



## **California's ReadyReturn Program: Fool's Gold in the Golden State**

### **NTU Issue Brief 153**

By  
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April 14, 2005

In his 2005 State of the State address, California Governor Arnold Schwarzenegger called on Members of the General Assembly to reorganize and transform state government saying, "We need a 21<sup>st</sup> Century government to match a 21<sup>st</sup> Century world."<sup>1</sup> At first glance a pilot program that allows the state's Franchise Tax Board (FTB) to complete your individual income tax return for you would seem like the epitome of 21<sup>st</sup> Century customer service. Yet, upon further reflection, the ReadyReturn project raises a number of issues that lead to the conclusion that the program is nothing but fools' gold for the taxpayers of the Golden State and a misstep on the road to government reorganization.

State Controller and FTB Chairman Steve Westly kicked off the experimental program in February by touting its simplicity: "For most people, filling out a tax return is about as fun as a trip to the dentist. With ReadyReturn, we've done the hard work for you."<sup>2</sup> The FTB selected 50,000 taxpayers to participate in the test project, based on their filing histories. The targeted individuals are single, have no dependents, do not itemize, and have only wage income from a single employer. Based on these characteristics and income withholding information provided by employers, the FTB sent completed tax returns to the taxpayers and invited them to participate in the program. Taxpayers had several options. They could accept the return as is and then file it with the FTB on paper or electronically. They could make certain corrections or adjustments and then submit the return, or they could ignore the invitation and file as they normally would.

On March 18<sup>th</sup>, the FTB reported that more than 1,800 taxpayers had participated in the program.<sup>3</sup> This represents a participation rate of just 3.6 percent. After April 15<sup>th</sup>, state officials will decide whether or not to expand the project in 2006. Since officials only provided the rather inexact, and perhaps purposefully vague, goal of easing the pain associated with filing a return, it will be difficult to evaluate the true effectiveness of the ReadyReturn program.

### **Benefit to taxpayers?**

While we may not know exactly what ReadyReturn is supposed to accomplish, its existence and possible expansion raise a number of questions. The first, and most elementary question is, why is the FTB getting into the tax preparation business? The FTB cannot believe that ReadyReturn is a needed service because taxpayers face a lack of tax preparation options. According to the California Board of Accountancy, the state has over 72,000 licensed certified public accountants and public accountants. A Google search on the term "California tax preparers" returned 43,600

results, while “California tax preparation” had over 1 million returns. The FTB web site ([www.ftb.ca.gov](http://www.ftb.ca.gov)) also links to 14 private firms that help prepare and submit returns electronically. Eight of these firms offer some sort of free filing option. As of March 15<sup>th</sup>, the Board reports that it received 4.2 million returns electronically, of which 3.5 million of them were submitted by professional tax preparers.<sup>4</sup> This certainly does not appear to be a market failure requiring intervention by the Board.

Even if the FTB were concerned about private firms charging taxpayers for tax preparation services, the agency offers a free electronic filing service named CalFile. CalFile, which the agency describes as free, easy, and fast, has been so successful that FTB canceled its telephone filing service this year and encouraged taxpayers to use CalFile instead. The electronic system is not limited to low-income taxpayers. Single individuals with incomes up to \$139,921 and couples with incomes up to \$279,846 are allowed to use the CalFile system. More than 84,000 taxpayers have used this program through March 15<sup>th</sup>.<sup>5</sup> This does not suggest that taxpayers either lack tax preparation options or are unable to reap some benefits from true tax simplification.<sup>6</sup>

An obvious selling point for the FTB would seem to be the potential to eliminate a taxpayer’s computational mistakes. Yet, the agency does not mention this benefit. Will the agency be any more accurate at preparing returns than the average taxpayer is? Even with all of the technology available to the Board, taxpayers would still be wise to scrutinize the computer-generated returns for errors. It seems unlikely that whatever instructions the Board includes with the returns would encourage a taxpayer to scour the tax code for ways to reduce the filer’s prepared tax liability.

A related concern is that program eligibility is based on a retrospective analysis. Meeting the profile requirements one year does not guarantee that a taxpayer will be able to participate in the service for any subsequent filing years. A taxpayer could marry, adopt a child, switch jobs, or move out of the state in a given tax year. FTB officials would likely say that taxpayers could just throw away the prepared return if their circumstances had changed. Without building a stochastic simulation, it is impossible to predict how many individuals might move from eligible to ineligible or vice versa, but such cases might just arise among some 4 million of California’s nearly 14 million taxpayers, if the program is expanded. Taxpayers should seriously question whether the FTB should dedicate staff and computer time to produce and mail tax returns that will only end up in the trash.

Even if widespread eligibility problems are avoided, one additional concern arises. Taxpayers are harmed, when as citizens, the true cost of government is kept hidden from them. Income tax withholding already “minimizes” the cost to taxpayers since government has first claim on each dollar earned. ReadyReturn will make the cost of government to taxpayers even less transparent by further removing individuals from the calculations that lead from gross income to net income.<sup>7</sup>

### **Benefit to the state?**

Jaded taxpayers might see ReadyReturn as a way to increase tax collections. After all the state did face a \$14 billion budget problem in 2004, and the Governor’s budget estimates the

Legislature must close a \$9 billion gap during its 2005 session.<sup>8</sup> At the same time, the FTB reports that California is facing a sizeable “tax gap.” According to its proposal to close that gap, “The Department’s Economic and Statistical Research staff has estimated that voluntary tax compliance and current enforcement-related compliance programs capture approximately 86% of all income tax revenue owed to the State of California.”<sup>9</sup> FTB believes the missing 14 percent fuels a gap of approximately \$6.5 billion.

Yet, ReadyReturn is unlikely to boost collections, not that California’s fiscal challenges arise from a lack of revenue. The program uses tax withholding information submitted by employers, so the state should already have most, if not all of the tax due from these returns. That is the “beauty” of withholding – at least from the state’s perspective, they get your money whether you file a return or not. Nor will the program reduce the number of non-filers, who may or may not be paying taxes. ReadyReturn not only uses current withholding data but also an individual’s filing history. Obviously, non-filers do not have a history of filing tax returns and ReadyReturn would do nothing to increase compliance by non-filers.

ReadyReturn is billed as “free” tax preparation, yet the cost of preparing and filing returns under the program ultimately falls on taxpayers since the program is taxpayer-funded. According to FTB, the state saves \$1 for every return that is filed electronically instead of being processed by hand.<sup>10</sup> Again, one must ask what benefit the ReadyReturn program offers compared to the opportunity costs of the time and other resources committed to it, when those same resources could be committed to encouraging more taxpayers to file electronically and save the citizens of California even more money. There is no such thing as a free lunch, and Californians should be aware that there is no such thing as “free” tax help from the government.

### **Benefit to FTB?**

Perhaps the agency sees the program as innovative customer service that meets the needs of 21<sup>st</sup> Century taxpayers. According to the Board’s 2003-2007 Strategic Plan:

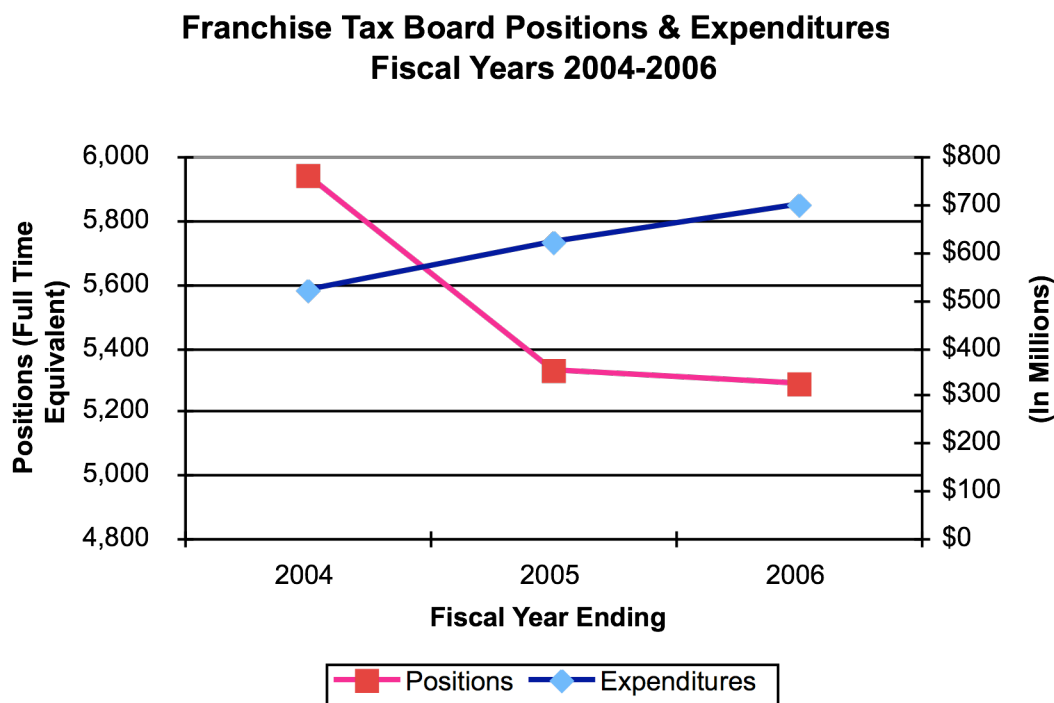
In 2000 FTB set its sight on transformation. Our 2000 E-Government Blueprint and 2001 Strategic Plan both described transformation as a powerful motivating concept to help us focus with renewed vigor on our mission, values and principles of tax administration. For FTB, transformation goes beyond providing good customer service to taxpayers over the Internet, by telephone and in person. It is more than improving our relationship with taxpayers, their representatives, and others who do business with us. And it involves more than simply carrying out our nontax responsibilities with a high degree of effectiveness and fiscal efficiency.

For FTB, transformation is a broad strategic imperative that helps us recognize that we must change the way we conduct our business because the world in which we operate continues to change.<sup>11</sup>

State Controller Westly told the *Los Angeles Times*, “We are trying to reform the way we do business. California is the center for technology in the world. It is only natural we lead in this

area.”<sup>12</sup> Yet, ReadyReturn seems designed to lead the agency away from its original mission – to be the state’s income tax collection entity. The success of ReadyReturn could lead to mission creep for the FTB. If the Board can increase the number of eligible taxpayers from 50,000 to 4 million, why not offer taxpayers additional services like bookkeeping or estimating tax liabilities for individuals and businesses? Having the FTB send a bill for what it thinks a taxpayer will owe, would certainly simplify the filing process as well as eliminate the need for recordkeeping and maintaining a familiarity with the tax code. If other state agencies were allowed to adopt this “transformational” model, the parks department could offer landscaping services. State wildlife employees could run pet stores at the mall. The DMV could arrange auto loans, and obviously, the Governor could freelance as a personal trainer. Taxpayers in California and around the country should be wary of government “innovation” that is financed by their tax dollars. Government reform should have a clear purpose. It should not be driven by a desire simply to spend taxpayer money in a new and different way.

A more likely scenario – one that does not rely on the altruism of government or assume that bureaucracies are driven to reinvent themselves – is that the FTB has an institutional interest in pushing ReadyReturn. As the graph below shows, the number of positions at the agency has been declining in recent budget cycles even though expenditures were increasing. It is not difficult to see the Board in the near future pointing to the influx of returns generated by the ReadyReturn program to justify its request for more employees and an even larger operating budget.



Expanding ReadyReturn might be more in the self-interest of the FTB than it is in the interest of California taxpayers.

## **Form vs. Substance**

Perhaps it is appropriate that California is the first state to offer a program like ReadyReturn. After all, California is a state where appearance often seems to trump substance. In this instance, the FTB lets taxpayers marvel in the belief that complying with the state's tax code is easy; yet, nothing substantial has changed. The tax code is still as complicated to understand and comply with as before the ReadyReturn program began. If legislators want to meet the Governor's call for a 21<sup>st</sup> Century government, they should replace the state's tax system with a simple, low-rate income tax or broad-based consumption tax. Otherwise, taxpayers will soon learn a costly lesson: the false luster of the ReadyReturn program hides a bureaucratic desire for more gold from the taxpayers of the Golden State.

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<sup>1</sup> Governor Arnold Schwarzenegger, State of the State Address, January 1, 2005, <http://www.governor.ca.gov>.

<sup>2</sup> California Franchise Tax Board, "State Launches ReadyReturn Program," February 25, 2004, <http://www.ftb.ca.gov/professionals/taxnews/article/ReadyRtn.html>.

<sup>3</sup> California Franchise Tax Board, "FTB Launches ReadyReturn Pilot Program," March 18, 2005, <http://www.ftb.ca.gov/professionals/taxnews/article/ReadyReturnpilot.pdf>.

<sup>4</sup> California Franchise Tax Board, "State Reports on Tax Filing," March 18, 2005, [http://www.ftb.ca.gov/aboutFTB/press/2005/05\\_17.html](http://www.ftb.ca.gov/aboutFTB/press/2005/05_17.html).

<sup>5</sup> Ibid.

<sup>6</sup> In the name of simplified filing, the FTB has also redesigned the California 540 2EZ form and eliminated several of its mathematical computations. Single individuals with incomes up to \$100,000 and married filers with incomes up to \$200,000 who take the standard deduction and have no more than three dependents can use the simplified form, as well as seniors with certain types of investment income. These changes were prompted largely by legislative lobbying efforts of citizen groups such as United Californians for Tax Reform.

<sup>7</sup> For more on the history of income tax withholding and its harmful affects on taxpayers, see Mark Schmidt, "Income Tax Withholding: Why 'First Dibs' for Uncle Sam Leaves Taxpayers Finishing Last," National Taxpayers Union Policy Paper 106, July 2002.

<sup>8</sup> California Department of Finance, *Governor's Budget 2005-06*, January 10, 2005, [http://govbud.dof.ca.gov/BudgetSummary/GOVERNORMESSAGE/section1\\_1.html](http://govbud.dof.ca.gov/BudgetSummary/GOVERNORMESSAGE/section1_1.html).

<sup>9</sup> California Franchise Tax Board, Budget Change Proposal No. 3, November 1, 2004, p. 2, <http://www.ftb.ca.gov/amnesty/taxgap/proposal.pdf>.

<sup>10</sup> California Franchise Tax Board, "State to End TeleFile Program," March 11, 2005, [http://www.ftb.ca.gov/aboutFTB/press/2005/05\\_14.html](http://www.ftb.ca.gov/aboutFTB/press/2005/05_14.html).

<sup>11</sup> California Franchise Tax Board, *2003-2007 Strategic Plan*, p. 5. Available at [http://www.ftb.ca.gov/aboutftb/stratgic/splan\\_0307.pdf](http://www.ftb.ca.gov/aboutftb/stratgic/splan_0307.pdf).

<sup>12</sup> Evan Halper, "State Will Do Taxes for Some," *Los Angeles Times*, February 20, 2005, as posted at <http://www.westly2006.com/Press/PressRelease.aspx?id=72>.