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SPECIAL REPORT

The Cost of Complying with the Federal Income Tax

*Individuals Will Spend \$86.1 Billion, Businesses \$102.5 Billion to File
Income Tax Returns*

J. Scott Moody
Senior Economist
Tax Foundation

Introduction

Many Americans think of their income tax burden simply as the amount at the bottom line of their 1040 forms. Economists, on the other hand, may express Americans' tax burden as a percentage of GDP or even as a date on the calendar, such as Tax Freedom Day®. But such measures fail to register another cost to taxpayers: the cost of complying with the

hours complying with the federal income tax code, with an estimated compliance cost of over \$194 billion. This amounts to imposing a 20.4-cent tax compliance surcharge for every dollar the income tax system collects.

While there is no question that this cost will be increasing in future years, there is room for debate on the rate of increase. Based on an estimate on data from 1995 through 1997, one could conclude that by 2007, the cost of compliance will reach \$244.3 billion (see Figure 1 and Table 1). However, compliance cost has grown faster since the Tax Relief Act of 1997 (TRA'97). If that new growth rate were projected into the future, the cost of compliance would reach \$267 billion in 2007.

The recently enacted Economic Growth and Tax Reform Reconciliation Act of 2001 (EGTRRA) changed the tax code even more dramatically than TRA'97. A speculative but reasonable assumption about its impact could lead to the conclusion that the cost of compliance would soar as high as \$350.2 billion by 2007.

In 2002 individuals, businesses and non-profits will spend an estimated 5.8 billion hours complying with the federal income tax code, at an estimated cost of over \$194 billion. This amounts to imposing a 20.4-cent tax compliance surcharge for every dollar the income tax system collects.

Federal income tax system. Over time, the cost of tax compliance has grown tremendously, due partly to the inherent difficulty of taxing income, but also because of the growing non-economic demands legislators are making on the tax code.

What Does Tax Compliance Cost?

In 2002 individuals, businesses and non-profits will spend an estimated 5.8 billion

How Compliance Costs Differ for Different Taxpayers

The burden of tax compliance does not fall evenly on all taxpayers. It varies by type of taxpayer, by income level and by state. In 2002, businesses will bear the majority of the compliance cost, 52.8 percent, totaling \$102.5 billion. Compliance efforts by individuals and non-profits account for the remainder, 44.4

percent (\$86.1 billion) and 2.8 percent (\$5.4 billion) respectively.

When examined by income level, compliance cost is found to be highly regressive. In other words, compliance cost takes a bigger toll on low-income taxpayers as a percentage

of income than it does on high-income taxpayers. On the low end, taxpayers with adjusted gross income (AGI) under \$20,000 incur a compliance cost equal to 4.53 percent of income while the compliance cost incurred by taxpayers with AGI over \$200,000 amounts to 0.29 percent of income.

State-by-state estimates of the 2002 federal compliance cost are also dissimilar because the composition of their populations and economies differ so significantly. On a per capita basis, Maryland, Delaware and New Jersey face the highest compliance cost while Mississippi, West Virginia, and New Mexico face the lowest. Measured per \$1,000 of income, Montana, Utah, and Wyoming face the highest compliance cost while California, Massachusetts, and Connecticut face the lowest.

Table 1
Total Federal Tax Compliance Costs
Calendar Years 1995-2007

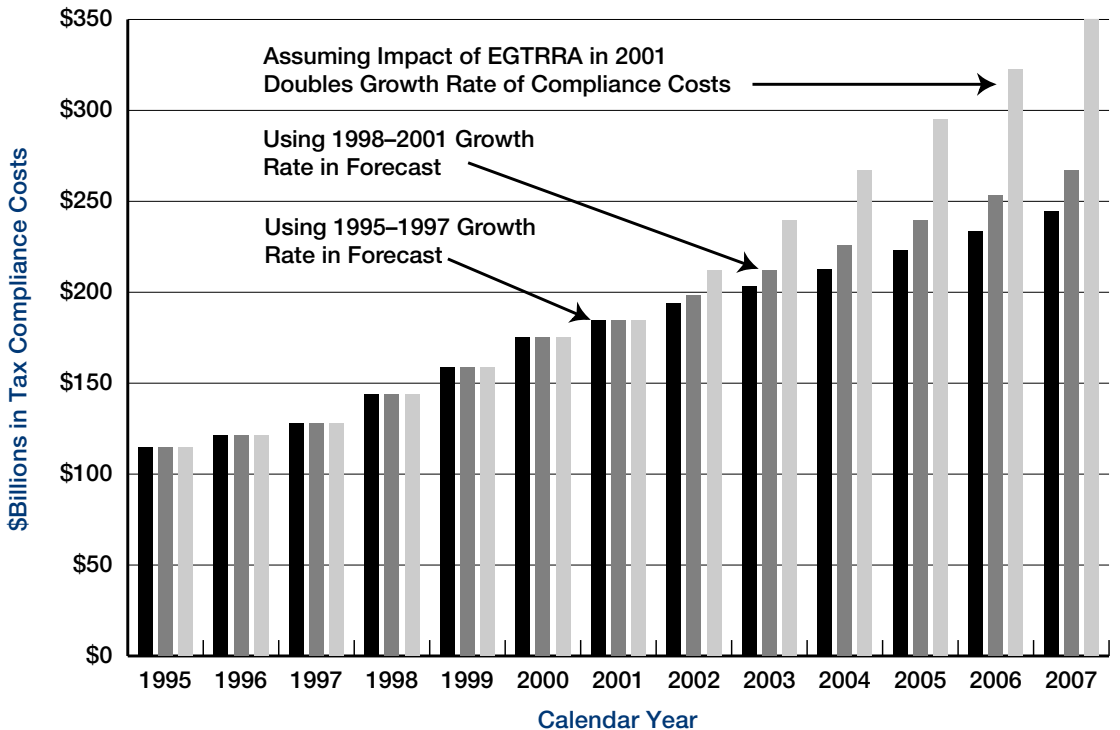
	Using 1995-1997 Growth Rate in Forecast	Using 1998-2001 Growth Rate in Forecast	Assuming Impact of EGTRRA Doubles Growth Rate
1995	\$ 114.4	\$ 114.4	\$ 114.4
1996	121.3	121.3	121.3
1997	127.6	127.6	127.6
1998	143.6	143.6	143.6
1999	158.7	158.7	158.7
2000	\$ 174.9	\$ 174.9	\$ 174.9
2001	184.3	184.3	184.3
2002e	194.0	198.1	211.9
2003e	203.4	211.9	239.6
2004e	212.6	225.7	267.2
2005e	\$ 223.1	\$ 239.6	\$ 294.9
2006e	233.7	253.4	322.5
2007e	244.3	267.2	350.2

Source: Tax Foundation; Internal Revenue Service.

The Complications of the Federal Income Tax

It is important for taxpayers to have an estimate of their compliance cost because the performance of the economy is dramatically affected by the state of tax law. If lawmakers

Figure 1
Total Federal Tax Compliance Costs
Calendar Years 1995-2007



Source: Tax Foundation; Internal Revenue Service.

create an Internal Revenue Code that is terribly complex or that changes rapidly, taxpayers may not be able to obtain a reasonably certain conclusion about how taxation will affect a business plan or investment. When the tax consequences of various economic activities are unpredictable, then tax policy is handicapping the growth and dynamism of the U.S. economy.

As if the complexities inherent in taxing income did not pose a sufficiently daunting

When the tax consequences of various economic activities are unpredictable, then tax policy is handicapping the growth and dynamism of the U.S. economy.

challenge to the writers and administrators of the tax code, political and social demands on the code have made matters much more complex. In particular, two goals for the code that contribute to complexity are “fairness” and social utility. They come into play when determining how much individual taxpayers should owe, the “ability-to-pay” principle, and when providing incentives for socially beneficial activities.

Studies of the federal tax code usually find that our system, particularly the income tax code, is excessively complex. This study concurs, quantifying the code’s complexity in a way that makes clear how unnecessary much of it is. 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 in fact the complaints are justified.

Experts complained about the complexity of the federal income tax system as early as 1914, the year immediately following the adoption of the 16th Amendment to the Constitution which authorized the income tax. Since then, the quest for tax simplification has waxed and waned with generally little progress over the years and the tax code has grown in complexity. Veteran tax professionals commonly point to the Tax Reform Act of 1969 as the legislation that infused much needless complexity into the income tax code, but they say nothing in that Act came anywhere near the bewildering complexities that were introduced by the tax enactments of the 1980s.

Within a three-year period in the first half of the 1980s, the income tax code was sub-

jected to three massive pieces of legislation. The first was what became known as “the Reagan tax cut,” the Economic Recovery Tax Act of 1981. This was followed immediately by the Tax Equity and Fiscal Responsibility Act of 1982, and soon thereafter came the Deficit Reduction Act of 1984. However, the tax drama had not yet reached its climax, which occurred in 1986 with the enactment of the Tax Reform Act of 1986 (TRA’86).

TRA’86 was meant to make a clean break from the past complexity and instability in the tax code. The primary goal of its authors was tax simplification, and toward that end, the act reduced the number of rates and expanded the tax base (through the elimination of numerous tax preferences). While the goal was laudable, the nation did not end up with a simpler tax code, especially from the perspective of businesses. Previous research by the Tax Foundation has found that there is near unanimity among senior corporate tax officers that TRA’86 brought tax complexity to an unprecedented level. They point to the alternative minimum tax, inventory capitalization rules, and foreign income rules as the main culprits.

The Complex Job of Taxing Income

In 1927, the Joint Committee on Internal Revenue Taxation reported that: “It must be recognized that while a degree of simplification is possible, a simple income tax for complex business is not.” This is certainly true of business income, but almost equally true of individual income.

The inherent complexity of any income tax results from the difficulty of defining income and determining when and to whom to recognize income and expense for tax purposes. Over time, the political process of give-and-take has made these questions of how to define the tax base inordinately complex. The definition of taxable income has not only expanded dramatically, but it has undergone chronic change.

Non-Economic Demands on the Code

Adding to the inherent complexities of taxing income are the political goals that government strives to achieve in its taxation: “fairness” and “equity.” These goals come into play in two important areas of the tax code that contribute to complexity: (1) determining how much individual taxpayers should owe — the “ability-to-pay principle,” and (2) providing incentives for socially beneficial activities.

Ability to Pay

From an economic perspective, the most efficient way to levy taxes is with a head tax. In other words, every person would pay an equal lump-sum tax. According to recent Tax

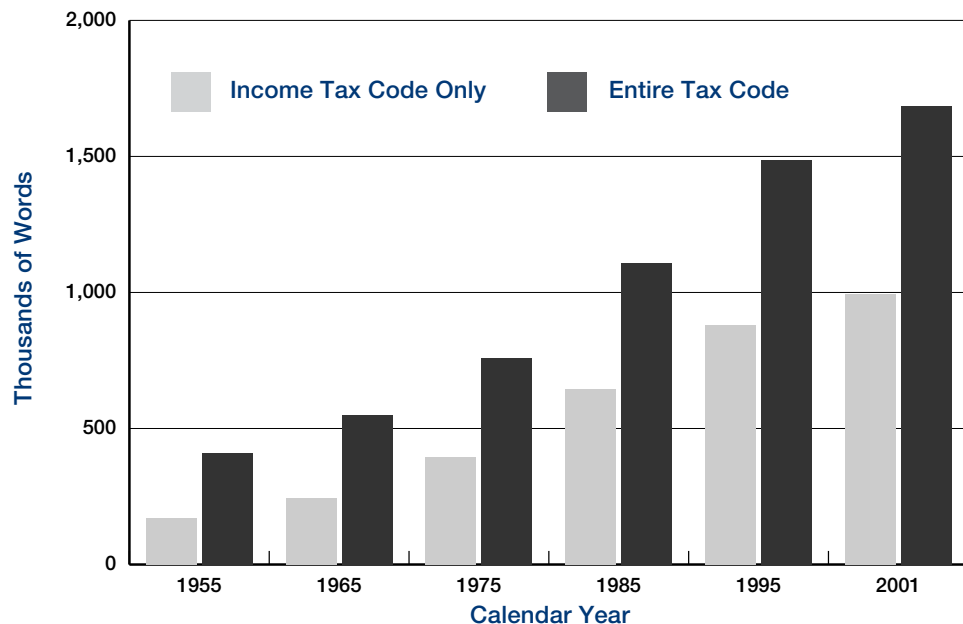
Foundation research, if such a head tax were instituted today, every man, woman and child in the nation would have to pay \$10,263 to fund the government at current levels. The federal government alone would account for almost 70 percent (\$6,989) of the tax bill, with

*Table 2
Growth of the Number of Words in the Internal Revenue Code
Thousands of Words
Selected Calendar Years 1955-2001*

	1955	1965	1975	1985	1995	2001
Internal Revenue Code						
Income Taxes Only	172	243	395	645	881	995
Entire Tax Code	409	548	758	1,107	1,488	1,685
Period-to-Period Percent Growth						
Income Taxes Only	*	41.4%	62.8%	63.2%	36.6%	13.0%
Entire Tax Code	*	33.8%	38.3%	46.0%	34.5%	13.2%
Internal Revenue Code Regulations						
Income Taxes Only	572	1,715	2,571	3,762	4,880	5,559
Entire Tax Code	1,033	3,098	3,295	4,613	6,135	6,752
Period-to-Period Percent Growth						
Income Taxes Only	*	199.6%	49.9%	46.3%	29.7%	13.9%
Entire Tax Code	*	199.9%	6.4%	40.0%	33.0%	10.1%
Internal Revenue Code and Regulations						
Income Taxes Only	744	1,957	2,966	4,406	5,761	6,554
Entire Tax Code	1,442	3,646	4,053	5,720	7,623	8,437
Period-to-Period Percent Growth						
Income Taxes Only	*	163.1%	51.5%	48.6%	30.8%	13.8%
Entire Tax Code	*	152.8%	11.2%	41.1%	33.3%	10.7%

Source: Tax Foundation calculations based on the annual publications of "Internal Revenue Code" and "Federal Tax Regulations" from West Publishing Company.

*Figure 2
Growth of the Number of Words in the Internal Revenue Code
Thousands of Words
Selected Calendar Years 1955-2001*



Source: Tax Foundation calculations based on the annual publications of "Internal Revenue Code" and "Federal Tax Regulations" from West Publishing Company.

state and local governments accounting for the remainder (\$3,274).

Economists would call such a head tax efficient because it is economically neutral, avoiding all distortion of the free-market process. In other words, the burden of a head tax does not fall on any particular economic activity, so taxpayers' economic decisions would be completely unaffected by the tax system. Even the simplest income tax could never be 100 percent economically neutral precisely because the burden of the tax falls on income-producing activity, inevitably persuading some taxpayers in some circumstances to earn less income than they otherwise would.

Obviously, such a head tax would be administratively efficient as well, as neither taxpayers nor the government would need to

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. Overall, two important measures of tax complexity have climbed dramatically since then: the size and the instability of the tax code.

document taxpayers' income. However, the head tax is politically troublesome, to put it mildly. Taxation anywhere near the current level would constitute an insuperable burden for low-income citizens. If television stars and day laborers must pool their resources to fund government operations that consume roughly one third of the nation's income, as they now do, then devising a tax system that takes "ability to pay" into account becomes politically inevitable, even if it does lead to a much more complex tax code.

Today the tax code includes a multitude of provisions to adjust the tax burden according to this "ability-to-pay" principle. The most obvious application is the graduated rate structure that increases a taxpayer's liability as a percentage of income as income rises. Other provisions adjust for the taxpayer's children, family status (single, married, head of household), etc.

Promoting Socially Useful Activities

In addition to making allowances for the poor, today's income tax code includes numerous provisions to encourage activities that

are deemed socially beneficial.

On the individual side of the code, taxpayers are allowed various credits and deductions for home mortgage interest, health care expenditures and child care, to name a few. And on the business side of the code, there are comparable provisions, such as the investment tax credit and preferential depreciation rules.

As a result, the income tax code today is a hodgepodge of deductions and credits that have nothing to do with raising the revenue needed to fund government operations. In fact, these tax code items not only reduce revenues but at the same time dramatically increase the complexity of the tax code.

The Results of these Complications

While some of these legislative adjustments to the tax code may be well-intended, they nonetheless lead to some undeniably serious problems.

The Problem of Rent-Seeking

Unfortunately, once inserted into the code, these preferential tax provisions become entrenched over time as various groups lobby for their protection and expansion. To economists this is known as rent-seeking. Such lobbies have a strong interest in maintaining the tax preference because they have usually spent substantial resources obtaining it. Also, the general public usually mounts little opposition since the benefits are concentrated on a relatively small group of taxpayers while the costs are spread amongst everyone else.

The Problem of Tax Evasion

A related problem is that a complex tax code is fertile ground for tax evasion. For example, let's look at the tax complexity caused by the ever-popular deduction for charitable contributions. As for any itemized deduction, taxpayers must keep an accurate accounting of their charitable contributions. If the value is over \$250, the taxpayer also needs a statement from the charitable organization. While such record-keeping does not appear overly onerous, just look at some of the problems lurking in the background.

For one, charitable contributions are a significant source of "tax leakage," a term the Internal Revenue Service uses when it refers to the loss of tax revenue caused by under-reported income or over-reported deductions. For instance, a phantom donation of \$25 a week would lead to a deduction of \$1,300 a year. Obviously, if a significant number of taxpayers did this, the revenue loss would be quite significant. Not all tax evaders are as

blatant as the tax lawyer who was recently caught claiming to have given his church \$500 every Sunday. When the IRS inquired with the church, the sin had gone unconfessed so the pastor was not obliged to keep his parishioner's lie a secret. Such over-reporting of deductions leads to higher compliance costs for all taxpayers as the IRS resorts to increased auditing and/or the addition of more rules and regulations.

The Problem of Administrative Complexity

Charitable organizations have to go through an approval process administered by the IRS before a contribution by an individual can be legally declared as a charitable deduction. The burden of this process is not a one-time cost because every approved charity has to be aware at all times that a change in its mission could nullify its charitable status according to the IRS. Of course, this process is costly, in time and money, for the charities and the IRS.

The rules and regulations governing the deduction not only add to the complexity in the tax code, but naturally, the deduction also

social benefits of the activity in question. This organized resistance to simplification has been phenomenally successful over many years, causing many legislators to despair of piecemeal efforts at tax simplification.

Fundamental Tax Reform

One way to get around the problems caused by rent-seeking, thereby reducing complexity and its attendant costs in the income tax code, is to reform the entire federal income tax system. Reform proposals are currently on the table that attempt to make simplification and the promotion of economic growth the principal strategies of tax policy. These include the national sales tax sponsored by Rep. Billy Tauzin and the flat income tax proposal sponsored by Rep. Dick Armey.

The national sales tax takes the direct approach and moves away from the concept of taxing income completely, taxing consumption instead. The flat tax, on the other hand, moves to cash flow as the tax base, rather than accrued income. A cash flow tax, as it applies to business, totals business receipts and then subtracts purchases from other businesses. On the individual level, the approach resembles a universal IRA.

Both proposals would boost economic performance by eliminating the double tax on savings, and both promise huge reductions in the complexity of the tax code. As of this writing, however, neither plan has garnered widespread support. Even if a plan to fundamentally simplify the tax system did gain momentum, the possibility exists that provisions would be added during the legislative process that would add new complexity, such as happened in 1986.

The Growth 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. Table 2 and Figure 2 chart the dramatic growth over the past 46 years in the combined number of words that define the body of both the federal income tax laws and the attendant regulations.

Since 1954, the estimated number of words in the entire tax code devoted to the income tax has grown from 42 percent to 59 percent, more than a 40 percent increase over the last four decades. 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. Today, that figure has grown to 81 percent, an in-

The 2001 tax cut took tax code instability to new heights, not for any specific policy reason but because of lawmaker's reliance on fiscal forecasts and artificial budget windows. Most amazingly, the entire bill sunsets after 2010, marking the first time in history that major income tax legislation was passed on a temporary basis.

lowers government revenue, forcing everyone else to pay higher tax rates. However, while there is a multitude of organizations standing ready to defend the deductibility of charitable contributions, there is no large group of taxpayers that opposes its complexity.

The complexity caused by this one popular deduction is like the proverbial tip of the iceberg. There are literally thousands of similar special preferences written into the tax law that promote various activities or benefit a group of taxpayers. These groups of taxpayers stand ready to defend their tax preferences with economic and emotional arguments that relate to the taxpayers' ability to pay or the

crease of more than 47 percent over the past four decades.

The Tax Foundation has determined that over the past 45 years the number of words detailing the income tax laws has grown from 172,000 words in 1955 to 982,000 by 2000, an increase of 472 percent. Income tax regulations, which provide taxpayers with the “guidance” they need to calculate their taxable income, have grown at an even faster pace from 572,000 words in 1955 to 5,947,000 words by 2000, an increase of 939 percent. Combined, the federal income tax code and

An effective way to provide tax relief to lower-income taxpayers is via tax simplification. In fact, nearly half of all the tax surcharge savings resulting from tax simplification would go to taxpayers with less than \$40,000 in AGI.

regulations grew from 744,000 words in 1955 to 6,929,000 by 2000—an increase of 831 percent.

Growth of the Code by Subject Area

Perhaps a more revealing measure of tax code complexity is the multiplication of the subchapters and subsections that comprise the Internal Revenue Code. In 1955, federal income tax law was comprised of 103 code sections. By 2000, there were 725 income tax code sections, a 604 percent increase (see Table 3).

Almost all of the growth relates to tax base questions. For example, since 1955, the number of sections dealing with the “Determination of Tax Liability” has grown 1,150 percent; the number of sections dealing with “Capital Gains and Losses” has grown 1,325 percent; the number of sections dealing with “Deferred Compensation” (e.g., pension plans) has grown 1,450 percent; and the number of sections dealing with the “Computation of Taxable Income” has grown by more than 1,600 percent.

The growth in the volume of the income tax laws and regulations is a direct result of the 33 significant federal tax enactments that have taken place since 1954, or approximately one every 1.4 years. Previous Tax Foundation research (based on a sample of one-fifth of the core sections of the income tax code) found that these enactments have not only increased the volume of the tax code, but resulted, on

average, in the amendment of each section once ever four years (as of 1994). This instability has been much more pronounced in the past 20 years than it was during the 20 years immediately following the 1954 Act.

More recently, the details of EGTRRA take instability to new heights, not for any specific policy reason but because of lawmaker’s reliance on fiscal forecasts and artificial budget windows. There are 108 occurrences of phase-ins, phase-outs, changes in rates, scale-ups, scale-downs, and other such unnecessary complexities within the legislation. Most amazingly, because of the unnecessary but increasing reliance on fiscal forecasts, the entire bill sunsets after 2010. This marks the first time in history that major tax legislation was passed on a temporary basis.

Quantifying the Cost of Compliance

The complexity generated by the growth and constant change of the tax code creates two general types of economic cost: overhead and opportunity cost.

The Cost of Overhead

Overhead can be divided into three principal activities: the economically sterile exercises of tax planning, compliance, and litigation, all of which act like tax surcharges on taxpayers.

- The first type of overhead, tax planning, refers to all the economic decisions that individuals and firms make to maximize their benefits in the tax code.
- The second type of overhead, tax compliance, refers to the basic actions required to file the federal income tax, including record keeping, education, form preparation and packaging/sending.
- The third type of overhead is tax audits and litigation, referring to the cost of the IRS and the Tax Court, as well as all the legal costs that taxpayers incur while dealing with these two government institutions.

Of these three costs, the second, tax compliance, is the only one estimated in this report. It is for this reason that the data presented here should be viewed as extremely cautious estimates of taxpayers’ federal income tax compliance cost.

For example, a company plans to build a manufacturing facility. However, after tax planning, the decision is reached to build a slightly different facility in a different location resulting in maximized tax benefits. The company’s tax department later files a tax return on the economic activities of the facil-

ity. However, the IRS objects to some aspect(s) of the tax return, and after some legal wrangling, their tax return is finalized. In this case, only the firm's costs of actually filing its tax return are part of the Tax Foundation's estimate of the "compliance cost."

Opportunity Costs

The second general type of economic cost caused by the tax system is opportunity cost. An opportunity cost is the result of a less efficient economic activity displacing a more efficient economic activity. For example, suppose two boys went out to pick berries to sell at the local market. The boys know that the berries on the other side of the river are more tasty, fetching 50 cents a pound, than those close to home, fetching 25 cents a pound. Unfortunately, the river is flooded and they are unable to pick the tastier berries. As a result, the lost 25 cents per pound (50 cents for the tasty berries minus 25 cents for the less tasty berries) is the boys' opportunity cost.

In this example, the determination of the value of the foregone economic activity was easy to identify since they knew how much the berries would sell for. Measuring the opportunity cost of tax compliance can be more difficult: some parts of it can be quantified but others are of a more speculative nature.

As an example of a quantifiable tax opportunity cost, wage-earners are currently required to have their taxes withheld from their paychecks. In essence, taxpayers are forced to prepay their income taxes. As a result, they lose any economic returns (interest, profit, dividends, etc.) they might have generated with this money between the time of withholding and the time when the taxes are actually due to be paid. The opportunity cost associated with withholding can be estimated.

In 2002, the federal government is estimated to collect \$949 billion in individual income taxes. In the absence of withholding, taxpayers could have conservatively invested this money into U.S. Treasury Bonds (T-Bills). In 2001, the average rate of return on the T-bill was 5.2 percent. Assuming the same rate for 2002, taxpayers could pocket \$23.4 billion in interest payments over the course of the year.¹ In reality, the federal government collects the withheld income tax payments and uses that money to fund current operations. Therefore, the foregone interest represents a significant opportunity cost.

The following is an example of an unquantifiable tax opportunity cost. Imagine a software developer who has just spent considerable time complying with the tax code. This time may have been spent working on a new

*Table 3
Comparison of 1954 Code and 2001 Code*

Subchapter of Income Tax Code	Number of Sections in Subchapter		Percentage Growth
	1954	2001	
Determination of Tax Liability	4	51	1175%
Computation of Taxable Income	9	153	1600
Corporate Distributions and Adjustments	14	31	121
Deferred Compensation	2	31	1450
Accounting Periods and Methods	6	33	450
Tax-Exempt Organizations	4	19	375%
Corporations Used to Avoid Income Tax on Shareholders	4	27	575
Banking Institutions	3	8	167
Natural Resources	3	9	200
Estates, Trusts, Beneficiaries, Etc.	7	27	286
Partners and Partnerships	7	36	414%
Insurance Companies	5	30	500
Regulated Investment Companies, Etc.	1	24	2300
Tax Based on Income from Within or Without the United States	9	77	756
Gain/Loss on Disposition of Property	7	51	629%
Capital Gains and Losses	4	57	1325
Readjustment of Tax Between Years and Special Limitations	6	7	17
Tax Treatment of S Corporations	0	14	NA
Other (a)	8	48	500
TOTAL	103	733	612%

(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.

¹ For the sake of simplicity, the calculation assumes that the income tax was collected evenly throughout the year and withholding is based on a bi-monthly pay period.

idea that one day blossomed into the next Microsoft — creating tens of billions of dollars in wealth. And even if phenomenal wealth would not have been created in that time, every hour or dollar spent complying with the tax code represents resources that could have been spent tending to business problems,

adding value to the economy while doing the work that the taxpayer is good at. Unfortunately, it is nearly impossible to quantify an economic activity that never happened.

The Burden of Compliance Costs

As shown in Tables 4, 5, 6 and 7, the Tax

Table 4
*Estimated Time That Individual Taxpayers Devote to the Federal Income Tax System
Hours Per Return in Calendar Year 2002*

Forms for Individuals	Number of Returns	Record-keeping	Education Stage	Form Preparation	Packaging/Sending	Total Hours for Each Taxpayer	Total Hours for All Taxpayers
1040 (a)	83,392,058	2.8 hrs	3.5 hrs	6.6 hrs	0.6 hrs	13.5 hrs	1,121,623,178 hrs
1040A (b)	13,892,400	2.3	3.6	7.0	2.3	15.2	211,396,020
1040EZ (c)	14,609,700	0.1	1.7	2.1	0.3	4.2	61,117,245
1040ES (Estimated Tax)	41,478,600	1.3	0.3	0.8	0.2	2.6	107,153,050
1040X (Amended 1040)	3,529,200	1.3	0.5	1.2	0.6	3.5	12,352,200
1041 (Estates and Trusts)	3,745,200	46.6 hrs	18.5 hrs	35.0 hrs	4.3 hrs	104.4 hrs	390,874,040 hrs
1041ES (Estimated Tax)	991,600	0.3	0.3	1.6	1.0	3.1	3,090,487
4868 (Extension of Time) (d)	8,320,700	0.4	0.2	0.3	0.2	1.1	9,291,448
2688 (Extension of Time) (e)	2,394,900	0.0	0.2	0.3	0.3	0.8	1,836,090
2555 (Foreign Earned Income)	366,631	1.9	0.4	1.8	0.8	4.9	1,796,493
4952 (Investment Interest)	1,701,974	0.2 hrs	0.3 hrs	0.4 hrs	0.2 hrs	1.0 hrs	1,701,974 hrs
4972 (Lump-Sum Distributions)	53,459	0.9	0.3	1.2	0.3	2.7	145,230
5329 (Retirement Plans Tax)	37,786	2.1	0.6	2.1	0.2	5.0	188,299
6198 (At-Risk Limitations)	369,710	1.2	1.0	1.4	0.3	4.0	1,466,518
6251 (AMT)	7,576,832	2.6	1.2	1.9	0.5	6.1	46,471,234
8582 (Passive Activity Loss)	3,427,565	1.1 hrs	1.7 hrs	1.5 hrs	0.3 hrs	4.7 hrs	15,938,177 hrs
8606 (Nondeductible IRA's)	3,710,178	1.4	1.7	1.4	0.9	5.3	19,725,778
8615 (Under Age 14 Tax)	760,412	0.4	0.2	0.7	0.3	1.7	1,254,679
8814 (Parent's Report for Child)	357,162	0.4	0.2	0.4	0.3	1.3	458,357
8815 (Exclusion of Bond Interest)	52,954	0.9	0.2	0.9	0.3	2.2	117,382
Tax Credits							
2441 (Child Care Expenses Credit)	6,927,706	0.7 hrs	0.4 hrs	0.8 hrs	0.5 hrs	2.4 hrs	16,511,033 hrs
1116 (Foreign Tax)	2,157,248	2.7	1.0	2.8	0.6	7.1	15,352,411
8863 (Education Credit)	4,760,771	0.2	0.2	0.6	0.6	1.5	7,220,503
8839 (Adoption Credit)	35,972	0.8	0.3	1.8	0.6	3.4	122,904
3800 (General Business Credit)	356,066	17.9	1.0	1.3	0.0	20.3	7,210,331
8396 (Mortgage Interest Credit)	142,529	0.8 hrs	0.1 hrs	0.5 hrs	0.2 hrs	1.5 hrs	216,170 hrs
8801 (Prior Year Minimum Tax Credit)	287,845	2.1	1.9	1.7	0.3	5.9	1,688,688
8844 (Empowerment Zone Credit)	2,137	9.3	2.5	0.0	2.8	14.5	31,061
4136 (Fuels Tax Credit)	331,419	16.7	0.1	0.0	0.4	17.2	5,689,366
8586 (Low Income Housing)	173,494	7.9	1.6	3.7	0.5	13.7	2,379,759
8812 (Additional Child Tax Credit)	813,757	0.1	0.1	0.5	0.3	1.0	800,194
1040 Schedules							
Sch A (Itemized Deductions)	53,722,551	3.1 hrs	0.7 hrs	1.6 hrs	0.3 hrs	5.6 hrs	301,741,660 hrs
Sch B (Interest & Dividends)	40,524,631	0.6	0.1	0.4	0.3	1.4	58,085,304
Sch D (Capital Gain/Loss)	38,071,117	1.5	3.0	2.6	0.6	7.6	289,340,486
Sch E (Supplemental Income)	22,515,376	3.0	1.0	1.4	0.6	6.0	134,341,745
Sch EIC (Earned Income Credit)	23,741,871	0.0	0.0	0.2	0.3	0.6	13,453,727
Sch H (Household Taxes)	406,352	1.6 hrs	0.5 hrs	0.9 hrs	0.6 hrs	3.6 hrs	1,456,094 hrs
Sch R (Elderly or Disabled Credit)	443,059	0.3	0.3	0.5	0.6	1.6	723,663
Estate and Gift							
706 and 706NA (Estate)	151,200	12.4 hrs	7.6 hrs	14.6 hrs	10.6 hrs	45.3 hrs	6,844,320 hrs
709 (Gift)	341,900	0.7	1.1	1.9	1.1	4.8	1,629,723
Total	386,676,020	150.3 hrs	59.7 hrs	106.2 hrs	35.8 hrs	352.0 hrs	2,872,837,024 hrs

(a) Includes 1040PC and electronically filed 1040 forms.

(b) Schedules 1-3 and EIC are included in the average time.

(c) Includes Telefiled 1040EZ forms.

(d) Application for automatic extension of time in which to file the individual income tax return.

(e) Application for additional extension of time in which to file the individual income tax return.

Foundation estimates that in 2002 individuals, businesses and non-profits will spend over 5.7 billion hours complying with the federal income tax. Using an hourly cost of \$29.98 for individuals and \$37.26 for businesses and non-profits, the estimated cost of compliance in 2002 is \$194 billion. (See Methodology for details about how the hours and wages were determined.) Individuals bear a cost of \$86.1 billion, businesses bear a cost of \$102.5 billion and non-profits bear a cost of \$5.4 billion. Therefore, the overall compliance cost surcharge alone amounts to nearly 20.4 cents for every \$1 collected by the federal income tax.

This staggering economic cost can be illustrated by comparison. The \$194 billion tax compliance cost is greater than the revenue of Wal-Mart (\$193 billion), the largest retail company in America. Similarly, 5.8 billion hours per year represents a work force of over 2,774,000 people: larger than the populations of Dallas (1,189,000), Detroit (951,000) and Washington, D.C. (572,000) combined; more people than would reside in four Congressional districts; and more people than work in the auto industry, the computer manufacturing industry, the airline manufacturing industry, and the steel industry combined.

*Table 5
Estimated Time That Businesses Devote to the Federal Income Tax System
Hours Per Return in Calendar Year 2002*

Forms for Businesses	Number of Returns	Record-keeping	Education Stage	Form Preparation	Packaging/Sending	Total Hours for Each Taxpayer	Total Hours for All Taxpayers
Sole Proprietorships							
Form 1040	19,828,142	2.8 hrs	3.5 hrs	6.6 hrs	0.6 hrs	13.5 hrs	266,688,512 hrs
Sch C (Sole-Proprietorship)	15,599,891	6.1	1.5	2.3	0.7	10.6	165,098,846
Sch C-EZ	2,506,840	0.8	0.1	0.6	0.3	1.7	4,303,410
Sch F (Farming)	1,721,411	3.5	0.5	1.4	0.3	5.8	10,027,217
Sch SE (Self-Employment)	19,954,865	0.3	0.3	0.4	0.3	1.3	25,608,743
4835 (Farm Rental)	728,761	3.0	0.1	1.0	0.3	4.4	3,206,549
8829 (Business Use of Home)	1,979,476	0.9	0.1	1.3	0.3	2.6	5,080,655
Partnerships							
Form 1065	2,433,300	41.9 hrs	23.6 hrs	41.3 hrs	4.0 hrs	110.8 hrs	269,569,085 hrs
Sch D	2,433,300	6.9	2.2	2.4	0.0	11.5	27,942,395
Sch K-1 (Partners' Share of Income)	2,433,300	26.9	10.4	11.3	0.0	48.7	118,420,600
Sch L (Balance Sheets)	2,433,300	15.5	0.1	0.4	0.0	16.0	38,892,245
Sch M-1 (Reconciliation of Income)	2,433,300	3.4	0.2	0.3	0.0	3.8	9,287,095
Sch M-2 (Analysis of Capital Accounts)	2,433,300	2.9	0.1	0.2	0.0	3.1	7,583,785
Corporations							
Form 1120 (C-Corporation)	2,411,100	71.3 hrs	43.5 hrs	75.4 hrs	8.3 hrs	198.5 hrs	478,563,165 hrs
1120A (C-Corporation Short Form)	265,700	43.8	24.6	49.1	5.1	122.5	32,534,965
1120S (S-Corporation)	3,219,500	63.9	23.2	43.8	5.4	136.2	438,388,583
1120X (Amended)	14,400	12.4	1.4	3.6	0.5	18.0	258,720
1120F (Foreign Corporation)	26,000	106.4	41.3	70.9	7.5	226.1	5,879,033
1120FSC (Foreign Sales Corporation)	6,700	94.2	19.1	33.6	0.0	146.9	983,895
1120H (Homeowners Associations)	133,600	11.7	5.3	13.2	2.2	32.4	4,326,413
1120POL (Political Organizations)	5,900	17.2	5.1	12.1	1.9	36.2	213,580
1120RIC (Regulated Investment Corporations)	12,500	57.2	20.6	36.4	4.0	118.2	1,477,292 hrs
7004 (Extension of Time) (a)	3,041,900	5.7	1.4	2.5	0.3	9.8	29,861,318
4626 (AMT)	385,776	18.2	12.2	13.1	0.0	43.4	16,749,108
1120 Schedules							
Sch D (Capital Gains/Losses)	2,411,100	7.2 hrs	4.1 hrs	6.3 hrs	0.5 hrs	18.1 hrs	43,560,540 hrs
Sch H	241,110	6.0	0.6	0.7	0.0	7.3	1,752,066
Sch PH (Personal Holding Company)	120,555	15.3	6.2	8.6	0.5	30.6	3,690,992
1120S Schedules							
Sch D (Capital Gains/Losses)	3,219,500	11.2 hrs	4.7 hrs	9.8 hrs	1.3 hrs	27.1 hrs	87,087,475 hrs
Sch K-1 (Shareholders' Share of Income)	3,219,500	16.5	10.6	1.3	1.1	29.5	94,921,592
Other							
4562 (Depreciation)	11,546,632	37.3 hrs	5.2 hrs	6.0 hrs	0.0 hrs	48.5 hrs	559,626,740 hrs
Total	107,200,659	710.2 hrs	271.6 hrs	455.5 hrs	45.4 hrs	1,482.7 hrs	2,751,584,615 hrs

(a) Application for automatic extension of time in which to file the corporate income tax return.
Source: Tax Foundation; Internal Revenue Service.

In addition, there is a direct expense to the IRS of administering and enforcing the federal tax code — of which the federal income tax is but one of many types of taxes. Table 8 details the growth of the IRS in operating costs and in employment, which has risen from 69,000 employees in 1970 to 97,000 in 2000, though it is down from the peak of 116,000 in the early 1990s.

Estimating Future Compliance Cost

The cost of compliance can be projected for future years by extrapolating estimates published by the Internal Revenue Service (see Methodology). There is no question that the cost has grown steadily and rapidly since 1995 and will be increasing in future years. However, there is room for debate on the rate of increase between 2001 and 2007. Making the perhaps overly cautious assumption that the rate of growth that prevailed between 1995 and 1997 — an average annual growth of 3.7 percent — would prevail in years to come, one could conclude that by 2007, the cost of compliance would reach \$244.3 billion (see

Figure 1 and Table 1).

However, this estimate does not take into account the faster growth rate that compliance costs have set since the Tax Relief Act of 1997 (TRA'97). Initiated by a Republican Congress and signed by President Clinton, TRA'97 was a series of compromises that resulted in a significantly more complex tax code. If the growth rate of compliance between 1998 and 2001, an average annual growth rate of 6.4 percent, were projected into the future, compliance cost would reach \$267 billion in 2007.

Tax compliance cost accelerated after TRA'97 mostly because it introduced a variety of new tax provisions intended, ironically, to reduce tax burdens. Table 9 shows how the introduction of new tax provisions have increased the time it takes to fill out commonly used tax forms for individuals and businesses. The form experiencing the greatest growth in filing time is Schedule D for Capital Gains and Losses. In 1995, it took 3.7 hours to file; by 2001 it took 7.6 hours, an annual average increase of 10.9 percent.

The recently enacted Economic Growth

*Table 6
Estimated Time That Non-Profit Organizations Devote to the Federal Income Tax System
Hours Per Return in Calendar Year 2002*

Forms for Non-Profits	Number of Returns	Record-keeping	Education Stage	Form Preparation	Packaging/Sending	Total Hours for Each Taxpayer	Total Hours for All Taxpayers
Form 990 (Tax-Exempt Organizations)	384,200	98.3 hrs	15.2 hrs	21.2 hrs	1.1 hrs	135.7 hrs	52,129,537 hrs
990-EZ	156,300	28.9	11.7	14.5	0.7	55.7	8,711,120
990-C (Farmers' Cooperative)	3,900	78.0	23.8	41.0	4.3	147.0	573,300
990-PF (Private Foundation)	84,600	141.3	28.1	33.5	0.5	203.4	17,210,460
990-T (Exempt Organization Business Income)	71,900	66.5	25.4	41.9	4.0	137.7	9,899,432
Form 4720 (Return of Excise Taxes)	3,000	39.9	16.5	23.5	1.6	81.5	244,600
Form 5227 (Split-Interest Trust)	136,300	61.9	11.3	19.3	1.9	94.4	12,868,992
990 Schedules							
Sch A	540,500	50.2 hrs	9.4 hrs	10.7 hrs	0.0 hrs	70.3 hrs	38,006,158 hrs
Sch B	625,100	4.8	1.4	1.5	0.0	7.7	4,792,433
Total	1,380,700	569.8 hrs	142.7 hrs	206.9 hrs	14.0 hrs	933.5 hrs	144,436,032 hrs

Source: Tax Foundation; Internal Revenue Service.

*Table 7
Estimated Time That Individuals, Businesses, and Non-Profit Organizations Devote to the Federal Income Tax System
Hours Per Return in Calendar Year 2002*

	Number of Returns	Record-keeping	Education Stage	Form Preparation	Packaging/Sending	Total Hours for Each Taxpayer	Total Hours for All Taxpayers
Total for Individuals (Table 4)	386,676,020	150.3 hrs	59.7 hrs	106.2 hrs	35.8 hrs	352.0 hrs	2,872,837,024 hrs
Total for Businesses (Table 5)	107,200,659	710.2	271.6	455.5	45.4	1,482.7	2,751,584,615
Total for Non-Profits (Table 6)	1,380,700	569.8	142.7	206.9	14.0	933.5	144,436,032
Grand Total	495,257,379	1,430.4	474.0	768.6	95.2	2,768.1	5,768,857,671

Source: Tax Foundation; Internal Revenue Service.

and Tax Reform Reconciliation Act of 2001 (EGTRRA) changed the tax code even more dramatically than TRA'97. With no actual compliance data yet published after its passage, making assumptions about its impact is more speculative. However, reasonable assumptions could lead to the conclusion that the tax compliance growth rate will double. Under this scenario, the total tax compliance cost in coming years would rise by \$138.3 billion, up from \$211.9 billion in 2002 to \$350.2 billion in 2007.

To illustrate the magnitude of this compliance cost, one could compare the cumulative compliance cost with the tax savings that taxpayers were estimated to achieve after passage of EGTRRA in 2001. By 2007, the compliance cost would more than double the size of the tax reduction — \$1.3 trillion in compliance cost versus \$630 billion in tax relief. So from the taxpayers' perspective, the recent tax cut represents only a partial refund of their compliance cost.

Table 8
Internal Revenue Costs, Collections and Employees
Fiscal Years 1970-2000

	Operating Costs (a) (\$ Millions)	Operating Costs (Real 2000 \$)	Gross Collections (b) (\$ Millions)	Cost of Collecting \$100	Number of Employees (c)		
					Total	National Office	Field
1970	\$ 886	\$ 3,264	\$ 195,722	\$ 0.45	68,683	4,103	64,580
1971	981	3,441	191,647	0.51	68,972	4,358	64,614
1972	1,127	3,792	209,856	0.54	68,549	4,134	64,415
1973	1,162	3,702	237,787	0.49	74,170	4,505	69,665
1974	1,313	3,838	268,952	0.49	78,921	4,310	74,611
1975	\$ 1,585	\$ 4,238	\$ 293,823	\$ 0.54	82,339	4,531	77,808
1976 (d)	1,667	4,219	302,520	0.55	84,264	4,732	79,532
1977	1,791	4,257	358,139	0.50	83,743	4,994	78,749
1978	1,962	4,355	399,776	0.49	85,329	4,919	80,410
1979	2,116	4,335	460,412	0.46	86,168	4,978	81,190
1980	\$ 2,281	\$ 4,280	\$ 519,375	\$ 0.44	87,464	5,114	82,350
1981	2,465	4,231	606,799	0.41	86,156	5,110	81,046
1982	2,626	4,243	632,241	0.42	82,857	5,098	77,759
1983	2,969	4,613	627,247	0.47	83,603	4,357	79,246
1984	3,279	4,913	680,475	0.48	87,635	5,327	82,308
1985	\$ 3,601	\$ 5,231	\$ 742,872	\$ 0.48	92,259	5,454	86,805
1986	3,842	5,461	782,252	0.49	95,880	5,361	90,519
1987	4,366	6,024	886,291	0.49	102,189	6,253	95,936
1988	5,036	6,720	935,107	0.54	114,875	6,934	107,941
1989	5,199	6,683	1,013,322	0.51	114,758	7,895	106,863
1990	\$ 5,440	\$ 6,732	\$ 1,056,366	\$ 0.52	111,962	7,459	104,503
1991	6,098	7,280	1,086,851	0.56	115,628	8,286	107,342
1992	6,536	7,618	1,120,800	0.58	116,673	9,333	107,340
1993	7,078	8,056	1,176,686	0.60	113,460	9,320	104,140
1994	7,245	8,078	1,276,467	0.57	110,665	9,467	101,198
1995	\$ 7,390	\$ 8,063	\$ 1,375,732	\$ 0.54	112,024	9,738	102,286
1996	7,240	7,750	1,486,547	0.49	106,642	8,766	97,876
1997	7,164	7,521	1,623,272	0.44	101,703	7,837	93,866
1998	7,565	7,846	1,769,409	0.43	98,037	7,468	90,569
1999	8,269	8,458	1,904,152	0.43	98,730	8,078	90,652
2000	\$ 8,258	\$ 8,258	\$ 2,096,917	\$ 0.39	97,074	(e)	(e)

(a) Starting with Fiscal Year 1975, represents actual IRS operating costs, exclusive of reimbursements received from other Federal agencies for services performed. While operating costs for earlier years may, in some cases, include reimbursement, the amounts involved were small and, therefore, do not affect comparability of the data on the historical costs of collecting \$100.

(b) Starting with Fiscal Year 1988, gross collections exclude alcohol and tobacco taxes and, starting with the second quarter of Fiscal Year 1991, exclude taxes on firearms, when responsibility for all these taxes was transferred to the Bureau of Alcohol, Tobacco and Firearms. Also, starting with Fiscal Year 1993, gross collections exclude foreign treaty money and arbitrage rebates.

(c) For Fiscal Years 1972 through 1974, includes average positions for the Economic Stabilization Program; for Fiscal Year 1974, includes average positions for the Federal Energy Program. Starting with Fiscal Year 1972, excludes 3,990 average positions transferred to the Office of the Secretary of the Treasury. In addition, for the years starting with Fiscal Year 1983 data are revised to reflect methodology in 1984 for computing average positions realized in conformance with Office of Personnel Management requirements. For these reasons, data for all years are not completely comparable.

(d) Represents fiscal year transitional period, July through September 1976, resulting from fiscal year redefinition. Fiscal Year 1976 covered July 1975 through June 1976 (earlier years were similarly defined). Fiscal Year 1977 covered October 1976 through September 1977 (subsequent years are similarly defined).

(e) The Internal Revenue Service discontinued the distinction between National Office and Field offices as a result of reorganization.

Source: Internal Revenue Service, Data Book (various years), Publication 55B.

Which Taxpayers Bear the Highest Cost of Compliance

Because complying with tax laws represents a fixed cost for many individuals, it seems likely that lower-income individuals would bear a greater relative tax compliance burden than higher income individuals. In previous research, the Tax Foundation has found this to be true for corporations. In fact, in 1996, small corporations — those with less than \$1 million in assets — spent at least 27 times more as a percentage of assets complying with the tax code than the largest U.S. corporations. New research by the Tax Foundation finds the same is true for individuals.

As shown in Table 10, the compliance cost on individuals is quite regressive (see Methodology). In other words, the compliance cost hits lower-income individuals harder than higher-income individuals. In fact, taxpayers with less than \$50,000 of adjusted gross income (AGI) pay almost 54 percent of the compliance cost for individuals — \$46.8 billion of \$86.1 billion.

As a percentage of AGI, taxpayers with AGI of less than \$20,000 are hit the hardest. They pay a compliance cost of 4.53 percent of their AGI. Because compliance costs are essentially a fixed cost, taxpayers' compliance cost falls as AGI increases. For those with \$40,000–\$75,000 in AGI, compliance cost consumes a much lower 1.32 percent of AGI. The compliance cost drops to 0.29 percent for taxpayers with an AGI over \$200,000.

This pattern occurs for two reasons. First, 60 percent of all returns are filed by taxpayers with less than \$50,000 in AGI. Secondly, taxpayers with less than \$50,000 in AGI only account for 25 percent of total AGI. Therefore, the fixed cost nature of tax compliance has a larger negative impact on lower income individuals.

It follows, therefore, that an effective way to provide tax relief to lower-income taxpayers is via tax simplification. In fact, nearly half of all the tax surcharge savings resulting from tax simplification would go to taxpayers with less than \$40,000 in AGI. For example, Form

*Table 9
Annual Growth in Time Estimates of Various Tax Forms
Calendar Years 1995–2001*

	1995	1996	1997	1998	1999	2000	2001	1995–2001
1040								
Hours per form	11.6 hrs	10.9 hrs	9.9 hrs	11.6 hrs	12.9 hrs	13.0 hrs	13.5 hrs	1.8 hrs
Percentage Increase	—	–6.4%	–9.0%	16.8%	11.1%	1.3%	3.3%	2.1%
1040A								
Hours per form	11.5 hrs	12.2 hrs	11.5 hrs	12.9 hrs	13.6 hrs	14.3 hrs	15.2 hrs	3.8 hrs
Percentage Increase	—	6.7%	–6.0%	12.5%	4.9%	5.4%	6.5%	4.1%
1040EZ								
Hours per form	2.7 hrs	2.8 hrs	2.8 hrs	2.8 hrs	3.8 hrs	3.9 hrs	4.2 hrs	1.5 hrs
Percentage Increase	—	2.5%	–0.6%	1.2%	35.3%	3.1%	7.7%	6.5%
Sch A (Itemized Deductions)								
Hours per form	4.6 hrs	4.6 hrs	4.6 hrs	4.5 hrs	5.7 hrs	5.6 hrs	5.6 hrs	1.0 hrs
Percentage Increase	—	0.0%	0.0%	–2.5%	26.5%	–0.6%	0.0%	2.9%
Sch D (Capital Gain/Loss)								
Hours per form	3.7 hrs	3.7 hrs	4.3 hrs	6.7 hrs	5.6 hrs	7.0 hrs	7.6 hrs	3.9 hrs
Percentage Increase	—	0.0%	17.2%	54.8%	–16.7%	25.1%	9.1%	10.9%
1065 (Partnership)								
Hours per form	98.1 hrs	101.0 hrs	102.9 hrs	102.5 hrs	102.5 hrs	104.0 hrs	110.8 hrs	12.7 hrs
Percentage Increase	—	3.0%	1.9%	–0.4%	0.0%	1.4%	6.6%	1.8%
1120 (C Corporation)								
Hours per form	193.7 hrs	192.8 hrs	192.1 hrs	192.1 hrs	192.1 hrs	194.5 hrs	198.5 hrs	4.8 hrs
Percentage Increase	—	–0.5%	–0.4%	0.0%	0.0%	1.3%	2.0%	0.3%
1120S (S Corporation)								
Hours per form	122.8 hrs	122.8 hrs	124.3 hrs	128.4 hrs	128.4 hrs	128.4 hrs	136.2 hrs	13.4 hrs
Percentage Increase	—	0.0%	1.2%	3.3%	0.0%	0.0%	6.0%	1.5%
4562 (Depreciation)								
Hours per form	44.1 hrs	45.6 hrs	45.6 hrs	48.5 hrs	48.5 hrs	48.5 hrs	48.5 hrs	4.4 hrs
Percentage Increase	—	3.5%	0.0%	6.3%	0.0%	0.0%	0.0%	1.4%
990 (Non-Profit)								
Hours per form	134.7 hrs	140.2 hrs	133.9 hrs	135.9 hrs	135.9 hrs	135.9 hrs	135.7 hrs	1.0 hrs
Percentage Increase	—	4.1%	–4.5%	1.5%	0.0%	0.0%	–0.2%	0.1%

Source: Tax Foundation; Internal Revenue Service.

1040 — which accounts for almost half of the compliance cost on individuals — takes 13.5 hours to complete. Every hour shaved off the 1040 would save taxpayers \$2.5 billion. A mere 3-hour savings would net a ten-year \$75 billion windfall for taxpayers at zero cost to the U.S. Treasury. Every hour shaved would also save taxpayers some 83 million hours a year, time better spent with family or tending to business.

Which States Bear the Highest Cost of Compliance

State-by-state estimates of the 2002 compliance cost are dissimilar for a variety of economic and demographic reasons (see Table 10). Table 11 breaks down the compliance cost by state by type of taxpayer—individual, business or non-profit. On a per capita basis, states such as Maryland, Delaware and New Jersey face the highest compliance cost while states such as Mississippi, West Virginia, and New Mexico face the lowest. On a per \$1,000 of income basis, the relative order changes with states such as Montana, Utah, and Wyoming facing the highest compliance cost and states such as California, Massachusetts, and Connecticut facing the lowest.

Measures to Reduce the Cost of Compliance

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

As explained earlier, 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, especially on the corporate side. 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 mind-boggling tax code complexity.

However, the political process, particularly the politics surrounding the deficit/surplus debate, 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.

This past 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, as the alternative minimum tax does, since raising rates or removing tax preferences in a straightforward 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 the proposal, or 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 specialties. Tax specialists begin writing detailed rules with other tax specialists in mind. This narrow focus explains why, on

*Table 10
The Income Distribution of Federal Income
Tax Compliance Costs
Calendar Year 2002*

Taxpayer's AGI	Compliance Burden as a Percentage of AGI
\$0 – \$20,000	4.53%
\$20,000 – \$40,000	1.84%
\$40,000 – \$75,000	1.32%
\$75,000 – \$200,000	0.90%
\$200,000 and over	0.29%

Source: Tax Foundation; Internal Revenue Service.

Table 11
Federal Tax Compliance Costs by State Per Capita and Per \$1,000 of Personal Income and Corresponding Ranks Calendar Year 2002

	Total			Rank	
	(\$Thousands)	Per Capita	Per \$1,000 of Personal Income	Per Capita	Per \$1,000 of Personal Income
All States (a)	\$ 194,040,491	\$ 695	\$ 21	—	—
Alabama	\$ 2,493,971	\$ 551	\$ 22	47	31
Alaska	418,677	623	21	39	37
Arizona	3,172,780	638	22	35	30
Arkansas	1,591,031	594	24	43	17
California	19,850,910	596	16	42	50
Colorado	\$ 3,766,964	\$ 878	\$ 24	4	18
Connecticut	2,857,660	867	18	5	48
Delaware	730,833	936	27	2	6
Florida	12,678,334	810	25	10	13
Georgia	5,208,011	644	20	33	43
Hawaii	\$ 812,667	\$ 629	\$ 22	36	28
Idaho	917,947	656	27	32	7
Illinois	8,724,038	719	20	21	44
Indiana	3,732,633	611	21	41	36
Iowa	2,103,438	721	25	19	15
Kansas	\$ 1,778,957	\$ 658	\$ 22	31	32
Kentucky	2,381,616	590	22	44	29
Louisiana	2,591,284	580	23	46	21
Maine	915,323	721	25	20	12
Maryland	5,008,950	936	25	1	14
Massachusetts	\$ 4,737,150	\$ 759	\$ 18	15	49
Michigan	6,661,806	686	21	25	33
Minnesota	3,628,043	740	21	17	38
Mississippi	1,464,154	513	22	50	27
Missouri	3,833,093	683	23	28	24
Montana	\$ 759,058	\$ 781	\$ 34	14	1
Nebraska	1,385,648	802	27	11	5
Nevada	1,687,050	865	25	7	16
New Hampshire	941,722	755	20	16	40
New Jersey	7,296,509	883	21	3	34
New Mexico	\$ 1,038,911	\$ 540	\$ 23	48	19
New York	14,988,830	824	20	8	42
North Carolina	5,093,022	640	21	34	35
North Dakota	493,540	739	28	18	4
Ohio	7,787,383	685	23	27	26
Oklahoma	\$ 2,345,679	\$ 686	\$ 26	26	10
Oregon	2,423,184	696	23	24	23
Pennsylvania	7,693,674	629	19	37	46
Rhode Island	869,343	866	26	6	11
South Carolina	2,470,016	629	23	38	22
South Dakota	\$ 567,537	\$ 718	\$ 27	22	9
Tennessee	3,381,178	585	21	45	39
Texas	12,692,642	614	19	40	45
Utah	1,787,760	781	30	13	2
Vermont	493,822	790	27	12	8
Virginia	\$ 4,706,656	\$ 660	\$ 19	30	47
Washington	4,063,586	675	20	29	41
West Virginia	969,928	526	23	49	25
Wisconsin	3,832,931	711	23	23	20
Wyoming	441,540	814	29	9	3
District of Columbia	\$ 556,550	\$ 1,059	\$ 23	—	—

(a) Forms filed internationally not included.

Source: Tax Foundation; Internal Revenue Service.

occasion, there are completely self-contradictory provisions 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.

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 stability. Although not measured in this study, the taxpayer uncertainty that results from frequent tax law changes is a key source of complexity. Second, legislators 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,” legislators 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.

Methodology

The federal income tax compliance cost estimate for 2002 is based on data from the Internal Revenue Service. Table 4 compiles a list of the core individual income tax forms along with both the estimated paperwork-burden calculation (in hours of compliance time) generated by the Internal Revenue Service. Tables 5 and 6 compile a similar list for the business and non-profit sector, respectively. These lists are far from exhaustive. Not only are many obscure forms and schedules left out, but the lists are also incomplete to the degree that adequate tax return information could not be obtained or estimated for the many schedules and forms that are common auxiliary components of the core forms.

One trend in tax filing has been the growth in alternative methods of filing, the tele-file and the e-file. These filing methods primarily affect the delivery of the tax filings rather than the filings themselves. In the case of the tele-file, the 1040EZ must be used in order to file over the phone. As such, all tele-filed forms were counted under the 1040EZ form. In the case of the e-file, both the 1040 and 1040A forms can be filed electronically. Unfortunately, no data is available to break down the types of e-filings. In order to keep the time estimates on the conservative side, all e-files were counted as 1040 filings (as the 1040 requires less time to file than the 1040A).

Once the total number of hours spent on compliance has been determined, an hourly rate is then applied in order to determine the compliance cost. This hourly rate was determined in one of two ways.

First, for individuals who filed themselves,

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the report uses their hourly compensation rate (wages and salary plus benefits) as a proxy for their “tax surcharge.” Some may argue that individuals would value their time more highly than their hourly salary rate since it is their leisure time (time not spent in formal work) that is given up to file taxes. However, to avoid speculation, the Tax Foundation believes that the hourly compensation rate represents the best estimate of a minimum compliance cost level for individuals.

Utilizing data from the National Compensation Survey and Employment Cost Index published by the Bureau of Labor Statistics in 2000, the Tax Foundation estimates a national hourly wage and salary rate of \$16.66. In addition, utilizing data from the National Income and Product Accounts published by the Bureau of Economic Analysis, the Tax Foundation estimates that benefits increase total compensation by 18.2 percent, for a total hourly compensation rate of \$19.68.

Second, for filings made by tax professionals, the report uses the average compensation rate for tax accountants. Unfortunately, the National Compensation Survey does not list “tax accountants” as a separate occupation. Therefore, the Tax Foundation estimates their rate by averaging “accountants and auditors” and “lawyers” together, since tax accountants must be adept not only in accounting procedures, but also in interpreting tax law and court rulings. This yields an hourly wage and salary rate of \$30.14. After adjusting this wage to include benefits, a final hourly compensation rate of \$35.60 is reached.

To derive the final average compensation cost for individual filings, the report also takes into account the number of forms prepared by individuals and those prepared by tax professionals. The latest IRS data shows that 56 percent of all forms are prepared by tax professionals. Using a weighted average, the final compensation cost is \$28.65. For businesses, the average compensation cost is the rate derived for the average tax accountant: \$35.60.

The compensation cost is derived for 2000—the latest year available. In order to project the compensation cost out to 2007, the cost was conservatively scaled up by the estimated rate of inflation as published by the Congressional Budget Office. The projections for the number of forms filed by type were taken from the Internal Revenue Service’s own estimates. The hourly estimates for the projections were taken from the 2000 forms and held static throughout the projected time span; therefore, recent policy changes are not incorporated into the hourly form estimate.

The distribution of tax compliance cost, by income and by state, is the result of an allocation model developed by the Tax Foundation utilizing data published by the Internal Revenue Service – Individual Income Tax Returns, 1999 and IRS Document 6149. Utilizing this data, the model allocates every IRS form examined in the compliance study by income cohort and by state. 



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Editor and Communications
Director, Bill Abern

Tax Foundation
1250 H Street, NW, Suite 750
Washington, DC 20005
(202) 783-2760
(202) 783-6868 fax
www.TaxFoundation.org
TF@TaxFoundation.org