

The Simple Return

Reducing America's Tax Burden Through Return-Free Filing



THE BURDEN OF AN INCOME TAX can be divided into two parts, one visible and the other hidden. The first burden is obvious—it is the actual tax payment. The second burden is less obvious. A major part of this burden arises from the costs of complying with the system: the hours spent preparing forms, gathering documents, and reading in-

structions; or the money a tax filer pays someone to do the tax preparation for him. Compliance costs for the individual income tax in the United States have been estimated at 10 percent of tax revenue collected, as much as ten times the level in some European countries.

In a paper for The Hamilton Project, Austan Goolsbee proposes to reduce tax compliance costs through the adoption of a “Simple Return.” When fully implemented, the Simple Return could save taxpayers up to 225 million hours of tax compliance time and more than \$2 billion a year in tax preparation fees.

THE CHALLENGE

For most American taxpayers, the costs of tax compliance are higher than they need to be. Most taxpayers do not have complex economic arrangements that become enmeshed with the massive tax code. Instead, their compliance costs arise simply because the government is not using the information it already has to help them calculate their taxes. The typical taxpayer has a relatively straightforward tax situation. About two-thirds of taxpayers take only the standard deductions and do not itemize. Frequently, these taxpayers' incomes consist of wages from only one employer and interest income from only one bank. The Internal Revenue Service (IRS) already receives information about this income for almost all of these people directly from their employers and banks. Nonetheless, the IRS then asks these taxpayers to spend time gathering documents and filling out tax forms (or paying tax preparers to do so) in order to provide the IRS with information that it already receives from other sources. Indeed, if these taxpayers do not fill out their tax forms correctly, the IRS will contact them and tell them exactly how much they owe, or how much they are owed as a refund.

Although many people with a relatively simple tax status do not need to fill out a standard 1040 form, even the simplified tax forms can prove challenging. Goolsbee notes that the simplified forms still entail gathering information, computing, and reading somewhat technical documents that include tables, worksheets, and instructions. The instruction booklet for the simplest form, the 1040EZ, is thirty-six pages long! Indeed, the difficulties that such forms present are evident in IRS data showing that more than 30 percent of 1040EZ filers and 56 percent of 1040A filers used a paid tax preparer in 2001.

For those who use paid tax preparers, the IRS estimates the average fee for a 1040EZ form to be \$81, a 1040A form to be \$122, and the full 1040 form (without itemizing, self-employment income, or capital gains) to be

Table 1. Compliance Times Estimated by the IRS for Selected Forms and Schedules

Form 1040EZ	3h 46m
Form 1040A	10h 25m
Schedule 1 (interest and dividends)	0h 56m
Schedule 2 (childcare expenses)	2h 6m
Schedule 3 (credit for elderly or disabled)	1h 27m
Form 1040	13h 35m
Schedule A (itemized deductions)	5h 37m
Schedule B (interest and dividends)	1h 26m
Schedule C-EZ (self-employment income)	1h 43m
Schedule D (capital gains)	6h 10m
Schedule E (supplemental income)	6h 14m
Schedule F—Cash method (farm income)	5h 52m
Schedule EIC (earned income credit)	0h 34m

Source: IRS 2004 tax forms

\$121. For returns including the earned income tax credit (EITC—the provision aimed at the working poor), the IRS estimates the average fee to be around \$200.

Tax filing also has a substantial cost in the time it takes self-filers to complete the forms. The IRS estimates that the average time required for taxpayers to complete its 2004 tax forms ranged from almost four hours for the 1040EZ to more than thirteen and one-half hours for the full 1040, as shown in table 1.

Goolsbee uses a standard method of estimating the monetary value of time—multiplying the hours spent on tax preparation by the taxpayer's hourly wage—to reveal the high cost of tax compliance. Table 2 shows that compliance costs range from an average of \$81 for those with low incomes to \$1,104 for those with high incomes. As a percentage of a person's income, compliance costs are highest at the bottom and generally fall as income rises.

A NEW APPROACH

Under Goolsbee's Simple Return plan, the government would take advantage of the extraordinary gains made in information technology in the past two decades to lighten the burden of tax compliance on American families. The benefit would accrue mainly to those with low and middle levels of income because they are the people who file relatively simple tax returns. Indeed, the Simple Return plan would not be available to those with the most complex tax situations, who also tend to have the highest incomes.

With the Simple Return, the IRS would use the information about income that it already receives from employers and banks to send prefilled tax returns to taxpayers who have sufficiently simple finances. The program would be voluntary. Taxpayers who prefer to fill out their own tax forms or to pay a tax preparer to do it could use the Simple Return as the basis for their own calculations, or simply set it aside and file their taxes the conventional way.

For the millions of taxpayers who would be able to use the Simple Return—up to 40 percent of all U.S. tax-

payers—filing a tax return would entail nothing more than checking the numbers, signing the return, and returning it with a check or, more typically, with a refund request.

Goolsbee proposes implementing the Simple Return in three distinct waves. The first wave would make the Simple Return available to taxpayers who had nothing but wage income, did not itemize, and had no other credits on their last return. Most such taxpayers currently file the 1040EZ or 1040A forms.¹ The first wave of the Simple Return would encompass two groups of tax filers. The first group would include single filers with no children who are not themselves dependents. This group includes about nine million taxpayers. The second group of filers includes married taxpayers, filers with child credits, and filers who are themselves dependents. In all, the first wave of the Simple Return would serve more than seventeen million taxpayers.

1. These forms are available to people who have income below \$100,000 and who do not itemize. The 1040EZ is for those with only wage income and limited interest income; the 1040A is for those with certain additional income sources, deductions, and credits.

Table 2. Summary Statistics for Compliance Costs and Tax Liability by Income Group

AGI (adjusted gross income)	\$5,000– \$25,000	\$25,000– \$45,000	\$45,000– \$65,000	\$65,000– \$85,000	\$85,000– \$105,000	\$105,000– \$125,000
AGI (\$)	14,526	34,057	54,264	74,181	93,801	114,334
Tax liability (\$)	622	2,893	5,794	9,092	13,426	18,323
Compliance costs for						
Self-filers (value of time, \$)	81	210	405	636	845	1,104
Paying filers (\$)	122	138	159	182	199	212
Compliance costs as percent of AGI (Median percent within group)	0.71%	0.43%	0.31%	0.31%	0.31%	0.27%

Source: Author's computations using the IRS Individual Public Use Data File (U.S. Treasury 2001) as described in the text. All values except those in the last row are means.

With the Simple Return, the IRS would use information that it already receives from other sources to send completed tax returns to taxpayers with sufficiently simple finances.

The second wave of the Simple Return system would include taxpayers with income from what are called *withholdable* sources. For purposes of the Simple Return, this means the kinds of income about which the IRS already receives direct information from documents other than the W-2 from employers. (For example, the IRS receives information on interest income on 1099-INT forms from financial institutions). Withholdable income would include interest, dividends (though not capital gains income), pensions, Social Security benefits, unemployment insurance, and individual retirement accounts. When expanded to cover these additional sources of income, the Simple Return would serve more than thirty-nine million taxpayers.

The third wave of the Simple Return program would cover all taxpayers who did not itemize deductions, including those eligible for the EITC. Adding the EITC to the mix of tax provisions that would be covered under the Simple Return would increase the number of potentially eligible people to more than fifty-two million.

Real-World Experience with Return-Free Filing

Return-free filing already has been tested successfully at the state and international levels. Goolsbee uses evidence from California and several European countries to inform his estimate of the benefits and costs of the Simple Return.

The California Pilot Program

In 2004, the Franchise Tax Board of California conducted a pilot program for its state income tax along the lines of the Simple Return system. There was no advertising of the program ahead of time—people simply received the form in the mail. The California ReadyReturn went out to over fifty thousand single taxpayers who had no dependents and only wage income. The returns used wage and withholding information that had been directly reported to the state by employers. Overall, more than eleven thousand people used the ReadyReturn—more than one-fifth of those who received it. Interest in using ReadyReturn was even higher: Twenty-two percent of the people who declined cited as the reason that they had already filed their tax return when they got the mailing. Participation among those who had not already filed was 27 percent.

ReadyReturn users were pleased with the program. More than 90 percent of ReadyReturn users said that they saved time using the system and that it was more convenient than their previous method of filing. The median filing time for ReadyReturn users who filed electronically was nearly 80 percent lower than the median filing time for the control group.² The ReadyReturn filers also saved money: They spent a median amount of \$0 to complete their state return, whereas the median control group expenditure was \$30. More than 98 percent of ReadyReturn users said they were “satisfied” or “very satisfied” with the program, and more than 97 percent said they would use it again next year.

The ReadyReturn filers were significantly less likely to have errors than filers in the control group. About 0.3 percent of ReadyReturn filers received an error notice, compared with 3.1 percent of the control group. The rate

2. The control group comprised eligible taxpayers who were excluded from the pilot program so that California could study the program's impact.

of electronic filing rose dramatically among the ReadyReturn filers, which further reduced the cost of processing their returns. Indeed, the Franchise Tax Board was so confident of the cost savings from the ReadyReturn that it asked the California legislature to reduce its long-term budget to reflect the savings from the program. There is every reason to believe that these same benefits of taxpayer satisfaction and cost savings would hold for a Simple Return applied at the federal level.

The International Experience

Return-free filing has been used in Europe; in some European cases, it has been used more extensively than the Simple Return would ever be used in the United States. According to a U.S. Treasury study, in 1999 about 87 percent of tax filers in Denmark and 74 percent of filers in Sweden had their returns prepared by the government. One reason that Denmark and Sweden have been able to generate such high participation rates is that their underlying tax systems are simpler than the U.S. tax code, and so more people qualify. In addition, Finland and Norway have experimented with these systems. As would be expected, the compliance costs in these countries are substantially lower than they are in the United States. In Sweden, for example, compliance costs have been estimated at about 1 percent of tax revenue collected, compared with more than 10 percent for the individual income tax in the United States.

The Value of the Simple Return

Goolsbee estimates that the Simple Return system would reduce the cost of tax compliance by about \$44 billion over ten years if everyone eligible to use the system actually did so. Data from the California experiment and other sources suggest that actual participation rates will depend, in part, on how the Simple Return program is administered. A survey conducted by the U.S. Department of the Treasury suggests that 39 percent of people were

interested in using such a system, and another 25 percent might be interested. As noted above, 27 percent of Californians who received the ReadyReturn form before filing their taxes chose to participate, even though the program had no advertising and only one mailing. Goolsbee argues that proper explanations of the program, advance media exposure, and the ability for taxpayers to opt in to the system easily could raise participation in the Simple Return program to nearly 50 percent in the short run, and to a significantly higher percentage over time. Regardless of the exact participation level, the Simple Return is sure to reduce compliance costs for millions of ordinary American taxpayers.

Implementation Issues

Full implementation of the Simple Return would require both further progress in the existing program to modernize the IRS processing capabilities, and modest adjustments by employers and financial institutions to provide the government with more timely reports on the income received by individuals. (The most important of these adjustments would be the requirement for

“More than 98 percent of participants in the California pilot program said that they were satisfied or very satisfied with the program, and more than 97 percent said they would use it again next year.”

employers and financial institutions to file the relevant information thirty days earlier than they do now.) Once implemented, the Simple Return could result in savings to the IRS. A 1996 General Accounting Office report estimates that a plan similar to the one proposed here could save the IRS close to \$36 million a year by reducing the number of errors in tax filings and the subsequent need for investigations.

Does the Simple Return Raise Privacy Concerns?

Some opponents of return-free filing think it invasive or inappropriate that the government would print up and mail out forms listing income and taxes. Indeed, some opponents suggest that a Simple Return would involve people having to divulge personal information to the government. Goolsbee notes that the Simple Return would not require employees to give their employers or the government any more information about themselves than they give now. He also notes that the Simple Return would not provide the IRS with any more information about wages or family status than other sources provide to the IRS now. Indeed, some privacy advocates strongly supported the California ReadyReturn pilot

program because the system inherently requires the government to turn over all the information that it has on each taxpayer—to lay all its cards on the table, in a sense.

Obviously, when tens of millions of these forms are mailed out, a small fraction may go to the wrong addresses. This is no different from the current system that mails W-2 forms, or the Social Security Administration's mailing that lists year-by-year earnings over a lifetime. The risk that some of this information will fall into the wrong hands is not new, and adopting the Simple Return would in no way interfere with efforts to reduce such errors.

Would the Simple Return Unfairly Infringe on Private Enterprise?

In California, opponents of the ReadyReturn argued that return-free filing constituted an inappropriate government intrusion on private enterprise. As Goolsbee notes, however, this argument implies that making the tax system more complex and more painful is desirable, because doing so would increase the employment of tax preparers. In practice, the government already seeks to reduce the compliance burden of taxation in a variety of ways, and few would advocate that the government not do so in order to bolster the market for paid tax preparers.

Would the Simple Return Raise Taxes?

Antitax advocacy groups and some members of Congress publicly oppose return-free filing. For example, Grover Norquist, president of Americans for Tax Reform, testified before the President's Tax Reform Commission against any kind of automatic filing. At first, such opposition seems ironic because antitax groups have long been the most vocal critics of the compliance costs of the tax system. However, these groups seem to believe that, if compliance with the tax code were to be less painful, people would be less adverse to higher tax rates. These

The Simple Return could serve up to 40 percent of taxpayers and save up to 225 million hours of tax compliance time and more than \$2 billion a year in tax preparation fees.

groups also argue that the government cannot be trusted to calculate taxes on behalf of taxpayers, and that return-free filing would expand the power of the IRS over people's lives.

In response to such concerns, Goolsbee notes that the Simple Return would be voluntary. No one would need to share any additional information with the IRS or pay any higher tax rate with the Simple Return than he would with conventional filing. Every taxpayer would have the right to throw the Simple Return away and file the usual way. In addition, the IRS would provide the Simple Return only to people who have extremely simple tax positions, so there would be little ambiguity about their tax liability and thus little room for the government to “trick” people into paying higher taxes. Finally, everything on the Simple Return would come from information that the IRS already receives about the taxpayer.

CONCLUSION

The Simple Return is based on a straightforward idea. It requires the tax authority to take information it already receives from employers and banks on the income and tax situation of taxpayers and use it, wherever possible, to prefill and send out a return. This prefilled return could spare the taxpayer the hassle of filling out a tax return or hiring a preparer to do so, but its use would be voluntary. Under the current tax code, the Simple Return eventually could serve up to 40 percent of American taxpayers and reduce the burden of tax compliance for these Americans by up to \$44 billion over 10 years. These benefits would accrue to taxpayers with simpler tax situations—generally those with middle and low incomes. Additionally, the Simple Return would lower IRS's cost of tax enforcement by reducing filing errors and associated investigations. By more effectively managing the information that it already collects from employers and financial institutions, the IRS could use the Simple Return to substantially reduce the compliance burden of our tax system.

Learn More About This Proposal

This policy brief is based on the Hamilton Project white paper, *The Simple Return: Reducing America's Tax Burden Through Return-Free Filing*, which was authored by:

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Goolsbee's areas of expertise include tax policy, budget and fiscal policies, public and antitrust law, and the information economy. He is a Sloan Research Fellow and a Fulbright Scholar and has been named one of the 100 Global Leaders for Tomorrow by the World Economic Forum in Switzerland.

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