# Discussant Comments for the 2008 IRS Research Workshop

John Karl Scholz

The University of Wisconsin - Madison

Joseph Pechman Fellow at the Brookings Institution, on sabbatical leave

June 11, 2008

# Three Papers, 15 Minutes, An Impossible Task

- I commend the paper authors. Too little research effort in academic and policy circles focuses on taxation. Hence, I applaud the IRS for holding this conference and for the efforts of the participants.
  - Taxation is an essential feature of modern economies, consequently, there are enormous potential payoffs to policy changes that enhance the efficiency of the tax system. Work that contributes to a better understanding of tax compliance and tax administration is also exceptionally valuable.
- I am discussing papers on
  - Changes in noncompliance for sole proprietors b/w 1988 and 2001.
  - Income reporting in household surveys in New Zealand.
  - Developments in use and compliance with the AEITC.
- I spent a while trying to figure out whether I could pull a David Blaine (do something impossible) and coherently draw sensible connections between the papers. I couldn't, so I'll discuss each sequentially.

# Sole Proprietor Noncompliance

- This is a very important topic. I have long been puzzled (I could use stronger words) about the attention Congress has asked the IRS to pay to EITC noncompliance compared to potentially bigger ticket items. I do not want to trivialize EITC noncompliance, which likely exceeds \$10b. But individuals with business income may account for more than \$240b in unpaid but legally obligated tax payments. Yet there have been far fewer studies targeting this population than have examined EITC returns.
- The strategy pursued in the paper is sensible. It is interesting to compare compliance results from 1988 and 2001, as well as to compare sole proprietors with other individuals. Moreover, the paper is packed full of interesting tables.

# Sole Proprietor Noncompliance, continued . . .

- I have several suggestions for the work:
  - The usefulness of the analysis depends, presumably, on the dollars that are at stake.
  - In addressing compliance issues, it makes sense to follow a "Jessie James" strategy. When ask why he robs banks, he said "that's where the money is."
  - We *need* a more serious focus on dollars.
- Once you start focusing on dollars, which likely will follow the patterns seen in the error rates (that reflect the "yes-no" question of whether a mistake was made on a particular item), it is critical that dollar amounts be put in constant dollars.
  - The justification for not doing so is that "people think about taxes in nominal terms" and it's not clear how to appropriately deflate credits and adjustments to income.
  - But the strategy of the paper is to make 1988 / 2001 comparisons. Dollar amounts have to be put in constant terms to make the comparisons sensible (using the CPI-U).

# Sole Proprietor Noncompliance, further continued . . .

- Lastly, there is a remarkable statement in the paper, "no questions were asked; therefore, no conclusions are reached."
  - The researcher is the expert on the data and topic. The holy grail here is to identify sources of errors that are amenable to policy or administrative actions that can improve compliance.
  - It strikes me as being a near-imperative to tell us your thoughts and, at a minimum, speculate on how the results of the paper might nudge us closer to better understanding these issues. You don't have to solve this problem, but you are uniquely positioned to more us forward in better understanding the issues at hand. Do so.

# You Earn How Much?

- This is an interesting paper, comparing differences between self reports of income and administrative reports of ostensibly the same income.
- Why do we care?
  - Most interestingly, New Zealand apparently bases some assistance payments on anticipated income for the forthcoming year. If people are not able to project income accurately, or even report accurately income that has already been received, administrative headaches will ensure.
  - Given the huge amount of social science research conducted using survey data, the quality of survey income reports is fundamental. Hence, the topic is critical.
- But the job of a discussant is not solely to praise. Let me offer a few comments.

# You Earn How Much? Continued . . .

- First, the income reports are remarkably similar to the administrative data. Median self-reported income is \$27,000, the administrative data are \$27,500. Median self-reported family income is \$42,000. The administrative data is \$41,800. Note, a New Zealand dollar is worth around \$0.75.
- Of course, while the central tendencies of the reports are identical, there is considerable differences in specific reports. The concern is *measurement error*.
  - If studies are seeking to explain the effects, for example, of WFF on family income, classical measurement error in the left-hand side (dependent) variable is not a problem.
  - Measurement error in right-hand side (independent) variables is more problematic. In bivariate regression, classical measurement error will attenuate regression coefficients. In a point that is frequently misstated, in multiple regression, the effects are indeterminate.

# You Earn How Much? Continued further . . .

- The survey questions could, perhaps, be improved. In particular, a common approach is to ask people for their incomes in the time frame in which income is earned. If the respondent is paid by the hour, you must also ask how many hours are typically worked in a week, or if paid over some interval less than a year, ask what income is over the time period people are paid.
- Lastly, it's ironic for me to say this, since American's almost always ignore relevant evidence from other counties, but it would be interesting to compare these results (and implications) with similar work done in the U.S. Citations might include Bound and Krueger (1991, JOLE); Hotz and Scholz (2002, National Academy Press).

# The Advance Earned Income Tax Credit

- I have spent many years thinking about the earned income tax credit, how it is administered and what are its effects. It's a treat to read this paper and learn from it.
- The work updates several important facts:
  - Roughly 3 percent of those eligible for the EITC receive it paycheck-by-paycheck (in an advance form). Of total EITC dollars, this is less than half of one percent.
  - In 1994 the IRS sent information on the AEITC to 13.5 million taxpayers. In 1997 they mailed information to another 6 million. It is hard to argue that the lack of takeup is due to information barriers.
  - There are important non-compliance issues associated with the AEITC. Namely, people often do not file returns doing the end-of-year reconciliation, or when they do, they fail to report their AEITC receipts.
  - 68 percent of EITC claimants use paid tax preparers.
  - The IRS claims that for every $1 spent on EITC non-compliance actions, the return on investment exceeds $17.

# The Advance Earned Income Tax Credit, continued . . .

- This is a skillfully done study that nicely addresses the request by Congressman Rangel and Senator Baucus that initiated the project. But it is worth stepping back a bit. In doing so I raise three points.
  - First, be clear about the magnitudes we are discussing – AEITC recipients who made tax return errors received, roughly $94 million. This is surely an upper bound, since many of those getting the AEITC but not filing a return would likely be eligible for an even larger EITC payment. The EITC in these years was around $38 billion. If 27 percent of payments are in error, we are talking about less than 1 percent of erroneous EITC payments. And I have already argued that the EITC is a relatively small corner of the tax noncompliance map. This isn't meant to be a criticism of the authors – they were asked to do the study by very important people. But the issue really is a tiny one.

# The Advance Earned Income Tax Credit, continued further . . .

- Second, there is a missing piece of the analysis, that ought to at least be mentioned given the policy options discussion (which has the tone, the IRS should try these 3 things to improve AEITC compliance – if these "fail," Treasury should inform Congress and the AEITC should be scrapped."
  - The GAO is typically resolute about comparing costs and benefits – shouldn't some effort go in to assessing the benefits of the AEITC? Some focus group work was done in this study – how helpful has it been for some working poor taxpayers to get the AEITC?
  - The analogy comes to mind of a discussion of a medical intervention, where we ignore the curative effects of the intervention. I've been a tax administrator, so I appreciate the desire to enforce the rules one has been asked to implement. But stepping back, our views about "leakage" or "EITC noncompliance" has to influenced, at least to a certain extent, by the benefits, if they exist, of the provisions.

# A Last AEITC Thought

- Third, does anyone really think the \$17 dollar return for every \$1 invested is plausible?
    - What is the return on compliance efforts on other tax provisions? Why spend the obvious talents of the people working on this project, from 12/05 to 7/07, when there is such extreme potential returns for compliance activities. It is critically important to develop "bang for buck" estimates of the return to marginal compliance investments across wide areas of the tax gap.
    - If Congress for one reason or another is unwilling to allocate resources, I promise that venture capital investors will be lining up to get a stake of investments yielding, in expectation, \$17 to \$1. There is a lot of rents to share with returns that are that large.

# In Closing

- I appreciate having the opportunity to read and think about these interesting papers. My hat is off to the researchers responsible for this work and to the IRS and organizers of this conference.