Economic Policy Institute

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THE CRISIS IN TAX ENFORCEMENT AND ADMINISTRATION

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INTRODUCTION

This edited transcript records a discussion from April 12, 2005 at the National Press Club in Washington, DC, on how inadequate enforcement of tax laws is sabotaging the federal government's ability to pay for programs and rewarding those who game the system. The panel of experts present examined the enforcement crisis plaguing the nation's tax collection system and to explore solutions.

Max Sawicky: We're going to talk about what more than one of us has called "The Crisis in Tax Administration and Tax Enforcement." Obviously the week provides an occasion. I wrote an overview of this issue, and I just want to say two things about it.

The U.S. is blessed with a great deal of voluntary compliance with our tax code, and it relieves the government of an enormous burden. It's an asset to the economy and to our fiscal policy, and it's something we're in danger of squandering because of an assortment of problems in tax enforcement.

We expect this to be especially salient in light of the difficulties in the federal budget, which at least some of us believe will require, among other things, more revenue than the government is currently collecting. Tax increases are not fun, but we expect to see a need for some. And for lack of ability to get all the increases we might need, we also expect to see a greater interest in enforcement of existing tax law, in light of the fact that over $300 billion of revenue is owed but not paid voluntarily and timely on an annual basis by the latest estimate. This clearly means an extra burden on everybody that is paying. So without further ado, let's begin with Donald Alexander.

After we're done, we'll have time for questions.

Donald Alexander: I've got a couple of points. As I'm sure many of you in the audience know already, IRS has to administer many programs that are not tax programs – economic, social and the like. They are at least equal to, and may well exceed, the volume of discretionary expenditures in the federal budget.

Not only does the IRS have the enormous responsibility to administer the largest public benefit program outside of welfare, but also it must decide such things as whether the National Press Club is located in one of Washington's economic districts that's entitled to help by municipal bonds, or whether that district stops on the other side of the street.

No wonder the IRS has problems administering this monstrous group of non-tax outlays, whether these tax expenditures are deemed to be good for the economy or whether the tax expenditure is deemed to meet a social need. And each Congress wants to have its own imprimatur on something that appeals to the public and to the voters.

So instead of increasing an outlay like Pell grants – something that works every week – Congress will create a new program, put somebody's name on it, and tell the IRS to enforce it, and the IRS simply can't do that. Until we face up to the idea that the tax laws should be used to raise revenues in a sound and administrable way, we're going to have huge problems in tax administration.

There's one other point. In former IRS Commissioner Charles Rossotti's book, he repeats the notion of a former commissioner: the way to obtain compliance with this Internal Revenue code of ours is not so much to enforce it as to interpret it, and that an educated taxpayer will comply since 98% of the revenues that IRS collects are collected without enforcement action by IRS. Most receipts come in through withholding, as you know.
You have to devote IRS resources to education and assistance rather than to audits, collection and other compliance actions. A former commissioner was pushing that under the label of "Compliance 2000." Mr. Rossotti bought into it, hook, line and sinker, and look what we have today. We tried it. It didn't work.

Sheldon Cohen: I've been practicing tax law in this city for a little over 50 years. When I came to the tax law, and I worked on drafting the code for the Treasury, it was as thick as my thumb. Today, it's two volumes of about two-and-a-half to three inches. So we got about six inches worth of statute, and that's what Don has indicated.

If you drive west of here on 270, which I do quite often to visit my children, you find that there's a 55-mile speed limit. You will find if there are a few police cars traveling out there, people will be going somewhere between 55 and 60. On the days when there are no police cars, people will be driving at 60 or 65. We're all that way. I mean, none of us are blatant violators, but we'll squeeze up a little bit.

So it is with tax enforcement. That is, you need to see some enforcement in order to understand better that you should comply. My father's favorite joke was the fellow who goes into the dry cleaner and lays down his tickets for his dry cleaning and a $20 bill. The owner brings him his suit, counts out the change, the customer is walking out the door, and the owner looks down. He says to himself, "I thought it was a $20 bill." It turns out it was a $50 bill. And he's struck with a moral dilemma.

Does he tell his partner? And that's the issue here. I mean, the United States has a tax system. It is working. It is working better than we give it credit for. It is not working near as well as it used to or ought to, because each of us who do comply is being shortchanged by those who don't.

And there is a tax that's imposed on us because compliance is not what it ought to be. Now, I'm not a Pollyanna, and I'm never going to tell you that we can design a system and that the Revenue Service is good enough to enforce a system that's going to get 99% of all revenue. But 85% is too low, and we see from recent data that the service has just published that it's fallen off 11% from the last time they did a survey.

Well, they did their last survey in '88; I think the most recent data was from 2003, so it's been 15 years. We fell off about 11% from what we would have expected. Now that's too much, and it's in the wrong direction. We ought to be improving compliance, so we need to encourage Congress to behave itself. And as Don indicated, for every illness of America, there should not be a tax cure. Because every time the Commissioner of Internal Revenue has to deal with that, he has to pull people off what they're doing and train them in the new statute.

When I first started in this business, there was a statutory change maybe once in two or three years. We now have four or five changes a year. We now have retroactive changes. All of these require vast administrative expenditures that are really negative. They don't do anything affirmative. They're just holding on. This is not political because you can lay this on either party.

Any program that you can design an expenditure for, Don and I can design a tax expenditure for. And therefore, I used to cry before the Appropriations Committee or the Ways and Means Committee, “Don’t lay that on me because I can’t do it. It’s too complicated.”

It’s too much for us to deal with. Now, you have a less receptive Congress in that sense today, whether it be controlled by either party. That is, because of budgetary constraints, Congress has moved more to tax expenditures than ever.

Henry Aaron: Since the early 1990s, the number of letters of inquiry that the IRS sends out to taxpayers has fallen by approximately 70%. The number of personal interviews of taxpayers regarding their liabilities has fallen by more than 70%. The number of IRS field staff is down by 25%. This has occurred as population has risen, as the complexity of tax law as described by both Sheldon and Don has increased enormously, and perhaps most importantly, as the number and complexity of international transactions has increased.

This opposite trend of the challenges the IRS is facing and the resources it is given is reminiscent of the story about the farmer who decided he was going to cut back on the amount of oats he gave to his horse and lace the feed with sawdust. His goal was to get to 90% sawdust and 10% oats. Unfortunately, the horse dropped dead when he got to about 70%.

One has the feeling at this point that the IRS is living on diminished resources and that the voluntary compliance that’s been emphasized so far as the keystone of successful tax administration is in jeopardy. I do not believe, despite the persuasive arguments that Don and Sheldon and others have made, that Congress is going to forebear from keeping the tax law as complex as it is now and making it more complex in the future.

Nor do I believe that they are going to forebear from pursuing expenditure goals through tax incentives of various sorts. The reason for the latter is simple enough. Tax incentives make the government look smaller. The people who are in effect using them and executing them are not on the government payroll. Therefore, one is more immune from the charge of big government, which still has sting in the American political landscape, if one uses tax devices rather than direct expenditures.

Everything they said is true about the preference for direct expenditures. But I think their preaching is not likely to stop the trend. What that suggests to me is that those who say that we do not need to devote more resources to administration are simply dead wrong. It doesn't mean pouring huge quantities of resources, but it means a gradual ramping up of IRS resources until we are able to perform as many direct investigations as were done a decade ago.

And that was not the high water mark of tax enforcement either. There are changes in tax law that would simplify administration, and they should be pursued. Others on the panel are going to address tax shelters directly. But my own view is that it would be useful if, in the cases where the government brings successful action against those who claim tax shelters, fines or other charges were also levied against the companies, legal firms or accounting firms responsible for the design of those shelters.

There are problems with this kind of change in responsibility within our legal system. But it seems to me the balance has to be shifted more in favor of the government and away from those who want to play the kind of Russian Roulette where the object at risk is the U.S. Tax Code.

Eric Toder: Since I was Director of Research at IRS, not a commissioner, I will confine my comments to the more narrow area of research. The IRS just recently completed – for 2001 tax returns – the first large scale random audit study of individual taxpayers since the last Taxpayer Compliance Measurement Program (TCMP) for tax year 1988.

In this phase of the National Research Program (NRP), the IRS audited about 46,000 individual taxpayers, with an over-sampling of high-income returns. IRS has released some preliminary figures from these audits, which show the estimated tax gap for 2001 is up slightly. The estimates have a pretty large range.

It used to be $311 billion. They've now raised their estimate to between $312 and $353 billion, which represents between 15 and 16½% of taxes owed. Underreporting by individual taxpayers, which was the subject of this study, accounts for roughly 50% of this tax gap.

The range of error suggests that the total underreporting by individual taxpayers could have remained the same or, if you used their upper-bound estimates, could have increased by 25% compared to the old estimates. So it's possible when the final numbers are in that we will see a fairly significant estimated increase on non-compliance.

While these results are interesting, even more interesting products of this kind of work are the detailed data it will produce on sources of non-compliance and the use of the results to update IRS audit selection formulas. None of us will ever get to see the selection formulas. But I do hope that we will see some of the results of that in terms of a decline in the percentage of no-change returns that IRS audits in future years. The next phase of the NRP is going to be a study of flow-through returns, S-corporations, partnerships, and the like. This is a very high priority area because flow-through entities are generally recognized to be a big part of the compliance problem.

However, there are some barriers to doing these studies that are worth mentioning. In the TCMP, a lot of people complained about the audits. They were called audits from hell. There was a lot of political pressure against doing a follow-up study. I think the NRP was designed in a somewhat more user-friendly way, and the IRS has overcome the hurdle to doing these.

But another part of the hurdle to doing these is resources. In fact, when you take auditors off-line from doing work that is known to be productive to do random audits, people in the IRS who have goals they want to achieve in terms of enforcement may get quite upset. And there's a lot of internal resistance and tension between the goals of finding out how to do things better and doing what you know how to do best right away.

To put this in perspective, looking at the IRS data book, the IRS in 2004 completed audits of just over 12,000 partnerships and S-corporation returns. So if the next study looks at 3,000 random audits, that would be 25% of the audits they actually did for operational reasons in 2004. I make these comments only to reinforce the point other speakers have made about the need for budgets.

As Henry has said, what we've seen as a big drop in enforcement resources since the early 1990s has been reversed.

Enforcement is up in the past two or three years, though there's a long way to bring it back to where it used to be. But in a world of tight budgets, dollars for additional audits can come at the expense of audits that try to find out how to do things better, and also at the expense of investments in computer modernization and research, which are critical for tax administration in the long run. So I guess in looking at what the IRS is doing and the adequacy of budgets, you should not only look at the number of bodies in enforcement, but there really needs to be an overall growth in the budget so that the increase in enforcement doesn't come at the expense of investments that the IRS needs to make to do its job better in the future.

Reuven Avi-Yonah: I want to talk specifically about the international aspect of this problem. And basically, out of the $350 billion tax gap that was mentioned before, knowledgeable people like former Commissioner Rossotti and others have estimated that something between $40 and $70 billion come from the fact that we don't collect taxes on income that is earned by American citizens overseas.

Now this is not tax sheltering in the sense that with tax shelters, there's always a debate about whether they're legal or not. This is all completely illegal behavior, and it's a major problem that we don't do nearly enough about. Now the IRS in general, despite all of this, is a very, very good tax administration.

I've been working in the last year on improving tax administration in China and I can tell you that they've got problems that we don't even dream about having, primarily the corruption of the tax administration itself. We don't have these kinds of problems. We have a very good compliance record of actually collecting close to $2 trillion dollars in taxes every year.

But the not-too-well-known reality is that the vast majority of this collection comes from withholding information reporting to a very good computer system through Americans paying their taxes. And the problem is that there are some people in this society who feel that it is their God-given right to put their money in the Cayman Islands and other places.

So, for example, some people have estimated that there is $800 billion of American money sitting in the Grand Caymans alone, and people do not pay tax on that and do not declare it to the IRS. Occasionally, a Cayman Islands banker is persuaded to speak because a money laundering activity suddenly revealed that he has 1,500 clients, all of whom are Americans who hide an average of $1.7 million each in the Caymans and don't pay tax on it.

So we're talking about significant figures. Just by comparison, if we're talking about $50 billion to $70 billion, the entire IRS estimate of the corporate tax gap of tax shelter activity is only $30 billion. So this is a significant thing. What can be done about it? Well several things.

The first thing is, as other speakers have emphasized, to increase resources. The IRS, as far as I know at least, has not really put a lot of emphasis on this area. The second thing is, we need to really emphasize getting information from other countries.

And there have been some recent initiatives about this, in particular, proposed regulations that the Clinton administration put out and that the Bush administration has, to some extent, endorsed about engaging in automatic information exchange when a U.S. bank sends interests overseas. But at the moment, it's limited to 16 countries, mostly the OECD member countries and some others.

There's no reason not to expand this further. Basically, there's no reasonable expectation of privacy vis-à-vis the IRS or, for that matter, other tax administrations and countries that we know are democracies and are not going to abuse the information. We need to cooperate more with international organizations like the OECD that happen to be at the forefront of this battle. And we need to even think about drastic measures that are already in the law today.

For example, the law today says the code that we are entitled to actually suspend the non-collection of withholding tax on payments to countries that do not cooperate on information exchange. That has never been implemented.

But the reality of the matter is that we do have the right to implement it and we should consider doing so in cases where this kind of blatant evasion is leading to a significant underpayment of American tax by American citizens.

Robert McIntyre: Ladies and Gentlemen, we have a crime wave on our hands in this country. And the perpetrators are some of the wealthiest and biggest corporations and people in America.

They're assisted, facilitated, and enabled by our most prestigious accounting firms, some of our most prestigious law firms, and most importantly, by our elected officials, who have turned a blind eye to tax cheating, tax evasion and tax avoidance and have ended up putting the bill on ordinary taxpayers to the tune of hundreds of billions of dollars a year.

Loopholes, tax avoidance, and tax evasion are sort of different, although sometimes it's hard to tell them apart. A loophole is when you lobby it into the law fair and square, I suppose. You paid for it, so arguably you ought to get it. Avoidance is when if you get caught, you've got a fighting chance that maybe you'll get away with it anyway. Evasion is when you're just flat out cheating. The lines are murky.

In fact, the Chairman of the Ways and Means Committee can't tell the difference among them and I have trouble myself sometimes. So Congress not only passes new tax breaks – and you've heard about how much thicker the tax code's gotten over the years – but it now tolerates tax cheating on the theory that's simply a backdoor tax cut for the same people to whom Congress gives the loopholes in the first place. So we see our companies and our wealthy people shifting their money offshore, taking advantage of pension funds, charities and Indian tribes to find non-taxable entities to shift income to while they take the tax deductions, and so on. It's horrible.

Meanwhile, the budget for the tax police – the IRS – is down by about a fifth since the mid-90s. The number of people working in enforcement is down by more than a third since the mid-90s. If, as Sheldon points out, you don't have any police, then people who want to break the law are going to think they're going to get away with it.

And right now, the audit lottery is stacked heavily in favor of those who want to cheat and against those who are honest. There is a very well-financed, politically well-connected tax cheaters' lobby in this country, led by the accounting firms and the lobbyists for the big corporations. There's even a group in Virginia that says on its website that it is devoted to making sure that people can cheat on their taxes, and oddly enough, it had some power.

So what do we need to do? Well, if we're going to address this problem there are some legislative and regulatory changes and international agreements that would be very good.

But what we need are more tax police. The public has to understand that the IRS are the good guys. They're on our side. They're protecting us from those who would steal our money with a fountain pen. Until we get the public to wake up and demand that our political leaders do something about this problem, we're going to continue to pay more than we need to in taxes, get less than we need in government services, and run great big budget deficits.

So my message to America is wake up. It's your money they're stealing. Let's do something about it.

Max Sawicky: Thank you. All right, we'll take questions now. Let me just note that Bob has written a paper especially for this project, and there's an EPI paper. I'd also like to refer people to the volume that Henry Aaron co-edited from Brookings, which has some of the latest and greatest research on this topic. So with that, we'll take questions.

Robert Kuttner (*The American Prospect*): Gentlemen, I commend you for doing this. Why is this such a hard sell politically? Bob McIntyre, I think, summed it up in a sentence that the IRS are the good guys, and as a result of all of this cheating, ordinary honest people pay more in taxes, get less back in services and the economy suffers the consequences of higher deficits. And here's $300 billion plus on the table. With a little bit of leadership, you would think this would be a slam-dunk. Go after the cheats, you get better services. You pay less in taxes. But this seems to be very uphill politically. Why is that?

Henry Aaron: I turn the question back to you. Why is it we all get a lump in our throat when we see a police car driving behind us on the freeway? I think it's really rather similar. We envision ourselves as being the object of the enforcement with greater acuity than we recognize the need for it with respect to those who are genuinely flouting the law.

Sheldon Cohen: Bob, I used to use this. And I use it before the Congress. That is, if you saw someone going into your neighbor's home, you'd call the police. Well, someone who steals from the tax system is basically stealing from all of us.

Well, when they steal from an insurance company or they steal from the government, it's somehow or other diminished because it's not so much from me, and I don't protect my neighbor's home that same way. There's something going on there. I mean, all of us have dealt with this at one time or another.

I was lucky I had a President and a Congress that were cooperative. We got what we needed. They didn't say to me, "What can you get by with?" The question was, "What do you need?" That's not the case any longer. As I say, it's not a partisan issue because both parties have engaged in this in the last 25 or 30 years. I mean, there has been a gradual complication of the Code and a gradual diminution of support for the Revenue Service over the last 25 years.

Donald Alexander: Nothing gets more applause, more money, and presumably more votes, than blasting the Internal Revenue Service and saying, "Let's abolish the IRS."

The National Retail Sales Tax proposal is based on the notion that the IRS should be abolished and then the states can, of course, collect the money very easily because people will rush forward to pay an additional 30% tax on that $500,000 home they intend to buy.

Big government is unpopular, and the IRS is, and has been, the poster child for big and intrusive government. That seems to be turning around particularly in the Senate, and I certainly hope that will last.

Unidentified Speaker: I wear two hats. One of them is working in one of the big accounting firms. The other one is as a professor, teaching tax policy and writing articles on tax shelters and all this kind of activity.

Just what I've seen in the last several years is a tremendous trend towards clients being more cautious today. Clients are asking us if these are reportable transactions and, if they have any doubt, we advise them to report a transaction. Clients are more aware today of penalties, and they're certainly careful enough. And if there is any doubt, they are going to maybe take the more conservative view. On the other hand, I must say that just a week ago, I was astonished to see a person came to us. He's the CFO for a corporation that hasn't filed returns for the last six years.

So I just wanted to say again that today, I think the trend is towards being more careful. I see reportable transaction regulations partially succeeding maybe in making taxpayers more alert. If there is a transaction, they should report it. Penalties certainly help.

Sheldon Cohen: I told the head of the Office of Professional Responsibility that when he bagged a senior partner at one of the major accounting or law firms for failure to supervise the idiot who approved the transaction, then we would see people say, "Hey, maybe that could happen to me."

And the problem is we all identified the bad guys as the actual fraud perpetrator. To the extent that any of us stand by and watch what goes on without wanting to know, we are aiding and abetting. And that's a problem. You can't build a peaceful society until everybody in the neighborhood wants a peaceful society because it requires everybody's cooperation in reporting the bad guys. And if we don't, then the bad guys predominate.

Henry Aaron: Certainly I think it's worrisome that whenever something bad happens to a corporation like Enron, you suddenly get a report that shows all of its tax shelters and all of the opinions. Such a wealth of information suddenly becomes available. That just suggests that we're just seeing the tip of the iceberg.

Sheldon Cohen: Gresham's Law applies in tax practice as it does in money. That is, bad practice will drive out good, and the problem is that as relatively honest practitioners see the people shading towards bad activities don't have any consequences from it, they tend to slide a little bit too. So it makes us all a little less punctilious.

Allen Kenney (*Tax Notes*): On the idea that some have put forward regarding a pendulum swinging back and forth at the IRS between service and enforcement, do you think that's the case? And if so, and we're heading back towards enforcement, are we simply just going to have another case where, somewhere down the line, we just swing back towards service? Thanks.

Robert McIntyre: I think the pendulum goes neither way personally, unless you get the budget bigger. The budget is just preposterously low at the IRS right now, compared to its history and given all the new duties that they have. They're running half the government through the IRS, and its budget is down by 20% in terms of share of the economy or number of employees, compared to the population over a decade. With the IRS's duties so much greater and its budget down, it's going to screw up on both service and enforcement unless Congress is persuaded that there are more votes in doing good than in doing bad.

Sheldon Cohen: Everyone forgets that in the first cut – no matter what your denominator, whether it's for service or for enforcement – you must produce returns. You must collect the tax and process the returns. There are certain things you must do.

So once you cover those things, if there's no money left for enforcement, it's gone. Even if, for example, the Service says this year it wants another half-billion dollars for increased enforcement, but they don't ask for any money for increased salaries, and if salaries are going to go up by 2% or 3% because the law mandates it, where is the money going to come from to pay those salaries out of that same half billion dollars? So the numbers don't add up.

Robert McIntyre: Let me talk about that so-called enforcement increase that the president has proposed. When you tot it up in terms of the responsibilities, it's about a 2% increase, if he gets it. That's after a 2% cut the year before. So they're treading water even on enforcement. But then you find they're closing the walk-in offices, and there's going to be no more telephone filing, and all the other things they should be doing on the service side. So give the IRS another $10 billion, then we'll pick up another $50 billion in uncollected taxes, and we can start having a government that works better and a tax system that people can have some respect for, rather than feeling like chumps.

Donald Alexander: I think the pendulum is swinging a little bit. I agree with my friends on the left wing that the aggregate budget is surely not enough. But out of that aggregate, more money has been moved into enforcement, leaving less for service. And that's too bad. However, one large element has not been mentioned: processing tax returns is a lot cheaper if the tax returns are filed electronically. So they're saving some money on one of the essentials that IRS has to do.

I would hope those savings would stay in IRS, and permit more enforcement. The pendulum that always was present, particularly service after the '97-98 hearings, is now swinging toward enforcement. We do need more enforcement resources. The pendulum may indeed shift back. While the IRS has received much support for increased enforcement in the Senate Finance Committee, the Ways and Means Committee has been remarkably quiet. And the Speaker of the House – when he occasionally calls for, if not the abolition, surely the reduction of the IRS – is not exactly IRS's closest friend.

Stephen Joyce (*Daily Tax Report*): You talked a little bit about tax shelters for the individuals. Treasury came out yesterday with some figures about corporate inversions companies going abroad and establishing business there. I was wondering, Mr. Cohen, because you've represented companies and also you're on the enforcement side, what should the IRS be doing about inversions?

Sheldon Cohen: I think Reuven's probably the expert in the area. What can you do about inversions? Well, you can do what the statute lets you do. And foreign operations are permissible. Congress keeps trying to contract what is permissible to shift offshore.

But we have this opportunity to bring dividends back. Of course, it's a screwed up statute that's causing a lot of problems. Congress doesn't know whether it favors our activities abroad at a lesser tax rate or whatever the international rates are, or if it favors treating corporations like it treats individuals – that is, taxable on their worldwide income. And with the Congress being schizophrenic, the enforcement is schizophrenic.

Reuven Avi-Yonah: Obviously something was done about inversion in the 2004 Act, but it still has significant problems. And one thing that was done deliberately in March 2003 was to grandfather companies like Tyco, who all got away scot-free.

The other thing is a definition of inversion in the Act which was deliberately relatively narrow so you could do several things, such as setting up the corporation in Bermuda to begin with. And in my mind, the best solution to that is the thing that was recently proposed by the Joint Committee, which is to only recognize corporations being overseas if they're really overseas. That is to adopt a plan for a corporate residency.

If a corporation is really here, then it shouldn't be treated as being in Bermuda or in Barbados or in any other place. If its management sits in New Jersey, Oklahoma, Connecticut – like Stanley, or some other firm like that – they really should be made to move overseas if they really want to move overseas. And if they continue to be here and just set up a fake operation in Bermuda, that shouldn't be enough.

Al Crenshaw (*Washington Post*): The question is for Eric primarily. The new audit examinations are presumably only of returns that actually got filed and Commissioner Everson said there was no effort to look at the underground economy. So presumably you have two areas here – people involved in legal activities who didn't file and people involved in illegal activities who presumably didn't file – that would suggest there's a lot more uncollected revenue out there than showed up in this study. I'm interested in your thoughts on that.

Eric Toder: Well, I guess two things. One, with respect to the underground economy, there are as you said two pieces of it. The tax gap does not include the illegal activities. However, there's a large piece of legal business activity in the so-called informal sector. The IRS, as part of TCMP, did a separate analysis of informal suppliers, and they will be doing such an analysis as part of the NRP. It has not been done yet. So they will be making some estimates of what the so-called informal suppliers are.

Max Sawicky: Anybody else care to hazard a guess on how much?

Eric Toder: I guess in some sense the gap that they're estimating derives from the extent to which the estimates are projections. The informal suppliers are included in the gap based on the 1988 study. So I don't know that it's going to change the numbers that much.

Max Sawicky: Other questions? Other comments from the panel?

Donald Alexander: On the last question: if we knew how big the illegal sector was, I guess we could do something about it. And one of the frustrating thoughts of trying to be in Room 3000 at 1111 Constitution is the fact that you know it's out there. You know it's large. You have all sorts of anecdotal information.

But you have trouble finding it. You have even more trouble attempting to measure it. IRS produces a pretty good, but insufficient, replica of how much it's paid, by whom in the legal sector and adds to that – back when I was there – a wild guess about the illegal sector and then takes the two together and rounds it off to the nearest dollar to try to make it appear to be more credible.

Little problem: IRS now talks about a tax gap which happens to be $1 billion higher than the prior one at the minimum and about $53 billion more at the maximum. I still think that announced gap is probably about $50 billion to $100 billion too low. And that if IRS were somehow able to collect all the taxes that were due from all people illegal or legal, we wouldn't have a deficit. But we have a massive deficit, and we're going to continue to have one.

Sheldon Cohen: There is another factor. The British Auditor General just put out a report on the collection of the value-added tax (VAT). Everyone on the Hill says how easy it is to collect the VAT – it's self-enforcing. We get a variety of such comments that are, for us professionals, silly. But the British Auditor General discovered that the evasion of the VAT under the present system is about 16%.

Henry Aaron: There are those who are currently suggesting that the personal and corporation income taxes should be replaced by an alternative system. Depending on who the speaker is, it's a retail sales tax, a value added tax, a direct personal consumption tax.

I think all of us here would agree, and if you do not I'm sure we'll hear about it, that the case for or against introducing one of these alternatives should not be made on administrative grounds. All taxes that raise sizeable revenues create incentives for people to try to avoid them and for those who are genuinely dishonest simply to evade them completely.

The decisions on whether to change our tax system should be made on considerations of what the revenue potential is and whether we think the burdens would be fairly distributed. The decision to change our tax system in a major way has to come to grips with a problem that is massively difficult, both from a technical tax standpoint and from an administrative standpoint.

There is no major alternative on the table that would escape massive transition problems that would bedevil tax administrators for a generation. So I guess I would correct myself and say that one would need to argue that the alternative tax system was considerably superior to the one we now have in terms of revenue raising potential and fairness in order to justify the disruption that would be associated with a transition.

Those who are lawyers and accountants among us would see their incomes rise, I am confident, very substantially were we to make such a shift. The economists among us, we always do pretty well anyway. But I don't think the lawyers, economists, or accountants among us would advocate a shift on the grounds that they will personally do better.

Robert Kuttner: The *New York Times* had a big story on Monday that the administration is using a provision of the recently enacted intelligence bill to potentially monitor hundreds of millions of international bank transactions, looking for money laundering by terrorists.

My question has to do with whether the same pathways that are used to launder money for purposes of terrorism can also be used by, not terrorists, but corporations for evading the law by booking profits in offshore tax havens. And could an administration that cared about that use the same kinds of information sharing and tracking of international transactions to deal with both? Or are these two completely separate realms? Or does the administration care about money laundering for purposes of terrorism, but not money sheltering for purposes of tax evasion?

Reuven Avi-Yonah: It may be true that the administration only cares about terrorism and doesn't care about tax evasion. But certainly the attitude has shifted considerably after September 11, 2001, given that the two are inextricably intertwined. That is, if you collect this information that is reported for one purpose, the information is also available potentially for the other purpose.

Now, the reality of the matter is that this debate has been driven, since at least the 1980s, by the reality that we've had budget deficits and that our budget deficits are financed largely by foreigners. Therefore, we don't want to do anything that will scare the foreigners from putting their money into U.S. government bonds, corporate bonds, bank accounts, and so on.

And this argument has always been made in Democratic and Republican administrations: that you don't want to do anything to create a tax wedge, and so forth. However, the reality of the matter is also that money cannot just sit in the Cayman Islands, Switzerland or other tax havens.

The real money launderers are paying money to the bank to be allowed to leave their money there. In order for money to be productive, it has to be invested in one of the rich countries in the world. And at the moment, we have a conjecture that both the EU and Japan and potentially us are on board in saying we don't like this type of tax evasion. It is costing us hundreds of billions of dollars. So I don't see any particular reason, if there was a political will, why we shouldn't be able to get together with these other rich folks and clamp down on the tax havens.

And if we pay them even a miniscule amount of what we would gather from that, we could make up for any potential losses to the tax haven economy.

Henry Aaron: I think, Bob, the instruments may be similar but it's vitally important to keep the framework of enforcement distinct. The monitoring of illegal or marginally commercial activities is one that should be dealt with on a routine basis by the tax authorities. What we're talking about in the case of terrorism is something very detailed and special and I worry a lot about a spillover into ordinary private lives of what are essentially police activities – going after the terrorists.

In both cases, standing back, they may look like very similar interest reporting by banks of transactions information returns of various kinds. But I think in terms of how information gets shared, you might even want firewalls between the two sides of the operation.

Joe Guttentag (former U.S. Treasury Department official): I think Mr. Kuttner raises an important question which really expands internationally an issue we've been discussing here: That is, how do we get people to realize that collecting taxes is a good thing? It benefits all of us if those taxes are collected under a regime which our legislatures have approved in a democratic system.

In the case of money laundering, I spent some time trying to get tax offenses included, particularly after 9/11, because tax offenses now are not a "predicate offense" as required to trigger the money laundering laws. If you're running drugs, then money laundering comes into play. If you're just evading taxes, you're not engaged in money laundering. There's a story, possibly apocryphal: A man walks into a Cayman Islands bank with a suitcase full of $100 bills and the teller says, "Well, this looks like a reportable offense under the international money laundering rules." And the customer says, "No, you don't understand. This is all tax evasion money." The teller replies, "Oh, well, that's all right."

In the rest of the world, there is a distinction between drugs and other types of criminal activity, and tax offenses, particularly civil tax offenses.

You have to remember that most of the money laundering offenses, while they may involve drugs and mafia operations and the like, also involve tax evasion. But we have to find a way in which, internationally, we do accept that paying taxes is a good and necessary thing, as the panel seems to agree. And if we don't like the system of taxes or we don't like the rates of taxes, the laws can be changed.

Sheldon Cohen: At the OECD, the cooperation effort there is headed by a fellow named Jeffrey Owen, who is a world expert in this area and has been pumping to try to get more and more cooperation. There are certain lobbying organizations within the United States who lobby heavily against any of that cooperation on the basis that there must be a God-given right to hide your money somewhere. And these people are allegedly upright people. They're not Mafiosos.

Max Sawicky: Other questions, comments, from the panel? Well, I think we can adjourn. Thank you for coming. We'll all go forth with a renewed determination to absolutely pay our taxes as accurately as possible. The panelists will be available for individual questions. Thank you.

(END OF TRANSCRIPT)