Tradeoffs in Designing Policies in the Collection of Taxes: Tax Amnesties and Third-party Information

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Designing tax policies requires balancing tradeoffs among competing goals, like
- Equity
- Efficiency
- Adequacy
... and of course taxpayer rights.

Tax administrations typically focus largely on the adequacy goal – or generating more and more and still more revenues.

Does this emphasis on adequacy conflict with taxpayer rights?

Here I discuss these tradeoffs, focusing especially on the policy tools of tax amnesties and of third-party information.

Do these tools actually present tradeoffs between efficiency, equity, revenues, and taxpayer rights? Or can these tools be designed to minimize these tradeoffs – and protect taxpayer rights?

I discuss recent research that examines these policies, research that suggests several promising approaches to policy (re-) design.
Tax amnesties, revenues, and taxpayer rights

• What is a tax amnesty?

A tax amnesty is a “forgiveness”, allowing individuals or firms to pay delinquent taxes without being subject to some or all of the financial and criminal penalties that the discovery of tax evasion normally brings.

• A typical amnesty has the following features:
  o Participating individuals must acknowledge their non-compliance.
  o They must submit any missing (and correct) tax returns and/or they must correct their filed tax returns.
  o They must pay all taxes owed plus interest and, if applicable, penalties.
  o In exchange for amnesty participation, participants typically are given relief from criminal sanctions and the reduction or elimination of penalty amounts, and they are then welcomed back as taxpayers.
Benefits

• There is an immediate and positive short-run revenue impact.
• And future revenues may increase if the amnesty induces individuals or corporations not on the tax rolls to participate, and if the amnesty is accompanied by more extensive taxpayer services, better education on taxpayer responsibilities, and greater post-amnesty enforcement.
• But: Why should anyone who has cheated in the past participate now? There must be some kind of post-amnesty change.

Costs

• The immediate short-run revenue impact is almost always quite small.
• And the long-run revenue impact is likely to be negative, if the announcement of an amnesty alerts honest taxpayers to the likelihood of large-scale cheating, if honest taxpayers resent the special treatment of tax evaders, and if individuals believe that the amnesty is not a one-time opportunity.
• And: Governments everywhere almost always offer repeated amnesties, despite promises of a “one-time-only opportunity”, in which each additional amnesty generates smaller additional revenues.
Third-party information, revenues, and taxpayer rights

• What is third-party information?
• **Information returns** are forms filed by **third-parties** such as employers and financial institutions, who provide information about taxable transactions to the IRS (and other government agencies).
• In the U.S., there are fifty unique types of information returns, including those that report on wages earned or amounts paid that qualify for a tax credit or deduction.
• The IRS identifies mismatches between information returns and tax returns for potential additional review, including enforcement actions.
• According to IRS (and much other) research, taxpayers are much more likely to misreport income when little or no third-party information reporting exists than when substantial reporting exists.
Conclusions: Implications for taxpayer rights

• What does all of this have to do with taxpayer rights?
• Both tax amnesties and third-party information returns – as currently used – violate some essential taxpayer rights:
  o The Right to Be Informed
  o The Right to Quality Service
  o The Right to Pay No More Than the Correct Amount of Tax
  o The Right to Challenge the IRS’s Position and Be Heard
  o The Right to Appeal an IRS Decision in an Independent Forum
  o The Right to Finality
  o The Right to Privacy
  o The Right to Confidentiality
  o The Right to Retain Representation
  o The Right to a Fair and Just Tax System
• Consider **tax amnesties**.
• A typical tax amnesty program suffers from a fundamental flaw: with repeated amnesties, an amnesty fails to adequately acknowledge the problem of recidivism – those who cheat are apt to repeat this behavior.
• Put differently, the rights of compliant taxpayers to a fair and just tax system are violated when a tax administration offers a tax amnesty – and especially when the tax administration offers repeated tax amnesties that welcome repeated tax offenders.
• All of this suggests that there is a tradeoff between the tax administration’s desire for revenues by the use of repeated tax amnesties and its need to treat compliant taxpayers with fairness and justice.
• But is there really such a tradeoff?
• Why not embrace a simple participation qualification, as suggested by Alm and Soled?
  o Taxpayers may use an amnesty to “cleanse” their tax record.
  o Thereafter, however, the taxpayer would be barred from subsequent tax amnesty participation offered by the same taxing jurisdiction involving the same type of tax.
  o In short, participation in any tax amnesty program would be a one-time opportunity.
• This reform reduces – even if it does not eliminate – the tradeoff for (repeated) tax amnesties between adequacy and taxpayer rights, especially the right to a fair and just tax system.
• Or consider **third-party information returns**.
• Third-party information reporting (often in combination with source withholding) has proven to be highly effective in improving tax compliance.
• Still, third-party information reporting is not a panacea, due largely to (at present) incomplete coverage.
• Indeed, research has shown that:
  o Third-party information reporting applied to specific margins of behavior improves compliance for those specific items subject to third-party reporting.
  o However, if some margins are left uncovered, research has also shown that compliance for these uncovered margins often changes to offset tax obligations 1-to-1, leaving total taxes paid unchanged!
• What this means is that – **as currently used** – third-party information implies that certain forms of tax evasion will become virtually impossible – especially for individuals with income mainly from wages, interest, dividends, (realized) capital gains, and such.
• Why? Because these individuals **are** subject to third-party information reporting (along with source withholding) and they engage in transactions that leave an electronic trail – and these taxpayers represent the vast bulk of taxpayers.
• What this also means is that other forms of tax evasion will remain possible, even likely – especially for high-income individuals and multinationals.
• Why? Because these taxpayers and their incomes **are not** subject to third-party information reporting – and note the implications for inequality.
• And this is hardly a fair and just tax system.
• But can this be fixed? What is needed is third-party information applied to all relevant margins and incomes.
• This may be coming due to technological changes like “digitization” and its applications (“digitalization”), which suggest that government can increase revenues while also making the tax system more fair and more just by extending the reach of its third-party information reporting.
• But we are not yet there.
• And remember that:
  o Government must have the resources to utilize the technology.
  o What are the implications for another taxpayer right – privacy?
  o These technologies are also available for abuse by those in the private sector.
• So...
• There is the potential for tax amnesties and third-party information returns – at least if reconsidered and/or redesigned – to generate revenues while maintaining taxpayer rights ("The Right to a Fair and Just Tax System").
• More broadly, governments need to take actions that ensure other aspects of procedural justice and procedural due process:
  o Maintain secure databases – taxpayers need to know that their data are protected and safe ("The Right to Privacy", "The Right to Confidentiality")
  o Be transparent on algorithms ("The Right to Be Informed")
  o Use technology to improve services, making it easier for individuals to pay their taxes ("The Right to Quality Service"):  
    • Answer phones – talk to people
    • Simplify tax forms
    • Provide digital version of paper tax forms (with links from specific line items to specific instructions)
    • Provide return-free filing where appropriate – especially when third-party information reporting and source withholding provide all relevant tax information.