

Remove the Return

William G. Gale¹

June 1, 2009

The Task Force on Tax Policy, part of the President's Economic Recovery Advisory Board, faces a daunting task that is made materially more difficult by ex ante constraints placed on its purview and recommendations. Broad-based reform proposals seem to be out of the question and distributional constraints appear to eliminate many serious ideas. Nevertheless, I believe that significant tax simplification is feasible given the Task Force's constraints, and I will take it as given that simplification is desirable.

Simplification efforts are never easy, of course. Although almost everyone agrees that the overall tax system is too complex, every year taxes become even more complicated. Why is that? We all know the reasons. Simplicity often conflicts with other tax policy goals, like equity and enforcement. People often don't mind complexity that reduces their taxes; indeed, many groups lobby for specific provisions that provide targeted benefits. There is a vicious cycle in which targeted subsidies for one group create demand for additional targeted subsidies by other groups. Complexity is hard to measure and so is often ignored in the political process. Simplification, in short, tends to get sacrificed for other policy goals. It is "always a bridesmaid, never a bride." This fact, however, could turn the Task Force's limited focus into an advantage for simplification efforts because more ambitious reforms are off the table. Here are five thoughts on simplifying the tax system.

First, the goal should not be (just) to simplify the tax system; it should be to simplify citizen's interactions with government. Converting all deductions, credits, etc., to government spending programs would simplify "taxes" greatly but would greatly complicate people's lives if it meant they had to apply separately for each benefit. The fact that the income tax form serves as the application for literally dozens of government programs makes the income tax more complex, but it can reduce citizens' overall cost of dealing with government.

Second, simplification is not just an issue of filling out forms; it also involves how individuals pursue activities that minimize or avoid taxes. Thus, the overall structure of the tax system – for example, lower marginal rates – can have a first-order effect on complexity, even if the forms don't change.

Third, complexity is now affecting taxpayers in all income groups; it is not "just" a problem for high-income taxpayers.

¹ Vice President and Director of Economic Studies, Brookings Institution, and Codirector, Tax Policy Center.

Fourth, several existing compendia contain very good specific simplification proposals.² These studies highlight several areas with “low-hanging fruit” for simplification efforts:

- Consolidate family, work, and dependent provisions;
- Consolidate education incentives;
- Consolidate saving incentives;
- Tax capital gains like ordinary income;
- Repeal the AMT;
- Reduce the number and variety of phase-outs;
- Eliminate hidden taxes and “take back” taxes (PEP and PEASE); and
- Increase the use of withholding taxes.

Fifth, and most important, the Task Force should recommend moving an increasing number of people over time to a “return-free” tax system. This could be either a fully return-free system, which would feature exact withholding, or more likely a tax agency reconciliation (TAR) system, in which the IRS sends households a provisional tax return for confirmation or changes. These systems are feasible; they already exist in several developed countries. A recent California experiment with a TAR system was successful and popular.³

A return-free filing system would have several advantages. First, it actually would simplify taxes for many people. Second, it would create an objective, measurable benchmark. Most simplification gains are hard to document. A return-free system would resolve that problem, by providing a very clear objective criterion – is the system simple enough to operate in a return-free manner? If not, which provisions of the system are getting in the way? Third, it would provide a real constraint on the creation of further complexity. With a return-free system in place, any new provision that could not be accommodated into that system would face a natural hurdle for enactment.

There are two major objections to a return-free system. One is that the current system is too complex to accommodate a return-free system. While it is correct that return-free systems would require some structural simplification, I view that as a strength of the proposal, not a weakness. This system could even create a “virtuous cycle:” the availability of return-free filing for some taxpayers, and the popularity it would likely receive from those using it, would create pressure to simplify the tax system further so that more people could avail themselves of the return-free system.

The second objection is that the IRS does not have the capacity to administer a system like this. After all, the systems could probably be applied to up to 50 million returns with relatively small structural changes.⁴ IRS capacity can be addressed fairly straightforwardly. A similar problem existed a few years ago with respect to electronic returns. In response, the IRS was given a goal set by Congress to have 80 percent of

² See Joint Committee on Taxation (2001), IRS National Taxpayer Advocate Annual Reports to Congress, President Bush’s Advisory Panel on Tax Reform (2005), and Department of the Treasury (2003).

³ Goolsbee (2006)

⁴ See Gale and Holtzblatt (1997) and Department of the Treasury (2003).

returns filed electronically by 2007. A similar phase-in approach would work well for return-free filing systems. Moreover, increasing the number of taxpayers in a return-free system would probably prove to be a more politically palatable way to justify additional IRS funding than giving the IRS more resources to monitor and enforce an ever-more-opaque set of tax rules.

So, let's start small and grow. Let's aim to get 10 million people into return-free systems by 2013 – that's less than one-fifth of all people who file the 1040a and 1040EZ – and then aim to get all of them – about 60 million filers – on the no-return system by 2016. At that point, voters can decide how far they would like to see the system extended to the rest of the population.

References

Joint Committee on Taxation, "Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986." JCS-3-01 April, 2001. <http://www.house.gov/jct/s-3-01 vol2.pdf>

Internal Revenue Service, Department of the Treasury, "National Taxpayer Advocate 2008 Annual Report to Congress." December 2008.
<http://www.irs.gov/advocate/article/0,,id=202276,00.html>

President Bush's Advisory Panel on Tax Reform, "Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System," November 2005.
<http://web.archive.org/web/20051124073832/http://www.taxreformpanel.gov/final-report/>

Department of the Treasury, "Report to the Congress on Return-Free Tax Systems: Tax Simplification is a Prerequisite." December 2003. <http://www.treas.gov/offices/tax-policy/library/noreturn.pdf>

Goosbee, Austan, "The Simple Return: Reducing America's Tax Burden Through Return-Free Filing." Hamilton Project Discussion Paper. July 2006.

Gale, William G. and Janet Holtzblatt, "On the Possibility of a No-Return Tax System." *National Tax Journal*. 50(3): 475-487 September 1997.