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## **Should the US Government Prepare Personal Income Tax Returns?**

I'd like to start by thanking the Technology Policy Institute for inviting me over here to speak and pay tribute to the efforts of all their staff in the build up to this event.

Before addressing the topic directly, it is perhaps worth me saying a little about the context in which I speak today.

For those of you who don't know me, I am the founding Chair of the British Parliament's All Party Tax Group.

As the name suggests: we're all party and non partisan.

There are Labour, Conservative and even Liberal Democrats in the Group. What's more, members of the Houses of Commons and Lords both participate.

We set up the group several years ago now in recognition that Parliament was failing to properly scrutinise a key function of Government: namely how tax is collected.

Yes, there are multiple committees and scrutiny bodies which also touch on this issue.

The Public Accounts Committee, the National Audit Office, the Public Administration Committee – on which I also sit, the Treasury Select Committee, the Regulatory Reform Committee, and the Work and Pensions committee.

All of whom do great work but none have so squarely in their sights this central issue upon which so much of our public policy issues stand.

Why is this?

Well we must be honest with ourselves: even your President would struggle to make soaring rhetoric from such terminology as cumulative and non-cumulative withholding.

For many British MPs and dare I say it, US Congressmen, this isn't where the action is to be found.

Our constituents worry about their jobs, their children's education and their family's healthcare.

I have yet to receive a letter from a voter responding the paper that just hit my desk from the OECD: "Strengthening Tax Audit Capabilities: Innovative Approaches to improve the Efficiency and Effectiveness of Indirect Income Measurement Methods

But when things go wrong – as they did so dramatically in the UK with delivering the working tax credits, and in the Revenue's Self-Assessment Online software service - we are the first to know about it.

You have two of our recent studies. These are our attempt to get ahead of the pack, spot the big problems emerging in the rear view mirror and hit the brakes before it's too late.

The first published last year pin-pointed some of the big challenges the UK's personal income tax administration face. The second, which we're releasing this morning, highlights the deficiencies of what we call "pre-populated returns", but which you know as the "ready" or "simple return".

In both studies, we showed how the architecture of revenue collection systems had profound but often unintended and unanticipated consequences for the way in which Government operates.

That brings me neatly onto the question at hand for discussion today: "Should the US Government Prepare Personal Income Tax Returns".

My argument is no, never, and that however "simple" the concept may sound, it is in truth anything but. However, let's look at some of the options available to your Government if it did choose to.

For one thing, you could follow the British example.

The majority of our population, those on middle and lower incomes, don't file a tax return. The Revenue instead calculates their liability – and their employers do all the rest of the work. They are expected to deduct the exact amount of tax owed from each of their employees wage packet and pass it back to the Exchequer. As a result, the average citizen who is subject to the PAYE does not prepare or file an income tax return at all.

So they withhold the right amount, the Revenue issues employers with a Pay As You Earn, or PAYE, code, which reflects each individual employee's circumstances. Those with complicated tax affairs, those who are the self employed or those who have multiple incomes, must file an income Self Assessment tax return to capture any income not accounted for through PAYE. For this, the Revenue provides its own tax software WebPortal.

In a more recent development, those on lower incomes, the working poor, whose wages are now supplemented through government tax credits, must also file something akin to a tax return in order to qualify for this tax credit benefit.

Our system has some big problems.

Problem 1. The character of our workforce is changing. 60 odd years ago when the Government dreamt up PAYE, we had jobs for life, within large static employment structures.

It was relatively straightforward for the tax man to calculate from his office in Whitehall every worker's PAYE code. And it was relatively straightforward for employers to use those codes to administer the process.

How times have changed and continue to.

The new economy means we change jobs more often to chase our aspirations for a better life. We balance our work life with other commitments and often work multiple jobs. Small business

enterprise, not monolithic state or large private sector bureaucracies, are now the engines of job creation.

This makes it much harder for Government to keep track of the tax that citizens owe and much more time-consuming for employers to administer the system. Small businesses, who can't afford to outsource the work, find it a particularly costly and difficult burden.

Problem 2. By taking from the citizen the responsibility for preparing their own tax return, by and large taxpayers have absented themselves from all compliance activities.

That is to say, people don't know their PAYE codes and don't know how to check them. People are by and large simply disengaged from their tax affairs.

Their assumption is that the Government must be right in their calculations, and even if we suspect some errors, it's better not to attract the attention of the Revenue by doing anything about it.

Of course the Revenue does make mistakes, and a lot of them – our research indicated that their errors impact around 1 in 6 taxpayers - and when they do, they often go unnoticed by the taxpayer for many years, remaining uncorrected, and exacerbating the damage done.

Problem 3. Tax credits. I've already mentioned how it is the working poor, alongside those on higher incomes, who have to file a return in the British system. If that sounds strange in a system that is often lauded for removing the burden of tax compliance from those least capable, let me explain why.

When the Labour party first came to power in 1997 it wanted to introduce its own Working Tax Credits to mirror the Earned Income Tax Credits that President Clinton had championed and expanded in his first term.

At first, the UK government attempted to do so without placing any additional responsibility upon the claimant. Instead, employers administered the working tax credit, with instructions from the Revenue, alongside their PAYE activities.

Many people were lifted out of poverty but at the same time, many billions of pounds were over paid to people, which then had to be clawed back. The Government had engineered a situation where many of the poorest within our society found themselves owing the State thousands of pounds that they had already spent.

Taking a step back from the political problems this caused, it was a very real tragedy for thousands of Britain's poorest people.

In the end, much of this money simply had to be left unrecovered.

As is the norm these days, the failure of Government's IT systems didn't help matters, but the true root cause for this was the inflexibility of the tax system itself.

Without a mechanism, like a citizen-generated tax return, to maintain the flow of information between the recipient of the credit and the Revenue, too often the government's and employers'

calculations were based upon on data which was out of date, redundant, or patched together in a highly flawed way.

The solution has been for the individual to begin to assume a greater share of the responsibility for ensuring their credits are paid correctly. We've gone so far down this road now that, as I said at the start, those receiving working tax credits are now expected to file what you would recognise as a tax return.

It's this fact above all others that makes our Return-Free system, out of all the tax administration systems you possibly could choose, almost uniquely unsuited to the US.

The US tax code has a series of targeted income deductions and tax credits, meant to advance any number of policy objectives.

In contrast the majority of taxpayers in the UK don't qualify for any deductions or credits.

Those that do exist – like the working tax credit – are the exception not the rule and limited to specific groups, in this case: the working poor. And we've learned the hard way that in that situation, some kind of return must be submitted by the taxpayer in order for the system to work.

The Revenue could not remotely assess every individual taxpayer's liability in the situation where there were multiple and varied forms of credits and deductions which the general population routinely qualified for.

If applied to the US, additional reporting structures would have to be devised to fill the hole left by the tax return in order to cope with the more sophisticated US tax code. You would quickly find yourselves back in the situation, as was the case in British experiment with tax credits, where almost everyone was filing something equivalent to a tax return, in order to make the Return-Free tax system work.

It would certainly be an interesting, even surreal ride, but if they are anything like the British, I'm not sure the US electorate would tolerate such an indulgence on the part of the political classes.

That said, even if you were to radically simplify the tax code here in the US, discarding your many targeted deductions and credits, as I know many argue for, the problems that beset PAYE in the UK should still give you good reasons not to go near it.

In fact I'd go far as saying that PAYE is the "straw man" in the US debate on tax reform, given the big structural problems which it faces.

Where I think there is, at least on the surface, more grounds for discussion is the issue of pre-populated or ready returns.

This is the subject the paper we are publishing today.

Again I'd argue this is the wrong way for the US to go, but let's first consider what does it would involve before dismissing the concept.

Under this scheme, the Revenue sends out a pre-populated tax return to taxpayers, containing all the information the Revenue already has. In most cases the Revenue uses this information to

calculate the taxpayer's final liability. In effect presenting them with a completed return they can simply sign and return.

In practice there are weak and strong forms of the proposal: in some cases, individuals just receive a half completed return, and they are expected to prepare the rest; in others the return is completed and their tax liability already calculated, and they can accept it as is. The Revenue can also choose only to send out these pre-populated returns to specific groups within the taxpaying population on a targeted basis.

I think we can rule out the strongest version of these proposals pretty quickly. This is the case where the Revenue completes the return and calculates the liability for all taxpayers.

Here are 3 reasons why.

Firstly it fails to avoid the structural problems that beset PAYE.

Taxpayers will only put up with these systems where it is unlikely that they will be left at the end of the year waiting for a large refund from the Revenue.

This is because, by introducing an additional step into the process – with the Revenue first completing the return, before the taxpayer gets the opportunity to review and amend their work – it lengthens considerably the time taken to release the refund back to the taxpayer.

And that puts the emphasis back upon the Revenue and employers to deduct the right amount of tax from the taxpayer's wages throughout the year.

In small countries like Denmark, that may not be a problem. But as I explained earlier, we have found this increasingly difficult to achieve in the UK, and I'd venture to say it would be nigh on impossible to do here in the US.

Secondly its only makes sense for the Revenue to go to the trouble of pre-populating taxpayer's returns and calculating their overall liability, if they can be certain that very few taxpayers will need to amend their returns.

Otherwise the Revenue is employing a vast army of bureaucrats and running very expensive systems to duplicate work that has to be re-done anyway.

And even this is possible only where the Revenue has all the data it needs at its disposal to perform these tasks, and at the right time in the annual tax cycle to actually be practical.

But where there are multiple deductions and credits in the tax code that are dependent upon factors beyond even the Revenue's roving eye, more and more taxpayers will need to amend the work that has already been done.

Clearly an awful lot of deductions and credits in the US tax code would fall into this category. And there may be a political case for eliminating those, but this is a larger question than the one we are considering today.

Finally, and perhaps most worryingly, such systems are not only open to tax fraud, they actively encourage it.

Revealing to taxpayers all the Revenue's known information about their financial affairs would herald open season to all those taxpayers willing to take a risk and not disclose other incomes not contained in the pre-populated return.

It is the doubt in our minds that the taxman will probably find out about whatever additional monies we have coming in, which keeps us honest.

If we know for certain, that the Revenue doesn't know about that second job or those investments, why point it out to them?

Those in favour of the proposal we are discussing this morning will say "okay – PAYE isn't right for the US, and pre-populating everyone's tax return isn't practical, but surely there are some circumstances in which it does make sense for the Government to prepare personal income tax returns and those situations would constitute reform?"

In other words they retreat to the weaker proposal of those I listed before, which I believe is often given the label "ready return" here in the US. Here the Government completes the returns for those taxpayers who have very simple financial affairs and don't qualify for any credits or deductions, and where the taxpayer might most readily be able to simply sign it and send it back.

At this point it is probably worth asking the question: why given all that I've already said, are some people so keen on the Government preparing tax returns?

From what I can gather from the discussions I've had, there are two reasons:

Reason 1. The central purpose of any tax system is to raise revenue. In this case, there is an assumption that if the Government prepared people's tax returns, it could raise additional revenue without having to actually raise the levels of taxation.

Reason 2. There is a perception that preparing a tax return is too much to ask of most citizens and it would be better if Government could take on board this responsibility.

I have difficulty with both of these arguments.

Firstly even if it is correct that you could raise additional revenue by the Government preparing people's tax returns and telling them what they owe, and I am sceptical, under the ready return model, that additional burden falls upon those with simple enough financial circumstances for it to be practical for the Government to prepare their return for them. You're talking about subsections of subgroups of the population, whose income is low enough, and tax status is simple enough, that they're eligible for nothing.

In other words, we'd be raising taxes on those just wealthy enough not to qualify for the earned income tax credit, but not yet rich enough to have a complicated investment portfolio.

Raising taxes on the well-to-do is so controversial that it's just easier to try to collect more from the lower middle class, without telling them.

That's a pretty shameful way to plug the tax gap. It would be better just to be honest with the electorate and make the case for higher taxes or lower public spending, the impact of which ought to be shared fairly throughout society.

Secondly having the Government prepare your tax return doesn't reduce the burden of your compliance activities, it just encourages you to absent from them.

You assume that the tax man must be right, or not worth challenging. But if you do double-check, and most in the UK don't, then you may as well have completed the return yourself in the first place, and the Revenue has saved you nothing!

What's more, given that these populations aren't static, taxpayers being effectively excused from compliance would, over the long term, have big knock on effects here in the US in particular, where tax policy is instrumental as the vehicle to deliver public policy objectives.

This matters and is important to understand, because once the taxpayer population begins to shed that voluntary compliance culture, it becomes very difficult if not impossible to get it back.

And getting us to change our behaviour is more often than not about overcoming our initial resistance to change, rather than persuading us that you have something better to offer.

So once those 10 or 20 or 30 million Americans have absented from compliance, it will be very difficult to persuade them back for any reason.

Even if their circumstances change and Government is now offering them carrots in the form of incentives or deductions, the taxpayer will rather not claim those credits than have to start filing a tax return again.

Over time this will steadily erode one of the core policy leavers that the US Government has at its disposal: its tax system.

So to summarise: the work of my Parliamentary Tax Group, albeit written in a British context, suggests that the US Government should not prepare personal income tax returns – not even for a minority of taxpayers .

Such approaches would ignore the changes we've witnessed to our economies.

They encourage taxpayers to absent from compliance activities and this undermines the Government's ability to influence their behaviours.

They encourage tax fraud by demonstrating to citizens just how little the government really knows about them and their sources of income.

And they have the potential to unfairly tax certain population groups within society to plug the public deficit, at the expense of an honest debate about taxing and spending strategies.

All good reasons I believe to leave tax preparation to taxpayers, and keep the Government out.

Let's end by briefly considering the issue that lurks behind this whole debate: the complexity of the US tax code.

In the UK we have a much simpler income tax code – principally because of the inflexibility of PAYE necessitates it being so.

There is an argument that having the Government prepare tax returns in the US would over time produce a counter-force to those special interests that seek to complicate the tax code.

As we've witnessed in the UK, trying to introduce targeted tax credits into a system where individuals don't file returns is so costly and causes so much confusion that policy makers either fall back upon taxpayer reporting, or if it isn't an option, just don't bother.

To me that's like taking a sledge-hammer to crack a nut, given the chaos it would cause. But nevertheless what that analysis also ignores is that, in the UK at least, all that complexity has simply been moved into other forms of taxation or led to the creation of new taxes, operating in parallel to income taxation.

Which, in turn, creates new compliance burdens which are principally felt by business, particularly small businesses.

Moreover a complicated income tax code is in itself no bad thing. It's if that complexity serves no good purpose that it ought to be tackled.

When politicians in my country seek to influence the way in which people live their lives, more often than not they have to introduce new *punitive* taxes to push people away from those behaviours they wish to discourage. They aren't very popular and tend to hit the poorest hardest.

What we can't do is use the tax system to reward them for "good" behaviours through credits that anyone can claim.

This is a huge political problem in the UK, which the US, because of its tax code, and the voluntary compliance culture that exists here, can avoid.

Again this comes back to the honesty point, which I made in relation to the question of additional revenue.

If you wish to simplify the US tax code, have the courage to say to the electorate: not all these deductions make sense and some of them have to go.

Don't hide behind proposals to reform the way in which their taxes are collected - which would have the effect of over time stripping them of these entitlements – without having the debate about how valuable some of them might be.

Thank you for listening.