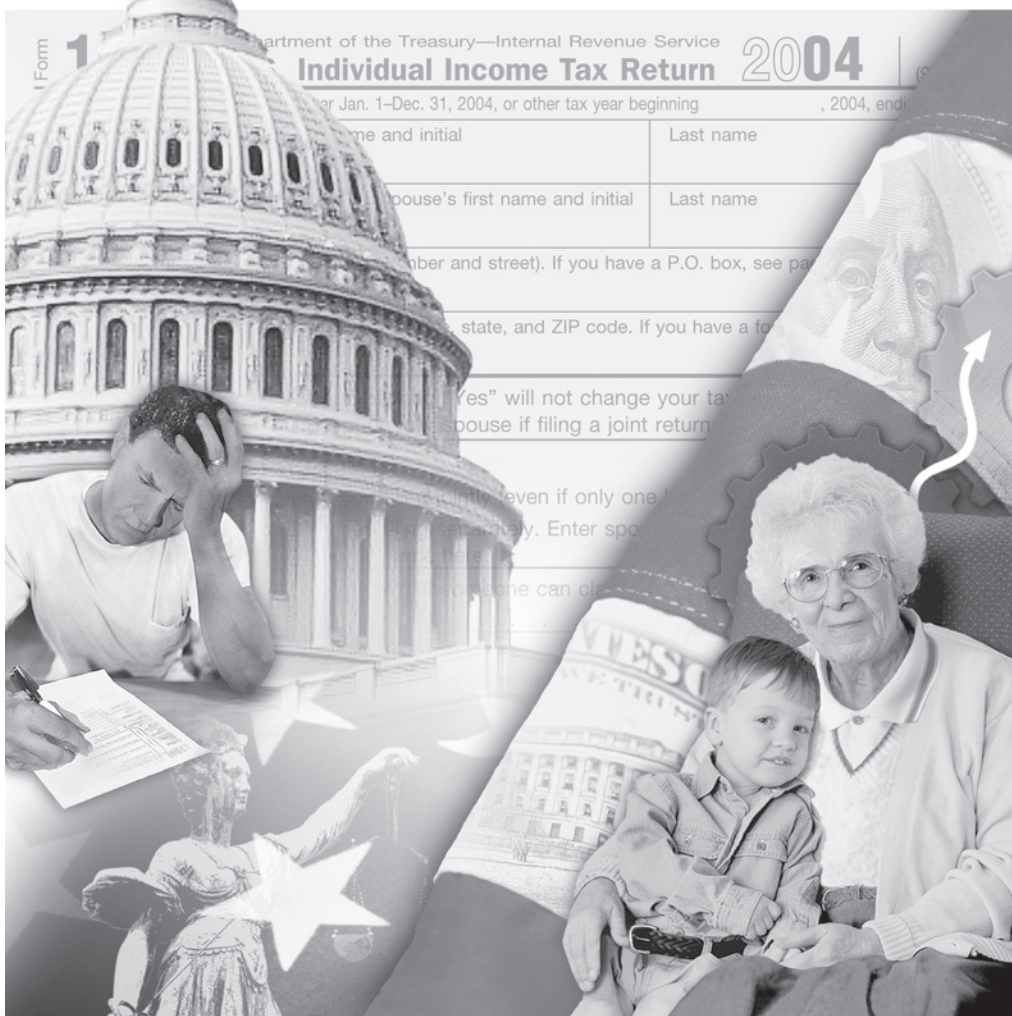


# Understanding the Tax Reform Debate:

## Background, Criteria, & Questions

September 2005



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# Preface

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Taxes are necessary because they fund the services provided by government. In 2005, Americans will pay about \$2.1 trillion in combined federal taxes, including income, payroll, and excise taxes, or about 16.8 percent of gross domestic product.

Beyond funding government, the federal tax system has profound effects on the economy as a whole and on individual taxpayers, both for today and tomorrow. Taxes change people's behavior and influence the economy by altering incentives to work, consume, save, and invest. This, in turn, affects economic growth and future income—and thus future government revenues. At the same time, the current tax system generates fierce controversy over fairness—who should pay and how much they should pay. In addition, the current tax system is widely viewed as overly complex, thereby reducing the ability of individuals to understand and comply with the tax laws. Furthermore, the tax system is costly to administer with most of the costs of administration, such as record keeping, understanding the laws, and preparing returns, borne by taxpayers.

Concerns about the economic effectiveness, fairness, and growing complexity of the current tax system raise questions about its credibility. These concerns have led to a growing debate about the fundamental design of the federal tax system. The debate includes the type of base—income or consumption—and the rate structure—flatter or more progressive. Additionally, some question to what extent and how the tax system should be used to influence economic behavior and social policy.

Some see tax rates as too high—discouraging work, savings, and investment and consequently slowing economic growth. At the same time, the myriad of tax deductions, credits, special rates, and so forth cause taxpayers to doubt the fairness of the tax system because they do not know whether those with the same ability to pay actually pay the same amount of tax. In addition, tax expenditures, also called tax preferences, just like spending programs, can lead to higher tax rates over time. Complexity and the lack of transparency that it can create exacerbate doubts about the current tax system's fairness. Public confidence in the nation's tax laws and tax administration is critical because we rely heavily on a system of voluntary compliance. If taxpayers do not believe that the tax system is credible, is easy to understand, and treats everyone fairly, then voluntary compliance is likely to decline.

The debate about the fundamental design of the tax system is occurring at a time when the nation also faces large current deficits and a significant and structural long-term fiscal imbalance. Long-term budget simulations by GAO, the Congressional Budget Office, the Office of Management and Budget, and nongovernment analysts show that absent policy changes, the federal budget is on an unsustainable path. Known demographic trends and rising health care costs will cause ultimately

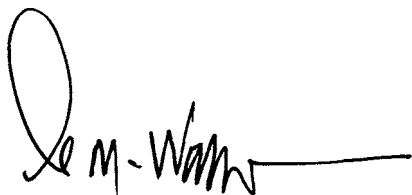
unsustainable deficits and debt that will threaten our national security as well as the standard of living for the American people in the future.

While additional economic growth is critical and can help to ease the burden, the projected fiscal gap is so great that it is unrealistic to expect that growth alone will solve the problem. Ultimately, the nation will have to decide what it wants from the federal government, that is, what level of spending do we want on programs, tax preferences, and other government services and how we will pay for that spending. Clearly, tough choices will be required. Addressing the projected fiscal gap will prompt policymakers to examine the advisability, which includes both the effectiveness and affordability, of a broad range of existing programs and policies throughout the entire federal budget—spanning discretionary spending, mandatory spending, entitlement programs, tax expenditures tax rates, and tax system design. This examination will likely result in actions affecting both tax revenues and tax expenditures.

The background, criteria, and questions presented in this report are designed to aid policymakers and the public in thinking about how to develop tax policy for the 21<sup>st</sup> century. This report, while not intended to break new conceptual ground, brings together a number of topics that tax experts have identified as those that should be considered when evaluating tax policy. This report attempts to provide information about these topics in a clear, concise, and easily understandable manner for a nontechnical audience. In developing this report, we relied on government studies, academic articles, and the advice of tax experts to provide us with information on the issues surrounding the tax reform debate. For a short bibliography of related publications, see appendix II. For easy reference, key terms are defined in the glossary located in appendix III—these glossary terms appear in **bold** type the first time they are used in the text.

This publication was prepared under the direction of James R. White, Director, Strategic Issues (Tax Policy and Administration Issues), who may be reached at (202) 512-9110 or [WhiteJ@gao.gov](mailto:WhiteJ@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Kevin Daly,

Tom Gilbert, Don Marples, Donna Miller, Ed Nannenhorn, and Amy Rosewarne made key contributions. This report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

A handwritten signature in black ink, appearing to read "D. M. Walker", with a long horizontal line extending to the right.

David M. Walker  
Comptroller General  
of the United States



# Introduction

This report provides background information, criteria, and key questions for assessing the pros and cons of tax reform proposals, both proposals for a major overhaul of the current federal tax system and incremental changes to the system. Figure 1 outlines the key issues that we address. First, we discuss how the size and role of the federal government drive the government’s revenue needs. Second, we describe a set of widely accepted criteria for assessing alternative tax proposals. These criteria include the equity, or fairness, of the tax system; the economic efficiency, or neutrality, of the system; and the simplicity, transparency, and administrability of the system. The weight one places on each of these criteria is a value judgment and will vary among individuals. As we note, there are trade-offs to consider among these criteria, and we discuss how these criteria can sometimes be in conflict with each other. Finally, we turn to a consideration of the issues involved in transitioning from the current tax system to an alternative tax system.

**Figure 1: Issues to Consider When Assessing Alternative Tax Proposals**



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

The primary purpose of the tax system is to collect the revenue needed to fund the operations of the federal government, including its promises and commitments. Tax revenues may not fully match government spending each year, but over time, the federal government needs to be able to raise sufficient revenue to cover its current and expected financial obligations. Decisions about spending and the role of government have a direct impact on the government's ultimate revenue needs.

Whether the resources to fund government spending are provided through taxes or borrowing has consequences for the economy and the federal budget. Borrowing (which has often led to budget **deficits**) may be appropriate for federal investment such as building roads and scientific research, and during times of recession, war, and other temporary challenges. However, federal borrowing also absorbs scarce savings that would otherwise be available for growth-enhancing private investment. In addition, large amounts of borrowing may increase the share of interest payments in the federal budget overtime, placing additional pressure on future budgets.

One's view about the equity of a tax system is based on subjective judgments about the fairness of the distribution of **tax burdens**. The actual burden of a tax—the reduction in economic well-being caused by the tax—is not always borne by the people who pay the tax to the government because tax burdens can be shifted to other parties. For example, the burden of a tax on business can sometimes be shifted to consumers by increasing prices or to workers by decreasing wages. Public debates regarding the equity of the tax system reflect a range of opinions about who should pay taxes and how much of the tax burden should be shouldered by different types of taxpayers.

Taxes impose **efficiency costs** by altering taxpayers' behavior, inducing them to shift resources from higher valued uses to lower valued uses in an effort to reduce **tax liability**. This change in behavior can cause a reduction in taxpayers' well-being that, for example, may include lost production (or income) and consumption opportunities. Efficiency costs, along with the tax liability paid to the government and the costs of complying with tax laws, are part of the total cost of taxes to taxpayers. One of the goals of tax policy, but not the only goal, is to minimize compliance and efficiency costs. The extent to which efficiency costs can be reduced by reforming the tax system depends on the design features of the new tax system, such as the nature and number of any **tax preferences**.

Simplicity, transparency, and administrability are related but different characteristics of a tax system. Simplicity is a gauge of the time and other resources taxpayers spend to comply with the tax laws. This includes the time and resources spent on record keeping, learning about tax obligations, and preparing tax returns. The transparency of a tax system refers to taxpayers' ability to understand how their liabilities are calculated, the logic behind the tax laws, what their own tax burden and that of others is, and the likelihood of facing penalties for noncompliance. Administrability refers to the costs, ultimately borne by taxpayers, of collecting and processing tax

payments as well as to the costs of enforcing the tax laws. While simplicity, transparency, and administrability are related concepts, they are not the same thing. A very simple tax rule may not be transparent if the rationale for the rule is not clear. Similarly, not all simple taxes are easy to administer.

Designing tax policy requires making trade-offs among these criteria. For example, a proposal to improve the efficiency and simplicity of the tax code may involve eliminating **exemptions** or **deductions** originally introduced to improve the equity of the system. Moreover, some criteria include subjective elements. One individual's perception of the equity of a tax proposal can differ from another's. However, being subjective or objective does not make a criterion superior.

In addition to determining the type of tax system, policymakers also determine the amount of revenue to be raised, which involves balancing the costs of taxes against the benefits of government services. Despite the fact that no tax system is perfectly fair, efficient, simple, transparent, and without administrative costs, in general people are willing to pay taxes and bear the other costs of the tax system because they desire the benefits of government and understand that sufficient tax resources are necessary for a sound fiscal policy in the long term.

Finally, because moving to an alternative tax system creates winners and losers, transition rules may be included in tax reform proposals to mitigate some of the **windfall gains** and **windfall losses** that are likely to occur. However, debate exists as to whether transition rules, which are usually proposed on equity grounds, are appropriate because they may also reduce the efficiency of the tax system and temporarily make the tax system more complex.

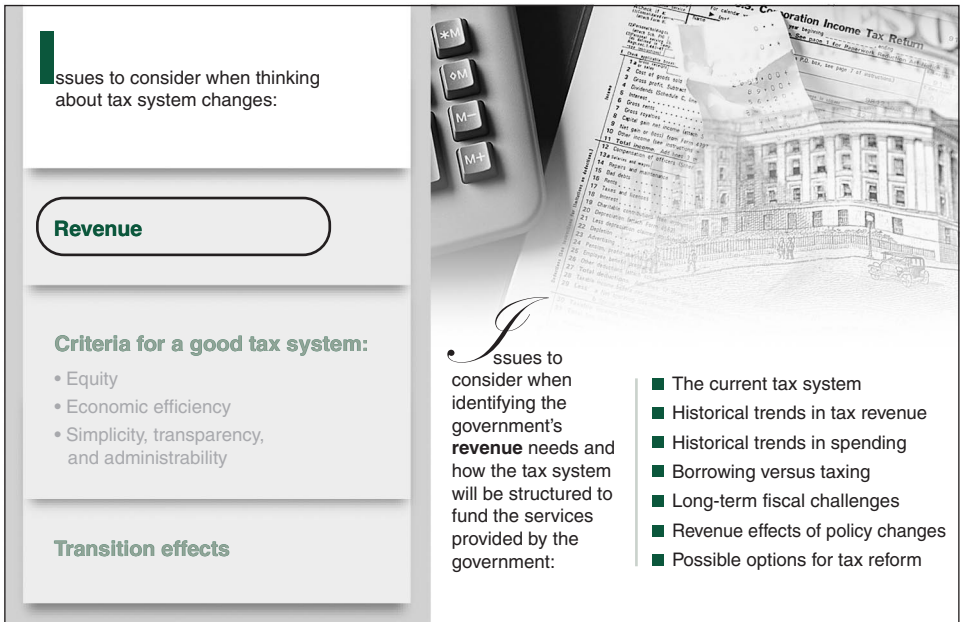
Tax reform proposals can range from small changes to the tax code to more comprehensive changes. The issues and questions we discuss in this report are designed to apply to both incremental changes to the tax system, such as changing **tax expenditures** to encourage savings, and to more comprehensive tax reform proposals, such as switching from a predominantly income-based tax to a **consumption tax base**.

In addition to discussing the criteria used to evaluate changes to the tax system, this report provides information about economic and budgetary trends, the current tax system, and definitions of important tax concepts. For each section of the report, we provide a set of key questions designed to help identify the important features of the proposals. This is information that we believe would be useful for evaluating the proposals and identifying limitations of the data and analysis.

# Revenue—Taxes Exist to Fund Government

Taxes exist to fund the services provided and the promises made by the government. Since tax revenue may not match spending in each year, the resources needed to fund government can be also be raised by borrowing (deficit financing). Both taxes and borrowing affect economic performance. Taxes can affect the economy because they alter decision making by people and businesses. Federal borrowing absorbs savings otherwise available for private investment and postpones the need to tax or reduce spending. (See fig. 2.)

Figure 2: Revenue Overview



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

## The Current Tax System

The federal tax system in the United States primarily consists of five types of taxes: (1) **personal income taxes**; (2) **social insurance taxes** (employee and employer contributions for Social Security, **Medicare**, and unemployment compensation); (3) **corporate income taxes**; (4) **estate and gift taxes**; and (5) **excise taxes** based on the value of goods and services sold and other taxes. The tax bases, rates, and collection points of the major federal taxes are summarized in table 1.

**Table 1: Features of the Current Tax System**

Type of tax	Tax base	Tax rates	Collection points
<p><b>Personal income taxes (PIT)</b></p>	<p><b>Regular PIT</b> Personal income, including income from wages, interest and dividends, capital gains, and small business income.</p> <p>Numerous tax expenditures exist that reduce the size of the tax base.</p>	<p><b>Regular PIT</b> Graduated rate structure: Statutory marginal rates of 10%, 15%, 25%, 28%, 33%, and 35%. Deductions and other tax expenditures, such as refundable tax credits like the Earned Income Tax Credit, create a group of taxpayers who have no tax liability or a negative tax liability.</p>	<p><b>Regular PIT</b> Employers withhold payments, but individuals file tax returns wherein they are also required to disclose nonwage income and remit appropriate taxes. Small business owners self-report income and remit taxes to the government.</p>
	<p><b>Personal alternative minimum tax (AMT)</b> Taxable income exceeding certain threshold amounts based on filing status.</p>	<p><b>Personal AMT</b> 26% or 28% depending on taxable income subject to the AMT. Individuals are eligible for a credit for a portion of the AMT paid in a prior year.</p>	<p><b>Personal AMT</b> Individuals compare their regular PIT liability to their AMT liability and pay the greater of the two (less taxes previously withheld or paid during the year).</p>
<p><b>Corporate income taxes (CIT)</b></p>	<p><b>Regular CIT</b> Corporate profits (total revenues less total expenses). Numerous tax expenditures exist that reduce the size of the tax base.</p>	<p><b>Regular CIT</b> Statutory marginal rates range from 15% to 35%.</p>	<p><b>Regular CIT</b> Corporations file tax returns and remit payment to the government.</p>
	<p><b>Corporate AMT</b> Broader definition of the tax base (corporate income) than regular CIT; less generous accounting rules.</p>	<p><b>Corporate AMT</b> 20% for all corporate income subject to the tax less the AMT credit for that tax year.</p>	<p><b>Corporate AMT</b> Corporations compare regular CIT to corporate AMT liability and pay the greater of the two.</p>
<p><b>Social insurance taxes</b></p>	<p><b>Social security</b> First \$90,000 of employee wages.</p>	<p><b>Social security</b> 6.2% employee contribution. 6.2% employer contribution. 12.4% for self-employed.</p>	<p><b>Social security</b> Employers withhold taxes from employee paychecks. The self-employed remit taxes themselves.</p>
	<p><b>Medicare</b> All wages.</p>	<p><b>Medicare</b> 1.45% employee contribution. 1.45% employer contribution. 2.90% for self-employed.</p>	<p><b>Medicare</b> Employers withhold taxes from employee paychecks. The self-employed remit taxes themselves.</p>

(Continued From Previous Page)

Type of tax	Tax base	Tax rates	Collection points
<b>Unified transfer tax—estate, gift, and generation skipping tax (GST)</b>	<b>Estate tax</b> Fair market value of the decedent's cash and securities, real estate, trusts, annuities, business interests, and other assets included in the decedent's estate at death less allowable deductions in excess of \$1.5 million in 2005. There is an unlimited deduction for transfers to a surviving spouse.	<b>Estate tax</b> Rates range from 45% to 47% in 2005. As a result of recent tax legislation, estate tax rates will fluctuate before the estate tax is eliminated in 2010. However, the estate tax will be reinstated in 2011.	<b>Estate tax</b> Decedent's estate is responsible for filing returns and remitting payment to the government.
	<b>Gift tax</b> Tax is imposed on the value of lifetime taxable transfers of gifts of property. Applicable exclusion amount of \$1 million for 2005. In addition, there is an annual exclusion of \$11,000 per donee and an unlimited exclusion for tuition and medical payments.	<b>Gift tax</b> Rates range from 41% to 47% in 2005. Rates fluctuate in the same manner as for the estate tax in coming years. Gift tax will be retained following repeal of estate and GST.	<b>Gift tax</b> Gift donor is responsible for filing returns and remitting payment to the government.
	<b>GST</b> Total generation skipping transfers (such as from a grandparent to a grandchild) in excess of \$1.5 million in 2005.	<b>GST</b> 47% (or highest statutory marginal tax rate for the estate tax) in 2005. GST rates decrease until the tax is repealed in 2010. GST is reinstated in 2011.	<b>GST</b> Depending on the form of the generation skipping transfer, gift donor, donee trustee, or decedent's estate is responsible for filing returns and remitting payment to the government.
<b>Excise and other taxes</b>	Selected goods, services, and other items (i.e., gasoline, alcoholic beverages, tobacco, airline tickets, etc.).	Various rates apply to different goods, services, and other items.	Generally collected by businesses, which remit payments to the government on a quarterly basis.

Source: GAO analysis of Internal Revenue Service information.

The revenue raised by the major federal taxes is determined by the size of their bases, their rates, and their levels of compliance. In addition, each tax base is affected by the size and growth rate of the economy.

Although called income taxes, the current federal individual and corporate income taxes have some features characteristic of a consumption tax. The current income tax system taxes the income of individuals and corporations, such as wages, interest, **dividend income**, **capital gains**, and other types of business income, including that of sole proprietorships and partnerships. (Some income is double taxed—corporate

earnings are subject to the corporate income tax and are taxed again under the individual income tax when they are distributed as dividends or as realized capital gains when shareholders sell their stock.) However, some income is treated as it would be under a consumption tax where income that is saved or invested is exempted from tax until it is consumed. For example, up to certain limits, income that is contributed to **individual retirement accounts** and **defined contribution pension plans** is tax-deferred during accumulation. The result is a hybrid income-consumption tax base wherein some types of savings and investment are exempt from taxation, but other types are not.

The current tax system includes tax expenditures, also called tax preferences, which reduce the size of the tax base. Tax expenditures are usually justified on the grounds that they promote certain social or economic goals. They grant special tax relief (through deductions, **credits**, exemptions, etc.) that encourages certain types of behavior by taxpayers or aids taxpayers in certain circumstances. Tax expenditures can promote a wide range of goals. For example, individual retirement accounts, discussed above, promote the goal of increased personal savings and investment, and the tax expenditures for owner-occupied homes encourage homeownership.

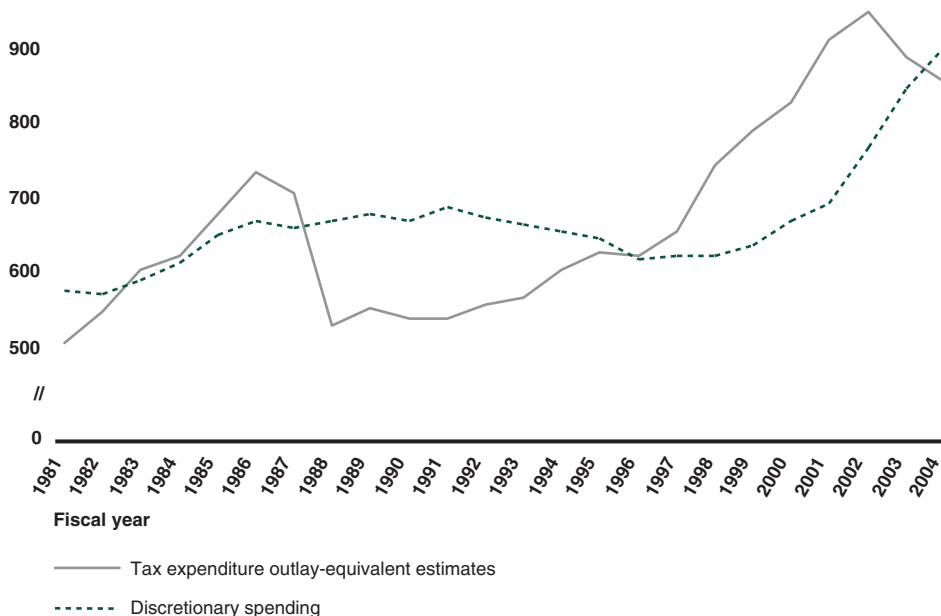
Summing one measure of tax expenditures, called outlay-equivalents, indicates that the aggregate value of tax expenditures was about \$850 billion in fiscal year 2004. Outlay-equivalents are budget outlays that would be required to provide the taxpayers who receive the tax expenditures with the same after-tax income as would be received through the tax expenditures.<sup>1</sup> As an indication of the size and impact of tax expenditures, figure 3 compares them to **discretionary spending**. In some years the outlay-equivalents for income tax expenditures exceeded federal discretionary spending.

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<sup>1</sup>Summing outlay equivalent estimates is controversial because doing so does not take into account possible interactions among tax expenditures. In addition, there are several ways to define and measure tax expenditures. The size of a tax preference can change over time. For example, accelerated depreciation of machinery and equipment drops out of the list of the top 10 tax expenditures in 2006. Moreover, what is considered a tax expenditure depends on the tax base. Some provisions of the tax code that are considered tax expenditures under an income tax base would not be considered tax expenditures under a consumption tax base. For further information on how tax expenditures are defined and measured, see GAO, *Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined*, GAO-05-690 (forthcoming).

**Figure 3: Sum of Tax Expenditure Outlay-Equivalent Estimates Compared to Discretionary Spending, 1981-2004**

1,000 Dollars in billions (in constant 2004 dollars)



Source: GAO analysis of OMB budget reports on tax expenditures, fiscal years 1983-2006.

A few large income tax expenditures account for most of the aggregate value. The 10 tax expenditures listed in table 2 accounted for over 60 percent of the outlay-equivalents in fiscal year 2004. The estimates in the table are for income tax expenditures. They do not include provisions that exclude income from other taxes, such as **payroll taxes**. For example, the income tax exclusion for health care permits the value of health insurance premiums to be excluded from employees' taxable earnings and also excludes this value from the calculation of Social Security and Medicare payroll taxes for both employees and employers.



**Table 2: The 10 Largest Tax Expenditures in 2004, Outlay Equivalent Estimates**

Dollars in billions	
Tax preference	Outlay equivalents
Exclusion of employer contributions to medical insurance premiums and medical care	\$126.7
Deductibility of mortgage interest on owner-occupied homes	61.5
Net exclusion of pension contributions and earnings: 401(k)	58.2
Net exclusion of pension contributions and earnings: employer plans	57.3
Deductibility of nonbusiness state and local taxes (other than on owner-occupied homes)	45.3
Accelerated depreciation of machinery and equipment	44.7
Exclusion of interest on public purpose state and local debt	37.5
Capital gains (other than agriculture, timber, iron ore, and coal)	35.9
Capital gains exclusion on home sales	35.0
Exclusion of net imputed rental income on owner-occupied homes	32.8

Source: GAO analysis of Office of Management and Budget (OMB), *Budget of the United States Government, Fiscal Year 2006, Analytical Perspectives*.

In the current tax system, tax rates vary across types of tax. Individual income and corporate income above certain levels are generally taxed at graduated rates. Taxes on individual income have six statutory **marginal tax rates** (the rate of tax paid on the next dollar of income that a taxpayer earns), ranging from 10 percent to 35 percent. Income earned by corporations has a statutory marginal rate structure that ranges from 15 percent to 35 percent. A separate rate structure exists for the individual **Alternative Minimum Tax (AMT)**—a tax on individual income that was originally designed to keep taxpayers with higher incomes from taking advantage of various tax provisions in order to pay little or no income tax. The current tax system also includes social insurance taxes, which are applied to wages at flat rates and remitted in equal shares by employees and employers. However, currently the first \$90,000 of an individual’s wages is subject to payroll taxes for Social Security, while all wages are subject to payroll taxes for Medicare.

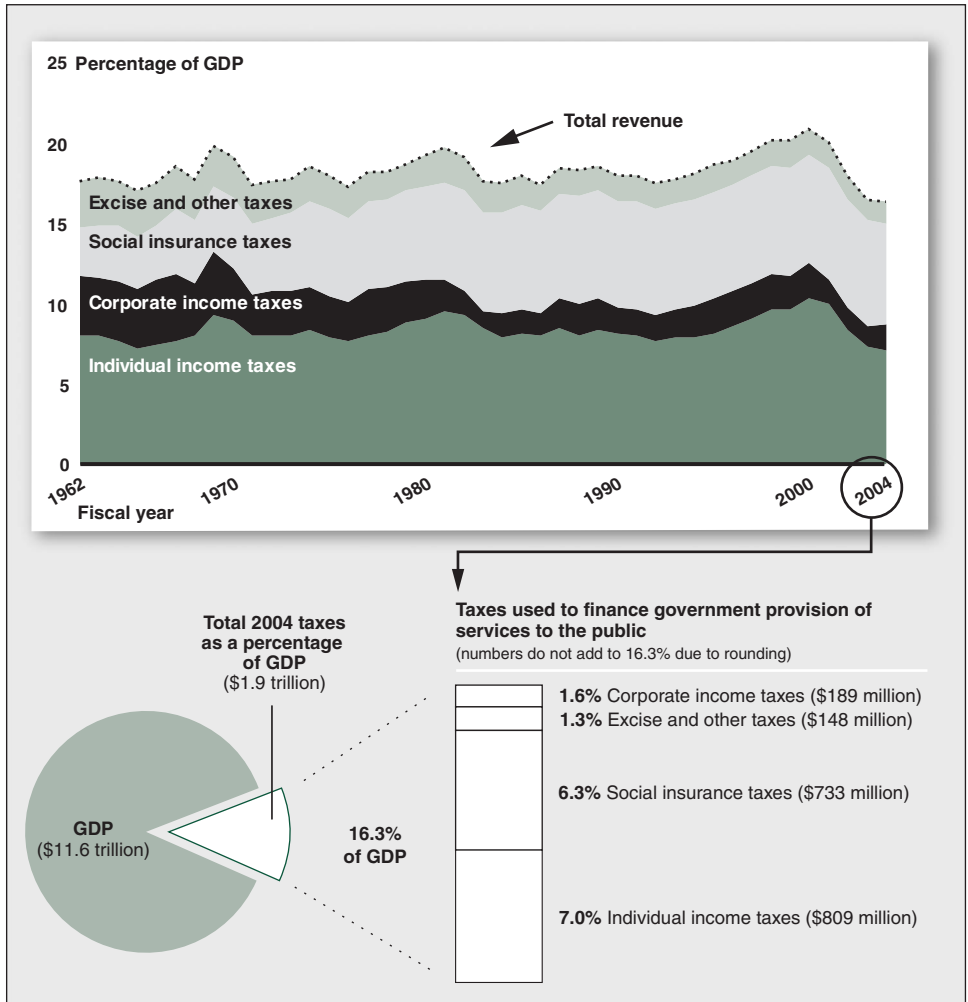
The government’s administrative burden and taxpayers’ **compliance burden** vary depending on the type of taxpayer, the type of tax, and the **collection point** of the tax. For the individual income tax and social insurance taxes, the primary collection point occurs at the business level: employers bear the burden of withholding employees’ taxes from their wages and remitting the tax payments to the government. However, all individuals with income above certain thresholds based on personal allowances and a **standard deduction** still must file tax returns. The Internal Revenue Service (IRS) bears the administrative burden of monitoring taxpayer compliance and applying penalties to noncompliant taxpayers when necessary.

## Historical Trends in Tax Revenue

Total federal tax revenues have fluctuated from roughly 16 to 21 percent of **gross domestic product** (GDP) over the last 43 years. In figure 4, total federal revenue is highest in 2000 at 20.9 percent of GDP and lowest in 2004 at 16.3 percent of GDP.

As figure 4 also illustrates, there have been important changes to the composition of federal revenues over the last 43 years. Corporate and excise tax receipts as a percentage of GDP have declined since 1960, while social insurance tax receipts have grown. The individual income tax and social insurance taxes have accounted for the majority of federal revenues during this period.

Figure 4: Federal Revenue as a Percentage of GDP and by Source, 1962-2004



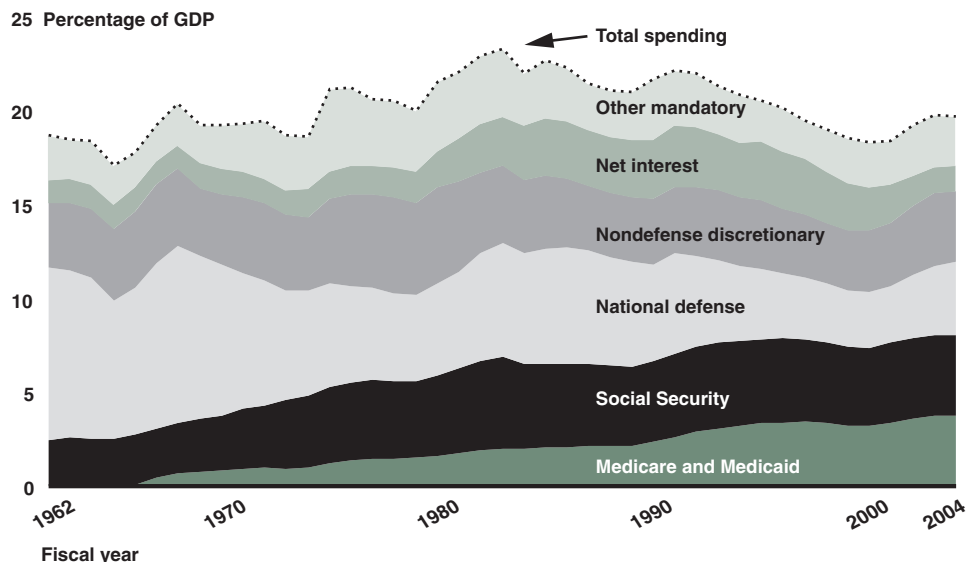
Source: GAO representation of OMB data.

## Historical Trends in Federal Spending

As figure 5 illustrates, over the last 43 years, federal spending as a portion of GDP has ranged from a low of 17.2 percent of GDP in 1965 to a high of 23.5 percent of GDP in 1983. In addition, figure 5 illustrates that as is the case with revenues, important changes to the composition of federal spending have occurred. For example, since 1962, the total share of federal spending devoted to national defense has decreased relative to the share devoted to Social Security and health care. Government

provision of Social Security and health care accounted for over 40 percent of government spending in 2004, a dramatic increase from the share before 1965 when the Medicare and Medicaid programs were enacted.

**Figure 5: Federal Spending as a Percentage of GDP and by Spending Category, 1962–2004**

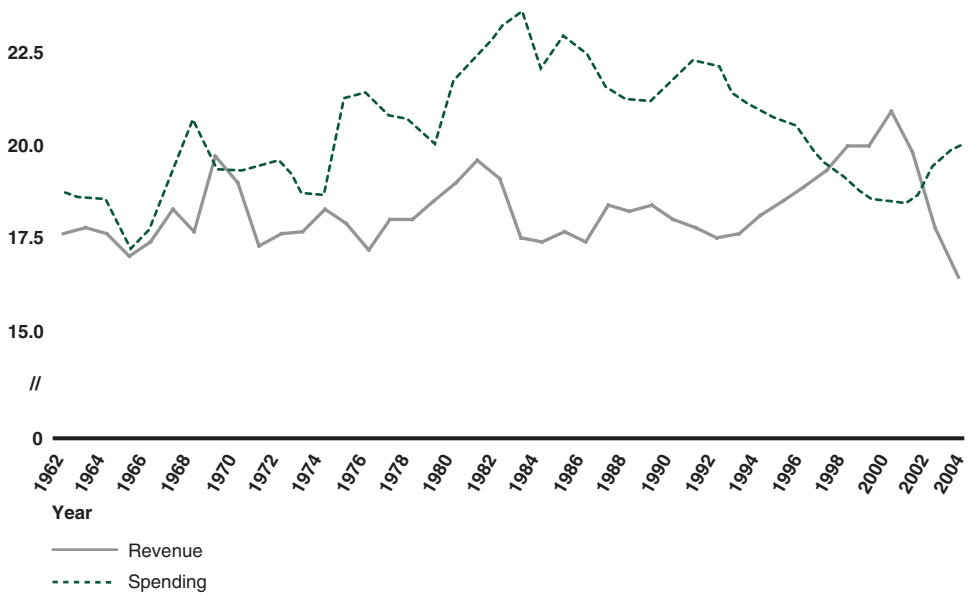


## Borrowing versus Taxing as a Source of Resources

The resources to fund government are raised primarily through taxes. However, borrowing is another source. Figure 6 combines figures 4 and 5 to show that the federal government has generally run a deficit in recent decades.

**Figure 6: Federal Tax Revenue versus Federal Spending, 1962–2004**

25.0 Percentage of GDP



Source: GAO representation of OMB data.

Public sector resources, whether from taxes or borrowing, make the benefits of government possible. However, taxes and borrowing also have costs. Obviously, they transfer money from the pockets of the public to the government. But they also affect the performance of the economy. As will be discussed under the criteria for a good tax system, taxes affect the performance of the economy by altering decisions, such as how much to work and save, what to consume, and where to invest.

Federal borrowing has advantages and disadvantages that vary depending on economic circumstances. Borrowing, in lieu of higher taxes or lower government spending, may be viewed as appropriate during times of economic recession, war, or other temporary challenges. Federal borrowing might also be viewed as appropriate for federal investment, such as building roads, training workers, and conducting scientific research, that contributes to the nation’s capital stock and productivity. If well chosen, such activities could ultimately help produce a larger economy. However, if not well chosen, such spending could displace more productive private sector investments.

Federal borrowing also can impose significant costs and risks. Borrowing for additional spending or lower taxes for current consumption improves short-term well-being for today’s workers and taxpayers, but does not enhance our ability to

repay the borrowing in the future. In the near term, federal borrowing also absorbs scarce savings available for private investment and can exert upward pressure on interest rates. Over the long term, federal borrowing that restrains economic growth will also restrain the standard of living of future workers and taxpayers.

## Long-term Fiscal Challenge

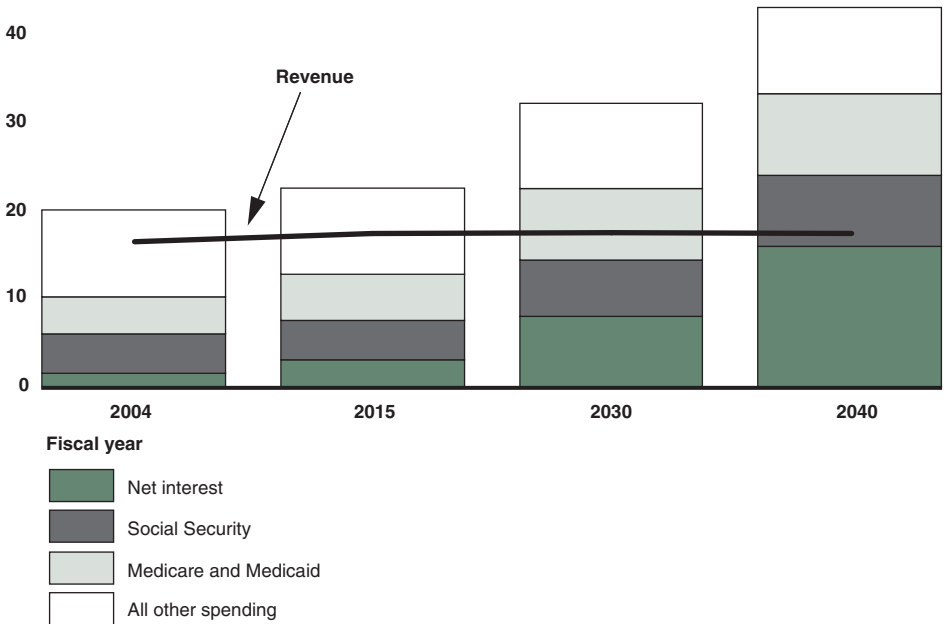
As discussed in our report on challenges facing the government, the fiscal policies in place today—absent substantive **entitlement** reform and changes in tax and spending policies—will result in large, escalating, and persistent deficits that are economically unsustainable over the long term.<sup>2</sup> In other words, given current forecasts for growth, government spending and resources, today's policies cannot continue and must change.

Over the next few decades, as the baby boom generation retires, federal spending on retirement and health programs, such as Social Security, Medicare, and Medicaid, will grow dramatically and bind the nation's fiscal future. Absent policy changes on the spending and/or revenue sides of the budget, a growing imbalance between federal spending and tax revenues will mean escalating and ultimately unsustainable federal deficits and debt. For example, as figure 7 indicates, if discretionary spending grows at the same rate as the economy and all expiring tax provisions are extended, federal revenues could be adequate to cover little more than interest on the federal debt by 2040.

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<sup>2</sup>GAO, *21<sup>st</sup> Century Challenges: Reexamining the Base of the Federal Government*, [GAO-05-325SP](#) (Washington, D.C.: February 2005).

**Figure 7: Composition of Federal Spending as a Share of GDP, Assuming Discretionary Spending Grows with GDP after 2004 and That Expiring Tax Provisions Are Extended**  
 50 Percentage of GDP



Source: GAO representation of OMB data.

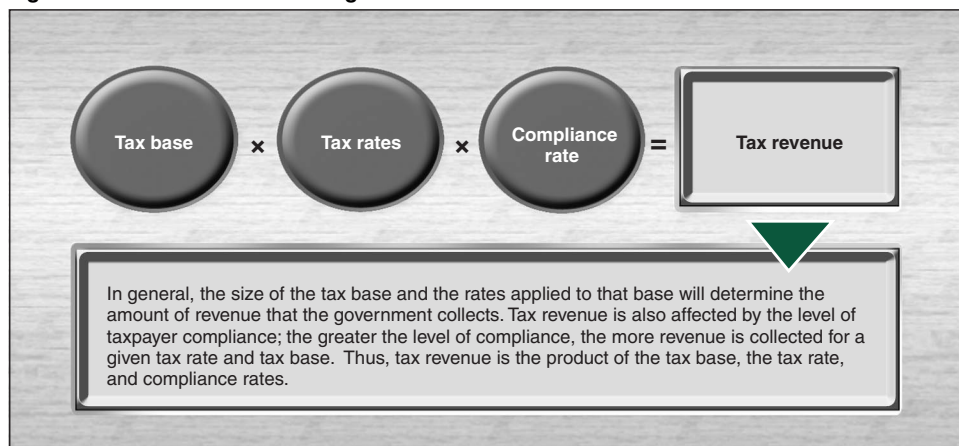
Notes: This figure is based on the assumption that discretionary spending grows at the same rate as GDP after 2004 and that expiring tax provisions are extended. Despite our assumption that expiring tax provisions are extended, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers being subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

Regardless of the assumptions used, reasonable long-term simulations indicate that the problem is too big to be solved by economic growth alone or by making modest changes to existing spending and tax policies. While entitlement reform as well as **mandatory** and discretionary spending cuts will likely be needed to close the long-term financial gap, the structure of the tax system should also be part of the debate as policymakers grapple with the nation’s long-term fiscal challenge. As part of this process, consideration could be given to improving taxpayer compliance and enforcement efforts, expanding the tax base, increasing current tax rates and tax rates on future generations, or a combination of these.

## Revenue Effects of Federal Tax Policy Changes

The amount of revenue raised from a tax is determined by the tax base, the tax rate, and the compliance rate, as shown in figure 8. Changes to the tax code can be **revenue neutral**, meaning that they are designed to raise the same amount of revenue as the current tax laws, or tax code changes can be designed to raise more or less revenue than the current tax laws. Additionally, changes to the federal tax system can have significant implications for state and local government tax revenues.

**Figure 8: Formula for Determining Tax Revenue**



Source: GAO.

Tax revenue can be affected by changing the current tax base, which could include replacing it with a pure consumption tax base or broadening the current tax base by eliminating certain tax expenditures. As we noted earlier, tax expenditures, which the government uses to encourage specific social and economic goals, reduce the size of the tax base. Tax expenditures may be justified because, in some cases, it may be less costly to achieve these goals through reductions to the tax base than through spending programs. The choice of whether to use tax expenditures or spending depends on which approach better targets and meets the program's objectives at the lowest cost. Even though spending programs show up in the federal budget and tax expenditures are not included as federal spending, taxpayers are paying for the program in either case. Both should be transparent and subject to periodic oversight concerning such factors as whether they meet the program's objectives or conflict with other government programs, grants, and regulations that have similar objectives.



The tax expenditure for **employer-provided health care**, discussed in text box 1, illustrates the importance of such oversight.

**Text Box 1: Tax Expenditure for Employer Medical Insurance Premiums and Medical Care**

The current U.S. tax system excludes employer-provided health insurance from individuals' taxable income even though such insurance is a form of income (nongratis compensation). As table 2 showed, the Treasury Department estimates that the tax subsidy for employer-provided health insurance was over \$126 billion in outlay-equivalents during 2004, not including forgone social insurance taxes and state taxes.

The tax exclusion increases the proportion of the population covered by health insurance. Currently, nearly 45 million Americans are without health insurance. The tax exclusion encourages employers to offer and employees to participate in health insurance plans, increasing the proportion of workers covered. The exclusion addresses a well-known problem with health insurance. Because individuals may be better able to anticipate their health care needs than insurers, health care plans may attract customers with higher risk of poor health, resulting in higher premiums. By encouraging the pooling of high- and low-risk individuals, the tax exclusion may help to reduce premiums below those that individuals would face if they purchased insurance on their own.

However, some question whether the tax subsidy for health insurance is the best way to increase health insurance coverage. For example, the tax exclusion provides the most assistance to taxpayers who have high marginal tax rates (those with high incomes)—the exclusion saves those taxpayers more in taxes owed than it saves those with lower marginal tax rates.

The tax exclusion for health insurance also contributes to higher health care costs. The exclusion, by lowering premiums, encourages more extensive insurance coverage, which compounds another well-known problem with health insurance. Because much of the cost of medical treatment is paid for by a third party (the insurer), patients and doctors are generally unaware of the total costs of health care and have little incentive to economize on health care spending.

Unlike the tax exclusion for employer-provided health insurance, an ideal health care payment system would foster the delivery of care that is both effective and efficient, resulting in better value for the dollars spent on health care.

Tax revenue can also be affected by changes in tax rates, where the amount collected depends on the definition of the tax base and taxpayer responses to changes in the rate. If the tax base is broad with few exclusions, deductions, and credits, then the tax rates required to generate a particular amount of revenue will be lower than if the base is narrow. The Tax Reform Act of 1986 broadened the current tax base, which is based largely on income, by eliminating some tax expenditures, which made more income taxable. Without any changes in rates, tax revenue would have increased, but instead, rates were lowered to keep revenue about the same. Within some range, rate increases bring in more revenue, but rates can become so high that a further increase discourages enough of the taxed activity to reduce revenue. A tax system is more adaptable to increased revenue needs to the extent that tax rates can be increased without other fundamental changes to the system and without excessively discouraging the taxed activity or increasing noncompliance.

Tax revenue is also affected by policies that change compliance rates. Noncompliance means that only part of the tax liability actually gets paid. Increasing compliance would bring in more revenue from the existing tax base without having to raise rates. IRS estimates that the **net tax gap** (the difference between taxes legally

owed to the government and what taxpayers actually paid to the government) was at least \$257 billion in 2001, the most recent year available. This is about 13 percent of federal revenue. Some experts believe that simplicity and transparency can contribute to compliance, as **voluntary compliance** is likely to increase if taxpayers are less likely to make errors on their tax returns and have fewer opportunities to evade taxes.

While federal tax policy changes may alter the amount of revenue collected by the federal government these changes can also alter the amount of revenue that state and local governments collect. State and local governments collect nearly one-third of all the tax revenue generated in the United States each year.

In many cases, state governments link their tax bases to the federal tax base. For example, some states use a taxpayer's **adjusted gross income** from the federal tax return to calculate state income taxes. If the federal government enacted provisions that reduce the size of the tax base used to calculate a taxpayer's adjusted gross income, then absent policy changes in the affected states, these state governments would likely see a decrease in state tax revenues. Conversely, if the federal government reduced the number of tax expenditures, increasing the size of the tax base, state governments would likely see an increase in state tax revenues. Thus, major changes to the federal tax base could lead to a variety of challenging tax system changes at the state level. For example, if the federal government adopted a consumption tax base, many states may have to consider whether they wish to maintain state income taxes.

## General Options Suggested for Fundamental Tax Reform

Recent years have seen a variety of proposals for fundamental tax reform. These proposals would significantly change the tax base, tax rates, and collection points of the tax.

Some of the proposals would replace the federal income tax with some type of consumption tax. The **retail sales tax**, **value-added taxes**, the personal consumption tax, and the **flat tax** are all types of consumption taxes. They vary in their collection points and structure. Similarly, collection points and rate structure will vary under an **income tax base**.

Text box 2 briefly summarizes the general categories of proposals.

**Text Box 2: General Categories of Tax Reform Proposals**

In recent years, lawmakers and analysts have suggested a variety of tax reform proposals that would change the way in which Americans pay taxes.

- *National retail sales tax (NRST)*: An NRST would be collected by businesses with, in most cases, no need for individuals to file tax returns (some taxpayers may be required to file tax returns in order to get back taxes that they paid on items for business use). The base would be retail sales of goods and services to final customers. Rates could not vary by individual.
- *Value-added taxes (VAT)*: VATs, now widely used in other countries, are collected by businesses with no need for individual tax returns. The VAT taxes all sales to both consumers and other businesses, adjusting for purchases from other businesses, which is equivalent to the base of an NRST. Rates do not vary by individual. Some experts believe a VAT would be easier to enforce than an NRST.
- *Flat tax*: A consumption flat tax would have the same base as an NRST or a VAT but would split collection between businesses and individuals by making wages deductible by businesses but taxable at the individual level. Generally, a single tax rate would apply to both individuals and businesses. Because of the individual component of the tax, wages up to some level can be exempted from tax, which would introduce some progressivity into this tax system.
- *Personal consumption taxes*: A personal consumption tax would look much like the current individual income tax. Individuals would report their income from wages, interest, dividends, and so on. It would differ in that borrowed funds would be included in the tax base, and funds that are saved or invested would be deducted. The base is equivalent to that of other consumption taxes. Rates could vary based on individual characteristics.
- *Reformed income tax system*: Over the years, the Department of the Treasury and others have discussed options for reforming the current tax system that would replace the current income tax with a more broadly based income tax. For example, proposals have been advanced to integrate the personal and corporate income tax and to eliminate preferences on certain types of income, which would broaden the tax base and could result in reduced tax rates (if the proposal were revenue neutral).

## Key Questions

1. What current taxes would the proposal change?
  - Does the proposal change personal income taxes, social insurance taxes, corporate income taxes, and/or estate and gift taxes?
2. What is the nature of the proposed change to the tax system?
  - Does the proposal change the tax base from income to consumption?
  - Does the proposal include tax expenditures?
  - Does the proposal change the tax rates?
  - Does the proposal change the collection points for the tax?
3. How will the proposed change affect total revenues?
  - Are proposed changes to the tax code likely to be revenue neutral?

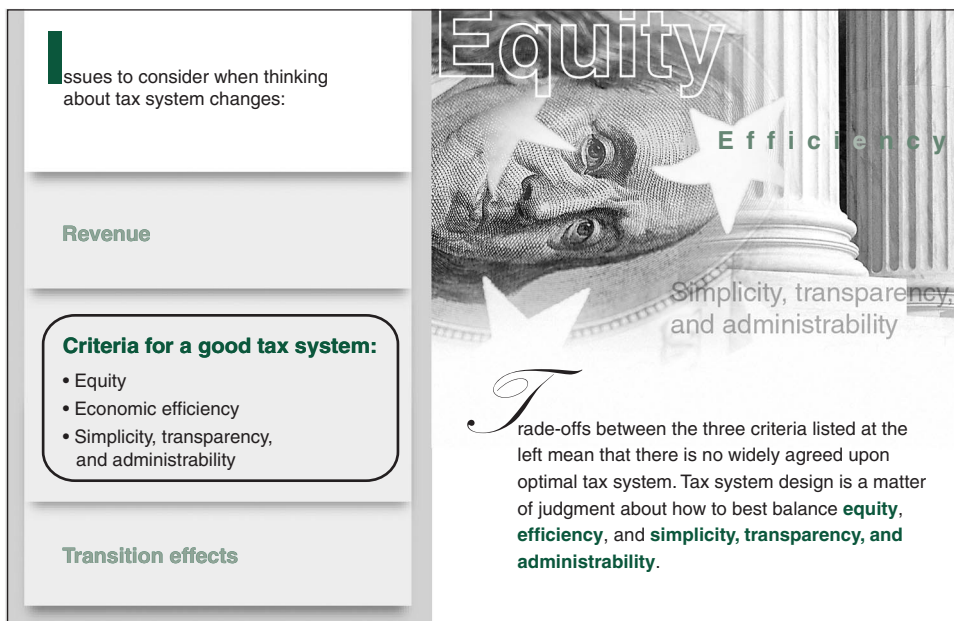
- If not, will they generate more or less revenue than the current tax laws?
4. What effect would the proposal have on the nation's projected budgets and long-term fiscal outlook?
    - Does the proposal take into consideration the sizable long-term fiscal gap that the country faces?
  5. What tax expenditures are included in the proposal, and what tax expenditures, if any, have been removed from the current tax system?
    - Are the social and economic goals of the tax expenditures likely to be achieved and worth the cost in lost revenue?
    - When the total costs of a program are considered, would it be less costly to implement the program as a tax expenditure or as a spending program?
  6. If the proposal changes the tax base, the tax rates, or the collection points, how would these changes alter the amount of revenue that the government is able to collect?
  7. What implications, if any, would the proposal have on the ability of state and local governments to collect tax revenues?
    - Would the proposal tax the same base that many states rely on?
    - Would the proposal allow many states to continue to rely on the federal tax base as a starting point for determining state taxes?

# 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**



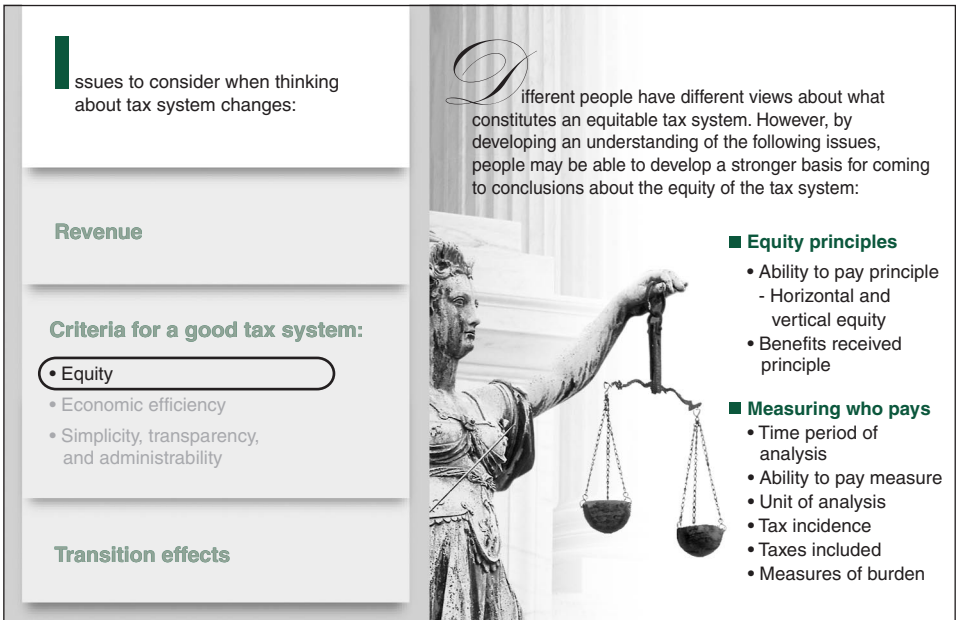
Sources: GAO (text); PhotoDisc (images).

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.

## Measuring Who Pays: Distributional Analysis

Distributional analysis, which shows tax burden by differing income groups, is used to measure how different tax proposals would affect taxpayers with varying ability to pay, or the way in which the tax burden is to be shared among various income groups. Some tax reform proposals may alter the distribution of taxes paid among various groups of taxpayers, while other tax reform proposals may be distributionally neutral, or maintain the same distribution of tax burdens as the tax system that is already in place. The Tax Reform Act of 1986 is an example of a tax reform proposal that was intended to be distributionally neutral.

The distributional analyses of a specific tax proposal may differ for a variety of reasons. Among the most important are (1) the time period included in the analysis, (2) the manner in which ability to pay is measured, (3) the unit of analysis, (4) assumptions regarding **tax incidence**, (5) the taxes included in the analysis, and (6) the measures of tax burden used in the table.

*Time period of the analysis:* Most distributional analysis tables use annual measures of income and taxes, although some use longer periods. However, a 1-year time horizon provides a limited perspective on the distributional effects of federal taxes. For example, consider the same individual at different points in his or her life. When he or she enters the workforce, income and wealth usually are relatively low but increase over time when prime earnings years are reached and assets and savings begin to be accumulated. With retirement, annual wages fall and savings are the primary support for the retirees lifestyle. As a result of fluctuations in income over time, annual tables measuring the distribution of tax burdens may group together people who have different lifetime economic circumstances.

*Ability to pay measure:* Most studies that measure distributional effects of alternative tax proposals include a broad measure of income that includes more than just taxable income to measure a taxpayer's ability to pay. Some types of nonwage income, such as investment income, are relatively easy to identify and include in distributional tables, while others are more difficult. For example, distributional analyses may attempt to adjust for such factors as the value of employer-provided fringe benefits in order to broaden the definition of income to better reflect ability to pay.

However, while income is the most commonly used measure of ability to pay in distributional analysis, other measures of ability to pay, such as consumption, may also be used to create distributional tables. As we mentioned earlier, some believe that consumption is a better measure of ability to pay taxes than income.

*Unit of analysis:* The unit of analysis used to group taxpayers together may also affect the outcome of distributional tables. Some analysts create distributional tables using individual taxpayers as the unit of analysis, while others group taxpaying units (people included on a tax return, families, or households) together. Distributional tables may differ if one table uses individual taxpayers and another table uses a taxpaying unit because a taxpaying unit may include more than one individual who pays taxes.

*Tax incidence:* The actual burden of a tax does not always fall on the people or businesses that actually pay the tax to the government, and assumptions about tax incidence may affect the results of distributional tables. The **statutory incidence** of a tax—the parties who are legally required to pay the tax—may not be the same as its **economic incidence**—the parties who actually bear the burden of the tax—because taxpayers who legally must pay the tax can sometimes shift the burden to others through changes in prices, wages, and returns on investments. For example, from a statutory perspective, the employee and employer contribution to the payroll tax are equal. However, most analysts agree that employees bear the entire burden of the payroll tax in the form of reduced wages.

Determining who bears the burden of the corporate income tax is an example of how difficult it can be to determine the incidence of a tax. Text box 4 illustrates some of the issues associated with identifying the incidence of the corporate income tax.

Text Box 4: Incidence of the Corporate Income Tax

Corporations do not actually bear the ultimate burden of the corporate income tax; instead, individuals bear the burden of the corporate income tax. A corporation writes a check to the U.S. Treasury to pay its tax liability, but the burden of the tax is shifted to other groups of people through lower incomes or higher prices.

The money to pay the tax must come from reduced returns to investors in the corporation, lower wages to the company's employees, or higher prices that consumers pay for the company's products. In the short term, the incidence of the corporate income tax is likely to fall on stockholders or investors in general. However, because corporate income taxes may lead to reduced capital investment, in the longer term some of the burden of the corporate income tax is more likely shifted to people who earn income from labor. Reduced capital investment can lead to lower productivity and, consequently, lower wages.

Due to the difficulty of identifying the incidence of the corporate income tax, some, including the Joint Committee on Taxation, often exclude the corporate income tax from distributional tables altogether.

*Taxes included in the analysis:* Some distributional tables include different taxes in the analysis, so when comparing two distribution tables, identifying which taxes are included in the analysis is necessary to ensure that a valid comparison can be made between the two estimates. For example, in table 3, one side of the table includes all federal taxes, while the other side only includes the federal income tax. Because it is often difficult to isolate the incidence of some taxes, analysts sometimes exclude those taxes from the analysis.

*Measures of tax burden:* Distributional tables may also produce different results based on the measures of tax burden that are used. Effective tax rates and share of tax liability (portion of total taxes that households in each quintile collectively remitted to the government), the measures used in table 3, are two common measures of tax burden. Some distributional tables show how effective tax rates would change if the tax code were changed.

Different Assumptions Lead to Different Distributional Analyses

The Office of Tax Analysis in the Treasury Department, the Congressional Budget Office (CBO), and the Joint Committee on Taxation are the three government sources of tax distributional analysis, and their distributional tables may differ based on the assumptions that they make about the issues we have outlined above.

The example in table 3, which shows two measures of tax burden, illustrates the fact that making different assumptions when conducting distributional analysis can lead to different results.

**Table 3: Measures of Tax Burden: Distribution of Total Federal Taxes and Individual Income Taxes in 2004**

Income quintiles	Total federal taxes		Individual income taxes	
	Average effective tax rates	Share of tax liability	Average effective tax rates	Share of tax liability
Lowest quintile	5.2%	1.1%	-5.7%	-2.7%
Second quintile	11.1%	5.2%	-0.1%	-0.1%
Middle quintile	14.6%	10.5%	3.5%	5.4%
Fourth quintile	18.5%	19.5%	6.6%	15.2%
Highest quintile	23.8%	63.5%	14.2%	82.1%
<b>All</b>	<b>19.6%</b>	<b>100.0%</b>	<b>9.0%</b>	<b>100.0%</b>

Source: Congressional Budget Office, *Effective Federal Tax Rates Under Current Law, 2001 to 2014* (Washington, D.C.: August 2004).

Note: In table 3, numbers do not always add due to rounding.

Both of the distribution tables were prepared by CBO using the same methodology to measure the distributional effects of the tax system in 2004 using 2001 income (adjusted for inflation and nominal income growth to reflect income in 2004) as the base for the analysis. The only difference between the left side of the table and the right side of the table is the taxes that are included in the analysis. The left side includes total federal taxes, excluding estate and gift taxes and several other miscellaneous sources of revenue, while the right side of the table only includes individual income taxes. The table that presents total federal taxes uses the assumption that individuals bear the burden of the employee and employer share of

payroll taxes, and owners of capital income bear the burden of the corporate income tax. The effective tax rates for individual income taxes are negative for the two lowest income quintiles because the table includes some offsets to tax liability, such as the earned income tax credit.

## Key Questions

1. How is a taxpayer's ability to pay broadly defined:
  - Income?
  - Consumption?
  - A broader definition of overall wealth?
2. What factors other than income, such as medical expenses, number of dependents, and so forth, does the proposal account for when considering a taxpayer's ability to pay taxes?
3. Will taxpayers with equal ability to pay taxes pay the same amount?
  - If not, what provisions of the proposal do not adhere to the principle of horizontal equity?
4. How will the tax system tax people with differing ability to pay?
  - Are the statutory tax rates progressive, proportional, or regressive?
  - Are the average effective tax rates progressive, proportional, or regressive (accounting for credits, deductions, and other tax expenditures)?
5. Are there any components of the tax proposal that are justified on the benefits received principle?
  - If so, what mechanisms are in place to determine that taxpayers who pay taxes for a particular government program are the same taxpayers who benefit from the provisions of that program?
6. Does the proposal maintain the distribution of taxes (i.e., is the proposal distributionally neutral)?
  - If not, who will be paying more in taxes and who will be paying less?
  - If so, what features of the proposal are in place to ensure that it will remain distributionally neutral?
7. What type of distributional analysis was done?

- What time period is covered? For example, does the distributional analysis measure the lifetime or annual effects of the tax system?
- How is ability to pay (income, consumption, or wealth) measured?
- What is the unit of analysis (individuals, households, or taxpaying units)?
- What assumptions are made about tax incidence (e.g., who is assumed to pay the corporate income tax)?
- What taxes are covered in the distributional analyses?
- What measures (e.g., tax rates, share of tax liability) are being used to calculate the distribution of tax burden?

## Economic Efficiency

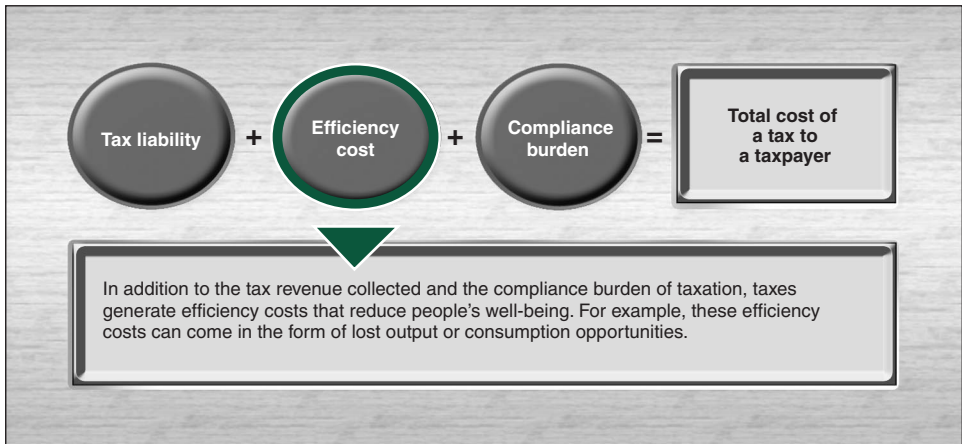
One reason people bear taxes is they desire the benefits of government programs and services. As taxpayers, they balance the costs of taxes with the benefits of government. From a taxpayer's perspective, the cost of taxes includes more than the tax liability paid to the government. These costs include 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**

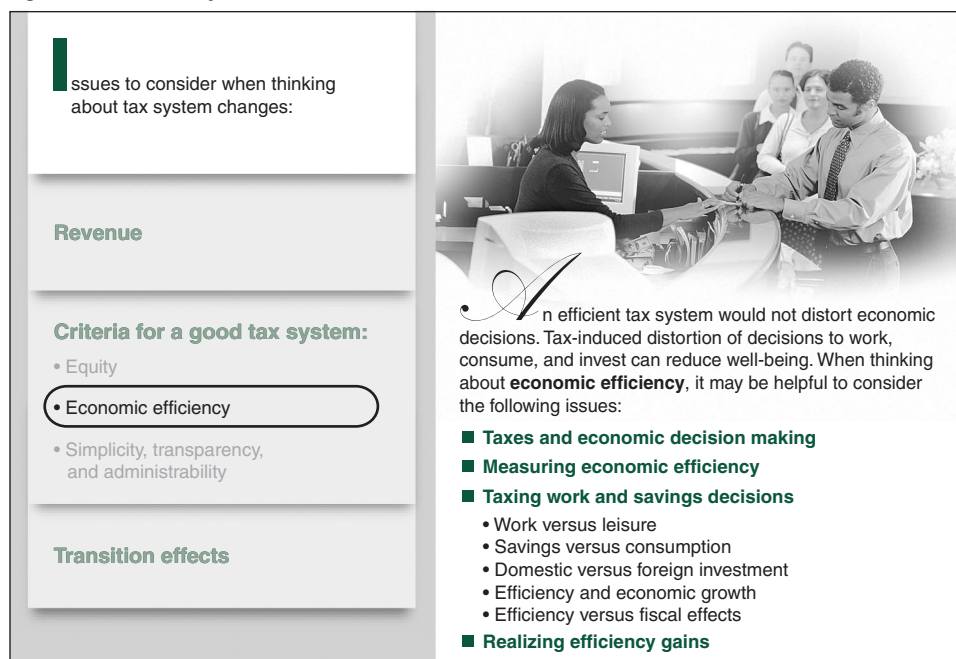


Source: GAO.

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.

## Measuring Economic Efficiency

While economists generally agree that the tax system imposes significant efficiency costs, estimating the magnitude of tax-related efficiency costs in an economy as complex as ours is extremely difficult. However, several attempts have been made to estimate the efficiency costs of parts of the tax system. For example, one study estimated the total efficiency cost of the personal income tax on labor income, which distorts labor supply decisions, to be from \$137 billion to \$363 billion in 1994.<sup>3</sup> A second study estimated the effects of the unequal taxation of savings and consumption to be about \$45 billion in 1995.<sup>4</sup> Text box 5 summarized estimates of the efficiency losses associated with the tax treatment of owner-occupied housing as ranging from 0.1 to 1 percent of GDP. For further information on efficiency cost estimates, see GAO, *Tax Policy: Summary of Estimates of the Costs of the Federal Tax System*, [GAO-05-878](#) (forthcoming).

These partial estimates indicate the significant uncertainty surrounding the magnitude of tax-induced efficiency costs. Nevertheless, they suggest that the overall efficiency costs imposed by the tax system are large—on the order of several percentage points of GDP.

As a result of these difficulties, simple rules of thumb are commonly used to provide rough estimates of the efficiency costs of taxes. Text box 6 describes two such rules of thumb.

### Text Box 6: Rules of Thumb for Estimating Efficiency Costs

Because of the difficulty of measuring efficiency costs, several rules of thumb have been used to approximate efficiency costs in certain situations. These rules suggest that efficiency costs from taxes may be considerable.

Two commonly cited rules are as follows:

- According to OMB guidance, the efficiency cost of a tax increase, which should be included as part of the total cost when calculating the benefits and costs of a government spending project, is equal to 25 percent of the tax revenue collected used to fund the project.
- Some economists agree that the efficiency cost of a tax increases with the square of the tax rate: a 50 percent tax increase, for example, from 25 percent to 37.5 percent, would more than double the efficiency cost. For this reason, progressive tax rate schedules, which have higher top marginal rates, are believed to have higher efficiency costs than a proportional schedule that raises the same amount of revenue.

<sup>3</sup>Martin Feldstein, "Tax Avoidance and the Deadweight Loss of the Income Tax," *The Review of Economics and Statistics*, vol. 81, no. 4 (1999).

<sup>4</sup>Jinyong Cai and Jagadeesh Gokhale, "The Welfare Loss From a Capital Income Tax," *Federal Reserve Bank of Cleveland Economic Review*, vol. 33, no. 1 (1997).

The extent to which tax reform can reduce such tax-induced inefficiencies and thus increase our economic well-being depends on the design of a reformed system. All practical tax systems distort some decisions so it is not possible to eliminate all the efficiency costs associated with taxes. The magnitude of the efficiency costs in a reformed tax system would depend on such design features as the treatment of savings versus consumption, the number of tax expenditures, and the level and progressivity of tax rates. While some economists believe that a pure consumption tax with no preferences and a flat rate would reduce efficiency costs relative to the current tax system, such a pure tax may not be a feasible alternative because of equity and other concerns.

In addition, as has been discussed, the revenue consequences of tax reform have economic effects. The efficiency gains from a reformed tax system could be offset if the new system increases long-term deficits.

## **Taxing Work and Savings Decisions**

In part because of the difficulty of measuring the efficiency cost of taxes, discussions of the impact of taxes on the economy sometimes focus on the effect that taxes have on changes in the output of the economy, labor supply, or other such economic variables. However, such changes do not necessarily measure efficiency costs. Efficiency loss is the difference between individuals' well-being with a tax and individuals' well-being under a revenue neutral, hypothetical tax that does not distort, called a lump sum tax.

Three choices commonly discussed are the choice between work and leisure, the choice between consumption and saving, and the choice between domestic and foreign investment. Intertwined with effects that taxes have on these choices is the effect of taxes on economic growth.

*Work versus leisure:* Taxes—both income and consumption taxes—can affect the decisions that people make about how much time to devote to work or leisure in two ways. First, taxes may increase the incentive to work because workers must work more to maintain their after tax income. Second, taxes may reduce the incentive to work because workers earn less from an additional hour of work. The net effect may be no change to the overall supply of labor. However, even in this case, there is still an efficiency cost, which is determined by the second effect. By reducing hourly after tax earnings, income and consumption taxes distort decisions about how many hours to devote to work or leisure.

Empirical research generally shows that at least for primary wage earners, decisions about labor force participation are not very responsive to taxes. However, decisions about labor force participation by secondary wage earners have been shown to be more responsive to changes in the tax system.

*Consumption versus savings:* Taxes on capital reduce the after-tax return to savings. In effect, this makes future consumption (savings) more expensive relative to current consumption and thus has the potential to distort savings decisions. While research has shown that the demand for some types of savings, such as the demand for **tax-exempt bonds**, is responsive to changes in the tax system, there is greater uncertainty about the effects of changes in the tax system on other choices, such as aggregate savings.

*Domestic versus foreign investment:* Taxes on income from capital can affect the location of investment by changing the relative after-tax return on domestic and foreign investment. This matters because the location of investment can affect the income of U.S. citizens. The income of people working in the United States is closely tied to their productivity, which generally increases with the amount of domestic investment. At the same time, U.S. citizens who own capital can earn higher incomes by investing their capital—in the United States or abroad—wherever it earns the highest rate of return. In a world of increasing capital mobility due to increasing trade and decreasing communication and transportation costs, the effect of taxes on the location of investment is even more important than in the past

*Efficiency and economic growth:* Removing or reducing distortions caused by the tax system can affect the size of the economy. Increasing the efficiency of the tax system can expand the economy through a temporary increase in the rate of growth. An increase in efficiency is an increase in well-being that comes from using existing resources in a better way. Efficiency raises capacity to a higher level but does not necessarily continue to increase it without additional resources. Such an increase could show up as a temporary increase in the growth of the economy. However, the long-term growth rate depends on the rates of change in population, the capital stock, and technology. Changes to the tax system that would increase economic efficiency could increase the long-term growth rate if they increase the rate of technological change. Thus, tax changes that increase economic efficiency may or may not result in an increased long-term rate of economic growth.

*Efficiency versus fiscal effects:* As has been discussed, taxes may have both efficiency effects and fiscal policy effects. Government spending in excess of government revenues creates deficits, which if large enough and continued over a period of time will ultimately have a negative impact on economic growth and productivity to the extent that they absorb savings that would otherwise finance investment in the private economy. Thus, the gain from changing the tax system to increase economic efficiency could be offset if the tax changes increase the deficit.

Tax policies designed to enhance economic efficiency can be designed independently of fiscal policy. For example, the Tax Reform Act of 1986 was designed, in part, to achieve increased efficiency by broadening the tax base and lowering rates in a way that was revenue neutral. Such a revenue neutral change would have no effect on deficits and debt.

## Realizing Efficiency Gains

The extent to which efficiency gains are realized by switching to an alternative tax system depends on at least two factors. First, the efficiency gains of switching to a new tax system depend on the extent to which that tax system reduces distortions caused by tax preferences, rate differences, sectoral differences, and switching the base from income to consumption. Second, the change to a new tax system may not improve the overall efficiency of the economy if the distorting tax incentives eliminated by switching to a new tax system are replaced with government spending or regulation that provides the same incentives.

### Key Questions

1. Does the proposal tax income, spending, assets, and investments differentially?
  - Which types of income, spending, assets, and investments are tax preferred?
  - Which decisions are likely to be distorted?
2. What social goals, if any, is the tax proposal trying to promote?
  - Is there an efficiency justification for the goal, or is the goal justified on other grounds, such as equity?
3. Do estimates of the cost of achieving the goal include efficiency costs?
4. What are the trade-offs between equity, efficiency, and the other criteria?
5. Is the tax proposal accompanied by estimates of the efficiency gains or losses to be realized by the new tax system?
  - Is the tax proposal accompanied by estimates of economic activity (e.g., change in labor supply or change in GDP) that will be encouraged or discouraged by the new tax system?
  - Is the proposal accompanied by estimates of the efficiency loss or gain associated with these changes in economic activity?
6. How does the tax change affect leisure versus work decisions?
7. How does the tax change affect savings versus consumption decisions?
8. How does the tax change affect decisions about foreign versus domestic investment?



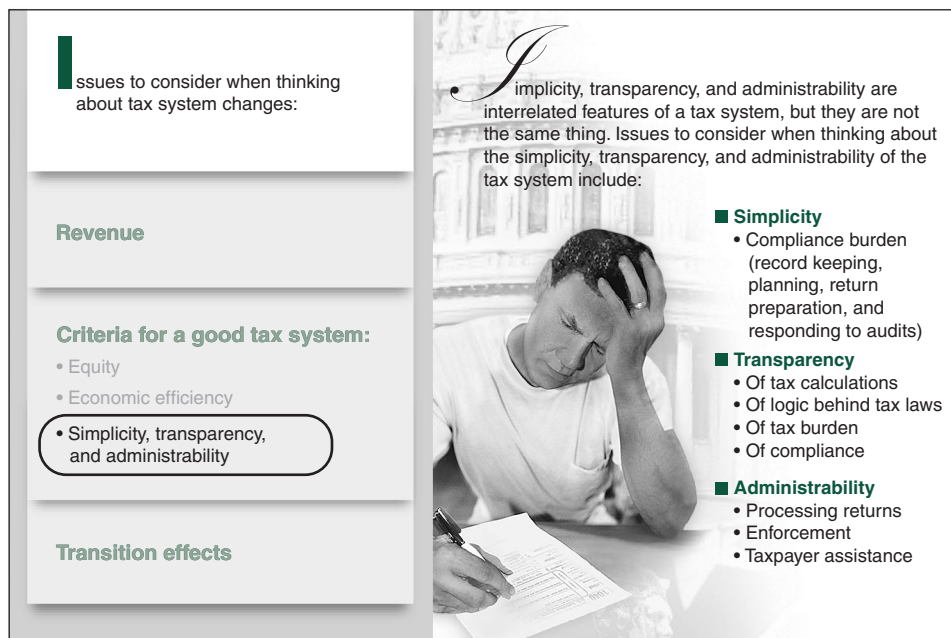
9. How does the tax change affect choices between different types of investments and different types of consumption?
10. Is the tax proposal likely to increase economic growth?
  - Is the growth achieved through a onetime rearranging of resources?
  - Is the growth achieved through a permanent increase in the rate of growth?
  - Does the tax proposal contain estimates of its effect on growth (often measured by changes in GDP) and estimates of the costs of achieving the growth (such as reduced leisure time)?
11. In addition to efficiency effects, will the proposal have other economic effects by increasing or reducing the deficit?

## 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**



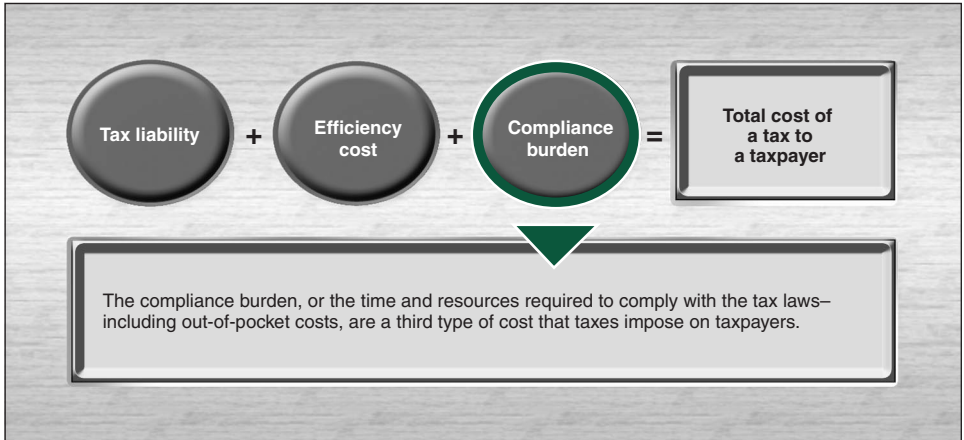
Sources: GAO (text); PhotoDisc (images).

### 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.<sup>5</sup> 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

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<sup>5</sup>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**

<b>Tax bracket (taxable corporate income)</b>	<b>Marginal tax rate in the tax bracket</b>
\$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 administering 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:

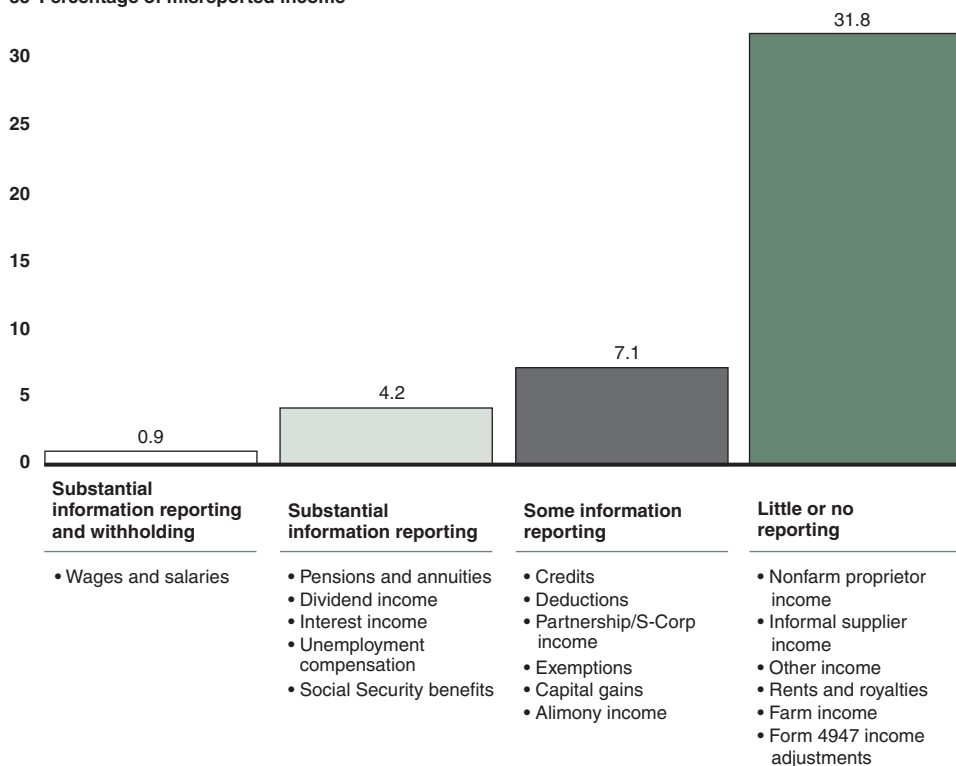
- *Processing tax returns and payments:* Currently, IRS processes over 130 million individual income tax returns each year, which taxpayers file electronically or through the mail. Under today's technology and any proposed alternatives to the current system, a return-free tax system may be difficult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

**Figure 15: Taxpayer Noncompliance Categorized by Amount of Withholding and Information Reporting, 1992**

35 Percentage of misreported income



Source: IRS.

Regardless of the amount of withholding and **third-party information reporting** required, other government enforcement activities are likely to be needed under any proposed tax system in order to ensure that taxpayers comply with the tax code. Proposals that simplify the tax code and administrative efforts to aid honest taxpayers in complying with the tax laws could increase compliance; however, under any system, costly enforcement efforts, perhaps including face-to-face audits of taxpayers, will likely always be needed to help detect and penalize dishonest taxpayers.

Measuring administrative costs is difficult. Budgetary costs are easily measured: IRS's budget in fiscal year 2004 was \$10.2 billion. However, as discussed earlier, the costs of other parties in tax administration are harder to determine. Compliance burden estimates range from \$100 billion to \$200 billion. Despite the uncertainty, the range of estimates indicates that compliance burden is likely to considerably outweigh IRS's budgetary costs.



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.

### **Key Questions**

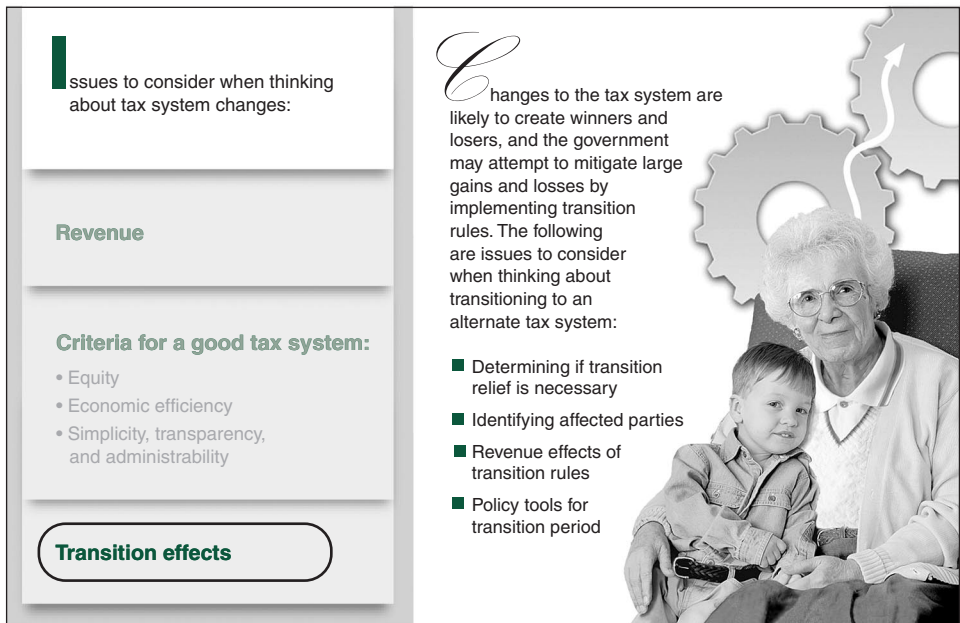
1. What impact is the tax proposal likely to have on the compliance burden that taxpayers face?
  - Will more or fewer taxpayers be required to fill out tax forms and file them with IRS?
  - What information will taxpayers be required to provide on the tax forms?
  - Does the proposal contain any estimates of its effect on compliance burden?

2. Will taxpayers' planning responsibilities (record keeping, research, etc.) likely increase or decrease in comparison to those under the current tax system?
3. Is the proposed tax system transparent?
  - Can taxpayers identify their tax liability easily?
  - Can taxpayers understand the logic behind the tax that they are paying?
  - Do taxpayers know what their true tax burden is (i.e., do they understand the incidence of the tax system)?
  - Do taxpayers understand the incidence of the tax system in terms of the tax burdens of other taxpayers?
  - Are taxpayers aware of the extent of compliance by others?
4. How would the tax system be administered?
  - What would be the role of taxpayers, employers, information return providers, and the IRS under the proposal?
  - Does the proposal contain estimates of its effect on budgetary costs?
  - Does the proposal contain any information about how administrative costs would be shared?
5. What would be the proposal's impact on IRS?
  - How would IRS functions of processing, compliance, collections, and taxpayer assistance be affected?
  - What enforcement tools (e.g., withholding and information reporting) would be added or taken away from tax administrators?
  - Does the proposal contain information about its likely effect on compliance?
6. Are there trade-offs between the simplicity, transparency, and administrability of the proposed tax system?
7. Under the tax proposal, have efforts to enhance the simplicity, transparency, and administrability of the tax system resulted in trade-offs with respect to the equity and efficiency of the proposal?

# Transitioning to a Different Tax System

Transition rules are sometimes proposed when switching to an alternative tax system. The rules are often intended to compensate certain people or entities whose losses are determined to be inequitable. However, not all tax experts agree that transition rules are appropriate when implementing changes to the tax code. Since transition rules are short-term tax policies, they should be judged by the same criteria for a good tax system that we discussed earlier. Many of the same trade-offs between the criteria that exist when considering tax reform proposals are also relevant when considering how to move from the current tax system to an alternative tax system. (See fig. 16.)

**Figure 16: Transition Issues Overview**



Sources: GAO (text); Dynamic Graphics (images).

## Deciding if Transition Relief Is Necessary

Changes to the tax code can create winners and losers. Taxpayers' losses, which are more often discussed in debates than gains resulting from tax policy changes, may be more obvious when tax changes increase government revenues or if the changes are

designed to be revenue neutral. However, even tax decreases can create losers depending on whether the tax burden is redistributed, spending cuts are made, or the tax burden on future generations is increased. Deciding if transition relief is necessary involves how to trade off between equity, efficiency, simplicity, transparency, and administrability.

Decisions about whether to tax previously accumulated savings when switching to a consumption tax provide an example of the trade-offs that need to be considered when determining if transition relief is merited. Some argue that switching from the current tax system to a consumption tax would merit some transition relief for equity reasons because accumulated savings, which may have already been taxed once under the income tax system, would be subject to a second tax when used for consumption purposes. In other words, those who had saved previously would be taxed higher than those just beginning to save. Proponents for transition relief argue that taxpayers who accumulated savings have an implicit contract with the government that savings would not be taxed when withdrawn. The notion that taxpayers rely on the continued existence of government policy when they make economic decisions is one of the key equity justifications for offering transition relief.

However, not everyone agrees that transition relief is justifiable based on equity grounds. Opponents of transition relief argue that taxpayers knowingly accept the risk that government policy may change when they make decisions, such as how much to save, and therefore do not need to be compensated for any losses that result from switching to an alternative tax system.

There are also trade-offs between equity and efficiency that should be considered when thinking about transition relief. The efficiency gains that could be realized by switching to a consumption tax could be negated if the government offered transition relief to taxpayers. Taxing accumulated savings is economically efficient because doing so does not distort work or savings behavior—taxpayers cannot avoid paying the tax by changing their behavior to work or save less. Offering transition relief would reduce the revenue gain from taxing accumulated savings, thereby requiring higher consumption tax rates.

Finally, developing and implementing transition rules could add a significant amount of complexity to the tax system—a characteristic of the tax system that the switch to an alternative tax system was likely intended to reduce. The new complexity would be temporary, phasing out with the transition rules.

## **Identifying Affected Parties**

Identifying winners and losers, the amount of gains and losses, and effective mitigation policies is complicated by the different ways tax changes can affect taxpayers. Tax law changes, by definition, affect taxpayers' future liabilities. In some cases, those future tax changes are capitalized into the prices of marketable assets.

For example, changes in the tax treatment of owner-occupied housing have the potential to affect current housing prices. In other cases, such as wealth accumulated in a savings account, tax law changes might affect the value of the wealth but do not change the price of a marketable asset. In still other cases, the after-tax return to future behavior, such as hours worked, is altered. Regardless of how taxpayers feel the impact of a tax change, the impact on their ability to consume over time is the same (assuming everything else is constant).

## Revenue Effects of Transition Relief

If transition relief is provided to compensate taxpayers for financial losses due to changes in the tax code, then revenues equivalent to these losses will need to be found from other sources, assuming the proposal is revenue neutral. One alternative source of revenue would be to tax those who have received windfall gains from the policy changes. However, debates about transition relief typically center around how to handle taxpayers who are likely to suffer windfall losses and not on how to impose special taxes on those who experience windfall gains.

## Policy Tools for Implementing Transition Rules

The two most commonly discussed policy tools for transitioning to an alternative tax system are **grandfather clauses** and **phase-in rules**.

- *Grandfather clauses:* Grandfather clauses are typically used to exempt people who would be subject to a new rule from the provisions of that rule. Grandfather clauses are generally used to exempt current assets or investments from new tax rules in order to protect taxpayers who purchased those assets from being penalized by unexpected changes to the tax system. One problem with grandfather clauses is that over time they can lead to unequal tax treatment of similar assets.
- *Phase-in periods for new laws:* Another form of transition relief would be to phase in new legislation over a period of time in order to reduce the effects that new tax laws would have on taxpayers.
- *Combination of grandfather clauses and phase-in periods:* It would also be possible to develop transition rules that allow for certain assets/investments to be grandfathered and others subject to phased-in tax laws. One possible variant previously outlined by the Treasury Department would be to apply new tax laws immediately to all new assets but phase in the tax laws on existing assets.

## **Key Questions**

1. Does the proposal include transition rules?
  - If so, what are they?
  - What gains and losses are the rules intended to mitigate?
  - Who bears these gains or losses?
2. What are the expected revenue effects of the transition rules?
  - If the proposal is intended to be revenue neutral, what additional revenue sources will be used during the transition period?
3. How will the transition rules affect the equity of the tax system as a whole?
  - Why were some taxpayers selected for transition relief but not others?
  - Who will pay for the transition relief?
4. How will the transition rules affect the overall efficiency of the tax system?
  - Do the transition rules have efficiency costs that offset some of the gains from changing the tax system?
  - Do estimates of these efficiency costs exist?
5. How will the transition rules affect the overall simplicity, transparency, and administrability of the tax system?

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# Appendix I: Key Questions

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## Section I: Revenue Needs—Taxes Exist to Fund Government

1. What current taxes would the proposal change?
  - Does the proposal change personal income taxes, social insurance taxes, corporate income taxes, and/or estate and gift taxes?
2. What is the nature of the proposed change to the tax system?
  - Does the proposal change the tax base from income to consumption?
  - Does the proposal include tax expenditures?
  - Does the proposal change the tax rates?
  - Does the proposal change the collection points for the tax?
3. How will the proposed change affect total revenues?
  - Are proposed changes to the tax code likely to be revenue neutral?
  - If not, will they generate more or less revenue than the current tax laws?
4. What effect would the proposal have on the nation's projected budgets and long-term fiscal outlook?
  - Does the proposal take into consideration the sizable long-term fiscal gap that the country faces?
5. What tax expenditures are included in the proposal, and what tax expenditures, if any, have been removed from the current tax system?
  - Are the social and economic goals of the tax expenditures likely to be achieved and worth the cost in lost revenue?
  - When the total costs of a program are considered, would it be less costly to implement the program as a tax expenditure or as a spending program?
6. If the proposal changes the tax base, the tax rates, or the collection points, how would these changes alter the amount of revenue that the government is able to collect?
7. What implications, if any, would the proposal have on the ability of state and local governments to collect tax revenues?

- Would the proposal tax the same base that many states rely on?
- Would the proposal allow many states to continue to rely on the federal tax base as a starting point for determining state taxes?

## Section II: Criteria for a Good Tax System

### Equity

1. How is a taxpayer's ability to pay broadly defined:
  - Income?
  - Consumption?
  - A broader definition of overall wealth?
2. What factors other than income, such as medical expenses, number of dependents, and so forth, does the proposal account for when considering a taxpayer's ability to pay taxes?
3. Will taxpayers with equal ability to pay taxes pay the same amount?
  - If not, what provisions of the proposal do not adhere to the principle of horizontal equity?
4. How will the tax system tax people with differing ability to pay?
  - Are the statutory tax rates progressive, proportional, or regressive?
  - Are the average effective tax rates progressive, proportional, or regressive (accounting for credits, deductions, and other tax expenditures)?
5. Are there any components of the tax proposal that are justified on the benefits received principle?
  - If so, what mechanisms are in place to determine that taxpayers who pay taxes for a particular government program are the same taxpayers who benefit from the provisions of that program?
6. Does the proposal change the distribution of taxes (i.e., is the proposal distributionally neutral)?
  - If not, who will be paying more in taxes and who will be paying less?
  - If so, what features of the proposal are in place to ensure that it will remain distributionally neutral?
7. What type of distributional analysis was done?



- What time period is covered? For example does the distributional analysis measure the lifetime or annual effects of the tax system?
- How is ability to pay (income, consumption, or wealth) measured?
- What is the unit of analysis (individuals, households, or taxpaying units, etc.)?
- What assumptions are made about tax incidence (e.g., who is assumed to pay the corporate income tax)?
- What taxes are covered in the distributional analyses?
- What measures (e.g., tax rates, share of tax liability) are being used to calculate the distribution of tax burden?

## Efficiency

1. Does the proposal tax income, spending, assets, and investments differentially?
  - Which types of income, spending, assets, and investments are tax preferred?
  - Which decisions are likely to be distorted?
2. What social goals, if any, is the tax proposal trying to promote?
  - Is there an efficiency justification for the goal, or is the goal justified on other grounds, such as equity?
3. Do estimates of the cost of achieving the goal include efficiency costs?
4. What are the trade-offs between equity, efficiency, and the other criteria?
5. Is the tax proposal accompanied by estimates of the efficiency gains or losses to be realized by the new tax system?
  - Is the tax proposal accompanied by estimates of economic activity (e.g., change in labor supply or change in gross domestic product (GDP)) that will be encouraged or discouraged by the new tax system?
  - Is the proposal accompanied by estimates of the efficiency loss or gain associated with these changes in economic activity?
6. How does the tax change affect leisure versus work decisions?
7. How does the tax change affect savings versus consumption decisions?
8. How does the tax system affect decisions about foreign versus domestic investment?
9. How does the tax change affect choices between different types of investments and different types of consumption?

10. Is the tax proposal likely to increase economic growth?
  - Is the growth achieved through a onetime rearranging of resources?
  - Is the growth achieved through a permanent increase in the rate of growth?
  - Does the tax proposal contain estimates of its effect on growth (often measured by changes in GDP) and estimates of the costs of achieving the growth (such as reduced leisure time)?
11. In addition to efficiency effects, will the proposal have other economic effects by increasing or reducing the deficit?

### **Simplicity, Transparency, and Administrability**

1. What impact is the tax proposal likely to have on the compliance burden that taxpayers face?
  - Will more or fewer taxpayers be required to fill out tax forms and file them with the Internal Revenue Service (IRS)?
  - What information will taxpayers be required to provide on the tax forms?
  - Does the proposal contain any estimates of its effect on compliance burden?
2. Will taxpayers' planning responsibilities (record keeping, research, etc.) likely increase or decrease in comparison to those under the current tax system?
3. Is the proposed tax system transparent?
  - Can taxpayers identify their tax liability easily?
  - Can taxpayers understand the logic behind the tax that they are paying?
  - Do taxpayers know what their true tax burden is (i.e., do they understand the incidence of the tax system)?
  - Do taxpayers understand the incidence of the tax system in terms of the tax burdens of other taxpayers?
  - Are taxpayers aware of the extent of compliance by others?
4. How would the tax system be administered?
  - What would be the role of taxpayers, employers, information return providers, and the IRS under the proposal?
  - Does the proposal contain estimates of its effect on budgetary costs?
  - Does the proposal contain any information about how administrative costs would be shared?
5. What would be the proposal's impact on IRS?

- How would IRS functions of processing, compliance, collections, and taxpayer assistance be affected?
  - What enforcement tools (e.g., withholding and information reporting) would be added or taken away from tax administrators?
  - Does the proposal contain information about its likely effect on compliance?
6. Are there trade-offs between the simplicity, transparency, and administrability of the proposed tax system?
  7. Under the tax proposal, have efforts to enhance the simplicity, transparency, and administrability of the tax system resulted in trade-offs with respect to the equity and efficiency of the proposal?

### **Section III: Transitioning to a Different Tax System**

1. Does the proposal include transition rules?
  - If so, what are they?
  - What gains and losses are the rules intended to mitigate?
  - Who bears these gains or losses?
2. What are the expected revenue effects of the transition rules?
  - If the proposal is intended to be revenue neutral, what additional revenue sources will be used during the transition period?
3. How will the transition rules affect the equity of the tax system as a whole?
  - Why were some taxpayers selected for transition relief but not others?
  - Who will pay for the transition relief?
4. How will the transition rules affect the overall efficiency of the tax system?
  - Do the transition rules have efficiency costs that offset some of the gains from changing the tax system?
  - Do estimates of these efficiency costs exist?
5. How will the transition rules affect the overall simplicity, transparency, and administrability of the tax system?

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# Appendix III: Glossary

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<b>Ability to Pay Principle</b>	A concept of tax fairness that states that people with different amounts of wealth, income, or other levels of well-being should pay tax at different rates. Wealth includes assets such as houses, cars, stocks, bonds, and savings accounts. Income includes wages, interest, dividends, and other payments.
<b>Adjusted Gross Income (AGI)</b>	All income subject to taxation under the individual income tax after subtracting certain deductions, such as certain contributions for individual retirement accounts, and alimony payments. Personal exemptions and the standard or itemized deductions are also subtracted from AGI to determine taxable income.
<b>Alternative Minimum Tax (AMT)</b>	A separate tax system that applies to both individual and corporate taxpayers. It parallels the income tax system but with different rules for determining taxable income, different tax rates for computing tax liability, and different rules for allowing the use of tax credits.
<b>Average Tax Rates</b>	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.
<b>Benefits Received Principle</b>	A concept of tax fairness that states that people should pay taxes in proportion to the benefits they receive from government goods and services.
<b>Capital Gains</b>	A capital asset's selling price less its initial purchase price. Investments that have been sold at a profit are called realized capital gains. Investments that have not yet been sold, but would yield a profit if they were sold have unrealized capital gains.
<b>Collection Point</b>	The individual or business that actually remits payment of taxes to the government.
<b>Compliance Burden</b>	The time and resources, including out-of-pocket costs, that taxpayers spend each year in order to comply with the tax laws. Compliance burden is often cited as a measure of the overall simplicity of the tax code.
<b>Consumption Tax Base</b>	A tax base where people pay taxes on goods and services that they purchase, or consume, effectively excluding savings and investment from the tax base. Capital assets are usually fully expensed when purchased under a consumption tax rather than depreciated over time, as is the case under an income tax.
<b>Corporate Income Taxes</b>	Taxes paid by corporations on net income, or the difference between corporate revenues and corporate business expenses.
<b>Credit</b>	An amount that offsets or reduces tax liability. When the allowable credit amount exceeds the tax liability, and the difference is paid to the taxpayer, the credit is considered refundable.
<b>Deduction</b>	An amount that is subtracted from the tax base before tax liability is calculated. Deductions claimed before and after the adjusted gross income line on the Form 1040 are sometimes called "above the line" and "below the line" deductions, respectively.
<b>Deficit</b>	The amount by which the government's spending exceeds its revenues for a given period, usually a fiscal year.

<b>Defined Contribution Pension Plans</b>	A type of retirement plan that establishes individual accounts for employees to which the employer, participants, or both make periodic contributions. Employees bear the investment risk and often control, at least in part, how their individual account assets are invested.
<b>Discretionary Spending</b>	Outlays controlled by appropriation acts, other than those that fund mandatory programs.
<b>Distortion</b>	Changes in behavior, such as how much to work, what to consume, and where to invest, due to taxes, government benefits, or monopolies.
<b>Distributional Analysis</b>	An analytical tool used by government agencies and other analysts to identify how different tax proposals or tax systems would affect different groups of taxpayers with differing ability to pay taxes, usually measured by income.
<b>Dividend Income</b>	A taxable payment made by a company to its shareholders, often quarterly, out of the company's retained earnings. Dividends are usually given out in the form of cash, but can also be given out as stock or other property.
<b>Economic Incidence</b>	The person or group of people that actually bear the burden of a tax regardless of who remits payment to the government. For example, even though businesses remit tax sales tax payments to the government, individuals who purchase items may bear the actual burden of the tax.
<b>Effective Tax Rates</b>	The amount of tax that a taxpayer pays to the government expressed as a percentage of some overall measure of total income.
<b>Efficiency Costs</b>	A reduction in economic well-being caused by distortions, or changes in behavior due to taxes, government benefits, monopolies, and other forces that interfere in the market. Efficiency costs can take the form of lost output or consumption opportunities.
<b>Employer-Provided Health Care</b>	Insurance plans offered by employers to employees where the employer pays all or a portion of an employee's health insurance costs. Employer-provided health care payments are not counted as nonwage income, and therefore these payments are not subject to taxation.
<b>Entitlement</b>	Programs that require the payment of benefits to persons, state or local governments, or other entities if specific criteria established in the authorizing law are met.
<b>Estate and Gift Taxes</b>	Assets an individual owns at the time of his or her death or gifts made during the course of his or her life may be subject to transfer taxes, sometimes referred to as estate and gift taxes. Estate and gift taxes are more likely to affect wealthier individuals, and most citizens are unaffected by estate and gift taxes.
<b>Excise Taxes</b>	A tax on the sale or use of specific products or transactions.
<b>Exemption</b>	A part of a person's income on which no tax is imposed. It is the amount that taxpayers can claim for themselves, their spouses, and eligible dependents. There are two types of exemptions—personal and dependency. Each exemption reduces the income subject to tax. The exemption amount is a set amount that changes from year to year.
<b>Externality</b>	A benefit or cost that is not captured or paid by the individuals or firms creating them.



<b>Flat Tax</b>	A type of tax reform proposal that, in most cases would change the tax base to a consumption tax base and impose a single, or flat, tax rate on individuals and businesses. Most flat tax proposals would not really be “flat” because they grant exemptions for at least some earnings.
<b>Grandfather Clause</b>	Provisions that are typically used to exempt people who would be subject to a new rule from the provisions of that rule. Thus, in the case of tax law changes, only people who engage in certain activities after a tax law change will be affected by changes to the tax treatment of that activity.
<b>Gross Domestic Product (GDP)</b>	The value of all final goods and services produced within the borders of a country such as the United States during a given period. The components of GDP are consumption expenditures (both personal and government), gross investment (both private and government) and net exports.
<b>Horizontal Equity</b>	The concept that people with the same ability to pay should be taxed at the same rate.
<b>Income Tax Base</b>	A tax base where individuals are taxed on the basis of income, or both the goods and services they consume as well as their savings and investments. Under an income tax, capital assets are usually depreciated over time rather than being fully expensed at the time they are purchased, as would be the case under a consumption tax.
<b>Individual Retirement Accounts</b>	Investment accounts that allow people to save a certain amount of income each year and, in most cases, deduct the savings from taxable income, with the savings and interest tax deferred until the person retires.
<b>Mandatory Spending</b>	Also known as “direct spending.” Mandatory spending includes outlays for entitlements (for example, food stamps, Medicare, and veterans’ pension programs), interest payments on the public debt and nonentitlements such as payments to the states from Forest Service receipts. By defining eligibility and setting the benefit or payment rules, the Congress controls spending for these programs indirectly rather than through appropriations acts.
<b>Marginal Tax Rates</b>	Tax rate 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.
<b>Medicaid</b>	A federal program that states administer to help pay medical costs for low income citizens. Each state in which applicants for the program reside establishes criteria for financial need. Medicaid supplements Medicare to pay for some of the costs that Medicare does not cover.
<b>Medicare</b>	A federal entitlement program that delivers medical care to eligible workers, spouses of workers, and retired workers when they reach age 65.
<b>Net Tax Gap</b>	The difference between taxes legally owed to the government and taxes actually paid to the government, less collected enforcement revenue.
<b>Payroll Taxes</b>	Often synonymous with social insurance taxes. However, in some cases the term “payroll taxes” may be used more generally to include all tax withholding. For the purposes of this report, payroll taxes are synonymous with social insurance taxes.
<b>Personal Income Taxes</b>	Taxes on income earned by individuals, including income from wages, interest, and nonwage income.

<b>Phase-in Rule</b>	A rule that allows for a new tax provision to be implemented gradually rather than immediately upon enactment of a new tax law. Phase-in rules help mitigate windfall losses during the transition to a new set of tax laws.
<b>Progressive Tax Rates</b>	A tax rate structure where tax liability as a percentage of income increases as income increases.
<b>Proportional Tax Rates</b>	A tax rate structure where taxpayers pay the same percentage of income, regardless of their income.
<b>Regressive Tax Rates</b>	A tax rate structure where tax liability is a smaller percentage of a taxpayer's income as income increases.
<b>Retail Sales Tax</b>	A tax levied on the sale price of a good and collected by the seller of the good.
<b>Revenue Neutral</b>	A term applied to tax bills or proposals are designed to raise the same amount of revenue as the system that is being replaced.
<b>Social Insurance Taxes</b>	Tax payments to the federal government for Social Security, Medicare, and unemployment compensation. While employees and employers pay equal amounts in social insurance taxes, economists generally agree that employees bear the entire burden of social insurance taxes in the form of reduced wages.
<b>Spillovers</b>	See externality.
<b>Standard Deduction</b>	A deduction that reduces income subject to tax and varies depending on filing status, age, blindness, and dependency. The standard deduction is taken instead of itemizing deductions.
<b>Statutory Incidence</b>	The party, usually an individual or a business, that is legally required to pay a tax to the government.
<b>Statutory Tax Rate</b>	Tax rates as written into law.
<b>Tax Burden</b>	See economic incidence.
<b>Tax-Exempt Bonds</b>	Bonds issued by state and local governments for public projects on which interest that is earned is exempt from federal income tax.
<b>Tax Expenditures</b>	A revenue loss attributable to a provision of the federal tax laws that grants special tax relief that encourages certain kinds of behavior by taxpayers or to aid taxpayers in special circumstances. The Congressional Budget and Impoundment Act of 1974 lists six types of tax expenditures: exclusions, exemptions, deductions, credits, preferential tax rates, and deferrals.
<b>Tax Incidence</b>	See economic incidence.
<b>Tax Liability</b>	The amount of tax that a taxpayer is legally required to pay to the government at a given time.
<b>Tax Preferences</b>	See tax expenditures.
<b>Taxable Income</b>	Income subject to tax that is used to determine tax liability. In the case of the federal income tax, taxable income is equal to a taxpayer's adjusted gross income less personal deductions and exemptions.
<b>Third-Party Information Reporting</b>	Information reported to IRS by third parties, such as banks or employers, that allows IRS to verify that information reported by taxpayers on their tax returns is accurate.
<b>Value-Added Tax</b>	A tax levied at each stage of production or distribution on the value added to the product during that stage of production. Value-added taxes are now commonly used in many Western European countries as a source of revenue.

<b>Vertical Equity</b>	The concept that people with differing ability to pay taxes should pay different rates of taxes or different percentages of their incomes in taxes.
<b>Voluntary Compliance</b>	A system of compliance that relies on individual citizens to report their income freely and voluntarily, calculate their tax liability correctly, and file a tax return on time.
<b>Windfall Gain</b>	A sudden and usually unexpected gain for a taxpayer or group of taxpayers owing to changes to the tax system.
<b>Windfall Loss</b>	A sudden and usually unexpected loss for a taxpayer or group of taxpayers owing to a change in the tax system. Transition rules are often proposed to mitigate the effects of windfall losses.

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