

TECHNOLOGY POLICY INSTITUTE

▫ Studying the Global Information Economy ▫

April 25, 2011

Honorable Max Baucus, Chairman, Senate Committee on Finance
Honorable Orrin G. Hatch, Ranking Member, Senate Committee on Finance
219 Dirksen Senate Office Bldg.
Washington, DC 20510-6200

Dear Senators Baucus and Hatch:

During the April 12, 2011 Senate Finance Committee hearing, *Best Practices in Tax Administration: A Look Across the Globe*, the issue of government-prepared tax returns was discussed. Given the Committee's interest in this issue, we respectfully submit the attached Technology Policy Institute paper, "Should the Government Prepare Individual Income Tax Returns," for your consideration and for the hearing record. The authors are the undersigned, Joseph Cordes, Professor of Economics at The George Washington University and Arlene Holen, Senior Fellow at the Technology Policy Institute.

The TPI paper examines evidence about efforts to improve tax administration and tax compliance using government-prepared or pre-populated tax returns. Other countries use such systems, including the United Kingdom, as does the state of California.

Our analysis concludes that adopting a pre-populated tax system is not advisable for the United States. The California system has not been popular. Only about 3 percent of the state's eligible filers have chosen to use it, suggesting that, given the choice, most people do not believe it is to their advantage. Carefully checking a government-prepared return for completeness and accuracy requires much of the same compliance work as preparing a return.

Cost savings for individual filers would likely be modest at best. On the other hand, additional, third-party costs—those of employers, financial institutions and other payers of income to individuals—could be substantial largely because reporting deadlines would have to be significantly advanced in order to provide the government with access to necessary information to prepare returns and timely tax refunds. Increased third-party cost could range from \$500 million to as much as \$5 billion annually, disproportionately burdening small businesses. The recent legislative repeal of last year's new 1099 reporting requirements highlighted such business cost burdens. Compressed income reporting schedules would also increase risks of error and similarly burden small businesses disproportionately. Proponents of government-provided returns typically overlook third-party costs or assume they are negligible.

IRS costs could substantially increase with added investment and ongoing manpower requirements of developing and managing new systems. Moreover, the IRS lacks the essential

electronic processing capabilities and would face a range of challenges in carrying out new responsibilities.

Beyond questions of costs, adopting pre-populated returns would introduce a host of challenges and difficult issues at the policy, economic, and operational levels. These include:

- The IRS would face a conflict of interest in functioning as tax preparer as well as tax collector, auditor, and enforcer.
- Taxpayers would become less cognizant of the incentives embodied in the tax code and their personal and family finances. In his opening statement at the hearing, Senator Hatch noted that pre-populated returns would make filers less aware of incentives in tax law.
- Risks of error would result from stretched IRS capacities, particularly as the agency's mission has been significantly expanded under healthcare reform and other initiatives. The UK has encountered significant problems with errors in its government-prepared returns.
- Taxpayers who are unwilling to challenge an official IRS document would nevertheless retain sole responsibility and liability for errors in government-prepared returns, a problem particularly for lower-income filers and those with English as a second language, who could interpret a government bill for their income taxes as definitive and simply sign it in good faith.
- IRS preparation of individual returns could compromise taxpayers' privacy. The government mailing pre-completed tax returns could result in privacy breaches with returns sent to incorrect addresses when people move. Similarly, the IRS posting returns on the Internet, seeking electronic signature, presents risks of breach and cyber-crime.
- IRS tax preparation may pose greater security risks because private providers face stronger financial incentives to invest in sound security practices in an environment of rapidly advancing technology and changing threats. The Government Accountability Office and the Treasury's Inspector General for Tax Administration have reported weaknesses in IRS security capabilities over a period of years.

Other countries that have adopted pre-populated returns have far simpler tax codes than the United States. Such systems cannot readily handle capital gains, itemized deductions, business income, employee business expenses, or individual retirement accounts. Importantly, those countries make far less use than does the U.S. of income tax incentives, such as the Earned Income Tax Credit (EITC) as a means of implementing social policies.

As is California's experience, the UK's experience with its government-prepared return system is instructive. A bipartisan Committee in Parliament (The All Party Parliamentary Taxation Group) has reported that rather than simply reducing filing burdens, the UK's system encourages taxpayers to absent themselves from compliance activities. People are presented with a tax bill that they assume must be correct or decide not to challenge to avoid unwelcome attention from the tax authority. The Parliamentary Committee found that the system places cost burdens on employers, particularly small employers, and is strained by increasingly dynamic labor markets

in which government data cannot accurately keep up with people's changing employment and life situations.

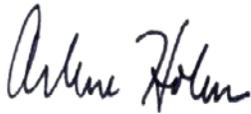
The UK's system has encountered major accuracy problems. In 2010, almost 6 million cases of incorrectly calculated taxes out of 40 million were found over two years. As a result of widespread errors in rebates, almost 1.5 million workers faced government demands to pay back funds, averaging almost 1500 Pounds per tax bill. This is an ongoing problem and the UK's bipartisan committee has called for fundamental reform of the UK tax system.

We hope this information is helpful to the Committee. Please contact Professor Cordes at 202-994-5826, cordes@gwu.edu, or Arlene Holen at 202-495-7725, aholen@techpolicyinstitute.org, if you or your staffs have questions.

Respectfully submitted,



Joseph Cordes
Professor, Trachtenberg School of Public Policy and Public Administration of The George Washington University



Arlene Holen
Senior Fellow, Technology Policy Institute

Attachment: Should the Government Prepare Individual Income Tax Returns?
<http://www.techpolicyinstitute.org/files/should%20the%20government%20prepare%20individual%20income%20tax%20returns.pdf>

cc: Honorable Jay Rockefeller, Honorable Kent Conrad, Honorable Jeff Bingaman, Honorable John Kerry, Honorable Ron Wyden, Honorable Charles Schumer, Honorable Debbie Stabenow, Honorable Maria Cantwell, Honorable Bill Nelson, Honorable Robert Menendez, Honorable Tomas Carper, Honorable Ben Cardin, Honorable Chuck Grassley, Honorable Olympia Snowe, Honorable Jon Kyle, Honorable Mike Crapo, Honorable Pat Roberts, Honorable Mike Enzi, Honorable John Cornyn, Honorable Tom Coburn, Honorable John Thune

Honorable David Camp, Chairman, House Committee on Ways and Means
Honorable Sander Levin, Ranking Member, House Committee on Ways and Means