TECHNOLOGY, PRIVACY, AND THE FUTURE OF TAXATION

Overview

Because, at its core, implementing taxation is a problem of information, the information revolution has the potential to radically alter the relationship between taxpaying citizens and the state. New technology that can manage a much richer exchange of information between taxpayers and government also raises objections against allowing the government better access to information about taxpayers.

Most people associate information technology with the efficiency benefits of the increased use of electronic processing by taxpayers and other agents to prepare tax returns and transmit them to the tax authority, and faster and more accurate processing by the tax authority. But the proliferation of software-prepared returns is not without its downsides. With it a taxpayer can deal with all the complications without having any sense of why and how the inputted information affects tax liability, making the system less transparent. Opaqueness is not good for democracy. Undoubtedly the growing complexity of the U.S. income tax has contributed to the growing use of tax software, and the ubiquity of software reduces the marginal cost of complicating the tax system further.

The new technology can be taken much farther than electronic transmittal and processing of information. For example, retail sales tax systems can be personalized and made progressive by providing every family with an annual "smart card" that would allow a sales tax credit based on family size, income, and other characteristics.

How to take appropriate advantage of information technology in taxation has been little studied in part because of the multi-disciplinary nature of the issues, which span technological issues such as the promise and security of smart cards, legal issues such as privacy, and the economics of taxation. For this project, leading scholars in economics, law, and technology were commissioned to address these issues both conceptually and by considering what specific policy responses may be needed to keep the proper balance between taking advantage of the efficiencies afforded by new technology and the potential dangers due to infringement of citizens' privacy due to the centralization of information collection.

Advances in technology will clearly change the tax environment. Technology will provide additional tools to tax administrators to observe and monitor individuals and transactions (e.g., it is likely that many capital goods such as cars, heavy machinery, or even televisions will have identification and tracking tags included as part of the manufacturing process.) This combination will provide an opportunity for countries to make tax policy changes both as to the relative role of different taxes in financing government, and as to the design of specific tax instruments. With potential benefits come substantial potential costs.

One of the key questions is whether the tax system is capable of taking advantage of the promise of technology in ways that are consistent with individuals' normal modes of life and conceptions of privacy. For example, the experience with pre-filled returns in the California ReadyReturn

pilot shows the promise of using third-party data to calculate estimated tax liability for taxpayers with simple returns. The social gains from using third-party data to populate more complicated returns might be even greater. Implementation of either proposal, however, will require changes in reporting deadlines, additional resources devoted to verifying, storing and transmitting data, solution to numerous smaller problems that are sure to arise – and the support of the legislature and executive branch.

In the future, tax information in the electronic age will be subject to the same critical issues, such as those involving data security, as other personal information. The government, the private sector, and sometimes even the general public have numerous opportunities to gain access to the same types of information that in the past were found exclusively in tax returns. The problems of data security for tax information are heightened by four developments of particular significance. First, more Americans file their tax returns with the IRS every year through e-filing. Second, tax preparation software, like other software, is subject to hacking, viruses, data security breaches, software failures, as well as use of online tracking tools by professional tax preparers. Third, tax returns may be prepared by U.S. firms that outsource work internationally. Fourth, the IRS already has faced the same problems as the private sector concerning data security. In sum, there are now threats of privacy meltdowns, or dramatic loss of gigabytes of personal information, in a way that was unthinkable in the age of paper tax returns. The government in its tax administration follows a data processing model that it uses in other managerial areas. The IRS gathers information about income from employees, investments from financial service companies, outstanding government loans from other branches of the federal government, and a broad variety of other data points about financial events. Much of the essential regulation for personal financial information occurs outside of the tax content. In conclusion, one's tax information and tax privacy remain important, but are increasingly subject to the same forces, legal, social, and technical, as other personal information.