

INDIVIDUALS AND THE COMPLIANCE COSTS OF TAXATION

A JOINT ECONOMIC COMMITTEE STUDY



Chairman Jim Saxton (R-NJ)

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Abstract

The federal tax code imposes a compliance burden of approximately \$83 billion on individuals because of the time requirements of filing. This paper examines how people respond to these costs, given certain constraints. It is commonly believed that complexity: (1) reduces levels of voluntary compliance, either through avoidance or evasion; (2) increases the difficulty in administering the tax law; and (3) may reduce the perceived level of fairness in the federal tax system.

Joint Economic Committee
433 Cannon House Office Building
Washington, DC 20515
Phone: 202-226-3234
Fax: 202-226-3950
Internet Address:
<http://www.house.gov/jec/>

Individuals and the Compliance Costs of Taxation

It will be of little avail to the people that the laws are made by men of their own choice, if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood; ... or undergo such incessant changes that no man who knows what the law is today can guess what it will be tomorrow. Law is defined to be a rule of action; but how can that be a rule, which is little known, and less fixed?

Alexander Hamilton or James Madison, The Federalist Papers, No. 62.

Introduction

Taxes impose many costs. It would be easy to view the costs as simply the amount of money a person gives to the tax collector. However, the economic effects go beyond simply transferring money from one party to another. Since Adam Smith, economists have been concerned with the costs of taxation and have developed several different measurements of the economic costs.

First, as Smith pointed out, taxes can change or alter behavior. This may or may not be intentional. For example, taxes on cigarettes have the stated purpose of reducing smoking. Likewise, tax incentives to attend school may lead to an increase in the demand for schooling. However, there are other costs that are not intentional. In the modern economic literature, these costs are known as the excess burden (or deadweight loss of taxation.) The excess burden is a loss of welfare above and beyond the tax revenues collected.

Additionally, we should consider what Slemrod (2005) terms the resource costs of taxation. These consist of two parts:

Compliance costs: the cost (usually thought of as time, but can also be monetary) that is borne by individuals as a result of paying their income taxes.¹ This includes record keeping, learning about specific laws and forms, preparation time, remittal time, and any monetary costs such as seeking assistance from a certified public accountant, tax lawyer, or tax preparer (such as H&R Block) or buying computer programs or books. It is a measure of the opportunity cost of complying with the tax code.²

Enforcement costs: the costs associated with the administrative operation of the Internal Revenue Service (IRS).

Empirical work on the deadweight loss of taxation has resulted in a vast literature.³ The purpose of the present study, however, is to examine only one aspect of

¹ Compliance costs also fall on businesses, however the focus here will only be on the cost to individuals.

² Some of the literature on compliance costs includes the administrative costs borne by the government, although here they are considered separately.

³ See Vedder and Gallaway (1999). JEC (2005) provides a brief overview of the topic.

the resource costs: the compliance costs associated with taxation. Compliance costs are a primary result of the complexity in the tax system.⁴ It is commonly believed that complexity reduces levels of voluntary compliance, either through avoidance or evasion, likely increases the difficulty in administering the tax law, and may reduce the perceived level of fairness in the Federal tax system.

While the tax system is obviously complex, it may not be that complex for everyone. Some individuals (those with lower incomes) qualify to fill out the 1040EZ, which is a comparatively easy document. Others may fill out the 1040A, which, while not as easy as the 1040EZ, is still not as complex as the 1040 basic form (see Table 1 for time estimates). Some people though, will use complex forms simply due to financial transactions. Others will try to minimize taxes by pursuing aggressive avoidance strategies. Ultimately, it is important to understand whether complexity is a result of the underlying transactions into which the taxpayer has chosen to enter, or whether the complexity is embedded in the tax code.

This study will focus on these questions and how individuals react when presented with complexity. The study will begin with a review of the estimated costs of compliance across time periods and will then examine the economic response of individuals to complexity.

Cost Estimates⁵

The modern literature on compliance costs begins with the work of Wicks (1965, 1966) who conducted the first study based on survey information. Wicks handed out questionnaires to 380 students with the request they mail the questionnaire to their parents. Adjusting for bias, Wicks estimated compliance costs amounting to 11.5 percent of the revenue raised.⁶

Slemrod and Sorum conducted the next survey (1984), this time of Minnesota households. They found that on average a taxpayer spent 21.7 hours on tax matters, or close to 2 billion hours for society. They estimated compliance costs as 5-7 percent of income tax revenue.

Blumenthal and Slemrod repeated the survey in 1990 and found that time requirements for 1989 returns had increased to 3 billion hours. In this study, individuals,

⁴ Complexity can have different effects, depending on the type of complexity. For example, in some instances complex laws may lead to uncertainty in the correct application of the law to particular facts. Or in may require complex numerical calculations that, while potentially beneficial, may intimidate the tax filer.

⁵ The works cited here refer only to the compliance costs associated with the U.S. federal income tax system. Scholars have surveyed the costs faced in other countries, most notably with respect to Australia and the U.K. See Slemrod and Sorum, (1984) and Blumenthal and Slemrod (1992) for a review of this literature.

⁶ Wicks (1966).

on average, spent 27.4 hours on tax matters, despite the intervening Tax Reform Act of 1986, which was intended to simplify the tax code.⁷

The largest survey, conducted by the consulting firm Arthur D. Little, Inc. (ADL) and commissioned by the IRS, was a mail questionnaire sampling approximately 6,200 individuals. ADL also conducted a diary study of time spent in 1983 by 750 individuals. The results were broadly consistent with those of Slemrod (1984), although there were important differences in the measurement of business compliance costs, which are not discussed here. ADL estimated that individual taxpayers spent 1.6 billion hours for tax year 1983 and 1.8 billion hours on 1985 returns.

The IRS now uses the ADL study as the basis for their estimates of time compliance. These estimates are published in the instruction booklets for the respective tax forms as part of the “Paperwork Reduction Act Notice.” For example, for tax year 2004, the IRS estimates the compliance burden for the standard 1040 at nearly 13.5 hours, on average (see Table 1 below).⁸

Table 1, Estimated Preparation Time

Form	Recordkeeping	Learning about the law or the form	Preparing the form	Copying, assembling, and sending the form to the IRS	Totals
2004 1040	2 hr., 46 min.	3 hr., 58 min.	6 hr., 17 min.	34 min.	13 hr., 35 min.
1992 1040	3 hr., 8 min.	2 hr., 42 min.	3 hr., 37 min.	49 min.	10 hr., 26 min.
2004 1040A	1 hr., 10 min.	3 hr., 28 min.	5 hr. 13 min.	34 min.	10 hr. 25 min.
1992 1040A	1 hr., 3 min.	2 hr., 8 min.	2 hr., 47 min.	35 min.	6 hr., 33 min.
2004 1040EZ	4 min.	1 hr., 41 min.	1 hr., 41 min.	20 min.	3 hr., 46 min.
1992 1040EZ	5 min.	33 min.	39 min.	34 min.	1 hr., 51 min.

Source: Selected IRS instruction booklets, various years.

Two recent studies by Payne (1993) and Moody (2002) base their estimates on the ADL/IRS time estimates. Payne uses data from the ADL survey while Moody considers

⁷ The previous study (Slemrod and Sorum) did not include a category on the time spent arranging financial affairs to minimize taxes, which the latter study (Blumenthal and Slemrod) does include. For this reason, the 1982 survey might have been biased downward slightly, although respondents may have included the time estimates included in this category implicitly elsewhere. Thus, the time estimates are roughly comparable, though the categories are not. See Blumenthal and Slemrod (1992) for a discussion.

⁸ The time estimates only reflect the time to complete one specific form. It is entirely possible, and if time estimates are to be believed, necessary, that other forms, with their own time requirements will also be completed. The IRS estimates preparation time for all of their forms, even though only a few are listed in Table 1.

the number of forms returned by type and simply adds the estimated totals per form to reach a cumulative total. Payne estimates that time spent complying equals 1.8 billion hours (for 1985) and Moody places the time at 2.8 billion hours (for 2002).

Because the ADL survey is over 20 years old, the IRS wishes to update its compliance estimates, which are derived from the survey. To accomplish this task, the IRS turned to IBM. IBM has now completed its Individual Taxpayer Burden Model (ITBM) and the results have been published in Guyton (2003.) The model is still being tested for reliability, but its compliance estimates are consistent with other studies. For tax year 2000, the ITBM model estimates a compliance burden of 3.21 billion hours. Guyton, et al., apply three different wage rates, \$15, \$20, and \$25 respectively, yielding a compliance cost of between \$48 and \$80 billion. If we add in the cost of paid preparers, tax software, and related expenses, which the authors estimate at \$18.8 billion, we can estimate a compliance cost between \$67 and \$99 billion.

Slemrod (2004) estimates taxpayers spent 3.5 billion hours complying with the tax code for tax year 2004. He follows the same methodology as Guyton, et. al. but estimates the compliance cost using the middle of the three wage rates (\$20). Slemrod estimates a cost of \$70 billion.

A conservative estimate would be to use the Guyton study methodology and estimate the cost at \$20 per hour and then add the costs for additional services, \$18.8 billion, which yields a total cost of \$83 billion.

A recent Government Accountability Office (GAO) report reached a similar conclusion. For individuals, GAO estimates compliance costs between \$67 billion to a little over \$100 billion.⁹ At the low end was the aforementioned IBM/IRS study and Moody's estimates (2002) were at the high end. It is important to remember that we are not dealing with absolutes and that even at the low end, the compliance costs are massive and are likely underestimated. They present a real cost to society because every dollar that is lost to inefficiency represents a dollar society could have used for productive purposes.

Individual Responses to Complexity

Economics is ultimately interested in how individuals behave given certain constraints and how incentives influence behavior. Given high compliance costs, it is important to understand what economic responses people exhibit.

Substitution Effect. Because people have some understanding of the time costs of preparing their taxes, many will choose to forgo the process entirely and have someone else do the work. About half of all taxpayers purchase assistance from an accountant or other tax professional.¹⁰ Those who purchased assistance spent about \$158 (1995

⁹ GAO (2005) p. 12.

¹⁰ Slemrod (2000).

dollars) on average, although the amounts varied widely depending on the complexity of the return.¹¹

Because leisure time is valuable, it is not surprising that so many people seek assistance. Indeed, even some people with comparatively simple returns, such as those who file the 1040EZ, seek assistance.¹²

While seeking assistance will reduce the time costs of taxation, records still need to be kept, and the individual must invest some level of time and effort. Nevertheless, because tax preparers have developed a high level of expertise, they will be more efficient and will lower the time requirements, but not necessarily the monetary costs, to comply with the Code.

Taxpayer Confusion. For those who file themselves, complexity can create confusion. People may intentionally take conservative filing positions when faced with a complex area of the tax code that seems to offer no clear answers. Alternatively, some people may want to “roll the dice” and try a more aggressive approach in the hope that complexity may protect them in case of an audit.¹³

In other cases, complexity may induce changes in behavior even when the tax law is clear and there is little chance of confusion. The tax law may be clear in some cases but involve a large number of steps or calculations that could be intimidating. This would not result in confusion or uncertainty, but might still alter behavior. For example, the Government Accounting Office (GAO) estimated that in tax year 1998, approximately 510,000 individuals did not itemize their deductions and may have overpaid their taxes by \$311 million.¹⁴

One possible reason for this apparently irrational behavior is that the GAO only considers the accounting costs involved. Itemizing may save a taxpayer money, but the economic costs, such as the lost time, may not be worth the accounting profit. Again, faced with a work-leisure constraint, people may simply decide to take the standard deduction in order to save themselves time and potential headaches.

As would be expected, individuals seek the easiest methods to complete the unpleasant process of filing taxes. Over the past 20 years, as technology has improved (especially computers), people have more and easier options to assist them. Now,

¹¹ Slemrod (2000).

¹² The 1040EZ constitutes 75% of all forms H&R Block files per year. Indeed, the fact that anyone would pay to have the form completed is a little surprising. A much higher number of people seek help to complete form 1040A, which, though it is still complex, is not as time intensive as the 1040.

¹³ Those that choose to pursue a more aggressive approach are also more likely to seek ways that avoid or evade taxation, usually with the assistance of a tax preparer. Comprehensive studies of tax evasion, though older (1992), suggest that noncompliance of both individual and corporate income tax cost the U.S. Treasury \$128.4 billion in that year (Slemrod, 2000).

¹⁴ GAO (2001). In tax year 1999 31.7% of filers itemized their returns. Similar numbers hold across time periods (Campbell, 2001).

approximately half of all returns are filed electronically.¹⁵ IRS forms can be downloaded online, saving individuals the time and effort of waiting in lines and traveling for the proper forms. Also, programs like TurboTax and Quicken can further simplify the process by making complex calculations that would have previously been done by hand. These programs do have a monetary cost though.¹⁶

Lack of Transparency. Complexity in the tax laws obscures the actual tax base and increases the tendency for people to “free ride” on the contributions of others because each citizen’s individual contribution is just a drop in the bucket and doesn’t affect what benefits one receives from the government. This added effect of complexity can, over time, increase the tendency of people to feel that the tax system is not fair. People may call for marginal tax rates to increase, so a higher percentage of the burden of taxation will fall on the wealthier individuals in society.¹⁷ Or, it can breed cynicism among taxpayers, which can ultimately lead to intentional noncompliance. Over time, this could make the collection duties of the IRS increasingly difficult.

Complexity Creep. One lesson of economics is that legislation can have unintended consequences. In tax law, one problem is that complexity does not become evident until many years after a change in the tax law. Consider the alternative minimum tax (AMT). In tax year 1990, only 132,000 people paid the AMT for individuals (there is also an AMT for corporations). In 2000 that number rose to 1.3 million and by 2010 the number is projected to rise to nearly 35 million, unless the current law is changed.¹⁸

Ultimately, in order for a “voluntary” tax system to work, people must believe in the inherent goodness of paying taxes and providing for the public goods that all enjoy, even if the act itself is still painful. Complexity undermines this process through many of the processes mentioned above.

Conclusion

The Internal Revenue Code now consists of more than 1.4 million words and the result is complexity and taxpayer confusion.¹⁹ The combination of compliance, administrative and welfare costs lead to very large economic costs and create strong disincentives to complying with the tax system. Tax reform is necessary and worthwhile. However, for tax reform to be successful, legislators should keep filing and administrative costs to a minimum and they should apply low marginal tax rates to a

¹⁵ Balkovic (2005).

¹⁶ Some filers — those with incomes below a certain income threshold — can now use certain tax programs for free if they file online. This has the added bonus of providing sound assistance while reducing time costs.

¹⁷ Several surveys, summarized in Slemrod (2000), suggest that people have a hard time identifying the true burden of taxation and frequently believe that the wealthier classes bear a smaller share of the burden than is actually the case.

¹⁸ See Schuler (2001) for an overview of the AMT. For the data on future AMT filers, see National Taxpayer Advocate (2004), p. 3.

¹⁹ National Taxpayer Advocate (2004).

broad economic base. These simple guidelines should ensure that tax reform reduces disincentives to work, save, and invest.

Brian Higginbotham
Economist

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