Why Evasion under a National Sales Tax Would Explode the Tax Gap: Lessons Learned from the States

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P. Cary Christian, Ph.D.
Institute for Public and Nonprofit Studies
Georgia Southern University
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Evasion and the Sales Tax

- Conventional wisdom
- Unfounded assumptions related to sales tax evasion
  - Sales tax evasion is nonexistent
  - Amount of sales tax collected by entities involved in sales tax evasion is immaterial
  - State estimates of compliance rates can be used to estimate tax lost to evasion
  - Under a national sales tax – no need for IRS!

Methodology

- 18-month, mixed-methods study within a state agency
  - Interviews within the agency
  - Document reviews
  - Observational survey
  - Analysis of task force operations
  - Quasi-experimental evaluation of industry enforcement methodologies
- Builds on experience in a state revenue agency

Evasion in a Sales Tax System

- Unfounded assumption 1: Evasion under a sales tax system is nonexistent
  - Basis for assumption
  - Income tax vs. sales tax compliance enforcement schemes
  - The role of third-party reporting

Category	Total	Verifiable	Percentage
Income	$8.8 trillion	$7.3 trillion	82.59%
Deductions for AGI	$123 billion	$89 billion	72.66%
Other deductions	$2.93 trillion	$1.597 trillion	54.51%

Evasion in a Sales Tax System

- Principle-agent issues
  - Adverse selection
  - Moral hazard
- Corporate view of opportunistic crime
  - Spending billions on
    - External audits
    - Internal audits
    - Tight internal controls and procedures
    - Fraud training and hotlines
  - Still losing $652 billion annually (2006)

Character of Sales Tax "Evasion"

- Unfounded assumption 2: The amount of sales tax collected by entities with a propensity toward theft of sales tax is immaterial
  - Basis for assumption
    - Small businesses are the problem!
    - Only evasion is considered
  - Difference between evasion and theft in a sales tax system

Character of Sales Tax "Evasion"

- Some statistics on small business sales
  - Businesses with less than 100 employees accounted for $8.8 trillion in receipts during 2007 (receipts not sales) – 28.5% of total
  - Businesses with less than 500 employees accounted for $12.4 trillion in receipts during 2007 (receipts not sales) – 40.25% of total

Character of Sales Tax "Evasion"

- Assuming revenue neutrality:
  - Small businesses will collect $712 billion to $1 trillion in sales tax
  - "Prebates" will place another $142.5 billion to $265.65 billion at risk
  - Total risk - $854.5 billion to $1.266 trillion
- IRS estimates net misreporting percentage (NMP) for amounts subject to little or no information reporting to be 56 percent

The Delinquency Dodge

- Unfounded assumption 3: State estimates of sales tax compliance rates can be used to estimate sales tax lost to evasion or theft
  - Most states boast voluntary compliance rates of 95% to 99%
    - Generally based on delinquencies only!
    - Tax thieves "fly below the radar"

The Delinquency Dodge

Collections & other non-verification activities – 80% of personnel

Delinquencies - $500 million/yr – Discovery - $50 Million/yr

THE GAP

TRUST WITHOUT VERIFICATION

968,422 businesses out of 972,977 – 99.53%

Estimated 60% of small businesses noncompliant to some extent

Audit & Criminal Investigations – 20% of compliance personnel

.38% of businesses audited, .08% investigated

The sales tax enforcement gap

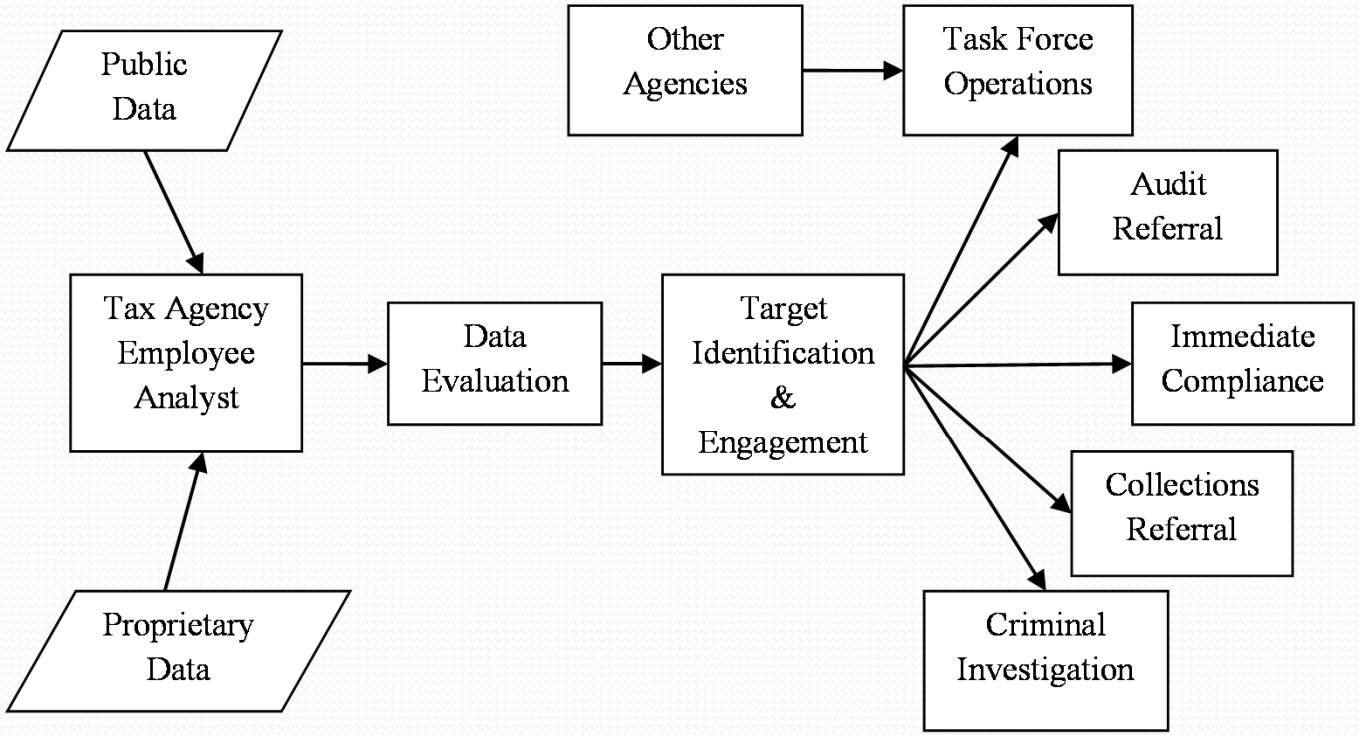
The Delinquency Dodge

Comparison of sales tax theft to delinquency amounts for a subset of dealers	
Number of dealers examined	192
Revenues reported	$1 billion
Sales tax reported	$36.7 million
Theft of sales tax identified	$21.4 million
Collection balances (delinquencies)	$.3 million
Percent of theft identified through delinquencies	1.4%

Compliance Enforcement Needs

- Unfounded assumption 4: Under a national sales tax there would be no need for the Internal Revenue Service
  - Basis is primarily faulty assumptions regarding evasion/theft
  - Currently: compliance issues with 17% of tax base
  - Under a sales tax, 100% of tax base at risk
  - Requires much different enforcement infrastructure

Compliance Enforcement Needs



Simple lead development process

Compliance Enforcement Needs

- Current focus of state agencies is primarily delinquencies
- States just beginning to get more sophisticated
- Expansion of enforcement capabilities required whether headquartered at the federal or state level
- Need for coordination at the federal level for a federal tax for a variety of reasons