PRESENTATION OF

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FEDERAL TAX DIVISION

ON [THE UNDERGROUND ECONOMY]

Speech —
Check O.P.'s for fighting.

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I appreciate this opportunity to talk to the Federal Tax Division of the Institute about the "underground economy" problem and what we in the General Accounting Office see can be done to help combat it.

Anyone concerned about maintaining the integrity of our voluntary tax assessment system has to be deeply troubled by the findings of IRS' September 1979 report on the extent to which an underground economy exists in our country. 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, for $45 billion to $19 billion.

It is unfair to the vast majority of Americans who pay their proper amount of taxes to have so many others cheating the Government. It is, therefore, imperative that the Government respond to this crisis by taking aggressive action. Over the past several months we have testified numerous times before congressional committees on actions we believe the Government should take to address this problem. Certain actions can be taken immediately while others require additional consideration by the Congress or long-range planning by IRS or other executive branch agencies. I would like to present to you our recommendations for action so that the Division can use this information as an aid in developing a position on whether and/or how you would like to assist the Government to solve this problem.

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. The Congress has already taken positive action in this regard. The Conference Committee on the Treasury Appropriations bill noted in its September 24, 1979, conference report that the conferees were extremely concerned
about the burgeoning subterranean economy and the declining trends of voluntary compliance with the U.S. tax laws that the situation may imply. Accordingly, the conferees directed the IRS to maintain quality audit coverage of 2.24 percent in fiscal year 1980. The conferees also allowed an additional 750 positions for this program and an additional $15 million to fund those positions. This action should stop the decline in the percentage of all tax returns audited by IRS.

IRS has a range of enforcement tools available to it to combat the underground 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. Historically, IRS has allocated a greater 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 now directly related to compliance, such as returns processing and taxpayer service.

Allocating resources this way may not assure coverage of identified non-compliance targets areas in proportion to their importance. IRS may have to completely rethink its current compliance strategy and reallocate its resources considering all of the forms of noncompliance and the enforcement tools available.
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 increase compliance among target groups or taxpayers they cannot effectively make such a decision.

IRS should also periodically update its estimates of the extent to which an underground economy exists and refine its data so that trends can be developed, pockets of noncompliance isolated, and resource allocation decisions made.

IRS also needs a better defined national criminal enforcement strategy. The Criminal Investigation Division plays a vital role in detecting underreporters and nonfilers of income taxes particularly those who derive their income from illegal sources. Today, IRS has not been as effective as it could be in dealing with the tax fraud problem, let alone detecting nonfilers 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. Its 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.

A 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.

Recently, the Criminal Investigation Division has recognized the inadequacy
of the guidance it provides special agents at the district level and has initiated actions to correct the problem. 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. Additionally, 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 underground economy coming from illegal activities may be much higher than IRS indicates, the Service and the Congress need to give immediate attention to determining whether IRS' Criminal Investigation activities are receiving sufficient resources as compared to the various compliance enforcement activities directed at detecting unreported income from legal sources.

Tax withholding and matching of information return documents are also very powerful tools for combatting, on a mass scale, the problem of individuals failing to report all income received from legal sources. As IRS noted in its September 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 testimony before the Ways and Means Committee
we have supported Treasury's position on need for withholding at source a percentage of payments made to independent contractors. Our support for Treasury's position is based on the results of several studies made since 1977 that all arrive at the same conclusion; the compliance of self-employed individuals as opposed to employees is much lower and, therefore, warrants the Federal Government taking additional action to assure that self-employed people, and therefore independent contractors, properly report all of their income.

The House of Representatives has passed four separate bills authorizing tax withholding for interest and/or dividends but the Senate has rejected the idea. Opponents of the proposals have argued, among other things, 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 underground economy, it is, or will soon be, in a better position to determine the cost 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.

More research also needs to be done to determine exactly who underreporters and nonfilers are, what type of income they are receiving, and why people either do not pay or underreport their income for tax purposes. In this regard, IRS currently has a study underway to determine why people pay or do not pay all of their taxes. This information is critical to determining what type of tax administration's strategies should be taken to enhance the integrity of our voluntary tax assessment system.
While IRS can take certain specific actions to expand the tax base to include those individuals who are now part of the underground economy, there are several other policy changes that the Government should consider. Although, we have not seen any hard data to support this contention, we believe that some people are reluctant to report all or part of their income because they perceive that our current laws are unfair and are designed to benefit wealthy taxpayers moreso than the average taxpayer. Reform of the tax laws and simplification of the code should help reduce such taxpayers empathy.

In this regard, it is interesting to note that the reductions in the individual income tax made as a result of the Revenue Act of 1978 were very similar an overall scale to those the Administration had proposed a few months before. But, the changes made by the Congress were very different from those urged by the Administration. If we regard families with income of up to $15,000 as being approximately the middle-class, this group would have received income tax reductions totaling $2 billion under the Administration's proposal. However, the 1978 Revenue Act as passed by the Congress provided them only half as much, a little more than $1 billion. If the middle-class concept is broaden to include all tax filers with income of up to $20,000, a similar contrast appears. The Administration proposed tax savings for this group totaling $4.2 billion, while the Congress gave them savings of about $2.6 billion. Even if one shifts the top limit upward to $30,000, this group of taxpayers, which includes nearly half of all tax filers, received less than half of all tax reductions enacted. The Administration proposed that this group received $9.1 billion or 72 percent, of all the tax reductions to be provided by amending the individual income tax law. But, the measure passed by the Congress gave them only 3/5 as much. Those taxpayers in the $30 - $50,000 range received 135 percent of the amount of cuts under the Administration proposal, while taxpayers in the $50 - $100 range received 803 percent of the cuts under the Administration proposal.
My point in citing those figures is not to comment one way or another on the appropriateness of the action taken by the Congress, but merely to highlight for you some statistics which might help explain why many people are beginning to perceive that the way they can beat the system is not to take advantage of the law as it exists, but rather to not report all of the income they earned.

There are no easy solutions to the underground economy problem. Indeed, we have to be very concerned about overreacting to it and developing draconian measures which are antithetical to the basic precepts of our society. But, the evidence suggest that unless effective action is taken to better enforce our tax laws, the voluntary assessment nature of our system could be subjected to increasing strain.