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5 Things You May Not Know About Our Tax System

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If you read the last article, you'll know that our current tax system was brought about by a bipartisan effort to broaden the tax base and close loopholes. At the same time, you know that those reforms have unraveled a bit over time. In today's article, as we shift our focus from the past to the present, I plan to pick up on some of those themes while also placing our tax system in a broader global context. Just in case you might be worried that this will get a little too technical or policy-heavy, I've organized the article into a clickbait-y, list-based format, and I've even thrown a more entertaining bit in at the end. So, strap in, and let's take a look at some important features of our tax system of which you might not be aware.

1. **You aren't likely to get audited, partly because you're so honest.**

I know. I'm really starting off with the fun stuff. Perhaps few things outside of a bad health diagnosis conjure quite the specter of fear that the concept of a tax audit does, and this is exactly the way the IRS wants it to be. In reality, the IRS audits less than 1% of all tax returns (0.7% in 2016), but the fact that you still consider the possibility of an audit to be both real and terrifying is one of many reasons why you pay your taxes anyway.

The vast majority of tax revenue that the IRS brings in is a result of "voluntary compliance," which doesn't mean you pay your taxes because you want to, but it does mean that you pay your taxes because you feel you should and you worry you might get caught if you don't. In fact, voluntary compliance rates in the United States are the highest in the developed world…by quite a bit.[1] This means the IRS doesn't have to audit as many returns as other nations try to in order to achieve the deterrent effect that contributes to compliance.

So, how does the IRS decide who makes the lucky 0.7%? The IRS has developed a top-secret tax return analysis system, called the Discriminant Inventory Function (DIF Score), that scores returns based on both the probability that they would contain some error or omission and the amount of money that could likely be generated by catching and fixing that error. This means that the IRS is generally more concerned with going after the big fish and the likely cheats, with the highest audit rates among large corporations, wealthy individuals, and those who have reported no income. That said, there are a number of factors known to increase the odds of an audit, so if you fall outside that list, breathe a little easier; the odds are overwhelming that you're in the clear.

2. **Did you know you're receiving welfare? The U.S. has hidden welfare spending.**

How's this for a provocative title? Of course, this statement is true only when we clarify the definition of welfare a bit. In this case, welfare does not mean the formal government program for helping the needy. If this piece is about putting the tax code in context, it would be nearly impossible to compare the U.S. program on an apples-to-apples basis with the rest of the world. Instead, "welfare spending" means economic spending that promotes social well-being, or—in legal terms—"spending for the general welfare." Most notably, when we use this definition, which includes both government programs and targeted tax incentives, the U.S. actually shows some one of the highest welfare spending in the world.

Ultimately, it's not the size of our welfare expenditures that sets the U.S. apart from Europe, it's how we run our program. The United States has a hybrid system that promotes social goals through the private sector to a much greater degree than Europe, and the effect is that, while much of our formal government spending is actually more progressive than Europe,[2] the incentives we have built into the tax code significantly benefit the upper and middle class.

The takeaway here is twofold. First, we need to try to think of the whole picture when we talk about government spending. Discussion of the federal budget often neglects the massive benefit that the Earned Income Tax Credit provides to low-income families, and we rarely consider the enormous amount of money (nearly $500 billion) that the government strategically turns its back on as an incentive to healthcare spending and retirement saving, which strongly benefit the middle class. Secondly, closing tax incentives like deducting consumer debt was a major driver of 1986 reforms, but changes to the mortgage interest deduction and the deductibility of student loans have seen some of these same gaps creep right back into the Code. America has a stronger preference for creating incentives through the tax system than most developed nations, and the creeping effect of this preference is another reason why periodic tax reform is so crucial.

3. **America is more progressive than Europe.**

If the last title ruffled conservative feathers, this one should do the same for liberals. (I must be trying to make sure that no one likes me.) The truth is that the U.S. tax system relies, both in terms of revenue and in terms of relative tax burden, more on its top income earners than virtually any other country. This means that not only do tax rates increase with the more money you make, but the top few percent of earners are responsible for the majority of the tax revenue that the United States takes in.

Why is this true? For starters, even if laws were the same, the higher rate of income inequality and the significantly greater wealth of the United States would suggest that it's natural that the U.S. takes in larger proportional receipts from the upper class than Europe. This isn't the whole story, though, as the United States relies more heavily on income taxation as a source of revenue than Europe does, and America imposes its top marginal rate at a much higher threshold than most European countries. If you recall the last piece on American taxation, one of the big reasons for tax reform in 1986 was to broaden the tax base (relative proportions of who pays taxes); the reason that America is more progressive is that Europe has a much broader tax base than we do.

This difference in tax base isn't inherently good or bad, but it does pose worrying implications for one of the most pressing economic issues in the developed world: large budget deficits. While there is certainly a fundamental fairness argument for taxing the rich more than the poor, narrowing the tax base to rely on the rich too much puts the tax burden on an income group with very volatile revenue streams. Basically, if you base your budget on how much you expect to collect in taxes, but that amount goes way down (something more pronounced among the wealthy in a recession, due to their high proportion of investment income) then you have a deficit. This has been a significant contributor to large state deficits, and the lack of the same budgetary restraints on the federal government only magnify this concern with increasing federal tax volatility. In short, base-broadening tax reform is not just about trickle-down economics, but it can be a key part of more responsible fiscal policy as well.

4. **The U.S. Taxes Businesses Differently from the Rest of the World**

You may remember President Trump calling the U.S. the "highest taxed nation in the world." Of course, this notion is patently false, but similar claims that cite America's high corporate income tax rates are more correct. The United States has one of the highest statutory rates of corporate income taxation in the world;[3] however, this doesn't tell the whole story.

The United States does tax its corporations more highly than other developed nations, but a bigger difference is *how* we tax businesses. Unlike virtually every other country in the world, we do not impose a special type of consumption tax called a Value-Added Tax. This doesn't mean we don't tax consumption; instead, this is taxed by most States, not the federal government, in the form of sales taxes. Because so many states rely heavily on this revenue stream, this important difference between how the U.S. and other nations tax domestic corporations is a major complicating factor in efforts toward tax reform. Efforts to resolve this issue will be big part of the next piece, so stay tuned, but for now, let's end on a more entertaining note.

5. **You Can't Escape Paying Taxes, but It's Entertaining when People Try**

Of course, it’s possible to cheat on your taxes and get away with it, but I don’t think I have to argue for why that’s not a good course of action. Instead, let’s talk about when people realize they’ve made a mistake or that the money to pay the bills just isn’t there. In this case, the first reaction of many people is to try to run and hide.

The government can seem like something big and scary at a time like that, but, believe it or not, the IRS is staffed by real people. I know; I spent time in law school developing training for them. These real people know that the tax code can be arcane, and they know that accidents or just plain bad luck providence happens. The IRS offers important help in these situations, including extensions, installment payments, and even settlements for lesser amounts. They even have an office dedicated to helping taxpayers navigate these difficult situations: the taxpayer advocate office. One of the biggest lessons I learned while actively practicing was that it’s much better to work with the IRS than to try to evade them.

Since I promised some entertainment, we’ll end by talking about the most creative (and ineffective) strategy for avoiding Uncle Sam altogether: seceding from the United States. Yes, the sovereign citizen’s movement is made up of special souls who believe that they can exempt themselves at will from U.S. laws, particularly the obligation to pay taxes. While the movement can be ugly, its more entertaining facets involve seizing onto misspellings as waivers of tax liability or believing that fringed flags in the courtroom mean that the court is actually under admiralty law. The IRS has to deal with a surprising number of these cases every year[4] , and there are special penalties for making legal arguments around these theories because of the on-going expense of dealing with sovereign citizens. That all being said, if you’re ever looking for an entertaining peek behind the veil of madness, feel free to check out videos like this one.

Footnotes

1. There are a variety of reasons why research says this is true. This includes lower tax rates and, oddly, the high complexity of the personal income tax; however, the intangible concept of “tax morale” (willingness to pay) just seems to be higher here than anywhere else. ↩

2. When I say “more progressive,” I mean this in terms of targeted redistribution to low-income individuals, not that it is politically more left-leaning or in any sense superior. For example, since the U.S. provides healthcare only to the needy (Medicaid) and the elderly (Medicare), it is more progressive than, say, the U.K.’s national healthcare system, which provides direct government assistance to everyone. ↩

3. The numbers I cite are actually under-representative because they do not include state-level corporate income taxes, which, if factored in, puts Iowa corporations at the highest international tax rate aside from the UAE. ↩

4. The Southern Poverty Law Center estimates sovereign citizen numbers around 500,000 . ↩