IDAHO'S TAX GAP, 2009

ESTIMATING IDAHO'S TAX GAP

AND

DEVELOPING STRATEGIES TO REDUCE IT

IDAHO TAX COMMISSION
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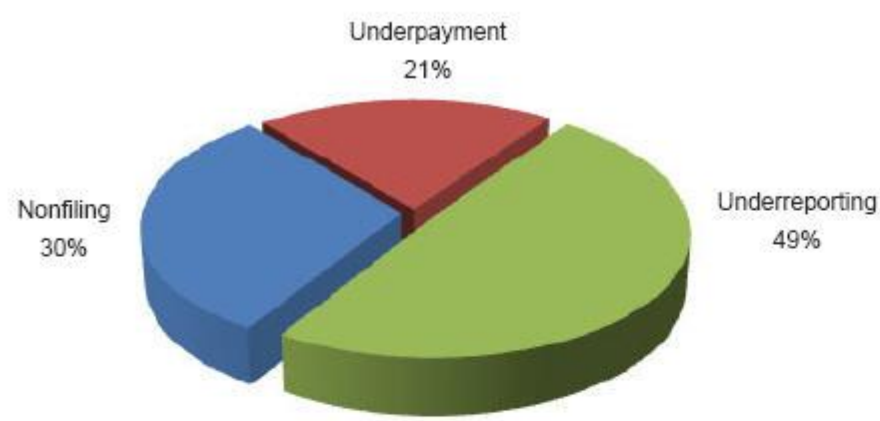
INTRODUCTION

"Tax Gap" is a term that describes the amount of tax liability imposed by existing law that is not paid voluntarily and in a timely manner. The tax gap is important because it imposes an unfair burden on those who pay on time and accurately, it erodes public confidence in the voluntary tax system, and it reduces revenue needed for the state to provide services. Understandably, the tax gap is subject to increased scrutiny when budgets are challenged by declining revenues, because it represents an opportunity to increase revenues without raising taxes.

The tax gap occurs for many different reasons, but there are three main causes. According to Tax Commission analysis, Idaho's tax gap results from:

- Underreporting (49%) – not reporting the full tax liability on a timely filed return (understated income or overstated deductions or credits)
- Underpayment (21%) – not paying the full amount of tax reported on a timely filed return
- Nonfiling (30%) – not filing returns on time or not paying on time

Idaho's Tax Gap



Just as there are several causes of the tax gap, there are various ways that it can be reduced. Voluntary compliance can be improved through public education, increasing access for taxpayers to view their accounts, and creating opportunities to file or pay taxes online. Legislative remedies include tax law simplification, requiring the reporting of financial information, or the withholding of certain disbursements such as real estate gains. This report focuses on the method under our direct control and that has the most immediate potential for reducing the tax gap: administration and enforcement.

In this report, we use several terms related to the tax gap, as described in the table below. We first determine the size of Idaho's gross and net tax gaps by using three models. We then examine some of the methods for reducing the tax gap and analyze how cost effective those methods are. Finally, we develop an estimate of how much of Idaho's tax gap is collectible in a cost-effective manner.

Important Definitions

Gross Tax Gap: Taxes due under current law, but not paid timely or voluntarily.

Net Tax Gap: Amount of tax gap remaining after subtracting the amount collected through current compliance efforts.

Collectible Tax Gap: The portion of the tax gap expected to be recoverable in a cost-effective way through enhanced funding of audit and compliance efforts.

This report is intended to be a living document. Future periodic updates will reflect changing economic conditions, the effects of various enforcement methods on voluntary compliance, and our own improved understanding of Idaho-specific data and assumptions used in making estimates.

The Idaho Tax Commission's mission, in part, is to "administer the state's tax laws in a fair, timely and cost-effective manner." Our continued study of the tax gap will help us evaluate our own effectiveness as a revenue collection agency. Understanding the collectible portion of the tax gap helps define the potential for a fully functional, cost-effective Tax Commission and the amount of staffing resources necessary to maintain it. In turn, understanding the full potential of the Tax Commission as a revenue-collecting agency will be helpful to executive and legislative policymakers as they establish budgets and determine our agency's part in serving the people of Idaho.

HOW BIG IS IDAHO'S TAX GAP?

Calculating or estimating a tax gap is a challenge at best. We have identified three different methods and applied each of them below.

METHOD 1:
THE IDAHO OFFICE OF PERFORMANCE EVALUATION

Before this year, the most recent formal attempt at estimating Idaho's Tax Gap came in 1996, when the Office of Performance Evaluation (OPE) issued its Report 96-06, "Estimating and Reducing the Tax Gap in Idaho." This report analyzed the most recent available data at the time, some from FY1994, some from calendar year 1995, and for corporate income tax an average between the three years 1992-1994. It concluded that the Gross Tax Gap was $244.8 million, or 14.64% of annual revenue. Applying this same percentage to current (FY2009) revenue produces an estimate of $463 million for the current Gross Tax Gap. Of this, a portion of the Tax Gap is already being collected through Tax Commission enforcement activity. When this portion is deducted, the "Net Tax Gap" is determined to be $299 million.

Idaho Total Gross Revenue	=	$3,163,005,652
Multiply, OPE Multiplier	X	.1464
Idaho Gross Tax Gap	=	$463,000,000 (rounded)
Less, Current Enforcement	-	$164,000,000
Idaho Net Tax Gap	=	**$299,000,000**

METHOD 2:
THE INTERNAL REVENUE SERVICE[1]

The IRS has conducted extensive research on the national tax gap. Prior to 1988 its Taxpayer Compliance Measurement Program (TCMP) examined thousands of tax returns line-by-line to determine compliance levels. After 1988 the IRS's National Research Program (NRP) developed and used a less intrusive - though statistically valid - method of desk audits for 13 years, covering 46,000 returns from 2001, the most recent tax year studied. This research indicates a 16.3% (gross) noncompliance rate across all federal tax types. By applying the 16.3% gross rate to Idaho's FY2009 revenue, we conclude a gross tax gap of $516 million. Deducting the amount already being collected through audit and compliance efforts leaves a net tax gap of $352 million.

Idaho Total Gross Revenue	=	$3,163,000,000
Multiply, IRS Multiplier	x	.163
Idaho Gross Tax Gap	=	$516,000,000 (rounded)
Less, Current Enforcement	-	$164,000,000
Idaho Net Tax Gap	=	**$352,000,000**

[1] Internal Revenue Service, "Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance," August 2007.

METHOD 3:
IDAHO TAX COMMISSION STAFF

The Tax Commission's Audit and Collections Division has estimated Idaho's tax gap by averaging results from completed audits and applying them to Idaho's overall taxpayer base. They concluded a value for underreporting at $203 million, nonfiling at $126 million, and underpayment of taxes at $85 million for a total tax gap of $414 million. Deriving the net tax gap requires once again subtracting the $164 million which is already being collected through audit and compliance efforts. This method indicates an Idaho net tax gap of $250 million.

Underreporting	=	$203,000,000
Nonfiling	+	$126,000,000
Underpayment	+	$85,000,000
Sum, Idaho Gross Tax Gap	=	$414,000,000
Less, Current Enforcement	-	$164,000,000
Idaho Net Tax Gap	=	**$250,000,000**

RECONCILING THE THREE ESTIMATES

It is important to recognize once again that there is no precise method to "measure" the tax gap, and making estimates is challenging. Most methods rely on significant assumptions. For instance, applying a tax gap percentage or multiplier from one year to another fails to account for changes in tax code or the economy. Conclusions based on data from one jurisdiction cannot be applied to another jurisdiction without huge caveats due to the difference in tax structures. (For example, IRS research does not take into account sales/use tax, which makes up a significant part of many states' total revenue.) Still, when several different models are used and a pattern appears, we can develop some confidence in our estimate when the goal is simply to derive a reasonable idea of how much revenue is not being collected in a voluntary, timely manner.

The three methods above produce a range of indicators from $250 million to $352 million with the average being $300 million. We give more emphasis to the third method which uses more timely and detailed data, and thereby conclude a "net" tax gap for Idaho of $275 million.

There is still a portion of this net tax gap that deserves special consideration, and that is the growing portion of unpaid sales/use tax from interstate e-commerce and mail-order transactions. The best estimate available for Idaho[2] is that $30 million of tax revenue (owed under current Idaho Code) is lost each year this way. A very small number of taxpayers make an effort to pay the sales/use tax for these transactions, but enforcement is not economically feasible. Therefore we deduct a major portion ($20 million) to arrive at an adjusted net tax gap of $255 million.

Conclusion: Idaho's Net Tax Gap

Reconciled Net Tax Gap	=	$275,000,000
Less, Adjustment	-	$20,000,000
Idaho's Net Tax Gap	=	**$255,000,000**

[2] Bruce, Donald et al, State and Local Government Sales Tax Revenue Losses from Electronic Commerce, University of Tennessee April 13, 2009. (Our $30 million estimate is based on the average of the preceding three years, rounded.)

FROM THE AUDIT AND COLLECTION FILES: METHODS TO REDUCE THE TAX GAP

The tax gap is also evident when we examine the productivity of our audit and collection staff, and how many cases of noncompliance are not pursued due to unmet staffing needs.

The Tax Commission currently has 29 vacant positions, yet these vacancies do not represent net savings to the state. Here are just a few examples of how budget restrictions affected General Fund revenue in FY2009:

- Our Tax Discovery Bureau (4 vacancies) found 55,000 potential cases of individual income tax nonfilers this year; we were able to work only about 5,000 of them. Each added employee devoted to these cases would have raised $1 million more.
- "Phone Power," our front line of collection agents, had 4 unfilled vacancies. Each Phone Power employee collects, on average, more than $2 million per year.
- Compliance Techs and Compliance Officers (6 vacancies in FY2009) work in tandem by phone, mail, and in the field. They collect an average of $1 million and $620,000 each year, respectively.
- Auditors and Audit Technicians (10 vacancies in FY2009). Had these positions been filled, they would have collected, on average, over $400,000 each per year.

Clearly, these examples demonstrate unrealized potential. And these figures do not capture the "indirect collection" effect. Voluntary compliance is proven to be greatly enhanced solely by having auditors and collectors on the job. Simply put, when taxpayers know that tax evaders are being held accountable, they feel the system is fairer and they are more likely to comply truthfully and on time.

> *Investing in tax compliance to reduce the tax gap is a revenue-producing* ***alternative to raising taxes*** *or cutting services.*

INVESTMENTS IN TAX COMPLIANCE: PROVEN RETURN ON INVESTMENT

The best demonstration of actual returns from investment in tax compliance comes from our own experience. In 2003 (another year characterized by declining revenues and budget holdbacks), the Governor signed legislation which boosted the compliance budget of the Tax Commission by $926,000. This allowed us to create new tax compliance positions which brought in more than $10 million in additional revenue within a year, and over the first four years produced an average return on investment (ROI) of 13 to 1.

Our research shows that this ROI is very consistent with the experience of other states. The table on the next page contains data from other compliance initiatives in a condensed format.

RETURN ON INVESTMENT FROM COMPLIANCE INITIATIVES

STATE, YEAR	COST	ADDED REVENUE	RETURN ON INVESTMENT (ROI)
Idaho, 2003	$926,000	$12,000,000+	**13 to 1**
Kansas, 2002	$6,000,000	$54,000,000	**9 to 1**
Minnesota, 2003	$10,300,000	$97,200,000	**9.4 to 1**
Kansas, 2005	$1,440,000	$15,000,000	**10.4 to 1**
Washington, 2009	$10,700,000	$67,800,000 (projected)	**6.3 to 1**
New Mexico, 2009 First year	$5,000,000	$29,000,000 (projected)	**6 to 1**
New Mexico, 2010 Ongoing, multi-year	$5,000,000	$45,000,000 (projected)	**9 to 1**
Average Return on Investment (ROI)			**9 to 1**

THE MULTIPLIER EFFECT ON REVENUE: STRONGER IN REVERSE

Just as additional tax compliance resources often produce 10-to-1 or better ROI, cuts to revenue-producing agencies cost far more budget dollars than they save. In fact, the further Tax Commission resources are cut, the greater the lost revenue multiplier becomes. This can be explained by the principle of marginal utility, or put another way, the concept of "low-hanging fruit." The Tax Commission concentrates its collection efforts on activities that produce the most revenue. As our workforce declines, we are forced to work fewer cases. We let go of the more difficult cases first, and retain those which produce the most revenue for the effort. Hence, the more cases we drop, the more valuable each dropped case becomes.

DIGGING THE HOLE DEEPER: UNINTENDED CONSEQUENCES OF ACROSS-THE-BOARD BUDGET CUTS

We understand the difficult decisions confronting Executive and Legislative budget writers in the current economic climate. But we believe that the preceding data show clearly that budget cuts have a contradictory effect when applied to the Tax Commission: a $1 million decrease in the Tax Commission budget will demonstrably lead to approximately $10 million fewer dollars available for all other General Fund agencies. And the more that is cut, the higher the lost revenue multiplier becomes.

Investments in tax compliance produce ***consistently high returns.*** *Conversely, cuts to revenue agency budgets cause* ***large decreases in funding*** *available for all other General Fund agencies.*

THE TAX GAP: HOW MUCH CAN WE COLLECT?

In this report, we have established an estimate of Idaho's current tax gap. We've shown the effectiveness of audit and collection personnel and the potential for increasing revenue by adding staff resources. And we've documented the evidence which shows that funding these staff resources would pay significant returns. So how much of Idaho's current tax gap do we believe is actually collectible? To answer this question, we must first explore the nature of tax collection and the tax gap. Then we will consider two methods to quantify Idaho's "collectible tax gap."

Consider all of the taxes owed to the State of Idaho under current tax laws as a continuum. The easiest taxes to collect are those paid voluntarily when due. The cost of administering these "easy" taxes would of course be minimal to include opening the mail, depositing checks, and distributing monies to the appropriate accounts. But when it comes to collecting from those who may have made an honest error, those who underreported income or overreported expenses, or from those who fail to file, more costs are incurred. Audit, collection and support staff is required, along with information technology resources and other support infrastructure. Moving along the continuum to those taxes which are increasingly more difficult to discover, assess and collect, costs continue to rise exponentially. Eventually diminishing marginal utility leads to a point where collection of taxes owed is not cost effective.[3] Above this point, tax liabilities can be characterized as "uncollectible."

In this context, the "collectible" tax gap is defined as: the portion of the Tax Gap expected to be recoverable in a cost-effective way through enhanced funding of audit and compliance efforts. The most reliable estimate of "collectability" that we have found, and the one generally accepted by other states, is the IRS's estimate that 30% of the net tax gap is collectible.

By applying the IRS collectability estimate of 30% to Idaho's adjusted net tax gap of $255 million, we conclude that Idaho's 2009 collectible tax gap is $76.5 million.

[3] Social and political costs become a factor as well; collecting 100% of the tax gap would require an untenable amount of information-gathering and loss of privacy. This "socio-political threshold" can't be quantified, but estimates of collectability do – at least tacitly - consider this factor.

Idaho's "Collectible" Tax Gap
(estimate, IRS collectability ratio):
$76.5 million

Our second method for determining the collectible portion of the tax gap is something of a test or "reality check" on the IRS collectability ratio estimate. It is more specific to Idaho, and it involves tallying the specific cases or leads known to us which are not investigated or pursued. (For examples, see section titled "From the Audit and Collection Files.") If the Tax Commission were given the resources needed to fully staff the audit, collection and support positions to pursue all of these cases, how much new revenue would be raised?

To answer this question, the Tax Commission built a business plan we call "Compliance Initiative 2011." This plan uses concrete data to build a case for closing the tax gap by fully staffing 20 specific areas or case types in our audit, compliance, collection and support job functions. "Compliance Initiative 2011" demonstrates our best projection on how much of Idaho's tax gap we can reasonably expect to collect with full staff support. As such, this plan's conclusion of $64.5 million is a practical measure of Idaho's collectible tax gap. To achieve this goal, the plan would require an investment of $9.9 million to fully implement. This corresponds to a 6.5-to-1 return on investment and it comprises 85% of our "collectible" tax gap estimate from the IRS collectability ratio.

Idaho's "Collectible" Tax Gap
(using Compliance Initiative 2011):
$64.5 million

CONCLUSION

As the agency charged with the duty of collecting revenue, we feel a heightened sense of responsibility in helping our states' leaders deal with the current budget crisis. Our investigation shows ample evidence that a tax gap exists in Idaho; that the return on investment in additional tax compliance resources is considerable; and that budget cuts at the Tax Commission would further frustrate the declining revenue problem that necessitated the cuts in the first place. We conclude with a projection of the amount of the tax gap that a fully staffed Tax Commission can reasonably be expected to collect.

In this report, we have strived in good faith to present an accurate picture of Idaho's revenue agency and the unique relationship we have to the General Fund budget. Many of the models, assumptions and data used were derived over the past decade when the state and national economy were on much better footing. There are no studies known to us that were conducted during an economic downturn like the one we are experiencing today. And there are several current trends that could negatively affect tax revenues and offset gains we might make through increased compliance efforts. These trends include:

- significant drops in capital gains income, particularly in real estate.
- corporate income losses that can be "carried back" to previous tax years resulting in unexpected revenue payouts.

Still, whatever the return on investment, funding of compliance initiatives will produce "net positive" results. Economic trends are happening with or without our efforts to enforce compliance. If those trends are negative, then we believe that law-abiding taxpayers – the vast majority of Idahoans - should not suffer loss of services or tax increases when others are not paying their fair share. So whichever way economic winds may blow, it makes sense to enforce the state laws that the vast majority of citizens obey. A fully functional Tax Commission can do this and significantly help increase state revenue without raising taxes.