

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

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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”

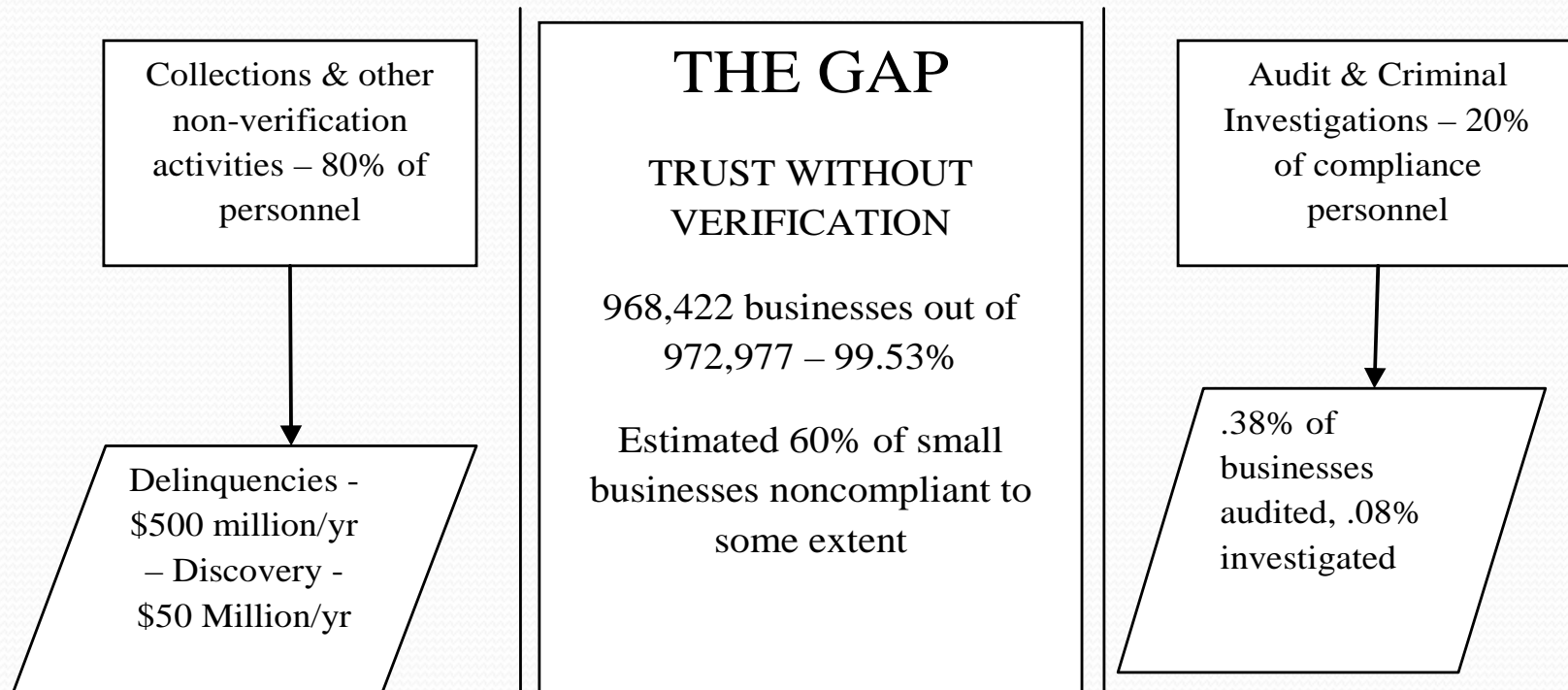
- Assuming revenue neutrality:
 - Small businesses will collect \$712 billion to \$1 trillion in sales tax
 - “Prebates” will place another \$142.5 billion to \$265.65 billion at risk
 - Total risk - \$854.5 billion to \$1.266 trillion
- IRS estimates net misreporting percentage (NMP) for amounts subject 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



The sales tax enforcement gap

The Delinquency Dodge

Comparison of sales tax theft to delinquency amounts for a subset of dealers

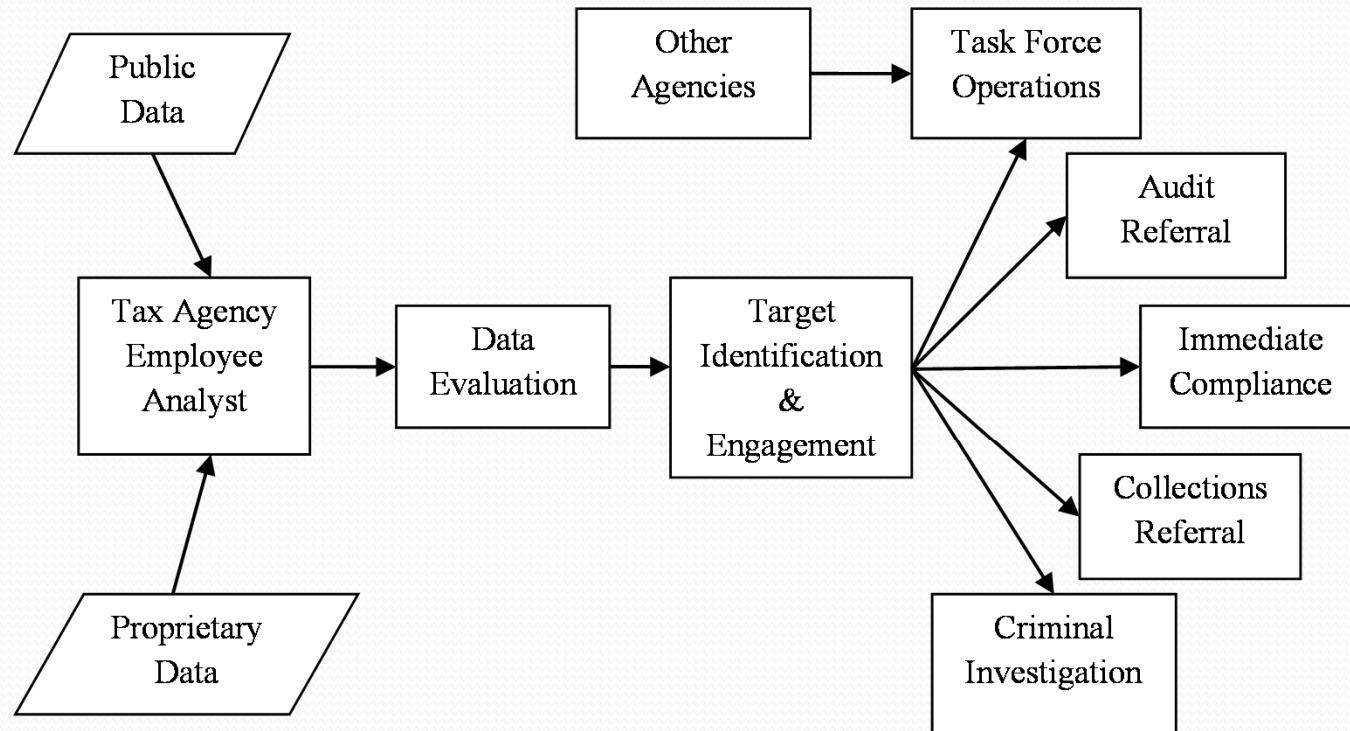
Number of dealers examined	192
Revenues reported	\$1 billion
Sales tax reported	\$36.7 million
Theft of sales tax identified	\$21.4 million
Collection balances (delinquencies)	\$.3 million
Percent of theft identified through delinquencies	1.4%



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