Tax System Design: The Role of Enforcement

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The Modern Theory of Taxation

- The modern theory of taxation, beginning circa 1970, represented a major breakthrough in how economics addressed the evaluation of taxes.
- It provided a rigorous basis for analysis, which enables intellectual progress.
- Like all models, the modern—now standard—model of taxation is stylized, making simplifying assumptions and emphasizing certain aspects of taxation at the expense of others.
- **But it hampers addressing many key issues, such as whether to raise revenue by increasing tax rates or increasing enforcement.**

Limitations of the Standard Toolkit

1. Little attention paid to the administrative and compliance costs of taxation.

2. A focus on tax rates and, to a lesser extent, tax bases, to the relative exclusion of all other tax system instruments, such as enforcement tools (audits, evasion penalties, public disclosure) and administrative choices.

More Limitations of the Standard Toolkit

3. A focus on what might be called real behavioral responses to taxation, to the relative exclusion of avoidance and evasion responses.

4. A recognition of the central role of asymmetric information between the government and private citizens, but extreme assumptions regarding what is measurable without cost and what is not measurable at any cost.

Even More Limitations of the Standard Toolkit

5. No meaningful role for firms. With the standard assumption of constant returns to scale, firm size is indeterminate and irrelevant. The implications of firm heterogeneity cannot be pursued.

6. No concern with the details of tax remittance. In spite of folk theorems about its irrelevance, the remittance regime does matter in the real world.

My Objectives Today

I have three objectives today:

1. To convince you that a tax-systems perspective can provide insight into many important issues relevant for tax design that the standard model is silent on.
2. To persuade you that, tax enforcement, broadly defined, is central to tax design.
3. To stimulate you with some examples of exciting recent empirical research in this field.

What Is a Tax System?

It is a set of rules, regulations, and procedures that:

1. Defines what events or states of the world trigger tax liability (***tax bases and rates***).

2. Specifies who or what entity must remit that tax and when ***(remittance rules)***.

3. Details procedures for ensuring compliance, including information-reporting requirements and the consequences (including penalties) of not remitting the legal liability ***(enforcement rules)***.

Three Aspects of Tax Systems

1. Multiple sources of cost—not just distortion of choices, but also administrative and compliance costs
2. Multiple behavioral responses, not just “real” but also avoidance and evasion
3. Multiple tax instruments—not just rates and bases but also audit strategy, the extent of information reporting, disclosure rules, etc., etc.

Today I will discuss the role of evasion and enforcement in tax design.

Evasion

- The deterrence model of Allingham and Sandmo (1972) still reigns, as it explains the bulk of evasion variation.
- Non-deterrence theories (e.g., duty, altruism, process) have proliferated, but with mixed empirical support to date.
- But how do we know this for sure?

The Empirical Analysis of Evasion

- Empirical analysis is challenging: the nature of evasion renders measurement problematic.
- A similar, but not identical, problem is faced by tax administrations.
- Compelling analysis requires creative research design and, often, the cooperation of tax administrations. Such cooperation can be a win-win proposition.
- There are three very promising approaches to empirical analysis.

1. Traces of Evasion

This approach looks for behavior that could <only> be due to tax evasion.

- The seminal example is Pissarides-Weber (1989), who examine the ratio of food spending to income fro employees versus self-employed.
- Feldman-Slemrod (2007) apply the same method to charity in the U.S.
- Artavanis et al (2013) examine Greek banks' lending practices.

2. Analysis of Administrative Data

Such data is now available to academics in Scandinavia, the UK, and the US.

- My recent paper on the effect on small-business non-compliance of payment-card reporting is a good example of a “win-win” research project.
- Current projects will address the impact on compliance of the U.S. FATCA legislation and the impact of “tough” auditing.

3. Randomized Field Trials

We may never be able to do randomized field experiments on tax rates or bases, leaving us out of the "credibility revolution" in empirical economics.

But we can do them for other tax-system instruments.

Examples include:

- Slemrod et al. on income tax in Minnesota (US
- Kleven et al. on income tax in Denmark
- Pomeranz on VAT in Chile
- Fellner et al. on TV fees in Austria
- Bhargava and Manoli on EITC in the US

Multiple Tax Instruments

- A tax policy includes tax rates and bases, but also critical aspects of tax systems such as audits, evasion penalties, information reporting, withholding regimes, taxpayer education, self-assessment regimes, and public disclosure.
- The good news is that modern analytical tools, econometric and theoretical, can be applied to these policies.

Withholding and Information Reporting

In the United States, the income tax noncompliance rate is:

- 56% when "little or no" information reporting
- 11% when "some" information reporting
- 8% when "substantial" information reporting
- 1% when both withholding and substantial information reporting

This pattern provides compelling empirical support for the deterrence theory.

Public Disclosure

- Policy in the United States during the Civil War, and again in the 1920s and 1930s.
- Current policy in Norway, Sweden, and Finland; it was policy in Japan from 1949-2004.
- A serious proposal in Australia recently.
- Supporters say it reduces tax evasion/avoidance and improves policy transparency, opponents decry the loss of privacy and the negative attention brought to the affluent.
- What do we know about its consequences?
- New evidence from Japan in Hasegawa et al. (2012) and from Norway in Slemrod et al. (2013).

Optimal Tax-System Design

- A tax-systems perspective changes answers to classic policy questions, such as optimal income tax progressivity and optimal commodity taxation.
- It also raises new questions, such as:
  - How many resources to devote to enforcement?
  - What is an optimal auditing structure?
  - How far to push third-party information reporting?
  - What is the proper role of firms in remittance?
  - If higher top tax rates would induce taxable income flight offshore, should we abandon the attempt, or crack down on the flight itself?

Taxes and the Missing Middle

- Dharmapala, Slemrod, and Wilson (2011) identify conditions under which it is optimal to exempt small firms from taxation, and consider per-firm administrative costs.
- These inefficiencies occur in part because some firms obtain the tax exemption by reducing their outputs to inefficiently low levels—below the tax net cutoff—creating a “missing middle” of intermediate-sized firms.
- This production inefficiency is balanced against the cost savings from collecting revenue from, on average, larger firms.

Insights

- The British economist Frank Hahn once wrote that “optimal tax formulas are either guides to action or nothing at all.”
- In the past, these formulas mostly refer to a stylized world far from the reality of withholding, information reports, audits, tax havens and evasion.
- Tax-systems analysis applies rigorous economic tools to issues that are prominent in the formulation and administration of tax policy.
- For more, see Slemrod and Gillitzer’s *Tax Systems* (MIT Press, 2014)

Policy Contributions

- Policymakers should recognize the interrelationship among tax rates, tax bases, enforcement, and administration.
- There are many alternative ways to raise revenue, and many types of costs, some that show up in government budgets but most of which do not.
- The costs of using one tax instrument often depends on the setting of the others.
- Recognizing that tax policy is really ***tax-system*** policy can ward off substantial policy errors, such as foregoing tax increases because the existing base is too narrow or too poorly enforced.