Paying Taxpayers to File Electronically

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Does it make sense to pay taxpayers to file their tax returns electronically? The Clinton administration thinks so. And so do I. In fact, I may be the original source of the idea.

The basic notion is simple. By filing electronically taxpayers save the IRS administrative costs, significantly reduce their mathematical errors, and ease enforcement of the tax laws. Why not reward them appropriately for helpful behavior?

I first conveyed the idea in a Tax Notes column on Aug. 3, 1992 (p. 659). Many times since then, I have suggested it to various contacts at the IRS and the Treasury Department.

But there was a theory behind the idea—a theory that should be attributed to Gerald Portney, who had been an important IRS official. The theory with which Gerald challenged many of us was that the IRS could create positive incentives, not merely negative ones.

The IRS's arsenal of negative incentives are obvious. It penalizes late payment, incomplete filing, and erroneous claims of income and deductions. It extracts extra money from those who violate the tax laws. If necessary, it will even lay claim to assets of individuals who have not paid their taxes and do not seem willing to try to come back into compliance with the laws. We know and read of examples of those types of enforcement actions every day. The fear of punishment acts as a negative reinforcement against bad or illegal behavior.

Despite mixed feelings about the IRS, most individuals support some form of penalty in the law. Those who willingly pay their taxes want enforcement of the laws so that they do not bear an unfair share of the tax burden. Nonetheless, if the contact between an authority and the subjects of that authority is almost always negative, then the subjects often begin to distrust the authority.

The tension between taxpayer and the IRS can never be eliminated, but it can be eased. The effort of the IRS to upgrade and improve its customer service provides an example. Motivating factors include the increased needs of taxpayers as the tax code gets ever more complex and the embarrassment of the IRS whenever there is a high error rate in answering taxpayer questions. But there is an added advantage: improved relationships with taxpayers, especially when there is some more direct contact by letter or phone, can positively affect their willingness to comply with the laws. Courteousness and interest in the taxpayer's questions can increase trust and goodwill.

Positive incentives go a step further. Think of a jurisdiction that is attempting to fight youth crime. Certainly it will have negative reinforcement through punishment of offenders, and it will engage in more neutral behavior such as providing information to help the public understand the laws. To be effective, however, the system is likely also to reward good behavior. Young people, for example, are usually rewarded if they stay in school, and boys and girls clubs and other activities are set up to encourage young people to use their time effectively. Portney's idea was that we similarly ought to figure out ways to reward taxpayers for good or helpful behavior.

Of course, this is easier said than done. Opportunities to provide positive incentives to pay taxes are limited. After all, the purpose of taxation is to raise revenues. The "rewards," if they exist, are usually on the expenditure side—such as a strong national defense or a good transportation system. But since one person's taxes often have little effect on the society-wide outcome, those broader rewards are little affected by each taxpayer's compliance with the tax laws.

That's where electronic filing comes in. Although private vendors sell it as a benefit to the client who might get a refund check back faster, the principal beneficiary is the IRS and the public that pays the agency's bills.

It turns out that the IRS spends substantial sums of money handling each tax return and then copying the data into various databases. First, it has to physically open and sort the paper returns. Many returns are then copied or scanned. For returns that are handwritten and especially for those that are barely legible, even a sophisticated scanning operation often can do little more than take a picture of the return. To digitize part of the return, thousands of IRS employees must sit down and type in the numbers or cross-check numbers that were digitized from a scan.

Next, many returns not electronically filed will be found to contain mathematical errors and incomplete entries. So the IRS must generate millions of form letters going back to taxpayers asking them to reconcile numbers that are inconsistent or don't add up. Then the IRS must handle the responses and amended returns when they come back.

To save on costs, the IRS does not usually copy and digitize everything on the return submitted by the taxpayer. If the IRS later wants to audit a return, then the auditor often can't run all the computer checks needed unless the extra data are also entered in another process. The auditor also has to check for IRS transcription errors.

Data from returns are also copied and digitized for various research purposes. For instance, an examination group might want to measure the effectiveness of its processes and of the returns it picks to examine. It must then have access to more than the limited data that was initially copied and digitized from paper tax returns. Similarly, when the IRS Statistics of Income Division wants to study particular issues—say, the average holding period for capital gains or gifts of appreciated property to charity or dividend rates—it needs much more than limited data.

Because transcription errors are unavoidable, the IRS goes through internal debates about how much to spend on checking and rechecking data. Quick entry with limited re-checking is cheaper but more inaccurate. When returns are required for studies and other purposes, not only will additional data be entered but also the data originally copied for such purposes as the Master File might be recopied because of its suspect accuracy.

Despite these multiple processes, much data is still "thrown away" or kept in a form that is seldom useful (such as a scanned picture or a filed paper copy). In many ways, it is a shame that so much information has been gathered, paid for (largely in terms of the cost to taxpayers filling out the forms), and then never used. Basic understanding of the economy and of the behavior of taxpayers is often foregone simply because the data are abandoned. Expensive surveys are undertaken to find out information already reported in more detail on tax returns.

Electronic filing removes so many of these costs, errors, and wastes. The data don't need to be copied. By their very nature, electronically filed returns contain digitized data for every item filled out on the return. Since almost all electronically prepared returns use software packages, arithmetical errors are largely eliminated. There is little need to send the taxpayers letters asking them to correct errors.

Those working on research or statistical studies also have access to complete information without worrying about recopying the return or deciding how to handle internal inconsistencies liable to be picked up in the software packages that prepare returns for electronic filing.

The electronic filer saves the IRS money. In fact, the electronic filer may make money for IRS, since a freed-up dollar devoted to examination or audit is liable to bring back more than a dollar in taxes owed to the Treasury. Therefore, it makes sense to pay the taxpayer for that service.

Paying a modest fee for electronic filing can be considered equitable as well as efficient. Suppose there are two taxpayers with the same income and lifestyle. Suppose one taxpayer files electronically and the other does not. The latter effectively pays a lower net tax because of the extra costs it takes to handle his return.

Now one way to try to create parity between the two taxpayers would be to assess more penalties against the second taxpayer when he makes an error, or to audit him more frequently. The alternative is to try to reward the behavior of the taxpayer whose return is easier to process.

If we are going to offer a tax cut this year or next, the money may as well be spent effectively. Paying taxpayers who file electronically meets that criterion because it enhances the efficiency of the IRS while modestly increasing equity among taxpayers. Not a bad deal.

Other Publications by the Authors

- C. Eugene Steuerle

WASHINGTON â€“ Most taxpayers can prepare and file their taxes cost-free this season with an online initiative the Bush administration announced Thursday. "Simply paying taxes is burden enough without the extra costs in time and professional help that too many Americans have endured until now," said Mitchell Daniels Jr., the White House's budget chief.Â People wanting to file electronically can do so if they owe taxes and pay later. Taxes can be paid electronically by authorizing funds withdrawal from a checking or savings account or credit card, or taxpayers can mail a check to the IRS by April 15.