TAX FOUNDATION

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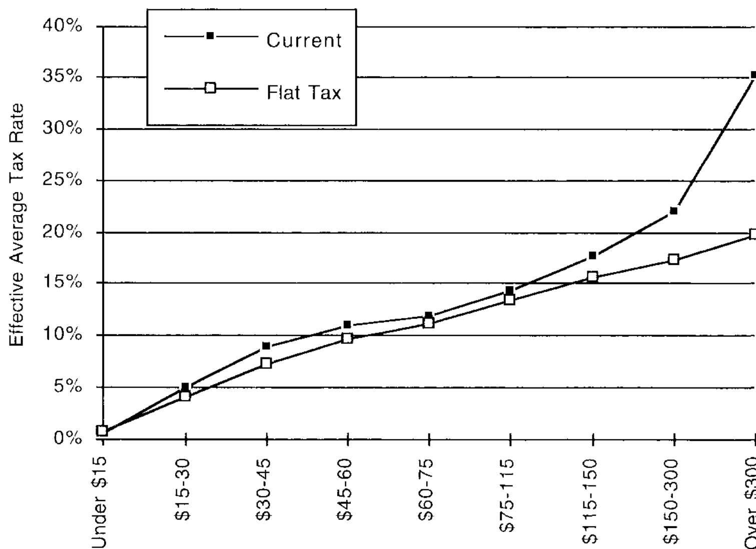
Armey Flat Tax Proposal Would Reduce Average Taxpayer Federal Tax Burden by $1,000

A Tax Foundation analysis of Rep. Dick Armey's (R-Texas) flat tax plan—which Republican leaders hope to include in the 1996 GOP platform—shows that his proposed 17 percent across-the-board rate would reduce the average American taxpayer's federal tax burden by $1,000 a year (see *Chart 3*, page 3). In addition, the effective average tax rate that individuals pay on income taxes would fall for virtually all income groups (see *Chart 1*).

Chart 1: Flat Tax (17%Rate) vs. Current System



Note: Analysis includes an equal capital/labor split on absorbing the business tax.
Source: Tax Foundation.

While most of the other recent tax relief proposals make modest adjustments within the current tax system (see related story, page 2), Rep. Armey's plan would replace the current individual and corporate income tax with a flat tax to simplify the federal tax code, reduce the tax burden on all Americans, and promote economic growth. To pay for the reduction in revenues generated by his plan, the congressman also calls for major reductions in government spending and strict budget rules to guarantee that these cuts occur.

Not only would the flat tax replace the current system of graduated tax rates with a single tax rate, says Tax Foundation Senior Economist Arthur P. Hall, II, it would eliminate the long-time bias in the current tax code against saving and investment.

In his analysis of the Armey plan, Dr. Hall takes into account the phase-in

Flat Tax *continued on page 3*

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Let's Change the Federal Estate and Gift Tax Laws—and Help the Economy

Rep. Bill Brewster (D-Oklahoma)

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Background Papers Examine U.S. International Tax Policy and Transfer Pricing Penalty

Two recent *Background Papers* by the Tax Foundation offer an overview and examination of controversial areas of U.S. tax policy.

In the first publication, Dr. J.D. Foster, Executive Director and Chief Economist at the Tax Foundation, discusses the tax treatment of foreign-source income in this country and the consequences for foreign investment. In *Background Paper* No. 12, titled "United States International Tax Policy: Tax Neutrality or Investment Protectionism?", Dr. Foster provides an overview of current international tax policy, and discusses the role that tax neutrality plays in international taxation. In this discussion he examines two competing theories of tax neutrality:

- "Territoriality," which seeks to prevent domestic tax considerations from diminishing or improving the competitiveness of any domestic taxpayer's foreign investments; and
- "Capital export neutrality," which seeks a domestic tax policy that eliminates tax considerations for investors choosing between domestic and foreign investment opportunities.

In the second publication, "Does the Transfer Pricing Penalty Violate the Fourth Amendment to the Constitution?" (*Background Paper* No. 13), Tax Foundation Special Tax Counsel J. Dwight Evans explores the U.S. Treasury Department's new temporary regulations relating to Section 482 of the Code. As part of these transfer pricing regulations, the Treasury has implemented a new regime of tax penalties on taxpayers who substantially understate taxable income as a result of misvaluation of the intercompany transfer prices used in their tax return. The penalties are accompanied by regulations requiring the creation and maintenance of supporting documents, which must be made available to the IRS upon request. This, says Mr. Evans, raises the question of whether these rules violate Fourth Amendment protections against unreasonable searches and seizures.

His study discusses the extent to which this may be a legitimate constitutional violation, using legal precedents to determine whether this could be considered a governmental search and, if so, could the governmental search be deemed reasonable? Mr. Evans' conclusion: the document production requirements of the transfer pricing penalty as they presently stand are vulnerable to the contention that they violate the Fourth Amendment's prohibition against an unreasonable search.

But with these rules currently in temporary form, the IRS can overcome such objections fairly easily, says Mr. Evans. The best way would be through the issuance of an administrative summons in connection with an IRS request for transfer pricing documents. •

With New Congress, Tax Proposals Pour Out of Nation's Capital

The political winds of change in Washington have blown a number of tax proposals to the fore of the fiscal policy debate. At least four tax relief proposals have been or will be debated in the U.S. Congress this year.

Following are the key aspects of these plans:

Clinton Administration Plan

- A $500 tax credit per child for families with children under 13.
- A new tax deduction of up to $10,000 a year for higher education tuition (for families with incomes below $120,000 a year).
- An increase in the deduction ceiling for deductible IRA contributions from $50,000 to $100,000 for couples, and from $30,000 to $70,000 for individuals.
- A new type of IRA for which contributions would not be deductible, but withdrawals of money after five years would be tax-free.
- Penalty-free IRA withdrawals to pay for education, major medical expenses, first-time home purchases, care of an ailing parent, and long-term unemployment.

House Republican Plan (as presented in "Contract With America" legislation)

- A $500 tax credit per child for families earning under $200,000 with children under 18.
- Elimination of the "marriage penalty," raising the personal credit for married couples to equal the personal credit for non-married individuals.
- A new type of IRA (to be called American Dream Savings-ADS-Accounts) to allow $2,000 contributions.
- Penalty-free withdrawals from ADS Accounts to pay for first-time home purchases, higher education, and medical expenses.
- A 50 percent exclusion of net capital gain from gross income for any taxable year.
- Indexing to inflation of the capital gains of assets held longer than one year.
- Phase-out of increased tax on Social Security earnings, reducing taxable amount from 85 percent to 50 percent of earnings by year 2000.

House Democratic Plan (as presented by Rep. Richard Gephardt (D-Mo.) in December)

- An income-based tax credit for families with earnings up to $75,000 a year.

Senator Phil Gramm's (R-Texas) Plan

- Double the dependent exemption for all children from $2,500 to $5,000 for families with a combined income of less than $132,000. •

Flat Tax

Continued from page 1

period for the flat tax. For the first three years, to mitigate revenue loss, Rep. Armey would set the tax rate at 20 percent. Using the economic assumptions used by the Office of Management and Budget, a 20 percent flat tax implemented in 1995 would raise an estimated $708 billion dollars for the federal government, says Dr. Hall. That is about $39 billion less than OMB's projection of $747.1 billion for the individual and corporate income tax combined.

Charts 1, 2, and *3* present Dr. Hall's estimates of the tax burden differences in 1998 between the fully-phased-in 17 percent flat tax and the current individual and corporate income tax system. *Charts 1* and *2* compare, by income group, the effective average tax rates of each tax system. The average rate was calculated by estimating the tax burden on individuals under each system and dividing by personal income.

As *Chart 1* reveals, the flat tax essentially mirrors the progressive tax distribution of the current income tax system. The difference is that, under the flat tax, virtually all taxpayers receive a reduction in their tax burden—from a current average burden of $6,759 to an average burden under the flat tax of $5,651 (see *Chart 3*).

Taxpayers whose income is below $15,000 annually would face a lower personal income tax burden. However, this would be more than offset by higher tax payments made by businesses—which Dr. Hall partially allocates to employees.

All else being equal, a reduced tax burden indicates less revenue generated for the federal government. If we assume that the flat tax were put in place in 1995 and promoted no change from the current economic growth projections, the 17 percent flat tax would generate an estimated $714 billion in tax revenue ($126 billion less than a 20 percent rate). The current income tax is projected to generate $867.6 billion, a difference of $153.5 billion from the 17 percent flat tax. Thus, the 17 percent flat tax would require cutting $153.5 billion from a $1.8 trillion dollar federal budget, a spending reduction of nine percent.

However, if the flat tax produces more economic growth than the current income tax, it would generate more tax revenue. An addition of one-tenth of a percentage point annually to the economic growth rate would generate flat tax revenue of an estimated $717 billion in 1998; a one-half percentage point increase in the growth rate would generate $725 billion; a one percentage point addition to the growth rate would generate $735.5 billion; and a two percentage point increase would generate $756 billion.

The Armey flat tax proposal is one of two comprehensive flat tax proposals currently under consideration in Washington. The other proposal is being developed by Senators Pete Domenici (R-N.M.) and San Nunn (D-Ga.) and is expected to be introduced early in the new year. The Armey flat tax and the Domenici-Nunn proposal are expected by many to give a huge push to the tax reform debate centered around the concept of shifting tax from saving to consumption. ●

Chart 2: Comparison of Avg. Effective Tax Rates in 1998 Current Income Tax vs. 17% Flat Tax

	Effective Avg. Rate	
Income Group	Current	Flat
Under $15,000	0.5%	0.6%
$15,000-30,000	5.1	4.0
$30,000-45,000	9.0	7.2
$45,000-60,000	10.9	9.6
$60,000-75,000	11.9	11.2
$75,000-115,000	14.4	13.5
$115,000-150,000	17.8	15.6
$150,000-300,000	22.1	17.4
Over $300,000	35.3	19.8

Note: Current estimates include individual and corporate income tax.

Source: Tax Foundation

Chart 3: Comparison of Avg. Tax Burden Per Taxpayer in 1998 Current Income Tax vs. 17% Flat Tax

	Average Burden	
Income Group	Current	Flat
under $15,000	$173.47	$204.45
$15,000-$30,000	1,856.95	1,560.02
$30,000-$45,000	4,400.65	3,727.93
$45,000-$60,000	6,867.27	6,382.99
$60,000-$75,000	9,205.35	9,145.01
$75,000-$115,000	14,235.34	14,041.55
$115,000-$150,000	23,903.68	22,142.02
$150,000-$300,000	43,698.60	36,374.41
$300,000 or more	264,226.33	156,330.81
U.S. Average	$6,759.30	$5,651.15

Source: Tax Foundation.

Let's Change the Federal Estate and Gift Tax Laws—and Help the Economy

Rep. Bill Brewster
(D-Okla.)

We need to do our best to assure that irrational tax laws do not create drags on job creation and job retention for workers all across the country. Experience shows us that we cannot rely solely on large corporations to create new jobs in this country.

The American family business faces many threats, but among the most serious must include the federal estate and gift tax. Currently, the federal estate tax has a maximum rate of 55 percent. This is substantially higher than the maximum income tax rate which is set at 36 percent, or 39.6 percent if you include the surtax on incomes over $250,000. Of course, this 55 percent does not apply to income generated by business property. It applies to the value of the property itself. A recent Tax Foundation study concluded that an estate tax rate of 55 percent has the same disincentive effect on entrepreneurs as a maximum income tax rate of 70 percent. Congress long ago determined that a 70 percent income tax rate is unreasonable. I doubt that anyone would seriously argue the contrary today.

When you think about it, an estate tax at 55 percent requires a family to enter into a "leveraged buyout" of the government's newly created 55 percent interest in the family's business or farm, just at the worst possible time—the death of a major owner-participant.

What happens all too often is that the family simply cannot borrow enough money to pay off the government and the business cannot borrow enough money to redeem enough of the decedent's interest to allow the estate to pay the tax. The family is forced to sell the business, often to a large agribusiness or another corporation that has few ties to the community.

Contrast this with what happens when a major shareholder in a publicly traded corporation dies. The estate can easily sell enough stock to pay the estate tax because there is a market for the stock. The corporation may have different owners, but the corporation continues as before—without being crippled with extraordinary new debt.

However, this threat to the continued existence of family businesses is not merely an isolated hardship to some unfortunate families. I am convinced that this "accordion" effect which shrinks family-owned businesses every time a family member dies is not only a significant factor in the concentration of agribusiness and reduction in the number of family farms, but also a major disincentive to economic growth in this country.

Family-owned businesses generate about 60 percent of our gross domestic product. During the 1980s, family-owned businesses accounted for an increase of more than 20 million private sector jobs. We need to do our best to assure that irrational tax laws do not create drags on job creation and job retention for workers all across the country. Experience shows us that we cannot rely solely on large corporations to create new jobs in this country. We need family businesses to grow and prosper if we want to employ Americans.

My colleague, Rep. Jim McCrery (R-La.), and I introduced legislation in the previous Congress that we will introduce in 1995 to safeguard and encourage family businesses in several ways. First, it will reduce the estate tax rate when at least half the value of the estate is in a family-owned business. If the heirs continue to be active in the business, the maximum rate on the family business interest will be 15 percent. If the heirs are not active in

FRONT & CENTER

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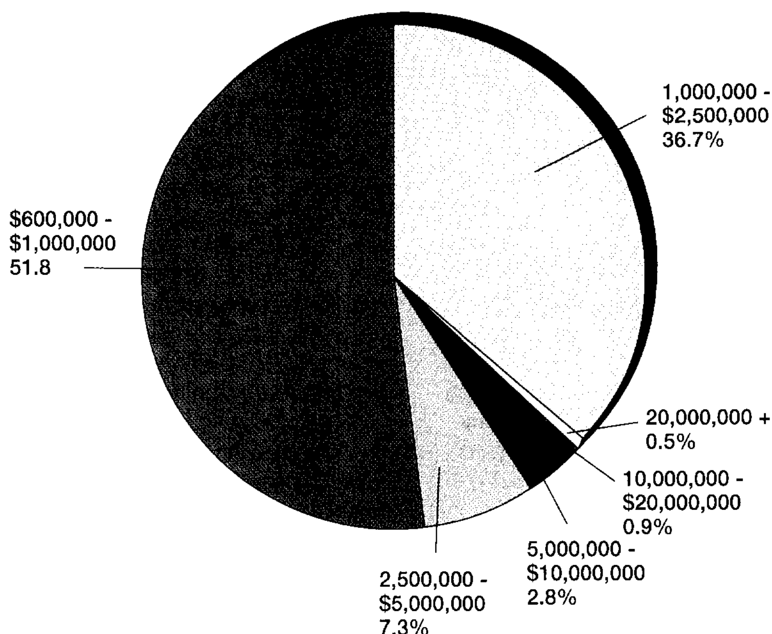
the business, but keep it in the family, the tax rate will be 20 percent. However, if the heirs do not keep the business for at least 10 years, then the estate tax "saving" will be recaptured.

This should be a strong incentive for successful entrepreneurs to keep working and creating jobs, rather than selling out to others. It won't lock in heirs who do not have the interest or aptitude for the business, but it will allow family members who desire to keep the business in the family to do so.

Second, the legislation will provide an alternative valuation date of 40 months after the death of the decedent for family-business property. This will go a long way to resolving estate valuation disputes where the value of the business is closely tied to the skills of the decedent.

Distribution of Estate Tax Returns by Size (1989 Estates)



Source: Tax Foundation.

Third, the legislation will index the so-called "unified estate and gift tax credit" for inflation so that inflation will not continue to erode the amount of the estate that is exempted from the estate tax. The unified credit, which effectively exempts from tax estates valued at less than $600,000, was last increased in 1981. It should have been increased for inflation since then. The least we can do is make certain that no further erosion takes place.

Finally, the bill will allow hard-working individuals to give up to 15 percent of their earned income each year to family members without being subject to a gift tax. This will not apply to investment income and, unlike gifts to charity, there will be no income tax deduction. However, if an individual wants to make a gift to a member of his family in a year when he has earned some money, the tax laws should not discourage it.

Most businesses in America today, no matter how large, were at one point in their history a family business. A family business is one of the most fundamental vehicles individuals have to try to use their talents to improve their economic lot. It would be very difficult to have a society full of opportunity without family businesses. And yet, the gift and estate tax is a serious threat to every successful family business. This threat must be curbed to insure a healthy economy. •

The views expressed in Front & Center are not necessarily those of the Tax Foundation.

VIEWPOINT

The Fiscal and Saving Crisis and the Role of Entitlements

Excerpts from a paper written for the Bipartisan Commission on Entitlements and Tax Reform and presented at the Tax Foundation's annual conference in November 1994.

Generational accounting is neoclassical economics' prescription for how we should assess the sustainability and intergenerational stance of fiscal policy. Generational accounting starts with the basic point that either current or future generations will have to pay the government's bills. The government's bills refers here to the present value of the government's projected future purchases of goods and services plus its official net financial liabilities. If one subtracts from the estimated value of the government's bills the present value of projected future net tax payments of current generations under current policy, one arrives at the net tax burden to be foisted on future generations as implied by current policy.

Generational accounting's methodology is quite similar to that employed by the Social Security trustees in formulating their annual assessment of Social Security's long-term finances. Like the *Trustee's Report*, generational accounting incorporates fiscal, demographic, and growth projections. But unlike the *Trustee's Report*, which considers only Social Security taxes, transfers, and net financial liabilities, generational accounting provides a comprehensive analysis of our fiscal well-being. It considers all taxes, transfers, net financial liabilities, as well as all government spending at all levels of government (federal, state, and local).

A convenient way to summarize the findings of generational accounting is in terms of lifetime net tax rates. A generation's lifetime net rate is defined as the ratio of its lifetime net tax payment to its lifetime labor earnings, both of which are measured as present values discounted to the year the generation is born. Lifetime net tax rates have increased from 24 percent for the generation born at the turn of the century to 36 percent for children who have just been born. In other words, over the course of this century the net taxation of successive generations has risen by over 50 percent. The net tax rate of future generations is a colossal 82 percent!

The difference between the 82 percent tax rate of future generations and the 36 percent net tax rate of current newborn generations tells us two things. It tells us that current fiscal policy is not sustainable, and it tells us that we can't leave such a large bill to future generations even if we wanted to. A net tax of 82 percent would simply be uncollectible. The message is that current generations will have to pay more. The only question is which current generations will pay more.

This fiscal crisis reflects a number of factors, including the demographic transition, the size of the official debt, and the scale of pay-as-you-go social security (OASDI). Eliminate any of these factors, and the generational imbalance in fiscal policy would be greatly reduced. Of course, we can't change the demographic transition or the size of official government debt. And social security is viewed by politicians as "the third rail."

There is, however, one policy that we could change, which would make an enormous difference to our fiscal problems and that doesn't involve raising taxes or cutting anyone's real benefits. The policy is simply eliminating continued excessive growth in government health care spending. The most recent annual data shows Medicare and Medicaid spending growing almost three times faster than the overall economy! Stabilizing growth in health care spending starting in 1994 at the growth rate warranted by demographic change and productivity growth eliminates most of the gap in the treatment of newborn and future generations. The lifetime net tax rate of future generations falls from 82 percent to 46 percent, while that of newborns rises from 36 percent to 40 percent.

If government health care spending cannot be contained, other very painful fiscal adjustments will be required to eliminate the imbalance in the fiscal treatment of current and future generations. The longer we wait to make these adjustments, the more painful they will be.

Laurence J. Kotlikoff
Professor of Economics
Boston University

One option is raising federal and state income taxes. If income taxes are raised permanently in 1994, they would have to rise by 32 percent to achieve generational balance. If they aren't raised until, say, 2009 (the year the oldest baby boomers reach age 63), they'd have to rise by 63 percent. Another option is increasing all federal, state, and local sales and excise taxes permanently by either 61 percent, starting in 1994, or 132 percent starting in 2009. Yet another option is permanently cutting Social Security OASDI benefits. The requisite cut, even starting in 1994, is 70 percent!

If and when Congress starts using generational accounting to steer our fiscal course, its goal should be to enact policies that immediately stabilize the lifetime net tax rates facing America's children. As a matter of generational ethics, Congress should not encumber our children with ever higher tax rates. And as a matter of economics, Congress should understand that there is an upper limit, which is well below 100 percent, at which it can hope to tax our children, and that we are getting dangerously close to that limit.

The Entitlement Commission can speed Congress' adoption of generational accounting by recommending, in its final report, generational accountings' systematic use by all Congressional and Administration fiscal agencies. This commission speaks not just for today's children, but for legions of Americans yet to be born. •

Horner Addresses Foundation Seminar

Fran Horner, detailed from the U.S. Treasury to the Organization for Economic Cooperation and Development (OECD) Secretariat, spoke December 15 at a Tax Foundation Capitol Tax Seminar to a select group of U.S. Senate tax staff about the OECD and its role in the making of international tax policy. Ms. Horner is in charge of the OECD Task Force on Transfer Pricing.

The Tax Foundation Capitol Tax Seminars are held periodically in meeting rooms in the U.S. Capitol for the benefit of the staff of the congressional tax writing committees and the Joint Tax Committee. The seminars allow staff to hear from experts in particular fields of tax policy in an informal setting and allow for an open discussion of the issues.

Ms. Horner indicated that the OECD Transfer Pricing Task Force is charged with updating the 1979 transfer pricing report. The centerpiece of the 1979 report, according to Ms. Horner, was the adoption of the arms-length pricing standard. The current effort appears likely to reaffirm support for the arms-length standard, but may also endorse a profit-split method as a proxy to the arms-length result. The profit-split method is, in a sense, a case-by-case formulaic method for allocating income and expense.

When asked about a move to worldwide formulary apportionment, Ms. Horner indicated that there was virtually no support within the OECD for such an approach, and that it would be impractical to implement such an approach in isolation.

She recognized that much of the interest in a worldwide formulary approach is generated by a concern that multinational taxpayers are able to avoid tax through the complexity of administering the arms-length standard. Ms. Horner pointed out, however, that the worldwide formulary approach may offer little remedy to such a problem given the creativity of the world's international tax lawyers and the ease with which factors of production can be shifted to take advantage of individual countrys' formulas. •

FOUNDATION MESSAGE

Change Comes to Congress

In Washington, D.C., the year gone by was marked by enormous energies spent in educating policymakers and the public on a number of issues, but above all, on health care. By the end of the year, of course, only the NAFTA and GATT trade agreements were acted on. This extraordinary ratio of energy-to-accomplishment might appear to some to symbolize what is wrong with Washington. On the other hand, would it not be fortunate if all legislation were so thoroughly considered prior to adoption?

At the start, 1995 promises an entirely different outcome. The new Republican leadership in Congress is very serious about making significant changes to how government runs, beginning with its own operations and working on down through the "Contract with America" to constitutional amendments to require balanced budgets, line-item veto authority, and middle-class tax cuts.

Few measures have been so thoroughly debated as a balanced budget amendment. No one knows whether a balanced budget amendment will work as intended. Some say it is a gimmick; some say it will be calamitous.

J.D. Foster
Executive Director and Chief Economist

What we do know is that some budget process reforms have worked to an extent, while others have failed. (As food for thought, here is an alternative method: pick the year by which the budget must be balanced; pick a pattern of declining deficits that achieves that result; then establish in law that the president and vice president, all executive branch employees subject to Senate approval, all Supreme Court Justices, and all Members of Congress and their staffs will forego wages and salary in any period that the deficit is projected to exceed the amounts specified in law.)

Middle-class tax cuts are sure to receive early attention in the new Congress. Thanks to Republican zeal to cut spending, backed by fairly tight budget rules against increasing the deficit, it is probably safe to assume for now that the tax cuts will be paid for in full (and without merely shifting taxes onto business). This will require watching, however, because the ability of the spending cutters to match results with their intentions is unproven, while the tendency of the Congress to fall into a tax cut frenzy must not be overlooked.

Suppose that the tax cuts have been paid for and enacted by April 15. What then on the tax front? Clearly, welfare reform, health care reform, and Superfund reauthorization are still with us from last year, each requiring attention. Also important are efforts at longer-term tax reform. Rep. Armey's flat tax plan is certain to get a fair hearing in both the House and the Senate this year. Meanwhile, Sens. Domenici (R-N.M.) and Nunn (D-Ga.) are expected to introduce their proposal for comprehensive tax reform in the first months of the year. While important differences exist between these proposals, they are sufficiently similar to suggest a serious trend towards greater federal taxation of consumption, rather than saving.

Tax reform requires presidential involvement, and that usually requires the focusing power of presidential elections. Thus, it would be very surprising if comprehensive tax reform legislation were enacted this year or next. However, such a sea-change in federal tax policy should be preceded by extensive debate, much as health care reform has benefited from such a debate. We can only hope that democracy will once again work its magic conjuring up satisfactory results in both cases.

Hall Testifies on Cost of Compliance Before Ways and Means Committee

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Tax Counsel
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Editor and Communications Director
Stephen Gold

Tax Foundation
(202) 783-2760 Tel
(202) 942-7675 Fax

At a December 9 subcommittee hearing in Elmira, N.Y., Tax Foundation Senior Economist Arthur P. Hall, II, provided evidence for the growing complexity of the federal tax code.

Dr. Hall noted that federal income tax compliance costs were probably directly related to the growing complexity of the tax system. Since the 1954 Internal Revenue Act, the income tax has grown substantially in many areas (see box, this page). This growth has not only increased the volume of the code but has resulted, on average, in the amendment of each code section once every four years.

"Because of complexity and instability," Dr. Hall stated, "taxpayers cannot be certain about how taxation will affect a business plan or investment. 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."

Dr. Hall noted that, based on his 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. And 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.

He noted that 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.

Since 1954 . . .

- . . . there have been 31 major tax enactments and 400 other public laws amending the Internal Revenue Code.
- . . . the number of words in the federal income tax code has grown 369 percent.
- . . . the income tax has grown from representing 41 percent of the entire tax code (in terms of number of words) to representing 60 percent of the code.
- . . . the number of sections in the federal income tax code has jumped from 103 to 698.
- . . . the number of sections dealing with "Determination of Tax Liability" has grown 1,000 percent.

"Clearly, that is a poor cost-benefit ratio from a public policy viewpoint," he told committee members. "In fact, a reasonable cost-benefit ratio applies only to corporations with $250 million or more in assets. These big corporations pay about $3 in compliance costs for each $100 of income tax liability."

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.

Dr. Hall conclude that, to reduce tax compliance costs, lawmakers and regulators must work to reduce the complexity of the current tax system through stability and simplicity. •

Tax Foundation
1250 H Street, NW
Suite 750
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