



**Testimony before the
Subcommittee on Energy Policy, Natural Resources and Regulatory Affairs
Committee on Government Reform
U.S. House of Representatives**

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**Paperwork Reduction Act
and
Tax-Related Costs on the U.S. Economy**

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Thank you for this opportunity to speak before the Committee today about various costs of the current tax system. My name is Raymond J. Keating, and I serve as chief economist for the Small Business Survival Committee (SBSC). SBSC is a nonpartisan, nonprofit small business advocacy group with 70,000 members across the nation.

The idea that small businesses serve as the backbone of the U.S. economy is not mere rhetoric. It is economic reality. As the U.S. Small Business Administration's Office of Advocacy has noted, small businesses:

- account for more than 99 percent of all employers;
- employ more than half the private-sector workforce, while creating 60 percent to 80 percent of new jobs each year;
- generate 51 percent of private sector output; and
- account for 96 percent of all U.S. exporters.

Nonetheless, the entrepreneurial sector of our economy must overcome many costly obstacles inflicted by the government.

The costs of taxation generally fall within three major categories. First, and most obvious, is the amount of resources directly extracted from the private sector for use by the government. So, a small business, for example, will have to pay income, property, sales, estate and a wide array of other taxes and fees imposed by federal, state and local governments. These dollars handed over to government mean that they are not utilized by the business, for example, as profits for the owners, as wages or benefits for employees, or as investment for expansion purposes.

Second, taxes impose a significant cost in terms of lost or redirected economic opportunity and activity. As the old saying goes, the more you tax something, the less of it you'll get. Therefore, high income taxes translate into less working, saving, and entrepreneurship. Capital gains taxes discourage investing and risk taking. Indeed, the incentive effects of taxation are quite powerful, and burdensome taxes restrain economic growth.

Third, there are the costs of regulation, compliance and collection with the tax code. Included in these costs are the time spent planning, record keeping, mastering tax instructions and forms, and the costs for staff, accountants, lawyers, financial planners and software, along with the government's expenditures for creating and enforcing the law, and collecting taxes. This third item is what we are focusing on today.

Unfortunately, regulatory costs – including tax compliance – hit small businesses hardest. That was illustrated in a 2001 report by economists W. Mark Crain and Thomas D. Hopkins for the U.S. Small Business Administration's Office of Advocacy. The authors found that the total costs of federal regulations hit \$843 billion in 2000, or about 8 percent of GDP. The per employee cost of federal regulations registered \$6,975 for firms with fewer than 20 employees, compared to \$4,722 for all firms. Tax compliance per employee costs came in at \$1,202 for

firms with fewer than 20 employees, which was almost double the \$665 per employee cost for all businesses.

The costs of the federal regulatory burden actually exceeded corporate pretax profits in 2001.¹

The number of pages in the *Federal Register* provides a signal as to the growth in new regulations, and in 2003, the page count hit 75,795, the highest ever and up from 65,500 in 2001.² The budget cost of writing and enforcing federal regulations has been estimated at \$29 billion in FY2004, with government staffing levels of more than 192,000.³ After examining the overall economic cost estimates for federal regulation and government expenditures on regulatory activities, Susan Dudley, director of the Regulatory Studies Program at the Mercatus Center at George Mason University, has noted that “for every dollar of direct budget expenditure devoted to regulatory activity, the private sector (individuals as consumers, investors, workers, etc.) spends \$45 in compliance.”⁴

Another recent report noted that paperwork and record-keeping cost small businesses \$48.72 per hour, with tax-related costs ranking as most expensive at \$74.24 per hour.⁵

It has been noted many times that the federal tax code is 17,000 pages long and includes more than 1,100 forms and publications.⁶ Individuals and businesses submit more than 200 tax returns to the IRS each year, and in FY2002, the IRS’s budget reached almost \$10 billion.⁷ One estimate of tax compliance costs pointed to a staggering \$203 billion in 2003.⁸ That equated to almost 2 percent of U.S. GDP.

The government recently announced that it took individual taxpayers, with itemized deductions and income from interest, capital gains and dividends, 28 hours and 30 minutes, on average, to complete their tax returns this year – 42 minutes longer than last year.⁹ Since 1988, this time dedicated to tax preparation increased by 67 percent. These estimates include time spent record gathering, reading and preparing the forms and sending them off to the IRS.¹⁰ Please note that it does not include tax planning that occurs throughout the year.

¹ Clyde Wayne Crews Jr., “Ten Thousand Commandments: An Annual Snapshot of the Federal Regulatory State,” Cato Institute, 2003 edition.

² Susan E. Dudley, “The Hidden Tax of Regulation,” Mercatus Center at George Mason University, January 5, 2004.

³ Ibid.

⁴ Ibid.

⁵ National Federation of Independent Business, “National Small Business Poll,” December 17, 2003.

⁶ See, for example, Alison Fraser, Bill Beach and Daniel Mitchell, “The Silver Lining of Tax Day 2004,” The Heritage Foundation, April 15, 2004.

⁷ John L. Guyton, John F. O’Hare, Michael P. Stavrianos and Eric J. Toder, “Estimating the Compliance Cost of the U.S. Individual Income Tax,” IBM Business Consulting Services and the Internal Revenue Service, presented at the 2003 National Tax Association Spring Symposium.

⁸ Ibid.

⁹ “More Time Needed for Figuring Taxes – IRS,” Associated Press, April 15, 2004.

¹⁰ Ibid.

One report has pointed to increased tax complexity adding about 1 billion hours in annual paperwork burdens over the past decade.¹¹ The IRS paperwork burden is estimated at 6.7 billion hours annually, with tax forms accounting for more than 80 percent of the overall federal paperwork burden.¹²

Again, the small business owner or entrepreneur gets hit hard. A 2003 analysis of compliance costs for individual tax returns performed in partnership with the IRS found that while self-employed taxpayers “represent only about 25 percent of all individual taxpayers, they experience approximately 60 percent of the time and money burden” in terms of compliance.¹³ Likewise, it was determined that tax return complexity was markedly higher for self-employed returns.¹⁴

Of course, tax software has made tax preparation easier for many filers, myself included. But again, there are costs here. It was just reported in one news story that H&R Block “wrote its own software program to break through the complexity in education tax credits and deductions. The education calculator prevents taxpayers or tax professionals from having to fill out their tax return as many as four different ways to find out which yields the lowest taxes.”¹⁵ Also, many taxpayers use paid tax preparers to do their returns. According to the National Taxpayers Union, about 87 percent of returns are done either by paid preparers or with computer programs.¹⁶ But the question must be asked: What would those tax software writers and tax preparers be doing if they weren’t dealing with a complex tax code? That’s a deadweight loss to the economy.

I spoke to a few business owners last week about government paperwork. The responses ranged from anger to resignation, but the costs were paid one way or another, for example, having to employ outside accountants or lawyers, or hire staff internally just to deal with all the paperwork the government inflicts. Again, what would those resources be used for if not lost on paperwork?

Unfortunately, recent attempts at easing such paperwork burdens don’t seem to have accomplished all that much. For example, in July 22, 2003, testimony before the Committee on Government Reform, Thomas M. Sullivan, Chief Counsel for Advocacy at the U.S. Small Business Administration, observed: “Despite the passage of laws designed to relieve the paperwork burdens imposed by the Federal government on such entities [i.e., small businesses] – such as the Paperwork Reduction Act, and, most recently, the Small Business Paperwork Relief Act of 2002 – the Federal paperwork burden continues to be cited by small businesses as one of their most significant problems... In addition to paperwork, small businesses tell us that they often encounter regulations written with no apparent awareness of the costs that must be borne

¹¹ David Keating, “A Taxing Trend: The Rise in Complexity, Forms, and Paperwork Burdens,” National Taxpayers Union, April 15, 2004.

¹² Ibid.

¹³ John L. Guyton, John F. O’Hare, Michael P. Stavrianos and Eric J. Toder, “Estimating the Compliance Cost of the U.S. Individual Income Tax,” IBM Business Consulting Services and the Internal Revenue Service, presented at the 2003 National Tax Association Spring Symposium.

¹⁴ Ibid.

¹⁵ Mary Dalrymple, “Taxes Take Longer Because of Complex Forms,” *Seattle Post-Intelligencer*, April 14, 2004.

¹⁶ David Keating, “A Taxing Trend: The Rise in Complexity, Forms, and Paperwork Burdens,” National Taxpayers Union, April 15, 2004.

by the affected businesses. This happens despite laws requiring agencies to account for the costs and benefits of new rules.”

So what can be done?

- First, it must be acknowledged that complexity starts with the tax code itself. In its 2000 report to Congress, the National Taxpayer Advocate noted that the top two problems facing taxpayers were complexity for individuals and complexity for businesses. Complexity arguably has increased since then.

Consider the 2001 and 2003 tax cuts passed by Congress. These had enormous benefits for the economy, particularly through reductions in personal income, capital gains and dividend tax rates, and the eventual elimination of the death tax. At the same time, though, phase ins and phase outs of these tax measures have added to the system’s complexity and costs, as well as creating economic uncertainty.

In the short term, Congress needs to make the 2001 and 2003 tax cuts permanent to alleviate these burdens and uncertainties. The permanent elimination of death taxes, for example, would greatly reduce the costs and complexity of the U.S. tax system. Business owners could make decisions based on economics, rather than with an eye toward estate planning. Investment and the economy would receive a boost.

For the longer haul, focus needs to once again return to tossing out the current income tax mess in favor of a fairer, simpler, less costly and more pro-growth tax system. The pluses and minuses of a flat tax or a retail sales tax must be fully explored. One thing, though, is for sure – either of those tax systems would be a dramatic improvement over what we have now.

- Second, Congress also needs to zero in on current major sources of complexity. One of the most costly is the alternative minimum tax (AMT).

The individual AMT was supposed to prevent the rich from avoiding personal income taxes. Prior to 2000, the AMT impacted less than one percent of taxpayers in any given year, according to a report released on April 15, 2004, by the Congressional Budget Office (CBO). But the CBO also noted that the number of taxpayers hit with the AMT will accelerate quickly in coming years, and that by 2010, one in five – or 29 million -- taxpayers will pay the AMT. Forty percent of married couples will fall under the AMT in 2010. The CBO points out that two-thirds of taxpayers earning between \$50,000 and \$100,000 will owe the AMT, and more than 90 percent of taxpayers with incomes between \$100,000 and \$500,000 will have an AMT liability.

The AMT also presents problems for the economy in general. The AMT effectively increases taxes. And the positive impact of any tax relief is lessened. Tax complexity and costs skyrocket, as taxpayers have to calculate their taxes under what are, in reality, separate tax systems – the normal income tax and the AMT

A key reason why the reach of the AMT is expanding so markedly is because the AMT is not indexed for inflation. The CBO explained: “Indexation under current law prevents regular

tax liabilities from growing simply because incomes keep pace with price inflation, but AMT liabilities have no such brake. As nominal incomes rise over time, more taxpayers become liable for the AMT.” So, with the AMT, a person can see absolutely no increase in real earnings, yet his tax burden actually rises.

Indexing would remove a big chunk of taxpayers from the clutches of the AMT – more than 80 percent of the projected 29 million in 2010. That would be a big step forward, obviously. However, some 5 million taxpayers would still be left with higher taxes and increased costs under the AMT. SBSC agrees with the National Taxpayer Advocate in recommending the repeal of the individual AMT.

In addition, tens of thousands of corporations – including thousands of manufacturing firms -- have to deal with higher taxes, increased tax complexity and costs, and diminished incentives for investing that come with the corporate AMT. That too deserves repeal.

- Third, we obviously do not want to see the current system worse than it is. For example, one area where we strongly disagree with the National Taxpayer Advocate’s latest report to Congress was its recommendation for Congress to “implement a mechanism to withhold on certain categories of non-wage workers.” Expanding withholding might sound good to some, but obviously there are costs involved for those having to deal with withholding. In addition, withholding comes with significant economic costs. Business owners, probably better than anyone else, understand the true costs of government exactly because they have to sit down and write out a check to the government for their taxes every quarter. Meanwhile, wage and salary earners often have little idea of what the government is costing them because with withholding, they never see their full earnings in the first place, and tend to look at the take home pay line.

It is far better that taxpayers fully understand the cost of government so they can make informed decisions at the voting booth and when talking to their elected representatives. Withholding accomplishes the exact opposite.

- Fourth, while we all understand how complex the current tax code is, we still would urge the IRS to find ways to alter the way it presents its booklets, instructions and forms to make them more friendly, with greater use of “plain English” and perhaps enhanced visual aids.

For example, various tax changes over the years have increased the number of deductions and credits, while also phasing out such measures at various income levels. These items obviously create confusion among taxpayers. Simple tables that list the deductions, credits and other incentives, along with the eligibility requirements, would help. Greater clarity and simplicity should be the goal with correspondence from the IRS as well.

- Fifth, the Taxpayer Advocate Service needs to better get the word out that among its duties are representing taxpayers’ interests in the formulation of policies and procedures, and identifying and developing proposals for simplifying the tax code and reducing taxpayer burdens. The Taxpayer Advocate has done some illuminating work on certain items that

increase complexity and costs – such as on the AMT – but much more can and should be done in making the case for a simpler and fairer tax system.

Analysis of what leading legislative initiatives would do to the costs and complexity of the tax system would be helpful. Also, in-depth analyses on what various alternative tax systems – such as a flat tax or retail sales tax – would accomplish in terms of system costs and complexities would be beneficial.

- Sixth, and finally, is dealing with the fear factor. The National Taxpayer Advocate noted in its last report to Congress: “We need, somehow, to show taxpayers that their duty to comply with tax laws is balanced by the IRS’s obligations to respect their rights – the right to disagree with proposed IRS adjustments and assert that disagreement within the tax system.” Congress and the IRS must somehow establish safeguards and boost confidence among taxpayers that the IRS is not going to run roughshod over individual rights. This is no easy task. After talking to individuals and business owners, and taking in horror stories on the news and in books, it becomes quite clear that the IRS and our elected officials have a lot of work to do in boosting confidence in the IRS’s fairness. Naturally, a society’s tax collector is never going to be loved, but it also need not be feared.

Thank you for this opportunity, and I look forward to any questions you might have.