National Conference on the Tax Gap

By Ellen Aprill*

On June 21-22, the Section, along with the American Institute of Certified Public Accountants, the American Tax Policy Institute, the Tax Executives Institute, and the American College of Tax Counsel, sponsored the National Conference on the Tax Gap. It brought together government officials, academics, and private practitioners, from both the United States and abroad, with the goal of helping policymakers address this difficult and important issue.

As those in attendance learned, additional revenue from increasing compliance is not likely to be great and will not close the looming budget deficit. Nonetheless, increased compliance efforts will have other benefits, including reducing concerns about the fairness of the tax system and helping to maintain the existing high level of compliance. Many of the speakers urged tax administrators to view themselves as providers of services to citizens seeking to understand and comply with the law as well as enforcers of the law seeking to punish those who seek to evade it. To that end, they urged policymakers to pay more attention to the psychological factors that influence compliance.

Dennis Zimmerman, Project Director of the American Tax Policy Institute, who served as the Conference's Reporter, has identified two themes related to the cash sector of the economy. First, while the level of compliance overall is surprisingly high, this sector is the major source of non-compliance. Second, better data, particularly increased information reporting, are key to closing the tax gap, but the compliance costs are high for obtaining such information for the cash sector.

The conference was organized into five panels. The first described the tax gap, including its size and how it is estimated. The second explored the key determinants of compliance and non-compliance by examining theoretical, survey, and experimental research conducted over the past 35 years. The three final panels discussed possible approaches to closing the gap. The five panel presenters and commentary on their presentations are discussed below.

DEFINING THE TAX GAP

Dr. Eric Toder of the Urban Institute opened the conference with his paper, "What Is the Tax Gap?" He defined it as the difference between tax liability under current federal tax law and taxes paid. The gross tax gap for 2001 was $345 billion, about 16% of federal tax liability. The tax gap has three main components—nonfiling, underreporting and underpayment. The underreporting gap at $285 billion is by far the largest of the three and poses the most challenging methodological issues. It is primarily attributable to individual taxpayers with income from businesses, rent and royalties, farms, partnerships and other flow-through entities.

While the Service has developed highly sophisticated techniques for estimating the tax gap, there are serious measurement issues. First, estimates of the tax gap's size rely on statistical estimates of the amount of underreported income. Second, individual measures of the tax gap capture the amount of tax avoidance from flow-through entities very incompletely. Third, the Service makes no adjustment for undetected overpayment of tax liability. Fourth, some components of the tax gap measure, especially estimates of the corporate income tax gap and the employer portion of the employment tax gap, are

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seriously out of date. Fifth, more work needs to be done on measuring the tax gap resulting from sophisticated tax avoidance strategies.

Dr. Toder concluded that the tax gap measure is a reasonably good indication of the gap's order of magnitude, but that it was a poor measure for measuring trends, evaluating Service performance, or determining the best enforcement strategies.

Professor Jay Soled of Rutgers Business School, and Dr. Mark Mazur of the Service commented on Dr. Toder's paper. Professor Soled emphasized that the government needs to know not only what the tax gap is, but also why it wants to know and how the size can be reduced. Dr. Mazur noted that making a tax gap estimate requires both art and science. Some estimate, even with uncertainty, is better than no estimate.

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COMPLIANCE AND NON-COMPLIANCE

Dr. John Hasseldine, Director of the Tax Research Institute of Nottingham University Business School, presented a paper that he and Dr. Peggy Hite of Indiana University had done on the key determinants of compliance and non-compliance. He reminded the audience that the objective for policymakers is to change noncompliant taxpayers to compliant ones. Thus, policymakers need to understand taxpayers' behavioral responses in order to evaluate new enforcement initiatives. Factors influencing behavior include socioeconomic and demographic considerations, financial self-interest, social sanctions, social commitment, and the influence of tax preparers. Extensive research has shown that tax accountants and preparers (including software) play a key role in compliance.

Drawing on the compliance literature, he described Australia's pyramid of responsive regulation. Instead of "command and control" with heavy reliance on penalty provisions, the Australian Tax Office now uses a compliance model that opts first for low cost persuasion and escalates to options more oriented toward deterrence as less interventionist strategies fail. The Australian Tax Office also works closely with tax preparers.

Dr. Hasseldine discussed a field experiment from Minnesota, to measure the effectiveness of four strategies to increase voluntary compliance. Among those who received a letter stating that the tax returns that they were about to file would be closely examined, low and middle-income taxpayers increased compliance, but high-income taxpayers reduced compliance. (Others at the conference speculated that one explanation might be that high income taxpayers viewed the likelihood of audit as a signal to make a low initial offer to begin a bargaining process.) Following the Minnesota experiment, Dr. Hasseldine participated in a British national field experiment to test five different treatment letters against a control group. In this experiment, every type of treatment letter showed a significant effect on improving compliance. An important lesson from these and other studies, Dr. Hasseldine concluded, is that no one approach will be effective for all taxpayers.

James Wetzler of Deloitte Tax LLP noted that in evaluating the costs of enforcement, we must consider the benefits of federal efforts for state tax enforcement, the costs enforcement imposes on the private sector, and the spillover benefits from current enforcement on future voluntary compliance. David Lifson of Hays & Company LLP emphasized two principles he believes should shape our tax law. First, people do not obey laws that they don't understand and, second, people don't disobey laws if they think they will get caught. Lennart Wittberg of the Swedish Tax Agency reminded the audience that the goal of tax administration is to prevent tax evasion rather than to detect it and that a customer-oriented approach is needed to achieve this goal.

BEHAVIORAL OPTIONS

Professor Joshua Rosenberg of the University of San Francisco School of Law examined behavioral options for narrowing the tax gap. Most people have definite emotional reactions to taxes, specific cognitive frames around taxes, and learned but unconscious behavioral reactions that can significantly affect their tax-paying or tax-evading behavior. For many Americans, these influences are negative, and they try to avoid their share of taxes in order not to be seen as a fool for complying.

Economic incentives also play a role, given the substantial gains for avoiding taxes. In addition, tax preparers generally see their job as minimizing tax liability. Low audit rates play a role as well. Moreover, tax evasion is perceived as different from other crimes because the victim is not an individual for whom we have empathy, but the huge impersonal entity we know as the government. It is difficult to see the adverse effects of non-compliance, namely, services that are not provided or higher tax rates. All these factors distort the perspective toward taxes.

Professor Rosenberg identified three problems that encourage policymakers to view tax laws differently from other kinds of laws. First, there is an illusion of precision that frees policymakers from the difficulties of exercising judgment to make hard decisions among conflicting goals. Second, analysis of tax laws undervalues the benefits of taxation. Third, analysis of tax laws ignores the effect of taxes on encouraging desired behaviors and penalizing undesirable conduct.

Nonetheless, he believes that change is possible if tax policy and administration take the nature of human interaction into consideration. Taxpayers must understand more about the tax law and tax administrators must understand more about taxpayers' behavior, feelings, and motivations.

Professor Rosenberg suggested imagining an ideal cycle of actions and reactions about taxes. In such a world, we would reward assistance in tax compliance rather than encourage complicity in tax avoidance. Tax officials would use the media to inform taxpayers and establish compliance as a norm. In this a world, we might, for example, require reporting by consumers, merchant bankers and credit card companies and even encourage individuals to volunteer to report all their accounts for the Service to compute their taxes.

In his commentary, Dr. Alan Lewis of the University of Bath Department of Psychology noted that behavior can shape attitudes as well as attitudes shaping behavior. While many do try to evade taxes, we have a very high rate of compliance, and we do not want to introduce rules that in fact encourage evasion by undermining the intrinsic motive to comply. Janet McCubbin of the Service was intrigued by the idea of taxpayers voluntarily providing their records to the Service and suggested that this proposal and the idea of rewarding taxpayers for good behavior merited further study.

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RESEARCH STUDIES

Dr. James Alm of Georgia State University School of Policy Studies reviewed theoretical, empirical and experimental research on why people do and do not pay taxes. The basic theoretical model is an economic one, which posits that an individual pays taxes out of fear of punishment. However, rates of compliance far exceed the level such a model would predict, and researchers have begun to enrich the economic model with psychological considerations. These include the fact that individuals act as if the probability of audit is much higher than its actual probability or the impact of social norms on behavior.

Empirical analysis suffers from the lack of reliable information on taxpayer compliance. Even the best data do not reveal all underreported income, capture nonfilers, or identify honest errors. To combat these problems, researchers have undertaken various approaches, such as using aggregate rather than individual measures or using surveys. Dr. Alm interprets the empirical studies as being consistent with a significant, though diminishing, deterrent effect of higher audit rates. There also seems to be some spillover effect in that audits produce an increase in compliance independent of revenues generated directly from the audits and penalties themselves. In contrast, tax amnesties seem to generate relatively little revenue or spillover effect.

He views laboratory experiments, yet another approach, as showing that a higher audit rate leads to greater compliance, that people tend to overweight the probability of an audit, that fines have small effects on compliance, that public disclosure of non-compliance can be effective as a deterrent, and that the compliance behavior of others has an effect. Other experiments show that individual rewards, such as eligibility for a lottery if an audit indicates full reporting, provide significant inducement for greater compliance. Experimental studies have also demonstrated the important role of social norms. Nonetheless, various methodological difficulties require that the results from laboratory experiments be used with care.

The results of these various types of research and experience in other countries suggest to him that the traditional paradigm, in which taxpayers are viewed and treated as potential tax criminals, needs to be supplemented with a service paradigm in which tax administrators see themselves as a

provider of services to taxpayer-citizens.

Commentator Claus Johannessen of the Danish Ministry of Taxation urged a multifaceted approach to increase compliance. As in the Australian regulatory model, tax administrators should distinguish different categories of taxpayers. Debbie Langsea of the California Franchise Tax Board described how California had increased revenue by using a multi-faceted plan that combined soft approaches with enforcement, including publishing the names of non-compliers. Commentator Lawrence Gibbs of Miller & Chevalier remarked that because the Service is not likely to get more funding, it will have to prioritize and to continue being creative in using its resources.

THE CASH ECONOMY

Professor Joseph Bankman of Stanford Law School focused on the cash economy. It is important to remember that, on the assumption that after-tax returns are equal in the cash and non-cash sectors, the practice in the cash sector of not paying its full share of taxes means a lower pre-tax return on investment in that sector. In addition, we are reluctant to treat tax evasion in the cash sector as a significant crime for a number of reasons. Consumers benefit from the lower prices in the cash sector; many in the sector work hard, take risk, and have low incomes; underreporting is accepted as the norm.

Experience from other countries may offer some useful ideas. Several countries have tried to reduce the cash economy by subsidizing credit and debit cards. The most prevalent approach to cash sector evasion is to enter consumers who comply with reporting requirements in a government-sponsored lottery.

Professor Bankman urged caution in considering third party reporting, an approach often recommended. Third-party reporting for individuals is unlikely to generate numbers that can be electronically (and thus inexpensively) checked by government and thus serve as a basis for audit. Third-party reporting of business-to-consumer transactions, such as requiring consumers to report provision of services in excess of $600, would improve compliance but impose significant compliance-related costs.

Any expanded third-party reporting envisions additional audits, and there is no way to reduce the cash sector tax gap without more audits. Yet political opposition to more audits and higher penalties is widespread. Although compliant taxpayers would benefit from such increased enforcement, they fear that the government will not limit its audits to those cases in which there is a high level of evasion and a high level of payoff from auditing. Any significant increase in audit rates will require us to overcome this skepticism as to Service motives and efficiency. Professor Bankman closed by suggesting that we consider at least a partial reimbursement for audit expenses for taxpayers who are found to have paid substantially all of their tax liability.

In her commentary, Pamela Olson of Skadden, Arps, Slate, Meagher & Flom LLP reminded the audience that, based on past history, Congress is unlikely to adopt approaches to the tax gap that intrude upon taxpayers or require substantial recordkeeping. Simplification of tax laws would help the Service target its efforts. Jeff Hoops of Ernst & Young argued that there are large cash-based businesses that could and should be targeted for enforcement. He believes that the best option is to increase the Service's budget to hire and retain more experienced auditors. The comments of Hank Gutman of KPMG LLP summarized succinctly many points made during the conference: There is no silver bullet to addressing the tax gap. We should take small, coordinated steps using a variety of techniques.

CONCLUSION

In sum, the conference adopted a multidisciplinary approach by drawing upon economics, sociology, statistics, and psychology. The examination of this serious topic was not without humorous moments. Dr. Alm, in discussing non-financial penalties, pointed to a city in India that sent drummers to the homes of people who had not paid their property taxes with instructions to beat their drums around the clock until the delinquent taxes were paid. Dr. Hasseldine told about the effect of social norms on one individual. This taxpayer sent a letter to the revenue department: "I can't sleep because I cheated on my taxes. Here is $1500. If I still can't sleep, I will send you the rest." ■

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