

# SPECIAL BRIEF

January 1995

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## The Compliance Costs and Regulatory Burden Imposed by the Federal Tax Laws *House Ways & Means Committee Testimony*

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*The following testimony was presented by Dr. Hall to the Subcommittee on Oversight of the House Ways & Means Committee on December 9, 1994.*

The cost of complying with a tax system is directly related to the complexity of the system. In terms of complexity, it is fair to say that an income tax — the core of the U.S. government's tax system — ranks among the top of the tax systems currently in operation around the world. Ironically, the term "income" itself accounts for the inherent

following the adoption the 16th Amendment to the Constitution which authorized the income tax. Indeed, the 1927 Report of the Joint Committee on Internal Revenue Taxation (Vol. 1, p. 5) states that: "It must be recognized that while a degree of simplification is possible, a simple income tax for complex business is not."

### Growth and Instability of the Income Tax Code

Despite decades of concern over its undue complexity, the income tax was formally placed at the core of the federal tax system by the Internal Revenue Act of 1954. Since then, the income tax has grown from representing about 41 percent of the entire tax code (in terms of the estimated number of words) to representing about 60 percent of the entire tax code in 1994, a 19 percentage point increase. The volume of income tax regulations has grown even more. In 1954, income tax regulations represented 55 percent of the body of tax code regulations. In 1994, that figure has grown to 83 percent, a 28 percentage point increase.

Tax law complexity is almost wholly related to tax base questions — that is, questions or uncertainty about the timing or definition of taxable transactions. The inherent complexity of an income tax results from the difficulty of defining income and determining when to recognize income and expense for tax purposes. Over time, the political process of give and take has made these difficult tax base questions inordinately

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complexity. Income, particularly business and investment income, is tricky to define, and has, therefore, always added excess complexity to our tax system.

I have discovered complaints about the complexity of the federal income tax system that date back to 1914, the year immediately

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*Table 2  
Comparison of 1954 Code and 1986 Code (as of 1994)*

Subchapter of Income Tax Code	Number of Sections in Subchapter		Percent Growth
	1954	1994	
Determination of Tax Liability	4	44	1000%
Computation of Taxable Income	9	145	1511
Corporate Distributions and Adjustments	14	35	150
Deferred Compensation	2	30	1400
Accounting Periods and Methods	6	33	450
Tax-Exempt Organizations	4	17	325
Corporations Used to Avoid Income Tax on Shareholders	4	27	575
Banking Institutions	3	20	567
Natural Resources	3	10	233
Estates, Trusts, Beneficiaries, Etc.	7	29	314
Partners and Partnerships	7	29	314
Insurance Companies	5	29	480
Regulated Investment Companies, Etc.	1	17	1600
Tax Based on Income from Within or Without the United States	9	78	767
Gain/Loss on Disposition of Property	7	42	500
Capital Gains and Losses	4	52	1200
Readjustment of Tax Between Years and Special Limitations	6	5	-17
Tax Treatment of S Corporations	0	14	NA
Other (a)	8	42	425
Total	103	698	578%

(a) Includes all subchapters not explicitly listed as well as Chapters 2-6 of Subtitle A of the Internal Revenue Code.

Source: Tax Foundation computations from Internal Revenue Code.

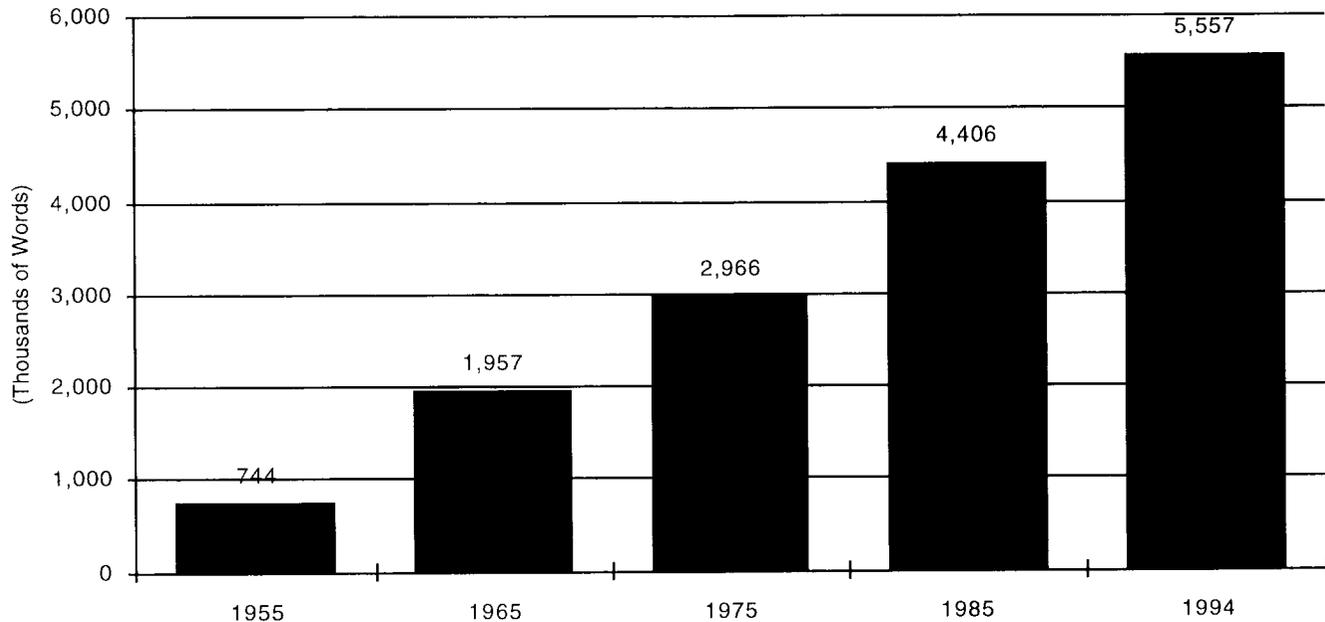
complex. The definition of taxable income has not only expanded dramatically, but it has undergone chronic change.

Table 1 reveals the dramatic growth in the income tax code over the past 40 years. In 1954, the federal income tax law comprised 103 code sections. Today, that law comprises 698 code sections, a 578 percent increase. Almost all of the growth relates to tax base questions. Note that since 1954 the number of sections dealing with the "Determination of Tax Liability" has grown 1,000 percent; the number of sections dealing with "Capital Gains and Losses," most of which detail "special rules" for calculating capital gains and losses, has grown 1,200 percent; the number of sections dealing with "Deferred Compensation" (e.g., pension plans) has grown

1,400 percent; and the number of sections dealing with the "Computation of Taxable Income" has grown more than 1,500 percent.

Perhaps a more revealing measure of the growth in tax code complexity is the growth in the number of words that comprise the income tax law and its attendant regulations. Figure 1 charts the growth in the combined number of words that define the body of both the federal income tax laws and their attendant regulations. The Tax Foundation has determined that over the past 40 years the number of words detailing the income tax laws has grown 369 percent. The words detailing income tax regulations, which provide taxpayers with the "guidance" they need to calculate their taxable income, have grown 730 percent. The combined growth is 647

Figure 1  
Growth of the Income Tax Code (Laws and Regulations)



Source: Tax Foundation.

percent.

The growth in the volume of the income tax laws and regulations has resulted piecemeal from the 31 major tax enactments and the more than 400 other public laws that have amended the Internal Revenue Code since the 1954 Act. Based on a sample of one-fifth of the core sections of the income tax code, these enactments have not only increased the volume of the code but have resulted, on average, in the amendment of each code section once every four years. As Figure 2 illustrates, this instability has been much more pronounced in the past 20 years than it was during the 20 years immediately following the 1954 Act.

### Quantifying the Overhead Cost of Tax Compliance

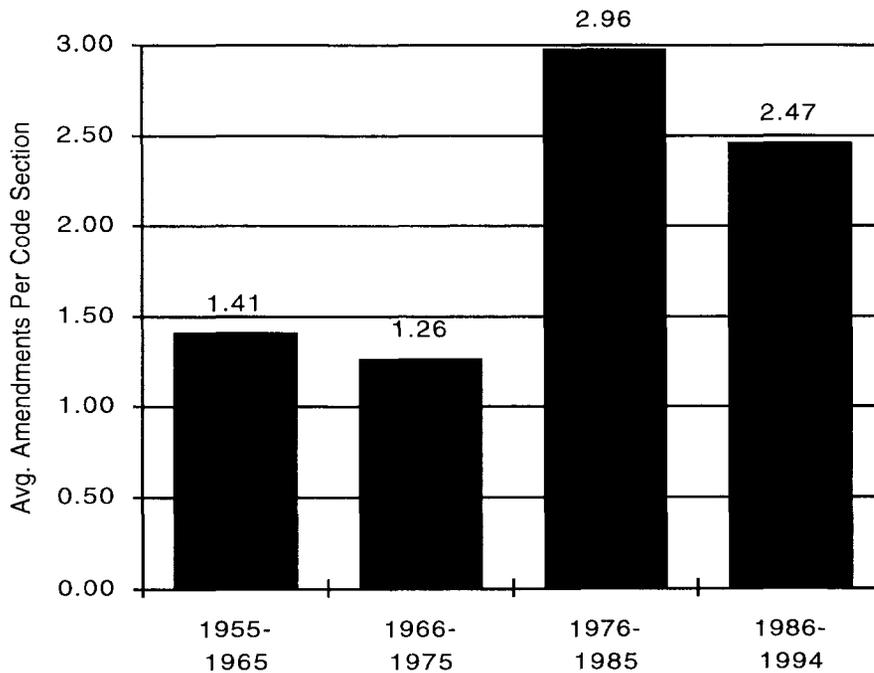
The complexity generated by the growth and constant change of the tax code creates two general types of economic costs. One is the overhead cost associated with the

economically sterile exercise of tax planning, compliance, and litigation, all of which act like a tax surcharge on taxpayers. The second cost results from the economic opportunities that are foregone because of taxpayer uncertainty.

Because of complexity and instability, despite substantial cost to fund diligent and expert research, taxpayers may not be able to obtain a reasonably certain conclusion about how taxation will affect a business plan or investment. In many businesses, research and development require longer and longer lead times. If taxpayers cannot accurately predict the tax consequences of a particular economic activity, either because of vagueness, complexity, or instability in the tax code, then tax policy is handicapping the growth and dynamism of the U.S. economy.

Veteran tax professionals commonly point to the Tax Reform Act of 1969 as the legislation that infused serious (and needless) complexity into the income tax code. But they say nothing in that Act came anywhere near the bewildering complexities that came

Figure 2  
Instability in the Federal Income Tax Code Based on Selected Code Items



Source: Tax Foundation compilation from U.S. Code Annotated (Title 26).

with the tax enactments of the 1980s.

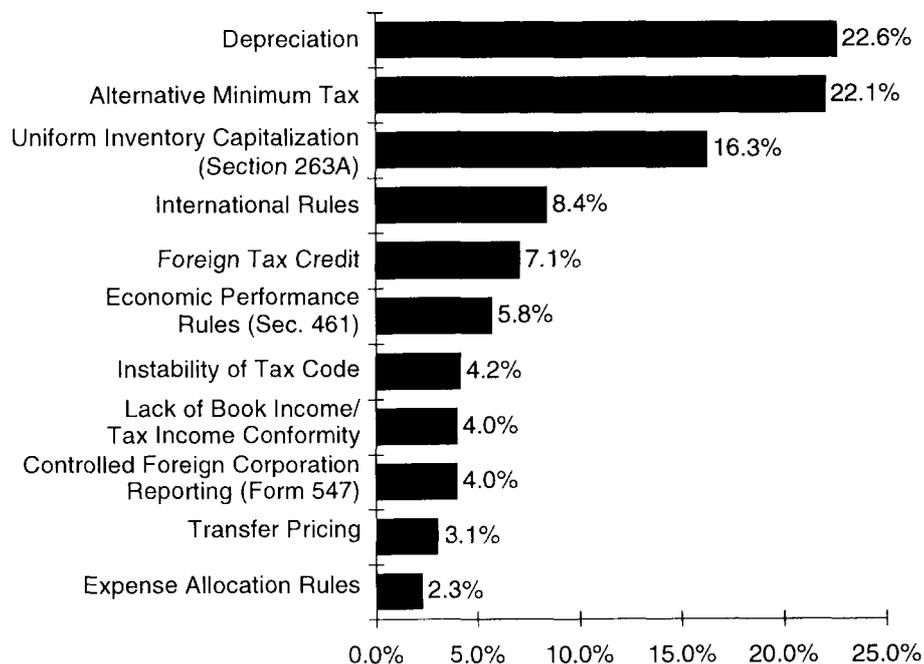
The Tax Reform Act of 1986 made a substantial contribution to the tax complexities that currently exist. This Act began as a simplification effort. But it ultimately enacted two of the most complex components of the current tax code — the corporate alternative minimum tax (AMT) and uniform inventory capitalization. The 1986 Act also further complicated the already complicated rules relating to the treatment of foreign-source income. A recent survey by the Tax Foundation shows near unanimity among senior corporate tax officers that the 1986 Act increased complexity and, therefore, the cost of compliance. (Figure 3 indicates the areas of the tax code that these tax officers consider to be the most complex.) My research indicates that, for all businesses, the 1986 Act increased the cost of compliance by about 10 percent. And I am confident that this is a conservative estimate.

In 1994, according to the Internal Revenue Service and the Office of Management and Budget, taxpayers will spend 5.1 billion hours

complying with federal tax laws. An hourly cost of \$38.70 can be derived by averaging the average labor cost of both the IRS and the accounting firm of Price-Waterhouse. Applying that hourly cost figure to 5.1 billion hours results in a total compliance cost of \$197.4 billion. Historically, about two-thirds of the compliance burden (or \$132.2 billion) is borne by the business sector.

Based on my calculations, at least 70 percent of the total cost of federal tax compliance is due to the income tax, indicating that businesses will pay an estimated \$92.5 billion in 1994 to comply with the federal income tax. That figure is up from an estimated \$81.2 billion in 1991 (70 percent of \$116 billion), the latest year for which complete income tax revenue data is available. The 1991 cost of \$81.2 billion amounted to 74 percent of the income tax revenue received from all businesses. This ratio offers solid evidence that the income tax on business, particularly the corporate income tax, is a grossly inefficient revenue system for the federal government.

Figure 3  
Where the Tax Code is Most Complex (percent of total survey mentions)



Note: 315 of 365 survey respondents answered this question. Many respondents listed more than one aspect. Only the responses receiving at least 10 mentions were included.

Source: Tax Foundation.

To date, the Tax Foundation has focused its detailed research on the cost to corporations of complying with the federal income tax. The total cost of compliance differs widely across companies of different size. Based on a 1992 survey of large corporations sponsored by the Tax Foundation, the 1994 cost of complying with the federal corporate income tax for the average Fortune 500 firm will amount to an estimated \$1.54 million (or \$770 million for the entire Fortune 500). For the average small corporation, those with \$1 million or less in assets, the minimum cost will amount to an estimated \$7,387. But simple averages are quite misleading.

A common research finding clearly demonstrated in Table 2 is that economies of scale exist in tax compliance. That is, relative to asset size, small corporations bear a compliance cost burden at least 24.6 times greater (and, on average, perhaps as much as 177 times greater) than the largest U.S. corporations, those with \$10 billion or more in assets. What makes this huge differential

more amazing from a public policy standpoint is that only 0.16 percent (5,933, in 1991) of all U.S. corporations paid about three-quarters of all corporate income taxes in 1991.

More than 90 percent of all U.S. corporations have assets of \$1 million or less and, therefore, bear tremendous relative compliance burdens. In 1991, as a group, these small corporations had to pay at a minimum \$382 in compliance costs for every \$100 they paid in income tax. They bore about \$14 billion in compliance costs for \$3.7 billion in income taxes. (That represents about 4 percent of corporate income taxes paid and about 90 percent of the minimum measure of the corporate income tax compliance cost.)

Clearly, that is a poor cost-benefit ratio from a public policy viewpoint. In fact, a reasonable cost-benefit ratio applies only to corporations with \$250 million or more in assets, the minute fraction that pays three-quarters of the income taxes. These big corporations pay about \$3 in compliance costs for each \$100 of income tax liability. This 3

*Table 2*  
*Estimated Cost of Corporate Income Tax Compliance by Amount of Company's Asset Size*

Asset Size/1 (\$Thousands)	Compliance Cost as % of Assets	Estimated Compliance Cost
\$1,000	0.74%	\$7,400
\$25,000	0.40%	\$100,000
\$50,000	0.40%	\$200,000
\$100,000	0.40%	\$400,000
\$250,000	0.14%	\$350,000
\$500,000	0.10%	\$500,000
\$1,000,000	0.09%	\$900,000
\$2,000,000	0.08%	\$1,600,000
\$3,000,000	0.08%	\$2,400,000
\$4,000,000	0.04%	\$1,600,000
\$5,000,000	0.04%	\$2,000,000
\$7,500,000	0.05%	\$3,750,000
\$10,000,000	0.03%	\$3,000,000

1. Excludes financial and life insurance firms.

Source: Tax Foundation.

percent ratio is comparable to what research has found in the United Kingdom and Australia.

In 1991, if a cost-benefit rule had existed to hold compliance costs to 3 percent of income taxes paid, corporations could have saved at least \$42 billion on their income tax compliance costs; businesses overall could have saved about \$78 billion.

Generally speaking, the income tax provisions that generate the highest compliance costs fall into two categories: (1) capital cost recovery, that is, the rules for depreciation, and (2) the rules on foreign-source income.

For example, all else being equal, the depreciation calculations required to comply with the notorious corporate AMT increases the cost of compliance by at least 17 percent. For the Fortune 500, the foreign-source income rules alone account for 45.5 percent of the total federal income tax compliance cost, or about \$700,000 per company.

Furthermore, the taxation of foreign-source income fails my 3-percent cost-benefit

test for all companies. Of the companies subject to the foreign-source income rules, 82 percent had under \$250 million in assets. As a group, these companies had a compliance cost-to-tax revenue ratio of 110 percent. The large companies that paid almost all of the tax had a ratio of 9 percent. Indeed, the taxation of foreign-source income may even be a revenue loser to the government, since the high compliance costs are deductible and the revenue so small (\$5.3 billion in 1991). I suspect that what is true about complying with foreign-source income rules is also true about the corporate AMT, but I do not yet have the data prove it.

### Measures to Reduce the Cost of Compliance

What can be done to reverse the current situation? To reduce tax compliance costs, lawmakers and regulators must focus on the causes of tax complexity. One set of causes is economic and the other set is political.

As I have already explained, the economic

causes of complexity are inherent in an income tax itself. The tax base questions: What is income? and when is it income? are difficult to answer. The inherent difficulty of these questions explains why, for example, the rules of depreciation and the rules of transfer pricing associated with foreign-source income create such apparent tax code complexity.

However, the political process, particularly the politics surrounding the past

forward manner would face clear and powerful opposition.

Naturally, when the individuals or businesses that will be affected by the tax changes get wind of the proposals, they lobby to change or alter the proposal, or to shift the tax burden altogether. These activities may further contort the tax proposals.

When the final provisions are passed into law, the regulating agencies must devise ways to administer them. When the regulations are drawn up so as to be comprehensive — that is, when they attempt to cover every contingency while attempting to assure a zero possibility that a taxpayer can avoid taxation — the result is complex regulation superimposed on complex (or vague) legislation.

The net result of this process over time, is that few, if any, of the tax writers — the “artificial” experts — understand the mechanics of the entire tax code. The tax writing specialists become comfortable in dealing only with their own narrow specialty. Tax specialists begin writing detailed rules with other tax specialists in mind. This narrow focus explains why, on occasion, there are complete inconsistencies in the Internal Revenue Code. No one person is capable of grasping the entire body of law. In this way, complexity seems to beget further complexity.

If the high cost of complying with the federal income tax were a necessary price to pay for a fair and effective tax system, perhaps there would be little room for complaint. But

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decade of the federal government's budget deficits, has made an inherently complex tax system worse. To a vast degree, the complexity of the current tax code is a by-product of the era of chronic federal budget deficits. The drive to balance the budget placed a policy emphasis on increasing government revenue, rather than on refining and promulgating consistent definitional answers about income. In this sense, tax policy has become tactical rather than strategic. Tax policy has no unifying theme. Instead, the budgetary aspects of dealing with the tax system are generally controlling the policy process.

The budgetary dynamic has combined with the issue of tax fairness and the normal course of lobbying to accelerate the trend of “created complexity” and the artificial expertise that necessarily accompanies it. And this artificial expertise creates its own problems with regard to tax code complexity.

The interplay of these forces works something like this: Under budgetary rules, nothing can be done unless it is paid for. To date, however, cutting spending has rarely been a realistic political option, so inventive ways are found to raise revenue. Often, such revenue-raising exercises amount to broadening the tax base in some ad hoc or indirect way — like the AMT — since raising rates or removing tax preferences in a straight-

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the complexity, and its costs, *is* unnecessary.

Short of overhauling the entire federal tax system, Congress can work to reduce the complexity of the current tax system (and, therefore, its high compliance costs) through two courses of action. First, Congress should strive to achieve a much larger measure of tax code stability. The taxpayer uncertainty that results from frequent tax law changes is a key source of complexity. Second, tax writers and

regulators should place a larger emphasis on tax simplicity. There exists an inherent trade-off between completeness and simplicity. In their steady pursuit of tax revenue and tax “fairness,” tax writers and regulators have emphasized completeness by trying to shut off all avenues of tax avoidance without regard to the incremental costs or unintended consequences of such an approach to governance.

However, such incremental measures tend to exacerbate many of the inherent complexities of the income tax. One way to reduce tax code complexity and its attendant costs is to overhaul the entire federal tax system completely. Reform proposals are currently on the table that attempt to put a strategy back into tax policy, namely, simplicity and economic growth. These include the Business Activities Tax proposed by retiring Senators John Danforth and David Boren, the Saving-Exempt Income Tax sponsored by Senators Sam Nunn and Pete Domenici, and the flat tax proposal sponsored by Rep. Dick Armey.

In general, each of these plans seeks to reform the tax system by moving to cashflow as the tax base, rather than accrued income. A cashflow tax, as it applies to business, totals business receipts and then subtracts off purchases from other businesses. On the individual level, the approach resembles a universal IRA. It eliminates the double tax on saving and eliminates any tax consequences of shuffling the composition of a savings portfolio.

## Conclusion

Misguided political tampering can ruin the integrity of any system. But aside from the potential for substantial simplification, the benefits of the approach pursued by the stated reform plans are that they both satisfy the current political demand for tax revenue and they promote economic growth. These plans stop punishing saving and investment and eliminate the biggest part of complexity: dealing with the timing of income and expenses. A business cashflow-type tax also eliminates any need for the complexities associated with foreign-source income rules, inventory capitalization, amortization of intangibles, depletion allowances, and long-term contracting.

Not surprisingly, the approach suggested by these plans is not a new idea. For example, in 1921, a CPA named Chester Jordan from the state of Maine testified before Congress that he could reduce his staff by one-half if the federal

government would replace the income tax with a tax on cashflow (or “spendings,” as he identified it). Congress never heeded Jordan’s suggestion, so he went back to Maine and built a thriving accounting business by merging with Price-Waterhouse.

As this example suggests, tax code complexity certainly offers lucrative opportunities for many people — in both the private and public sector — but it is highly unproductive in the larger economic sense.

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*The Tax Foundation, a nonprofit, nonpartisan research and public education organization, has been monitoring tax and fiscal activities at all levels of government since 1937.*

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