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RESEARCH SUMMARY

THE HIDDEN COSTS OF TAX COMPLIANCE

JASON J. FICHTNER AND JACOB FELDMAN

Washington has long employed the tax code for purposes extending beyond collecting revenue to fund the federal government. Lawmakers use special provisions inserted in the code to advance objectives ranging from increasing "fairness" to granting competitive advantage to favored businesses or industries.

The price of riddling the tax code with special provisions is, however, far higher than the revenue lost from the tax breaks themselves. The true cost of tax compliance also exceeds the obvious time and money expended on tax preparation.

A new study published by the Mercatus Center at George Mason University surveys the current economic literature to document the hidden costs of the US tax system. Beyond accounting costs, the study takes a broad look at other hidden costs and implications of taxation: lobbying to gain and maintain tax advantages; economy-wide costs as tax incentives alter work, leisure, savings, consumption, production, and investments; and lost revenues as a result of taxpayer noncompliance.

The study finds that Americans face up to nearly $1 trillion annually in hidden tax-compliance costs, while the Treasury forgoes approximately $450 billion per year in unreported taxes.

Below is a brief summary. To read the study in its entirety and learn more about the study's authors, please see "The Hidden Costs of Tax Compliance."

KEY POINTS

According to the National Taxpayer Advocate, there were 4,428 changes to the Internal Revenue Code between 2001 and 2010, including an estimated 579 changes in 2010 alone. The tax code averages more than one change per day. The resulting complexity creates hidden compliance costs between $215 billion and $987 billion annually. To put this in perspective, total revenue collected by the federal government in 2012 was $2.5 trillion.

Accounting Costs

- Americans spend an estimated between $67 billion and $378 billion annually in accounting costs related to filing taxes. Americans spent more than 6 billion hours (2011) complying with the tax code. This represents an annual workforce of 3.4 million—a population that could be the third largest city in the United States, surpassing Chicago (2,707,120), Houston (2,145,146), and Philadelphia (1,536,471), and larger than the population of 21 states. A workforce equivalent to that employed by the four largest US companies—Walmart, IBM, McDonald's and Target—combined.

Economic Costs

- The impact of taxes on the economy extends beyond the revenue taken by the government. The compliance burden results in estimates of foregone economic growth from $148 billion to $609 billion annually.

Lobbying Costs

- While an estimate for tax lobbying specifically, is not available, lobbyists spent nearly $28 billion petitioning federal, state, and local governments for policy preferences between 2002 and 2011.

Lost Revenue

- The United States has a tax-reporting compliance rate of 85.5 percent—leaving a 2012 revenue gap of $452 billion in unreported taxes, some of which is can be attributed to complexities in the tax code.

SUMMARY

Accounting Expenses and Economic Distortions

In 2011, there were 173 different tax deductions and credits for individuals and corporations that amounted to around 7 percent of GDP. The economic costs of these tax provisions and marginal rates are estimated between $148 billion and $609 billion.

Itemized Deductions:

- Nearly one-third US taxpayers itemize specific tax deductions. This increases the costs of filing taxes, and distorts prices of goods and services ranging from homes to medical care.
- In a 2011 study (using 2006 tax data), the IRS estimated individuals spent more than 3 billion hours complying with personal deductions.
- The IRS also estimated businesses spent nearly 3 billion hours complying with deductions.

Corporate Tax Code:

- The deductibility of interest payments also provides incentives for companies to load up on debt, rather than issue stock, to finance new business ventures.
- Larger companies possess the resources and scale to more easily comply with a complicated depreciation schedule for capital investments than smaller companies. Further, while recent changes to the depreciation schedule under the American Taxpayer Relief Act provides more favorable treatment to both small and large firms, the provision favors capital intensive firms over those that are more labor intensive.

Tax Avoidance

Tax avoidance occurs when individuals or businesses adjust consumption and savings patterns in order to reduce tax burdens. This results in forgone economic transactions—or “deadweight loss”—that would have increased standards of living: the vacation not taken, the food not purchased, and so on. Estimates of this foregone investment and consumption range from $148 billion to $609 billion.

Gaining and Protecting Current Tax Advantages

Lobbyists spent more than $27 billion to petition federal, state and local governments between 2002 and 2011. While not all of this lobbying was related to obtaining and protecting tax advantages, research confirms a strong relationship between lobbying expenditures and changes in tax policy.

A 2009 study found:

- Each additional dollar spent on lobbying translated into $6 to $20 of tax benefits.

- Firms that increase lobbying expenditures by one percent reduce their effective tax rates by an amount in the range of 0.5 to 1.6 percentage points the following year.

Complying with Complexity—The IRS

According to the National Taxpayer Advocate—part of the Internal Revenue Service—the IRS itself cannot meet the needs of taxpayers who attempt to contact the agency.

- Of the 115 million phone calls the IRS received in fiscal year 2012, it was only able to answer (actually pick-up) 68 percent of the calls, down from an 87-percent pickup rate in 2004.
- The IRS also failed to respond to almost half (48 percent) of all taxpayer letters within the agency's own established time frame—a dramatic increase from the 12 percent rate in 2004.
- The US Treasury Inspector General's semiannual report to Congress (2011) found that most taxpayers who contact the IRS do not receive quality responses to their correspondence. It cited a review of three IRS functions—the Accounts Management function, Automated Underreporter Program, and Field Assistance Office—where 19 percent, 56 percent and 8 percent, respectively, of correspondents received both timely and accurate responses.

POLICY RECOMMENDATIONS

US history and international reform can guide legislators to reduce the staggering compliance costs of the overly complex tax code. Reform must significantly reduce or eliminate special tax provisions and lower rates. A simplified tax code will yield a more equitable, higher-performance economy with more federal revenues while reducing economic and accounting burdens.

The Tax Reform Act of 1986 was passed with significant bipartisan support and was the first tax reform in US history to replace a significant number of tax expenditures by lower tax rates on individuals. Federal Reserve Bank economist Anil Kumar found (2007) that TRA86 reduced deadweight losses as a percentage of taxes by 6 percent. Studies estimate that US revenue lost from individual and corporate overseas tax evasion alone is between $50 billion and $130 billion.

CONTACT

Angela Kuck, email: akuck@mercatus.gmu.edu, phone: 703-993-9338
Mercatus Center, 3301 Fairfax Drive, 4th Floor, Arlington, VA 22201