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

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Conventional wisdom has it that evasion is nearly nonexistent with respect to consumption taxes, perhaps partially explaining why evasion research in the United States has focused almost entirely on income tax evasion. More recent research on both consumption and income tax enforcement indicates that the conventional wisdom suffers from a number of poor assumptions that, upon closer inspection, have no grounding in evidence. If a national sales tax were instituted to replace the income and payroll tax systems currently in place, the acceptance of these assumptions in designing the enforcement mechanisms for the national system would result in a dramatic increase in the tax gap, substantially reduced revenues, and ultimately a requirement to increase rates to account for revenue losses from evasion. Ultimately, it would require a large expansion of Internal Revenue Service (IRS) compliance enforcement efforts rather than contraction or, as has been proposed in some cases, outright elimination of the IRS. I will address the following **four assumptions** in this paper:

- Evasion under a sales tax system is nonexistent,
- The amount of sales taxes collected by entities with a propensity toward theft of sales tax is immaterial,
- State estimates of sales tax compliance rates can be used to estimate sales tax lost to evasion or theft, and
- Under a national sales tax there would be no need for the Internal Revenue Service.

Methodology

The discussion and conclusions in this paper were developed based on qualitative, quantitative, and quasi-experimental research carried out over an 18-month period within the Department of Revenue (DOR) of Florida—a major state that relies heavily on the sales tax for revenue (59 percent of total taxes). This research project was composed of four major components:

1. Interviews of DOR field personnel were conducted, accompanied by review of current and historical management data, reports, audit and investigative results, and other relevant documents covering a period of 10 years. This portion of the project was designed to construct a baseline for compliance activities currently carried out by DOR personnel and to develop an understanding of the existing enforcement paradigm. Additionally, interviews of subjects in criminal investigations over a 10-year period were reviewed. Finally, interviews of subjects and potential subjects were conducted during the quasi-experimental portion of this study to provide a profile or typology of those who evade or steal sales taxes collected.
2. Since there is no third-party verification of sales taxes collected, an observational survey was developed to test the efficacy of the use of tax evasion predictors in a sales tax system. The survey was designed as a proxy for DOR personnel's evaluation of potential fraud indicators through the review of available reporting and compliance data supplemented by other readily-available third-party and observational data. The purpose of this survey was to test the ability to accurately predict fraudulent activities with a minimal amount of data gathering from outside the DOR.

3. An analysis of the use of task force operations was conducted to gauge the impact on enforcement outcomes of magnifying available enforcement resources through cooperative operations with other federal and state agencies.
4. In the quasi-experimental portion of this project, detailed third-party data were accumulated in several industries to identify potential sales tax evasion and theft more accurately. This quasi-experimental activity was designed as a pilot test of a Targeted Industry Enforcement Program. Companies identified as potentially involved in fraudulent activities were contacted by letter and were provided with detailed information providing evidence of a compliance problem. Those companies were required to respond and provide information to verify that their reporting was accurate or enter into agreements to rectify their compliance issues. These issues were resolved through a variety of actions including referral to collections, full audit, or criminal investigation and prosecution. Interactions with these subjects were documented and contributed to the development of the evader typology mentioned above.

A discussion of the specific results of each part of this project goes well beyond the scope of this paper. However, much of what was learned in carrying out the above research informs the conclusions reached in this paper. Complete details related to the above study are available (Christian, 2010).

Assumption One: Evasion Under a Sales Tax System Is Nonexistent

Sales tax enforcement efforts in the states are structurally similar to the income tax enforcement model used by the IRS, but adapted to sales tax enforcement. The same voluntary reporting structure is used and enforced through punishing deterrence policies linked to delinquency identification and audit capabilities. This adaptation of the income tax compliance enforcement system to sales tax systems is the beginning of the problem: sales tax compliance enforcement issues are very different from income tax enforcement issues. Income taxes are relatively easier to enforce due to the level of third-party reporting required in such systems. Based on data from the IRS 2007 Statistics of Income, 82.59 percent of all income reported on tax returns is subject to some type of third-party verification (Internal Revenue Service, 2007). Based on IRS tax-gap estimates, the majority of the tax gap is related to income that is not subject to such third-party verification. With respect to the tax gap related to individual income tax underreporting, the net misreporting percentage with respect to amounts subject to little or no information reporting is 56 percent and the misreporting percentage with respect to amounts subject to some information reporting is 11 percent. By contrast, the misreporting percentages for amounts subject to substantial information reporting and amounts subject to substantial information reporting *and* withholding are 8 percent and 1 percent, respectively (Internal Revenue Service, 2012). Table 1 summarizes the impact of third-party verification with respect to individual income tax returns based on both reported and estimated unreported revenues. Unreported income is based on the individual income tax underreporting gap of $190 billion divided by an assumed marginal tax rate of 28 percent.

TABLE 1. Impact of Third-Party Verification of Income in Income Tax Enforcement

Amount Reported by Taxpayers	Estimated Unreported	Amount Verifiable by Third-Party Information	Amount Verifiable as a Percent of Amount Reported	Amount Verifiable as a Percent of Amount Reported + Unreported
$8.8 trillion	$.7 trillion	$7.3 trillion	82.59%	76.84%

Research indicates third-party verification plays an important role in compliance enforcement on several levels. The 1982 Taxpayer Compliance Measurement Program (TCMP) found a positive correlation between underwithholding of income tax and a subsequent underreporting of the tax liability (Chang & Schultz, 1990). Martinez-Vazquez, Harwood, and Larkins (1992) observed that people with liquidity problems were less likely to pay commercial debts and theorized that liquidity problems may have the same effect on the behavior of taxpayers. Using experimental methods, they found that if the possibility of evading taxes in a safe manner existed, a near-majority of people would take that chance, and the proportion of individuals choosing to evade who were in an illiquid position was significantly larger. Blanthorne (2000) found that taxpayers who have the

opportunity to underreport income actually underreported more, in both frequency of underreporting and in the amount underreported, and had lower tax reporting ethics than taxpayers who did not have the opportunity to underreport. Carnes and Englebrecht (1995) found that tax compliance increases as the visibility of income to the taxing authority increases. Antonides and Robben (1995) found that the probability of tax evasion was related to the opportunity available to the taxpayer to conceal income.

There is a generally implied assumption that there is virtually no opportunity for evasion with respect to sales tax because it is collected, and thus verified, by third-party business entities. This assumption misses the point: in a retail sales tax system there is no mechanism to verify that all of the sales tax collected is actually remitted to the government. Therefore, the real issue is not sales tax evasion; it is sales tax theft by the parties who collect the tax as an agent of the state.[1]

In a sales tax system, retail businesses become collection agents for the government and agency theory yields important insights in the analysis of sales tax compliance enforcement efforts. Two primary concerns addressed by agency theory are the problems of adverse selection and moral hazard (Droege & Spiller, 2009). Adverse selection occurs when a principal selects an inappropriate agent based on false or inaccurate information. Moral hazard refers to the situation where the agent does not provide appropriate effort to achieve the goals of the principal. Agency theory assumes adverse selection can be controlled if the principal has access to all available information, and that the required information can be obtained for a price. The principal must balance the cost of acquiring the information needed with the potential gain from selecting an appropriate agent. Moral hazard can be controlled through either behavioral contracts designed to control the activities of the agent, or through outcome-based contracts that are designed to align the goals of the principal and agent and allow the principal to monitor specific outcomes produced by the agent rather than the agent's activities (Droege & Spiller, 2009).

The state will encounter problems with both adverse selection and moral hazard in its dealings with its collection agents and must address several unique problems:

First, the state cannot choose only those collection agents it wishes to work with. Businesses meeting the minimal requirements to obtain a license to collect sales tax become agents of the state. In current sales tax systems there are few reasons for disqualification and even new businesses owned by known tax cheats or their family members cannot generally be denied a license. As a result, the state is guaranteed an adverse selection problem regardless of the availability of information about potential agents.

Second, agency theory assumes a direct relationship between the principal and the agent that makes it possible to either monitor the agent's activities or require specified results based on contract specifications. Since all retail businesses engaged in the sale of taxable property become agents, direct monitoring is impossible: there are simply too many of them. Outcomes cannot be predicted since sales tax collected will be proportional to the sales the business is able to make and the mix of taxable and exempt items sold. Setting quotas for tax collected is not possible nor would it be good public policy. The agent's duty is simple: collect the tax on all sales of taxable items, properly account for the taxes collected, and remit the total amount of sales taxes collected to the government. To ensure the agent carries out this duty, the state must either allocate the resources required for direct monitoring, or develop methodologies for predicting outcomes at the single-business level for use in direct monitoring by exception.

Third, agency theory assumes that the agent will perform well based on incentives provided by the principal. In most state sales tax systems a minor collection allowance is given to the sales tax collection agent for its efforts. This incentive is normally a small percentage of the tax collected and is generally capped at a certain dollar amount per month. In terms of agency theory, these provisions provide no incentive at all. For example, in the State of Florida the collection allowance is capped at $30 regardless of whether the business collected hundreds of thousands of dollars in sales tax or just a few thousand. Miller and Whitford (2006) point out that

[1] Sales tax evasion does exist in the form of a business refusing to collect the tax, or by treating taxable items as nontaxable, usually as a form of achieving a competitive pricing advantage over competing retailers, and losses through this type of evasion can be substantial depending on the structure of the sales tax system.

incentives large enough to induce an appropriate level of effort in the agent are prohibitively expensive for public agencies, who rely more on coercive monitoring and sanctions.

Fourth, agency theory presumes that the principal is risk neutral and the agent is risk averse, a dynamic that does not exist in the sales tax principal-agent relationship. The risk presumptions of agency theory assume the incentives to the agent under the contract take into account the fact that the risk of failure is borne by the principal, whose portfolio is sufficiently diversified to absorb the risk of failure. In the sales tax collection contract, the agent has no incentive at all, other than possibly the incentive to steal as much tax money as possible. The agent bears no risk from subpar sales tax collections because of the lack of incentive payments. The agent is essentially working for no compensation. Moreover, the principal is not risk neutral because sales tax collections are a major component of state revenue.

Finally, agency theory assumes that information is a commodity, and that all information can be known and purchased. This is simply unrealistic in the sales tax collection principal-agent contract since the state must attempt to manage hundreds of thousands, or even millions, of separate retail establishments. The cost of acquiring the level of information required to effectively monitor every agent would be cost prohibitive as is indicated by the reliance of tax agencies on audit regimens rather than contract-management activities to enforce compliance.

These problems might be interpreted to mean that agency theory is only contingently valid in the case of the sales tax collection principal-agent relationship, and it is apparent that major presumptions of the theory are, indeed, invalid in this relationship. But agency theory is instructive nonetheless in that agency theory will predict very poor results for the state as principal for the reasons discussed above.

Indeed, an agency theory analysis of the state's position in the sales tax collection principal-agent relationship provides ample reasons why compliance is significantly lower with respect to retail consumption taxes versus income taxes, where third-party verification removes the opportunity to evade with respect to a large portion of taxable income. Agency theory informs the principal in the design of contracts that control adverse selection and moral hazard, but in the instant case, it is impossible for the principal to follow that guidance. Agency theory provides the warning that in the sales tax collection process, the state must find alternative means to monitor and enforce compliance because standard methods of controlling adverse selection and moral hazard will be of little use.

Agency theory makes an implicit assumption that the agent is dishonest, and this somewhat "politically incorrect" assumption contributes to the theory's power to predict poor results for the principal when control over agent dishonesty is not perfected (Bohren, 1998). It is difficult to acknowledge that so many people will choose to evade or steal tax monies when faced with the opportunity to do so, but the research on evasion continually supports this conclusion regardless of the theory or determinant of evasion under study. Corporations take a more realistic view of opportunistic crime and commit vast sums of money each year to internal controls, corporate security, employee screening, and outside consultants in an attempt to control employee theft or embezzlement. In spite of these efforts United States organizations still lose almost 5 percent of their revenues to fraud, an estimated $652 billion in 2006 (Ramamoorti, 2007). In the private sector it is deemed reasonable to assume that many will choose to steal, and it is expected that management will be forthright in accepting that premise and take steps to minimize the damage from theft. For unknown reasons we expect our citizens, who are the same individuals corporations pay to protect against, to be much more ethical and honest in their dealings with the government than they are with private-sector enterprises. The government response to this threat is to audit less than 1 percent of accounts each year for compliance, and at the state level, audit activity is so low that it is almost nonexistent. In an environment where there are no third-party controls to help enforce remittance of sales taxes collected, government cannot reasonably assume that sales tax theft will not occur regularly.

Given that the remittance of sales tax collected by business agents is not subject to any third-party verification, the aforementioned findings predict dire consequences for compliance under a sales tax regime. Yet Watrin and Ullman (2008) note that their work is the first to explicitly focus on the behavioral differences between compliance in the realm of income tax versus compliance related to sales taxes. The lack of specific research related to tax evasion in a consumption tax environment is surprising given the core differences between how

income taxes and consumption taxes are administered and given the lack of third-party controls in a sales tax system. Watrin and Ullman (2008) also found that none of the previous models developed for the analysis of consumption tax utility and optimal mixes of taxation regimes have even allowed for the possibility of tax evasion in a consumption tax setting, and there has never been a model that allows for evasion in income tax and consumption tax regimes at the same time. To provide context for this glaring omission, it must also be understood that research related to evasion in value-added consumption taxes (VAT) are inapplicable to studies of the American retail sales tax. VAT regimes are more easily enforced because the tax is collected at multiple stages during the production process. Taxes not collected at one stage can still be collected at a subsequent stage of production. More importantly, the VAT calculations at each stage of production leave a paper trail that makes it easier to find and prove evasion, and provides an incentive for proper reporting because of the built-in credit structure (Garner, 2005). This verification and incentive structure does not exist with a retail sales tax.

Transitioning to a national sales tax from the income tax would result in moving from a tax where approximately 76 to 83 percent of the tax base is verified through third-party reporting to a tax where zero percent of the tax base is verified through third-party reporting. The results of current state compliance enforcement efforts clearly indicate that sales tax evasion and theft occur, and the installation of a national sales tax would raise the stakes through greatly increased rates and less ability to verify the tax actually collected.

Assumption Two: The Amount of Sales Taxes Collected by Entities With a Propensity Toward Theft of Sales Tax Is Immaterial

Sales tax theft is primarily a small business problem. Larger companies have internal controls in place that make it more difficult to retain sales tax monies collected from customers and, at a minimum, would require a high degree of collusion among multiple positions within the business to accomplish the theft and conceal it. Larger businesses tend to rely instead on exploitation of the “gray areas” of the law to reduce liabilities, which may in some cases rise to the level of evasion. The effect is the same: the government loses revenue. Losses from larger businesses are more likely to stem from activities related to refusal or failure to collect tax than in theft, and will often represent avoidance rather than evasion.

For example, the State of Florida had lawsuits pending against several online travel companies who were collecting Florida sales tax based on the discounted price they paid to Florida hotels for blocks of rooms rather than on the proceeds from the sale of those rooms to individual customers.[2] While expensive in terms of lost sales tax revenues, this type of activity is arguably avoidance rather than evasion because the positions being taken by the companies are generally transparent and based on an interpretation of the law. In smaller businesses, whether incorporated, operating as partnerships, or sole proprietorships, the owner or owners exercise more control over all aspects of operations, and internal controls are generally lacking. This enables the theft of state funds without collusion, which is important since employees would have less incentive to participate in theft.

It should be noted that IRS tax gap research also identifies small businesses and individuals as responsible for the majority of the income tax gap at the federal level, with underreporting noncompliance accounting for about 83.5 percent of the gross tax gap (Internal Revenue Service, 2012). Some have argued that the sales by these small businesses are immaterial and evasion would result in a lower tax gap than currently exists under the income tax. It can be difficult to develop a proxy for sales by small businesses that would be subject to the national sales tax, but consider the following:

1. Businesses with fewer than 100 employees accounted for $8.8 trillion—or about 28.5 percent—of all receipts during 2007.[3] Using the higher threshold of fewer than 500 employees for classification as a small business (per the Small Business Administration), we find that these businesses accounted for

[2] Alachua County v. Expedia Inc., 1D12-2421, Florida First District Court of Appeal (Tallahassee) finally resolved this issue in favor of the online companies.

[3] Receipts were used for this analysis rather than retail sales since a national sales tax would be applied to receipts and to a much broader range of transactions than retail sales. The actual tax base estimated for a national sales tax is $11.244 trillion gross (Bachman, Haughton, Kotlikoff, Sanchez-Penalver, & Tuerck, 2006).

$12.4 trillion in receipts during 2007, which is about 40.3 percent of the total. Therefore, small business receipts are not a trivial amount (U. S. Census Bureau, 2007).

2. If we assume a national sales tax is designed to be revenue neutral with respect to the taxes it replaces, then based on the above percentages from $712 billion to $1 trillion in sales taxes will be collected by small businesses. Again, not a trivial amount.
3. It is also assumed that the "prebate" will be funded through new revenues raised by the sales tax in order to achieve revenue neutrality (Tuerck, Haughton, Bachman, & Sanchez-Penalver, 2007). The prebate amounts to $500 billion to $660 billion at risk, based on the assumed base reduction of $2.1 trillion. These monies are being transferred by the government, in advance, under the assumption that all sales tax collections will be remitted, but 28.5 percent to 40.3 percent of these collections will be at risk as well (another $142.5 billion to $265.7 billion).[4]
4. The total amount of sales tax and prebates collected by small businesses will therefore be in the range of $854.5 billion and $1.266 trillion.
5. The Internal Revenue Service estimates the net misreporting percentage (NMP) for amounts subject to little or no information reporting to be 56 percent (Internal Revenue Service, 2012).

In my studies I found that it was not uncommon to find individual businesses stealing 90 percent or more of all sales tax collected in a variety of industries, and evasion rates of up to 92 percent with respect to certain types of income industry wide (Christian, 2010). In many cases relatively small businesses selling high-priced items, such as automobiles, or high-volume services, such as security guard services, were able to steal $2 million or more in 2 years or less at sales tax rates of only 6 to 7 percent. Many small businesses would have previously paid little or no income tax, either because they operate at breakeven or less, because they avail themselves of many of the preferences found in the Internal Revenue Code, or because they were among those businesses that fail to report all of their income (contributing to the 56-percent misreporting percentage). They will now be entrusted with up to $1.266 trillion collected as an agent of the government and will recognize that the government has no means of knowing just how much in sales taxes they have collected. Many of these businesses would not steal sales tax collections under any circumstances. Others may not view this as an opportunity to steal, but may be struggling to meet payrolls, pay vendors, and pay rent or mortgages due. When faced with a choice of remitting funds to the government that the government does not know the business has collected or keeping the doors of the business open, many of these businesses will resort to "borrowing" funds for the short term with every intention of repaying these funds at a later date. Once the realization sets in that the government has no idea the funds were "borrowed," the "borrowing" becomes a common occurrence (Christian, 2010).

This type of "borrowing" occurs now at the federal level with respect to the payroll trust-fund taxes even though employers understand that their "borrowing" may be uncovered once employees file their income tax returns and claim their withholding credits. During 2012 the IRS issued 1.6 million delinquency penalties related to employment taxes, 3.9 million penalties for failure to pay employment taxes, and 1.5 million penalties for violations of federal tax-deposit rules with respect to employment taxes (Internal Revenue Service, 2012). Some businesses, such as criminal enterprises, those interested in terrorist financing, or businesses in need of money laundering vehicles will seize on the opportunity to steal sales taxes.

It should be noted that using a cutoff of 100 employees, or even 500 employees, to signify those businesses best able to steal sales tax monies is obviously not a hard line for this determination. Many businesses with far more employees exhibit a control structure conducive to theft and many businesses smaller than 100 or 500 employees may in fact have rather sophisticated internal controls.

It should also be recognized that failure on the part of companies of any size to collect sales taxes would add to the sales tax gap, as well. Moreover, a high-rate sales tax may increase the likelihood of expanding black markets and cash-only transactions, thus reducing sales tax collections.

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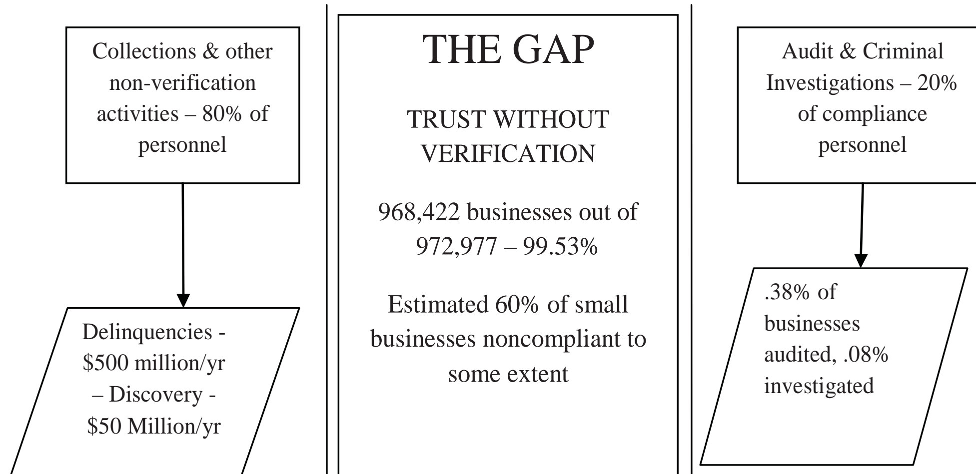
[4] To maintain revenue neutrality, the prebate will be collected on top of the revenue required to replace current tax receipts.

Assumption Three: State Estimates of Sales Tax Compliance Rates Can Be Used To Estimate Sales Tax Lost to Evasion or Theft

Many states boast of voluntary sales tax compliance rates of 95 to 99 percent, but it is important to understand that these quoted rates are generally based on delinquent returns and/or payments only ("delinquencies"). Delinquencies arise when a taxpayer has either failed to file a sales tax return, or has filed a return and failed to remit the sales tax due with the return. If no return is filed, an estimated delinquency amount is computed based on that specific taxpayer's filing history. Nothing in this process addresses those taxpayers who collect taxes and report smaller amounts of tax to the state, retaining the remainder. Further, it is unproductive to look for stolen sales tax among those taxpayers who are delinquent, because those who steal sales tax nearly always file returns on time and pay whatever tax they decide to report. In this manner, they "fly below the radar" and are rarely subject to other enforcement efforts (Christian, 2010).

Sales tax compliance efforts are generally geared toward delinquent taxpayers. For example, in Florida more than 80 percent of compliance enforcement personnel are tasked with collection of delinquencies or other nonverification activities. Collectors do not verify that amounts reported on returns are correct. Auditors and investigators review and verify the activities of only .47 percent (.0047) of taxpayers annually; meaning more than 968,000 businesses (99.53 percent) are not subject to any type of verification whatsoever. It is further estimated that as many as 60 percent of these businesses are noncompliant to some extent.

FIGURE 1. The Sales Tax Enforcement Gap



I evaluated sales tax theft in a number of industries, finding that the amount of sales tax theft far exceeds the amounts of delinquencies reflected on the books of the Florida DOR. In one such exercise, I began with several hundred dealers in a single county and used external data to develop fraud indicators. Using these indicators, I identified 192 dealers for further review. Each of these dealers was contacted and confronted with the evidence indicating they had underreported and underpaid their taxes. Given the possibility that each of these 192 cases had the potential to become a criminal tax investigation, full criminal investigation procedures were followed. The owners of the companies were called to come in for voluntary interviews and asked to bring records that might explain why they had failed to report all of their sales and remit the taxes collected. Most dealers cooperated immediately, appearing either in person or by sending an internal or outside accountant to the meeting. All were informed that the inquiry could become a criminal investigation and were advised they had the right to contact legal counsel before cooperating with the investigation, and several did, in fact, hire attorneys and refused voluntary interviews. For each of these dealers, the violations were for periods extending back three to four years (the statute of limitation for Theft of State Funds is 5 years in Florida). The latest period under investigation was at least 6 months prior to the date of contact with the dealers to prevent investigation

of dealers who were simply delinquent with their payments. Thus, all 192 dealers exhibited lengthy periods of consistent noncompliance. The following table summarizes the results of that review.

TABLE 2. 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 nonremitted tax identified through delinquencies	1.4%

There were significant revenues ($1 billion) and sales tax reported ($36.7 million) on the returns filed by these entities. However, my investigation showed that these companies failed to remit, on average, 36.8 percent of all the sales tax they collected. The vast majority of these companies filed their returns on time, but some were delinquent with respect to some periods resulting in $302,000 of delinquent taxes on the books that were subject to Department of Revenue collection activity. The delinquent taxes reflected were based on returns filed by the delinquent entities for which no payments had been received or based on estimates made by collectors based on prior filings of the entities. Collectors are not responsible for verifying that amounts reflected as due on those delinquent returns were correct and reflected all of the taxes collected by these taxpayers, or that prior returns that form the basis of current estimates of delinquent taxes were correct. Such verification is not in their job descriptions. The $302,000 delinquent out of the $36.7 million these companies had reported yields a delinquency rate for this group of companies of only .8 percent. The Department would have reported 99.2-percent voluntary compliance with respect to these taxpayers—an obviously incorrect conclusion. The end result is that by focusing only on delinquencies, the department might have eventually realized enforced collections of $302,000 from these companies but would have never been aware of and would have been unable to recover the additional $21.4 million stolen. Further, none of these businesses had been selected for audit for any of the periods under review.

There is no generally acceptable basis for estimating the total sales tax gap, and it cannot be derived from general audit and investigative results because only a tiny percentage of businesses collecting the sales tax are audited or investigated. Moreover, since audits are strategic in nature rather than random, there is no basis to generalize audit results to the entire population. One thing that is clear, however, is that delinquency rates are not a valid proxy for evasion and theft potential.

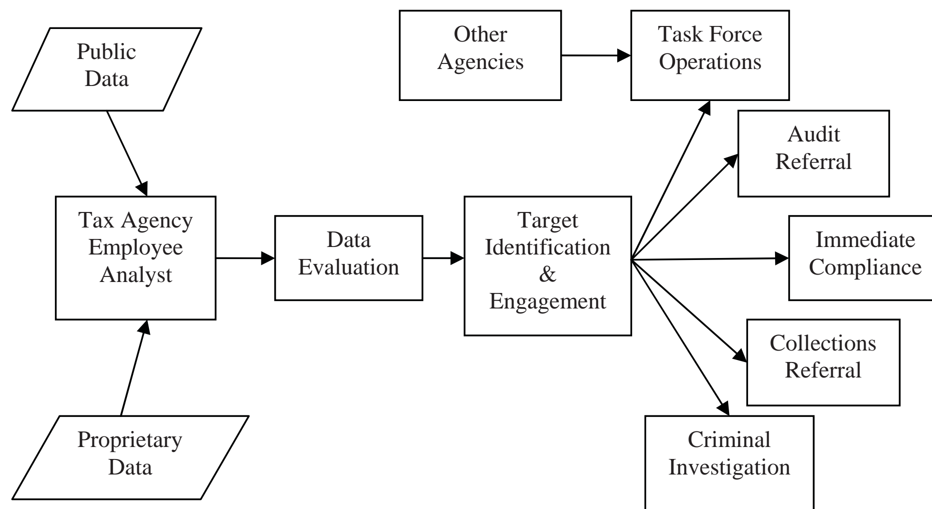
Assumption Four: Under a National Sales Tax There Would Be No Need for the Internal Revenue Service

There are those who advocate a national retail sales tax to replace all other taxes at the federal level. Some of those advocates attempt to “sell” the idea by playing to populist anger and frustration with the income tax system generally and the IRS specifically. They argue that the IRS would no longer be necessary in a sales tax regime. The author believes such arguments are based on faulty assumptions regarding evasion, or the lack of any assumptions regarding evasion in some cases. The assumption is made that the federal government would be just as efficient in collecting sales tax revenue (through the states) as the IRS is in administering and collecting those taxes currently in effect (Tuerck, Bachman, & Sanchez-Penalver, 2007). This assumption ignores the fact that the enforcement environments for these varying taxes have little in common. It also demonstrates a lack of understanding of the sales tax enforcement environment specifically, which is critically important to understand if states are to bear the burden of collecting a high-rate federal consumption tax.

While states do not actively attempt to estimate the true sales tax gap for publication (since they have no empirical basis for estimating what cannot be observed), they do indeed recognize the much higher risk of sales tax theft and most have active data analysis programs in place or under expansion to aid in the develop-

ment of compliance leads for audit and investigative activities. The task is complicated by the requirement to sift through and match tremendous amounts of internal and external data in an effort to frame and understand return data and flag those taxpayers who might be engaged in theft. The required analysis process can be somewhat represented by Figure 2.

FIGURE 2. Simple Lead Development Process



A detailed analysis and evaluation of both internal and external data are required to identify sales tax theft. While third-party reporting of credit-card sales and, in some cases, of wholesale alcohol and tobacco sales can be helpful, such reporting is not comprehensive enough to stand alone as compliance-enforcement tools. For example, many have suggested to me that comparing gross sales as reported on sales tax returns over the course of a year to gross sales reported on the business' income tax return should be a good way to estimate the volume of sales taxes due. At the current time, it is not possible for states to prepare an estimate in this manner. The fact pattern may vary from state to state depending on differing state reporting requirements, but I will continue to use Florida as an example.

In Florida, businesses that elect Subchapter S status and those organized as Limited Liability Companies do not have to file a state corporate return. There is no individual income tax in Florida, so sole proprietorships do not file an income tax return. As a result, gross sales data do not exist for comparison at the state level for most small businesses. The state does acquire federal income tax return data to match to business sales tax reporting to make sure that federal sales reported matches state sales tax reporting.[5] However, companies that steal sales tax will generally make sure the sales reported on sales tax returns are consistent with sales reported on federal income tax returns. In other words, these businesses are understating gross revenues on their federal returns as well, and contributing to the 56-percent net misreporting percentage referred to in the federal tax gap estimates.

A larger problem is determining the amount of taxable sales. In most businesses gross sales do not equal taxable sales since about 60 percent of all sales are exempt from sales tax under one provision or another. Many companies who steal do so by claiming fraudulent exempt sales. There is no way to determine what portion of sales is exempt when looking at gross sales on a federal income tax return. But perhaps more importantly from the standpoint of the argument set forth in this paper, these points become moot when we consider a national sales tax, because there will no longer be an income tax return at the federal level to use for measuring whether or not an entity reported all their sales.

[5] Matching gross sales reported on sales tax returns to sales reported on federal income tax returns is not definitive with respect to underreporting sales because sales taxes in Florida must be reported on the accrual basis while sales on the income tax return could be reported on cash basis, and frequently are by small businesses.

To better understand the dimensions of the analysis problem, consider the following:

- States currently focus most enforcement efforts on managing delinquencies rather than identifying theft. The result is an allocation of maximum resources to those efforts that produce the lowest yield in terms of revenue recovered. Optimal levels of enforcement resources and the allocation of those resources to enforcement strategies should be based on an analysis of marginal revenue compared to marginal costs. It is difficult in the current political environment to convince legislatures to adopt a marginal-cost approach to tax enforcement because their primary focus is generally on reducing taxes and regulation, and cutting costs rather than optimization.
- Budget constraints dictate that agencies must seek to improve compliance results in an ever more cost-effective manner by employing innovative compliance-enforcement solutions that do not require large increases in the overall level of resource dedication. Such solutions may involve reallocating and refocusing certain existing resources and greater investments in technology.
- Sales tax enforcement is more difficult than income tax enforcement because of the lack of third-party verification that is so integral to the income tax system. Sales tax enforcement requires more manpower and the use of more complex technologies because internal systems should ideally be interfaced with a wide variety of third-party systems to approach the level of verification that exists in an income tax system. If programmed interfaces are not possible, then more manual analysis is required and the cost of enforcement increases.
- To ensure adequate enforcement of a national sales tax, IRS human and technological capabilities would need to be expanded dramatically. Currently, IRS enforcement personnel are tasked with controlling evasion related to only about 17 to 26 percent of the total tax base. Under a national sales tax the tax base subject to evasion would arguably expand to 100 percent of the base when all avoidance and evasion possibilities are considered. Auditing at current rates would be insufficient and all systems would need to be retooled for the collection and analysis of greatly different types of data than what are currently used for enforcement purposes.
- IRS systems would need to be integrated with systems from other federal agencies and from state and local Governments to approach maximum effectiveness, and this would prove troublesome given the confidentiality requirements attached to tax information.
- The increase in the sales tax rate to a combined federal and state rate that exceeds 30 percent would increase the benefits related to evasion or theft to the point where theft could become both more commonplace generally and, because of the higher yield, a major source of funding for criminal and terrorist activities.

Moving all tax compliance responsibilities down to the state level would not work, either, without large increases in the enforcement budgets at the state level. States are only just beginning to upgrade their enforcement capabilities to a more sophisticated structure designed to deal with sales tax theft rather than primarily delinquencies, so many of the costs of retooling the IRS to enforce a national sales tax would be required at the state level as well. These costs cannot be avoided merely by moving the enforcement responsibility to the states. Moreover, states would have to be able to enforce the law consistently from state to state, a function better served by a federal-level entity. To expand state capabilities to enforce a sales tax with rates that are five to six times larger than the rates they currently administer, making theft so much more profitable, is no mean task. The enforcement issues at the state level are similar to the issues faced by the IRS with respect to income items where no third-party reporting exists, except that the states are not currently addressing in adequate fashion any noncompliance beyond delinquencies and the results of the strategic audits of a tiny proportion of the businesses collecting sales tax.

Studies have shown that there is also a significant indirect effect of targeted enforcement activities (Christian, 2010), particularly within an industry that is targeted for enforcement action. To achieve this indirect effect, which will result in lower enforcement costs overall, an adequately funded, well-conceived, and active enforcement capability is required. Talk of no longer requiring the enforcement capabilities of the IRS may be popular rhetorical red meat for the masses, but such a course of action would have disastrous consequences for effective and efficient revenue collection.

Conclusion

The tasks performed by collections personnel, auditors, and criminal investigators in modern revenue agencies are critical to the mission of the agencies, but there remains a gap in enforcement coverage that allows unacceptably large amounts of sales tax theft to escape detection. Most states are quietly aware of this issue and many have embarked on sophisticated lead development programs to address this shortcoming. The implementation of a national sales tax system without accounting for the loss of third-party verification and without retasking the income tax enforcement structure to address the substantially different needs of a sales tax enforcement regime would result in a substantial increase in both the ability of taxpayers to engage in noncompliant behavior and the amount of tax revenue lost to fraud and abuse. Additionally, a high-rate sales tax with inadequate or no administrative enforcement capabilities is a perfect tool for criminal enterprise: fraud, money laundering, and terrorist financing activities.

What is surprising is that with 45 sales tax systems in existence in this country, few attempts to study sales tax theft and evasion have been made at the level required to justify some of the critical assumptions inherent in what would be a massive tax policy shift at the federal level. It is true that the ability to study sales tax enforcement in the field can be extremely limited. Access to data have been a perennial problem for tax evasion researchers because of confidentiality issues, and the same holds true with respect to the retail sales tax. It is difficult to acquire data that has not been summarized to the point of being useless, as was noted by Alm (1991), but limitations should not preclude cooperative studies within state revenue agencies with appropriate privacy protections in place. Much more research would be required to determine what an appropriate compliance enforcement regime would look like with respect to a national sales tax.

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