TaxWatch

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TAX FOUNDATION Since 1937

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America's Hidden Tax Burden: Compliance Costs

American taxpayers paid roughly $1.2 trillion in federal income taxes in 2005, but the nation's true tax burden is even higher.

Last year, individuals, businesses and nonprofits spent an estimated 6 billion hours complying with the federal income tax code with an estimated compliance cost of over $265.1 billion, according to a recent Tax Foundation study.

This includes the cost of tax preparation, paperwork and other hassles caused by tax complexity. These translate into imposing a 22-cent tax compliance surcharge for every dollar the income tax system collects.

Projections show that by 2015 the compliance cost will grow to $482.7 billion.

"In the last decade the cost of tax compliance has grown tremendously," said Tax Foundation President Scott A. Hodge. "This is due partly to the inherent difficulty of taxing income, but also because of growing non-economic demands lawmakers place on the tax code."

Tax Reform and Compliance Costs

As Congress debates the tax reform recommendations of the President's Advisory Panel on Federal Tax Reform, members should address this growing compliance burden, and work to reduce it through tax simplification and reform.

How Much Does Paperwork Cost?

If Americans were able to save the $265 billion in tax compliance costs and spend the money elsewhere, it could pay for any *one* of the following…

- The combined budget of the Departments of Education, Homeland Security, Justice, Treasury, Labor, Transportation, Veterans Affairs, Health and Human Services and NASA;
- More than half of the U.S. defense budget;
- One laptop computer for every American;
- Four iPod nanos for every American;
- A 6-month supply of Denny's Grand Slam Breakfasts for every American;
- One treadmill for every American— to help work off any Denny's breakfasts.

The burden of tax compliance does not fall evenly on taxpayers. It varies by type of taxpayer, income level and state. In 2005, businesses had to bear the majority of tax compliance costs, totaling nearly $148 billion or 56 percent

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Tax Watch

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Message from the President:
Who Profits at the Pump?

Over the past quarter century, oil companies directly sent more than $2.2 trillion in taxes, adjusted for inflation, to state and federal governments — three times what they collectively earned in profits over the same time period. Yet some politicians say this is not enough and are proposing a new "windfall profits" tax to raise billions more for federal coffers.

Of course, as most economists agree, corporations don't pay taxes, people do. Folks like us will really pay those new taxes, either through higher prices at the gas pump or through lower returns in our 401(k)s. Smaller profits for companies means smaller returns for our retirement funds.

Congress recently brought in oil executives for a grilling on "excessive" profits. The press piled on with headlines such as, "It's Open Season on Big Oil." At a minimum, both politicians and the media are guilty of biting the hand that feeds them and, perhaps, a bit of hypocrisy: Oil companies hand over more than $35 million per year to newspapers for advertising, while the government profits far more from each gallon of gas sold than do the oil companies.

Today, Americans pay an average of 45.9 cents in taxes per gallon of gas. The federal gas tax is 18.4 cents per gallon while the average state and local tax is 27.5 cents. These taxes pumped more than $54 billion into federal and state coffers last year alone. Diesel taxes totaled $9 billion more.

Almost all gas taxes are levied at a flat rate per gallon, regardless of whether a gallon of gas costs $1.49, $2.49, or $3.49. So while industry profits go through booms and busts, government profits grow steadily larger.

While politicians decry large corporate profits, those profits generate large corporate income-tax payments. We estimate that over the past 25 years, the major domestic oil companies paid about $518 billion in corporate income taxes to Uncle Sam and state governments. Oil companies pay billions more to governments in off-shore royalties, severance taxes, property taxes, and payroll taxes — and the list goes on.

The last time this country experimented with a windfall profits tax was in the 1980s. Back then, the tax depressed the domestic oil industry, increased our reliance on foreign oil, and failed to raise a fraction of the revenue forecasted. According to a 1990 Congressional Research Service study, the tax stunted domestic production of oil by 3 to 6 percent and created a surge in foreign imports between 8 and 16 percent.

Because it receives so much tax revenue from this one industry, the government is subject to the same risk as any parasitic organism: If it eats too much it will kill the host. The last windfall profits tax nearly killed the domestic oil industry. A new one could finish the job.

Sincerely,

Scott A. Hodge

U.S. Corporate Taxes: Handicapping America in the Global Economy

The U.S. is lagging behind its trading partners in a worldwide trend toward lower corporate tax rates, according to a new study from the Tax Foundation.

In the Tax Reform Act of 1986 (TRA'86) the U.S. Congress lowered the top corporate income tax rate from 46 percent to 34 percent, the largest reduction since the tax was enacted in 1909. This change, along with an earlier move in the United Kingdom, started a wave of corporate income tax reduction worldwide.

"One of the ironies of tax policy during the Bush presidency is that five years of tax-cutting legislation have left the corporate income tax rate unchanged," said Staff Attorney Chris Atkins, co-author of the new report with Tax Foundation President Scott A. Hodge.

Every nation in the Organization for Economic Cooperation and Development (OECD) taxes corporate income, but most do not have a second layer of corporate income taxes at the state level as the U.S. does. As a result, tax writers at the federal level in the U.S. need to take that into account when deliberating how high the federal corporate income tax rate should be.

"The U.S. now has the highest combined statutory corporate income tax rate among OECD countries."

"The U.S. now has the highest combined statutory corporate income tax rate among OECD countries," said Hodge. "The U.S. will not attract new business and job creation if its corporate income tax is significantly higher than in comparable nations. As the U.S. contemplates fundamental tax reform, one of the major goals should be a lower corporate income tax rate."

The President's Advisory Panel on Federal Tax Reform has suggested modest cuts in the federal corporate income tax rate in its final report released November 1. The panel suggested a 31.5 percent top rate in one plan and a 30 percent top rate in an alternative plan. Both plans would improve the U.S. worldwide ranking, but the U.S. would still be taxing corporate income at a rate well above the OECD average.

"Lawmakers should consider reducing the federal rate to 25 percent which, when coupled with state corporate income taxes, would almost bring the U.S. rate down to the OECD average of 29.2 percent," said Atkins.

Read the full report, "The U.S. Corporate Income Tax System: Once a World Leader, Now A Millstone Around the Neck of American Business" online at www.taxfoundation.org.

Country	Corporate Tax Rate	Rank
United States	39.3%	1
Japan	39.0%	2
Germany	38.9%	3
Canada	36.1%	4
Spain	35.0%	5
Greece	35.0%	5
France	35.0%	7
Belgium	34.0%	8
New Zealand	33.0%	9
Italy	33.0%	9
OECD Average	*29.2%*	

Fixing Health Care with Tax Reform

The following remarks were delivered by Eli Lilly and Co. Chairman and Chief Executive Officer Sidney Taurel at the Tax Foundation Annual Dinner in Washington, D.C. on November 17, 2005.

I am very grateful to all the members of the Tax Foundation for the exceptional honor you pay me tonight. Lilly has been a supporter of this organization for nearly 60 years, because we see it as a welcome advocate for clarity, efficiency, and common sense in a system that too plainly lacks these virtues.

> "The road to a better health care system runs through the tax code."

I also want to express my admiration and appreciation for this evening's other honoree — Mr. Charles Rossotti. As just the latest chapter in his distinguished career, Mr. Rossotti has served on the President's Advisory Panel on Federal Tax Reform…

As it happens, one of the panel's recommendations has important consequences for health care reform as well as tax reform. I'm referring to the recommendation that the tax exclusion for employer-provided health benefits be capped at $11,000 a year … and that an equivalent deduction be offered to those who pay for health care on their own.

The tax exclusion for employer-provided health benefits is a major factor in at least two chronic problems in U.S. health care — first, the problem of ever-rising costs and, second, the problem of the uninsured.

Start with the cost issue. It's not the politically popular explanation, but there is substantial agreement among economists that what drives the upward spiral is a breakdown in the economic signals between buyers and sellers where, normally, price is the balancing mechanism.

In health care, that exchange never happens … because one party — the patient — needs and consumes the medical service, while another party – the government, or one's employer, or the insurance company — appears to pay for it.

I say "appears," because economists would argue that, in one way or another, consumers do bear the cost. But, because we think of it as "somebody else's money," we feel little inhibition about spending it.

This split between patients and payers can be traced to a quirk of policy expediency during World War II — when the Roosevelt administration allowed employers to skirt temporary wage and price controls by offering health benefits to workers in lieu of higher wages.

But what really locked this system in place — and greatly amplified the economic dislocation it causes — was the subsequent decision by the government to exempt these benefits from taxation.

The proposals of the president's tax reform panel can have a meaningful impact on both the problem of "the fractured customer" and the problem of the uninsured.

But these solutions would not quite address the needs of the core group of the uninsured… For this reason, free market reformers argue that the best way to address these problems is to replace the tax exclusion for employer-based benefits with a refundable tax credit, available to all.

Experts working for free market reforms have argued for many years that the road to a better health care system runs through the tax code.

I would just urge all of you … committed as you are to a better tax system and a stronger free market economy … to help spread that understanding as far and as wide as you can.

Our health … and our wealth … as a nation may depend on it.

For more information about our Annual Dinner, visit www.taxfoundation.org/events/.

Seniors Benefit from Cuts in Capital Gains and Dividend Tax Rates

The percentage of middle-income Americans who depend on dividends and capital gains continues to grow, especially among the elderly, according to new research by Tax Foundation President Scott A. Hodge.

"Because of the graying of America and the trend toward stock ownership by middle-income people," said Hodge, "recent cuts in the tax rates on capital gains and dividends have provided welcome relief to millions of middle-income elderly."

The temporary 15-percent tax rate on capital gains and dividends passed in 2003 benefits millions of middle-income people, according to the Foundation's analysis of IRS data. Those taxpayers will face a tax hike when it expires at the end of 2008 unless Congress acts to extend this favorable rate or make it permanent.

Hodge estimates that more than 80 percent of taxpayers who claim dividend income earned less than $100,000 in 2004. The percentage is similar for capital gains income, 76 percent.

> "Recent cuts in the tax rates on capital gains and dividends have provided welcome relief to millions of middle-income elderly."

Capital gains realizations clearly increase with age. Some 30.2 percent of taxpayers between age 65 and 74 claim capital gains income, while 27.6 percent of taxpayers over age 75 have capital gains income. The percentage of taxpayers over age 65 with capital gains income is higher than any other age group, and is more than twice the national average of 12.9 percent.

Older Americans are even more reliant on dividend income than on capital gains. Among taxpayers aged 65 to 74, a remarkable 51.3 percent claim dividend income. Among taxpayers above age 75, dividend income is claimed by 50.4 percent.

These figures represent a universe of taxpayers in which the leading edge of the "baby boom" generation has just reached its 60th birthday. As this generation continues to age, the demographic balance of capital gains and dividend earners will undoubtedly shift even more dramatically up the age scale.

The most frequently criticized provision of the Bush tax cuts is this cut in the rates on dividends and capital gains because the bulk of these income streams flow to high-income people. To the assertion that the President and Congress gave wealthy people too much tax relief, the Administration has generally responded that tax cuts on capital income pay back a generous premium to the economy at large in the form of capital formation and higher wages. The steady and strong economic growth that has occurred since those tax cuts in 2003 is cited as empirical proof.

Focusing solely on current income distributions when deciding whether or not to extend the lower rates on dividends and capital gains provides little information about those taxpayers who actually benefit from these policies. When we examine the demographic details behind tax return data it becomes clear that these policies significantly benefit older Americans who are growing in numbers each year.

This report from the Tax Foundation provides a different type of support for the rate cuts, arguing that the smaller tax benefits of millions of middle-income elderly should not be ignored in the debate.

View the full analysis, "Majority of Seniors Benefit from Reduced Capital Gains and Dividend Tax Rates," online at www.taxfoundation.org.

Compliance Costs (continued from page 1)

of total compliance costs. Compliance costs for individuals were $111 billion or 42 percent, and for nonprofits this was nearly $7 billion or 2.5 percent of the total.

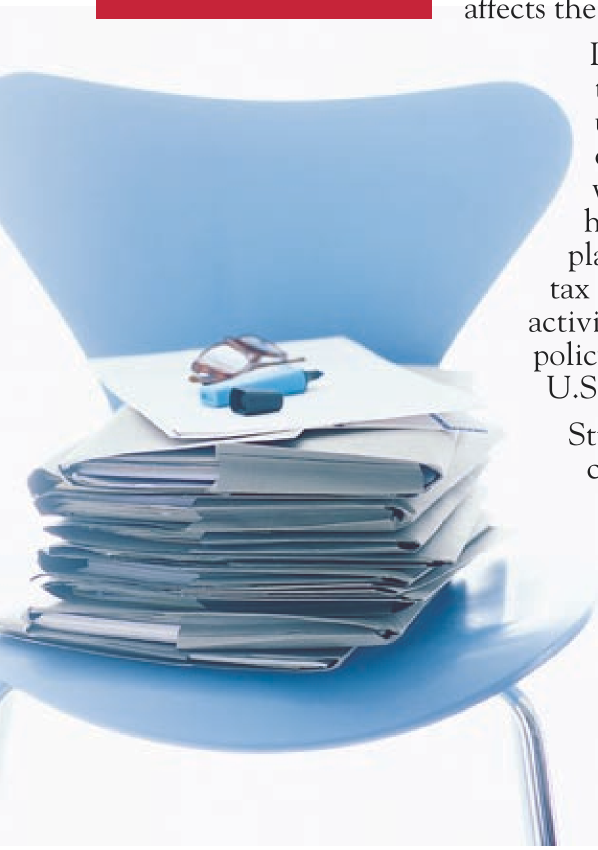
When examined by income level, compliance cost is found to be highly regressive, taking a larger toll on low-income taxpayers as a percentage of income than high-income taxpayers. On the low end, taxpayers with adjusted gross income (AGI) under $20,000 incur a compliance cost equal to 5.9 percent of income while the compliance cost incurred by taxpayers with AGI over $200,000 amounts to just 0.5 percent of income.

State-by-state estimates of the 2005 federal compliance cost also vary widely because state populations and economies differ so significantly. On a per capita basis, Wyoming ($1,242), Delaware ($1,181) and Colorado ($1,167) face the highest compliance cost while Mississippi ($658), West Virginia ($689), and Tennessee ($705) face the lowest.

> *"It's important for taxpayers to have an estimate of their compliance cost because tax complexity affects the performance of the economy."*

Why Compliance Costs Matter

It's important for taxpayers to have an estimate of their compliance cost because the level of complexity in tax law affects the performance of the economy.



If lawmakers create an Internal Revenue Code that's unnecessarily complex or that changes rapidly, taxpayers will face uncertainty about how taxes will affect business plans or investments. When the tax consequences of economic activities are unpredictable, tax policy handicaps growth of the U.S. economy.

Studies of the federal tax code consistently find that the current system is excessively complex. The new study concurs, quantifying the code's complexity in a way that makes clear how unnecessary much of it is.

Measuring Paperwork Burdens

As high as the burden may seem in the Foundation's study, the data presented are in fact cautious estimates of taxpayers' true compliance cost.

"In the study, compliance cost refers to the basic actions required to file federal income tax returns," said Hodge. "But there are additional economic costs."

Americans incur tax planning costs by making decisions to minimize their tax liabilities under current law. They also fund the IRS and Tax Court and rack up legal costs by dealing with these institutions.

The complexity of the current tax system forces Americans to miss out on economic opportunities. When taxes are withheld from a worker's paycheck before the taxes are actually due, that person forgoes interest, profit, or dividends that could have been earned in the meantime.

"A software developer who spends considerable time complying with the federal income tax code could have instead been using that time to create new products that would generate wealth," said Hodge. "Because these costs are difficult to quantify, our study may underestimate the true costs of the tax code."

Read the full report, "The Rising Cost of Complying With the Federal Income Tax" on our Website at www.taxfoundation.org.

Making Taxes Simple: Flat Taxes Around the World

Perhaps the world is becoming flat.

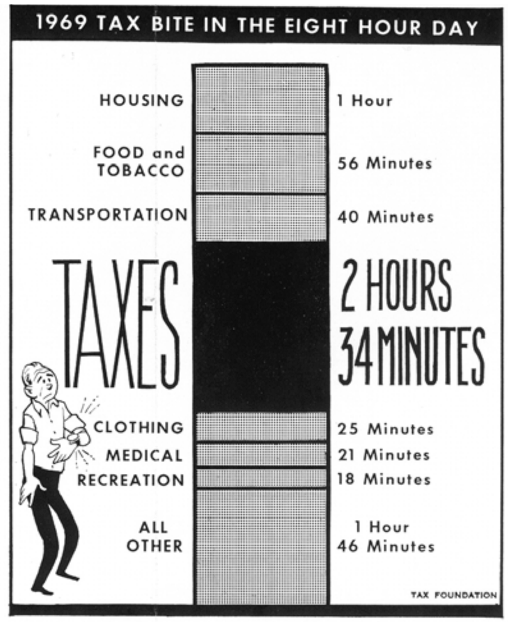
The most striking trend in global tax policy in recent years has been the rapid rise of flat tax systems. Once considered a sacred cow of tax policy, progressive-rate income taxes are being abandoned in favor of improved economic performance.

Since 1994, Estonia, Georgia, Latvia, Lithuania, Romania, Russia, Serbia, Slovakia and Ukraine have all adopted single-rate income taxes ranging from 12 percent to 19 percent. Poland is set to replace its progressive system with a flat rate of 18 percent, and Greece and Italy are both considering single-rate taxes in the range of 25-30 percent.

According to the National Post, Canada may be next in line to join the flat-tax club, possibly putting pressure on U.S. lawmakers to follow suit or risk being left in the dust economically.

Although lawmakers are often behind the academic learning curve, there's increasing consensus among economists that single-rate taxes gain an economic system far more in enhanced efficiency than they sacrifice in supposed tax equity. Hopefully the experience of Eastern Europe in the coming years will help show that to lawmakers in a concrete way.

From the Archives: 1969



In 1969 Americans will need eight minutes more of their eight-hour workday to meet their taxes than they did last year, says Tax Foundation. Two hours and 34 minutes will be required as against two hours, 26 minutes in 1968. In 1966, working time needed was two hours 19 minutes.

(Two-column mats available without charge on request)

Time to Reform the Charitable Tax Deduction?

The federal tax deduction for charitable gifts is highly regressive and subsidizes many organizations that are questionably charitable, a new Tax Foundation study finds.

"More than 75 percent of tax benefits from the charitable deduction go to the 12 percent of taxpayers with incomes over $100,000," said Staff Economist Andrew Chamberlain, co-author of the new study.

In addition to being regressive, the study finds that charities now subsidized by the charitable deduction provide services that would otherwise be supplied in the marketplace without a tax subsidy.

Nonprofit magazines such as *Ms.*, *Harper's*, *Mother Jones* and others are indistinguishable from for-profit magazines. The National Geographic Society sells videos and maps in direct competition with for-profit stores. The YMCA operates health clubs that are similar to for-profit gyms.

Nonprofit human services groups receive just 6.5 percent of charity revenue, while scientific research, civil rights, and environmental quality groups receive less than one percent each. In contrast, hospitals and universities, which are not primarily charitable organizations, receive nearly 57 percent of charity revenues.

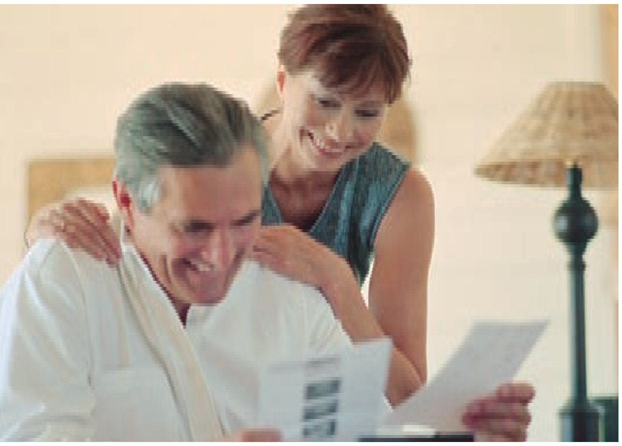
The study notes the charitable deduction comes at a real economic cost to society. By shrinking the federal tax base, the exemption for charitable gifts forces up tax rates for everyone.

"There's no justification for subsidizing services that free markets will normally provide," said Chamberlain.

Read the full report, "Charities and Public Goods: The Case for Reforming the Federal Income Tax Deduction for Charitable Gifts," online at www.taxfoundation.org.

What Will Be Your Legacy?

When you plan your estate it is important to provide for those you love, as well as those who uphold your values. As you provide for your estate please consider making a gift to support the Tax Foundation's work.



From our founding day, the Tax Foundation has been grounded in the belief that dissemination of basic information about government finance is the foundation of good policy in a free society. In 1937, at the height of the New Deal when federal spending had grown 170 percent in the previous decade, the Tax Foundation was founded to monitor the growth of government. We continue that mission today.

> *"By making a gift to the Tax Foundation, you help ensure the future of sound tax policy for coming generations of American taxpayers, as well as our own."*

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Our staff is available to discuss planned giving options such as bequests, stock gifts or endowed gifts. Please join us in leaving a legacy of improved tax policy in America.

For more information on our planned giving program, please contact Julie Burden, Director of Development, at (202) 464-5102 or burden@taxfoundation.org.

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