

# Tax simplification and tax compliance: An economic perspective

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## Introduction

The gross tax gap in 2001—the amount of Federal taxes not paid voluntarily and on time—was estimated to be between \$312 billion and \$353 billion, or between 15 and 16.6% of total tax liability (IRS 2005b). Clearly, enforcement of taxes in the United States is far from perfect. This essay considers the extent to which tax law should be enforced, and analyzes the best means to improve compliance with tax law.

The main argument is that the appropriate extent of tax enforcement critically depends on the underlying tax structure. In particular, the role of complexity in the tax system as a factor influencing the size of the tax gap, as well as legal but undesirable tax avoidance, are highlighted.

Two principal implications of tax complexity are stressed here. First, complexity permits additional ways to shield income from tax and, consequently, complexity increases the overall cost of taxation.

Second, complexity increases the likelihood that taxpayers make inadvertent mistakes in calculating their tax liabilities. From this standpoint, penalties are a less appealing means of enforcement, and increasing the probability of detection becomes more costly. Hence, tax complexity undermines the effectiveness of tools at the disposal of the Internal Revenue Service.

The central objective of reform should be simplifying the tax system. Reasonable simplification can more adequately combat tax evasion and avoidance than traditional enforcement measures and, at the same time, simplification would make standard enforcement policies more effective without increased enforcement spending.

The ideal compliance policy should target both tax avoidance and tax evasion. While there is a legal distinction between the two, from the economic point of view the difference is less explicit. Both types of activity involve a loss of revenue and both involve a loss of economic welfare.<sup>1</sup> The loss of revenue implies an additional economic cost because the revenue must be recouped by resorting to further distortionary taxation.<sup>2</sup>

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<sup>1</sup> A loss of welfare occurs if there is a way to allocate the same resources in a way that makes a taxpayer better off. For example, in the context of tax evasion, a taxpayer would be made better off by receiving the expected gain from tax evasion directly rather than taking a risk.

<sup>2</sup> A tax distortion is a provision of the tax code that can influence a taxpayer's behavior, over and above the fact of taxation itself. Insofar as a tax alters the taxpayer's behavior, his new circumstances are less advantageous than previously, and the extent of this disadvantage is known as the deadweight loss from taxation. For instance, if a cigarette tax causes one to smoke less, the difference in the individual's well-being implied by the switch is an economic cost, apart from the tax he actually pays. The tax paid is not a loss to society, since it is merely transferred from taxpayer to government. The deadweight loss is an economic cost to society. At the same time, the public services financed by the tax could provide benefits

In the case of the simplest form of tax evasion, an additional loss of welfare is due to the risk taken by the (cheating) taxpayer. In the case of more complicated forms of purely tax-motivated financial planning, taxpayers use up real resources to shelter income. Preventing such waste should be a leading concern in tax policy. In particular, from an efficiency point of view,<sup>3</sup> it does not matter whether or not the underlying activity is legal.

The main points in this paper are:

- While the implications of tax complexity are multi-dimensional, its most important consequence is the extent of opportunities for tax avoidance and evasion that it creates.
- By reducing tax complexity, policy makers change how responsive taxpayers can be to changes in taxation. Consequently, a less complex tax system may provide a lower marginal excess burden of taxation.<sup>4</sup> There is some evidence that this was the result of the Tax Reform Act (TRA) of 1986. When the tax system is less costly, enforcement is less important because alternative ways of collecting revenue are less damaging.
- Tax evasion is illegal while tax avoidance may be legal, but from the economic point of view, they are similarly costly and tax avoidance should be a higher priority target.
- Tax complexity increases the likelihood that taxpayers are non-compliant unintentionally. This has an important policy consequence: when taxpayers make honest mistakes, enforcing taxes is harder because it requires distinguishing between cheaters and honest-but-confused taxpayers. Therefore, complexity reduces the effectiveness of standard enforcement tools such as detection or penalties.
- There may be positive aspects of tax avoidance (an incomplete list is in Section 6). One should consider opportunities for tax avoidance as a potential policy tool. While in most cases avoidance is undesirable, there may be circumstances when limited and judiciously designed avoidance opportunities are socially beneficial.

The plan of this chapter is as follows. In the next two sections, the basic economic approach to tax evasion and tax avoidance is presented. This is followed by a discussion of the social costs of evasion and avoidance. In Section 4, implications for the appropriate extent of enforcement and the impact of complexity are drawn. In the following section, for completeness, a number of arguments suggesting that tax avoidance and/or evasion can have positive social spillovers are offered. Section 6 contains a discussion of enforcement and complexity in specific cases: the Earned Income Tax Credit, reliance on floors and ceilings for deductions, the role of tax preparers, and the use of phase-ins and phase-outs of tax provisions. Concluding thoughts are offered in a final section.

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that exceed those of whatever the tax money would have been used to purchase by the taxpayer.

<sup>3</sup> By referring to efficiency I have in mind how resources are allocated to various productive uses. This is conceptually separate than a concern about equity or fairness. By referring to efficiency I also place no independent value on taxpayers being honest (although, to the extent that increased honesty has an effect on behavior of other taxpayers, it could indirectly affect how efficiently resources are allocated).

<sup>4</sup> The excess burden of taxation is the extra welfare loss over the revenue collected by the government. The marginal excess burden refers to the incremental change in the excess burden due to a small change in tax rates. The marginal excess burden (or, more precisely, the marginal cost of funds discussed later in the chapter) is both the measure of the cost of increasing the reliance on a particular type of taxation and the measure of the cost of collecting more revenue.

## 1. Preliminaries—straightforward cheating

The basic theoretical framework for tax evasion was derived by Allingham and Sandmo (1972) from the Becker model of crime. This approach views tax evasion as a gamble. Some degree of risk is always present in the context of evasion, so this model captures at least one important aspect of non-compliance. It may not capture all important determinants of tax evasion, and some extensions of it will be discussed below.

In cases when tax evasion is successful, the taxpayer gains by not paying taxes. In other cases, tax evasion is uncovered by tax authorities, and the taxpayer has to pay taxes due and fines. The taxpayer compares the expected gain to the expected loss. The expected gain or loss is the size of the possible gain or loss multiplied by its probability. For instance, if 100 people each have an equal chance to win a lottery with a prize of \$100, the expected gain is \$1.

In the economic models, the decision whether to evade at all turns out to depend only on this comparison: if the expected gain is greater than the expected loss, the taxpayer decides to evade at least a little. How much is evaded depends on the aversion to risk, the expected gain, and the risk faced by the taxpayer.

This approach highlights a number of factors that determine whether and to what extent taxes are evaded. These are: the magnitude of potential savings (which, on the margin, is simply equal to the tax rate), the probability of getting caught, and penalties when caught. More subtly, the extent (but not the presence) of evasion depends on risk aversion, which itself may be a function of the level of income, and it may depend on the tax liability. This model therefore highlights three natural policy parameters that can affect evasion. The IRS can work harder at trying to find cheaters, it can punish them more severely, or the marginal gains from tax evasion could be reduced by imposing lower marginal tax rates. A more unorthodox enforcement measure would entail overstating the risk of getting caught, or trying to affect preferences for risk.<sup>5</sup> Each of these tools has associated problems.

Penalties for tax evasion have generally been low, perhaps barring relatively rare criminal cases. This is puzzling in the light of the Allingham-Sandmo model, because that approach implies that penalties are *the* preferred way of dealing with tax evasion. One would like to reduce the expected gain from cheating. Very high penalties naturally help in achieving this and, the argument goes, imposing penalties is cheap while increasing the probability of detection is not. Among various types of possible penalties, monetary fines have the advantage of recouping revenue while criminal sanctions do not. Therefore, increasing penalties that focus on fines are a natural policy response.

While this may be true in an idealized world, in practice it does not seem to be the case. There is no doubt that penalties could be increased beyond their current levels. However, one needs massive increases in penalties to make the expected gain from tax evasion negative. Under audit rates of 1% (this is approximately the audit rate nowadays, but as will be discussed later, this is not necessarily the right measure of the probability of detection), and a marginal tax rate of 35% (for the highest income taxpayers), cheating the government out of a dollar in taxes due results in an expected gain of  $0.99 \times 0.35 = 34.6$  cents. To combat this gain and discourage a risk-averse taxpayer from pursuing any tax

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<sup>5</sup> No such instruments should have an effect on a rational taxpayer, but a growing literature on behavioral economics argues that deviation from economic rationality may be important.

evasion, the expected loss should be equal to the gain. The expected loss is 0.01 times the penalty, and therefore the penalty (per dollar of cheating) should be \$34.65. This is several orders of magnitude higher than current penalties. Penalties of this magnitude would certainly be extremely controversial, and they may not even be legal.

There are also reasons why very large penalties may not be desirable. For one thing, distinguishing honest mistakes from cheating is hard, and therefore in practice penalties cannot be exorbitant. Furthermore, when high penalties require criminal prosecution, they are neither easy nor cheap to implement.

The natural alternative to penalties is a higher probability of detection. Audits may take many different forms. Standard audits—direct examination of a taxpayer's return and financial records—are one example, but there are many others. Detecting misreporting early on by automatic cross-checking of taxpayer information from alternative sources, also known as document matching, is another example.

The withholding system effectively eliminates evasion of taxable income by making detection a near-absolute certainty. Nevertheless, expanding such approaches is undoubtedly costly.

The third class of policy tools is setting marginal tax rates. Low marginal tax rates may reduce the incentive to cheat on the margin, although from a theoretical point of view, the effect is ambiguous when penalties are proportional to the tax evaded, rather than income unreported (Yitzhaki 1974). Low marginal tax rates also reduce revenue collections, and therefore relying on this tool for combating tax evasion requires adjustments in the tax code elsewhere, perhaps offsetting the potential gains.

## **2. Tax avoidance**

The risk in tax evasion is not beyond the taxpayer's control. In fact, sophisticated kinds of tax planning blur the line between legality and crime and therefore reduce the likelihood that the transaction will be questioned.

This discussion will not try to clearly delineate tax avoidance from tax evasion. The distinction stressed here is in terms of the cost to the taxpayer: informally speaking, activities where the ultimate tax treatment is uncertain, with the risk imperfectly controlled by tax collection agency, could be classified as evasion. Activities where costs have a different nature are avoidance. When a tax-saving scheme is illegal, it is uncertain whether a preferential tax treatment will be ultimately available, and therefore such a scheme is naturally considered evasion according to this classification. Taking advantage of tax incentives (e.g., selling and buying back the same asset in response to a temporarily reduced capital gains rate) does not involve uncertainty about the ultimate tax treatment and is considered avoidance.<sup>6</sup> Many kinds of real-life tax planning are likely to have elements of both.

The concept of avoidance has a number of implications within the framework that

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<sup>6</sup> There is some ambiguity in this definition. The actual amount of tax savings may be risky under tax avoidance if the underlying activity is risky. For example, a taxpayer who chooses to realize capital gains does not know the exact magnitude of tax savings because they depend on future appreciation. Tax avoidance by deferring taxes involves uncertainty about future taxes, but the risk is not under control of the tax collection agency.

we have just discussed. First, taxpayers have a range of options: there is no single kind of tax avoidance. Second, probabilities of detection are lower than for outright tax evasion, and they may be reduced further if the taxpayer chooses to invest in protecting herself by hiring an adviser, paying for a legal opinion, or structuring the transaction appropriately. Third, each of these extra options has various kinds of costs associated with it that are not present under the simplest kind of tax evasion. One of these costs has already been mentioned: taxpayers can invest in reducing the probability of detection. In addition, there may be a fixed cost necessary in order to even attempt tax avoidance: hiring a professional may not be optional but rather a necessary condition for pursuing a particular kind of tax avoidance, and so can be the cost of having an off-shore account, a foreign subsidiary, or a charitable foundation of a future estate taxpayer. Furthermore, pursuing an avoidance strategy may require modifying real economic decisions or subjecting oneself to extra constraints (for example, a tax shelter may be illiquid).

On the other hand, combating tax avoidance is harder for tax authorities. Because taxpayers are blurring the line between legal and illegal, establishing that the behavior in question is in fact illegal requires expending resources. Auditing a single taxpayer may no longer be enough: transactions may have many participants. A court battle may ensue as a result. Tax auditors need considerable knowledge to cope with tax planning. Accordingly, their qualifications and compensation have to increase with the sophistication of those who practice avoidance strategies.

Understanding that tax avoidance adds extra costs is the key point, because the costs affect how harmful the activity is from a social point of view, and therefore how much it should be discouraged. This issue is discussed below.

Availability of simple tax evasion is a fact of nature—one can always cheat—but tax avoidance is not. Tax avoidance is a function of ambiguity in the tax system. This is not to say that ambiguity can always be avoided in real life. Still, what and how many avoidance opportunities are available depend on the structure of the tax system.

Consider the simplest of taxes: a uniform poll tax—let us say that everybody has to pay \$10,000 in taxes. There is still room for tax evasion: tax authorities have to find the taxpayer to make him pay, and there are places in the New York subway system where no authorities will venture. Making oneself hard to find is all that one can do, however, if there is a desire to cheat.

Any attempt to complicate the system will introduce extra possibilities for avoidance. For example, if we limit the tax to adults, we will have to determine who the adults are. While forging a birth certificate is illegal, it is not impossible (and neither is a decision not to induce birth on December 31<sup>st</sup>). If we limit the tax to working adults, we will have to determine the appropriate definition of working and monitor appropriately.

Any attempt to make tax liability different for different individuals will introduce incentives to respond. At various points in history there were attempts to impose taxes on the number of windows, beards, and servants. Not surprisingly, they gave rise to predictable tax anecdotes. In the 19<sup>th</sup> century, the United States had occupation-based taxes: naturally, it made it worthwhile to misrepresent one's occupation. Any modern tax system will create these kinds of incentives, but some will create more than others.

What determines the extent of such ambiguity? Stiglitz (1985) highlights three principles of tax avoidance: postponement of taxes, arbitrage across individuals subject to different marginal tax rates, and manipulation of different types of income that are taxed

to different degrees. It is clear from this classification that the key factor affecting opportunities for tax avoidance is the number of options under different tax treatments.<sup>7</sup> What is an option is hard to specify in the abstract, perhaps partly explaining why measuring and understanding the overall cost of complexity appears so hard to do. There have been only limited attempts to formalize this issue in empirical work.

Triest (1992) recognized the importance of itemization and analyzed the labor supply responses. Kopczuk (2005) measures complexity as a fraction of income reported on the tax return that is not subject to taxation and provides a simple theoretical model justifying this measure as an adequate summary of opportunities for shifting income away from taxable form. There is a voluminous literature on behavioral responses to assorted tax provisions (Slemrod and Yitzhaki 2002 provide a recent survey).

It should be noted here that complexity need not be increased by new rules. To the contrary, if new statutes are intended to clarify the existing law or to ban particular loopholes discovered by taxpayers, they may result in the overall reduction of opportunities for tax avoidance. It could be argued, therefore, that such an extension of the tax code, if successful, in fact reduces complexity even though it adds to the tax code. The question is whether the new rule is successful in closing avoidance opportunities.

Summarizing, any differential treatment of two related economic activities gives rise to an opportunity for avoiding and, therefore, opportunities for avoidance are naturally a function of complexity in the tax code. A natural way of reducing avoidance opportunities is therefore a simplification of the tax code. To reduce complexity, such a simplification must involve reducing the number of special tax treatments. Since special tax treatment most often takes the form of tax preferences (deductions, credits, and exclusions from income), the corresponding expansion of the tax base allows for reduced rates and may have a side-effect of further reducing opportunities to avoid taxes.

In this context, it is interesting to note that this was the direction of the Tax Reform Act of 1986 (TRA). It is suggestive (though hardly definitive) to observe that the estimated tax gap in the aftermath of the TRA 86 actually declined from a bit over 18.5% in 1985 to a little bit less than 17.5% in 1988 (IRS 1996).<sup>8</sup> The tax gap is an estimate of tax evasion only.

Although the loss of revenue due to avoidance is much harder to compute, Gordon and Slemrod (1988) calculated that the U.S. tax system in 1983 collected no revenue from taxing capital income, in large part due to tax arbitrage. But when they repeated the calculations well after the TRA 86 (for 1995), they found that no longer to be true. They estimated that capital income tax revenue exceeded 100 billion (Gordon, Kalambokidis, and Slemrod 2004).

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<sup>7</sup> Note that tax deferral also falls here. For example, realization-based taxes treat investment strategies with different frequency of trading differentially.

<sup>8</sup> The tax gap was estimated to decline a little bit more (.2-.3%) by 1992, however these estimates were projections based on the same data source (1988 TCMP) and therefore do not provide new information about the actual change in compliance but only about the composition of tax base (which may itself be affected by compliance).

### 3. Cost of avoidance and evasion

#### *Private costs*

Some costs of non-compliance have already been mentioned. Tax evasion is a decision under risk. As such, it reduces the taxpayer's welfare relative to receiving the same expected amount with certainty. At the other end of the range of tax-motivated planning activities, cost has nothing to do with risk, but instead involves paying for advice, tax preparers, misallocating resources, and so on. Most tax planning falls in between and involves both exposure to risk and extra costs.

Some exposure to risk is likely to characterize transactions that fall in the gray area between unambiguously legal tax planning and unambiguously illegal tax evasion. For example, a taxpayer may be uncertain whether a transaction is going to be challenged and finally accepted by the IRS, or a taxpayer may view the whole situation as negotiation with the IRS, subject to an uncertain outcome.

Extra costs may also be associated with unambiguously illegal tax evasion. The benefit to the consumer of avoiding a dollar is given by expected tax savings minus expected penalties. Taxpayers will pursue evasion/avoidance until the marginal benefit is equal to the marginal cost:

$$\text{expected gain} = \text{direct non-risk costs} + \text{welfare loss due to exposure to risk}$$

(where all effects are on the margin). Note that the loss due to extra exposure to risk accrues to the cheating taxpayer but does not by itself affect other individuals. Direct costs, on the other hand, effect a real resource cost for the economy.

While it is true that in either case the marginal cost is equal to the taxpayer's expected gain, direct costs are different in two respects from the "risk exposure" category. First, by affecting the real side of the economy, they may have implications for tax revenue from other sources. This effect may be negative (for example, time spent shredding documents is not devoted to a taxable activity), or positive (the shredder itself is taxable, otherwise the taxpayer might buy non-taxable carrots instead).

Second, by affecting the real side of the economy and therefore relative prices, other taxpayers are affected by avoidance. From the distributional point of view, such effects may be harmful or beneficial, depending on the direction of the effect. In practice both evasion and avoidance will feature both direct costs and risk-related costs, but the composition will be different.

Although the welfare implications of spillovers due to the direct costs are ambiguous in theory, they should be deemed harmful in practice unless there is strong evidence to the contrary. Revenue implications are, if anything, negative for important kinds of costs such as time spent planning and implementing non-compliance. Hiring tax professionals, while it may contribute to higher tax revenue from taxes imposed on their incomes (depending on whether the marginal reduction in spending on other things was subject to higher or lower tax rates), corresponds to an increased demand for relatively high-skilled labor and therefore, it is likely to exacerbate rather than reduce inequality.

Concluding this discussion, both tax evasion and tax avoidance have private costs that the taxpayer compares to expected tax savings. These costs also constitute a social welfare loss, apart from the gain to the taxpayer, which is a loss to the budget and

therefore only a transfer and not a net gain to the economy. Furthermore, tax avoidance and tax evasion are equally costly (holding tax savings constant) on the margin, when only the effect on the cheating taxpayer is considered. Therefore, as a matter of economic efficiency, focusing solely on tax evasion is not warranted, and tax avoidance should be considered as an equally serious problem, even though one activity may be borderline legal and the other not. Finally, negative spillovers from tax avoidance are likely greater than spillovers from tax evasion, strengthening the case for targeting tax avoidance as a policy objective.

### *Inequity*

The second class of costs due to tax avoidance has to do with fairness. This discussion will be confined to considerations of horizontal equity.<sup>9</sup> This concept is hard to quantify (see Auerbach and Hassett 2002 for an attempt), although most have an intuition for what it means to treat equals equally.

In the context of tax evasion, horizontal equity may be compromised for two reasons. First, successful and unsuccessful evaders are treated unequally *ex post*. This is not a serious concern, both because *ex ante* they have identical welfare, and because most people would not be concerned about unfair treatment of cheaters.

Second, there is horizontal inequity between otherwise equal people who do cheat, and those who do not. The relevant question is why there is a difference in the behavior of otherwise identical individuals. There may be many reasons: different attitudes toward cheating, different access to avoidance opportunities, differences in perception of risk or different circumstances.

The first two of these truly amount to the tax code treating individuals differently based on their tastes or occupation. Differences in perceptions may be indicative of differences in ability to understand complex economic problems, and thus may indicate that these taxpayers are not in fact “equal,” even though other observable criteria (such as income) would have suggested so. Similarly, taxpayers may experience different circumstances. For example, it has been suggested that cheating taxpayers are in fact worse off (Andreoni 1992), and they treat the IRS as a sort of lender of a last resort. If this were the real reason for most tax evasion and avoidance, horizontal inequity would not in fact be a valid concern. Empirical work has, however, failed to convincingly establish a relationship between tax evasion and personal circumstances, and we still lack an understanding of the determinants of compliance. It appears very likely that a lot of tax evasion is a matter of personal preference, and in that case the horizontal equity considerations should be taken seriously.

### *Distortionary taxation*

A loss of revenue is a transfer from the government to the cheating or avoiding individual, but the social value of government's revenue and private dollars is not the same. This is because collecting taxes requires distortionary taxes, and therefore a dollar

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<sup>9</sup> This is not to say that vertical inequity due to tax avoidance is not important. My view is however that redistributive implications of tax avoidance should be analyzed jointly with other policy instruments and such a discussion is, for the most part, beyond the scope of this chapter. For an example of such a discussion, see Kesselman (1997). I also do not tackle the issue of incidence of evasion and avoidance (see, for example, Kesselman 1989).

of revenue lost by the government leads to extra cost from additional taxes.<sup>10</sup> Because there is a difference between social valuations of government's and private dollars of evaded taxes, the presence of non-compliance reduces welfare even if the private costs of evasion and avoidance are zero and horizontal equity is not a concern.

#### **4. How and how much should we enforce?**

A simple but illuminating result about enforcement is due to Baldry (1984). Suppose that a bit more enforcement increases the total cost of enforcement; in other words, it is costly on the margin. Then it is never optimal to eliminate all evasion. This is because the social loss from the first dollar of tax evasion is negligible, while the cost of administration is not. Given that full enforcement makes no sense (and is not even possible), the question is the best level. The usual economic answer is that the marginal cost of enforcement should be equal to its marginal benefit. Implementing that solution requires identifying the costs and benefits.

There are two costs of combating tax evasion or avoidance. First, authorities spend money on enforcement. Second, as discussed in the previous section, taxpayers who cheat face some likelihood of getting caught and penalized. Taxpayers who avoid taxes legally face other types of costs. All in all, the dollar of tax savings is not worth a dollar to either side. What are the benefits? More tax revenue is collected.

How do costs and benefits compare? With reduced evasion or avoidance, a taxpayer loses a dollar and the government gains a dollar. If the value of this expected dollar in the government's coffers is the same as its value to the individual, there is no gain. In fact, there is likely a loss because the government pays for enforcement. As discussed in the previous section, however, these values are not the same. The expected dollar from evasion involves a risk. When taxpayers are averse to risk, the expected dollar is worth less than a certain dollar from the individual standpoint. At the same time, a government that deals with many different taxpayers is not affected by this kind of idiosyncratic risk. By pursuing enforcement the government reduces the exposure to risk and that is a good thing.

We further need to consider alternative sources of financing. Gaining a dollar of revenue reduces the need to rely on other taxes. Because other sources of revenue are distortionary, the extra burden imposed by the need to rely on alternative sources is the cost of evasion, and eliminating the need to resort to alternative revenue sources (higher taxes) is a gain. Enforcement from this perspective is therefore beneficial, and its profitable extent is limited only because it is costly (see Mayshar 1987 for an extended discussion along these lines).

Note, however, that the benefits of reducing tax evasion are especially subtle. Collecting more revenue by itself is not a benefit, because it only represents a transfer

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<sup>10</sup> More precisely, the value of government's dollar (ignoring distributional concerns) is given by the marginal cost of funds (MFC) which is defined as the ratio of the effect of change in the tax rate on the revenue absent behavioral response over the revenue effect accounting for behavioral responses (see, for example, Slemrod and Yitzhaki 2002). A government's dollar is more costly than a private one (even if the MCF is less than one) as long as substitution effects due to increased taxes act to reduce revenue. This is because the social value of a private dollar is equal to the value of a lump-sum transfer and therefore it is affected by income effects on the revenue, but not by substitution effects.

from individuals to government. It becomes beneficial only because it reduces the exposure to risk by evaders and, perhaps more appealingly, because it reduces the need for other taxes. The same applies to tax avoidance but, as argued above, avoiding misallocation of resources devoted to financing tax avoidance is more important than reducing cheating taxpayers' exposure to risk.

Administrative investment in enforcement becomes more important when the tax system is more distortionary. One way to reduce the need for costly tax enforcement is to reduce distortions. Under a more efficient tax structure, the same level of tax evasion will have a lower cost. It has been suggested that how distortionary the tax system is (in terms of the marginal cost of funds—the ancillary costs of collecting a dollar of revenue) does depend on the choice of tax structure. This point was originally suggested by Slemrod (1994), and it was analyzed in detail by Slemrod and Kopczuk (2002). The issue goes back to the previous discussion of complexity. Higher complexity induces tax avoidance and other types of substitution responses. A tax system that allows for many different types of avoidance responses is likely to cause stronger behavioral effects and therefore higher excess burden. In other words, the cost of additional revenue is higher. Shrinking the menu of tenable responses reduces the marginal excess burden of taxation, and therefore the benefits of extensive tax enforcement are lower.

Shutting down extra margins of response can be loosely summarized as expanding the tax base by eliminating preferential treatment of some types of income, deductions, and exemptions. In the context of the personal income tax, Kopczuk (2005) estimated that the elasticity of income reported on individual income tax returns<sup>11</sup> as well as the elasticity of taxable income falls when the tax base is broader.<sup>12</sup> One implication, therefore, is that the need for extensive tax enforcement was likely to be lower after the Tax Reform Act of 1986, since the tax base was broadened.

The notion that the excess burden of taxation and therefore the benefit of stronger enforcement varies with the tax base is also consistent with other findings in the taxable income literature, such as varying elasticities by itemization status (Gruber and Saez 2002), elasticities varying with the tax reform (Saez 2004), or with the source of income (Sillamaa and Veall 2001).

Without changes in the tax structure, the choice of where to put an administrative dollar becomes more critical. Assume that revenue gains from any type of reduced evasion go in the same general revenue category. Different targets for increased enforcement will have different implications for risk exposure and will have different revenue consequences. Under a more distortionary tax system more weight should be

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<sup>11</sup> The elasticity of income refers to the effect of a 1% change in the tax price (one minus the marginal tax rate) on the level of income, expressed in percentage terms. Reported income refers to the total income reported on the tax return while taxable income refers to the actual income subject to taxation (after suitable deductions and exemptions have been subtracted). The elasticity of taxable income is the key parameter underlying the calculation of the cost of the income tax (Feldstein 1995, 1999).

<sup>12</sup> Elasticity is formally defined as the percent change in one variable, given a 1% change in a related variable. It's a way to measure the response of something to a given change in something else. For instance, if a 1% increase in an hourly wage causes the worker to work half a percent more hours, the elasticity of hours worked with respect to the wage is  $\frac{1}{2}$ . In this context, the elasticity of taxable income with respect to the tax base is the percentage change in taxable income, given a 1% change in the size of the tax base. The broadness of the tax system was measured as a fraction of income reported on the tax return that was ultimately subject to taxation, with itemized deductions, exclusions, and adjustments making up the difference.

placed on the latter aspect: the types of enforcement that most increase revenue are more valuable. When the tax system is otherwise relatively efficient, the individual cost considerations become more important.

### *Complexity, confusion, and penalties*

One of the consequences of complexity is that it makes it difficult for honest taxpayers to fulfill their obligations. When understanding the tax code is difficult, taxpayers are bound to make mistakes. The uncertainty that an honest taxpayer faces in figuring out her true tax liability may result in overpayment of taxes on average (Scotchmer and Slemrod 1989), but this source of revenue is not a net social gain because it is due to extra cost or hassle imposed on taxpayers. Liebman and Zeckhauser (2005) argue that individuals respond to complexity by ignoring the details and using heuristics instead. The revenue implications of such behavior are ambiguous.

The mix of intentional and unintentional mistakes complicates enforcement. In essence, it reduces the ability of authorities to rely on standard tools of enforcement. While it is likely true that higher penalties will result in more effort devoted to compliance, they are unlikely to eliminate mistakes altogether. In fact, if penalties are an effective tool for reducing intentional cheating, high penalties may lead to a situation where the only penalized taxpayers are the honest but confused ones. Because honest taxpayers will sometimes be penalized, penalties imply a cost that is not otherwise present.

One possible channel of taxpayer response to increased enforcement is to reduce their claims for objectively legitimate but subjectively uncertain credits and deductions, with a resulting increase in the overall tax liability. Assuming a good reason for these types of tax preferences to begin with, foregoing them is harmful, even though revenue consequences are positive. It is also likely to be horizontally inequitable, as more sophisticated taxpayers are likely to be less affected.

Another possible channel of response is to opt out of the tax system, either partially or altogether by not filing at all (see Erard and Ho 2001, for evidence of the importance of non-filing), shifting a business to the informal ‘underground’ sector or switching to tax bases where either uncertainty or the probability of detection is lower. These types of responses may have negative revenue implications.

The probability of detection is another leading instrument of enforcement. Taxpayer confusion due to complexity undermines the value of this approach as well. Assuming that the tax collection agency does not wish to penalize honest taxpayers, it has to attempt to establish whether cheating occurred intentionally, or whether it was an honest mistake. This adds an extra layer of costs after detection of an incorrect filing that would not be present otherwise. Furthermore, when taxpayers can claim that non-compliance was unintentional, penalties become uncertain as well (hence reducing the effective “probability of detection”), even when the agency intends to impose them, unless taxpayers are denied the right to defend themselves. When a legal battle ensues, there is also a possibility of horizontal inequity, as more sophisticated taxpayers may do better in such circumstances.

The bottom line is that complexity makes relying on penalties a much less appealing approach to enforcement. This is so for two reasons: penalties and audits become more costly because they have to be associated with some attempt to distinguish honest

taxpayers from cheaters, and they directly reduce the welfare of honest taxpayers.

### *Manipulating the probability of detection*

Increasing the probability of detection should reduce cheating by rational taxpayers. Devoting more resources to audits would increase the probability of detection and therefore expected penalties. With no changes to the underlying tax structure and no ability to significantly increase penalties, devoting more resources to detection is the way to go if one wants to reduce non-compliance. To the extent that an examiner may be able to arrive at an informed judgment about whether a taxpayer made a mistake or was cheating intentionally, more detailed audits would also alleviate problems resulting from taxpayers' confusion. Increased auditing would also increase the probability of penalizing dishonest taxpayers who are audited and, therefore, the overall probability of being subject to penalties. The problem with direct audits is that they are costly.

Auditing is not the only way of increasing the probability of detection. Withholding and matching various sources of data by the IRS are also measures that affect detection. This more general definition of the probability of detection helps in making sense of the patterns of non-compliance. Compliance is very high in case of wages and salaries that are subject to withholding, and where the IRS can match taxpayers report to the W2 form.<sup>13</sup> Almost 99% of such income is reported accurately. Misreporting of business income is much harder to monitor, since no independent source of information is available. In this area there is 30% misreporting, according to the 1992 IRS estimates.

Some categories where misreporting is non-trivial are puzzling. Misreporting of alimony income and unemployment income is sizable (on the order of 20% and 10% in 2001, respectively), and the 2001 estimates also include a 6% misreporting of state income tax refunds (a much higher rate than in 1992). These categories are puzzling because verification is relatively straightforward—in the case of state refunds and unemployment it requires respective state agencies and the IRS to exchange information. In the case of alimony, a taxpayer who claims a deduction for alimony payments is required to report the Social Security number of the spouse, so matching this information should also be automatic.

The IRS has been well aware of the potential for detecting non-compliance by cross-matching various source of information, but much remains to be done. For example, Steuerle (2005a) has suggested that requiring financial intermediaries to report net capital gains rather than just total payments from sales of assets would increase compliance in this area by allowing the IRS to cross-match taxpayer's reports with those obtained from financial institutions, while simultaneously reducing compliance costs. Similarly, Steuerle (2005b) suggested that the IRS should expand reporting of charitable contributions by charities, with an ultimate objective of matching them against individual reports.

Changes in the ability of the IRS to match various sources of information as well as new reporting requirements have increased the effective probability of detection without changing the number of audits. The number of audits had been declining until 2000, and

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<sup>13</sup> Preliminary estimates based on the 2001 National Research Program are available at the IRS Web site as "Tax Gap Facts and Figures," accessed on October 3<sup>rd</sup> at [http://www.irs.gov/pub/irs-utl/tax\\_gap\\_facts-figures.pdf](http://www.irs.gov/pub/irs-utl/tax_gap_facts-figures.pdf). Estimates for 1985, 1988, and 1992 (based on 1988 TCMP and earlier ones) are in IRS (1996). The overall patterns are quite similar.

it has increased in the past few years, though it still remains below historical levels. At the same time, the expanded use of cross-matching of various sources of information has contributed to the increase in the effective rate of detection of cheating for many types of income. Consequently, it is hard to judge whether the probability of detection is now higher or lower than it was in the past. Unfortunately, there are not enough estimates of the tax gap to study the relationship between its various determinants, but the overall size of the tax gap based on 2001 data does not look markedly different than it was in the past. Using the size of the tax gap as a share of revenue, the non-compliance rate was estimated to be 18.5-18.8% in 1985, 17.2-17.5% in 1988, and 16.9-17.3% in 1992 (IRS 1996) and 15.0-16.6% in 2001 (IRS 2005).<sup>14</sup>

## 5. Social benefits of not enforcing

It is natural to think of tax avoidance and evasion as unmitigated evils that should arise only because the cost of eradicating them is too high. There are, however, some situations when eliminating avoidance would not be desirable, even if it was possible at a low cost.

The first argument is redistributive. Increasing the extent of redistribution is costly because it requires increasing effective marginal tax rates at least for some, and therefore increasing the excess burden of taxation. A simple insight of Akerlof (1978) is that governments should rely on “tagging”: they should use observable characteristics of individuals that are correlated with the need for redistribution. As shown by Kopczuk (2001), this logic applies in the context of tax avoidance: to the extent that particular types of avoidance are more likely to be pursued by low-ability individuals, an optimal redistributive policy may involve laxer enforcement in this dimension.

One example is an informal economy where the benefits are skewed toward low-income individuals (or, at least, let's assume that for the sake of the argument). Enforcing taxes in this context while compensating would-be nannies using other redistributive policies would require extra revenue and therefore increasing marginal tax rates at the top of the income distribution. Not enforcing allows for holding tax rates lower and, because of the nature of this activity, does not otherwise affect labor supply decisions of the higher income population that is not as inclined to operate in the informal economy. From this point of view, enforcement of taxes at the bottom of the distribution should be given a lower priority than at the top, although horizontal equity issues are a serious mitigating concern.

The second class of arguments has to do with diverse preferences. Perhaps its best application is tax avoidance in the context of the estate tax. It is generally believed that avoiding the estate tax is relatively easy (although see Schmalbeck 2001 for an important qualification: most avoidance strategies involve a loss of control over assets and therefore may be undesirable and costly to the taxpayer). Still, estate tax revenue is significant and taxpayers do appear to be ignoring some simple and effective avoidance strategies, such

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<sup>14</sup> The non-compliance rate was defined as the gross tax gap divided by sum of the gross tax gap and “voluntarily and timely paid” taxes. An alternative definition would replace the numerator by the (necessarily smaller) net tax gap that further accounts for enforcement revenue. Using this definition and the data from sources cited in the text, the non-compliance rate was 15.3-15.6% in 1985, 13.6-13.8% in 1988, 14.2-14.6% in 1992, and 12.4-14.1% in 2001.

as making annual, tax-free *inter vivos* gifts.

Suppose that there are two classes of estate taxpayers. The first class includes those who have no interest in leaving an inheritance, but who save for their own benefit, either to finance future spending or to enjoy benefits derived from controlling assets. Leaving a bequest is just a side-effect of their behavior. The second group are those who save with beneficiaries in mind. Estate taxes have different consequences for the two groups: they influence decisions of the latter group but are of no consequence to the former. Imposing heavier taxation on the former group would therefore be desirable; allowing for easy tax avoidance reflects such a policy. Those who would otherwise be hurt by taxation avoid it at a low cost while those who do not care about bequests pay the tax. Other than the costs associated with implementing avoidance strategies, no extra damage is done.

As another example, the presence of tax avoidance opportunities for multi-nationals may keep them from shifting their income abroad, while not affecting the decisions of domestic corporations.

Third, a higher efficiency cost of taxation can be beneficial in some contexts. Becker and Mulligan (2003) argue that a high deadweight loss of taxation imposes a constraint on the growth of government spending. Taking this argument seriously, a complicated tax system is a commitment device for policy makers not to spend too much or not to raise taxes. Alternatively, it may be a constraint imposed by one political group on another.

Fourth, too much auditing can backfire. Slemrod, Blumenthal, and Christian (2001) found making audits a certainty, by sending taxpayers a letter informing them that they will definitely be audited, resulted in a *reduction* in voluntary compliance by high-income taxpayers. This may seem puzzling until one realizes that audits are costly to taxpayers. One reason to comply with the law is to not attract attention and reduce the likelihood of audits. When this motive for compliance is eliminated, the taxpayer may decide to pursue tax evasion more rather than less aggressively. Of course, in this case the probability of detection increases as well, and the net effect on compliance is unclear.

There is at least a possibility that a very high probability of audit (such as for large corporations that are almost continuously audited) can backfire when audits are themselves costly. According to Frey (1997), another way in which auditing could backfire is by changing the motivation of taxpayers from intrinsic (“it’s my duty to pay taxes”) to extrinsic (“I pay because otherwise I’ll get punished”).

Fifth, Andreoni (1992) suggested that tax evasion may be pursued by taxpayers lacking easy access to credit. To the extent that this motive is important, an increased enforcement could potentially eliminate the role of the IRS as the lender of last resort and therefore reduce welfare.

It is sometimes suggested that tax considerations drive a lot of financial innovations. This is the sixth reason why tax avoidance may have some positive spillovers. While most of the financial products developed for avoidance purposes are likely not useful otherwise, there is a possibility that some of them turn out to have independent value but would not be invented otherwise.

Seventh, real-world tax systems are unlikely to be ideal. Addressing inefficiency of the tax system requires politically costly tax reform, and tax avoidance—letting well enough alone—may be a simple and practical way of addressing shortcomings of an inefficient tax structure. For example, suppose that, as much of the optimal taxation

literature suggests, capital incomes should not be taxed, or should only be taxed lightly. In that case, the best policy response would be cutting tax rates imposed on capital income. If it is not politically feasible to pursue such policies explicitly, a similar outcome can be accomplished by reducing enforcement or increasing avoidance opportunities in this area. This is not how policy ought to be made, because a roundabout way of exempting capital income from taxation must be more costly than the explicit approach, but it may be better than preserving distortions present in the existing tax structure.

This is likely not an exhaustive list of potential positive side-effects of tax evasion and avoidance. These potential advantages do not provide automatic justifications for accepting non-compliance, but their existence suggests that understanding the side-effects of tax avoidance is relevant, and that benign neglect of certain types of tax avoidance can be a policy tool.

## **6. Some examples**

### *Earned Income Tax Credit (EITC)*

Of the slightly over than one million individual income tax returns audited by the IRS in 2004, almost 500,000 were for EITC recipients, resulting in an examination rate exceeding 4%, compared to 0.77% for all individual income tax returns (IRS 2005). While I have not been able to obtain the exact amount recovered by EITC audits, examinations of all returns with income below \$25,000 (therefore including most of the EITC recipients but not just them) resulted in additional revenue of approximately \$1.4 billion dollars, or slightly less than 25% of total discovered underpayments on the individual income tax returns. While examination of the return of an EITC claimant is likely to be much less costly than that of a high income taxpayer,<sup>15</sup> the point remains that the IRS devotes very significant resources to enforcement related to this program. The question is whether this is a cost-effective use of these marginal enforcement dollars.

Efficiency in collecting revenue (or declining refunds) is clearly not the correct measure of enforcement impact, because it does not account for the deterrence effect. Still, on efficiency grounds the mere fact that substantial enforcement dollars are spent on the low-income population is puzzling. One of the original objectives of the Earned Income Tax Credit was to offset Social Security taxes. The credit grew over the years. With a phase-in rate of 40% for families with two children, for many its value now exceeds Social Security taxes. The fact remains that a large tax is paid on one side, and a large refund is received on the other. The world would have been simpler without low income taxpayers paying FICA taxes during the year and receiving large refunds next April, with the associated enforcement problems on both sides.

Complexity is an important feature of the EITC. Taxpayers may and do deal with complexity by hiring professional tax preparers. The reliance on paid tax preparers grew

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<sup>15</sup> In fact, almost 95% of below-\$25,000 tax filers were examined by compliance centers without a need to send an agent, while the corresponding number for all income tax returns is just 80%. It also seems safe to assume that the qualifications of an examiner inspecting EITC cases may be much lower than average. The costs associated with the Earned Income Tax Credit in 2004 were on the order of \$200 million, relative to an almost \$4 billion enforcement budget (IRS 2005, table 30).

in the 1990s. Most of the growth is due to EITC filers increasing their reliance on professionals (Kopczuk and Pop-Eleches 2005). This is one area where tax evasion attracted a lot of attention because it indeed appears widespread, but this is also a place where confusion caused by complexity is particularly visible.

As Holtzblatt and McCubbin (2004) discuss in detail, determining eligibility for the EITC is not easy for a large number of low income individuals. While things are relatively straightforward for a two-parent family living with their children, for single, divorced, separated parents or extended families, defining what a household is, establishing whether a child is eligible for EITC purposes, and determining who should claim the credit is far from trivial. The compliance problem is further complicated due to inconsistency between the EITC definition of the “qualifying child” and the eligibility rules for the dependent exemption and Child Tax Credit. Many EITC claimants will be eligible for all three benefits.

Streamlining the definitions of a qualifying child used in the tax code would be another natural area of improvement. There seems to be no justification for having a child eligible for the purpose of claiming an exemption but not for the EITC. The resulting reduction in taxpayers’ confusion would make it easier to assume that mistakes are in fact intentional and would therefore allow for more aggressive penalties, likely resulting in higher compliance.

McCubbin (2000) cites evidence suggesting that examiners believed that as much as 50% of EITC-related mistakes were unintentional. Simultaneously, estimates of participation in the Earned Income Tax Credit (e.g., Scholz 1994 IRS 2002; see also Holtzblatt and McCubbin 2004 for a concise summary of issues and findings) imply that about 20% of eligible individuals do not claim benefits, with higher estimates for subgroups such as new entrants to the labor market (Hill et al. 1999). On the other hand, Kopczuk and Pop-Eleches (2005) show that the EITC take-up increased as a result of an expansion of the tax preparation industry (stimulated by higher profit opportunities due to electronic filing), and they discount the possibility that the response is just due to increased cheating. They suggest that low-income taxpayers may have obtained access to a complexity-reducing technology—tax preparers—and responded by increasing participation. Alternatively, there could have been an increase in the visibility of the program driven by marketing efforts of the tax preparation industry. The latter could also be thought of as a special case of a reduction in complexity (from “I have no clue how the system works and I didn't even know that the program existed” to some awareness of it).

The EITC is an example of a situation where mistakes and non-compliance problems run in both directions. Simultaneously there is cheating, honest confusion, and non-participation by eligible taxpayers. All of these problems owe something to the complexity of the tax code. Once complexity is reduced, pursuing fraud in the system would be much easier, while the objectives of the programs would be better served.

### *Deductions*

Itemization creates a lot of tax avoidance opportunities by reducing the after-tax price of deductible activities. As such, it is likely to result in a higher elasticity of response to tax rates and therefore higher excess burden. This is mitigated by the fact that some deductible activities may indeed warrant lower tax rates, although an argument of this kind has to be made on a case-by-case basis. A number of deductions (for medical

expenses, theft, and casualty losses) presumably adjust for a lower ability to pay. The basic optimal tax argument (Atkinson and Stiglitz 1976) would suggest that one needs to concentrate on the redistributive impact of such deductions *conditional* on the level of income: for example, given their level of income, are people who have high mortgage deductions or charitable contributions better or worse off? It is likely that this argument would go against subsidizing these activities. Furthermore, it is not at all clear why the preference for some of these activities should apply only at higher levels of income. Yet, this is precisely what happens, due to the allowance of a standard deduction.

From the complexity point of view, itemized deductions add a multitude of tax avoidance and evasion opportunities. They stimulate evasion by introducing into the tax code variables that are hard to monitor. They stimulate avoidance by introducing extra margins with differential tax treatment. The standard deduction in this context is a welcome means for reducing the complexity.

The Alternative Minimum Tax (AMT) plays a similar role by limiting deduction opportunities for people with higher income levels, including itemizable deductions. Three features of the AMT make it less effective though. First, from the taxpayer's point of view, the AMT calculation is implemented as a supplement to the individual income tax return. One has to explicitly figure out the difference between the regular income tax base and the alternative tax base. Computing taxable income directly, starting from the sources of income and allowable deductions, would be simpler from the taxpayer's point of view. Streamlining the computation would reduce the direct compliance cost, but it is unlikely to have much of an effect on the extent of avoidance and evasion other than, perhaps, reducing the likelihood of mistakes.

Second, while the AMT makes most of the deductions infra-marginal (good from the complexity point of view), it does so only *ex post*. At the beginning of the tax year, a taxpayer does not necessarily know whether she is going to be subject to the AMT because both future income and future deductions are uncertain. As a result, even if the AMT ends up applying *ex post*, *ex ante* one may be induced to engage in avoidance/evasion behavior. To some extent, this argument also applies to the standard deduction, but because a broader set of factors affect whether the AMT applies to an individual, predicting one's status is more of an issue in the AMT case.

Third, some deductions that are disallowed by the AMT have not much to do with tax sheltering. Examples are a deduction for state and local taxes and personal exemptions.

An effect similar to that of the AMT could be accomplished by simply capping the itemized deductions (or a subset of itemized deductions) using an appropriate threshold. It could be absolute in dollar terms, or it could mimic the current system more closely and avoid the danger of erosion by inflation by being set proportional to taxpayers' adjusted gross income. With a little bit of effort, one could also envision a similar change for the disallowed income preference items. This would make the whole calculation more transparent, would therefore reduce the *ex ante* uncertainty in tax planning, and likely reduce the direct compliance cost.

### *Tax preparers and software*

More than 60% of personal income tax returns in the United States are prepared by paid tax preparers. Most of the remaining ones, while prepared by taxpayers themselves, rely on tax software. This pattern suggests that certain aspects of filing that are commonly considered to add complexity are less relevant in practice. This applies in particular to computing one's tax liability. When a tax preparer or software does this computation for the taxpayer, progressivity of the tax code—the use of multiple tax brackets and rates—no longer imposes any extra burden on the taxpayer. Neither do other features of the tax code, such as separate computations of taxes on dividends or capital gains or the phase-outs of various benefits.

The import of tax preparers is less clear. A large number of options available to taxpayers makes it worthwhile to hire a professional who can help in identifying the most promising course of action. However, it is unlikely that outright tax evasion is facilitated by tax preparers. This is because the financial reward from cheating on the tax return accrues mostly to the taxpayer, but penalties are much harsher on tax preparers; in particular, criminal prosecution is more common. A tax preparer may have a better understanding of how the IRS operates, and therefore be more realistic about the risks involved. As a result, tax preparers might choose to pursue different avoidance and evasion strategies than taxpayers would pick themselves.

Blumenthal and Christian (2004) provide a short survey of the literature of the impact of tax preparers on compliance. Identifying the effect is difficult because the decision to hire a tax preparer is endogenous, and furthermore the choice of a particular type of tax preparer is endogenous (Erard 1993). Evidence on this topic is scarce, but does not point to tax preparers systematically increasing non-compliance.

From the point of view of the IRS, reliance on tax preparers should be welcome. As mentioned before, one way of increasing enforcement—penalties—is threatened by the importance of unintentional mistakes that taxpayers make. The likelihood of such mistakes falls when a tax professional is involved, thus reducing the likelihood that penalties will be imposed on otherwise honest taxpayers. This makes it possible to increase penalties. Harsh penalties can be (and are) imposed on tax preparers, thereby increasing the likelihood that they do not, in fact, facilitate tax evasion. Because a tax preparer deals with many customers, the IRS can more easily identify clusters of cheating by identifying preparers who systematically file fraudulent returns.

This is not to say that devoting attention to preparers solves the compliance problem. As argued above, tax preparers may facilitate tax avoidance, and not much can be done when the promoted strategy is legal. Tax preparers also have to rely on information provided to them by taxpayers, and there is little that can be done if a taxpayer chooses to withhold it. A tax preparer cannot, of course, play the role of an auditor without facing a risk of losing business. The IRS could remedy this by mandating all tax preparers to behave in the same way. For example, the IRS could impose requirements on tax preparers (and penalties in case of discrepancies) to verify information that currently need not be reported to the IRS (such as the purchase price of an asset) or that is currently not verified by the IRS. On top of the direct effect, strategies of this kind would make it harder to rely on a paid professional and cheat. As a result, taxpayers who do cheat would

be more likely to file on their own, making self-filers a natural target for audits.

### *Phase-ins and phase-outs*

Recent tax reforms included a multitude of phase-ins and phase-outs of various tax provisions. This is a natural example of the kind of undesirable complexity stressed here. By legislating predictably different tax treatments of the same activity in subsequent years, it creates an opportunity for successful tax planning by, for example, retiming realization of income or shifting deductions to years when their tax treatment is more beneficial. While much planning of that kind is not illegal, it does amount to an extra loss of revenue beyond legislation's intended effects. This loss is costly because it requires either keeping other tax rates higher or running debt (and increasing future taxes).

From the point of view of individual taxpayers, there are a few additional costs. First, there is a cost of implementing a particular method of shifting income across years with different tax treatment. Second, there is an extra risk because future policies are uncertain; for example, many of the 2001 provisions were accelerated in 2003.<sup>16</sup> Third, this kind of tax policy has made the tax system much less transparent. Taxpayers cannot rely on their experience because the law does in fact change from one year to the next. They may also assume that tax provisions that they took advantage of last year apply this year as well, when in reality they do not. The resulting confusion increases the likelihood of mistakes and therefore, as previously argued, makes standard enforcement much harder.

## **7. Conclusions**

This chapter has presented an overview of policy implications of tax complexity from an economic perspective. It suggested that tax evasion and tax avoidance are similarly costly from the social point of view, despite differences in their legal status. A comprehensive compliance policy should target both. While penalties and increased probability of detection are the main tools of targeting tax evasion, a reduction in complexity of the tax code would reduce opportunities for both tax evasion and tax avoidance, and it would additionally make penalties a more viable policy choice.

Complexity in the tax code should be thought of as the extent of variation in possible tax treatments of economically related activities. This kind of complexity naturally creates opportunities for tax avoidance, and it also causes difficulties for otherwise honest taxpayers. As a result, it leads to confusion and mistakes that are often hard to distinguish from dishonesty. Consequently, penalties become a less appealing approach to enforcement while, simultaneously, detection becomes more costly. From this perspective, efforts of the IRS to educate taxpayers and provide better customer service are a reasonable compliance approach, because they increase the effectiveness of the standard enforcement tools of penalties and audits.

Several methods of reducing complexity have been briefly discussed. Reliance on the standard deduction and capping deductions or preferences is one approach to making the tax code simpler for many taxpayers. An increased reliance on commercial tax

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<sup>16</sup> This is a cost imposed even on those who do not wish to engage in tax avoidance because it amounts to uncertainty about disposable income.

preparers allows for a reduced likelihood of unintentional mistakes and, while it does not eliminate the complexity of the tax code, it reduces confusion and makes standard enforcement more effective. It also allows for shifting some of the enforcement focus to the tax preparation sector, which is arguably easier to target than individual taxpayers. Two examples of questionable complexity that were highlighted were the eligibility criteria in the EITC and the use of phase-in and phase-out provisions.

Policy makers are unlikely to stop experimenting with the tax code. Some aspects of special tax provisions are fairly well understood: there is a direct revenue cost as well as the potential response of the affected and related activities. What is not sufficiently appreciated is that any provision of this kind adds to complexity in the tax code. This effect is hard to quantify, but its implications are real. New and innovative avoidance strategies are hard to predict. The increased cost of enforcement is also difficult to quantify. We also have no direct way of measuring the effect on unintentional mistakes. Slemrod and Kopczuk (2002) suggest that the first of these effects will show up as an increased elasticity of response to taxation and therefore higher marginal excess burden. There is no progress so far on the other two. Building an economic framework that allows for measuring the costs due to a marginal increase in complexity is a necessary input for understanding the full impact of specialized tax provisions.

The main point is that the costs of complexity go far beyond the direct compliance costs in the form of time or money that are imposed on taxpayers struggling to understand and comply with the tax law. While such direct costs are undoubtedly important, in practice, complexity also breeds opportunities for successful tax planning. Hence, complexity generates distortions; it makes the effective tax treatment of related activities different. Complexity also results in inequities because otherwise similar taxpayers end up with different tax burdens, simply because their willingness to exploit the law varies, or opportunities to do so vary. Moreover, complexity creates confusion and in the presence of confused taxpayers, enforcement is more difficult and less effective. Tax collectors have to sort through more non-compliance cases and, unless one is willing to punish honest taxpayers, they also have to spend resources on distinguishing between mischief and error.

The preferred way of dealing with compliance problems is fixing the tax code. When taxpayers can no longer easily claim confusion, what is left on the table will be noncompliance by cheaters, thereby allowing the IRS to enforce free of distraction.

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Directions for simplifying taxes. The key to tax simplification is to make fewer distinctions across economic activities and personal characteristics. Taxes should be imposed on a broad base at relatively low rates that do not vary by income source or expenditure type. Progressivity should be embodied in the rate structure and the tax base, not in the design of specific provisions. Thus, from a social perspective, the sum of all individuals' "good complexity" could be zero or negative. II. Simplification and the new tax law. The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) was signed into law by President Bush on June 7, 2001. Both the most important and most novel aspect of EGTRRA is the general provision that the entire bill "sunset" at the end of 2010. Compliance with tax rules in particular can be challenging for small businesses. Tax legislation is in many cases rather complex. Tax laws are drafted in a way that allows their application to businesses of all sizes and to all types of economic transactions, even for operations that are only carried out by large corporations. This report describes the various measures that the participating countries have taken to reduce tax compliance costs for SMEs. 2006. "Tax Simplification and Tax Compliance: An Economic Perspective." In *Bridging the Tax Gap: Addressing the Crisis in Tax Administration*, edited by Max Sawicky, 111-143. Washington, DC: Economic Policy Institute. Maag, Elaine. 2011. "Tax Simplification: Clarifying Work, Child, and Education Incentives." Washington, DC: Urban-Brookings Tax Policy Center. National Taxpayer Advocate. 2020. *National Taxpayer Advocate 2020 Purple Book: Compilation of Legislative Proposals to Strengthen Taxpayer Rights and Improve Tax Administration*. Washington, DC: Internal Revenue Service. Tax simplification always has been on the agenda of policymakers to increase the efficiency of tax systems. Less complex taxes can contribute to higher tax revenues with minimum negative distortions to economies. Therefore, the link between tax simplification and tax efficiency is even more relevant now for policymakers in the era of high government budget deficits. The aim of this paper is to explain the empirical study of this important link in a panel setting, which is considerably limited in the literature. The findings of the paper place numerical values on the impact of tax simplification... An Annotated Bibliography of Tax Compliance and Tax Compliance Costs. Compiled by Simon James and Alison Edwards. University of Exeter Business School 2010. Economic and Social Research Council funding is gratefully acknowledged (award number RES-000-23-1595 "Optimum Tax Compliance Costs and Tax Simplification"). 1. Preface. This collection of contributions to the study of tax compliance was compiled as part of an Economic and Social Research Council funded project which formally took place from March 2006 to August 2007. It builds on a great deal of earlier work "most notably by Ahmed et al.