shares are considered.[12] These frames of reference, of course, look only at the payment of taxes. An even wider frame of reference would take into account the benefits taxpayers receive, which could alter yet again judgments about the equity of the tax system. In fact, it could be argued that the full effect of federal government policies on different groups of individuals can only be determined by examining the effects of all federal taxes, spending programs, and regulations.

Ensuring Individual Taxpayer Compliance with the Tax Laws Is Challenging

The extent of individual taxpayer noncompliance with the current tax laws is another factor that could motivate calls for reform. Ensuring compliance with our nation's tax laws is a challenging process for both taxpayers and IRS. The difficulty in ensuring compliance is underscored by the tax gap—the difference between the taxes that should be paid voluntarily and on time and what is actually paid—that arises every year when taxpayers fail to comply fully with the tax laws. Most recently, IRS estimated the gross tax gap for tax year 2001 to be $345 billion, including individual income, corporate income, employment, estate, and excise taxes. IRS estimated it would eventually recover about $55 billion of the

[11]Although it makes sense to consider the significant additional burden of social insurance taxes when evaluating individual tax burdens, there is some disagreement regarding the proper way to analyze the two taxes jointly. Many economists consider the portion of payroll taxes that fund Old-Age and Survivors Insurance benefits to be materially different from other federal taxes because individuals receive future benefits that are directly related to the amount of tax they pay. In their view some account should be made of the redistributive nature of the social security benefits formula. (See, for example, Richard V. Burkhauser and John A. Turner, "Is the Social Security Payroll Tax a Tax?," *13 Public Finance Quarterly*, (1985) and Andrew Mitrusi and James Poterba, "The Distribution of Payroll and Income Tax Burdens, 1979-99," *National Tax Journal*, Vol. 53 no. 3 Part 2 (September 2000) pp. 765-794.) Other observers assert that future benefits are an entitlement based on participation in the workforce, not on the payment of tax, and that all social insurance taxes should be treated the same as individual income taxes when analyzing the distribution of tax burdens. (See Patricia E. Dilley, "Taking Public Rights Private: The Rhetoric and Reality of Social Security Privatization," *Boston College Law Review*, 975 (2000) and Deborah A. Geier, "Integrating the Federal Tax Burden on Labor Income," *Tax Notes*, January 27, 2003), pp. 563-583.)

[12]The Tax Policy Center, using its tax simulation model, has estimated that 96 percent of taxpayers pay more in payroll taxes than individual income taxes when both the employee and employer shares of taxes are considered. Economists widely agree that the employee bears the full amount of the payroll tax.

gross tax gap through late payments and enforcement actions, resulting in a net tax gap of $290 billion.[13]

About 70 percent of the gross tax gap for tax year 2001, or an estimated $244 billion, was attributed to the individual income tax. As shown in table 1, individual taxpayers that underreported their income, underpaid their taxes, or failed to file an individual tax return altogether or on time (nonfiling) accounted for $197 billion, $23 billion, and $25 billion of the tax gap, respectively.

Table 1: Individual Income Tax Portion of the Tax Year 2001 Gross Tax Gap Estimate

Type of noncompliance	Tax gap (dollars in billions)
Underreporting	$197
Business income	109
Nonfarm proprietor income	68
Partnership, S-Corp, estate and trust	22
Rents & royalties	13
Farm income	6
Nonbusiness income	56
Capital gains	11
Wages, salaries, tips	10
Pensions and annuities	4
Interest and dividend income	3
Other	28
Credits	17
Deductions, exemptions, adjustments	15
Underpayment	23
Nonfiling	25
Total	**$244**

Source: IRS.

Note: Figures may not sum to totals because of rounding.

Improving compliance and reducing the tax gap would help improve the nation's fiscal stability. Even modest progress would yield significant revenue; each 1 percent reduction would likely yield nearly $3 billion

[13]Unless otherwise noted, references to the tax gap refer to the gross tax gap.

annually. However, the tax gap has been a persistent problem in spite of a myriad of congressional and IRS efforts to reduce it, as the rate at which taxpayers voluntarily comply with our tax laws has changed little over the past three decades. As such, we need to consider not only options that have been previously proposed but also explore new and innovative approaches to improving compliance including fundamental reform of the tax system as well as providing IRS with additional enforcement tools and ensuring that significant resources are devoted to enforcement.

Fundamentally reforming our tax system has the potential to improve compliance, especially if a new system has few tax preferences or complex tax code provisions and if taxable transactions are transparent to tax administrators. One factor that some believe contributes to the difficulty of achieving compliance is the complexity of our tax system. The complexity of, and frequent revisions to, the tax system make it more difficult and costly for taxpayers who want to comply to do so and for IRS to explain and enforce tax laws. Complexity also creates a fertile ground for those intentionally seeking to evade taxes, and often trips others into unintentional noncompliance. Likewise, the complexity of the tax system challenges IRS in its ability to administer our tax laws.

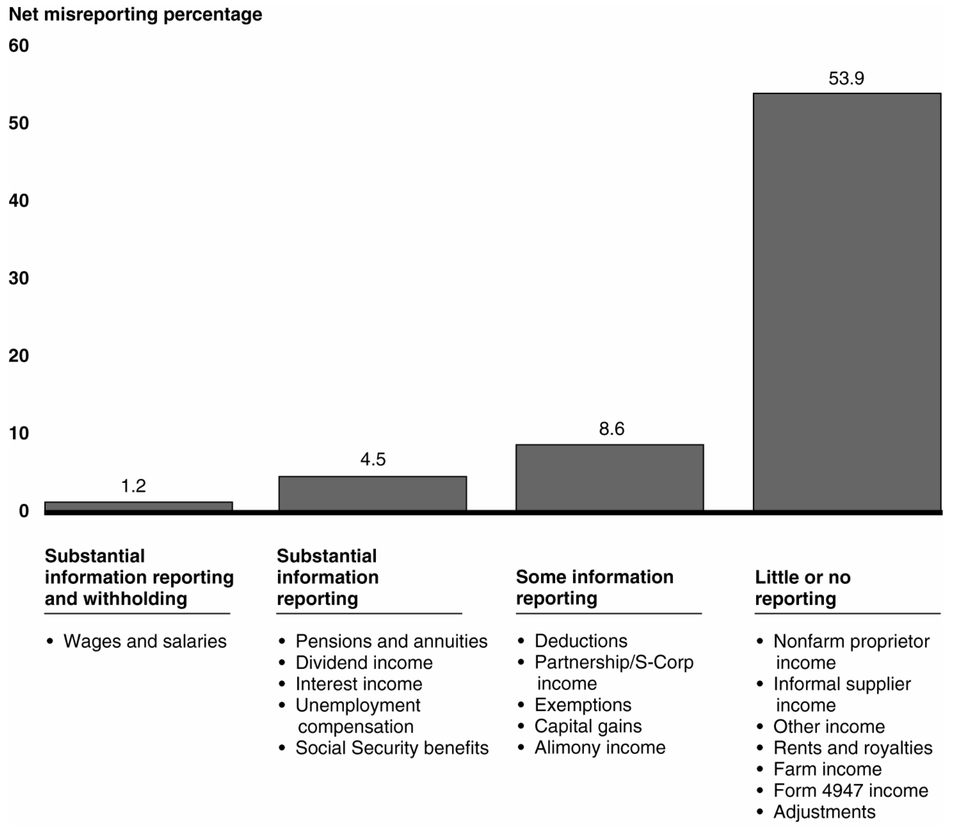
Whether under our current income tax system or a reformed one, enforcement tools, particularly information reporting[14] and tax withholding,[15] are key to high levels of compliance. The extent to which individual taxpayers accurately report the income they earn has been shown to be related to the extent to which the income is reported to them and IRS by third parties or taxes on the income are withheld, as shown in figure 6. Taxpayers tend to report income subject to tax withholding or information reporting with high levels of compliance because the income is transparent to the taxpayers as well as to IRS. For example, employers report most wages, salaries, and tip compensation to employees and IRS through Form W-2. Also, banks and other financial institutions provide information returns (Forms 1099) to account holders and IRS showing the taxpayers' annual income from some types of investments. Findings from IRS's recent study of individual tax compliance indicate that nearly

[14]Information reporting involves the filing of information returns with IRS and taxpayers that contain information on certain transactions, such as wage and salary information employers report to employees and IRS through Form W-2.

[15]An example of tax withholding is when employers withhold taxes on the wages that employees earn and remit them to IRS.

99 percent of these types of income are accurately reported on individual tax returns. For types of income for which there is little or no information reporting, individual taxpayers tend to misreport over half of their income.

Figure 6: Individual Net Income Misreporting Categorized by the Extent of Income Subject to Withholding and Information Reporting



Source: IRS.

Ensuring that significant resources are devoted to enforcement also has the potential to minimize the tax gap for our current income tax system as well as for reformed systems Congress may adopt. For the current system, devoting more resources has the potential to reduce the tax gap by billions of dollars in that IRS would be able to expand its enforcement efforts to reach a greater number of potentially noncompliant taxpayers. Importantly, expanded enforcement efforts could reduce the tax gap more than through direct tax revenue collection, as widespread agreement exists that IRS enforcement programs have an indirect effect through increases in voluntary tax compliance.[16] However, determining the appropriate level of enforcement resources to provide IRS requires taking into account many factors, such as how effectively and efficiently IRS is currently using its resources, how to strike the proper balance between IRS's taxpayer service and enforcement activities, and competing federal funding priorities.

Generally, when holding IRS accountable for the use of resources, it is also desirable to focus on the outcomes achieved rather than on how IRS allocates the resources it receives. Results are really what counts. If IRS, or any other agency, can figure out how to more cost effectively achieve a result, then reallocation of resources to other problem areas could be an appropriate strategy, within the restrictions applying to appropriation accounts, for making the best use of limited resources. In sum, regardless of the tax system, Congress needs to assure itself that the revenue agency has sufficient resources and reasonable flexibility to achieve desired outcomes and hold the agency accountable for those outcomes.

Comparing Proposals on Common Dimensions

In moving forward on tax reform, policymakers may find it useful to compare proposals on common dimensions. These comparisons can be helpful whether reform is of the individual income tax, the current tax system more broadly, or in considering new systems altogether.

First, is the tax base as broad as possible? Broad-based tax systems with minimal exceptions have many advantages. Fewer exceptions generally means less complexity, less compliance cost, less economic efficiency loss, and by increasing transparency may improve equity or perceptions of equity. In terms of the individual income tax, this suggests that eliminating or consolidating the myriad of tax expenditures must be considered. We need to be sure that the benefits achieved from having these special provisions are worth the associated revenue losses just as we must ensure that outlay programs—which may be attempting to achieve the same purposes as tax expenditures—achieve outcomes commensurate with their costs. To the extent tax expenditures are retained, consideration should be given to whether they are better targeted to meet an identified

[16]Two types of indirect effect are (1) the increase in voluntary compliance in the larger population resulting from examinations or other enforcement and nonenforcement actions on targeted taxpayers, and (2) the increase in voluntary compliance of the targeted taxpayer in subsequent years.

need. Many tax expenditures are broadly available and, in fact, provide greater "assistance" to those that most would consider least in need. This is broadly true of any tax expenditure that is worth more to higher income taxpayers than to lower income taxpayers, like the exclusion for the value of employer-provided health insurance and the mortgage interest deduction.

Broad based tax systems can yield the same revenue as more narrowly based systems at lower tax rates. The combination of less direct intervention in the marketplace from special tax preferences, and the lower rates possible from broad based systems, can have substantial benefits for economic efficiency. For instance, some economists estimate that the economic efficiency costs of tax increases rise proportionately faster than the tax rates. In other words, a 50 percent tax increase could more than double the economic efficiency costs of a tax system.

Does the proposed system raise sufficient revenue over time to fund our expected expenditures? As I mentioned earlier, we will fall woefully short of achieving this end if current spending and/or revenue trends are not altered. The economic efficiency costs of our current tax system likely will become an even more important issue as we grapple with the nation's long-term fiscal challenges. Although we clearly must restructure major entitlement programs and the basis of other federal spending, it is unlikely that our long-term fiscal challenge will be resolved solely by cutting spending. If we must raise revenues, doing so from a broad base and a lower rate will help minimize economic efficiency costs.

In this regard, the President's Advisory Panel on Tax Reform has taken a useful step forward for tax reform, helping, for example, to focus the debate on specific proposals. Those proposals incorporate broader bases, with lower rates. However, the Panel acted within the guidance it was given, and one result is that the proposed reforms, if implemented as proposed, appear to provide much less than the necessary revenue to fund expected government spending. Although we have not evaluated the revenue effects of these proposals, other respected analysts have and they point to future revenue yields that would worsen the already difficult fiscal challenges the nation faces.

Does the proposal look to future needs? Like many spending programs, the current tax system was developed in a profoundly different time. We live now in a much more global economy, with highly mobile capital, and investment options available to ordinary citizens that were not even imagined decades ago. We have growing concentrations of income and wealth. More firms operate multi-nationally and willingly move operations and capital around the world as they see best for their firms.

Do the revenues for the proposed system hold up in the future? As an adjunct to looking forward when making reforms, the revenue consequences of all major tax changes should be estimated well into the future. Such long-term projections undoubtedly will be subject to uncertainty, but at the very least we should have the best estimates possible of whether the revenue trend is likely to shift up or down over the long-term.

Does the proposed system have attributes associated with high compliance rates? Because any tax system can be subject to tax gaps, the administrability of reformed systems should be considered as part of the debate for change. In general, a reformed system is most likely to have a small tax gap if the system has few tax preferences or complex provisions and taxable transactions are transparent. Transparency in the context of tax administration is best achieved when third parties report information both to the taxpayer and the tax administrator.

What transition issues exist and have they been dealt with in an equitable fashion that minimizes additional complexity and any adverse effects on the benefits to be gained from the new tax system? Under the current individual income tax system, citizens have made fundamental life choices based at least in part on the incentives in the tax system. For many, the favorable tax treatment of owner-occupied housing has led to choices to invest disproportionately in housing. Others have made long-term investments in tax-favored college savings plans. Thus, changes to the tax system can materially affect citizens' futures. Still others make their livings advising taxpayers, helping them understand tax provisions and complete their tax returns, and helping them devise investment and other financial plans taking into account current tax rules.

Our publication, *Understanding the Tax Reform Debate: Background, Criteria, and Questions*,[17] may be useful in guiding policymakers as they consider tax reform proposals. It was designed to aid policymakers in thinking about how to develop tax policy for the 21st century. While not designed to break new conceptual ground, this report brings together a number of topics that tax experts have identified as those that should be

[17] GAO-05-1009SP.

considered when evaluating tax policy. It attempts to provide information about these topics in a clear, concise, and easily understandable manner for a non-technical audience.

Concluding Observations

The problems that I have reviewed today relating to the compliance costs, efficiency costs, equity and tax gap associated with the current individual income tax system—many of which arise from the complex accumulation of tax preferences in that system—would seem to make an overwhelming case for a comprehensive review and reform of our tax policy. Further, we live a world that is profoundly different than when the individual income tax and many of its provisions were adopted. Despite numerous and repeated calls for such reform, progress has been slow. One reason why reform is difficult to accomplish is that the provisions of the tax code that generate compliance costs, efficiency costs, the tax gap and inequities also benefit many taxpayers and the individuals and companies that advise taxpayers and help them with their tax filing obligations. Reform is also difficult because, even when there is agreement on the amount of revenue to raise, there are differing opinions on the appropriate balance among the often conflicting objectives of equity, efficiency, and administrability. This, in turn, leads to widely divergent views on even the basic direction of reform.

Fiscal necessity, prompted by the nation's unsustainable fiscal path, will eventually force changes to our spending and tax policies. We must fundamentally rethink policies and everything must be on the table. Tough choices will have to be made about the appropriate degree of emphasis on cutting back federal programs versus increasing tax revenue.

Tax reform, if it broadens the tax base, could reduce the costs of raising a given amount of revenue by reducing the associated efficiency costs. Such a reform also likely would reduce inequities, compliance burden, and administrative costs. The recent report of the President's Advisory Panel on Federal Tax Reform recommended two different tax reform plans. Although each plan provides for significant simplification, neither of them addresses the growing imbalance between federal spending and revenues that I highlighted earlier. One approach for getting the process of comprehensive fiscal reform started would be through the establishment of a credible, capable, and bipartisan commission, to examine options for a combination of entitlement and tax reform.

As policymakers consider proposals to reform the current individual income tax, or the entire tax system, they may find it useful to compare the proposals on common dimensions. Our publication, *Understanding the Tax Reform Debate*, may be useful when making these comparisons.

Mr. Chairman and Members of the Committee, this concludes my statement. I would be pleased to answer any questions you may have at this time.

Contact and Acknowledgments

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