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Real-World Tax Screening

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http://tax.jotwell.com/real-world-tax-screening/

Emily Satterthwaite, *Tax Elections as Screens*, **Queen's L. J.** (forthcoming 2016), available at SSRN.

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The concept of "screening" taxpayers is theoretically appealing. According to optimal tax theory, our tax system should impose tax liability based on ability, which is a characteristic that reflects relative well-being. However, since ability cannot be directly observed, the tax system has to rely largely on income, a presumed surrogate of ability, as a tax base. The problem is that income is easily manipulable, making the tax system an inefficient tax on ability. Screening is a potential, partial solution to this problem. Screening involves relying on other characteristics that are more revelatory of ability. For instance, as it turns out, height is surprisingly strongly correlated with earning ability. However, as theoretically appealing as screening may be, the discussion of it is generally politically unrealistic enough, or sufficiently divorced from the realities of the actual tax system, to make it a largely academic exercise.

In *Tax Elections as Screens*, Emily Satterthwaite gets beyond the theoretical possibilities of screening taxpayers. She does so by examining how an existing tax election—the election to itemize deductions—can serve as a screening mechanism. By examining how screening may work in our actual tax system, Satterthwaite offers an important contribution that has few companions in what is a largely theoretical field.

Satterthwaite begins by offering a simple model of the potential value of tax elections. She then goes on to illustrate what practical information the election to itemize may offer the government. She marshals evidence from an empirical study that, for taxpayers with income below $58,000, a taxpayer's cost of itemizing cannot be inferred from observable characteristics on the taxpayer's return (such as gross income). As a result, Satterthwaite posits that the election to itemize may reveal otherwise unobservable information about this income group.

Specifically, Satterthwaite posits that the election to itemize can reveal information about earning ability, how responsive a taxpayer is to taxation, and a taxpayer's compliance posture. She then makes suggestions about how each of these various possibilities might shape tax policy. First, a taxpayer who is more conscientious is likely to have higher earning ability, and is also likely to face lower costs to engage in all of the tasks required to itemize (such as collecting, saving, and using deduction records). Satterthwaite suggests that the government may use this information to target various forms of assistance to non-itemizers, who are more likely to need it. Alternatively, a taxpayer may be more likely to itemize because the taxpayer is more responsive to incentives that reduce taxation, a quality that means the taxpayer is correspondingly likely to be more tax-elastic on other dimensions (for example, being more likely to change labor, savings, and other behavior in order to reduce tax liability). Satterthwaite suggests the government may therefore want to target higher marginal tax rates to non-itemizers, based on their low elasticity. As a final possibility, taxpayers who are more likely to itemize may also be more likely to take other steps (including aggressive tax reporting positions) to reduce tax liability. The government may therefore want to target more enforcement and auditing resources toward itemizers.

However, as Satterthwaite acknowledges, the analysis of exactly what the government should do in response to a taxpayer's decision to itemize is quite complex. A taxpayer may be itemizing for any or all of the three reasons she posits (i.e., because the taxpayer is more conscientious, has lower tax-elasticity, or has a more aggressive compliance posture). What the government should do depends on the taxpayer's dominant motive. For instance, if the taxpayer is itemizing because the taxpayer is more conscientious, the government would theoretically want to impose a higher rate of taxation (or the equivalent through higher auditing or the like) in response to the taxpayer's higher ability. However, if the taxpayer is itemizing because the taxpayer is more tax elastic, this would be the exact wrong result. Ferretting out why the taxpayer is itemizing, all else being equal, would be difficult. Indeed, knowing whether a taxpayer is itemizing because the taxpayer has lower costs from itemizing, or just has more deductions, would itself be a difficult task. As Satterthwaite also acknowledges, determining whether it makes sense to introduce itemizing as a screen also presents other estimating difficulties, such as estimating the compliance costs of the election.

Despite these difficulties, Satterthwaite's insights are important. First, whether optimal or not, the tax code does provide an election to itemize deductions. As a result, Satterthwaite does not need to prove that introducing itemizing as a screen is welfare enhancing. Rather, she merely needs to show that, given that the election is already in place, the election can provide the government valuable information. And she succeeds in this task. Perhaps the most useful insight is Satterthwaite's suggestion that the government may use the failure to itemize (and the likely higher cost of itemizing) to target *other*assistance to the taxpayer, such as help preparing a tax return or enhanced information about government benefits that are provided through the tax code, such as the earned income tax credit. This suggestion is particularly helpful because, even without being able to determine definitively why a taxpayer failed to itemize, the government can reasonably imagine that a non-itemizing taxpayer is likely to be less well-informed or sophisticated in preparing government forms than a taxpayer who itemizes. Targeting greater assistance to the former than the latter may create welfare improvements at a low cost. Moreover, the suggestion harnesses information that can be gleaned from tax filing behavior to help improve the administration of unrelated welfare benefits that, whether rightly or wrongly, are already being provided through the tax code. This sensible, incremental improvement arises out of Satterthwaite's real-world tax policy approach. This approach, which has much to commend it, merits more scholarly attention.

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