# How Could We Improve the Federal Tax System?



## Q. Would tax evasion and avoidance be a significant problem for a national retail sales tax?

## A. A national retail sales tax would certainly not eliminate tax evasion and avoidance, and might increase it.

Advocates of the national retail sales tax claim that tax avoidance and outright evasion would decline, and that tax revenue collected from the underground economy would rise significantly. But critics view these claims as somewhere between overly optimistic and nonsensical. The President's Advisory Council on Federal Tax Reform (2005, 218) noted in its final report that "a federal retail sales tax assessed at a rate of at least 34 percent, added on to state retail sales taxes, would provide a substantial inducement for evasion."

By eliminating the current tax system, the national retail sales tax would indeed eliminate current avoidance and evasion schemes. But that does not mean it would eliminate avoidance and evasion. It would simply change their locus and nature.

The overall rate of evasion of the US income tax is estimated at around 16 percent, with the net percentage of misreported income equaling 22 percent. But these figures mask great differences in behavior that depend on the source of the income. At one extreme, where taxes are withheld and reported to government by a third party (predominantly wages), the misreporting rate is just 1 percent. At the other, where taxes are not withheld and there is no cross-reporting among government agencies, the misreporting rate averages 63 percent. If the income is subject to reporting but no withholding, about 7 percent is misreported. (Think interest, dividends, unemployment compensation, etc.) A national retail sales tax would feature no withholding and no cross-reporting, and so the potential for evasion needs to be taken seriously.

Individuals might avoid or evade a national retail sales tax in several ways. They might misreport personal consumption as business activity (e.g., using a company car for personal use). Treating property that involves mixed consumer and business use would also be a problem, as would verifying that retail goods were not purchased for personal use by business representatives (e.g., a bar owner purchasing a flat-screen for his or her home).

Previous studies have found a 13 percent "delinquency" rate for state sales taxes. This rate of evasion is lower than the likely rate under a national retail tax, though, since the tax rate under a national plan would be significantly higher than the rates applied by the states, increasing the incentive to cheat. Underreported sales would almost certainly be much higher with a national retail tax for two reasons: (1) enforcing the income tax currently relies on cross-verification between federal and state income taxes, and (2) the effective sales tax rates are currently low. With a tax-regime change, both conditions would change.

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Then there's the question of taxing the underground economy. The example frequently offered is that of a drug dealer who does not pay income tax on his earnings today but would be forced to pay the sales tax if he took the funds and bought, say, an expensive car. The flaw in this argument was laid out years ago by former congressman Richard "Dick" Armey: "If there is an income tax in place, he [the drug dealer] won't report his income. If there is a sales tax in place, he won't collect taxes from his customers and send them to the government. In the end, neither system taxes the [illegal] drug trade."

### Further Reading

Armey, Richard K. 1995. "Caveat Emptor: The Case Against the National Sales Tax." *Policy Review* 73 (Summer): 31–35.

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President's Advisory Council on Federal Tax Reform. 2005. *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*. Washington, DC: President's Advisory Council on Federal Tax Reform.