Issue Brief

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What's Going on With Tax Refunds?

When the IRS released data on tax refunds through the first week of the 2019 tax filing season, a minor panic ensued, as the average refund was down 8.4 percent from last year. Politicians began to blame the tax reform law — the Democrat-controlled House Ways & Means committee tweeted that "refunds are plummeting this year thanks to the #GOPTaxLaw," while Senator and presidential candidate Kamala Harris (D-CA) claimed that the lower refunds were proof that the Tax Cuts and Jobs Act (TCJA) was a "middle-class tax hike."

The IRS has now released data through two weeks of the filing season, and tax refunds are still down compared to last year. So what's going on?

Higher Refunds Do Not Mean Lower Tax Liability

Before getting into the reasons behind lower tax refunds, it's important to note that while many Americans think of a tax refund as "bonus cash," that's not actually what it is. A refund is, in effect, a loan that a taxpayer provided to the federal government for months without receiving any interest. It's money from a taxpayer's paycheck that, ideally, should never have been in Uncle Sam's pockets to begin with.

Key Facts:

A larger refund isn't necessarily a good thing - it's an interest-free loan that the taxpayer provided to the government.

The important figure is tax liability, or the amount taxpayers owe in total. Thanks to the Tax Cuts and Jobs Act, that amount will go down for the vast majority of middle-class taxpayers.

But for taxpayers counting on a large refund, it's still early. Only two weeks of data are in, and the shutdown has had a significant effect on IRS operations.

It's not mere semantics — that money should have been the taxpayer's to spend, save, or invest far earlier. That's why a lower refund isn't necessarily a bad thing. In fact, the goal for policymakers should theoretically be to make refunds (and filing-day tax payments) as small as possible, because that means that withholding tables were more accurate.

What matters is overall tax *liability*. According to the Tax Foundation, middle-class families will receive a tax cut of 1.7 percent, while the Tax Policy Center estimates that 90 percent of middle-class families will receive a tax cut. In other words, that the vast majority of middle-class taxpayers will receive reduced tax liability this year as a direct result of the TCJA is in question. That's why the Washington Post gave Kamala Harris' aforementioned statement "four pinocchios" in a fact check of her claim.

That's All Well And Good, But What's Going On With Refunds?

Even knowing that early refund information is not indicative of a tax hike, it's still worth asking what caused this early drop in the size of tax refunds. In all likelihood, a combination of factors is creating a perfect storm and resulting in lower refunds.

The first factor is simple: data thus far is limited. Two weeks' worth of returns, particularly the *first* two weeks, are not representative of tax refund data on the whole. This batch of refunds may simply just be lower than average, but could even out as tax filing season goes on.

The counterpoint here would be that the average refund is down 8.7 percent compared to the *same time last year*. And it's true that the small sample size alone is not enough of an explanation.

Given this, the next consideration is indeed the TCJA, and the effect the law had on withholding tables. Technically, taxpayers were supposed to update withholding tables themselves following passage of the TCJA, but predictably most did not. A survey by H&R Block found that only about 20 percent of taxpayers actually got around to doing this. It stands to reason that many of the people who were on top of updating their withholding tables were also some of the same people who filed taxes as soon as the filing season opened — their more accurate withholding tables would mean that they had less money incorrectly withheld as the year went along, but also less of a refund. And as Ryan Ellis pointed out in the Washington Examiner, many filers that were previously trapped in the dreaded "Alternative Minimum Tax" may not have submitted their returns yet, suggesting large refunds may be coming later in the filing period.

Another related factor is the government shutdown. The shutdown had a significant effect on IRS operations, which likely has carried over to the early returns (pardon the pun) for tax refunds. Across the board, the IRS has been struggling to catch up with statistics it reached last year.

The IRS Is Struggling to Catch Up With Last Year Following the Shutdown

Category	Percent Change Compared to 2018 After One Week	Percent Change Compared to 2018 After Two Weeks
Total Returns Received	-12.4	-6.9
Total Returns Processed	-25.8	-10.2
Total Refunds	-24.3	-15.8
Total Refund $ Issued	-30.6	-23.2

The IRS has done a good job attempting to play catch up given the situation, but the shutdown has put the organization a month behind. More importantly, it has put *taxpayers* a month behind, leaving them with less support from a slammed IRS when attempting to file their tax returns. Taxpayers attempting to navigate all the changes to exemptions and deductions have run into a brick wall at the IRS — the National Taxpayer Advocate is reporting that the IRS is answering 48 percent of phone calls compared to 86 percent last year, with an average wait time of 17 minutes (compared to 4 minutes last year).

All these changes, including lower overall rates, a nearly doubled standard deduction, capped mortgage interest and state and local tax deductions, a higher exemption for the Alternative Minimum Tax and the estate tax, and a boosted child care tax credit (among other changes) add up to a set of confusing changes that have left many taxpayers needing IRS employees to help them through the process of filing their taxes. Although most taxpayers will benefit from these changes, it's entirely possible that a disproportionate share of taxpayers seeking to itemize deductions (and likely to receive a larger refund) have not been able to file yet, either waiting on IRS assistance or attempting to muddle through on their own.

The last major factor is that the Treasury Department adjusted its methods of withholding following the passage of the TCJA in an effort to reduce the bias towards overwithheld taxpayers. Generally, Treasury prefers to err on the side of overwithholding, but this can cause issues for lower-income families with less liquidity. The Government Accountability Office (GAO) estimated in July that those changes, coupled with changes to deductions and exemptions in the TCJA, would cause 3 percent of taxpayers to transition from being overwithheld to being underwithheld. Functionally, GAO still estimated that 73 percent of taxpayers would be overwithheld and only 21 percent would be underwithheld, but 3 million taxpayers owing taxes after April when they were used to receiving a check in the mail would be sufficient to drive a perceived "refund crisis."

Conclusion

Many factors are combining to result in lower tax refunds through the first couple weeks of filing season. A tax law that caused a lot of changes and a government shutdown that reduced access to resources to navigate those changes are likely pushing those with larger refunds to a later date. On top of that, an effort by the Treasury Department to shift the bias away from overwithholding could reduce returns come this time of year.

On the other hand, it's still far too early to say for certain that refunds will simply be lower this year. Morgan Stanley, for instance, is estimating that refunds will end up being 26 percent higher. Only one thing is for certain — refund sizes are a bad metric for evaluating the benefits of the tax reform law to the middle class.