

12101
110919

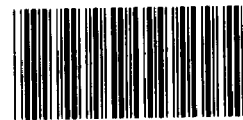
UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

FOR RELEASE ON DELIVERY
Expected at 10 a.m., EST
November 15, 1979

STATEMENT OF
RICHARD L. FOGEL, ASSOCIATE DIRECTOR,
GENERAL GOVERNMENT DIVISION
BEFORE THE
JOINT ECONOMIC COMMITTEE
ON
[THE UNDERGROUND ECONOMY]

Mr. Chairman and Members of the Committee:

My testimony today concerns (1) the size of the underground economy as presented by the Internal Revenue Service (IRS) in its September 1979 report entitled, "Estimates of Income Unreported on Individual Income Tax Returns," (2) how the existence of an underground economy may distort the Government's data on the unemployment rate and other economic indicators, and (3) actions the IRS and other Government agencies can take to deal with the underground economy problem.



110919

007872

In its report, (IRS estimated that during tax year 1976 as much as \$135 billion in income went unreported and that as a result as much as \$26 billion in potential tax revenues to the Government went uncollected.)

Those are staggering estimates, yet they ^(are) probably understated. IRS' study focused only on individual taxpayers and certain types of illegal income. For example, including unreported income such as kickbacks received by corporations, would obviously increase the amount of tax loss. (IRS did not include estimates of unreported illegal-source income for many type activities because, to quote the study, "(of) the chaotic state of the statistical information in this area." No figures are available on illegal-source income obtained from such ^{activities} as arson for profit; smuggling goods other than drugs; bootlegging of cigarettes, films, tapes, records; or pornography, protection rackets, embezzlements, or theft.)

Had IRS been able to make estimates of the illegal income derived from such activities there is no doubt the illegal-source income figure cited would have been much higher. For example, in 1974, the U.S. Chamber of Commerce estimated that total losses from white collar crime in both the public and private sectors exceeded \$40 billion annually.

Other studies of the underground economy have estimated unreported income to be larger than \$135 billion. The studies'

definitions and methodologies vary and are subject to debate. Moreover, their estimates of the problem vary substantially. However, their conclusions are similar--unreported income and the resulting uncollected taxes constitute a serious national problem.

Even if we accept the findings of the IRS study as a low estimate, ^{the IRS study} (the results indicate that some of our economic indicators and unemployment rate statistics may be overstated.) On the basis of the results of IRS' work and our own findings in our July 11, 1979, report to the Congress on people who do not file income tax returns but should, it is probably safe to conclude that (some people involved in the household survey from which unemployment rates are calculated, are not telling the truth. Some of these people may have income that they are not reporting.)

For example, detailed results from our report on nonfilers show that (many people in socio-economic categories that we might ^{be} expect to exhibit high unemployment rates were required to file tax returns in 1972 and did not.)

Fifty-two percent of the people required to file tax returns in 1972 but who did not had incomes below \$5,000. Only 19 percent of the filers had income in this range. Laborers and service workers made up about 33 percent of the nonfiler population whereas they represented only about 18 percent of the filer population. Overall, 13 percent of the laborers and service workers required to file tax returns were nonfilers. Some categories of

laborers and service workers had particularly high nonfiling rates. For example, about 33 percent of all farm laborers and 64 percent of private household workers were nonfilers.

The implications of these findings are that certain policies designed to stimulate the economy to increase employment may be exacerbating the inflationary situation because the data triggering these policies over-estimates the true unemployment rate. The problem is that we are not sure by how much the unemployment estimate is off.

If sales, output, and income statistics are also understating the true magnitude of economic activity, then our economic policy makers need to know the magnitude of the problem and adjust their decision-making accordingly. Again, assuming that the existence of a fairly large underground economy means that our economy is more healthy than we may realize, it is possible that the inflationary consequences of a given macro-economic policy will be more severe than we planned.

It is obvious that one of the key steps that the Government must take to get a better picture of how the underground economy affects our policies is to get more extensive data on the size and scope of the problem. But there are certain actions that the Government can begin to take now to better come to grips with the problem. Many of those actions relate to the activities of the Internal Revenue Service.

It is essential that the Government improve its tax administration activities so more of the income earned in the underground economy is subject to taxation. We have to reduce the economic incentive that individuals perceive they have to become part of the underground economy. To do this IRS needs to determine the extent to which it is presently detecting unreported income from the various pockets of noncompliance. It then needs to consider reallocating its resources based on that determination and assess the need for additional resources to close the tax gap for each source of unreported income.

IRS also needs a more effective national criminal enforcement strategy to deal with the extensive amount of illegal income on which no taxes are paid.

Withholding of income at source and document matching must be extended. These are the primary tools available to ensure that most taxpayers properly report the amount of income on which they are obliged to pay taxes.

More research needs to be done to determine exactly who the underreporters and nonfilers are, what type of income they are receiving, and why people either do not pay or underreport their income. In this regard, IRS currently has a study underway to determine why people pay or do not pay all of their taxes. This information is critical to determining what type of tax administration strategies should be taken to enhance the integrity of our voluntary tax assessment system.

It is also important that IRS initiate action to periodically try to estimate the size and analyze the characteristics of the nonfiler and underreporter population. Such estimates should include gathering the operational information necessary to determine the best methods for detecting and pursuing these individuals and for increasing compliance with the filing requirements.

While IRS can thus take certain specific actions to expand the tax base to include those individuals who are now part of the underground economy there are some other policy changes that the Government should consider. While I have not seen any hard data to support this contention, I believe that some people are reluctant to report all or part of their income because they perceive that our current tax laws are unfair and are designed to benefit the wealthy taxpayers moreso than the average taxpayer. Reform of the tax laws and simplification of the code should help reduce such taxpayers' antipathy.

It is fundamental to all of these concerns that we have good information. The Government and various members of the academic community have made a start at developing such information. It is critical that these efforts be continued and refined so that we can have a more reliable picture of the exact scope of the problem we are dealing with.

This concludes my prepared statement, Mr. Chairman.