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Return Free Filing Won't Fix What's Wrong With America's Tax System

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INTRODUCTION

Because of COVID-19 Tax Day moved this year from April to July. That means the debate over the supposed panacea to the convoluted process of filing taxes – a return-free filing system (RFF) – is now making its annual appearance, albeit four months late.

The return-free filing idea has been around for a longtime and is currently in practice in Denmark, Sweden, Spain, and the United Kingdom (among other countries), places with limited or no tradition of voluntary compliance. If the U.S. government adopted RFF, the Internal Revenue Service (IRS) would estimate your taxes by using information from a mix of sources (depending upon the system) including employers, financial institutions, other third parties, and in some cases the individual taxpayer themselves. Proponents say (in effect) let the government do your taxes and spare you the burden of hiring a tax preparer, purchasing commercial tax software, or trying to do it yourself.

That sounds alluring, but it's important to underscore the limits of what an RFF system could achieve and what it would not. For example, an RFF would not eliminate the $1.6 trillion in tax incentives that benefit primarily wealthier taxpayers.[1] Nor would it raise revenue to build new roads, rail, or schools; support scientific research; pay down public debts; make the tax code fairer and more progressive; or, help us close our $458 billion annual tax gap (the difference between what is owed in taxes versus what is paid).[2]

Rather, pursuing return-free filing is a way to avoid the hard choices needed to revamp our tax code to promote economic fairness and growth. It would put the burden of contesting initial tax determinations on the filers rather than on the IRS, fundamentally reversing the presumption of the tax system today. And, if truly voluntary, it is unlikely to have a significant impact on the way most Americans complete their taxes. In California, which proponents often cite as a good example of how an effective return-free filing can be implemented only about 90,000 people used "Ready Return" in any given year of that experiment (despite the some two million Californians that were annually offered the government-prepared tax returns) — putting into serious doubt the idea that a federal return-free filing system could be voluntary and actually achieve the purported national benefits it proponents claim will occur.[3]

In fact, moving away from a voluntary tax filing system would actually worsen many of the problems that an RFF system is supposedly designed to fix — accuracy, tax evasion, and simplicity. Furthermore, were the U.S. to implement an RFF system, it would eliminate the moment of financial planning and review that is tied to the self-return process, and as the only time each year many households take stock of their finances, has an intrinsic value for American families.

Accuracy

As tax codes around the world have become more complex, many countries that are currently using RFF systems are increasingly finding it necessary to re-engage taxpayers in order to ensure accuracy. In the introduction to a 2017 report by the UK's All-Party Parliamentary Taxation Group on Pay-As-You-Earn (PAYE), the RFF system utilized by the United Kingdom. Ian Liddell-Grainger, the Chair of this non-partisan policy committee and a Conservative Member of Parliament, noted that:

> **(Given) the changing nature of the workforce, a growing self-employed community and the complexity of our current system leading to significant overpayments…It is my firm belief that we need to involve the taxpayer in this process. It is them who can improve the accurate flow of information throughout the fiscal year.[4]**

The Parliamentary report found that as a result of a number of economic changes since the creation of PAYE, approximately one-third of British taxpayers were effectively filing their own taxes via a process known as Self-Assessment — negating much of the "will save the taxpayer time" rationale for a RFF system. The report cited a number of reasons for the increase in Self-Assessments, including a rising number of self-employed workers; a more mobile workforce; and an increase in tax code complexity driven in part by the growth in tax incentives.[5]

Unfortunately for the PAYE system, these trends are likely to worsen over time given the growth in globalization and the growing mobility of the workforce.

The PAYE report also noted that error rates had been rising significantly in the United Kingdom, costing the government and taxpayers billions over the years. This counters another rationale for RFF — that no-file systems reduce the error rate and the thus help close the size of the tax gap.[6] The parliamentary analysis points to exactly the opposite outcome in the real-world experience of their RFF in practice.

Tax Evasion

While unintended error is one major source of the tax gap, another is the intentional underreporting of income subject to tax — or tax evasion.

Some have argued that RFF systems could help reduce the tax gap because it would reduce underreporting. In a 2006 paper on return-free filing, Austan Goolsbee, former Chairman of the White House Council of Economic Advisers under President Obama, cites a 1996 General Accounting Office (GAO) report that concluded that a no-file system could help the Internal Revenue Service significantly reduce its number of "underreported" cases.[7]

In a 2010 paper, economists Jeffrey Eisenach, Robert Litan, and Kevin Caves took a contrary view. They argued that the adoption of an RFF tax system would not have any impact on the U.S. tax gap, adding that it would

> **"do virtually nothing to reduce under-reporting on individual tax returns, because almost all under-reporting is associated with types of income that would make filers ineligible to use RFF in the first place."[8]**

In fact, the authors contend that RFF might actually make the tax gap larger, since taxpayers who receive completed tax returns that understate their actual tax liabilities are not likely to challenge the IRS's errors in their favor. Even Joseph Bankman, a longtime advocate of RFF, has explicitly acknowledged it could lead to greater opportunities for taxpayers to underpay what they owe.

In a 2017 article in Propublica, Bankman noted there were multiple ways taxpayers could benefit from an RFF system and stated that "If there's a mistake that goes in your (the taxpayer's) favor, maybe you don't call attention to it."[9]

Supporting this argument is data on tax evasion in countries with return-free systems compared with the U.S, which relies on voluntary citizen compliance.

According to the Tax Policy Center (TPC), 36 countries permit return-free filings for some taxpayers.[10] This is typically accomplished in one of two ways. In the pay-as-you-earn systems used in Japan, Germany, and the United Kingdom, the government calculates tax withholding to match the amount of annual taxes due. Most citizens, particularly those whose income is derived from a single employer, never even see a tax return.

Other nations like Belgium, Spain, and Denmark, use what's called a pre-populated return. Employers report individuals' income directly to the government, which then sends the taxpayer a pre-filled return he or she just has to verify.

In Table 1 we compare tax evasion rates in 13 countries — six that use pay-as-you-earn systems in which the government calculates withholding, six that pre-populate returns with information provided by employers, and one, the United States, where citizens file their own tax returns. (Tax evasion data was not available for all 36 countries using RFF)[11]

TABLE 1[12]

COUNTRY	RETURN FREE GOVERNMENT CALCULATES WITHHOLDINGS	RETURN FREE PRE-POPULATED RETURN SUBMITTED TO TAXPAYER FOR APPROVAL	SELF-RETURN	TAX EVASION AS PERCENTAGE OF GDP FROM 1999 TO 2010
Italy	Yes	-	-	1.5
Luxembourg	Yes	-	-	1.0
Germany	Yes	-	-	1.1
South Korea	Yes	-	-	2.1
Netherlands	Yes	-	-	1.3
United Kingdom	Yes	-	-	1.1
Sweden	-	Yes	-	1.7
Norway	-	Yes	-	1.7
Denmark	-	Yes	-	1.7
Finland	-	Yes	-	1.5
Spain	-	Yes	-	1.2
Estonia	-	Yes	-	2.5
RETURN FREE AVERAGE				1.45
UNITED STATES			Yes	0.1

The average rate of tax evasion as a percentage of GDP for the 12 countries on this list was 1.45. For those countries that have pay-as-you-earn systems, the average was 1.35. For those with a pre-populated return system, the average level was 1.71. In contrast, the level of tax evasion for the United States as a percentage of GDP was only 0.1.

While many other factors need to be taken into account when looking at what is responsible for the different levels of tax evasion by country, including trust in government, complexity of the tax code, type of taxation (income tax, sales tax, etc.), and effective rate of taxation, it is nevertheless of interest that the U.S. had a significantly lower level of tax evasion as measured by GDP than those countries that utilized either system of return free filing.

Simplicity

Proponents of return-free filing say it would greatly simplify the process of filing taxes. Goolsbee argued in 2006 that moving to a return free filing system would save taxpayers 225 million hours of tax compliance time.[13]

However, it's doubtful that such savings would materialize in the United States. We have a very complicated tax system. Governments at the federal, state and municipal levels all have taxing authority. The federal tax code, moreover, is encumbered with $1.6 trillion worth of tax incentives for a vast array of activities. And because we have a large number of self-employed workers and two-income families, moving to an RFF system would still necessitate a great deal of taxpayer involvement to ensure accuracy, completeness, and fairness.

Adopting an RFF would not address the growing complexity of the U.S. tax code. In fact, if an RFF system works as its proponents argue, it would leave the status quo in effect – an inefficient tax code riddled with tax breaks that disproportionately benefit wealthy taxpayers at the expense of working class families.

As PPI has long contended, what America really needs is a comprehensive overhaul of the tax code, not an army of government tax collectors doing your taxes for you. In addition to big changes in what we tax and restoring progressivity, radically streamlining the tax code is the right way to make our government more user-friendly and to reduce the time and money citizens spend on filing their taxes.

Financial Planning

One often overlooked benefit of America's tradition of voluntary tax compliance is that it educates citizens about their financial condition. Ironically, filing one's taxes provides a window of opportunity during which Americans can review their financial history from the prior year and reassess their needs for the future — such as how much to save for retirement.

But shifting to an RFF system would eliminate or reduce that educational moment. As former Senator (and co-chairman of the National Commission on Restructuring the IRS) Bob Kerrey noted in an article for Time Magazine entitled "Beware of Simple Solutions to the Tax Code:"

> **"Perhaps the worst aspect of the simple return is that it reduces or eliminates one of the most important activities that occur during the tax-filing season: individual financial review and planning. Calculating how much we owe in taxes is an unpleasant activity, but it is also central to understanding our personal financial situation and planning our financial futures — and often the only time all year that the average family looks at its finances."[14]**

As exasperating as it can be, doing your own taxes, and understanding you family's financial relationship with government, is more worthy of a free and self-reliant citizenry than delegating that responsibility to government tax collectors. We shouldn't reduce taxpayer engagement in their own financial affairs simply to avoid the hard work of passing and implementing real tax reform. The impact of greater taxpayer disengagement from their own personal finances is not an inconsequential consideration as a matter of national economic policy. To the contrary, numerous analyses of the national savings rate and financial literacy underscore the need for more personal engagement in one's financial affairs—not less.

CONCLUSION

Nobody enjoys paying taxes, and the U.S. tax system leaves a lot to be desired. It is overly complex, wasteful, does not raise enough revenue to cover the needs of its citizens, and tilts toward the interests of the wealthy. Moving to a return free filing tax system would not address any of those problems.

If policymakers want to reduce the amount of time taxpayers spend on filing taxes, they should be not be distracted by magical panaceas, but rather aim their sights on creating a simpler, more efficient and fairer tax system that promotes economic growth and equity.

ABOUT THE AUTHOR

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3 "How Could We Improve the Federal Tax System?" Tax Policy Center Briefing Book, Updated May 2020. https://www.taxpolicycenter.org/briefing-book/what-was-experience-return-free-filing-california

4 Report on the Administration of Pay-As-You-Earn (PAYE), All-Party Parliamentary Taxation Group, September 2017

5 Self Assessments were first implemented in 1995-1996. Today approximately 11 million taxpayers in the U.K. must file them out of a total of 30.5 million.

6 During the period 1999 to 2009 it was discovered that 36% of all returns had some form of income under reporting

7 It should be noted that underreporting of taxes can be intentional and unintentional.

8 Jeffrey Eisenach, Robert Litan, Kevin Caves, The Benefits and Costs of Implementing Return Free Filing in the U.S.", Computer & Communications Industry Association, 2010. According to the authors income from sole proprietorships (which is responsible for 34% of the tax gap) would not qualify for RFF.

9 Jessica Huseman, "Filing Taxes Could Be Free and Simple," Propublica, March 20, 2017

10 "How could we improve the federal tax system," Tax Policy Center Briefing Book, https://www.taxpolicycenter.org/briefing-book/what-other-countries-use-return-free-filing

11 The 12 RFF countries listed here represent one-third of the total number of countries utilizing RFF. Tax evasion data was not available for all 36 countries using RFF.

12 OECD and Andreas Buehnaa & Friedrich Schneider, "Size and Development of Tax Evasion in 38 OECD Countries: What do we (not) know?" Journal of Economics and Political Economy, March 2016

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