Implications of the Tax Reform Proposals for Fraud – or – How to Shift to a Consumption Tax Without Helping the Cheaters

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Implications of the Tax Reform Proposals for Fraud
-Or-
How to Shift to a Consumption Tax Without Helping the Cheaters

By Kalyani Robbins

Kalyani Robbins considers the implications that current tax reform proposals have on tax compliance enforcement.

Introduction

One need only spend a few minutes searching the Internet to be overwhelmed by the intensity of the tax reform debate. In addition to the discussions among scholars and specialists, there are more grass roots movements than one could possibly count. Some of them seem credible, often pushing for one of the proposals already being considered by Congress, and others do nothing but scream so loudly against the IRS that you can almost hear them through cyberspace. Organizations with names like Americans for Fair Taxation,1 Americans for Tax Reform,2 Citizens for an Alternative Tax System,3 Citizens for Tax Justice4 and the Great American Taxpayer’s Revolution5 litter the Web, calling for a better way but only rarely explaining in much detail just what

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that way should be. The one thing everyone does seem to agree upon, scholars and angry citizens alike, is that the time has come to “[shift] from the question of whether to alter our current tax system to the question of how to alter it.”6 Given the strength of this mandate, it is worth taking a moment to consider the ramifications of reform for tax cheating.

The vast majority of the proposals on the table today are simply different implementation mechanisms of the same basic idea: a change in the tax base from income to consumption. The purpose of this article is to consider the implications some of these proposals have for the enforcement of tax compliance (prevention of cheating). For this reason, it will only briefly address the impetus for a consumption tax and the policy considerations behind it.7 The first part will also give short descriptions of the proposals that will be considered in this article: the National Retail Sales Tax, the Savings-Exempt Income Tax and the Value-Added Tax (VAT). Next, I will analyze each of these proposals with regard to the feasibility of evasion. Finally, the article concludes that with regard to the prevention of tax-cheating, the VAT is the most efficient of these proposals. In light of the fact that in most other respects they are effectively the same (they all tax the same base at what would become the same amount after determining revenue needs and effectively operate to encourage saving and boost the economy through investment), I would endorse a VAT in order to discourage cheating and to take the burden of compliance out of the hands of the average citizen.

Taxing Consumption

What reason is there, that he which laboureth much, and sparing the fruits of his labor, consumeth little, should be charged more, than he that living idlely, getteth little, and spendeth all he gets: Seeing that one hath no more protection from the commonwealth than the other?8

Fairness to those who are capable of delayed gratification is only one of the many reasons that people in the United States are beginning to seriously consider a move toward a consumption tax (though it is key to distinguish between excessive consumption and poverty conditions that cause people to spend all of what they earn—this can be taken into account through progressive rates and standard deductions.) Another important consideration is that just about every consumption tax proposal, even the fairly complex VAT, is significantly easier to report and collect than our current income tax and would therefore save time and money and increase productivity.9 Perhaps most importantly from a policy perspective, taxing consumption encourages saving. Under our present system, which rewards immediate spending, the U.S. has fallen behind almost every developed country in percent saved per year.10 Not only will increased savings benefit future generations directly,11 but it will also provide funds today that can be invested in business and boost the economy,12 which is good for all generations.

One consumption based tax reform proposal is the National Retail Sales Tax. This is exactly what it sounds like. Instead of taxing income at all, a tax of at least 15-20 percent (some argue much more would be necessary) would be levied on all retail purchases. “In order to tax only final consumption, however, purchases by businesses [would] be tax-exempt.”13

Only retail businesses would be responsible for reporting and paying the taxes they had collected, and they would be reimbursed for the added effort. These taxpayers would remit the federal tax money to the states, as they already do with state sales tax in most states. The states in turn would send it to the federal government, less a one percent fee for their trouble. In total, far fewer individuals and entities would be involved than with an income tax,14 which would reduce the aggregate cost of compliance. Regressivity would be avoided through across the board refunds in an amount determined to be representative of the cost of basic needs.

Another way to tax only consumption and leave investment income alone is the Savings-Exempt Income Tax. Under this system, taxes would still be collected from individuals, eliminating some of the efficiency benefits available with the sales tax. It would, however, still provide the previously discussed policy benefit of encouraging saving by deducting the amount newly saved in a given year from total income, effectively taxing only that which is spent. This method can also be more reliable than a sales tax by accurately determining the figure expended on all consumption, not just the spending that fits into the retail sales (or other easily tracked transfers such as those of homes and automobiles) model. Progressivity would be attained through very large standard deductions, and in some proposals, graduated rates.15 Naturally, in order to make this system feasible, the tax rates would
still have to be higher on average than they are now to make up for the smaller tax base.

Finally, there is the method used in many other countries, known as the Value-Added Tax (VAT). The VAT is a bit more complicated than the other two systems discussed herein, but is essentially a multi-level sales tax, charged to providers rather than buyers (which basic economic theory tells us is effectively the same thing). Goods and services generally go through several stages (and pass through several sets of hands) before reaching the final purchaser. A VAT does not involve charging the tax directly to the consumer, though he or she will pay for it through higher prices. Rather, it is a tax on the difference in value between the goods purchased for each stage of production, and the thing produced at that stage. A company would be taxed on its gross revenues less the amount it spends on supplies (but not wages). This figure represents the value that a given company has added to those goods as they move along the chain of production, hence the name of the tax. In effect, the value of the final retail product is taxed, with each business that contributed to its final value paying in proportion to the portion of that value it contributed.

Because a VAT taxes consumers by increasing the prices of the goods they purchase, it does not lend itself well to progressivity. All consumers would have to pay the same higher prices for what they buy, regardless of their income levels. Although politically difficult, there are some ways to deal with this problem. One would be to tax different production chains at different levels, depending on whether the goods produced are deemed necessities or luxuries. This determination, however, is highly subjective. Another way would be to give monthly checks to low-income individuals in an amount that reflects the tax they are likely to be paying on their necessities. Finally, we could give people with lower incomes special discount cards to use when making purchases. The retailers would then submit copies of the receipts from these discounts to the government for reimbursement (or even just deduct it from the tax they pay, perhaps). Regardless of the method used, if any, there would still be one benefit that we do not have under our present tax system: the wealthy would no longer be able to avoid paying their share of taxes through manipulation of the provisions in the tax code. This may offset the problems with making a VAT progressive.

Possible Evasion Tactics for Each Proposal

NATIONAL RETAIL SALES TAX
While a move to sales tax would make it much more difficult for individuals to cheat and eliminate entirely the problems of false deductions and unreported income, it would also invite a host of new opportunities for cheating. To realize this one need only look at the common phenomenon, under existing law, of businesses under-reporting their sales to evade taxes. This would continue and possibly increase, as the rewards of such tactics would be higher when the taxes they pay are no longer diminished by including individual income taxes in the overall revenue pool. In other words, all tax dollars will pass through retailers’ hands. This sort of cheating is one of the easiest to get away with, as there is no other source of information for the government to cross-reference with the retailer’s reporting. At least with an income tax, if an individual does not report income, it is likely that the employer did. In contrast, with a sales tax the consumers would exit the store and have at that point completed their role in the process. We would depend almost entirely (and for the entire tax revenue) on the retailers to accurately report their sales and submit the tax dollars to the states. Add to that the complexity of policy-related differential taxation levels for different sorts of goods, and the fact that some goods are sold both to final consumers and to other businesses, and proper compliance becomes even more difficult, even for the honest.

A sales tax can also be evaded on the individual level. First, people could seek out “under the table” sales, much like they do now with employment. This
would save them from paying the (most likely quite large) sales tax, and there would be an incentive for sellers to participate in order to make more sales and perhaps charge a little bit more (but still less than the price would have been after the tax). Second, consumers can avoid paying what they feel to be an excessive sales tax by purchasing higher ticket items through the international market. Finally, people could create phony businesses through which to make their purchases, which would then be exempt from the sales tax.

Of course, some of these dangers could be avoided through electronic means. Several proposals involve requiring that all purchases be made with “personal smart cards,” allowing the government to collect sales taxes directly from the consumer, at the point of sale. One such proposal involves a special card that also contains data on the consumer’s income level, allowing for a progressive sales tax rate. The card would be capable of immediate funds transfer, the government would be able to collect the tax electronically on the same in-store device which would collect the payment. This suggestion, however, would do nothing to prevent some people from illegally selling goods for cash in order to evade the tax. Another proposal involves something more like a typical ATM card, to be used for most purchases, but with continued legal use of cash for small expenditures. The government would review the consumer’s checking account at the end of each month, and directly withdraw tax on the total ATM amount (card purchases plus cash withdrawals). This method does not suggest a way to deal with credit card purchases, though. Under either of these methods, most of the evasion techniques discussed above would be impossible.

The fatal flaw in these electronic methods is that they are overwhelmingly Orwellian. The government would no longer merely track a person’s employment history, investments and those purchases he chose to claim as itemized deductions (which already leaves some people feeling as though their privacy has been violated, especially during an audit). Big Brother would observe everywhere one went and everything one purchased. There would truly be no privacy left at all with regard to an individual’s lifestyle choices. Ironically, privacy is one of the many reasons some people have supported a national sales tax in the first place. This level of invasion is untenable, and besides, it is unlikely that any workable electronic system could even be in place within a reasonable number of years.

Finally, in addition to the strong likelihood of cheating under the National Retail Sales Tax, the distribution of this cheating poses a greater risk to fairness and to total revenue than under other possible taxation regimes. First, because the states will be collecting and enforcing the tax, it is likely that it will be enforced differently in different parts of the country. While there would be a uniform federal requirement of compliance, “[o]ne state’s collection efforts or interpretation of the federal law might be more aggressive than that of another state.” This could result in unfair variations in effective (post-cheating) taxation levels in different states, which would not correlate to their representation in Congress. The second problem is the sheer volume of tax dollars that could be lost. When only one single stage of production is taxed (as opposed to a VAT), if just one party (the retailer) cheats, the entire tax is lost, rather than merely a portion of it.

Under a Savings-Exempt Income Tax we would be faced with approximately the same potential for fraud as under the current system, but with a few changes. The problem of unreported income would remain the same, and assuming we kept some of the currently available deductions, taxpayers would continue to lie about those, but there would also be an entirely new problem. With an unlimited new deduction (saved/invested money) comes incentive to claim more of it than...
one really has. This could be done by selling previously held assets (the proceeds of which would not be reported as income) and purchasing new ones (i.e. deductible “new savings/investments”) or simply spending the proceeds (but not paying the consumption tax on that spending, as it does not vanish from that year’s income). Even if this could somehow be avoided by determining the exact amount and whereabouts of everyone’s assets before each tax year began (which would be exhausting), we would still have the general problems of income tax evasion.

VALUE-ADDED TAX

While no alteration of the method of taxation could ever keep some people from wanting to cheat on their taxes, the beauty of a VAT is that it makes it virtually impossible to do so. There would be no income reporting and no separable tax charge on retail purchases. In fact, although the consumers would be effectively paying the tax through its reflection in prices, they would seemingly pay no tax at all, and therefore have no way to withhold payment. Because the actual taxpaying responsibility would be divided among the various manufacturers involved in any product, a VAT is essentially self-enforcing. Each producer will want to report the amount spent on goods bought from the company one step behind it in the chain, in order to subtract that amount from the proceeds of its later sale of the goods to the next link in the chain, which will report that amount for the same reason. In other words, each link in the chain of production has incentive to police the one that comes before it. For a company in the middle of the chain, there is practically no way to cheat.

Every production chain, however, has an end. As discussed, there is nobody to police the retail seller. The customers make their purchases and leave, and without invasive methods, there is no way to cross-reference them. The VAT, however, provides two safeguards at the retail level that do not exist under the sales tax model. First, the penultimate transaction has been recorded, so there is a record of the quantity of (let’s say) widgets the retailer bought. If the retailer sells all of those widgets (as evidenced by its purchasing more of them), it will be expected to report gross revenues somewhere in the neighborhood of their market value, or at least in an amount sufficient to turn a net profit after the subtraction of likely other, non-deductible overhead expenses. Second, not only can the retailer only slightly underpay its taxes because of these records, but that figure will be negligible in light of its diminished total tax responsibility (relative to a sales tax). Because the retailer pays only one small portion of the total tax, and can only cheat on a very tiny part of that, and because there are no other potential cheaters in the system, a VAT is nearly cheat-proof. The only way for meaningful fraud to take place would be to elaborate coordinate it among all of the links in a particular production chain. This would require the consent of every entity involved, which is far too unlikely to address with any real concern.

Conclusion

While there is no such thing as a good tax, the best we can hope for is one that is less painful than the current system, and which can be more evenly applied through the prevention of evasion. Not only would a VAT be less directly burdensome for most citizens, but for the reasons discussed, it would nearly eliminate cheating. This would quickly lead to a reduction in the overall tax rate, as we would regain the fortune lost each year to fraud under our present system. This would make almost everyone more content with the tax system, and provide an additional boost to an economy already improved by the increase in savings discussed above. Alexander Pope said “[w]hoever hopes a faultless tax to see, hopes what ne’er was, is not, and ne’er shall be.” Truer words may never have been spoken, but a VAT might be the closest we can come to attaining a livable, albeit imperfect, tax.


7 This discussion, if thorough, would be its own law review article.

8 Thomas Hobbes, LEVIATHAN 184 (Dutton ed. 1914).

9 See Joseph Bankman & Thomas Griffith, Is the Debate Between An Income Tax and a Consumption Tax a Debate About Risk? Does It Matter?, 47 TAX L. REV. 377, 386 (1992) (“The consumption tax has also been supported on the grounds that it will be easier to administer.”).

10 See Laurence J. Kotlikoff, Should We Tax Consumption, and If So, How? (last modified Mar. 14, 1996) http://www.mijcf.org/Policy/jobs_capital/jc1995_2/a06.html (“Our nation’s net national saving rate is running at less than three percent per year – less than one-third the rate observed in the 1950s and 1960s. It is also among the lowest of the developed countries. For example, we are routinely saving at less than one-third the rate of Japan and less than one-half the rate of Germany.”).

11 See Bankman & Griffith, supra note 9, at 385 (Advocates of efforts to increase savings are concerned about leaving “an adequate stock of wealth for future generations.”).

12 See Kotlikoff, supra note 10 (despite that domestic investment can be financed by foreigners, it nonetheless seems to correlate over time with the national savings rate.)


15 For example, the Nunn-Domenici proposal (which combines this method with a VAT) provides for progressive income tax rates.

16 For example, we might tax luxury items at a higher rate than necessities, and both may be available from the same retailer.

17 See Arguments for a Consumption Tax (visited Mar. 28, 1998) http://www.ruf.rice.edu/~philip/tax_policy.html (“The international market provides consumers the opportunity to evade the consumption tax.”).


19 See Kotlikoff, supra note 10.

20 See, e.g., Great American Taxpayer’s Revolution, The Better Way USA Plan (visited Mar. 16, 1998) http://www.noirs.com/noirs/plan.html (If we abolish the income tax and the IRS, and replace them with a sales tax, “we will get our privacy back.”).


22 See id. (“The retail sales tax imposes tax only at a single stage in the production and distribution chain. This increases the opportunity for the evasion of the entire tax when just one party (the retailer) fails to meet its taxing duty.”).

23 See Kotlikoff, supra note 10 (“[H]ouseholds could sell [their] assets and purchase new ones, and claim the amount of the new asset purchase as a tax deduction.”).

24 One way to picture this is to imagine that four people decide to purchase a pizza. No one person would be able to avoid paying his share, as the rest of them would then be responsible for it. Each member polices the others’ contributions. Because a VAT taxes the total value of the final product, it is in the interests of each manufacturer to ensure that the others pay tax on the full values added at their stages of production.

25 Even if the retailer and its provider wanted to agree on a lesser quantity to be recorded (to enable the retailer to evade taxes on the value added to those products and to allow the provider to report less gross profits), they would run into the same problem of the previous transaction’s having been recorded, and so on. The need to under-report would slide all the way up the chain, making it much more risky and difficult.

26 See Deloitte & Touche, supra note 21 (“The complete amount of tax is evaded only when there is some coordination between parties at different stages of the production and distribution chain.”).