The FairTax, Tax Evasion, and the Underground Economy

An old aphorism says that only two things are certain in life-death and taxes. Perhaps a third certainty should be added to the list---tax evasion! Taxes are unpopular and breed resentment today – as they undoubtedly always have, and to some degree probably always will. Accordingly, some people will evade taxes no matter what the governing tax system, but perhaps some tax systems will "inspire" less tax evasion than others. This paper examines the issue of whether replacing the income tax with a single rate, federal sales tax is likely to increase or reduce tax evasion.[1]

Tax Evasion Today

Under today's income tax system, tax evasion is a major, continuing and growing problem. Under the pressures of a much larger Internal Revenue Service (IRS), more burdensome information reporting requirements, increasingly stiff and numerous penalties, and a host of legislative initiatives, the problem is getting worse. Based on IRS figures, tax evasion has increased by 67 percent during the most recent 11-year period for which data is published. As a percentage of Gross Domestic Product (GDP), tax evasion has reached 2.0 percent in 1992 as compared to 1.6 percent in 1981. Tax evasion continues to amount to approximately 22 to 23 percent of all income taxes collected. (See table next page). And, these IRS figures **do not** include taxes lost on illegal sources of income.

The income tax is collected with a heavy hand. In 1997, the IRS assessed over 33 million civil penalties on American taxpayers in an effort to force compliance with the tax system. Of these, about 4.1 million were forgiven. 22.7 million penalties involved the income tax and 9.7 million involved the payroll tax, taxes that the FairTax would replace.[2] Under the FairTax, even if we assumed that every business in America was a retailer and required to file a tax return, no more than 19 million businesses would be required to file returns compared to over 154 million returns (of all types) filed today.[3]

The tax gap is the difference between what is theoretically owed in taxes and what is actually collected in taxes. In a comprehensive look at the tax gap, the General Accounting Office stated:

> *Almost every year since 1981 has witnessed legislation to address tax gap issues. These legislative actions generally required information returns [1099's] reporting on income and deductions, imposed penalties for tax noncompliance, or reduced the opportunity for noncompliance by eliminating certain tax write-offs.*

---

[1] In the parlance of modern tax administration, the question of whether the FairTax would increase or reduce voluntary compliance would be posed. Many taxpayers, however, find the term 'voluntary compliance' to be oxymoronic since failure to pay taxes would result in a prison term.

[2] Internal Revenue Service, 1997 Data Book, Table 15.

[3] See SOI Bulletin, Winter 1998-1999, Table 12, p. 210. Note: Sole Proprietorships with less than $2,500 in annual receipts excluded since they de minimus rules in the FairTax would not require most of them to file returns.

[The] IRS estimated that some of these provisions resulted in additional 1990 tax revenue of $3.4 billion. Even so, [the] IRS' estimated tax gap increased $50.7 billion in current dollars from tax years 1981 to 1992. However, the growth of the gap could have been higher without these legislative actions.[4]

Relative Magnitude of Tax Evasion Under the Income Tax 1981-1992[5]
Using Internal Revenue Service Estimates

	1981	1992	1998
Total tax gap (Real 1992 $ millions)	$75,966	$127,129	177,518[6]
As a Percentage of Income Taxes Collected		22.2%	19.9%
As Percentage of Gross Domestic Product	1.6%	2.0%	2.3%
Annual Growth Rate (1981-1992)		6.1%[7]	
Annual Growth Rate (1981-1998)			6.6%[8]

According to the IRS, individuals accounted for $94 billion of the $127 billion tax gap and corporations for $33 billion in 1992. About half of the gap is caused by unreported income. If all of this lost tax revenue were collected, the tax burden on law-abiding citizens could be reduced by one fifth to a quarter.

Periodically, the IRS conducts a series of extremely intrusive audits of taxpayers selected at random, and requires those taxpayers to document every item on their tax return to the minutest detail. These audits are part of the Taxpayer Compliance Measurement Program or TCMP. The 1988 TCMP statistical sample included audits of over 54,000 individual taxpayers, theoretically representing 104 million taxpayers. TCMP data showed that if all 104 million taxpayers had been audited, 42 million (40 percent) of them would have seen increases in their tax liabilities.[9]

---

[4] Tax Gap: Many Actions Taken, But A Cohesive Compliance Strategy Needed, May 1994, General Accounting Office, GAO/GGD-94-123 (hereinafter ‘GAO’)
[5] GAO, Supra.
[6] $198 billion in 1998 dollars. See, e.g. “IRS Doubles Previous Estimate of Unpaid Taxes,” Associated Press, May 3, 1998.
[7] 4.79 percent using a continuously compounding growth rate.
[8] 5.72 percent using a continuously compounding growth rate.
[9] GAO, Supra.

Tax Evasion Under the Income Tax 1981-1992[10]
Internal Revenue Service Estimates
($ millions (inflation adjusted 1992 dollars))

Source of tax gap	1981 tax gap amount	1992 tax gap amount	Percentage increase
Individual tax gap	$61,900	$93,994	51.8%
Unreported income	40,433	62,759	55.2
Sole proprietors	18,714	30,173	61.2
All other income	21,719	32,586	50.0
Overstated deductions	7,449	8,081	8.5
Individual non-filers	5,231	10,233	95.6
Individual remittance gap	8,300	11,400	37.3
Math errors	487	1,521	212.3
Corporate tax gap	14,066	33,135	135.6
Small corporations	4,461	6,999	56.9
Large corporations	8,638	23,716	174.6
Others	167	420	151.5
Corporate remittance gap	800	2,000	150.0
Total tax gap	$75,966	$127,129	67.2%

The General Accounting Office, in its recent tax gap report said:

> *The TCMP data showed that an estimated 33 million of the 42 million taxpayers (82 percent) were not assessed a fraud or negligence penalty, suggesting that much of their noncompliance was unintentional.*

Although forty percent of Americans are not in compliance with the income tax, the reasons for non-compliance are instructive: (1) taxpayers lack the requisite knowledge of the tax law – of course, even tax lawyers and IRS agents cannot grasp the entire tax code these days; (2) taxpayers interpret the law differently than the IRS – but you can depend on the IRS to almost always make aggressive interpretations in favor of the government; (3) taxpayers lack record-keeping ability sufficient to satisfy the IRS – this from an agency that has such poor internal records that it cannot even be audited! (4) taxpayers do their math wrong, or they rely on professional return preparers who get it wrong – if professional tax preparers can't get it right, how are ordinary Americans to do so?[11]

---

[10] See, GAO, Supra.

[11] The annual Money magazine survey in which 50 accountants prepare a hypothetical middle class couple's tax return and come up with at least 45 different answers each year is a major indication that our tax system is simply not administrable.

Primary Taxpayer Compliance Measurement Program (TCMP) Reasons for Tax Increase[12]
When Taxpayers Were Not Assessed a Negligence or Fraud Penalty for 1988
(Dollars in millions)

Reason for noncompliance	Number of taxpayers	Amount of tax increase
Multiple interpretations of tax law	1,230,202	$1,237
Lack of substantiation	9,074,690	3,765
Incorrect accounting or computational procedures	5,215,212	2,710
Relied on a return preparer and did not help with preparation	4,964,121	3,166
Lacked knowledge of tax laws to prepare accurate return	7,648,492	3,259
Other	5,004,042	1,549
Totals	33,136,759	$15,686

Tax evasion is a major, growing problem under the income tax system, notwithstanding the monumental and increasingly harsh and administratively burdensome steps taken to enforce the law. Forty percent of the American public is out of compliance with the current tax system. All of this despite the $225 to $300 billion spent by the private sector trying to comply with the federal income tax system.[13]

The FairTax and Tax Evasion

Opponents of the FairTax like to assert that a federal sales tax would increase tax evasion. It is more likely, however, that the FairTax would increase tax compliance while reducing compliance costs at the same time. It is impossible to argue in good faith that the current approach is doing its job since the problem is getting worse with the passage of time despite major and ever more intrusive attempts to address the problem.

[12] GAO, Supra.
[13] See, e.g. "Federal Tax Compliance Costs Climb to $225," Tax Features, Tax Foundation, March 1996. See also, March 20, 1996. James L. Payne, Costly Returns, The Burden of the U.S. Tax System. (ICS Press, 1993). Testimony of James L. Payne, "Replacing the Federal Income Tax", Hearings before the Committee on Ways and Means, House of Representatives, June 6, 7 and 8, 1995, Serial 104-28, p. 183-187.

Estimated Tax Gap by Source[14]
for 1981 and 1992, in Current Dollars
(Dollars in millions)

Description	1981 Tax Gap Amount	1992 Tax Gap Amount
Individual filers		
Wages and salaries	$2,378	$1,919
Interest	1,969	1,891
Dividends	2,075	2,142
State tax refund	127	102
Alimony	124	253
Capital gains	1,822	11,535
Form 4797	217	1,264
Pensions and annuities	456	144
Taxable unemployment	107	388
Farm income	2,350	1,909
Partnership income	2,755	2,246
Small business (S) corporation	912	729
Estates and trusts	49	73
Rents and royalties	2,012	4,481
Non-farm sole proprietors	18,714	30,173
Other income	4,366	3,465
Taxable Social Security	0	44
Adjustments to income	752	694
Deductions	3,540	3,889
Exemptions	1,844	2,224
Credits	1,313	1,274
Math errors	487	1,521
Individual non-filer tax gap	5,231	10,233
Individual remittance gap	8,300	11,400
Total individual tax gap	$61,900	$93,994
Small corporation tax gap	4,461	6,999
Large corporation tax gap	8,638	23,716
Unrelated business income gap	56	218
Fiduciary tax gap	111	202
Corporate remittance gap	800	2,000
Total corporate tax gap	$14,065	$33,135
Total tax gap	$75,966	$127,129

[14] Source: Income Tax Compliance Research, IRS Publication 1415. Gross Tax Gap Estimates by Source of Tax Gap for Tax Years 1981 and 1992, in 1992 Dollars, reprinted in GAO Supra.

Some of the problems regarding the underground economy that exist under the income tax would remain under the FairTax, particularly those involving cash transactions made in the illegal economy or with the explicit intent of evading taxation. However, as the costs of compliance shrink and the perceived fairness of the tax system increases, some of the hostility to the tax system will decline. People who are in non-compliance because they perceive the present system as unfair or illegitimate may choose to comply with the FairTax. Most importantly, because of lower marginal tax rates, the benefit from lawful tax avoidance or illegal tax evasion will be much less at the margin relative to either the present system[15] or competing alternative tax systems, such as the USA Tax or flat tax[16], that have higher marginal tax rates, particularly on wages or self-employment income.[17] Research has confirmed the intuitive relationship between higher marginal tax rates and higher rates of evasion.[18] Lower rates, all other things being equal, imply lower evasion because the benefits from evasion decline while the costs of evasion remain comparable.

Much is made from the fact that a federal sales tax would place the responsibility for tax collection with the retailer, a sector of the economy in which small businesses are better represented. Small businesses are viewed as more likely to evade taxes since the owner, and beneficiary of tax evasion, is more likely to also be responsible for keeping the books and filing the tax returns. While there is, of course, some truth to the proposition that evasion rates among small businesses are higher, it is highly implausible to suggest that evasion would increase under the FairTax. First, those small businesspersons that are inclined to cheat on their sales tax are probably already cheating on their income tax and would be inclined to do so under any tax system. Second, the economic importance of small firms in the retail sector is usually grossly overstated. According to the Joint Committee on Taxation (JCT), small firms only account for 14.9 percent of gross receipts by all retailers, wholesalers and service providers.[19] Since the gross receipts of wholesalers would not typically be subject to tax, the true scope of the small

[15] For 2000, the 28 percent marginal rate is effective on taxable incomes of $43,850 for joint filers and $26,250 for single persons. The top federal tax rate, of course, is 39.6 percent.

[16] The USA Tax has a top marginal tax rate of 40 percent (actually an effective rate of 32.35 once the payroll tax credit is considered) that takes effect at relatively low taxable income levels. Even a relatively low flat tax rate of 17 percent, plus the 15.3 percent payroll tax, yields a marginal tax rate of 32.3 percent until the Social Security wage base is reached and 19.9 percent thereafter (including the 2.9 percent Medicare tax). At a 20 percent flat tax rate (the beginning rate under the Armey plan), the *lowest* marginal tax rate is 22.9 percent and 35.3 percent for most middle class wage-earners.

[17] For a particular taxpayer, the marginal benefit from failing to report a given amount of gross receipts under an income tax and a given amount of gross receipts under the FairTax are the same. Under an income tax, the taxpayer will reduce his taxable income one for each dollar not reported. In the FairTax, failing to report sales receipts would also reduce taxable receipts dollar for dollar. Although the problem of falsifying deductions or deducting personal items as a business expense does not arise in the FairTax, the corresponding problem in the FairTax is using a business to attempt to purchase personal goods and services on a tax-exempt basis.

[18] See, e.g. "Estimating the Underground Economy: A Critical Evaluation of the Monetary Approach", Peter S. Spiro, 42 Canadian Tax Journal 1059-1081 (1994); "The Underground Economy in the United States: Annual Estimates, 1930-80", Vito Tanzi, 30 International Monetary Fund Staff Papers 283-305 (June 1983).

[19] IRS Statistics of Income, reported in "Impact on Small Business of Replacing the Federal Income Tax", Joint Committee on Taxation, April 23, 1996, JCS-3-96, pp. 109-127.

"problem" companies is smaller still. However, sole proprietorships, perhaps the most likely to evade tax under the present system and under the FairTax, are not included in the JCT figures.

Share of Total Gross Receipt by Firms with less than $1 million of Gross Receipts[20]
($ millions, 1993)

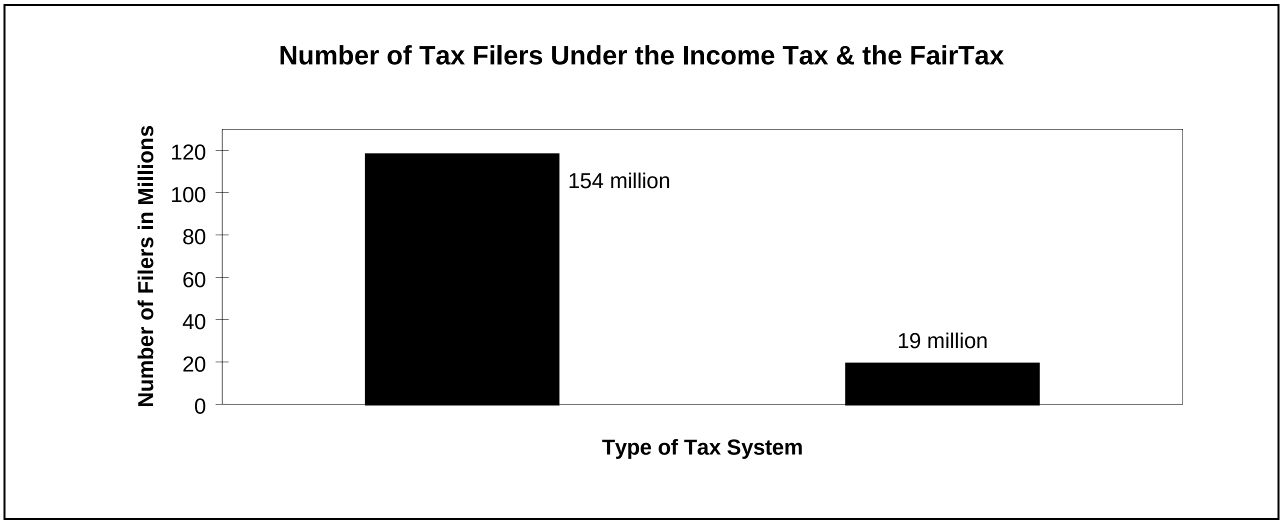
Industry	Entity Type	Firm Sales Under $1 mil.	Firm Sales All Firms	Small Share Percent
Retail and Wholesale Trade	C Corp.	116,929	2,663,541	4.4%
Services	C Corp.	91,383	610,438	15.0
Retail and Wholesale Trade	S Corp.	358,566	959,501	37.4
Services	S Corp.	98,721	283,680	34.8
Retail and Wholesale Trade	Partnership	22,938	112,112	20.5
Services	Partnership	30,783	187,588	16.4
Total	Combined	719,319	4,816,860	14.9

Third, the necessary corollary of the tax collection point being concentrated at retail establishments, rather than with individuals or other businesses, is that there are fewer points where revenue agents must concentrate their enforcement efforts. The collection points in the FairTax system would be perhaps 10 percent of those under the current income tax system or other alternative tax systems.[21] Because the number of collection points is so much lower, if enforcement funding is held equal then the audit rate for potential evaders would increase considerably, and the likelihood of them being apprehended is correspondingly higher. In other words, the risk of detection would increase and risk-adjusted cost of evasion would increase. Increased evasion due to the greater concentration of small businesses in the retail sector would be outweighed by greater compliance due to greater simplicity and perceived legitimacy of the tax system, from reduced temptation due to lower marginal tax rates, and from higher risk of detection due to a smaller taxpayer population. Fourth, some small business owners evade taxes because they feel the present system is unfair or overly complex and burdensome, or that they have been wronged by the system. They are much less likely to feel that way about the FairTax. Fifth, and perhaps most importantly, the marginal benefit from evasion will decline under the FairTax since the marginal tax will decline. Thus, the incentive to cheat will decline markedly.

Any one of the 118 million income tax filers can cheat the income tax system today, and a great many do so. Under the FairTax, however, only retailers (about 14 million-tax filers altogether) would be in a position to cheat. In addition, the vast majority of retail sales, 90 percent, are made by large firms that are less likely or find it more difficult to cheat. <u>A retailer who cheats under the income tax system has very similar, if not the same financial gain, as a retailer who cheats</u>

[20] Ibid.
[21] See note 3, supra.

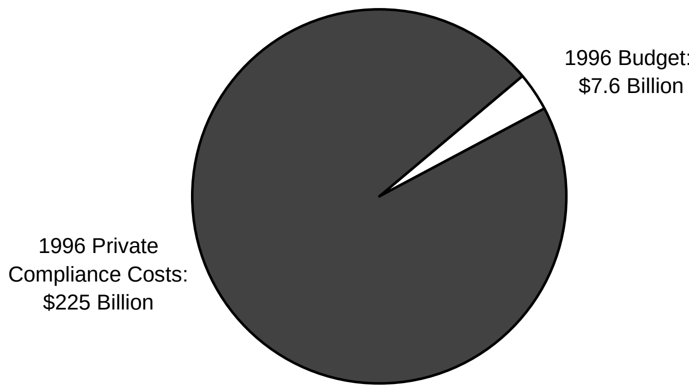
under the FairTax system. If a retailer under the FairTax system, failed to report taxable sales, the government would lose and the evader would gain by an amount equal to the sales tax on the good or service purchased. In an income tax system, the government loses and the evader gains by an amount equal to the marginal income tax rate times the amount not reported. An income tax evader will see his taxable income go down dollar for dollar, for every dollar of income not reported. Typically, failing to report a small fraction of a business' gross income will be sufficient to drive its reported profit to zero.



Even if, however, we were to make the unlikely assumption that evasion rates would be higher under the FairTax system than under an income tax system, they would have to be *much* higher to justify the income tax's huge compliance costs (estimated to be over $225 billion in 1996), many of which are incurred by businesses and are deductible as a business expense. Moreover, if compliance proved to be a problem, information reporting along the lines of present law (1099s) could be implemented to facilitate cross-checking by government auditors. These 1099s would reflect the quantity of product sold to retailers. An auditor could then ensure that the retailer's books either reflected a sale of these products or that the products were in inventory. The FairTax requires all businesses (including non-retailers) to keep business records kept in the ordinary course of business that would aid cross checking by government auditors.[22]

[22] State governments, particularly with respect to tax due on out-of-state purchases by businesses, currently use this method. State sales taxes are, unfortunately, often applied to business inputs.

1996 IRS Budget & Compliance Costs



<u>Conclusion</u>

Tax evasion will undoubtedly be a problem under any tax system. It is a major *and growing* problem under the current tax system, despite very substantial efforts and increasingly harsh treatment of the taxpaying public. Almost 40 percent of the public, according to the IRS, is out of compliance with the present tax system, mostly unintentionally due to the enormous complexity of the present system. This breeds disrespect for the tax system and the law, and makes a system based on taxpayer self-assessment less and less viable.

The FairTax is likely to reduce rather than exacerbate the problem of tax evasion. The increased fairness, transparency, and legitimacy of the system will induce more compliance. The roughly 85 to 90 percent reduction in filers will enable tax administrators to address instances of non-compliance more effectively, and increase the likelihood that tax evasion will be discovered. The relative simplicity of the FairTax will promote compliance. Businesses will need to answer one question to determine the tax due: how much was sold to consumers? Finally, the dramatic reduction in marginal tax rates will reduce the gains from tax evasion. If the cost of non-compliance remains comparable (or even increases due to the increased likelihood of getting caught caused by the much smaller number of filers), then both the expected profit from and frequency of tax evasion will decline.