



FISCAL RESEARCH CENTER

TAX COLLECTIBILITY AND TAX COMPLIANCE IN GEORGIA

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Introduction

On July 27, 2006, the Georgia House of Representatives' Tax Reform Committee held a session on the topic of tax "collectibility." This policy brief provides an elaboration of the presentation that the Fiscal Research Center made at that session.

We consider three questions:

- How large is the tax gap?
- Why does the tax gap exist? i.e., why do people pay (or don't pay) taxes?
- What can be done to reduce the tax gap? i.e., what actions might be taken to improve collections?

How Large is the Tax Gap?

The “tax gap” refers to the difference between the tax revenue that would be collected if there was full compliance (i.e., the tax liability) and the actual tax collections. In other words, the tax gap is the amount of tax revenue that is not collected because of a lack of compliance.

We are interested in the size of the tax gap because it is a measure of the size of the compliance problem. If the tax gap is small, then there should be less concern regarding compliance, and thus less effort devoted to trying to improve compliance. On the other hand, a large tax gap should be a cause for concern. It should be noted, however, that a small tax gap is in part due to the strength of the tax administration, so a small tax gap is not a signal to reduce compliance-related tax administration.

Unfortunately, there has not been a study of the tax gap for Georgia. Despite this lack of a study for Georgia, we present some information regarding the possible size of the tax gap. We consider each of the three major taxes: sales and use tax, income tax, and property tax.

Sales and Use Tax

Two states, Minnesota and Washington, have conducted studies of the tax gap for their sales and use tax. The two studies take different approaches, with Minnesota’s study being the more comprehensive.

Minnesota’s study is based on audits and measures of overall economic activity in the state.¹ This information is used to estimate how much sales and use tax the state should be collecting. The analysis includes tax revenue that is lost from sources that are generally not revealed in audits. For example, use taxes that are owed by individuals on purchases from remote vendors are normally not collected, nor are such purchases identified in audits.

The Minnesota study estimates that the tax gap in 2000 was \$451 million. This amounts to about 12 percent of actual sales and use tax collections. The study

¹ “Minnesota Sales and Use Tax Gap Project: Final Report” American Economics Group, Inc, November 19, 2002.

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finds that of this amount, \$288.1, or 63.9 percent, is from underreporting and \$163.0 million (36.1 percent) is from non-reporting. The study projects a tax gap for 2007 of \$693.1, an annual increase of 6.3 percent.

The state of Washington's tax gap study includes not only sales and use taxes, but excise taxes such as tobacco taxes as well.² The Washington study is based only on audit information, so unlike the Minnesota study it does not include estimates for tax revenue from economic activity that would not be identified by an audit. Thus, it is expected that the Washington study will uncover less of the uncollected taxes than the Minnesota study.

The Washington study finds that in 2000, the tax gap was \$182.6 million, or 2.2 percent of tax liability. This is a much smaller tax gap than estimated in the Minnesota study, and is due, at least in part, to the narrower approach to the estimation. The estimated tax gap is also slightly smaller than the Washington estimate.

The Washington study found that there was a higher rate of noncompliance among newer and smaller firms. For firms that have been in business two years or less, the noncompliance rate was estimated to be 6.7 percent, compared to 1.5 percent for other firms. For firms with gross income between \$100,000 and \$500,000, the noncompliance rate was 9.1 percent.

These two studies provide some benchmark for the possible compliance problem for Georgia. However, without a Georgia study, it is not possible to determine whether the sales and use tax gap in Georgia is closer to 2 percent or 12 percent, or the smaller or the larger than these two estimates.

Income Tax

The Internal Revenue Service conducts an extensive tax gap study for Federal taxes, including personal income tax, corporate income tax, and payroll taxes (e.g., the Social Security tax). The IRS updates its tax gap estimates regularly, although the lag is substantial. The most recent IRS tax gap estimate was released in February

² "Department of Revenue Compliance Study" Research Report #2004-4, December 20, 2004, Washington Department of Revenue.

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2006, but is for the tax gap in Tax Year 2001. The tax gap is estimated based on a random sample of about 46,000 tax returns, which are audited in great detail.

The IRS tax gap is an estimate of the difference between what taxpayers should have paid and what they actually paid on a timely basis. The IRS estimates that the overall gross tax gap for Tax Year 2001 comes to \$345 billion, or 16.3 percent of tax liability. This gap is comprised of non-reporting (\$27 billion), underreporting (\$285 billion), and underpayment (\$33 billion). IRS enforcement activities, coupled with other late payments, recover about \$55 billion of the tax gap, leaving a net tax gap of \$290 billion for Tax Year 2001.

Federal compliance rates are much higher when there is a substantial third party reporting and withholding (98.6 percent compliance rate) than when there is little or no information reporting (46.1 percent compliance rate).

Of the \$285 billion in underreporting, \$197 billion is from the personal income tax, \$30 billion from the corporate income tax, and the rest from other taxes. The overall underreporting gap for the personal income tax is 18 percent.

Table 1 shows the net misreporting rate by various tax items for the personal income tax. As can be seen, compliance is highest for wages, since that source is subject to withholding, while business income has a much lower compliance rate.

Georgia relies on the Federal adjusted gross income as the basis for its income taxes. Thus, any tax gap at the Federal level is likely to be realized at the state level. Thus, we would expect that the personal income tax gap is at least 18 percent in Georgia, if the Federal non-reporting is similar over all states.

But it is also possible that individuals file and report income at the Federal level, but fail to do the same at the state level. We compared Georgia personal income tax returns for resident filers to Federal personal income tax returns for Georgia residents. We find that approximately \$3 billion of Federal adjusted gross income that is reported for Federal personal income tax purposes does not appear to be reported for Georgia income tax purposes. We also find that there are about 7 percent fewer Georgia resident state income tax returns than Georgia resident Federal tax returns. Because Georgia's filing threshold is relatively low, we do not believe

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TABLE 1. INDIVIDUAL INCOME TAX UNDERREPORTING GAP ESTIMATES, TAX YEAR 2001

Type of Income or Offset	Tax Gap (\$B)	NMP†
<i>Total Underreporting Gap</i>	<i>197</i>	<i>18%</i>
<u>Underreported Income</u>	<u>166</u>	<u>11%</u>
Non-Business Income	56	4%
Wages, Salaries, Tips	10	1%
Interest Income	2	4%
Dividend Income	1	4%
State Income Tax Refunds	1	12%
Alimony Income	*	7%
Pensions & Annuities	4	4%
Unemployment Compensation	*	11%
Social Security Benefits	1	6%
Capital Gains	11	12%
Form 4797 Income	3	64%
Other Income	23	64%
Business Income	109	43%
Nonfarm Proprietor Income	68	57%
Farm Income	6	72%
Rents & Royalties	13	51%
Partnership, S-Corp, Estate & Trust, etc.	22	18%
<u>Overreported Offsets to Income</u>	<u>15</u>	<u>4%</u>
Adjustments	-3	-21%
SE Tax Deduction	-4	-51%
All Other Adjustments	1	6%
Deductions	14	5%
Exemptions	4	5%
<u>Credits</u>	<u>17</u>	<u>26%</u>
<u>Net Math Errors (non-EITC)</u>	<u>*</u>	

†NMP = Net Misreporting Percentage. *Less than \$0.5 billion.

that much of this loss is due to individuals who file the Federal return but are not required to file Georgia's return.

While these are rough, "back of the envelope" calculations, they do signal the possibility that there is substantial income reported on Federal returns that is not being reported for Georgia personal income tax purposes. Given our analysis, the Georgia Department of Revenue analyzed their 2004 returns, and categorized differences between Federal and Georgia reporting by reasons for non-filing. For 2004, the Department reports that 97.17 percent of Federal returns were also filed in Georgia. The difference is 111,684 returns, or 2.83 percent of the Federal returns

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filed for 2004. Of this, a number were legal non-filers (due to part-year residents with no tax liability or Georgia residents with zero tax liability). A total of 42,278 (or 1.07 percent of all Federal returns filed with Georgia identified as state of residence) were identified by the Department of Revenue for further investigation. If the level and distribution of non-filers were approximately the same in 2002 and 2004, this suggests that about 1/3 of the tax returns that we identify as potential non-filers in 2002 would be classified for further investigation by the Department of Revenue.

Property Tax

We know of no study of the tax gap for property taxes. However, we also know that the collection of tax liability is very high. Generally 94 percent to 98 percent of the property tax levy is collected on time; probably 99 percent or more is ultimately collected.

There are two reasons for this. First, the tax collector knows who owes the property tax. Second, the tax collector has a very powerful enforcement tool since he/she can foreclose on the property if the owner does not pay the property tax.

However, tax avoidance is still possible. The taxation of much taxable personal property is based on a return filed by the business, which could under report such property. The Wisconsin Department of Revenue audited several large firms with out-of-state headquarters, and found substantial under reporting of personal property. Used aircraft sellers are known to fly their planes out of state in order to avoid paying the property tax on their inventory. Owners register their cars in a jurisdiction that is not the true domicile of the car in order to face a lower property tax rate. It is also possible that owners claim inappropriate homestead exemptions. For example, an owner may convert the house to a rental unit and continue to take the homestead exemption. Also, someone might take homestead exemptions in more than one jurisdiction. There is no evidence regarding how large this tax avoidance is.

Why Does the Tax Gap Exist?

In very basic terms, there are three reasons why there is a tax gap: taxpayers make mistakes, taxpayers cheat, and there is poor tax administration. The first part of the explanation for the tax gap is simply that people make errors (unintentionally) in their bookkeeping, and that they also make errors because they do not fully understand the tax law.

A second part, probably the major part, is that people cheat on their taxes. Some individuals or firms simply do not file tax returns. Many of those who do file misreport various items, either underreporting income or sales, or overreporting expenses and deductions. There are also instances where firms who withhold income or payroll taxes, or who collect sales and excise taxes, do not remit these taxes to the authorities.

Third, underlying all of this is poor tax administration – few audits, tax auditing systems that are outdated, under-funded, and poorly targeted, even corruption and malfeasance in the tax administration.

To focus more on some different aspects of these three basic reasons, we discuss some recent research evidence that addresses the basic question: why do people pay taxes (and, thus, why do people not pay taxes)? This research has been conducted by economists, other social scientists, and tax administrators, working in the United States and in many other countries around the world.

A standard – and obvious – conclusion from the economic analysis of the tax gap is that enforcement of the tax law is a central factor in peoples' decisions to pay taxes. This means that *fear of detection* is a powerful incentive for people to pay their taxes: if people are afraid that their cheating will be detected in an audit, then they are more likely to pay their taxes – and so the tax gap will be smaller. The evidence is that an increase in the audit rate (i.e., the percent of returns that are subjected to an audit) of, say, 10 percent will increase reported income by 1 to 2 percent.

There are other ways to increase the fear of detection besides increasing the audit rate. These alternatives include:

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- Audits can be more selectively targeted to those occupations and sectors where cheating has been found to be more prevalent;
- Source-withholding – or the withholding of taxes at the point where income is earned – reduces the opportunities for cheating. (In Section II it was noted that the compliance rate was much higher for income which was subject to withholding.)
- Wider use of third-party sources of information can establish a “paper trail” or a “data warehouse” that makes it easier for the auditor to determine if a taxpayer fails to report a particular source of income (e.g., interest income);
- Information-sharing between states, and between the states and the Federal government, can increase the probability that cheating will be detected.

Related to enforcement is the *penalty* – or the punishment – that is imposed on any cheating that is detected. Without a penalty, audits would provide little incentive to not cheat. Most monetary or financial penalties are small (typically back taxes plus an interest penalty), unless fraud is proven. Even so, there is evidence that larger penalties encourage more reporting (e.g., an increase of 10 percent in the effective penalty rate increases reported income by about 1 percent). There are also ways in which punishment can be imposed other than through financial penalties. Sending cheaters to prison (think of Leona Helmsley) and even making the names of cheaters publicly known are also forms of punishment. A particularly creative example comes from a city in India, which recently sent drummers to the homes of people who had not paid their property taxes. The drummers stood outside the homes beating the drums around the clock until the delinquent taxes were paid.

Linking in the taxpayer’s mind the taxes paid with government services received has been shown by researchers to increase peoples’ willingness to pay taxes; that is, no one likes paying taxes but everyone likes receiving quality government services. Thus, getting the taxpayer to make more clearly this connection will reduce the tax gap. There is also evidence that people pay more taxes the more they feel that government is responsive in providing what they value. There is even some evidence that suggests that positive rewards to individuals found to be honest, via such things as lotteries for passing an audit, encourages more compliance.

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There is also some evidence from around the world (e.g., Singapore) that providing better *taxpayer services* encourages people to pay more taxes. Here we mean that the tax administration makes it “easier” for individuals to pay their taxes. We will discuss this in more detail below.

Related to making it easier for individuals to pay their taxes, there is growing evidence that *a simpler and more stable tax code* encourages increased compliance. Making the tax code simpler will also likely reduce errors that contribute to the tax gap.

Finally, economists (with the help of psychologists) are recognizing that, although incentives matter in why people pay taxes, there are other, more *psychological factors* as well. There is evidence from many countries of a “social norm” of compliance. What is meant by this is a pattern of behavior that is judged in a similar way by others and that is sustained in part by social approval or disapproval. If others behave according to some socially accepted mode of behavior, then you will as well; if others do not so behave, then you won’t either. This notion suggests that you will tend to comply as long as you believe that others are complying, but if cheating becomes the norm – if there is seen to be a widespread and socially acceptable “culture of evasion” – then you will cheat as well.

This point is relevant to a tax amnesty in which tax cheaters are allowed to pay back taxes without penalty. Such a program can send the signal that cheating is acceptable, and so can affect the social norm of compliance.

Another psychological factor is that there is overwhelming evidence that individuals “overweight” the probability of being audited, acting as if the audit rate that they face is much higher than its true value. This is something that works to the benefit of the tax administration.

Among the *other insights* from recent research on why people pay taxes are the following:

- A higher tax rate leads to less reporting (and more cheating), with an estimate that reported income falls by 0.5 percent to 3.0 percent for a one percent increase in the tax rate;

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- It is easier to collect some taxes than others. For example, collecting the use tax from individuals on items purchased over the internet is nearly impossible;
- The average level of cheating is higher for returns prepared with paid assistance;
- A one percent increase of income increases reported income from 0 to 1.0 percent, implying that higher income individuals report a smaller percentage of their income;
- Women, the elderly, and married couples are less likely to cheat on their taxes.

What Can Be Done To Improve Compliance?

The discussion in Section III suggested various actions that can be taken to improve compliance. We expand here some on that discussion. Methods to address the broad issue of tax compliance fall into several main categories: tax administration, tax services, tax culture, and tax structure.

Tax Administration

First, there is scope for an improvement in tax administration. Traditionally, there are three main aspects of tax administration: taxpayer registration, taxpayer audit, and collections. Improvements in each of these areas are feasible.

- Increase taxpayer registration and identification via better use of third-party information. Tax administrators could use the following information:
 - Cross-reference between different taxes such as checking sales tax vendors against income tax returns;
 - Use of social security records, phone records, financial system data, and agency data bases such as driver's licenses to identify potential non-filers;
 - Consistent use of IRS information.
- Increase the number of audits. This can be done either by hiring additional auditors or by contracting out audits to for-profit firms. There is evidence that providing an additional \$1 of audit resources to the IRS generates additional revenues of \$3-\$5. Evidence for the Oregon Department of Revenue suggests additional revenue of \$1 to \$3 per additional dollar of audit resources;
- Improve the quality of audits – and of the auditors. The usefulness of the audit depends on the time devoted to the audit and the competence of the auditor. Potential auditors are graduates of accounting program, and better students (auditors) have lots of opportunities to work in the private sector. Thus, to get the better students, government has to pay a comparable salary;

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- Increase penalties for tax cheating, such as the interest rate on unpaid taxes, and publicize tax evasion convictions as an alternative type of penalty;
- Improve the effectiveness of audits via adoption of modern audit technology, including more systematic selection of returns for audit. By developing and using a method of “scoring” tax returns in the hope of identifying likely tax cheaters, the return on the investment in audits can be increased;³
- Follow up on taxpayers found to be noncompliant with the Federal personal income tax. Certainly, if the IRS does an audit and finds underreporting, the state should follow up to determine whether the taxpayer also owes the state addition taxes. The IRS and the Oregon Department of Revenue appear to have similar but nonetheless distinct audit strategies. Even so, there is evidence that Oregon could increase its collections by making better use of IRS audits per se. But the state should do more than just piggy-back on IRS audits. The state might do additional audits because the number done by the IRS is relatively small and because it appears that there are taxpayers who file Federal returns but who do not file state returns or file inaccurate state returns;
- Apply non-harsh penalties often and consistently, facilitate payments through the banking system, allow for simple cross-tax deductions (e.g., interests payments on loans or mortgages), and rely more heavily on source-withholding;
- Grant additional power for collecting delinquent accounts. For example, in addition to imposing interest and fines for late reporting, the Department of Revenue could be given the power to revoke business licenses or driver’s licenses.

In addition to these somewhat standard suggestions, the state might consider the following policies.

- Disallow cash deductions unless the taxpayer identifies the person or firm that was paid. The IRS already requires such information for charitable contributions;
- Require increased information from selected taxpayers. For example, as a form of simple audit, the state might request more detailed information

³ Scoring is a way of ranking taxpayers for audit purposes that uses various characteristics of the taxpayer such as sources of income and the magnitude of particular deductions, as well as a scheme for weighting these factors.

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from certain taxpayers about sources of income or deductions, particularly regarding business income;

- Allow 3rd party audits. Ohio allows firms that have been identified for an audit to contract with a 3rd party to conduct the audit. This is less disruptive for the firm and reduces the workload of the state audit staff. In addition, firms can voluntarily subject themselves to a 3rd party audit, and, in return, the state waives any penalty for underpayment of taxes.

Taxpayer Services

It is increasingly the case that reforms are not limited to these traditional enforcement mechanisms, which tend to emphasize the threats of detection and punishment. Instead, tax administration may be changed by introducing policies that see the taxpayer more as a client in need of services. This alternative approach emphasizes the provision of taxpayer services via such things as:

- Promoting taxpayer education and developing taxpayer services to assist taxpayers in filing returns and paying taxes;
- Simplifying taxes and the payment of taxes;
- Simplifying tax forms and editing the instructions, recognizing that the education level of many taxpayers is very low;
- Promoting voluntary compliance by lowering taxpayers' costs associated with filing their taxes;
- Improving phone service by expanding the hours of operation and reducing the time taxpayers have to spend on hold;
- Using focus groups of taxpayers to improve the tax administration website, including the ability to ask questions via email;
- Ensuring relative stability of the tax systems;
- Promoting a taxpayer and a tax administrator "code of ethics."

The basic thrust of these "service paradigm" actions is to treat the taxpayer more as a client than as a potential criminal.

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Change Tax Culture

Government can take various actions that change the culture of paying taxes. Among the steps that might be considered are the following:

- Use the mass media, or send personal letters, to reinforce tax compliance as the social norm – and publicize cheaters;
- Emphasize the link between payment of taxes and the receipt of government services;
- Target certain groups (e.g., new firms or employees) in order to introduce from the start the notion that paying taxes is the social norm;
- Enlist other organizations such as retired teachers to promote compliance, so that it is seen (again) that paying taxes is the accepted pattern of behavior;
- Avoid leading individuals to think cheating is “okay” – a tax amnesty is a classic example of sending the wrong signal, as is demonizing the tax code and tax collectors such as the IRS or the State Department of Revenue;
- Address perceived tax inequities in the ways people feel that they are treated through the tax system. If taxpayers think they are being treated unfairly, they are less inclined to respect the tax code and therefore less likely to comply.

Tax Structure

Finally, there is scope for changes in tax structure (e.g., rates and bases) that can encourage more compliance. Lower marginal tax rates give incentives for greater tax compliance. This would also require broader tax bases, and it is not known precisely how this aspect would affect compliance incentives.

About the Authors

James Alm is Professor and Chair of the Department of Economics in the Andrew Young School of Policy Studies. Much of his research has examined the responses of individuals and firms to taxation, in such areas as the tax treatment of the family, tax compliance, tax reform, the line item veto, social security, housing, indexation, and tax and expenditure limitations. He has also worked extensively on fiscal and decentralization reforms overseas. He is Editor of *Public Finance Review* and an Associate Editor of *Economic Inquiry* and *Review of Economics of the Household*.

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About The Fiscal Research Center

The Fiscal Research Center provides nonpartisan research, technical assistance, and education in the evaluation and design of state and local fiscal and economic policy, including both tax and expenditure issues. The Center's mission is to promote development of sound public policy and public understanding of issues of concern to state and local governments.

The Fiscal Research Center (FRC) was established in 1995 in order to provide a stronger research foundation for setting fiscal policy for state and local governments and for better-informed decision making. The FRC, one of several prominent policy research centers and academic departments housed in the School of Policy Studies, has a full-time staff and affiliated faculty from throughout Georgia State University and elsewhere who lead the research efforts in many organized projects.

The FRC maintains a position of neutrality on public policy issues in order to safeguard the academic freedom of authors. Thus, interpretations or conclusions in FRC publications should be understood to be solely those of the author.

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The Demographics of Georgia III: Lesbian and Gay Couples (Gregory B. Lewis). Using 2000 Census data, this report compares the residential patterns, household incomes, house values, property taxes, and parenting patterns of Georgia's same-sex and different-sex couples. FRC Report/Brief 124 (March 2006)

The Demographics of Georgia IV: Hispanic Immigration Economic Policy Issues (Felix Rioja, Neven Valev, and Amanda Wilsker). This report analyzes the economic policy issues in education, health care, the labor market, financial services and the fiscal impact arising from the large increase in Hispanic immigration in Georgia. FRC Report/Brief 122 (March 2006)

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The Demographics of Georgia I: Population in the State of Georgia: Trends and Projections to 2030 (Glenwood Ross). This report explores trends in Georgia population dynamics and projects population growth to the year 2030. FRC Report/Brief 120 (February 2006)

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The Fair Tax and Its Effect on Georgia. (Laura Wheeler, Sally Wallace and Lakshmi Pandey). This brief analyzes the impacts of a national retail sales tax on Georgians. FRC Brief 118 (December 2005)

A Tax Limitation for Georgia? (David L. Sjoquist). This brief examines the need for a tax limitation in Georgia and the issues of design of tax or expenditure limitations. FRC Brief 117 (December 2005)

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Potential Effect of Eliminating the State Corporate Income Tax on State Economic Activity (Laura Wheeler). This report analyzes the effects to state employment and investment of eliminating the state corporate income tax. FRC Report/Brief 115 (October 2005)

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Tax Collectibility and Tax Compliance in Georgia

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