Conference Commentary: Improving Tax Administration through Research Driven Efficiencies.

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The Internal Revenue Service (IRS) and the Tax Policy Center (TPC) conference on Improving Tax Administration Through Research-Driven Efficiencies was held at the Urban Institute, Washington, D.C., on June 18, 2015[2]. As with the previous conferences organized annually by IRS and TPC, the presenters and the attendees were primarily researchers from academic and independent research institutions, research divisions of tax administrations, as well as tax practitioners and tax law specialists. The participants were greeted by Eric Toder, a Co-Director of the TPC, Alain DuBois, an Acting Director of the IRS Office of Research, Analysis, and Statistics (RAS), and John Koskinen, the IRS Commissioner. Twelve original research papers were presented and discussed in four thematic sessions.

The first session, on the Innovative Methods for Improving Resource Allocation, brought together three conceptually and technically distinct methodologies aimed at measurement and improvement of the effectiveness of tax audits by better targeting.

Alan Plumley (IRS, RAS) presented an empirical estimation of marginal revenue-to-cost functions for a number of categories of correspondence audits of tax returns conducted by the IRS over 2006-2010. For a given amount of audit resources the maximal audit efficiency (in terms of the net direct revenue) is achieved when the marginal revenue-to-cost ratio is equalized across all audit activities (assuming that any possible resource constraints on separate activities are not binding, and that strictly positive amount of resources is allocated to each activity). The authors demonstrated that an efficient allocation of audit resources could deliver an estimated $190 million of additional direct enforcement revenue annually for these tax years. The calculation ignored the indirect, deterrence effect, or the behavioural response of taxpayers to the changes in audit targeting, and any non-monetary effects, but it gives a useful benchmark.

In the study presented by Jeff Wilson (Taxpayer Advocate Service) the researchers investigated how the rate of collection of underpaid tax changes over time subsequent to the issuance of a delinquency notice. A striking result is that money collected typically falls by 50 per cent from year 1 to year 2, and by further 30 per cent from year 2 to year 3; furthermore, the most successful collections are from accounts with relatively small liabilities, $5000 or less, and with self-reported liabilities. Therefore, the research suggests improving efficiency in resource allocation by tagging the most "productive" delinquent accounts and collecting the tax due quickly.

The third paper, presented by Shannon Chen (PhD student, UT Austin), explored how social network analysis (SNA) techniques can be used to identify legal entities with higher tax compliance risk. The underlying idea is the following: in a given industry, firms are characterized by a certain degree of complexity which can be measured using SNA tools. An unusual value of some measure, or an outlier, could then indicate a structure created to facilitate financial flows leading to deficiencies in tax compliance. The authors estimated a regression with detected deficiency as dependent variable and firm characteristics as

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[2] Presentations and related material can be found at http://www.taxpolicycenter.org/events/tpc-irs-conference-2015.cfm

explanatory variables, including the network measures (density, diversity, degrees of centrality, etc.), in addition to the standard economic measures (assets, income, etc.). Some network measures were found to be associated with higher compliance deficiency. This suggests a method of flagging up and targeting for audits the “outlier” firms.

In the second session three studies were presented under the headline of Taxpayer Responses to Rules and Enforcement. The common approach was to explore the links from the determinants of the current taxpayer behaviour, or the rules, to audits, from audits to the taxpayer responses, and from responses to the future rules. The first two papers focussed on large businesses, and the third paper on small business and self-employed.

Erin Towery (University of Georgia) presented an investigation of the deterrence effect of audit certainty for the large firms assigned to the Coordinated Industry Case (CIC) programme of the IRS. The IRS uses a point scheme to select the firms for CIC, with the main determinants being the size and complexity, as suggested by the study. The firms assigned to CIC are monitored by the IRS team until the IRS decides this is no longer needed. A typical model of strategic tax compliance assumes that a taxpayer conditions its actions on a belief about the probability of audit. While in a programme such as CIC the audit is certain, a taxpayer may or may not believe that it will uncover its true tax liabilities, and, therefore, may respond with less or more aggressive tax planning. The authors found that the firms assigned to the programme tend to increase tax reserves, indicating a change in expectations regarding future tax payment, but there was no significant deterrence effect of the programme on tax avoidance.

In the second paper, presented by Lisa Rupert (IRS), the authors explored the patterns in the tax return data for the citations on the Uncertain Tax Position Statement (UTP) schedule. The five most commonly cited IRS sections are transfer pricing, research and development credit, trade or business expense, domestic production activities deduction, and capitalized cost. The study provides a comparison of characteristics of the UTP filers and non-filers, and those of UTP-filing firms citing or not citing different sections, for 2011-2012, and concludes that quantitative models can be developed to help IRS with the selection of returns. An interesting question is about the strategic response of the firms: how will the use of the UPT citation patterns for return selection alter the UTP reporting strategies?

The third paper, presented by Saurabh Datta (IRS), investigated how the IRS resources can be used more efficiently in the collection of delinquent taxes, where taxpayers failed to file returns. Specifically, after a series of reminders, the IRS can file a so-called substitute for return, based on the information obtained from other sources and from the previous year, and many such assessments are done within the Automated Substitute for return (ASFR) programme. The authors investigated the effect of the ASFR assignment on collected tax and on the future voluntary filing compliance in the subsequent two to four years. The estimated regression results suggest significant positive and stable effect of ASFR. The estimated model was used to simulate the response of a sample of 1000,000 taxpayers randomly selected from those not assigned to ASFR to a hypothetical assignment in 2009. The additional tax collected per case (direct effect) was estimated to exceed the cost of treatment by the factor of 40 ($3,262 vs $80), and the subsequent increase in voluntarily filed returns (indirect effect) was estimated at 0.19 in 2010, 0.25 in 2011, and 0.29 in 2011 per case. Important issues are the prioritization, or how the taxpayers are selected for ASFR, and the comparison of the cost-effectiveness of ASFR with that of other similar programmes.

In her keynote speech Professor Lillian Mills (UT Austin) talked about the advantages of bringing together research and institutional knowledge in tax compliance. She emphasized the importance of the ease of enforcement for the academic view on tax changes, in addition to the traditional focus on economic efficiency. As another pressing challenge for research in tax administration Professor Mills mentioned a sensible estimation of the tax gap.

The third session, on Improving Tax Administration by Understanding Taxpayer Behaviour, presented studies based on a field experiment (Marco Hernandez, World Bank), on a survey (Mackenzie Wiley, IRS), and on a combination of a lab experiment and a survey (Ariel Wooten, IRS). The common feature of these three studies was an attempt to understand psychological reaction of individuals to various ways of delivering information by tax authorities and to identify the best means of improving compliance as well as the quality of services provided by tax administration to taxpayers.

In the first study the researchers investigated the effect of wording in the letters sent to delinquent taxpayers on behalf of the Guatemalan Tax Authority (GTA). The taxpayers (over 23 thousand individuals or firms) were randomly allocated to receive no letter, the standard GTA letter, or one of four adapted versions of the GTA letter. In the adapted versions non-compliance was framed either as an oversight, or as an intentional and deliberate choice, and an additional message was included either calling to join the compliant majority (social norm) or to be a good citizen and support own country (national pride). The letters citing deliberate choice and social norm appeared to have significant and persistent positive effect on the rate of payment and the amount paid conditional on payment. The authors' estimate of the additional revenue that would have been generated by sending the social norm letter to all taxpayers in the sample was $760,000, or 36 times the cost of sending the letters. In the absolute terms this might be rather a small amount; also, a look at the disaggregated data (who paid and how much) rather than the average could provide an additional insight into the behavioural responses. An interesting question is about the interpretation of the social norm statement: the compliant majority quoted in the letter was 64.5 per cent, suggesting that over a third of taxpayers do not comply. The effect of a similar statement in a country with different cultural background might well be the opposite.

The aim of the second study was to understand taxpayers' preferences over the less expensive digital communication channels for IRS services traditionally provided over the telephone or by regular mail, or in person at a local IRS office. The survey respondents were asked to choose from a list the channel they would prefer for each of the following six services: "submit documentation", "status of a case/transaction", "information about a notice received/case details discussion", "set up a payment plan", "request an extension". The channels included, in addition to a toll-free live or automated phone assistance, regular mail, or a visit to a local office, a number of digital communication products, such as the IRS website – interactive tool, smartphone application, secure message or online chat, automatic e-mail or text message; not all channels were offered for each service. The study also investigated the demographic profiles (age, return preparation method, previous channel use and previous post-filing contact) associated with preferences for a particular channel. The authors found that getting the status of a case has the higher potential for migration to digital channels, and that secure message was preferred to other channels for all services where it was offered as one of the alternatives, whereas there was an almost uniform preference to shift away from the phone. Demographic differences were stronger for some services and channels and weaker for others. The study, however, did not provide any estimates of cost savings for hypothetical migration. One important related issue is whether switching makes compliance cheaper for both sides or shifts the compliance cost onto the taxpayers. Among other concerns mentioned during the discussion were the potential data breach in digital communications and the fact that, according to the study, about two-third of taxpayers needed some help with complying.

The third study investigated a specific and very interesting situation arising from the decision to assign the task of implementing the Affordable Care Act (ACA, also known as "Obamacare") to the IRS. The researchers recruited 119 individual and small business taxpayers to participate in a lab experiment and in a subsequent discussion of their experience and expectations in focus groups. In the lab the participants were presented with hypothetical situations involving compliance with and tax implications of ACA, where they had an option to use an automated phone line newly developed by the IRS for ACA inquiries. The results of this qualitative study are potentially useful for improvement of other IRS services provided by the IRS toll-free telephone lines; however, as noted in the discussion, a survey of taxpayers with actual, rather than lab, experience in ACA inquiries could provide an additional insight in taxpayers' needs. Also, if, according to the previous presentation, for many services telephone assistance is the one most likely to be abandoned given a set of digital communication alternatives, there is, perhaps, a case for considering alternatives for ACA help services as well, before the IRS is locked into an expensive, and potentially far from the most preferred by taxpayers, system.

The final session, with the headline of Helping Taxpayers Get it Right, brought together two studies of the Earned Income Tax Credit (EITC) claims, presented by Patricia Tong (Treasury Office of Tax Analysis) and Elaine Maag (The Urban Institute), and a study of the effect of recent changes in the IRS regulation of the paid preparer industry, presented by Karen Masken (IRS Return Preparer Office). The common motivation was the complexity of the existing system of tax benefits, where differentiated tax treatments are used to support incomes or incentivize certain behaviours. There is evidence that because of the complexity not all targeted taxpayers understand how correctly to claim benefits, and those using paid tax preparer benefit the most.

In the first study the researchers investigated how military personnel taxpayers use the non-taxable combat pay election (NCPE) in calculation of their EITC. Military service members do not pay tax on any income earned while in combat zone, which results in the reduction of EITC for low incomes. However, since 2004 taxpayers can choose to include some or all of their non-taxable combat pay in EITC (by default it is excluded). An optimizing taxpayer would calculate EITC with and without NCPE to determine the optimal amount of earnings to exclude under NCPE. According to the study, in 2009 about 82 per cent of taxpayers in the sample of 1 million (representing 30 per cent of military service members with non-taxable combat pay) optimized their EITC, with the optimization rate being higher for those using paid tax preparer. Importantly, taxpayers who would benefit from NCPE provision and did not use tax preparer were the least likely to exercise the NCPE option correctly and also had the lowest average income. The authors conclude that NCPE provision increases the complexity of the tax code while benefitting only a small fraction of the military service members.

The second study investigated the links between the errors in the EITC claims and in the Supplemental Nutrition Assistance Programme (SNAP) benefits claims in Florida. This was part of a follow-up of a large project commissioned by the Office of Management and Budget (OMB) on how data can be used across agencies to help reduce over- and under-payments of benefits under various programmes. In this example, because of a certain overlap between EITC and SNAP recipients, SNAP data was used as a potential third-party source for IRS to verify the residency of children of EITC claimants, - an important piece of information, since the largest proportion of EITC over-claims is related to errors with including children who do not meet the residency requirement. The researchers find that SNAP data may help IRS to select post-refund audit cases when "childless" EITC is erroneously claimed by workers with a qualifying child, and to identify eligible non-claimants.

The focus of the final presentation was on the compliance of paid tax professionals who prepare individual income tax returns. The behaviour of tax preparers is largely overlooked in the theoretical literature on tax compliance, although it is recognized that certain regulation and oversight of the preparer industry can improve compliance of their clients. Similarly, in practice the focus of the IRS and other tax authorities was primarily on taxpayer-level treatment, and the effect of preparer-level treatments has not been studied. As part of the new regulations introduced in 2010, aiming to improve industry standards, from 2011 all individual tax returns prepared by paid professionals must show the preparer's tax identification number (PTIN) obtained by registering with IRS. A multi-year study of the effect of various treatments on preparer compliance started in 2012. The results of investigation of two items, Schedule C Net Income returns (a source of about 30 per cent of the individual income tax gap, with large proportion of errors in paid prepared returns) and Additional Child Tax Credits (ACTC, where the majority of claims are prepared by about 1 per cent of paid preparers), were presented. The goal was to identify the cost effectiveness of targeted treatments, such as visits and letters, for different segments of preparer population. The researchers found that for Schedule C preparers all three treatments studied (educational visits, due diligence letters, and continuing education letters) were effective. Letters were, overall, less effective but considerably less costly than visits. For ACTC both treatments studied (letters explaining the use of the relevant schedule, with and without emphasis on a particular provision) were found to be effective. However, the study did not report the size of the effect of these treatments on tax gap, and there was no information on the background characteristics of the selected preparers.

Overall, the range of research questions and methods under the common headline of improving efficiency demonstrated, first, close attention of tax authorities to academic research in taxation and tax administration and, more widely, in economics and other social sciences, and, second, understanding of mutual benefits of communication and collaboration between academics and tax authorities. For understandable reasons, the main, all be it not exclusive, focus of the conference was on the U.S. context.

It seems natural to expect that with growing needs to co-ordinate the efforts of national tax authorities in globalized economy this and other similar conferences will broaden their scope and attract wider international participation.