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Reviewing Different Methods of Calculating Tax Compliance Costs

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Key Findings

- Complying with the individual income tax code creates real costs for taxpayers. Estimates of the compliance burden vary widely depending which calculation method is used. Each method produces unique illustrations of the cost of complying with the U.S. tax code.
- Quantifying compliance costs can be complex. Calculations may include out-of-pocket costs on things like software or the cost of time spent keeping records and filling out forms instead of engaging in productive economic activities. Other costs associated with tax code complexity may be considered as well, such as lobbying and the tax gap, or the difference between taxes owed and collected.
- We estimate that the individual income tax reforms in the Tax Cuts and Jobs Act could result in compliance savings ranging from \$3.1 billion to \$5.4 billion.

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Introduction

Reforms to the individual income tax in the Tax Cuts and Jobs Act (TCJA) helped simplify the tax code. Most importantly, doubling the standard deduction, curbing several itemized deductions, and limiting the Alternative Minimum Tax (AMT) will make the tax filing process simpler and reduce compliance costs. However, trying to calculate the compliance cost of the tax code is complex, and estimates vary widely depending on how one tries to measure compliance costs.¹

In the Tax Foundation's recent paper on the changes the TCJA made to the individual income tax, we used two different estimates to illustrate the reduced compliance burden.² However, there are a variety of ways to think about measuring the cost of compliance.

Different Compliance Measures

Complying with the federal tax code creates a burden on taxpayers, resulting in real economic costs. The Internal Revenue Service (IRS) estimates time spent on tax compliance activities as well as out-of-pocket costs; see the table below.³ The IRS separates the average time burden across recording keeping, tax planning, form completion and submission, and all other activities; time spent on post-filing activities is not included.

TABLE 1.

Estimated Average Taxpayer Burden for Individuals by Activity

Primary Form Filed or Type of Taxpayer	Percentage of Returns	Average Burden					Average Cost (Dollars)**
		Average Time (Hours)					
		Total Time*	Record Keeping	Tax Planning	Form Completion and Submission	All Other	
All Taxpayers	100	12	5	2	4	1	\$210
Primary forms filed							
1040	68	15	7	2	4	1	\$270
1040A	20	7	4	1	3	1	\$90
1040EZ	10	5	1	***	2	1	\$40
Type of Taxpayer							
Nonbusiness****	70	8	3	1	3	1	\$120
Business****	30	21	11	3	5	1	\$410

*Detail may not add to total time due to rounding.

**Dollars rounded to the nearest \$10.

***Rounds to less than one hour.

****You are considered a "business" filer if you file one or more of the following with Form 1040: Schedule C, C-EZ, E, or F or Form 2106 or 2106-EZ. You are considered a "nonbusiness" filer if you don't file any of those schedules or forms with Form 1040 or if you file Form 1040A or 1040EZ.

Source: Internal Revenue Service, 2017 Instructions 1040

1 Michelle Ye Hee Lee, "Ted Cruz's claim that tax compliance costs as much as the military budget," *The Washington Post*, May 12, 2015, https://www.washingtonpost.com/news/fact-checker/wp/2015/05/12/ted-cruzs-claim-that-tax-compliance-costs-as-much-as-the-military-budget/?noredirect=on&utm_term=.aff2c18e1ea5.

2 Erica York and Alex Muresianu, "The Tax Cuts and Jobs Act Simplified the Tax Filing Process for Millions of Households," Tax Foundation, Aug. 7, 2018, <https://taxfoundation.org/the-tax-cuts-and-jobs-act-simplified-the-tax-filing-process-for-millions-of-households/>.

3 Internal Revenue Service, "2017 Instructions 1040," 100-101, <https://www.irs.gov/pub/irs-pdf/i1040gi.pdf>.

In general, the IRS estimates that individuals spent 12 hours on average completing their individual income tax returns in 2017, with an average out-of-pocket cost of \$210 per return. Pass-through businesses, such as S corporations, limited liability corporations, and sole proprietorships, file their taxes using the individual income tax, and those businesses spent significantly more time completing their taxes. On average, it took pass-through businesses 21 hours to complete their 2017 tax returns, with half that time spent on record keeping.

These estimates provide a useful starting point for quantifying the burden of tax code compliance.

Out-of-Pocket Costs

The simplest way to calculate compliance costs is just considering out-of-pocket expenditures on complying with the tax code. In other words, all spending on tax preparation fees, software, and other supplies taxpayers use to file their taxes. The National Taxpayers Union Foundation estimated that out-of-pocket costs for tax year 2017 were \$31.9 billion.⁴

While this number is easier to calculate and understand, solely looking at expenditures ignores the economic costs of the time spent complying with the tax code instead of engaging in other productive economic activities, which the National Taxpayers Union Foundation acknowledges.

Cost of Time Spent Complying

Another way to calculate compliance costs is to convert the time spent complying with the tax code into a dollar figure. One way to do this is to assume that an hour spent preparing a tax return has the economic cost of an hour of work.

The Tax Foundation calculated the cost of complying with the individual income tax in a 2016 publication.⁵ According to IRS estimates that year, Americans spent 2.6 billion hours complying with the individual income tax. The hourly aggregate can be translated into compliance costs by multiplying them by an hourly compensation number. In the 2016 Tax Foundation report, the average hourly compensation for all full-time private sector workers in December 2015 (\$37.28) was used to estimate the total annual cost in dollars, which amounted to \$98.68 billion.⁶ Note, this does not include the out-of-pocket expenses on tax preparation fees, software, and other supplies.

There is an argument to be made, however, that using average hourly compensation to calculate the economic cost of an hour of tax compliance is inaccurate. Higher-income taxpayers pay a larger share of taxes and are subject to more complex provisions than lower-income taxpayers. For instance, higher-income taxpayers are more likely to itemize deductions and have AMT liability, both of which require more compliance time than a basic tax form. And the opportunity cost of higher-income individuals complying with the tax code is greater than the average hourly compensation.

4 Demian Brady, "Tax Complexity 2018: With Relief on the Way, Taxpayers Hope Headaches Will Ease," National Taxpayers Union Foundation, April 16, 2018, <https://www.ntu.org/foundation/detail/tax-complexity-2018-with-relief-on-the-way-taxpayers-hope-headaches-will-ease>.

5 Scott A. Hodge, "The Compliance Costs of IRS Regulations," Tax Foundation, June 15, 2016, <https://taxfoundation.org/compliance-costs-irs-regulations/>.

6 Ibid.

According to this idea, economists should use a different measure to calculate compliance costs. For example, the same Tax Foundation report used an hourly compensation cost of \$52.05, the Bureau of Labor Statistics' estimate for professional and related workers, for more complex provisions to better approximate the cost.⁷

Lobbying Costs

Some economists think that factors other than out-of-pocket and time costs should be considered when calculating the economic costs of tax compliance. For example, the Mercatus Center included spending on lobbying in their estimate of tax compliance costs.⁸ A more complex tax system creates more opportunities for lobbyists and special interests to try to influence public policy in the way a simple tax system does not. Thus, a complex system leads to money spent on lobbying rather than spent on productive economic activity.

The Tax Gap

Another factor to consider is the tax gap: the gap between the amount of taxes owed versus the amount of taxes actually collected. According to recent estimates, the U.S. has a tax-reporting compliance rate of 85.5 percent, meaning current tax revenues are 85.5 percent of what the U.S. government is owed. The IRS estimates that the average annual tax gap for the period from 2008 to 2010 was \$458 billion.⁹ A simpler tax system could reduce this gap and raise revenue.

Other Measures

UCLA economist Youssef Benzarti created a novel process to calculate tax compliance costs, which uses the idea of revealed preferences.¹⁰ For the individual income tax, taxpayers choose to either take the standard deduction or itemize their deductions. Theoretically, taxpayers should add up their itemized deductions to see if they can deduct more than the standard deduction. However, that's not always the case: many taxpayers choose to take the standard deduction even if they could deduct more if they itemized, forgoing tax savings to avoid the complexity.

Benzarti used the forgone tax savings to estimate tax compliance costs, finding they increase with income, which is consistent with the idea that higher-income taxpayers have a higher opportunity cost. He used these estimates and estimates of the time required to file other schedules to estimate the cost of filing federal income taxes, finding they have reached 1.2 percent of Gross Domestic Product in recent years.

7 Scott A. Hodge, "The Compliance Costs of IRS Regulations."

8 Jason J. Fichtner and Jacob M. Feldman, "The Hidden Costs of Tax Compliance," Mercatus Center, May 20, 2013, https://www.mercatus.org/system/files/Fichtner_TaxCompliance_v3.pdf.

9 Internal Revenue Service, "Tax Gap Estimates for Tax Years 2008-2010," <https://www.irs.gov/newsroom/the-tax-gap>.

10 Youssef Benzarti, "How Taxing Is Tax Filing? Using Revealed Preferences to Estimate Compliance Costs," NBER Working Paper No. 23903, October 2017, <http://www.nber.org/papers/w23903>.

Estimating the Compliance Cost Reductions of the TCJA

In our recent paper on the simplifications of the TCJA, we estimated the compliance savings of all the changes made to the individual income tax as well as the reforms made to the AMT.¹¹ One important note: these two estimates cannot be combined. Both are useful in illustrating the reduction in compliance burden driven by the TCJA.

All Individual Income Tax Reforms

The IRS estimated that the TCJA will reduce the average time to complete an individual income tax return by 4 to 7 percent.¹² This estimate is the net effect of *all* changes made to individual income taxes, such as the expanded standard deduction and AMT reforms (which reduce the compliance burden) and the new Section 199A deduction (which increases the compliance burden).¹³

The average time to complete a Form 1040 was 15 hours in 2017.¹⁴ If filing time is reduced by 4 to 7 percent, it will take from 13.95 to 14.4 hours to complete a Form 1040 under the new tax law, meaning the average time will be reduced by 0.6 hours to 1.05 hours per form. To convert this to an aggregate time savings, we multiplied the estimated differences in average time by 150 million, assuming that 150 million tax returns will be filed. This translates to a total estimated time savings between 90 million and 157.5 million hours.

To convert this time savings to dollars, we multiplied the hours saved by an estimate of the opportunity cost. We used \$34.17, the most recent average total employer compensation costs per hour for private industry workers.¹⁵ We estimate that all the changes to individual income taxes taken together translate to compliance cost savings of \$3.1 billion to \$5.4 billion.

Alternative Minimum Tax Reforms

We also estimated the compliance savings of AMT reforms on their own. The IRS estimates that 9 million fewer AMT forms will need to be filed under the new tax code.¹⁶ Estimates show that those who file an AMT form spend nearly double the time on their tax returns than those who do not.¹⁷

11 Erica York and Alex Muresianu, "The Tax Cuts and Jobs Act Simplified the Tax Filing Process for Millions of Households."

12 Internal Revenue Service, "Proposed Collection; Comment Request for Regulation Project 83 FR 34698," July 20, 2018, <https://www.federalregister.gov/d/2018-15627/p-49>.

13 Scott Greenberg and Nicole Kaeding, "Reforming the Pass-Through Deduction," Tax Foundation, June 21, 2018, <https://taxfoundation.org/reforming-pass-through-deduction-199a/>.

14 Internal Revenue Service, "2017 Instructions 1040," 100-101.

15 U.S. Bureau of Labor Statistics, "Employer Costs for Employee Compensation – March 2018," June 8, 2018, <https://www.bls.gov/news.release/pdf/ecec.pdf>.

16 Internal Revenue Service, "Proposed Collection; Comment Request for Regulation Project 83 FR 34698."

17 Taxpayer Advocate Service, "Repeal the Alternative Minimum Tax, 2013 Annual Report to Congress," 298, <http://www.taxpayeradvocate.irs.gov/2013-Annual-Report/downloads/Repeal-the-Alternative-Minimum-Tax.pdf>.

If 9 million fewer forms are filed, and if it takes about 15 hours more to file an AMT tax return than a regular tax return, the changes made to the AMT will save approximately 135 million hours. Again, using the assumption that an hour of compliance bears the economic cost of \$34.17, the AMT changes translate to compliance savings of \$4.6 billion.

However, given that AMT filers tend to be higher-income, it might make sense to use a higher-income taxpayer's compensation. We might use the employer cost per hour worked for full-time workers in management, professional, and related occupations as a higher-income proxy: \$62.99.¹⁸ This would change the estimated compliance savings of AMT reforms to \$8.5 billion.

Conclusion

Complying with the tax code creates real costs as taxpayers must spend valuable time keeping records and filling out forms instead of engaging in productive economic activity. There are several ways to quantify these costs, and estimates can vary widely depending on which method one uses to calculate them. These different methods are important to keep in mind when evaluating how tax policy changes might affect taxpayer burdens. Each method produces different estimates that provide unique illustrations of the cost of complying with the U.S. tax code.

¹⁸ U.S. Bureau of Labor Statistics, "Employment Cost Trends," <https://www.bls.gov/ncs/ect/>.