



Highlights of [GAO-06-1028T](#), a testimony before the Committee on Finance, U.S. Senate

## Why GAO Did This Study

The federal government currently relies heavily on the individual income tax and payroll taxes for about 80 percent of its total annual revenue. Long-range projections show that without some form of policy change, the gap between revenues and spending will increasingly widen. The debate about the future tax system is partly about whether the goals for the nation's tax system can be best achieved by reforming the current income tax so that it has a broader base and flatter rate schedule, or switching to some form of consumption tax.

This testimony reviews the revenue contribution of the current individual income tax as well as its complexity, economic efficiency, equity, and taxpayer compliance issues; discusses some common dimensions to compare tax proposals; and draws some conclusions for tax reform.

This statement is based on previously published GAO work and reviews of relevant literature.

[www.gao.gov/cgi-bin/getrpt?GAO--06-1028T](http://www.gao.gov/cgi-bin/getrpt?GAO--06-1028T).

To view the full product, including the scope and methodology, click on the link above. For more information, contact James White at (202) 512-9110 or [whitej@gao.gov](mailto:whitej@gao.gov).

# INDIVIDUAL INCOME TAX POLICY

## Streamlining, Simplification, and Additional Reforms are Desirable

### What GAO Found

The United States faces a large and growing structural budget deficit as current projected revenues are not sufficient to fund projected spending. The individual income tax has long been the largest source of federal revenue—amounting to \$927 billion (7.5 percent of Gross Domestic Product (GDP)) in 2005. (Total revenues that year amounted to 17.5 percent of GDP.) Income tax policy, including existing tax expenditures, such as the exclusion of employer-provided health insurance from individual income, and enforcement approaches, need to be key elements of a multipronged approach that reexamines federal policies and approaches to address our nation's large and growing long-term fiscal imbalance.

Concerns regarding the complexity, efficiency, and equity of the individual income tax have contributed to calls for a substantial restructuring of the individual income tax or its full or partial replacement with some form of consumption tax. The widely recognized complexity of the tax results in (1) significant compliance costs, frustration, and anxiety for taxpayers; (2) decreased voluntary compliance; (3) increased difficulties for the Internal Revenue Service (IRS) in administering the tax laws; and (4) reduced confidence in the fairness of the tax. The tax also causes taxpayers to change their work, savings, investment, and consumption behavior in ways that reduce economic efficiency and, thereby, taxpayers' well-being.

Taxpayer noncompliance with the current individual income tax is another factor that could motivate reform. For tax year 2001, IRS estimated that noncompliance with the individual income tax accounted for about 70 percent of the \$345 billion gross tax gap, which is the difference between the taxes that should have been paid voluntarily and on time and what was actually paid. Reducing this gap can improve the nation's fiscal stability, as each 1 percent reduction in the tax gap would likely yield about \$3 billion annually. Reducing the tax gap within the current income tax structure will require exploring new and innovative administrative and legislative approaches.

In moving forward on tax reform, policymakers may find it useful to compare alternative proposals along some common dimensions. These include, in part, whether proposed tax systems over time will generate enough revenue to fund expected expenditures, whether the base is as broad as possible so rates can be as low as possible, whether the system meets our future needs, and whether it has attributes that promote compliance. Our publication, *Understanding the Tax Reform Debate* (GAO-05-1009SP), provides background, criteria, and questions that policymakers may find useful.