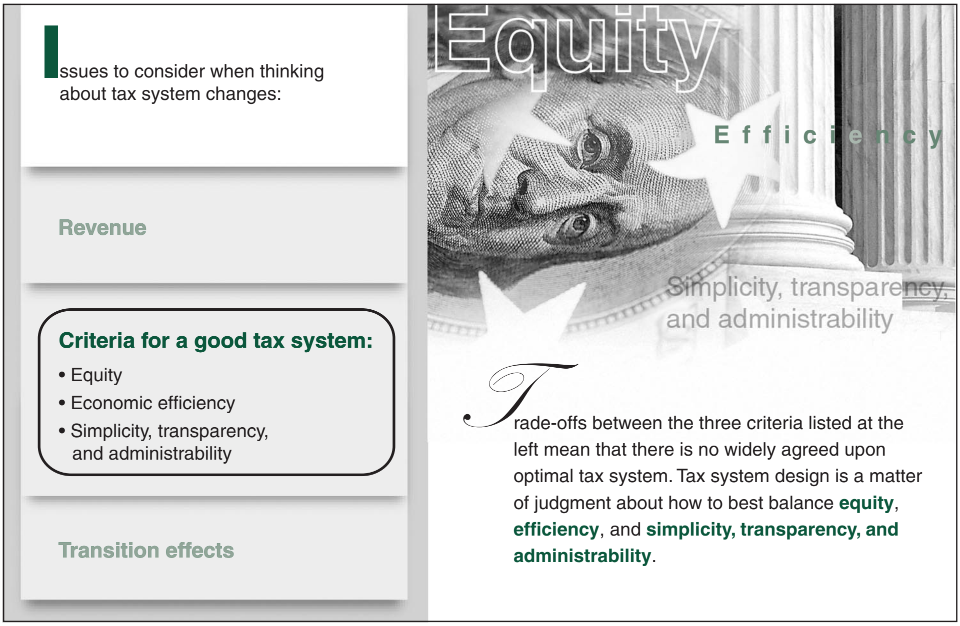
[Excerpts from Government Accountability Office, *Understanding the Tax Reform Debate: Background, Criteria & Questions* (GAO-05-1009SP Sept. 2005)]

Criteria for a Good Tax System

How should a tax system be designed to raise a given amount of revenue? More specifically, what criteria should be used to evaluate the advantages and disadvantages of a particular tax system, or a particular tax policy proposal? The answers matter because various combinations of tax bases and rates can raise the same amount of revenue.

Three long-standing criteria—equity; economic efficiency; and a combination of simplicity, transparency, and administrability—are typically used to evaluate tax policy. These criteria are often in conflict with each other, and as a result, there are usually trade-offs to consider between the criteria when evaluating a particular tax proposal. Some of the criteria, such as equity and transparency, are more subjective while other aspects of some of the criteria, such as economic efficiency, can be defined more objectively. Additionally, people may disagree about the relative importance of the criteria. Consequently, citizens and elected officials are likely to hold a wide range of opinions about what the ideal tax system should look like. (See fig. 9.)

Figure 9: Trade-offs in the Criteria for Assessing Tax Reform



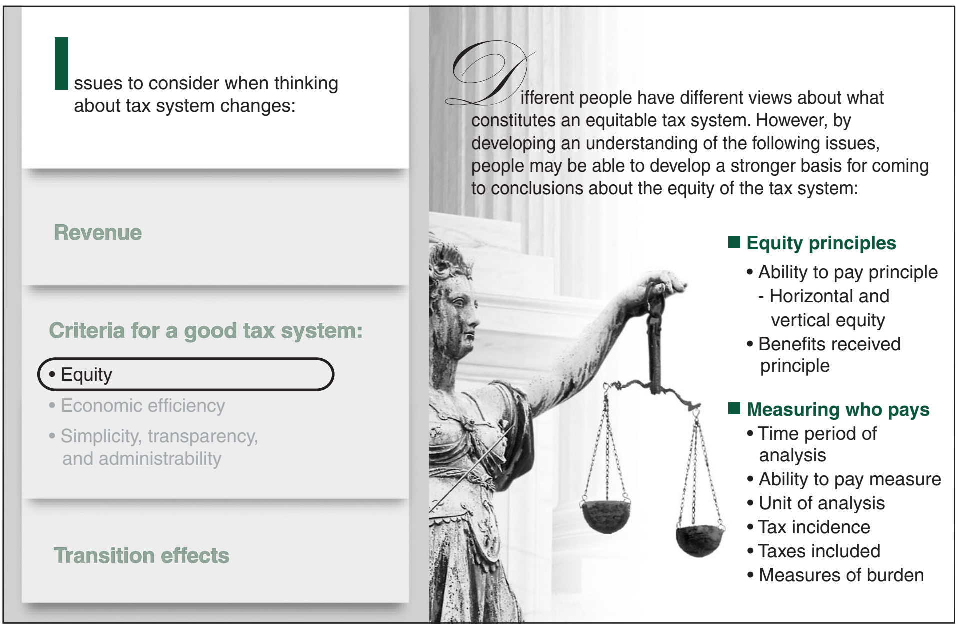
Sources: GAO (text); PhotoDisc (images).

In the following sections, we explain these criteria. The fact that a particular tax is viewed favorably from the perspective of one of the criteria is not an overall endorsement of the tax.

Equity

There are a wide range of opinions regarding what constitutes an equitable, or fair, tax system. There are principles—a taxpayer's ability to pay taxes and who receives the benefits from the tax revenue that is collected—that are useful for thinking about the equity of the tax system. However, these principles do not change the fact that conclusions about whether one tax is more or less equitable than another are value judgments. Similarly, analytical tools, such as **distributional analysis**, while providing useful factual information about who pays a tax and how much they pay, do not replace individuals' value judgments about what constitutes a fair tax system. (See fig. 10.)

Figure 10: Equity Overview



Sources: GAO (text); PhotoDisc, ©Corbis (images).

Equity Principles

Two principles of equity underlie debates about the fairness of different tax policies. The **ability to pay principle** and the **benefits received principle** do not identify one tax policy as more equitable than another, but they can be used to clarify and support judgments about equity. When making judgments about the overall equity of government policy, it is important to consider both how individuals are taxed and how the benefits of government spending are distributed. Even if some judge tax policy to be inequitable, government policy as a whole may be considered more equitable once the distribution of both taxes and government benefits is accounted for. For the purposes of this report, we have confined our discussion of equity to the distribution of tax burdens.

Ability to Pay Principle

The ability to pay principle states that those who are more capable of bearing the burden of taxes should pay more taxes than those with less ability to pay. The ability to pay principle relates taxes paid to some measure of ability to pay, such as overall wealth, income, or consumption. However, ability to pay may vary depending on the measure chosen. For example, a taxpayer's ability to pay, measured by overall wealth, may differ significantly from his or her ability to pay measured by income. A taxpayer who worked for many years and then retired may have accumulated a significant amount of wealth and may, as a result, have a higher ability to pay taxes but may have low current income.

Some features of the current income tax can be viewed as reflecting attempts to account for differences in ability to pay. For example, two taxpayers with the same income may not have the same level of economic well-being—the same ability to pay—if one has high medical expenses and the other does not. For this reason, the current income tax allows deductions for large medical expenses. Other provisions of the tax code, such as the deduction for the number of dependents, may also adjust income to better reflect ability to pay. Some items that clearly affect ability to pay, such as the contribution provided by a nonworking spouse to a family's well-being, are not included in taxable income, in part because of difficulties in valuing these aspects of economic well-being. People have different views about the factors that affect ability to pay.

Additionally, some do not agree that income is the best measure of ability to pay. As noted above, some argue that consumption provides a better measure of a taxpayer's ability to pay taxes than income.

Horizontal and Vertical Equity

The concepts of **horizontal equity** and **vertical equity** are refinements of the ability to pay principle.

Horizontal equity requires that taxpayers who have similar ability to pay taxes receive similar tax treatment. Targeted tax expenditures, such as deductions and credits, could affect horizontal equity throughout the tax system because they may favor certain types of economic behavior over others by taxpayers with similar financial conditions. For example, two taxpayers with the same income and identical houses may be taxed differently if one owns his or her house and the other rents because mortgage interest on owner-occupied housing is tax deductible.

Vertical equity deals with differences in ability to pay. Subjective judgments about vertical equity are reflected in debates about the overall fairness of the following three types of rate structures, where for this example, income is used as the measure of ability pay:

- ***Progressive tax rates***: The tax liability as a percentage of income increases as income increases.

- ***Proportional tax rates***: Taxpayers pay the same percentage of income, regardless of the size of their income.

- ***Regressive tax rates***: The tax liability is a smaller percentage of a taxpayer's income as income increases.

Just because the statutory rate structure for a tax is progressive does not necessarily mean that the tax system is progressive overall. For example, when considering an individual income tax, if statutory marginal tax rates increase as taxable income increases the tax rate structure is progressive. However, as shown in text box 3, **statutory tax rates** are not the same as **effective tax rates**—progressive statutory tax rates could be offset by other features of the tax system. Average effective tax rates, or the amount of tax that a taxpayer actually pays as a percentage of his or her total income (after deductions, credits, and exclusions are removed from the equation) may make the tax less progressive if there are a variety of provisions in the tax code that reduce the taxable income of wealthier taxpayers.

Text Box 3: Examples of Different Types of Tax Rates

Conclusions about the overall equity of the tax system may be different depending on which type of tax rate one considers.

Statutory tax rates are the tax rates that are defined by law in the tax code and applied to taxable income. Effective tax rates differ from statutory tax rates in that they are typically measured using a broader definition of income, which includes items excluded under the current tax code in order to provide an estimate of what a taxpayer pays in relation to his or her overall total income.

Marginal tax rates are the rates that taxpayers pay on the next dollar of income that is earned. Marginal tax rates can be presented as both marginal statutory rates and marginal effective rates. **Average tax rates** are the total amount of tax a taxpayer pays divided by some measure of his or her income. In the current tax system, average tax rates are sometimes presented as the amount of tax a taxpayer pays divided by his or her taxable income. Average effective tax rates differ in that they are developed using a broader measure of total income than taxable income.

The following tax rates are often discussed when considering the equity of the tax system.

- *Marginal statutory tax rates*: The tax rate that a taxpayer pays on his or her next dollar of income earned as defined by law in the tax code.
- *Marginal effective tax rates*: The actual rate of tax that a taxpayer faces on the next dollar of income earned when all other provisions of the tax (deductions, credits, etc.) are included.
- *Average effective tax rates*: The overall rate of tax a taxpayer pays as a percentage of his or her total income after all other provisions of the tax system (deductions, credits, etc.) are included.

Conclusions about the progressivity of the tax system may differ, for example, depending upon whether they are based on an examination of the statutory marginal rate structure or on the effective marginal rate structure.

People hold different opinions as to whether the current rate structure is vertically equitable. Some believe that the rate structure should be more progressive, and that effective tax rates should rise with income more rapidly than they do under the current system. Others support a proportional rate structure. They believe that a tax system that imposes a single flat tax rate on income is more equitable because each additional dollar earned is taxed at the same rate.

Benefits Received Principle

In contrast to the ability to pay principle, the benefits received principle states that the amount of tax paid should be directly related to the benefits that a taxpayer receives from the government. In practice, the benefits received principle requires the government to identify who benefits from specific government services. As a result, the benefits received principle is usually not applicable when considering government programs intended to provide societywide benefits or redistribute wealth.

The federal tax on gasoline is an example of a tax that is sometimes justified on the benefits received principle. Gas taxes are paid by road users. This means that the people who pay the tax (drivers) are the same taxpayers who receive the benefits from the revenue collected in the form of both new and improved highways. User fees, such as postage stamps or fees to enter national parks, are another example of taxes based on the benefits received principle.

* * *

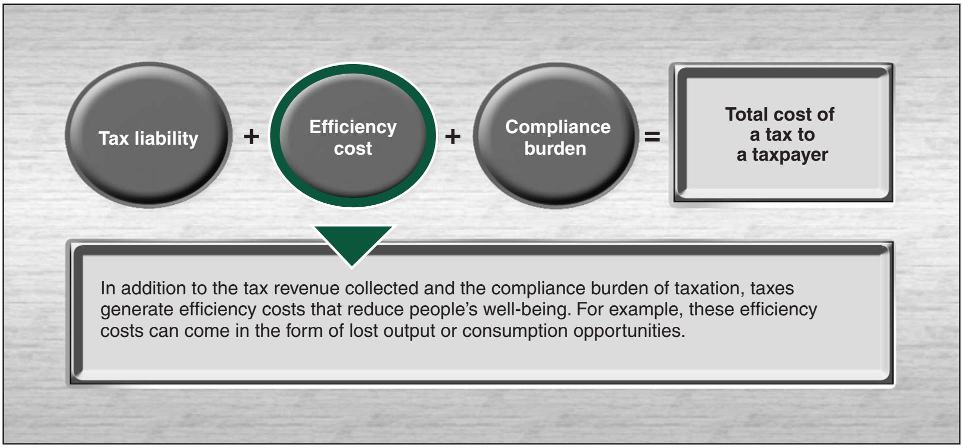
Economic Efficiency

One reason people bear taxes is they desire the benefits of government programs and services. As taxpayers, they balance the costs of taxes with the benefits of government. From a taxpayer's perspective, the cost of taxes includes more than the tax liability paid to the government. These costs include efficiency costs, which result from taxes changing the economic decisions that people make—decisions such as how much to work, how much to save, what to consume, and where to invest. These changes, referred to by economists as **distortions**, reduce people's well-being in a variety of ways that can include a loss of output or consumption opportunities. These reductions in well-being are efficiency costs, also called deadweight losses, excess burdens (excess because they are a cost in addition to the tax liability), or welfare losses.

Because taxes generally create inefficiencies, minimizing efficiency costs is one criterion for a good tax. However, the goal of tax policy is not to eliminate efficiency costs. The fact that taxes impose efficiency and other costs beyond the tax liability does not mean that taxes are not worth paying. The goal of tax policy is to design a tax system that produces the desired amount of revenue and balances economic efficiency with other objectives, such as equity, simplicity, transparency, and administrability. Moreover, as noted in the revenue section, the failure to provide sufficient tax revenues to finance the level of spending we choose as a nation gives rise to deficits and debt. Large sustained deficits could ultimately have a negative impact on economic growth and productivity.

Because taxes impose efficiency costs, the total cost of taxes to taxpayers is larger than their tax liability (the check they send to the U.S. Treasury). The total cost of taxes from a taxpayer's point of view is the sum of the tax liability, the efficiency costs, and the costs of complying with the system (which we discuss later), as shown in figure 11.

Figure 11: Efficiency Costs Are One Cost Taxpayers Face in Complying with the Tax System

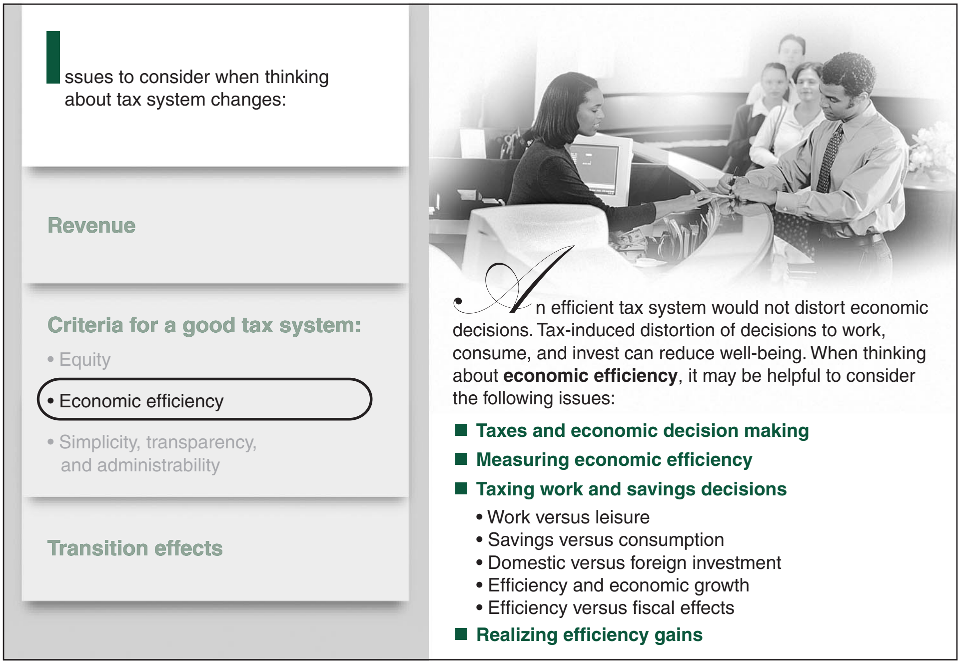


Source: GAO.

From a national perspective tax revenue is not a cost. Tax revenue is not lost to the nation—it is moved from taxpayers' pockets to the Treasury in order to pay for the programs and services that the government provides. On the other hand, efficiency costs and compliance burden are costs from a national perspective because, for example, they can result in forgone production and consumption opportunities, as well as the loss of taxpayers' time spent on complying.

Tax systems can differ in the magnitude and nature of their efficiency costs. Differences in the base, rates, preferences, or tax-induced responses can all affect the extent one tax distorts when compared to another. Tax systems can cause distortions that affect both individual taxpayers and businesses. Figure 12 outlines some of the key issues to consider when thinking about the efficiency of the tax system.

Figure 12: Efficiency Overview



Sources: GAO (text); PhotoDisc (image).

Equity concerns may force a trade-off between fairness and efficiency. Progressive tax rate schedules are believed to have higher efficiency costs than a proportional schedule that raises the same amount of revenue. However, proponents of progressive rates are willing to trade off some efficiency in order to gain, in their view, more vertical equity. As will be shown below, efficiency costs, although they are hard to measure, often can be defined objectively. Nevertheless, they still must be balanced with the more subjective criteria like equity when reaching general conclusions about a tax proposal.

Taxes and Economic Decision Making

Economic efficiency can be thought of as the effectiveness with which an economy utilizes its resources to satisfy people's preferences. Economists generally agree that (from the perspective of efficiency and ignoring other considerations, such as equity) markets are often the best method for determining what goods and services should be produced and how resources should be allocated. Self-interest is assumed to motivate resource owners to try to use their resources in a manner that realizes the highest return. When resources are directed to their highest valued uses the economy is said to be efficient.

Inefficiencies reduce the economic well-being of people in the aggregate, since resources are not directed to their highest valued uses. By reallocating resources from lower valued uses to higher valued uses, the economic well-being of people can be increased. However, gains from reallocating resources from lower valued uses to higher valued uses may not be distributed in manner considered fair, that is, some people may lose because of the reallocation.

Generally, taxes alter or distort decisions about how to use resources, creating economic inefficiencies. By changing the relative attractiveness of highly taxed and lightly taxed activities, taxes distort decisions such as what to consume, how much to work, and how to invest. Households and firms generally respond to taxes by choosing more of lower taxed items and less of higher taxed items than they would have otherwise. The change in behavior can ultimately leave individuals with a combination of consumption and leisure that they value less than the combination that they would have chosen under a tax system that does not distort their behavior.

As a simple example of the effects of a tax distortion, suppose an investor is choosing between two investments, one that has an expected annual return of 10 cents on every dollar invested and a second that has an expected annual return of 15 cents. If the income from neither investment is taxed, or if the income is taxed equally, the investor will choose the second investment with its higher economic rate of return. However, if the first investment continues to be untaxed, while the second is subject to a 40 percent tax, the decision will be based on the investment's after-tax rate of return. In this case the after-tax return on the first investment continues to be 10 cents for every dollar invested, while the after-tax return on the second investment is now 9 cents. An investor would choose the first investment because it has a higher after-tax return. However, this results in a loss to the economy, or inefficiency. Society gains a 10 cent return from the first investment, all of which goes to the investor. Society would have gotten the 15 cent return from the second investment, 9 cents for the investor, and 6 cents for the government.

Note that a tax does not actually have to raise revenue to cause inefficiencies. In the previous example, the investor who chose the first investment would pay no tax. However, the tax system design has distorted the investor's decision-making and reduced output.

The example of the tax-preferred treatment of owner-occupied housing illustrates a trade-off between efficiency costs and using the tax system to achieve other social goals. Text box 5 presents some estimates of the efficiency costs of the tax treatment of owner-occupied housing due to large differences in effective tax rates across three major investment categories. However, even in situations such as the one outlined in the text box, where the tax preference imposes some efficiency costs, there may still be valid reasons for using tax preferences as a tool of government for achieving certain social and economic goals. As we note in the example, most economists agree that the tax-preferred treatment of owner-occupied housing distorts investment patterns in the economy. The tax preference promotes the social goal of increased home ownership—a goal that many policymakers advocate.

Text Box 5: Tax Treatment of Owner-Occupied Housing Distorts Investment Choices and Lowers Wages

Compared to other types of investment, owner-occupied housing enjoys tax advantages primarily because the value that homeowners receive from housing services, which is a part of the return on their investment in housing, is excluded from taxation. Economists view these services, called imputed rent, as income in kind, which is valued at what the homeowner would receive as income if the house was rented. Under a pure income tax, imputed rent net of such costs as mortgage interest would be taxed. This tax treatment would help insure that investment in housing is taxed as other investments are taxed. As the table below shows, the tax advantages under the current system lead to lower marginal effective tax rates (METR) for housing relative to other investments.

METRs on Capital Income, by Source, in 2003

- Owner-occupied housing 2%
- Noncorporate investment 18%
- Corporate investment 32%

Source: Jane Gravelle, "The Corporate Tax: Where Has It Been and Where Is It Going?" *National Tax Journal,* vol. 57, no. 4 (2004): 903-23

Economists generally agree that the favorable treatment of owner-occupied housing, by lowering METR, distorts investment in the economy, resulting in too much investment in housing and too little business investment. The consequence of this is that businesses invest less in productivity-enhancing technology. This in turn results in employees receiving lower wages because increases in employee wages are generally tied to increases in productivity.

The resulting distortions from the tax-preferred treatment of owner-occupied housing lead to efficiency costs that have been estimated to be large. Gravelle's summary of estimates reports that the efficiency costs of the tax-preferred treatment of owner-occupied housing could be as much as 0.1 to 1 percent of GDP.

In addition to efficiency concerns, the tax treatment of owner-occupied housing also raises equity concerns. The current exclusions from income are more valuable to taxpayers in high tax brackets. Taxpayers in lower brackets receive a less valuable homeownership subsidy or no subsidy at all.

Although taxes generally result in efficiency losses, there are exceptions. In special cases, tax distortions may offset other inefficiencies, which can be caused by what economists call market failures. An example is an **externality** or **spillover**, where the benefits or costs of an activity are not fully captured by the individuals or firms undertaking the activity. Research and development is commonly cited as generating positive externalities—in some cases, the entity doing the research and development may produce knowledge that enters the public realm and is freely available to users. For example, some medical innovations, such as surgical techniques, cannot be patented. To the extent that benefits cannot be sold in a market, private firms that innovate will not reap the full financial benefits of the innovation and, therefore, will invest too little in research. Tax incentives for research might be one way to address the problem, but other governmental tools such as grants, loans, or regulations could also be considered. Efficient taxes are special cases—tax systems large enough to fund the federal government impose efficiency costs.

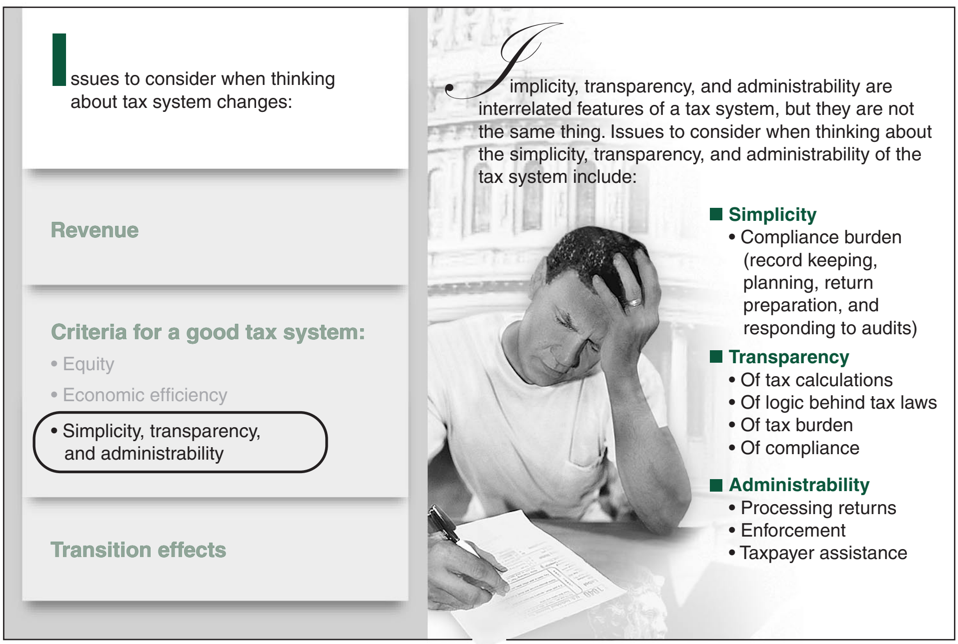
* * *

Simplicity, Transparency, and Administrability

Simplicity, transparency, and administrability are interrelated and desirable features of a tax system. Simple tax systems are, in many cases, the most administrable, and tax systems that are both simple and administrable are often considered to be the most transparent. However, even though there is considerable overlap between simplicity, transparency, and administrability, they are not identical. (See fig. 13.)

Because there is considerable overlap between these concepts, even though they are not the same thing, we combine simplicity, transparency, and administrability into one section and discuss them as a group. While others may not use the same terminology, the debates implicitly use the same or very similar criteria.

Figure 13: Simplicity, Transparency, and Administrability Overview

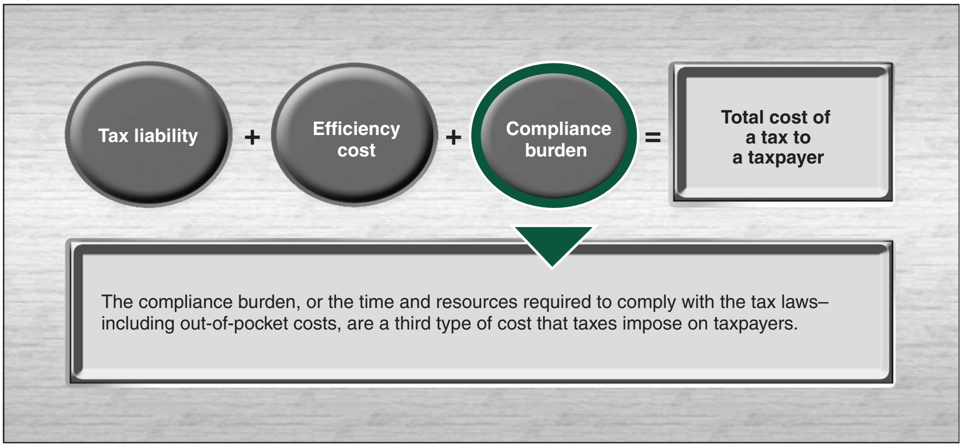


Sources: GAO (text); PhotoDisc (images).

Simplicity

Simple tax systems impose less of a compliance burden on the taxpayer than more complex systems. Taxpayer compliance burden is the value of the taxpayer's own time and resources, along with any out-of-pocket costs to paid tax preparers and other tax advisors, invested to ensure compliance with tax laws. As figure 14 demonstrates, in addition to the actual tax payments remitted to the government and the efficiency costs of taxation that we discussed earlier, compliance burden is the third cost that the tax system imposes on taxpayers. Compliance costs include the value of time and resources devoted to (1) record keeping, (2) learning about requirements and planning, (3) preparing and filing tax returns, and (4) responding to IRS notices and audits. Taxpayers can either choose to fulfill these responsibilities on their own or they can hire paid preparers to aid them in complying with the tax code. According to IRS, over 61 percent of returns filed in 2003 included a paid preparer's signature, contributing to considerable out-of-pocket costs to taxpayers.

Figure 14: Compliance Burden Is One Cost Taxpayers Face in Complying with the Tax System



Source: GAO.

The current tax system has grown increasingly complex over time, and many believe that taxpayer compliance burden has grown accordingly. The amount of time that taxpayers actually spend filling out tax forms may only constitute a small amount of the overall compliance burden. For many taxpayers, the bulk of the compliance burden comes in the form of tax planning and record keeping. For example, taxpayers spend time determining how the growing number of tax expenditures will affect their respective tax liabilities. The Treasury Department listed 146 tax expenditures in 2004, up about 26 percent since the last major tax reform legislation in 1986. Frequent changes in the tax code reduce its stability, contributing to compliance burden by making tax planning more difficult and increasing uncertainty about future tax liabilities. Moreover, an increasing number of taxpayers are becoming subject to the individual AMT. Determining how the provisions of the AMT affect a taxpayer's tax liability adds to the compliance burden.

Compliance burden is difficult to measure in part because it is difficult to measure the amount of time taxpayers spend planning and preparing their returns and the value of that time.[5] Nevertheless, researchers have made several attempts to quantify the costs that taxpayers incur while complying with the tax system. Most estimates suggest that taxpayer compliance burden falls between $100 billion and $200 billion each year.

Because compliance burden is difficult to measure, other, less direct measures of burden are frequently used. These include the number of pages in the tax code, the number of IRS forms to fill out, the length of tax instructions, and the number of lines on the tax form. These measures are believed to be correlated with compliance burden, but the correlation is recognized to be far from perfect. In some situations, longer instructions and more details on a form may reduce compliance burden by clarifying what a taxpayer must do to comply with the tax laws. These alternative measures of simplicity may provide some insight into the simplicity of the tax code, but they do not directly measure the impact that the tax code has on the costs to taxpayers of complying with the nation's tax laws.

The intergovernmental effects of tax policy changes can also affect compliance burden. Due to the close links between the federal tax system and the tax systems in many states, changes to the federal tax system could have implications for the compliance burden that taxpayers face when completing their state tax returns. For example, if the federal government switched from the current income tax system to a national retail sales tax, or a different type of consumption tax, but states—most of which have developed income tax forms that are based in large part on an individual's federal tax return—maintain their income tax requirements, then overall taxpayer burden would not likely be greatly reduced. Taxpayers might not have to file federal tax returns, but many, if not all, of the record keeping and administrative tasks would still exist when complying with the state-level income tax requirements.

Transparency

A transparent tax system is one that taxpayers are able to understand. Transparent tax systems impose less uncertainty on taxpayers, allowing them to better plan their decisions about employment, investment, and consumption. This leads to more confidence that they can accurately predict their future tax liabilities and contributes to the credibility of the tax system. Tax systems that are difficult to comply with and administer may lack transparency. A nontransparent tax system could be difficult to administer because tax administrators may have difficulty consistently applying the law to taxpayers in similar situations. In this sense, transparency is closely linked to

[5] It is difficult to measure the amount of time that taxpayers spend planning and preparing their returns because, among other reasons, when surveyed, taxpayers may overstate or understate the amount of time that they spent depending on how straightforward or complicated their returns were (i.e., how frustrating the experience was). Additionally, there is no consensus among researchers regarding the appropriate monetary value to be assigned to each hour of time spent on tax compliance activities.

the simplicity and administrability of the tax system. Transparent tax systems include the following elements:

- *Taxpayers can easily calculate their liabilities*: Taxpayers can easily follow instructions and tax rate tables in order to determine their tax base, their marginal tax rate, and their tax liability to the government.

- *Taxpayers grasp the logic behind tax laws and tax rates:* Taxpayers can look at a tax form or a tax rate schedule and understand lawmakers' reasoning. For example, whether or not they agree with it, taxpayers are likely to be able to comprehend the logic behind a progressive rate schedule.

- *Taxpayers know their own tax burden and the tax burden of others:* Irrespective of who actually writes a check to the government, taxpayers can identify who actually bears the burden of a tax. For example, the payroll tax is not transparent to the extent that taxpayers in general are unaware of the incidence of the tax. Even though payroll taxes are divided equally between employees and employers, economists generally agree that employees bear the entire burden of payroll taxes in the form of reduced wages.

- *Taxpayers are aware of the extent of compliance by others:* Taxpayers understand the extent to which the tax laws are enforced, meaning that they know how likely their friends, neighbors, and business competitors are to actually pay what they owe.

While the concept of transparency is closely linked to simplicity and administrability, they are not always the same. For example, some tax provisions may be simple but not transparent. The corporate tax rate schedule example in table 4 illustrates this. While determining taxable income under the corporate income tax is often a complex procedure, it is relatively simple for corporations to calculate their tax liabilities by referring to tax tables published by the IRS once this income has been determined. However, the logic underlying the marginal tax rates in the corporate tax schedule is not transparent. The marginal rate structure is progressive up to taxable income of $335,000, but marginal rates then decrease before increasing again and then decreasing once more.

Table 4: The Corporate Tax Rate Schedule: Simple but Not Transparent

Tax bracket (taxable corporate income)	Marginal tax rate in the tax bracket
$0 to $50,000	15%
$50,001 to $75,000	25%
$75,001 to $100,000	34%
$100,001 to $335,000	39%
$335,001 to $10,000,000	34%
$10,000,001 to $15,000,000	35%
$15,000,001 to $18,333,333	38%
Over $18,333,333	35%

Source: IRS instructions for Form 1120.

Some experts who have written on transparency believe that the tax code's transparency has declined in recent years. Numerous tax provisions have made it more difficult for taxpayers to understand how their tax liability is calculated, the logic behind the tax laws, and what other taxpayers are required to pay.

Administrability

Administrable tax systems allow the government to collect taxes as cost effectively as possible. Even though tax administration is usually considered to be IRS's responsibility, taxpayers, employers, and financial intermediaries such as banks and tax professionals play important roles in administering the tax code. For example, under the current system, banks file information returns about the amount of interest earned by deposit holders that assist IRS in determining tax liabilities. There is overlap between the simplicity and the administrability of a tax system, but simple tax systems are not always easier to administer.

Comparing the Administrability of Tax Systems

All tax systems have administrative costs. A more administrable tax system collects more of the statutorily required tax at a lower cost per dollar collected. However, there are trade-offs between the level of compliance and administrative costs to IRS. The costs of enforcing the tax code sufficiently to achieve complete compliance from all taxpayers are likely to be prohibitive. In addition, the costs of administrating the tax code are not limited to the budgetary costs of IRS. As noted above, some of these costs are shared by other parties in the form of increased compliance burden. Finally, the costs can be affected by the use of different enforcement policies.

The following summarizes the key tasks required for administering tax systems:

- *Processing tax returns and payments:* Currently, IRS processes over 130 million individual income tax returns each year, which taxpayers file electronically or through the mail. Under today's technology and any proposed alternatives to the current system, a return-free tax system may be difficult to implement.

- *Enforcing the tax code:* Perhaps the government's most challenging role in administering the tax system is detecting and penalizing taxpayer noncompliance. Under the current system, withholding and information reporting are important enforcement tools that generally increase compliance rates. However, they are not sufficient by themselves, and IRS devotes considerable resources to collecting taxes owed but not remitted.

- *Providing taxpayer assistance:* In order to reduce compliance burden and increase compliance rates, tax administrators generally provide assistance to taxpayers by such means as publishing forms and answering questions.

A tax change proposal may reduce the cost of some administrative tasks but raise others. Compared to the current personal income tax, consumption taxes like an NRST or a VAT reduce the number of filers because only businesses file. As a result, they reduce processing costs and eliminate the compliance burden on individual taxpayers. However, other aspects of enforcement costs may increase because administrators would no longer be able to rely on withholding and information returns as enforcement tools.

The way the tax system is structured by Congress can affect how it is administered, and this can affect compliance. For example, taxes withheld from employees and taxes that have information reporting requirements have lower income misreporting rates than other taxes. As figure 15 shows, taxes on wage and salary income, which is subject to both withholding and information reporting, have the lowest rate of misreported income; whereas taxes on income from such sources as self-employment (nonfarm proprietor income) have the highest rate of misreported income.

* * *

Changes in the technology of tax administration and in the tax code may have had offsetting and, as yet, unmeasured effects on the costs of tax administration. On the one hand, recent innovations in computer software and electronic financial transactions have made it easier to administer the tax code. On the other hand, since the last major tax reform initiative in 1986, the number of special rates, credits, deductions, and other provisions in the tax code have increased. This added complexity has made the tax code more difficult to administer.

Trade-offs between Equity, Economic Efficiency, and Simplicity, Transparency, and Administrability

While the concept of administrability is closely linked to the concepts of simplicity and transparency, they are not always the same. For example, a national retail sales tax would be a relatively simple form of taxation for taxpayers to understand. At the same time, a national retail sales tax could present administrative difficulties because it would be difficult to distinguish between similar commodities that are tax exempt and those that are not, and to distinguish retail sales, which are taxed, from sales to other companies, which are not taxed.

Similarly, just because a tax is administrable does not necessarily mean it would be transparent. For example, although payroll taxes are fairly easy to administer, who pays them in an economic sense is not necessarily transparent. As we discussed earlier, many economists agree that employees bear the entire burden (both the employer and employee share) of payroll taxes, making the incidence of payroll taxes nontransparent.

Improving the simplicity, transparency, and administrability of the tax system may affect the equity and efficiency of the tax system. Simplified, transparent, and administrable tax codes are generally thought to enhance efficiency because (1) taxpayers can redirect resources that would have been used to comply with the tax code to other, more productive purposes and (2) these tax systems have fewer incentives that distort decision making about work, savings, and investment. However, proposals to simplify the tax system may reduce equity because many tax provisions that are complex and difficult to comply with are also designed to promote fairness.

* * *