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STATEMENT OF

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BEFORE THE

SUBCOMMITTEE ON COMMERCE, CONSUMER AND MONETARY AFFAIRS

HOUSE COMMITTEE ON GOVERNMENT OPERATIONS

ON THE [SUBTERRANEAN ECONOMY]

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Mr. Chairman and Members of the Subcommittee:

Our testimony today deals with an issue that has been of concern to this Subcommittee since 1976 and which has been the subject of extensive recent Government and public attention-- the extent to which a subterranean economy exists in the United States and the consequences of its existence for our voluntary tax assessment system.

Anyone concerned about maintaining the integrity of our voluntary tax assessment system has to be deeply troubled by the findings of the Internal Revenue Service's (IRS') subterranean economy report released last Friday. The staggering amount of income, at least \$135 billion, on which taxes are not paid is shocking. To illustrate, had people paid the \$26 billion in taxes due on this income, the fiscal year 1977 budget deficit would have been reduced by 58 percent, from \$45 billion to \$19 billion.

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It is unfair to the vast majority of Americans who pay their proper amount of taxes to have so many others cheating the Government. As Oliver Wendell Holmes stated in a quote inscribed in stone above the IRS Headquarters building, "Taxes are what we pay for a civilized society." Apparently, too many Americans today do not subscribe to that philosophy.

It is imperative that the Government respond to this crisis in our tax system by taking aggressive action. Our testimony focuses on actions the Government should take. Our views are based on our knowledge of how IRS has previously administered our tax system and our assessment of IRS' proposals presented in its August 31 report on the subterranean economy.

In the short-term, the level of IRS' audit activity should not decline. We cannot have adequate assurance that the integrity of our voluntary tax assessment system is being maintained if IRS audits fewer returns while the number of taxpayers increases.

Over the long-term, IRS has to reconsider how to most effectively allocate its compliance resources--\$1.2 billion of the \$2.2 billion appropriated to IRS in fiscal year 1979. This includes those resources devoted to examinations, collections, criminal enforcement, and document matching.

For many years, IRS has measured compliance through its Taxpayer Compliance Measurement Program. This program, which is not sufficient for ferreting out a great deal of unreported income, has shown the compliance rate for individual taxpayers to be about 93 percent.

Thus, as late as 1976, IRS apparently was satisfied that there was not extensive underreporting and nonfiling in our economy. Indeed, IRS advised this Subcommittee in April 1976 that only about \$1.4 billion in interest and dividends went unreported. In June 1976, Treasury advised the Senate Finance Committee that unreporting of interest and dividends may have been close to \$20 billion. Last Friday, IRS said that there was about \$14 billion in unreported interest and dividends for the same period. Given IRS' apparent lack of accurate information in 1976, it is not surprising that the Service made no real effort to think about refocusing its compliance strategy.

The figures contained in Friday's report can only mean that IRS' compliance strategy has not been as effective as the Service thought. How could it have been when the income that should have yielded about 15 percent of all potential taxes due the Government in 1976 was not even reported in the first place?

Given the results of IRS' study, it is clear that the Service needs a comprehensive compliance strategy. To develop this, IRS needs to determine the extent to which it is presently detecting unreported income from the various pockets of non-compliance. It then needs to consider reallocating its resources based on that determination and assess the need for additional resources to close the tax gap for each source of unreported income. (The Treasury Department, the Office of

Management and Budget, and the Congress should be involved with IRS in deciding how to most effectively allocate the compliance dollars <sup>the way we</sup> IRS ~~has~~ to insure that the Government can more adequately go after unreported income.)

Regardless of what else is done, IRS needs a more effective national criminal enforcement strategy to deal with the extensive amount of illegal income on which no taxes are paid.) We have observed the lack of such a strategy. This must change.

(Withholding of income tax at source and document matching must be extended.) These are the primary tools available to insure that most taxpayers properly report the amount of income upon which they are obligated to pay taxes. Some of the problems with the document matching program are that (1) payers are not submitting all required information documents, (2) many information documents are not used, (3) additional income could be subject to document matching, and (4) a management information system is needed for proper program planning and evaluation.

We have not had sufficient time to study IRS' report in detail, but IRS' findings are certainly not out of line with the conclusions reached by various scholars in the past several years--that our country's subterranean economy and the resulting amount of tax revenues not collected are substantial. From a policy standpoint, the cumulative data is sufficient to eliminate any argument about the significance of the problem. The discussion now needs to focus more precisely on how

accurate the estimates are, what can be done about the problem, and how resources should be allocated to do it.

IRS' study focused only on individual taxpayers and certain types of illegal income. Thus, its estimate of unreported income obviously is understated as is its estimate of the tax loss. For example, including unreported income, such as kickbacks received by corporations, would obviously increase the amount of tax loss. IRS did not include estimates of unreported illegal-source income for many types of activities because, to quote the study, "[of] the chaotic state of the statistical information in this area." No figures are available on illegal source income obtained from such activities as arson for profit; smuggling of goods other than drugs; bootlegging of cigarettes, films, tapes, records, or pornography; protection rackets; embezzlements; or theft. Had IRS been able to make estimates of the illegal income derived from such activities, there is no doubt the illegal-source income figure cited would have been much higher.

For example, in 1974, the U.S. Chamber of Commerce estimated that total losses from white-collar crime in both the public and private sectors exceeded \$40 billion annually. This means that the balance between the resources IRS needs to devote to legal and illegal sources of unreported income cannot be accurately determined on the basis of the statistics presented in its August 31 report.

Other studies of the subterranean economy have estimated it to be larger than IRS' estimates. The definitions and methodologies vary and are subject to debate. The estimates produced are as varied as the methodologies. The conclusions, however, point toward a massive problem permeating all stratas of American society.

In late 1977, Professor Peter Gutmann of the City University of New York estimated that the subterranean GNP was about \$176 billion, a figure equal to 10 percent of the legal GNP. Professor Gutmann's methodology is based on the fact that currency in circulation, which has been growing more rapidly than demand deposits, is being used for "off the books" transactions. From 1961 to 1976, the ratio of currency in circulation to demand deposits grew from 25 to 34 percent. He attributes the growth in the subterranean economy to high taxes, government rules and regulations (social security, employment, building codes), illegal activities, and taxpayer disenchantment with government policies. He calls for improved government services and income redistribution policies, control of inflation, and tax code revisions to allow for greater upward social mobility.

More recently, in May 1979, Professor Edgar Feige of the University of Wisconsin - Madison defined the "irregular economy" as including traditional illegal activities and such tax evasion schemes as moonlighting, "off the books" employment, skimming of retail sales, illegal alien employment, and barter.

He disputed Professor Gutmann's basic assumption that all unreported income is the result of cash basis transactions. He argued that total transactions must be used as a basis to compare official national income accounts such as GNP with total income produced. On this basis, he estimates the subterranean economy for 1978 to be about \$542 billion, or equivalent to 26 percent of the official GNP. Professor Feige suggests that incentives must be provided to reduce the irregular economy; and that some of these include lower taxes and legalization of certain illegal goods and services.

Other estimates have concentrated on specific parts of the subterranean economy. For example, the annual heroin traffic at the retail level has been estimated to range from \$3.5 billion to \$10 billion, and more. In December 1978, the National Narcotics Intelligence Consumers Committee estimated the total annual retail value of illegal imported drugs to be \$40 billion.

Other types of studies have attempted to measure the rate of noncompliance with tax laws and the characteristics of noncompliers without attempting to estimate the dollar magnitude. For example, the Survey Research Center of Oregon State University, in a December 1975 report, stated that about 15 percent of Oregon's taxpayers admitted underreporting their income to the State and about 9 percent admitted not filing a State income tax return. The Center found that taxpayers' age,

expected likelihood of being caught, occupational skill level, extent to which tax matters were discussed with friends, and sex could be used as predictors of underreporting. The July 1979 Annual Tax Study done by the Roper Organization observed that taxpayers thought overdeducting was the most common form of Federal income tax cheating--39 percent of all taxpayers who itemize deductions. Those interviewed perceived 22 percent of the public to be underreporting and 7 percent as failing to file. Tax evasion through bartering and solicited cash payments was perceived to run into billions of dollars.

The remainder of our testimony addresses in more detail some of the specific corrective actions IRS should take. We recognize that the purpose of IRS' report was to measure the extent of the subterranean economy, not to develop a detailed plan of action regarding what to do about it. But the Commissioner did point out, in his foreword to the report, some steps IRS and Treasury are taking to increase compliance.

The actions the Commissioner said IRS was taking are appropriate. However, the actions cited by the Commissioner are almost all underway and represent responses to earlier Congressional, GAO, or internal IRS concerns. The Service should give attention to some more fundamental corrective actions, such as reexamining its compliance and enforcement strategies.

## IRS' COMPLIANCE STRATEGY

IRS has a range of enforcement tools to combat the subterranean economy. These tools, which include collections, withholding and document matching, audits, and criminal investigations, must be combined in a compliance strategy which seeks to maximize voluntary compliance among all taxpayer groups. This may require IRS to completely rethink its current compliance strategy and to reallocate its resources considering all the forms of noncompliance and the enforcement tools available. Such a strategy could have major implications in terms of the effect of the current mix of compliance efforts.

IRS needs to monitor relative noncompliance

The need for information on the extent to which taxpayers underreport their income was pointed out to IRS by this Subcommittee in 1976. IRS' August 31 report is a necessary first step toward developing an overall national strategy to deal with the problem. As the Commissioner points out in his foreword, "Knowledge about overall compliance is important for the efficient administration of tax laws."

This monumental effort, however, should not be construed by IRS as a one-time response to increasing publicity and pressure from the Congress. Instead, it should be viewed as a necessary prerequisite to developing a national strategy to attack noncompliance. As such, these estimates should be periodically updated and refined so that trends can be

developed, pockets of noncompliance isolated, and resource allocation decisions made.

IRS needs to determine the extent to which its resources should be devoted to areas of noncompliance

IRS believes examining returns stimulates voluntary compliance more than investigating taxpayers, matching documents, closing delinquent accounts, or conducting other compliance-related activities. Historically, IRS has allocated the greatest share of its compliance resources to the examination program. From fiscal year 1974 to 1978, IRS allocated an average of 62.4 percent of its compliance resources to examinations although the percentage of returns audited during this period dropped from 2.4 to 2.3 percent.

In its financial plan for fiscal year 1979, IRS allocated about \$713 million, or 61 percent, of the total \$1.167 billion in compliance resources to the examination program. Of the remainder, IRS allocated \$275 million (24 percent) to collections, \$128 million (11 percent) to criminal investigations, and \$51 million (4 percent) to document matching. IRS allocated the other \$1 billion of the \$2.2 billion appropriation to activities not directly related to compliance, such as returns processing and taxpayer service.

Allocating resources this way may not assure coverage of identified noncompliance "target areas" in proportion to their importance. For example, a greater positive effect on voluntary compliance might be achieved by putting additional

compliance resources into the document matching program as opposed to the audit or collection programs. But, unless IRS looks at all three programs within the context of how they together foster increased compliance among targeted groups of taxpayers, it cannot effectively make such a decision.

IRS needs to determine the impact of its programs on compliance

The basic measure of taxpayer compliance is the extent to which reported tax liability is valid and paid. Several components exist within this basic measure. These include the extent to which (1) taxpayers report all their income; (2) deductions, exemptions, and credits are correctly claimed; and (3) reported liability is paid. IRS' measures of compliance are more limited in many cases.

IRS uses as its primary measure of noncompliance the Taxpayer Compliance Measurement Program, which measures only the audit detectable noncompliance of taxpayers who file a tax return. Thus, it ignores the noncompliance of individuals who do not file. It cannot measure noncompliance associated with tax fraud; nor does it adequately measure illegally-earned, and, to some extent, legally-earned, but unreported income.

While IRS' recently issued report on the subterranean economy sheds more light on the compliance levels in these areas, the programs directed at these forms of noncompliance are not equipped with good measurement criteria. For example, the document matching program has no measure of the total

income subject to the program, and cannot measure its effectiveness against the total of income reported on the documents. Thus, the document matching program managers do not know whether they are achieving 10, 50, or 90 percent of the program's potential.

IRS needs an overall compliance strategy

Given the magnitude of the noncompliance problem, and the failure to adequately address areas such as the subterranean economy, IRS must have a comprehensive, long-range strategy to assure the most effective use of its compliance resources.

However, within the compliance function, the examination, collection, document matching, criminal investigation, and related programs do not appear to follow an overall strategy or a systematic and well-integrated approach to the noncompliance problem. Each compliance group establishes its own objectives, approach, and plans which may be most beneficial to its own goals but may not necessarily be the most beneficial to the overall compliance mission. Thus, planning is a fragmented process. As a result, IRS has no assurance that the process adequately directs programs and resources toward overall compliance goals and issues.

On an overall basis, it is extremely difficult to assess the extent to which IRS' various compliance programs are on target with areas of noncompliance. In its recently issued report, IRS estimated for example that tax due on legally earned unreported income totaled as much as \$17.1 billion

in 1976. For tax year 1975, the document matching program recovered \$148 million. The nonfiler program recovered \$425 million that year. If those amounts were related to the \$17.1 billion, it would mean that the programs recovered 3.4 percent of the tax due. The question is: how much of the \$17.1 billion was targeted for recovery by these two programs as opposed to other compliance programs? The answer cannot be found in IRS' management information systems.

#### NEED FOR A NATIONAL CRIMINAL ENFORCEMENT STRATEGY

Regardless of what other actions are taken to establish an overall compliance strategy, IRS needs a better defined national criminal enforcement strategy. IRS' Criminal Investigation Division plays a vital role in detecting underreporters and nonfilers, particularly those who derive their income from illegal sources. Each year, over 95 percent of the Criminal Investigation Division's 9,000 detailed investigations are directed at underreporters and nonfilers. Moreover, about 27 percent of the investigations are directed at individuals who do not report all or part of the income they derive from illegal activities.

The complex and devious nature of schemes involving illegal activities limits IRS' ability to detect and deter the tax evasion which goes hand-in-glove with those activities. Routine audits and collection actions have little chance of detecting such schemes, which often involve no "paper trail."

Special agents assigned to the Criminal Investigation Division are specifically trained and authorized to (1) use sensitive investigative techniques such as surveillance and controlled informants, (2) work with grand juries, strike force attorneys, and Drug Enforcement agents, (3) issue taxpayer and third-party summonses, and (4) otherwise gather and analyze information from sources outside IRS. Properly directed, special agents have the potential to have a substantial impact on the problem of unreported income arising from illegal activities.

However, IRS has not been as effective as it could be in dealing with the tax fraud problem, let alone detecting non-filers and underreporters who derive their income from illegal activities, because it has not developed a well-defined national strategy for dealing with tax fraud. National direction has been inadequate. The Criminal Investigation Division's long-range plan is very general in nature and basically states that the Division will fight tax crime during the next three years. The Division's short-range plan outlines some areas which require national emphasis and does contain several specific, measurable goals. However, it needs to (1) identify more tax evasion areas requiring emphasis and (2) more specifically allocate resources to those areas.

One of the goals included in the current short-range plan requires each of IRS' seven regions to apply from 25 to 35

percent of its investigative time to illegal activities. However, the regions do not allocate this goal among the 58 district offices. Thus, each district has much latitude in allocating its criminal investigative resources.

The lack of effective national direction and control is particularly distressing from the standpoint of illegal activities because the Criminal Investigation Division has a key investigative technique--information gathering--which enables special agents to get at pockets of noncompliance that might otherwise go untouched and to detect complex and devious tax evasion schemes. However, its value and impact has been limited because little effort has been made to coordinate the information gathering activities of the 58 district offices.

Basically, information gathering differs from other IRS activities in that it does not center on analysis of information already in IRS' possession. Rather, it involves obtaining information from other Federal, State, and local agencies, using informants, conducting surveillances, and using other investigative techniques. It is that type of effort which, in our view, is needed to detect and deter nonfilers and underreporters getting their income from illegal activities. Too often, however, some district office criminal investigation divisions try to use this important investigative tool to get at (1) localized pockets of noncompliance, (2) groups which display no clear tax evasion tendencies, and (3) national problems for which they do not have adequate resources such

as tax evasion arising from international investments and fraud in Government programs. All in all, IRS' national office has done little to coordinate information gathering activities, thus reducing the effectiveness of special agents.

In recent years, the Criminal Investigation Division has recognized the inadequacy of the guidance it provides special agents at the district level and has initiated some actions to correct the problem. For example, the Division conducted a planning model study in fiscal years 1977 and 1978. During fiscal year 1980, the Division plans to test a more rigorous long-range planning process. In addition, the Division has established a research group which is seeking to develop data top management can use to better direct special agents' activities on a national basis. These actions will not have immediate, measurable effects but the Criminal Investigation Division is moving in the right direction.

More important, given that the portion of unreported income in the subterranean economy coming from illegal activities may be much higher than IRS indicates, the Service needs to give immediate attention to determining whether its criminal investigation activities are receiving sufficient resources as compared to the various compliance enforcement activities directed at detecting unreported income from legal sources. In this regard, the Commissioner stated in the August 31

report on unreported income that IRS plans to allocate more of its investigative resources to the areas of high noncompliance identified in the report. However, the Commissioner did not discuss whether the current level of investigative resources is even sufficient to deal with the problem. Moreover, to have the most impact, IRS needs to make sure that any action it takes is not reactionary but part of a carefully thought out nationally coordinated criminal enforcement plan. This means that IRS may have to reallocate discretionary resources in those districts not having nationally determined priority noncompliance programs to those districts having such problems.

#### DOCUMENT MATCHING AND WITHHOLDING

In early 1976, this Subcommittee found that IRS was failing to use millions of information documents to catch underreporters. The documents were simply being thrown away. The Subcommittee also found that tax withholding did not eliminate the need for a document matching program.

The document matching program and tax withholding are, indeed, powerful tools for combatting, on a mass scale, the problem of individuals failing to report all income received from legal sources.

#### The Matching Program

In document matching, payers are required to submit to IRS information on the type and amount of income paid to taxpayers. IRS can use its computers to match this information with income reported on the taxpayers' returns.

The program--as it exists now--started with tax year 1974 when IRS processed about 40 percent of the information documents it received from payers. For tax year 1977--the latest year for which a match has been conducted--about 271 million or 54 percent of the 505 million documents received were processed. This match involved about 70 percent of the tax returns filed and identified about 2.5 million potential underreporters.

Under the new Combined Annual Wage Reporting System, the Social Security Administration will convert millions of wage documents to magnetic tape. IRS expects to process about 80 percent of the information documents it will receive for tax year 1978 and has estimated that the 1978 matching program will identify about five million potential underreporters.

Our ongoing work in the document matching area is directed at evaluating its effectiveness in detecting underreporters. We have identified some potential problem areas.

Payers are not submitting all  
required information documents

To implement a full document matching program, IRS needs to assure that payers are providing all required documents. Previous and current IRS research has consistently shown that payer noncompliance is a serious problem, particularly among payers of miscellaneous income such as nonemployee compensation, rents, and royalties. For example, a study conducted

during 1978 and 1979 of small and medium size corporate payers showed that about 60 percent of those sampled had not filed all of the required documents for miscellaneous income amounting to over \$25 million.

In spite of the significance of the problem, IRS does not have a mass detection mechanism for verifying, on a regular basis, that payers are providing all required documents.

IRS is taking steps to develop the capacity to detect payer noncompliance on a mass scale. This fall, IRS plans to match a sample of Forms W-3 (transmittal documents for Forms W-2) against Forms 941, "Employer's Quarterly Tax Return." A research project is testing the feasibility of matching Forms 1096 (transmittal documents for Forms 1099) to the Business Master File to detect businesses who probably should, but did not, file information documents.

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Many documents submitted  
are not used

IRS matched about 54 percent of the information documents it got for tax year 1977 principally because it is too expensive to process more than a small percentage of paper information documents. The key to increasing the number of information documents matched against tax return data as well as increasing overall system efficiency is getting more payers to provide documents on magnetic media. IRS says it costs \$400 to process 100,000 documents submitted on magnetic media as opposed to over \$20,000 to process the same number received in paper form.

IRS has been promoting the use of magnetic media since 1967 and has had considerable success. The number of documents provided to IRS on magnetic media has increased from 48 million in 1968 to about 435 million (87 percent of the 501 million total) for tax year 1978. The Social Security Administration, however, and not the payers will be putting many of these documents on computer tapes. Thus, the U.S. Government still has the task, and still must bear the cost of converting 130 million or 72 percent of the wage documents to tape. Although IRS will no longer have to convert paper wage documents to computer tapes, it will still receive about 66 million paper, nonwage information returns (interest, dividends, partnerships, and foreign) for tax year 1978. It will use about 15 percent (10 million) of these. This is about the same percentage of paper documents processed in prior years when IRS also had to convert paper wage documents to tape.

More income could be  
subject to matching

There is potential for subjecting more income to information reporting and matching. For example, most interest paid in tax year 1978 on marketable U.S. public debt obligations--Treasury bills, notes, and bonds--is not subject to information reporting. As a result of efforts to establish what is called a book entry system on these securities in which the purchaser's name and social security number are known, a possibility exists to identify the taxpayers who receive such

interest. IRS has been working with the financial community to develop some type of information reporting for the interest paid to individuals.

Sources other than the information documents now used in the matching program are also available for matching income paid to the taxpayer's return. For example, IRS is researching the feasibility of obtaining and matching state tax refund data. Other surrogate information documents may be available. For example, a 1040 return containing an alimony deduction could possibly be used to determine if the recipient reported the alimony as income. IRS now relies on its audit program to detect noncompliance in these areas. IRS, however, can only audit a limited number of returns.

A management information system  
is needed for proper program  
planning and evaluation

IRS needs a better management information system to plan, manage, and evaluate the results of the document matching program.

To plan and manage the program, information is needed on the amount and relative importance of unreported income that the program can be expected to reach and the extent to which the program covers the total unreported income problem. Currently, IRS does not plan and manage the matching program in these terms.

Information is also needed to assess the effectiveness with which the program works internally. For example, about

one-half of IRS' potential underreporter cases are dropped. Many potential underreporters are not pursued and some are not even identified as a case because of various money or status drop criteria applied by the computer and by IRS staff. IRS lacks information on how many such drops occur or the relative significance of each drop criteria. Consequently, IRS does not know how many underreporters or how much unreported income the matching program actually detects.

Many cases are also dropped because they are invalid, thus wasting staff resources expended on them up to that point. The taxpayer may have simply recorded the income on the wrong line of the return, there may be offsetting errors, or a mistake could have been made by IRS in the matching process. IRS could refine its process to identify such cases earlier.

For example, in conducting the 1976 match, IRS failed to pick up pension income reported on the 1040 tax returns and to distinguish between taxable and nontaxable pension amounts reported on the accompanying schedules. Neither we nor IRS know how many incorrect cases were produced nationally, but our work at one IRS service center indicates the number of such cases may have been quite high. Of the center's 347,000 cases, at least 75,000 or about 21 percent were dropped because of problems with pension data. IRS told us that the pension problem was corrected for the tax year 1977 match.

IRS officials told us that they are (1) considering developing a management information system for the tax year 1978 matching program which would provide information on why cases are dropped, (2) eliminating some status drop criteria, and (3) reviewing all drop criteria. These actions are certainly a step in the right direction.

### Withholding

Besides document matching, tax withholding on income payments represents the only tool for dealing with income underreporting on a mass scale. There are three major questions involving the use of withholding: (1) how much underreporting do existing withholding provisions prevent, (2) should additional types of income be subject to tax withholding, and (3) how much document matching is needed for those incomes subject to withholding?

Withholding obviously prevents some underreporting. As IRS noted in its August 31 report, "income reporting is strongly influenced by whether incomes are, first of all, subject to withholding. . . ."

IRS and the Treasury Department want more income types subject to withholding because of the income underreporting problem. They have long advocated a withholding system for interest and dividends. They also recently asked the Congress to authorize withholding at source a percentage of payments made to independent contractors. In our July 17, 1979,

testimony before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, we supported Treasury's position.

The House of Representatives has passed four bills authorizing tax withholding for interest and/or dividends but the Senate has rejected the idea. Opponents of the proposals have argued, among other reasons, that IRS should make full use of the document matching tool in dealing with the unreported income problem before subjecting the private sector with the burden of more withholding.

IRS is now making greater use of document matching and, with its recent effort to develop better information on the nature and extent of the subterranean economy, is, or will soon be, in a better position to determine the costs and benefits of subjecting more income types to tax withholding. But, in the long run, withholding at source is the best way to assure the continued strength of our voluntary tax assessment system.

This concludes our prepared statement. We would be pleased to respond to questions.