

Remove the Return

By William G. Gale

William G. Gale is the Arjay and Frances Fearing Miller Chair in Federal Economic Policy at the Brookings Institution and codirector of the Urban-Brookings Tax Policy Center.

*Copyright 2009 William G. Gale.
All rights reserved.*

The Volcker task force on tax reform, 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 despite the task force's constraints, and I will take it as a 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. That 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 to just simplify the tax system; it should be to simplify citizens' 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. 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.

Fourth, several existing compendiums contain good, specific simplification proposals.¹ Those studies highlight several areas of 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 alternative minimum tax;
- reduce the number and variety of phaseouts;
- eliminate hidden taxes and "take-back" taxes, including the personal exemption phaseout and the Pease itemized deduction limitation; and
- increase the use of withholding taxes.

Fifth, and most important, the task force should recommend gradually moving an increasing number of people 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 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. And a recent California experiment with a tax agency reconciliation system was successful and popular.²

¹See Joint Committee on Taxation (2001), IRS national taxpayer advocate annual reports to Congress, President's Advisory Panel on Federal Tax Reform (2005), and Treasury (2003).

²See Goolsbee (2006).

A return-free filing system would have several advantages. First, it 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 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 help prevent 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. A return-free system could even create a “virtuous cycle”: The availability of return-free filing for some taxpayers, and the likely resulting popularity of the system, would create pressure to simplify the tax system further so that more people could use the return-free system.

The second objection is that the IRS lacks the capacity to administer a system like this. However, the system could probably be applied to up to 50 million returns with relatively small structural changes.³ IRS capacity can be addressed fairly straightforwardly. A similar problem existed a few years ago with electronic returns. In response, Congress set a goal for the IRS to have 80 percent of returns filed electronically by 2007. A similar phase-in approach would work well for a return-free filing system. And 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 a return-free system by 2013 — that’s less than one-fifth of all people who file forms 1040a and 1040EZ — and then aim to get all 60 million filers of those forms on the no-return system by

³See Gale and Holtzblatt (1997) and Treasury (2003).

2016. At that point, voters can decide how far they would like to see the system extended to the rest of the population.

References

- Gale, William G. and Janet Holtzblatt, "On the Possibility of a No-Return Tax System," 50 *Nat'l Tax J.* 475-487 (Sept. 1997).
- Goolsbee, Austan, "The 'Simple Return': Reducing America's Tax Burden Through Return-Free Filing," Brookings Institution White Paper 2006-04 (July 2006).
- Joint Committee on Taxation, "Study of the Overall State of the Federal Tax System and Recommendations for Simplification," JCS-3-01 (Apr. 2001).
- Olson, Nina, "National Taxpayer Advocate 2008 Annual Report to Congress" (Jan. 7, 2009).
- President's Advisory Panel on Federal Tax Reform, "Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System" (Nov. 2005).
- Treasury, "Report to the Congress on Return-Free Tax Systems: Tax Simplification Is a Prerequisite" (Dec. 2003). ■