The Hidden Cost of
Federal Tax Policy

JASON J. FICHTNER & JACOB M. FELDMAN

MERCATUS CENTER
George Mason University

Arlington, Virginia

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What Are the Hidden Costs of Tax Compliance?

The US tax code, far beyond simply collecting revenue to fund the operations of the federal government, attempts to perform policy and political functions as well. This chapter does not examine the normative value of these provisions but instead examines the hidden costs of the federal tax code: time and money spent submitting tax forms, forgone economic growth, lobbying expenditures, and gaps in revenue collection. These problems grow larger as the Internal Revenue Code becomes more complicated and temporary.[1] On the basis of the studies reviewed in this chapter, we estimate that hidden costs range from $215 billion to $987 billion annually and that the tax code results in a $452 billion revenue gap in unreported taxes (see table 1.1). For calendar year 2012 alone, the economic costs were substantial relative to the $2.45 trillion in revenue raised by the federal government.[2]

The structure of individual and corporate income taxes in the United States—accounting for over 55 percent of total tax revenue—reflects policymakers' agglomerated attempts to increase fairness, conduct social policy, encourage economic growth,

Table 1.1. Hidden Costs and Revenue Implications of the US Tax Code

HIDDEN COSTS		REVENUE IMPLICATIONS	
Accounting costs	$67 billion– $378 billion	Tax gap	$452 billion
Economic costs	$148 billion– $609 billion		

Note: Lobbying costs are another form of hidden costs; however, because a specific annual cost could not be approximated, they are not included here.

and promote favored industries.[3] According to the National Taxpayer Advocate, between 2001 and 2010 there were 4,428 changes to the Internal Revenue Code, including an estimated 579 changes in 2010 alone.[4] In other words, the tax code averages more than one change per day. The complexity of the tax code is largely responsible for the $67 billion to $378 billion in annual accounting costs incurred by taxpayers in the process of filing their tax returns. A simpler tax code with fewer deductions would assist in alleviating these costs.

Revenue collected by the federal government through taxes prevents economic transactions from occurring. The economic size of the purchases and business deals that do not occur is larger than the total revenue collected by the federal government. Net estimates of annual forgone economic growth range from $148 billion to $609 billion (see table 1.3, page 20).

Along with both accounting and economic costs, lobbying costs are a third cost of the existing US tax code. Although we do not have a full and complete estimate of annual lobbying costs to petition

federal, state, and local governments for policy preferences, $27.6 billion was spent on reportable lobbying activities between 2002 and 2011 (see figure 1.2, page 25). More significantly for long-term economic growth, rather than providing an incentive for innovation, a tax code that is open to lobbyists encourages the pursuit of rent-seeking careers to protect and expand tax advantages.[5]

Finally, although it is not an economic cost, the structure of the federal tax code affects the government's ability to raise revenue efficiently and equitably. The United States has a tax-reporting compliance rate of 85.5 percent—leaving an estimated revenue gap of $452 billion in unreported taxes.[6] The government's failure to collect all revenue owed by law creates a social cost of inequitable tax burdens among similar taxpayers.[7] Policymakers who want to increase revenue for the federal government need to understand the risks and benefits that taxpayers assume by not reporting all taxable income. One case study based on the Russian economy suggests that shifting the US tax code to a flat tax holds promise for reducing the revenue gap.[8]

The extent to which many of these costs could be reduced quantitatively by tax code reform is beyond the scope of this chapter. The purpose here is to use the relevant scholarly literature to document the true costs of the US tax system. Later in the chapter, we provide qualitative recommendations based on successful tax reform in Russia and on the 1986 Tax Reform Act in the United States. Tax reform today must negate the incentives for both legal and illegal

tax sheltering. Curtailing the hidden costs of taxation will require a simpler tax code with lower rates.

HOW THE TAX CODE INDUCES ACCOUNTING EXPENSES AND CREATES ECONOMIC DISTORTIONS

The federal government assesses personal income taxes on citizens or resident aliens on the basis of their worldwide adjusted gross income.[9] Individuals may reduce their tax liability by taking advantage of the personal exemption deductions[10] and the applicable standard deduction,[11] or they may join the 32 percent of taxpayers who choose the complicated and costly process of itemizing specific deductions.[12] Claiming tax deductions increases the accounting costs of filing tax returns, as well the economic costs caused by distortions in the price system. Determining tax liability for a given year may then be further complicated by the necessity of complying with the alternative minimum tax.[13] Later in this chapter, we quantify the financial and time costs of complying with the many deductions—approximately $378 billion. Each itemized deduction targets a specific set of taxpayer characteristics or a specific policy objective. The itemized deductions allowed, as well as their value, vary from tax year to tax year. As detailed in figure 1.1, in 2011 the 173 different tax deductions and credits for individuals and corporations amounted to about 7 percent of GDP. The numerous existing personal and corporate federal tax provisions have implications for economic growth in that they affect individual prosperity and the inter-

Figure 1.1. Growth in Federal Tax Expenditures, 1975–2013
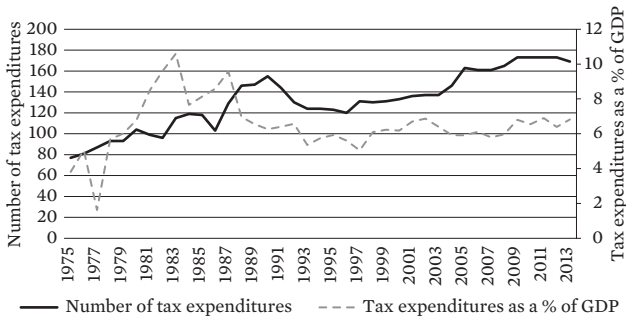
Source: Based on data from Office of Management and Budget, *Fiscal Year 2015 Analytical Perspectives, Budget of the US Government* (Washington, DC: Government Printing Office, March 4, 2014).

national competitiveness of American businesses—decreasing economic welfare by an estimated $148 billion to $609 billion annually (see table 1.3, page 20).

Unlike most industrial countries and all other members of the Group of Seven, the United States taxes all corporate income, regardless of where in the world it was generated. As a result, the current corporate tax structure discourages money earned abroad from being reinvested in the United States.[14] Foreign-source income is subject to taxation under the US tax code only when it is repatriated, or brought back to the United States.[15] Under this country's worldwide tax system, active income generated in a foreign country is subject to taxation under the US corporate tax code even after being taxed by the foreign government. To slightly reduce the negative effect of double taxation, the US tax code allows income tax paid to a foreign

country where income is earned to be deducted from a corporation's US tax liability. But the US tax code provides a strong incentive for American corporations to retain earnings overseas instead of paying them out as dividends to shareholders or reinvesting the earnings here.

The structure of the US tax code cultivates unequal competition opportunities between large and small companies. As in all industrial nations, an American corporation may deduct from its income tax liability all expenditures needed to undertake its activities, including interest payments on any debt. However, although interest payments on corporate debt are deductible, returns to equity (shareholders' earnings) are taxed at the corporate tax rate. This feature of the US corporate tax code biases the financing decisions of businesses toward using debt financing rather than equity financing.[16] As a consequence, businesses are prone to being highly leveraged. Small businesses and less well-established businesses, which have more limited access to debt financing, are thus at a competitive disadvantage.

In addition to differences in competitive advantage based on access to corporate debt, small businesses are not as well equipped as large businesses to take advantage of complex depreciation schedules. In other circumstances, multinational companies engage in transfer-pricing activities through affiliates for tax purposes rather than for efficiency reasons. The documentation of sales from controlled affiliates in foreign countries to a larger American parent company may be adjusted to reduce tax liabilities. Even among large

businesses, certain industries are able to take advantage of tax provisions while others languish under the high US corporate tax rates.[17] Larger businesses may deduct a capital investment over a number of years, subject to a complex depreciation schedule, whereas smaller businesses may deduct capital purchases at the time of investment. As a result, the after-tax cost of investments by larger businesses increases, because a dollar of spending today is more expensive than a dollar of spending in the future. On top of this complex system of deductions, depreciation, and liabilities, there are other deductions and benefits for favored industries or taxpayers perceived to perform socially beneficial functions. For example, Robert Dietz, assistant vice president for tax and policy issues for the National Association of Home Builders, argues that favorable tax treatment for homeownership lowers crime rates and provides varied personal benefits.[18] Such a complex system of taxation, however, imposes a compliance cost on individuals and corporations in addition to the missed economic growth opportunities.

COMPLYING WITH COMPLEXITY

Under the US tax system, which is enforced primarily through voluntary compliance, it is the taxpayer's obligation to compute and pay federal taxes to the IRS. Voluntary tax compliance is achieved through countless hours of taxpayer efforts, often with the help of paid tax consultants. The accounting costs of complying with the US tax code range from $67 billion to $378 billion (see table 1.2).

Table 1.2. Studies on the Costs of Taxation

STUDY	ANNUAL COMPLIANCE COSTS	IMPORTANT DIFFERENCES IN SCOPE AND ASSUMPTIONS	NOTABLE METHODOLOGICAL ISSUES
Guyton, O'Hare, Stavrianos, and Toder (2003) Year of data: Tax year 2000	$67 billion–$99 billion for individuals (Individual taxpayers experienced a total compliance burden of 3.21 billion hours and $18.8 billion.)[a]	• This study covers taxpayers' time, preparers' fees, and any other out-of-pocket expenses. • Taxpayers' time is monetized at $15 per hour for the low estimate and $25 per hour for the high estimate.	• This study is based on surveys of two samples of taxpayers: one (in 2000) of individuals who earned only wage and investment income and the second (in 2001) for self-employed individuals.
Slemrod (2004) Year of data: Tax year 2004	$85 billion for individuals	• This study covers tax-payers' time, preparers' fees, and any other out-of-pocket expenses. • Taxpayers' time is monetized at $20 per hour.	• This study is based on the author's informed judgment of accumulated research on this topic, including his own study of a sample of Minnesota taxpayers in 1989 (with Marsha Blumenthal)[b] and the Guyton et al. (2003) study.

Study	Estimate	Description	Notes
Moody, Warcholik, and Hodge (2006) Year of data: Calendar year 2005	$111 billion for individuals, $148 billion for businesses, and $7 billion for nonprofits	• This study covers taxpayers' time, preparers' fees, and any other out-of-pocket expenses. • Taxpayers' time is monetized at $39.18 per hour for individuals and $47.96 per hour for businesses and nonprofits.	• This study covers taxpayers' estimated paperwork burden. • The study is based on data from an IRS survey of taxpayers for tax year 1983; the methodology for updating the data is simplistic and does not account for changes in tax preparation and recordkeeping technology.
Laffer, Winegarden, and Childs (2011) Year of data: Tax year 2008	$378 billion total: $216 billion for individuals and $162 billion for businesses	• This study covers taxpayers' time;[c] individuals' time is monetized at $68.42 per hour and businesses' time at $55 per hour. • When preparers' fees and IRS administrative costs are included, Laffer, Winegarden, and Childs estimate that the total cost of tax compliance is potentially upward of $431 billion.	• The average income used to monetize taxpayers' time is significantly greater than the average income used in other estimates. The authors note that this difference is due to their use of a weighted average, which accounts for the fact that low-income taxpayers pay less in taxes.

Table 1.2. (*continued*)

Sources: John L. Guyton, John F. O'Hare, Michael P. Stavrianos, and Eric J. Toder, "Estimating the Compliance Cost of the U.S. Individual Income Tax," presented at the 33rd National Tax Association Spring Symposium, Washington, DC, May 29–30, 2003; Joel Slemrod, Written testimony submitted to the Committee on Ways and Means, Subcommittee on Oversight, Hearing on Tax Simplification, Washington, DC, June 15, 2004; J. Scott Moody, Wendy P. Warcholik, and Scott A. Hodge, "The Rising Cost of Complying with the Federal Income Tax," Tax Foundation, Washington, DC, Special Report 138, December 2005; Arthur B. Laffer, Wayne H. Winegarden, and John Childs, *The Economic Burden Caused by Tax Code Complexity*, Laffer Center, Austin, TX, April 2011.

a. Guyton et al. adjusted their estimates in accordance with the reduced compliance time estimated by the IRS.

b. See Marsha Blumenthal and Joel Slemrod, "The Compliance Cost of the U.S. Individual Income Tax System: A Second Look after Tax Reform," *National Tax Journal* 45, no. 2 (June 1992): 185–202.

c. The IRS estimates that individuals spent 6.1 billion hours in 2008 complying with filing requirements: 3.16 billion hours for individuals and 2.94 billion hours for businesses. The IRS provides its own compliance cost estimates. On the basis of the average hourly cost of a civilian employee, the IRS Taxpayer Advocate Service estimates that the costs of complying with the individual and corporate income tax requirements in 2008 were $163 billion, which is equivalent to 11 percent of aggregate income tax receipts. See Taxpayer Advocate Service, *National Taxpayer Advocate 2010 Annual Report to Congress*, vol. 1 (Washington, DC: IRS, 2010). Laffer, Winegarden, and Childs (2011) adjust the IRS numbers upward because the IRS does not adequately account for the skewed nature of the tax complexity burden toward higher-income earners. The weighted average hourly income used by Laffer, Winegarden, and Childs for each individual's time is $68.42. For businesses, the labor expense is estimated at $55 per hour for a tax accountant and is based on a weighted average annual salary, with bonuses and benefits, of $102,184.50 (plus the employer portion of FICA).

About 60 percent of individual taxpayers and 71 percent of unincorporated business taxpayers hire others—accountants, lawyers, tax professionals—to prepare their tax returns.[19] An additional 32 percent of individual taxpayers use tax preparation software to complete their tax returns.[20] As a direct result of the large and growing complexity of the US tax code, the vast majority of Americans now incur some type of monetary expense to determine their income tax liability and to comply with filing requirements.

Furthermore, some taxpayers venture to contact the IRS directly with questions regarding their income tax liability. In 2012, the IRS website received more than 1.7 billion page views. The agency also received 115 million phone calls in each of fiscal years 2011 and 2012—and more than 30 percent of those phone calls were not answered.[21] The agency was able to answer only 68 percent of phone calls in 2012, compared with 87 percent in 2004.[22] Additionally, the IRS failed to respond, within the agency's own established time frame, to almost half (48 percent) of all taxpayers' letters, up drastically from 12 percent in 2004.[23] In September 2011, the Treasury Department inspector general's semiannual report to Congress found that most taxpayers who had contacted the IRS had not received "quality" responses to their correspondence. The report cited a review of three IRS functions—Accounts Management, Automated Underreporter Program, and Field Assistance Office—and noted that 19 percent, 56 percent, and 8 percent, respectively,

of correspondents received timely and accurate responses to their questions.[24]

On the basis of costs incurred by taxpayers in terms of personal time and estimated direct outlays for products and services used to determine their federal income tax liability, several economists have formulated empirical estimates of the cost of tax compliance (see table 1.2). These estimates, though not comprehensive, suggest that the direct costs of tax compliance are substantial, particularly relative to the actual amount of revenue raised.[25]

The staggering costs of tax compliance efforts by individuals and businesses are well illustrated in a 2011 study by Laffer, Winegarden, and Childs.[26] The study estimates that taxpayers spent $378 billion in compliance costs in 2008—an amount that exceeds the profits of the 25 largest American corporations.[27] Similarly, an estimated 6.1 billion hours spent annually on efforts to comply with income tax forms represents an annual workforce of over 3.4 million people—a population surpassing that of Chicago, the third-largest city in the United States, which has only 2,707,120 residents.[28] This workforce is larger than the populations of 21 states. Even the four largest American companies combined employ only slightly more workers (Wal-Mart Stores, 2.2 million; IBM, 433,000; McDonald's, 420,000; and Target, 365,000).[29] And these administrative tax costs reveal only the more easily measured surface costs of federal income taxes. The true cost of tax compliance far exceeds taxpayers' documented personal time and financial expenses. The remainder

of this chapter addresses three other costs of taxation: lobbying efforts to gain and maintain tax advantages; economy-wide costs, as a result of work, leisure, savings, consumption, production, and investments being altered by tax incentives; and revenue lost as a result of taxpayer noncompliance. Several recommendations are given to lessen the hidden costs of taxation.

THE COSTS OF TAX AVOIDANCE

Tax avoidance occurs when individuals or businesses reallocate consumption and saving patterns to minimize tax burdens. Behavioral responses to tax avoidance result in what economists call *decreased allocative efficiency*—a loss of economic transactions that would increase standards of living, such as vacations not taken, food not purchased, and less expensive gifts purchased. In other words, consumers make smaller spending and saving decisions than they would otherwise.[30] Estimates of economic growth lost annually as a result of taxes range from $148 billion to $609 billion (see table 1.3). Taxes increase the cost of doing business—buying materials, paying workers, making investments. Businesses sell fewer products and services in response to resources shifting to the next-best social function. The extent to which the federal tax code distorts business decisions may be thought of in terms of whether consumption is penalized relative to saving. Additionally, different forms of saving may be penalized or rewarded relative to one another. If individuals or businesses are unsure how

Table 1.3. Studies on the Costs of Deadweight Loss

STUDY	DEADWEIGHT LOSS
Harberger (1964) Year of data: 1964	The study calculates $14 billion annually for federal income taxes. Estimate does not include the effect of payroll taxes. Loss is equal to 2.5 percent of revenue raised.
Feldstein (1999)[a] Years of data: 1994, 2012	For 1994, the study estimates $181 billion for federal income taxes without payroll taxes and $284 billion with payroll taxes. Loss is equal to 32.2 percent of the computer program TAXSIM's estimate of personal income tax revenue ($543 billion). Feldstein calculates that the marginal deadweight loss per tax dollar was $2.06. For 2012, deadweight loss is estimated at $388 billion without payroll taxes and $609 billion with payroll taxes.[b]
Blomquist and Simula (2012) Years of data: 1994, 2012	For 1994, $69 billion is estimated after accounting for federal income taxes with payroll taxes and for state income and sales taxes. Blomquist and Simula find a marginal deadweight loss per tax dollar of $1.35. For 2012, deadweight loss is estimated at $148 billion after accounting for federal income taxes with payroll taxes and for state income and sales taxes.[c]
Chetty (2009)	Deadweight loss is less than contemporary estimates because of the material costs necessary to dodge taxes. Some deadweight loss is actually a payment for services rendered for income to be sheltered from taxation. As a result, these transactions do materialize, although they would not be necessary under a simplified tax code.

Table 1.3. (*continued*)

Sources: Arnold C. Harberger, "Taxation, Resource Allocation, and Welfare," in *The Role of Direct and Indirect Taxes in the Federal Reserve System*, ed. John Due, 25–80 (Princeton, NJ: Princeton University Press, 1964); Martin Feldstein, "Tax Avoidance and the Deadweight Loss of the Income Tax," *Review of Economics and Statistics* 81, no. 4 (1999): 674–80; Sören Blomquist and Laurent Simula, "Marginal Deadweight Loss When the Income Tax Is Nonlinear," Uppsala University and Uppsala Center for Fiscal Studies, Uppsala, Sweden, March 8, 2012; Raj Chetty, "Is the Taxable Income Elasticity Sufficient to Calculate Deadweight Loss? The Implications of Evasion and Avoidance," *American Economic Journal: Economic Policy* 1, no. 2 (August 2009): 31–52; Office of Management and Budget, "Receipts by Source as Percentages of GDP: 1934–2017," table 2.1, http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/hist02z1.xls.
a. Harberger's (1964) approach is applied in Feldstein's (1999) paper to 1994 data.
b. Estimate is based on data from Office of Management and Budget, table 2.1, "Receipts by Source as Percentages of GDP: 1934–2017," http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/hist02z1.xls
c. This estimate assumes the ratio of deadweight loss to federal income tax revenues is fixed. The Office of Management and Budget has applied this ratio to estimated data for 2012 in an effort to estimate deadweight loss for that year. However, the data are more complex than this rough estimation shows, because the elasticity of taxable income may be calculated differently than Friedman calculated it in 1999.

the tax code will affect returns on investment, they may put off investing until more certainty exists.[31] Investments that do not occur because they are prohibitively expensive—an implicit result of taxation—slow economic growth.

Economists have a term for forgone investments and consumption—*deadweight loss*, an idea that gained prominence from the work of Arnold Harberger in

the 1960s.[32] More recently, Martin Feldstein builds on Harberger's work with his own methodology and finds that deadweight loss in general is higher than Harberger anticipated because tax rates are not applied evenly between spending and saving choices.[33] Examining 1994 data on income taxes, Feldstein estimates that deadweight loss to revenue was 12 times larger than Harberger's estimate. Feldstein estimates that 1994 deadweight loss from federal income taxes was $181 billion, or 2.55 percent of GDP, which would equal approximately $388 billion in 2012. In 2008, Feldstein reexamined deadweight loss by using an estimated compensated elasticity of 0.4, given the existing US tax code.[34]

With 124 special deductions and credits in the 1994 federal tax code (there were 173 in 2011), there was a menu of effective rates for businesses and individuals to shift resources toward to avoid higher tax liabilities. These deductions assisted businesses in equalizing some of their decisions about whether to save or consume. However, these deductions also further added to the federal tax code's complexity, which not only tied up other resources but also rendered better outcomes for businesses (often corporations) with professional tax compliance officers, while smaller businesses missed out on such opportunities.[35] Despite the highest level of deductions and credits in US history, the incentive to save versus consume is still treated unevenly in the tax code for many industries. It is clear that carving out special deductions and exemptions ties up far too many resources in the compliance process, favors larger businesses, and still does not

achieve the goal of taxing both saving and consumption at equal rates.

In 2012, Uppsala University economists Sören Blomquist and Laurent Simula revisited Feldstein's analysis of deadweight loss by using a model that better resembles today's tax code (i.e., a nonlinear model). Blomquist and Simula claim theirs is a more accurate model because the US tax code is progressive, meaning that tax rates increase with income. Using the same datasets as Feldstein, Blomquist and Simula find that Feldstein's linear model overestimates marginal deadweight loss per tax dollar by 61 percent. Under the 2006 tax code, which had the same marginal income tax rates as the 2012 code, deadweight loss per tax dollar was 4.1 percent.[36] In 2006, deadweight loss totaled $98.7 billion, and if the same levels were applied to 2012 revenue, the total would be $100.4 billion.[37]

University of Nebraska–Lincoln economist Seth Giertz estimates a range of potential deadweight losses if all individual federal income tax rates were increased after expiration of the Bush-era tax cuts.[38] Giertz's numbers reveal that deadweight loss would fall to between 0.72 and 3.62 percent of GDP ($15.6 billion and $77.8 billion, respectively), depending on the elasticity of taxable income response ranging between 0.2 and 1.0.[39]

Another response to Feldstein—suggesting that deadweight losses were lower than his estimates—comes from UC–Berkeley economist Raj Chetty. He questions whether the efficiency cost of taxation for tax avoidance and tax evasion exhibits the same deadweight loss as marginal tax rates. Chetty emphasizes

that tax evasion often exhibits different deadweight loss characteristics than tax avoidance does but that both may exhibit deadweight loss 40 percent smaller than that from marginal tax rates.[40] Tax avoidance is the act of using a legal method to reduce tax liability, such as using tax expenditures or not repatriating foreign earnings to the United States. Tax evasion is an illegal behavior—reducing tax burden by not reporting taxable earnings. Feldstein assumes that the decision to shelter income has a marginal cost rate similar to taxes. However, economists Joel Slemrod and Shlomo Yitzhaki explain that the US tax system sets the relative price of avoidance or evasion through the costs and benefits of "honesty."[41] Chetty argues that many forms of tax sheltering require resource costs lower than complying with the top marginal tax rates. Therefore, much of perceived deadweight loss is actually a transfer cost to shelter income.[42]

Although the costs of deadweight losses are difficult to estimate, policymakers can take steps to lessen the damage that does occur. A more complex tax code might lower deadweight losses slightly as long as marginal rates remain constant, because a more complex code also increases resources spent on tax preparation and lobbying efforts. An ideal tax code would be one in which deadweight losses remain low and resources spent on tax compliance are minimized. The policy recommendations presented later in this chapter examine contemporary solutions and historical responses. The next section examines the costs of lobbying.

Figure 1.2. Growth in Lobbying, 1998–2011
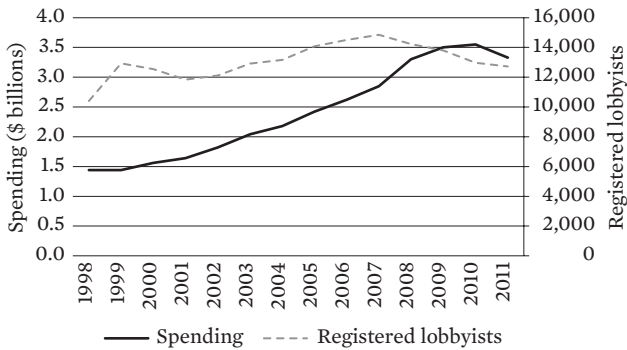
DIRECT COST OF GAINING AND PROTECTING CURRENT TAX ADVANTAGES

Lobbying costs are expenditures made by businesses to petition federal, state, and local governments for particular tax advantages. As shown in figure 1.2, between 2002 and 2011, $27.61 billion was spent on lobbying efforts. Although not all such spending is related to obtaining and protecting tax advantages for particular interests, empirical research has found a relationship between the two.

A 2009 study by political scientists Brian Richter, Krislert Samphantharak, and Jeffrey Timmons finds that resources spent on lobbying efforts yield high returns. Businesses that increased lobbying expenditures by 1 percent reduced their effective tax rates by 0.5 to 1.6 percentage points the following year. In nominal terms, an increase of approximately $7,800 in lobbying costs correlated with tax benefits of $4.8 million

to $16 million. Including existing annual spending on lobbying efforts, each additional dollar spent on lobbying translated to $6 to $20 in tax benefits. Richter, Samphantharak, and Timmons also find that returns on lobbying efforts are relatively high compared to the investment, although the revenue cost to the federal government is somewhat modest.[43] Similarly, business professors Hui Chen, David Parsley, and Ya-Wen Yang find that lobbying expenditures positively correlate with financial performance. However, not all businesses benefit equally from the marginal unit of lobbying expenditures. Businesses with the highest levels of lobbying earned excess returns of 5.5 percent over three years following portfolio formation.[44]

Visible lobbying expenditures are, however, not the only costs of an "influenced" Congress. Other costs to a business include forgone investments and employment, given that financial resources are redistributed from creative entrepreneurship to rent-seeking behavior. As a result of lobbying costs, resources might, for example, be redistributed from the next engineering innovation to lawyers seeking to secure a slice of the existing economic pie. According to economists Kevin Murphy, Andrei Shleifer, and Robert Vishny, there is an international correlation between a reduction in a country's economic growth and an increase in the number of law students. Countries with robust economic growth have higher levels of students engaged in engineering studies. Murphy, Shleifer, and Vishny suggest that well-developed economies encourage rent-seeking rather than cultivate innovative careers.[45]

The durability of tax policy can also affect the pursuit of rent-seeking behavior. A 2012 paper by Seth Giertz and Jacob Feldman finds that uncertainty over which provisions the tax code will include correlates with a rise in rent-seeking behavior, particularly during the 21st century.[46] In some circumstances, industries may emerge in response to policy uncertainty. A 1994 study by Federico Sturzenegger and Mariano Tommasi finds that countries with unstable macroeconomic growth policies induced entrepreneurs to spend more time collecting information about decision-relevant variables, rather than going directly to production and investment. Evidence of growing rent-seeking behavior in these countries included a large financial sector in high-inflation economies, as well as growing information-gathering and policy-influencing activities. In short, when talent is allocated to influencing— that is, lobbying—rather than producing, economic growth stalls. The damage to businesses of resource misallocation can be diminished if the government acts to limit tax policy uncertainty. Sturzenegger and Tommasi claim that, "when winners and losers are clearly defined, the incentive to shift resources out of productive activities is much weaker."[47]

VISION OF A BETTER STATE

To achieve a stronger US economy and bring in higher tax revenue, tax code reform needs to simplify the economic and accounting burdens of complying with federal taxation requirements. The burdens of these costs often fall inequitably on smaller businesses and

individual taxpayers. An overly complex and cumbersome tax code favors businesses and individuals who can afford well-paid accountants and lawyers. Both US history and international reforms should guide legislators toward how best to achieve a more productive and equitable federal tax revenue system.

During the Reagan administration, the Tax Reform Act of 1986 (TRA86) was enacted with significant bipartisan support. The act was important because it represented the first time in American history that a significant number of tax expenditures were removed from the tax code in exchange for reducing income tax rates on individuals. Although much of the act's successes had unraveled by the time of the 1993 Omnibus Act under the Clinton administration, there were some efficiency gains that reduced deadweight loss (see chapter 2). A 2007 paper by Federal Reserve Bank economist Anil Kumar finds that TRA86 reduced deadweight loss as a percentage of taxes by 6 percent. Combined with the positive labor effects of federal tax reform, Kumar estimates that an average male head of household was 10 percent better off after tax reform: "Before TRA 1986 an average male head would have been willing to pay about 28% of his Adjusted Gross Income to do away with the pre-TRA 1986 tax system. This figure drops to 25% after the tax reform—a drop of about 10%."[48]

Empirical literature suggests that income tax reform may diminish tax evasion but that reducing deadweight loss from tax avoidance may be more difficult. In a 2009 paper examining the 2001 Russian

tax reform actions, economists Yuriy Gorodnichenko, Jorge Martinez-Vazquez, and Klara Peter find that welfare gains from adopting a flat tax were relatively low, whereas tax compliance improved significantly, with an additional 10 percent of reported income relative to consumption. These authors estimate that the deadweight loss effects of tax evasion are 30 percent lower than the deadweight loss effects of traditional income responses to tax changes. They conclude that two-thirds of the increase in taxable income may be attributable to reduced tax evasion, rather than increased productivity.[49]

Improved taxpayer compliance in the United States would have important implications for the federal government. According to the IRS, there was a compliance rate of 83.1 percent in 2006—which resulted in a revenue gap of $450 billion, or 3.36 percent of 2006 GDP.[50] After IRS enforcement, there was a net compliance rate of 85.5 percent. Hence, 14.5 percent of 2006 estimated tax liabilities could not be collected through IRS enforcement efforts—$385 billion, or 2.88 percent of GDP. In 2012 dollars, that percentage would be $452 billion in revenue.[51] In part, tax revenue not collected by the federal government may instead be used in ways that contribute to economic growth, which would offset economic loss caused by the tax code. However, some revenue that is shifted overseas is not reported to the IRS. Some studies estimate that the revenue cost to the federal government from individual and corporate overseas tax evasion ranges from $50 billion to $130 billion.[52] Tax reform intended to

increase taxpayer compliance will require an understanding of the risks and costs of underreporting income.

University of Michigan economist Joel Slemrod notes that income tax evasion generates normative public policy problems, which this chapter does not address. First, evasion creates horizontal inequities because workers with equal earnings have different tax burdens. Second, evasion provides perverse social incentives for production activities where taxation is relatively light. An efficient tax code—and one that reduces the social costs of inequity—treats all production activities equally.[53]

Tax compliance costs in the United States are very high, and these costs have implications for lost economic growth, money spent unnecessarily on professional tax services, and even the collection of federal revenue. In 2011, individuals and businesses spent approximately $378 billion in time and for products and services to comply with the overly complex US tax code. For businesses, these resources would have been better spent on activities that increased capacity and production—and at the individual level, on work, saving, and investment. The US tax system may, in fact, have unintentionally thwarted approximately $148 billion of economic growth. Tax reform that reduces marginal tax rates may have a small and positive effect on national productivity. Finally, complying with higher marginal tax rates affects the federal government's ability to bring in needed revenue. The federal government may have missed out on approxi-

mately $452 billion in tax revenue in 2012 alone as a result of illegal evasion.[54]

As policymakers debate reforming the federal tax code, they should pay attention to the approximately $452 billion in uncollected revenue and the high-end estimate of almost $1 trillion from annual compliance, complexity, and economic costs associated with the current tax system.[55] Tax reform that reduces overall complexity will likely lead to greater efficiency, less paperwork, and higher tax revenue.

6. William C. Randolph, "International Burdens of the Corporate Income Tax," Working Paper 2006-09, Congressional Budget Office, Washington, DC, August 2006.

7. Stephen J. Entin, "The Tax Treatment of Capital Assets and Its Effect on Growth: Expensing, Depreciation, and the Concept of Cost Recovery in the Tax System," Background Paper 67, Tax Foundation, Washington, DC, April 2013.

8. Edward L. Glaeser and Jesse M. Shapiro, "The Benefits of the Home Mortgage Interest Deduction," in *Tax Policy and the Economy*, ed. James M. Poterba, 37–82 (Cambridge, MA: MIT Press, 2003).

CHAPTER 1: WHAT ARE THE HIDDEN COSTS OF TAX COMPLIANCE?

1. The Joint Committee on Taxation lists 60 different federal tax provisions (excluding temporary disaster relief provisions) that were scheduled to expire in 2011. An additional 41 provisions were scheduled to expire in 2012. See Joint Committee on Taxation (JCT), "List of Expiring Federal Tax Provisions 2011–2022," JCX-1-12, Washington, DC, January 6, 2012. Some of these provisions were extended for an additional five years under the American Taxpayer Relief Act of 2012.

2. Congressional Budget Office (CBO), "The Budget and Economic Outlook: Fiscal Years 2013 to 2023," Washington, DC, February 2013, table 1-1, 9.

3. The bulk of the remaining tax revenue generated comes from social insurance and retirement taxes, which accounted for 36 percent of total revenue collected in 2011. See Office of Management and Budget, "Receipts by Source as Percentages of GDP: 1934–2017," table 2.1, http://www.whitehouse.gov /sites/default/files/omb/budget/fy2013/assets/hist02z1.xls.

4. Taxpayer Advocate Service, *National Taxpayer Advocate 2010 Annual Report to Congress*, vol. 1 (Washington, DC: IRS, 2010), 4.

5. See Seth H. Giertz and Jacob M. Feldman, "The Economic Costs of Tax Policy Uncertainty: Implications for Fundamental Tax Reform," Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, November 27, 2012. See also Kevin M. Murphy, Andrei Shleifer, and Robert W. Vishny, "The Allocation of Talent: Implications for Growth," *Quarterly Journal of Economics* 106, no. 2 (1991): 503–30.

6. Authors' calculations based on IRS, "Tax Gap for Tax Year 2006," January 6, 2012.

7. US Government Accountability Office, "Tax Gap: IRS Could Significantly Increase Revenues by Better Targeting Enforcement Resources," GAO-13-151, Washington, DC, December 2012, 24.

8. Yuriy Gorodnichenko, Jorge Martinez-Vazquez, and Klara Sabirianova Peter, "Myth and Reality of Flat Tax Reform: Micro Estimates of Tax Evasion Response and Welfare Effects in Russia," *Journal of Political Economy* 117, no. 3 (2009): 504–54.

9. According to the Joint Committee on Taxation, adjusted gross income is computed by subtracting "trade or business expenses, capital losses, and contributions to a tax-qualified retirement plan by a self-employed individual, contributions to individual retirement arrangements ('IRAs'), certain moving expenses, certain education-related expenses, and alimony payments" from gross income. JCT, "Overview of the Federal Tax System as in Effect for 2012," JCX-18-12, Washington, DC, February 24, 2012, 2. See also Susan C. Nelson and Julie-Anne Cronin, "Adjusted Gross Income," in *The Encyclopedia of Taxation and Tax Policy*, ed. Joseph J. Cordes, Robert D. Ebel, and Jane G. Gravelle, 2–4 (Washington, DC: Urban Institute Press, 2005).

10. See JCT, "Overview of the Federal Tax System," 3:

> Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2012, the amount deductible for each personal exemption is $3,800. This amount is indexed annually for inflation. In tax years beginning after 2012, the personal exemption phase-out ('PEP') will reduce a taxpayer's personal exemption by two percent for each $2,500 by which the taxpayer's AGI [adjusted gross income] exceeds a certain threshold. JCT staff estimates of the PEP thresholds in 2013 are $172,250 (single) and $258,350 (married filing jointly).

11. Ibid.:

> The basic standard deduction varies depending upon a taxpayer's filing status. For 2012, the amount of the standard deduction is $5,950 for single individuals and married individuals filing separate returns, $8,500 for heads of households, and $11,900 for married individuals filing a joint return and surviving spouses. An additional standard deduction is allowed with respect to any individual who is elderly or blind. The amounts of the basic standard deduction and the additional standard deductions are indexed annually for inflation.

12. Ibid.:

> The deductions that may be itemized include State and local income taxes (or, in lieu of income, sales taxes), real property and certain personal property taxes, home mortgage interest, charitable contributions, certain investment interest, medical expenses (in excess of 7.5 percent of AGI), casualty and theft losses (in excess of 10 percent of AGI and in excess of $100 per loss), and certain miscellaneous expenses (in excess of two percent of AGI). In tax years beginning after 2012, the total amount of itemized deductions allowed is reduced for taxpayers with incomes over a certain threshold amount, which is indexed annually for inflation. JCT staff estimates of these limitation thresholds in 2013 are $172,250 for both single taxpayers and those who are married filing jointly.

> The percentage of taxpayers who itemize deductions is calculated from data from IRS, table 1.1, "All Returns: Selected Income and Tax Items, by Size and Accumulated Size of Adjusted Gross Income, Tax Year 2010," http://www.irs.gov/file_source/PUP/taxstats/indtaxstats/10in11si.xls, and IRS, table 3, "Returns with Itemized Deductions: Itemized Deductions by Type and by Size of Adjusted Gross Income, Tax Year 2010," http://www.irs.gov/file_source/pub/irs-soi/10in03id.xls.

13. The alternative minimum tax exemption amount for tax year 2013 is $51,900 ($80,800 for married couples filing jointly). A minimum tax rate of 26 percent applies to income earned above the exemption. See IRS, "Annual Inflation Adjustments for 2013," news release IR-2013-4, January 11, 2013.

14. C. Fritz Foley, Jay C. Hartzell, Sheridan Titman, and Garry Twite, "Why Do Firms Hold So Much Cash? A Tax-Based Explanation," Harvard Business School, Cambridge, MA, February 2007.

15. Active foreign-source income is subject to taxation only on repatriation, whereas passive foreign-source income and royalties are subject to taxation during the tax year in which they are generated.

16. Kate Linebaugh, "How Firms Tap Overseas Cash," *Wall Street Journal*, March 28, 2013.

17. John D. McKinnon, "Big Business Spars over Rewriting Tax Code," *Wall Street Journal*, March 28, 2013.

18. See *Hearing on Tax Reform Options: Incentives for Homeownership before the United States Senate Committee on*

Finance, 112th Cong., 1st sess. (October 6, 2011) (testimony of Robert Dietz, assistant vice president for tax and policy issues, National Association of Home Builders).

19. Taxpayer Advocate Service, *National Taxpayer Advocate 2010*, vol. 1, 5.

20. Treasury Inspector General for Tax Administration, "Analysis of Internal Revenue Service Employees' Use of Tax Preparation Assistance," report 2012-40-001, Department of the Treasury, Washington, DC, January 9, 2012, 1. However, tax software may not address all taxpayer responsibilities, as former Treasury Secretary Timothy Geithner can attest. See Mary Pilon, "TurboTax and Timothy Geithner's Tax Problems," *Wallet* (blog), January 22, 2009, http://blogs.wsj.com/wallet/2009 /01/22/turbo-tax-and-timothy-geithners-tax-problems/.

21. Taxpayer Advocate Service, *National Taxpayer Advocate 2012 Annual Report to Congress*, vol. 1 (Washington, DC: IRS, 2010), 9.

22. Josh Hicks, "IRS Ombudsman: Overly Complex Tax Code Needs Overhaul," *Washington Post*, January 9, 2013.

23. Ibid.

24. Treasury Inspector General for Tax Administration, *Semiannual Report to Congress: April 1, 2011–September 30, 2011* (Washington, DC: Department of the Treasury), 30–31.

25. In this chapter, various estimates from the scholarly literature are used to assign dollar values to the "costs" of the US tax code so that readers can understand and put meaning to their impact. These figures are estimates. Moreover, a dollar in compliance costs would not necessarily have the same economic impact as, or be equivalent in magnitude to, costs associated with a dollar of defense spending, a dollar of health care spending, a dollar of government stimulus spending, and so forth.

26. Arthur B. Laffer, Wayne H. Winegarden, and John Childs, "The Economic Burden Caused by Tax Code Complexity," Laffer Center, Austin, TX, April 2011.

27. These companies are Exxon Mobil, Chevron, Apple, Microsoft, Ford Motor, JPMorgan Chase, American International Group, Wells Fargo, IBM, Wal-Mart Stores, General Electric, Intel, ConocoPhillips, Procter & Gamble, Citigroup, Berkshire Hathaway, Pfizer, Google, Johnson & Johnson, General Motors, Philip Morris International, Coca-Cola, Oracle, Hewlett-Packard, and MetLife.

28. US Census Bureau, *State and County QuickFacts* database, http://quickfacts.census.gov/qfd/. Data are for 2011.

29. CNN Money, "Top Companies: Biggest Employers," May 21, 2012.

30. Alan Auerbach and James Hines describe the effects and problem of deadweight loss as follows: "A major practical difficulty in measuring the excess burden of a single tax, or of a system of taxes, is that excess burden is a function of demand interactions that are potentially very difficult to measure. . . . In order to estimate the excess burden of a labor-income tax, it is in principle necessary to estimate the effect of the tax on . . . decision margins." See Alan J. Auerbach and James R. Hines Jr., "Taxation and Economic Efficiency," in *Handbook of Public Economics*, vol. 3, ed. Alan J. Auerbach and Martin S. Feinstein, 1347–421 (Amsterdam: Elsevier, 2002), 1359.

31. Giertz and Feldman, "Economic Costs of Tax Policy Uncertainty."

32. Arnold C. Harberger, "Taxation, Resource Allocation, and Welfare," in *The Role of Direct and Indirect Taxes in the Federal Reserve System*, ed. John Due, 25–80 (Princeton, NJ: Princeton University Press, 1964). See also Arnold C. Harberger, "The Measurement of Waste," *American Economic Review* 54 (1964): 58–76. Using labor supply as a proxy for deadweight loss, Harberger finds an increasingly negative effect on the number of individuals looking for work as marginal tax rates increase. He finds that personal income taxes reduce labor supply by a minimum of 2.5 percent among earners with the lowest marginal tax rate (20 percent) to a high of 11.38 percent for workers in the highest marginal tax rate (91 percent).

33. Martin Feldstein, "Tax Avoidance and the Deadweight Loss of the Income Tax," *Review of Economics and Statistics* 81, no. 4 (November 1999): 674–80.

34. Martin Feldstein, "Effects of Taxes on Economic Behavior," *National Tax Journal* 61, no. 1 (March 2008): 131–39.

35. Alexander Eichler, "10 Most Profitable U.S. Corporations Paid Average Tax Rate of Just 9 Percent Last Year: Report," *Huffington Post*, August 6, 2012.

36. Sören Blomquist and Laurent Simula, "Marginal Deadweight Loss When the Income Tax Is Nonlinear," Uppsala University and Uppsala Center for Fiscal Studies, Uppsala, Sweden, March 8, 2012.

37. These numbers are the authors' calculations. See CBO, "Historical Budget Data—February 2013 Baseline Projections," February 2013, table 1, http://www.cbo.gov/sites/default/files /cbofiles/attachments/43904-Historical%20Budget%20Data

-2.xls, and CBO, "Budget and Economic Outlook: Fiscal Years 2013 to 2023," summary table 1, 3.

38. Seth Giertz, "The Elasticity of Taxable Income: Influences on Economic Efficiency and Tax Revenues, and Implications for Tax Policy," in *Tax Policy Lessons from the 2000s*, ed. Alan D. Viard, 101–36 (Washington, DC: AEI Press, 2009).

39. Percentages are the authors' calculations.

40. Raj Chetty, "Is the Taxable Income Elasticity Sufficient to Calculate Deadweight Loss? The Implications of Evasion and Avoidance," *American Economic Journal: Economic Policy* 1, no. 2 (August 2009): 31–52.

41. Joel Slemrod and Shlomo Yitzhaki, "Tax Avoidance, Evasion, and Administration," in *Handbook of Public Economics*, vol. 3, ed. Alan J. Auerbach and Martin S. Feinstein, 1423–70 (Amsterdam: Elsevier, 2002).

42. Chetty, "Is the Taxable Income Elasticity Sufficient to Calculate Deadweight Loss?"

43. Brian Kelleher Richter, Krislert Samphantharak, and Jeffrey F. Timmons, "Lobbying and Taxes," *American Journal of Political Science* 53, no. 4 (October 2009): 893–909.

44. Hui Chen, David Parsley, and Ya-Wen Yang, "Corporate Lobbying and Financial Performance," Working Paper, University of Colorado–Boulder, Boulder, November 23, 2012.

45. Murphy, Shleifer, and Vishny, "Allocation of Talent."

46. Giertz and Feldman, "Economic Costs of Tax Policy Uncertainty."

47. Federico Sturzenegger and Mariano Tommasi, "The Distribution of Political Power, the Costs of Rent-Seeking, and Economic Growth," *Economic Inquiry* 32, no. 2 (April 1994): 236–48, 237.

48. Anil Kumar, "Labor Supply, Deadweight Loss, and Tax Reform Act of 1986: A Nonparametric Evaluation Using Panel Data," *Journal of Public Economics* 92 (2008): 236–53, 238.

49. Gorodnichenko, Martinez-Vazquez, and Peter, "Myth and Reality of Flat Tax Reform."

50. IRS, "Tax Gap for Tax Year 2006."

51. The $385 billion figure is from IRS, "Tax Gap for Tax Year 2006." Other numbers are the authors' calculations. See CBO, "Budget and Economic Outlook: Fiscal Years 2013 to 2023," table B-1.

52. See Jane G. Gravelle, "Tax Havens: International Tax Avoidance and Evasion," Report 7-5700, Congressional Research Service, Washington, DC, January 23, 2013. Gravelle's

range of estimates (corporate: $10 billion to $60 billion; individual: $40 billion to $70 billion) come from the following studies: Martin Sullivan, "Shifting Profits Offshore Costs US Treasury $10 Billion or More," *Tax Notes*, September 27, 2004, 1477–81; Kimberly A. Clausing, "The Revenue Effects of Multinational Firm Income Shifting," *Tax Notes*, March 28, 2011, 1580–86; Joseph Guttentag and Reven Avi-Yonah, "Closing the International Tax Gap," in *Bridging the Tax Gap: Addressing the Crisis in Federal Tax Administration*, ed. Max B. Sawicky, 99–110 (Washington, DC: Economic Policy Institute, 2005).

53. Joel Slemrod, "Cheating Ourselves: The Economics of Tax Evasion," *Journal of Economic Perspectives* 21, no. 1 (2007): 25–48.

54. Jason J. Fichtner and Jacob Feldman, "The Hidden Costs of Tax Compliance," Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, May 2013.

55. Ibid.

CHAPTER 2: WHAT CAN BE LEARNED FROM THE TAX REFORM ACT OF 1986?

1. *Hearing on Tax Reform: Lessons from the Tax Reform Act of 1986 before the United States Senate Committee on Finance*, 111th Cong., 2nd session (September 23, 2010) (testimony of Randall D. Weiss, managing director of economic research, The Conference Board, New York, "How Did the 1986 Tax Reform Act Attract So Much Support?"). Note: Many of these provisions were renewed with the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

2. The Joint Committee on Taxation's estimation of the revenue effects of the Tax Increase Prevention Act of 2014 are available at https://www.jct.gov/publications.html?func=startdown &id=4677.

3. For a discussion of what is and is not a tax expenditure, see Donald B. Marron, "Spending in Disguise," *National Affairs* 8 (Summer 2011): 20–34.

4. Ibid, 25–26.

5. Ibid, 26.

6. Edward D. Kleinbard, "The Congress within the Congress: How Tax Expenditures Distort Our Budget and Our Political Processes," *Ohio Northern University Law Review* 36 (2010): 1–30, 15.

7. Edward A. Zelinsky, "James Madison and Public Choice at Gucci Gulch: A Procedural Defense of Tax Expenditures and