COMMENTS

"PRE-FILLED PERSONAL INCOME TAX RETURNS IN QUEBEC" BY FRANCOIS VAILLANCOURT, UNIVERSITE DE MONTREAL AND "PRE-COMPLETED INCOME TAX RETURNS: EVIDENCE FROM THE CALIFORNIA READYRETURN PROGRAM" BY BRIAN ERARD, B. ERARD & ASSOCIATES

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I AM HONORED THAT PROF. VAILLANCOURT INVITED me to discuss the two subnational papers in this session: his paper on prefilled personal income tax returns in Quebec and Brian Erard's paper on prefilled returns for state income taxes in California. Prof. Vaillancourt also asked me to briefly present the results of a paper I recently wrote with Joseph Cordes of the George Washington University, "Should the Government Prepare Individual Income Tax Returns?" (Cordes and Holen, 2010)

Proponents of adopting a prefilled return system at the federal level in the United States have argued that it would sharply reduce the burdens of income tax compliance and would be a welcome boon to filers.[1] Some make the analogy to the ease of paying real estate taxes and credit card bills. The papers in this session, which, in addition to the two subnational ones, include papers on national systems in Australia and Spain, shed much-needed empirical light on the subject.

As Prof. Vaillancourt notes, prefilling is usually introduced gradually over time, permitting evaluation and expansion as a prefilled income tax program warrants. The major strengths of both papers are that they examine data on the acceptability of the program to filers as well as available evidence on government costs and identify several administrative, and other, problems that emerged during implementation.

A major weakness of both papers is their reliance on survey evidence of program users, which tends to show very high satisfaction but is of limited value because of self-selection bias. Because users are those who choose to participate in the program voluntarily, the personal benefits of participation for that group would be expected to be higher than the personal costs. It is striking that both papers report low participation rates—about 33 percent in Quebec and only about three percent in California.

Both papers address the issue of governmental administrative costs in implementing a prefilled filing system, but evidence is sparse. Vaillancourt believes that government administrative costs may increase as private costs decrease, but does not find evidence available and notes that it is not known whether savings in private costs justify increased government costs. Erard examines California's administrative startup costs and concludes that they are likely more than offset by reduced private compliance burdens. Erard finds that the California program had the effect of increasing the rate of electronic filing by about two percentage points and thereby reducing the state's administrative costs. Electronically filed returns are less expensive to process than paper returns, but can be achieved otherwise, without prefilled returns.

A challenge facing all attempts to assess the cost-effectiveness of prefilled tax return programs is the virtual absence of detailed evidence on third party compliance costs, which most certainly would be higher if employers and other payers of income were required to provide the information needed by the government in a timely fashion to complete prefilled tax returns on behalf of taxpayers.

More specifically, Vaillancourt reports that the Quebec program appears to have been intended as a prototype for a national Canadian program of prefilled returns that has not materialized. Surprisingly, the vast majority of the 100,000 filers who were invited to participate in 2007 were over 65 years of age, not a group that might be expected to warm readily to a new tax filing system. Users were more likely to have had taxes withheld but the prefilled return did not incorporate information on withholdings, perhaps because it could not be compiled quickly enough.

Another surprise was that among Quebec users who answered the survey, slightly more than half reported using the prefilled returns themselves while more than 44 percent had someone else prepare it for them. If the preparer were not a family member and had to be paid for those services, that would surely have reduced compliance savings from using the prefilled return.

A telephone survey provided little information about reasons for nonuse in Quebec. About half reported that the offer came too late and 46 percent said they preferred the usual form.

Vaillancourt appropriately concludes that the results of the survey and the program cannot be generalized to all Quebec filers. He expresses the concern that a prefilled return system could reduce filers' interest in their tax affairs.

Brian Erard describes California's pilot programs in 2005-2006 in some detail and the evolution to a full-fledged program of prefilled returns offered to qualified filers. The pilots consisted of a statistically valid sample of 52,000 taxpayers invited by mail to participate and a separate random sample of 32,000 eligible, but uninvited, taxpayers as a control group. The pilot take-up rate was 22 percent in the first year and 21 percent in the second year.

After being put on hold for a year, the full program was implemented on an opt-in basis and offered to 1.9 million eligible filers of state income taxes: those included single filers, heads of households with up to five dependents, and filers with a rental credit. The full-fledged program was opt-in and was not offered by mail but through electronic access.

Erard analyzes the pilot surveys in great detail. He concludes that the second year survey oversampled prior participants and placed insufficient weight on prior-year nonparticipants. Eligibles were not a low-income group; the highest AGI was $143,000. Eligibles had a higher refund rate and a much lower electronic filing rate than the general population, 40 percent versus 60 percent. About 40 percent of eligible filers used tax professionals, compared with 65 percent of the general filing population.

The prefilled return was not universally popular—50 percent of the control group said they favored the government providing the service of prefilled returns and 12 percent were opposed. Erard speculates that lower actual repeat usage than indicated in the survey responses may have been due to a later implementation date, resulting in filers already having sent in their returns when the prefilled return became available or subsequent changes in taxpayers' situations. Among nonparticipants, 30 percent reported their preference for using a tax preparer and 22 percent had already filed; others reported various other reasons. Users reported a reduction in their average filing and preparation time of seven minutes out of about 35 minutes. Erard found that the program had little effect on overall tax compliance levels.

Although he concludes that nontrivial startup costs were likely more than offset by reduced compliance burdens, Erard finds that Goolsbee (2006) exaggerated the likely reduction in compliance costs. Goolsbee found that reduced compliance burdens amounted to about $85 per filer, but Erard found a much smaller reduction, a maximum of about 5.3 percent, mainly because filers using prefilled returns still have to keep and check their records.

Erard, among others, concludes that the California ReadyReturn program remains controversial and may be a niche program rather than one with broader potential applicability. Very low participation may be explained in part by the relatively late arrival of 4th quarter wage data. As to federal implementation of a prefilled system based on the California model, slow wage reporting would be a particular problem at the federal level and filers would need assurance as to data security. In his oral comments, Erard noted that a data retrieval system, i.e. one where the government simply shares information it already has with taxpayers, could be preferable to one of prefilled returns.

My paper, coauthored with Prof. Joseph Cordes, presents a simple framework for examining the costs and benefits of prefilled returns: total compliance costs equals costs to individuals plus costs to government plus costs to third parties. It examines available evidence from studies by the Government Accountability Office and the Internal Revenue Service, among others, as well as evidence from the California ReadyReturn system.

Our paper concludes that there is substantial uncertainty as to how a federal return-free system would affect the costs of government and individual filers. California's program appears to have reduced the state's administrative costs, but net savings are largely attributable to e-filing rather than to the return-free system itself. Although some participants report enthusiasm for ReadyReturn, the vast majority of eligible filers in California, roughly 97 percent, have declined to use prefilled returns suggesting that most people believe the savings they would realize in time and out-of-pocket spending are outweighed by the costs, including risks to privacy and security. Productivity advances in taxpayer assistance match productivity advances in the economy and have mitigated the rise in compliance costs to filers as the complexity of the tax code has increased.

We found that although there is little evidence on added costs to third parties, those costs would tend to outweigh any changes in individual and government costs. We estimated that costs to employers and other payers of income would range roughly between $500 million and $5 billion per year, largely because reporting deadlines would have to be advanced in order to provide timely returns and tax refunds. Added costs would fall disproportionally on small businesses (Electronic Tax Administration Advisory Committee, 2010).

Aside from costs, we also examined other important issues that are associated with the government assuming responsibility for preparing individual tax returns. The IRS would face a conflict of interest in functioning as both tax preparer and enforcer. Risks of error would result from stretched IRS capacities. The IRS lacks the essential electronic processing capabilities and would face challenges in carrying out new responsibilities, particularly while its mission is expanding under health reform. Compressed income reporting schedules would also increase risks of error.

Further, taxpayers who are unwilling to challenge an official IRS document—even when it may be erroneous—would retain responsibility and liability for error, a problem particularly for lower-income filers and those with English as a second language. In addition, taxpayers would become less cognizant of the incentives in the tax code and their personal finances. IRS preparation of individual returns could compromise taxpayers' privacy and may pose greater security risks. Moreover, the government would enter into competition with the private sector, reducing incentives for investment in innovation and electronic tax preparation systems.

Our paper concludes that adopting a prefilled personal tax return system is not an advisable policy for the federal government. Simplifying the complex U.S. tax code is the most direct way to reduce both the public and private costs of complying with the federal income tax, but tax reform is extraordinarily difficult to achieve.

Note

1 See e.g. William G. Gale (2009) and Austan Goolsbee (2006).

References

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