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Who Should Bear Tax Compliance Costs?

Joseph Bankman*

Regulation is expensive. The federal income tax comprises one of the most extensive forms of government regulation, and one of the most expensive. Much of this expense is recognized in the form of reduced work effort or saving. Economic models that evaluate fundamental tax reform proposals often focus exclusively on these two forms of tax-induced changes in behavior, ignoring compliance compliance costs.[1] These costs, however, are quite significant. They include the time spent filing one's tax return and maintaining records related to that filing; the time spent learning and negotiating the rules when engaged in various forms of tax planning; and the amounts paid to third parties, such as accountants, lawyers, financial planners or software providers, to that same end. They also include the costs the government incurs to promulgate and enforce the law.

Estimates of compliance costs imposed on both individuals and business entities range between 10% to 25% of revenue raised, or from about $100 billion to $250 billion a year. Estimates of compliance costs associated with only the individual income tax range between about 10% and below 20% of revenue raised.[2] These estimates measure only the costs associated

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* Ralph M. Parsons Professor of Law and Business, Stanford Law School

[1] See, e.g., David Alteg, et. al., Similating Fundamental Tax Reform in the U.S., available at http://emlab.berkeley.edu/users/auerbach

[2]There is no widespread agreement on how to define or measure tax compliance costs. Virtually all estimates are based on a few dated data sets. In 1983, Slemrod and Sorum sent questionnaires to 2,000 Minnesota taxpayers; respondents were asked to estimate the time spent on their 1982 tax returns; a similar survey was conducted by Blumenthal and Slemrod in 1990, asking taxpayers to estimate time spent on their 1989 tax returns. Slemrod, J. & Sorum, N., the Compliance Cost of the U.S. Individual Income Tax System, 37 Nat. Tax J. 461 (1984);

with filing of the most recent tax return. The estimates do not attempt to put a cost figure on the anxiety many taxpayers feel when filing their return. Compliance costs substantially reduce the social gains from taxation; in some areas, these costs may outweigh those gains altogether.

This paper examines the question "Who should bear tax compliance costs?" The question is important for a number of reasons. First, many voters believe that those responsible for the tax law do not accurately reflect constituent needs, and that as a result the government does not adequately take taxpayer compliance costs into account when designing tax rules. If this belief is correct, then internalization of compliance costs might lead to more optimal tax rules. If this belief is incorrect, internalization of compliance costs might still be optimal, as a way to reduce political constraints placed upon the tax authorities by those unhappy voters.

Blumenthal, M. & Slemrod, J, The Compliance Cost of the U.S. Individual Tax System: A Second Look After Tax Reform, 45 Nat. Tax J. 185 (1992); see also, Slemrod, J. & Blementhal, M., The Income Tax Compliance Cost of Big Business, 24 Public Finance Quarterly 441 (1996). The IRS commissioned Arthur D. Little, Inc. to conduct a somewhat larger survey that asked taxpayers to estimate the time spent on their 1983 tax returns. Arthur D. Little, Inc., Development of Methodology for Estimating the Taxpayer Paperwork Burden (1988). Both sets of surveys suffer from the problem, inherent in the methodology, that taxpayers may not accurately estimate time spent on their return. It is unclear how taxpayers categorized – or were expected to categorize – time spent on issues that related in part to taxes and in part to investments, or that related to taxes but were not tied to preparing a return (e.g., time spent learning about an IRA or company pension plan). Some of the surveys suffer from a low response rate. Estimates based on the Arthur D. Little survey put total compliance costs between 20% and 30% of the tax raised. See, Hall, R & Rabushka, A., The Flat Tax (2nd ed. 1995); Payne, J., Costly Returns (1993); Arthur P. Hall, Testimony Before the House Ways and Means Committee (March 20, 1996); Estimates based on the Slemrod/Sorum and Blumenthal/Slemrod surveys or (in at least one case) on a combination of all surveys place compliance costs closer to 10% of the tax raised. See Slemrod & Sorum, & Blumenthal & Slemrod, above. See also Willam G. Gale, Tax Simplification: Issues and Options (Brookings Institution, July 17, 2001). Differences in the estimates can be traced, among other items, to the different numbers produced by the different surveys, different methods of adjusting the 1980's responses to the current tax law, and different values placed upon the taxpayers' time (Slemrod & Sorum, Blumenthal & Slemrod and Gale value time at after-tax wage rate, others value taxpayers' time at the before-tax wage rate or weighted labor cost of IRS and large accounting firms). These differences produce somewhat different estimates of individual compliance costs and much different estimates of business compliance costs. Most estimates of the cost of individual tax compliance range from about 10% to 15% of the revenue raised. See also, Tax Administration: IRS is Working on Its Estimates of Compliance Burden, GAO (May, 2000).

Second, some compliance costs fall disproportionally upon a small group of taxpayers. A rule that shifted these costs to the government might comport with some notions of fairness. Third, and more generally, many compliance costs are variable, and it may be efficient to require those costs be borne by one party or another. Finally, compliance costs reduce the social value of regulation in fields other than tax, and it may be possible to extend the analysis here to those other fields.

Part I introduces the subject and analysis with an example that provides probably the strongest case for government reimbursement of compliance costs: taxpayer compliance management program ("TCMP") audits. The IRS has historically relied upon so-called TCMP audits to provide a statistically accurate portrait of taxpayer behavior. The benefits of these audits far outweigh costs. However, the costs are borne almost exclusively by the taxpayers randomly chosen for TCMP audit. The concentration of costs is thought unfair and/or politically unsustainable and for that reason the program was discontinued after the 1988 tax year. A generous reimbursement system – based on average or expected costs – might resolve the fairness and political issues that have dogged that program.

Part II sets forth a preliminary analytical framework with which to view compliance costs. Part II.A. examines the special case in which voter preferences are flawlessly translated into law and procedure. There are still compliance costs; however, it can be shown that will generally be undesirable for the government to absorb these costs. Part II.B. assumes that compliance costs are not adequately weighted in the legislative process; but that costs would receive greater weight if they were treated as a separate budget item. The implications of these assumptions are complex. A straightforward reimbursement program would increase the government's incentive to manage costs but reduce taxpayer's incentive to manage costs. The offsetting effects are similar to that present with strict liability/no liability schemes in tort. A more efficient rule would decouple the budget cost and payments from actual out-of-pocket expenditures. At the administrative level, Part II.B. assumes that the electorate and/or Congress wrongly believes that

the IRS does not adequately weigh taxpayer compliance costs when setting policy and so sets undesirable constraints on agency behavior. Here, it may be efficient for the IRS to establish a policy of internalizing compliance costs as a way of removing those constraints.

Part III uses this analytic framework to analyze two significant forms of taxpayer compliance costs: the costs of "garden-variety" audits and the costs of filing individual tax returns.

I. Internalization of Taxpayer Compliance Costs: An Example

It might be useful to start discussion of compliance cost internalization with an example. Perhaps the best example for these purposes are the costs incurred under the former Taxpayer Compliance Management Program, or TCMP, audits. The TCMP audits were designed to provide estimates of taxable income and expense, and of compliance rates. The audits were, and still are, used to provide data on the basis of which the IRS selects other returns for (non-randomized) audit. The data provided by the audits was, and still is, of enormous value in setting tax policy[3]. Unfortunately, the audits were extremely burdensome on those unlucky enough to be selected for audit, as the audits required verification of many items of the tax return. There does not appear to be any precise calculation of TMPC costs borne by taxpayers.[4] However, anecdotal accounts, some of them in published form, suggest that the audit process required as much as 40

[3] A summary and description of the benefits of the program can be found in Tax Administration: IRS' Efforts to Measure Tax Compliance Can be Improved, GAO (April, 1993)["GAO 1993 Compliance"]. See also Tax Administration: Information on the Taxpayer Compliance Management Program, GAO (October 6, 1995)

[4] The IRS estimated that in the audit for the 1988 tax year (the last year of the program) it had incurred direct costs of $83 million, most of which represented labor costs of staff. GAO 1993 Compliance. The burden on individuals was described as follows: "Concern about individuals usually refers to the effort required to respond to up to 367 questions on the [auditor's] worksheet. [O]n average, taxpayers had to respond to less than 35 of these questions... And the requested information generally could be retrieved without much burden if taxpayers maintained their tax records as required." GAO 1993 Compliance at 10.

hours of taxpayer time.[5] Taxpayer complaints about the process led to the abolition of TCMP audits after the 1988 tax year. The government has not had a statistically accurate portrait of taxpayer compliance since that time. A scaled-down (and presumably less accurate) version of the program is scheduled to come back into service in 2003[6].

Taxpayer compliance costs are, of course, real costs and as an abstract matter it is possible that the costs exceeded value. In fact, the program required only about 50,000 audits and would be justified under any realistic cost-benefit analysis[7]. The problem was that the program unfairly concentrated costs on a small handful of taxpayers, who were randomly chosen to perform a subsidized public service for other taxpayers.

Some idea of the benefits of the program, and the advantages of a cost internalization mechanism, can be gleaned by imagining a revised TCMP audit program that reimbursed taxpayers for compliance costs. Here, that would include the imputed value of the taxpayer's time plus any adviser fees. An estimate of $2,000 costs per audit, in taxpayer time and advisor fees, is probably generous[8]. Payment of $3,000 per audit would overcompensate almost all taxpayers[9]. Total pre-tax costs at this higher figure would come to $150 million a year, or less than three one-hundreds of one percent of the amount of annual federal income tax collected from individuals. If this sum were (like any other receipt) subject to tax, both the after-tax cost to the government and after-tax return to the taxpayer would fall.

One difficulty of any reimbursement system, is, of course, the cost of determining the

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[6] [Provide information on National Research Program]

[7] See GAO 1993 Compliance, supra note 3.

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[9] This would be equivalent to a per hour rate of $75 if we assume that each audit requires 40 hours of taxpayer time. Slemrod puts the after-tax value of a taxpayer's own time at $15 an hour (in 1995 dollars); other scholars have measured taxpayer time at a before-tax rate of approximately $50 (again in 1995 dollars).

amount of reimbursement. A second difficulty is that reimbursement of audits itself could raise the costs of audits. Here, one can imagine both difficulties presenting themselves: if the IRS announces it will assume the costs of audit those costs will go up as taxpayers will hire advisers; and taxpayers have an incentive to overestimate the value of their time, to misallocate advisers time to audit and so on. These problems are compounded by a related political/fairness problem: costs undoubtedly rise with income, and the reimbursement program might be attacked as subsidizing well-heeled taxpayers.

These difficulties could be reduced by eliminating the revenue function of the TCMP audits[10]. Taxpayers would still find the verification requirement burdensome, but would not have any motive to defend their return. Taxpayers would spend less on audit. Taxpayers would also no longer have any incentive to hide tax liability. On the other hand, taxpayers would not have any incentive to provide necessary information to support legitimate deductions. Whether the net result would be a more or less accurate measure of tax liability is uncertain.

The difficulties described above could be eliminated, without dropping the revenue function of the audits, but at the expense of some inaccuracy, by using a standard fixed cost per audit. If compliance costs were generously estimated, as above, the reimbursement rate would overcompensate all taxpayers except for those with the most complex returns and/or the highest imputed value of time. The fixed payment plan would ensure internalization of costs as well as a more straightforward reimbursement plan. This approach would decouple the payment from the taxpayer's actual expenditure, and remove any incentive to increase that expenditure. Most importantly, it would eliminate the related political and fairness concerns that plagued the program.

II A Preliminary Analytic Framework

[10] A variant of this idea is suggested in GAO 1993 Tax Compliance at 10.

Compliance costs are high, and there is no meaningful effort to ensure internalization of those costs. It might at first seem that compliance costs would always be too high, and that any system of cost internalization would reduce those costs. In fact, the problem is not necessarily that the costs are too high; it is that marginal costs are not equilibrated with marginal benefits; and that sometimes the two seem much farther apart than required by considerations of measurement or politics. In some cases, the present system produces too few compliance costs. The operative mechanism here is a political one, as second-best constraints are placed upon government policymakers. We have seen an example of that immediately above, in connection with the TCMP audits. Clearly, what is required is an analytic framework with which to evaluate compliance costs. That framework must be robust enough to incorporate varying assumptions about the political process. What follows is a preliminary stab at that framework.

A. Compliance costs under the ideal legislature, executive and administrative agency

Consider, first, the appropriate treatment of tax compliance costs in the special (and obviously unrealistic) case in which voter preferences are accurately translated into law; the law is administered in a manner than reflects voter preferences; and voters know that the law and procedure reflects their preferences. One such preference is to adequately weight compliance costs in evaluating the desirability of a particular rule or procedure. The tax law is not perfect, because of constraints on information and because it is built on voter preferences, but the there is no systemic misfunction in the translation of preferences into law. In these circumstances, it will usually be undesirable for the government to reimburse taxpayers for any significant portion of compliance costs. The primary reason for this is that compliance costs are real costs that vary among taxpayers, and therefore, from a welfarist perspective, should be borne by taxpayers in order to accurately reflect their differential costs of production. Consider, for example, a tax subsidy, or credit, for low income housing[11]. Assume here that the credit is well designed to

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produce the right amount of housing and to minimize compliance costs. It cannot and does not reduce compliance costs to zero, however. Taxpayers wishing to take advantage of the subsidy must understand the tax provision, including the definition of terms such as low income, and the amount and usability of the tax credit; understand and comply with various recordkeeping requirements, and so on. A sophisticated home builder may find these costs low, and be able to amortize these costs over many units. The costs will be higher for other taxpayers. The key point is that these costs are analytically identical to any other costs that go into the production of low income housing. It will be no more efficient for the government to absorb compliance costs than it will be for the government to absorb the costs of labor. Absorbing a specific cost that goes into production will introduce inefficiency in production. The government will always be better off subsidizing the product it wants (here, low income housing) than a factor that goes into producing that product.

In addition, a reimbursement system will itself impose costs. The system will have its own filing requirements and penalties; and reimbursement will lead efficient and inefficient producers to increase the amounts spent on legal fees and the like. But reimbursement will be undesirable even if for any given taxpayer, compliance costs are fixed and so will not increase under a reimbursement regime, and there are no transaction costs associated with reimbursement, as long as these costs vary among taxpayers.

Consider now a more typical case. An individual is considering whether to use a portion of her salary to fund a business venture or to spend on a consumption good. An income tax discourages the business investment by levying a tax on the return, and imposing certain compliance costs associated with that tax. It may seem that it would be desirable to absorb those compliance costs and thus reduce the disincentive to invest. But the compliance costs are merely one of the many costs associated with the business venture. It will be no more efficient to reimburse taxpayers for these costs than any other investment costs. From a welfarist perspective, a reduction in tax on investment return will dominate reimbursement of any other

investment cost, including compliance. The former will directly reduce the welfare loss from tax; the latter will introduce inefficiencies in investment, by subsidizing high-compliance-cost investments and investors.

The foregoing assumes that supplying low income housing, and investment in general, are activities that society wishes to encourage. If it is nonetheless undesirable to reimburse taxpayers for compliance costs associated with these activities, a fortiori it will be undesirable to for the government to reimburse compliance costs with respect to other activities. For example, it can be shown that it will be inefficient to reimburse compliance costs association with garden-variety tax-planning (e.g., costs incurred to structure a tax-favored compensation package). The same is true with costs associated with aggressive tax planning, with tax evasion, and so on.

These results should not be surprising. The primary purpose of a cost-internalization or reimbursement program is to force government to equilibrate costs and benefits of compliance. We are assuming here that the government is already doing that.

The conclusion that compliance costs initially borne by taxpayers should rest with taxpayers is subject to two important qualifications. First, compliance costs include all costs of locating and understand relevant rules. It is probably efficient for the government to absorb directly a portion of these costs, particularly with respect to the most basic rules. For example, it will be more efficient for the government to mail basic forms and instructions to each taxpayer than for each taxpayer to find the forms on his or her own. In theory, it is possible that it would be efficient for the government to go far beyond providing that basic level of information, and absorb much higher compliance costs. Suppose, for example, taxpayers found it so difficult to understand the law that they did not respond to a particular tax subsidy; and that increasing the subsidy would fail to evoke taxpayer response due to the same lack of knowledge. It might then be efficient to reimburse the taxpayer for the cost of an adviser. Reimbursement might be a solution to the problems posed by high information costs. In practice, the presence of a strong competitive market in tax planning and filing services (ranging from large accounting and law

firms to tax preparation firms such as H&R Block) probably makes more expansive forms of reimbursement unnecessary – at least as a means of compensating for informational problems. The tax planning and preparation sector will inform taxpayers of particular programs, and will be at least as good as the IRS at communicating specialized information to taxpayers.

Second, many of the inefficiencies of reimbursement can be limited by pegging reimbursement to average or expected costs, and decoupling the reimbursement from actual costs. Examples of this approach are found in Parts I and III of this paper. But the fact remains that there is no upside to transferring compliance costs borne by taxpayers to the government, since the government is already assumed to correctly equilibrate costs and benefits.

A taxpayer directly bears only part of compliance costs associated with his or her return or planning; the remaining costs are borne by the government (and then of course by taxpayers in general). If it is efficient to leave direct compliance costs with the taxpayer, what about costs incurred by the government? Should a taxpayer who qualifies for the low-income housing credit absorb the government's cost of processing that claim? The answer to this question will usually be no, because the government faces a declining marginal cost curve. Adoption of a new rule requires considerable up-front costs; a new regulation may require years of person-effort; still more effort must be expended to educate staff as to those rules and develop internal procedure with which to implement those rules. The marginal cost associated with taxpayer use of any particular program will generally be low. In addition, as noted above, reimbursement programs are in themselves costly.

B. Compliance Costs in a Non-Ideal World

The assumption that government perfectly translates voter preferences into operating rules is unrealistic. Unfortunately, the dynamics by which preferences are mistranslated or

intentionally disregarded is enormously complex.[12] The tax law is the joint product of thousands of individuals and a number of institutions. The law is formulated in Treasury and (to a lesser extent) in the Ways and Means, Finance and Joint Tax Committees; enacted by Congress; signed into law by the President, and administered by the IRS. The motivating desires of any one of these institutions (or of any subunit or individuals within any institution) is to some extent unknowable. Each institution (or subunit or individual) might respond differently to a particular set of controls and some of those responses may be undesirable.[13]

Consider, for heuristic purposes, one particular set of assumptions. Excessive taxpayer compliance costs are primarily a product of the tax law rather than tax administration; Congress and the Executive branch do not correctly weight compliance costs when enacting law; and a rule that required internalization of costs (for example, as a budget item subject to a constraint) would focus attention on those costs.[14] The IRS is thought to (but in fact may not) underweight compliance costs.

Consider first, the special situation in which compliance costs are solely a function of government-adopted rules and procedures. All else equal, it will be efficient for the costs to be borne solely by the government; the internalization of costs will act as a constraint against the

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[12] A standard reference from a rational choice perspective is D. Mueller, Public Choice II, (1989); see also K Shepsle & M Bonchek, Analyzing Politics (1997).

[13] For example, a reimbursement program would increase the size and budget of the IRS; this might be regarded as a positive by some within the agency. Certainly, it would be regarded positively by those whose jobs were dependent upon the program. A reimbursement program might also reduce antipathy with which IRS personnel are sometimes regarded on and off the job. All else equal, the incentive within the agency to reduce complexity might fall. Of course, other effects would push in the opposite direction (e.g., Congress might pressure the IRS to reduce complexity and so reduce costs).

[14] The assumption that (under certain conditions) government officials underweight indirect costs of regulation, and that direct internalization of those costs by the government would affect government behavior, is common in the law and economics literature. See, e.g., Posner, Rubinfeld, Cooter. These assumptions are consistent with a prominent strand of public choice theory. ___ But c.f. note __ supra (internalization within the legislature does not translate into internalization to individual legislator.)

promulgation of inefficient rules and procedures. Of course, measured against the efficiencies entailed in internalization of compliance costs must be the inefficiencies in any cost reimbursement system.

Consider, now, a more realistic case in which compliance costs are variable at both the government and taxpayer level. The government has a choice of tax rules that vary in costs externalized to taxpayers, and taxpayers will vary in their response to each rule. If the only policy instrument is one in which one party compensates another, then the optimal rule is one that weights one set of inefficiencies against another. A rule that reimburses taxpayers for compliance costs will avoid the externalization of costs by the government to taxpayers but lead to externalization of taxpayer costs to the government. The government will have an incentive to minimize costs within its control. If it enacts a high compliance cost statute, it must pay for that cost, and so take politically unpopular actions such as raising rates, reducing programs, or increasing the deficit. However, taxpayers will have no incentive to minimize their costs. Tax planning becomes a costless resource to them since the cost is reimbursed. The same result obtains, in the opposite direction, for a rule that leaves all costs on the taxpayers. The problem of warring incentive considerations is structurally identical to the problems presented by government takings[15] and legal transitions[16], and in the private sphere by strict liability in tort, or mandatory warranty in contract[17]. Leaving the liability with a manufacturer correctly leaves the manufacturer with an incentive to minimize costs within its control, but does not give the correct incentives to the purchasers or users of the manufactured product. The problem is that at the

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[15] See Richard A. Posner, Economic Analysis of Law: Fifth edition (1998) at 64; Robert Cooter, Unity in Tort, Contract and Property, The Model of Precaution, 73 Cal. L. Rev. 1 (1985) at 9-11; Lawrence Blume & Daniel Rubinfeld, Compensation for Takings: An Economic Analysis, 72 Cal L. Rev. 569 (1984); Daryl J. Levinson, Making Government Pay: Markets, Politics, and the Allocation of Constitutional Costs, 67 U. Chicago L. Rev. 345 (2000).

[16] See B. Fried, Ex Ante Ex Post, _____.

[17] See, generally, Robert Cooter, Unity in Tort, Contract, and Property: The Model of Precaution, 73 Cal. L. Rev. 1 (1985).

margin the costs are the responsibility for each party[18]. One solution is to drop all-or-nothing liability schemes (e.g., strict liability or no liability) in favor of a fault standard that correctly assigns responsibility; another solution is to decouple the payments by one party from the amounts received by another party. [19] As discussed in Parts I and III, that approach here might entail internalization without dollar-for-dollar reimbursement or internalization without any reimbursement..

Consider, finally, the treatment of agency-related compliance costs. Voters believe that the agency systemically underweights costs; to counteract that tendency, voters place constraints on government rules or procedures. These constraints are best seen as second-best approaches to internalization of compliance costs; they are inferior to true cost internalization even if the underlying assumption that the agency ignores taxpayer compliance costs is correct. The constraints are, of course, still more inefficient if that assumption is incorrect. In the latter case, it may be desirable for the government to volunteer to absorb taxpayer compliance costs. The situation is similar to that faced by a developer whose project imposes negative externalities such as traffic congestion and is therefore denied a building permit. If the project has a high expected value, it will be sensible for the developer to offer to pay for or take action to eliminate the externalities (e.g., provide funds to construct new parking, expand roads). The voluntary internalization of these costs is intended to remove political constraints on a high value project.

IV. Treatment of Specific Compliance Costs

Part I explored how a reimbursement/internalization program might work with one specific compliance cost: the cost of TMPC audits. Section IV.A. discusses a more difficult issue: whether an internalization/reimbursement program might be adopted for "garden variety"

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[18] See Id ("double responsibility for costs at the margin.")

[19] See L. Blume & D Rubinfeld, supra note 10 at _____.

audits. Section IV.B. discusses a still more difficult issue: whether it would be feasible or desirable for the government to absorb any portion of taxpayer filing costs.

A. Audits

The percentage of returns audited has fallen dramatically in the past few decades; the IRS now lists the audit rate at about 2/3 of 1%[20]. Most of these audits consist only of letters sent to taxpayers asking for a single piece of information. Only about 1/5 of 1% of returns generate an audit that requires person-to-person contact[21]. Most of these audits require only a few hours of taxpayer and/or taxpayer advisor time[22]. Greater use of third-party reporting has lessened the need for in-person audits. Still, most tax scholars believe the current audit rate is too low.[23] The low rate deprives the government of revenue directly received from audit and, more significantly, reduces the general deterrence function of audits. The unwillingness of Congress to provide resources needed to increase the audit rate is usually attributed to the belief that audits are unduly burdensome and anxiety-provoking even for honest taxpayers[24].

A fixed payment set at a generous rate of something like $150 an hour for in-person audits would overcompensate almost all taxpayers for their own time[25]. Many (if not most) taxpayers will hire an adviser to represent them at the audit; for most taxpayers, that hourly rate will be sufficient to cover at least some (and perhaps all) of the cost of that adviser. The number

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[20] See _____. Audit rates are scheduled to increase slightly in 2003. See _____.

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[22] _____ [Current source: extrapolation of IRS data on audit labor costs; anecdotal information, consistent with data, on accountant time spent on in-person audits]

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[25] The imputed value of taxpayer time used to calculate filing costs is discussed in note ___, supra. The value of taxpayer time in audit is no doubt much higher, since the audit rate increases with income, and wage rates also increase with income.

of hours, and therefore the amount of reimbursement, could be estimated by the IRS in advance. To avoid perceived fairness and/or political problems, the number of hours could be capped at a figure high enough to encompass almost all audits but below that required for audits of the wealthiest and/or most complicated returns. Taxpayers would receive payment for their estimated rather than actual time and would therefore have no incentive to increase resources devoted to audit. The pre-tax cost of this program would appear to be relatively low – in the same range as the cost of the TCMP reimbursement program and a negligible fraction of the tax revenue.[26] Of course, if the program succeeded in its goal and so eliminated a undesirable constraint on audit rate, the program would increase net revenue. The program would compensate taxpayers for the compliance burden of audits and, in so doing, reassure legislators and voters that the IRS was adequately weighing those burdens when setting audit policy.

One drawback to this program is that general audits are not selected randomly. Instead, audits are selected on the basis of expected yield; expected yield is in turn based on a regression done on other audits, such as the TCMP audits. To the extent that the regression is accurate, those selected are those most likely to underreport. It might seen inapposite to reimburse compliance costs for those who seem likely to, and in fact do, cheat on their taxes. Moreover, to the extent that the taxpayer compliance burden operates as a penalty, a system that removes this burden (and in fact overcompensates for compliance costs) might reduce tax compliance.

On the other hand, it seems unfair and undesirable to use audit compliance costs as a penalty, since these costs are faced by all taxpayers selected for audit. One way to avoid this result, and address the concerns stated above, is to limit reimbursement to those taxpayers who

[26] If we assume each in-person individual audit requires three to four hours of an accountant's time, and that the number of audits is held constant, the pre-tax cost would be about $300 million. This cost would be further reduced by taxing the portion of audit reimbursements not spent on preparers, and by limiting reimbursement to those taxpayers without significant adjustments (see text infra). On the other hand, if the program worked as intended, the result would be fewer political constraints on audit, more audits and higher costs. [IRS for data]

emerge from audit with relatively few adjustments, or perhaps to establish a sliding scale of reimbursement, with full reimbursement limited to those who emerge from audit with no adjustments. To avoid the complaint that the new regime would increase the IRS' incentive to find adjustments, the IRS could commit in advance to making a set amount of audit compliance payments. Limiting payments to those with few adjustments would have the same economic effect as providing (on an ex ante basis) complete reimbursement for compliance costs but increasing the penalty on those who are found to significantly understate income. Since the existing compliance burden acts as an unfairly levied de facto penalty, this should not be undesirable as a matter of tax policy. No portion of this de facto penalty should apply to taxpayers who do not understate income. The desired result can be achieved directly, through complete (ex ante) reimbursement and a higher penalty, or through a reimbursement program that leaves compliance costs as a penalty in proportion (under a sliding scale) to understatement of taxable income. A limitation on payout would reduce the cost of the program. The limitation would also reduce (but not eliminate) one perverse incentive created by the program: to deliberately misstate income to trigger audit and reap the high per hour audit reimbursement rate.[27] However, any phase-out of the reimbursement rate would give taxpayers an incentive to increase resources spent on audit and avoid any assessment of tax due and therefore gain full reimbursement of cost.[28]

IV.B. Filing Costs

Filing costs differ in almost every respect from audit compliance costs. Audit compliance costs are quite low. Audit policy is in the first instance set by the IRS. There is in fact no

[27] Query how many people would willingly provoke an audit for a few hundred dollars....

[28] The same incentive would be created by leaving reimbursement intact and raising the penalty level. Using compliance costs as a disguised penalty may be unfair and lead to political constraints on audit policy, but it has has the advantage of minimizing compliance costs

indication that audit costs are underweighted by that agency. However, by any reasonable welfarism measure, audit costs are currently overweighted by Congress, and the result is a set of socially undesirable constraints on the audit rate. It would be relatively inexpensive to remove that constraint. Correct weighting of these costs would produce more audits, higher compliance rates, and (due to the increase in audits) higher costs associated with compliance. In contrast, filing costs are enormous. These costs are primarily attributable to the complexity of the tax law enacted by the legislative and executive branch. The goal here would be to ensure that those branches are not underweighting compliance costs when enacting tax legislation. Unfortunately it is difficult to measure the costs of marginal changes to the tax law and for that reason would be difficult to force those branches to internalize the effects of those changes. (In contrast, it is much easier to measure the marginal costs of audits and to adopt an internalization/compensation system for those costs). In addition, filing costs vary widely among taxpayers, and the magnitude of these costs precludes adopting a reimbursement system that elides fairness and measurement issues by overcompensating the average taxpayer.

It might nonetheless be useful (at least as a heuristic) to consider the following reform. Suppose the IRS absorbed filing costs for taxpayers with relatively simple returns, and gave an equivalent amount of compensation to taxpayers with more complex returns. The government might set the project out to bid with companies such as H&R Block, and pay 100% of the costs of filing from the preferred provider. The government might alternatively pay a high percentage of the first few hundred dollars of cost for the preferred providers and a lesser percentage of costs for other providers. At the expense of complexity, these reforms could be tied to a cash-out option: the government would establish a maximum amount of reimbursable filing costs; directly absorb varying percentages of that cost (depending on the provider) and the taxpayer would receive some percentage of any remainder.

One portion of one leg of this program now exists. The IRS, together with a consortium

of tax software providers, offers free web-based filing for taxpayers with very simple returns[29].

This reform would be far from perfect. The link between any particular rule or procedure adopted and the negotiated price for preferred providers would be attenuated. The market for providers might be dominated at first by one or two organizations and the bidding process might be flawed. The process would produce only one price per year, and that for the cost of filing for only some subset of the taxpaying population. A signification portion of filing costs are comprised of record-keeping costs, and these costs would not be covered by the reform. The payment would require higher marginal tax rates; the combination of the lump-sum payment to most taxpayers and the higher rates would produce some welfare loss from reduced work effort and savings (this is a problem with the audit payments as well, thought the amounts in that case are too small to be significant). The payment would have at least one perverse effect: taxpayers would no longer be as angry at having to bear filing costs; as a result, there would be less pressure on the tax-writing bodies to reduce those costs. The process would, however, yield a reasonably accurate estimate of costs for an important subset of taxpayers.

Consider – this as an admittedly fanciful heuristic – tying this reform to a reform of the current (semi-effective) constraints on government spending[30]. Assume current constraints were loosened to allow deficits equal to the initial level of filing payments. A reduction in filing payment costs (due to a reduction in complexity, and reflected in lower bids by third party preparers) would, as against the loosened constraint, generate funds that could be "spent" by

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[29] See http://www.irs.gov/app/freeFile/welcome.jsp. Eligibility for free filing differs from one provider to the next. Turbo-tax, for example, offers the service to taxpayers with adjusted gross income below $27,000 or who are eligible for the Earned Income Tax Credit. http://www.irs.gov/app/freeFile/jsp/all_offers.jsp? The so-called Free File Alliance represents a compromise between the IRS and the electronic preparer community. Preparers offer on-line filing at no cost to taxpayers or the IRS; the IRS, in turn, agrees to not to compete with the consortium in providing on-line tax preparation and filing services. See Free File Tax Agreement, Id. The free filing program thus represents what the government, using the threat of competition, is able to get at no cost.

[30]

Congress in the form of lower taxes or increased programs. The deadweight loss created by the combination of internalization and reimbursement could be reduced by reducing the percentage of total costs actually reimbursed, but giving Congress the benefit of the total reduction in costs.[31] One suspects that the net result would be to make both branches more receptive to simplifying reforms.[32]

[31] Thus, for example, the government might absorb half of the first few hundred dollars of filing costs with a preferred provider; the constraint on government spending would initially be reduced by the actual amount of reimbursement. However, the constraint would be loosened by the full amount of the reduction in total costs, not just the reimbursed costs. One drawback to this solution is that it would no longer be deficit-neutral.

[32] A common-sense intuition, consistent with the brief discussion of somewhat analogous problems in the law-and-economics literature, is that placing the costs within the legislature or executive branches would remove the systemic underweighting of the costs. Under some models of legislative behavior, however, this would not occur because the costs would not be internalized at the level of the relevant political actor, the legislator. For example, in the pork barrel model set forth by Weingast and others, legislators are rewarded for bringing home the bacon to constituents but not much penalized for the costs of the bacon, which is largely externalized to some other legislator's constituents. Weingast posits a Nash equilibrium that is socially suboptimal. The Weingast model can be extended to this issue by treating tax complexities as bacon for a particular legislator's constituency; the compliance costs would be just another cost externalized to other constituencies. Even in this model, however, internalization of compliance costs would be beneficial because it would increase the costs of this form of pork barrel project against others. See Barry R. Weingast, Kenneth A. Shepsle & Christopher Johnsen, The Political Economy of Benefits and Costs: A Neoclassic Approach to Distributive Politics, 89 J Pol Econ 642.