



United States  
General Accounting Office  
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General Government Division

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The Honorable Paul Simon  
The Honorable David Boren  
United States Senate

You asked us to analyze the potential revenue, costs, and feasibility of a tax compliance proposal submitted by a concerned citizen. The proposal intends to help prevent businesses from underreporting sales income and thus underpaying the proper amount of taxes. IRS estimated that the underreporting of business income created at least a \$38 billion federal income tax shortfall for 1992.<sup>1</sup> IRS recognizes the seriousness of this tax noncompliance and has planned and undertaken initiatives to increase compliance.

SUMMARY OF THE PROPOSAL

The proposal centers on requiring businesses to enter sales figures into portable meters at each point of sale. The meter would have a keypad for manually entering sales and would store daily sales totals in a tamper-proof 7-year memory. This meter technology could eventually be built into cash registers to eliminate the need for separate meters. Businesses would be allowed a federal tax credit to reduce the cost of the meter.

When businesses prepare their tax returns, they would use this meter to print a small slip of paper showing cumulative sales for the period of the return. Businesses would be required to attach this slip of paper to their tax returns.

<sup>1</sup>This 1992 tax gap estimate totalled \$35 billion for individual taxpayers involved in businesses such as sole proprietorships and partnerships and \$3 billion for small corporations. Also, large corporations had a \$24 billion tax gap but the portion arising from underreported income was not estimated by IRS.

Further, the meters would issue special receipts that customers could redeem for free tickets to enter a new, nationwide lottery. To receive the tickets, customers would enter data from their receipts into conveniently located self-service lottery terminals across the country. Centrally-located computers with related software would be used to manage the lottery system and validate receipts before authorizing the issuance of any lottery ticket.

The proposal relies on customers to ensure that businesses enter sales into the meters. The lottery is intended to induce customers to demand receipts from businesses, which better ensures that sales are recorded in the meters. To maintain this inducement, the government would pursue complaints from customers who were refused receipts, impose severe fines (\$10,000 to \$250,000) on a few of these businesses, and highly publicize those fines. The proponent believes that only a few such fines would be needed to deter noncompliance by other businesses. The government also would visit businesses to inspect meters, administer meter use nationwide, and resolve any discrepancies between sales income reported in meters and on tax returns.

The proposal is based on a similar system first implemented by Italy in 1983 to help ensure compliance with value-added taxes and the reporting of gross sales. Other European countries, such as Hungary and Greece, have adopted the system used in Italy. The memory and receipt features are built into all electronic cash registers ranging from portable models used by outside vendors to programmable models used by large stores. The Italian system uses neither the proposed lottery or large fines to compel compliance. Instead, Italy uses officers empowered to confirm that customers have receipts as they exit shops. If customers lack receipts, Italy imposes fines smaller than those contained in the proposal against the business and the customer.

#### RESULTS OF OUR ANALYSIS

Compliance proposals can appear attractive when they seek to raise revenue by collecting taxes already owed but not paid rather than by raising tax rates or broadening the tax base. However, the meter and lottery proposal lacked many details and relied on a number of untested assumptions that appeared to be relatively optimistic. As a result, any expected tax revenue gains are very uncertain. Nor have the costs been estimated. Even so, the proposal would require creating vast systems for administering the lottery, the meters, and other features. In our discussions of this proposal with several federal and state tax administrators and various business associations, they expressed no support for the proposal.

PROPOSAL'S FEASIBILITY RESTS  
ON UNTESTED ASSUMPTIONS

The overall feasibility of the proposal is based on the premise that the revenues generated will far exceed its costs. This premise could not be confirmed due to a number of untested assumptions. Some of these major assumptions follow.

Assumption 1: Government at all levels will support and can integrate the proposal. The proposal assumes that all levels of government will support the proposal and can integrate it into their tax systems. However, federal and state tax officials and representatives of a state tax association neither supported the proposal nor believed it warranted further consideration. Business organizations we contacted also were not supportive. Further, differences in the requirements of state and local tax systems could pose significant barriers to the efficient integration of the proposal into their existing tax systems.

Assumption 2: A free lottery will motivate and sustain customer participation. Key to the proposal's feasibility is the assumption that it will be self-policing; that is, customers will request receipts from businesses to obtain free lottery tickets, thereby ensuring that sales are entered into the meters. It assumes that the lottery will be held frequently enough and that its prizes and odds will be high enough that customers will want to play over the long term and not waive receipts in return for lower prices. This may be an optimistic assumption. A representative of a major nationwide free sweepstakes conducted through the mail would not provide the exact number but told us that their response rate is above 10 percent but well below 50 percent.

Assumption 3: Noncompliant business groups will be unable to avoid issuing receipts. The proposal assumes that businesses responsible for the most underreporting of sales income will be unable to avoid issuing receipts. The proposal assumes it can change the attitudes, behaviors, and other forces that drive sales practices and business relationships. State and federal tax officials and business association representatives we interviewed doubted that the proposal would change the behavior of the most noncompliant businesses and pointed to the burdens imposed on all businesses.

Assumption 4: Imposing large fines on a few businesses and highly publicizing them would be politically feasible and deter other businesses from not issuing receipts. The proposal assumes that imposing large fines on a few businesses and highly

publicizing them would motivate businesses to use the meter and issue receipts. However, the assumption that large penalties have a significant deterrent effect has not been proven. Further, a few penalties may not create enough deterrence; a high likelihood of being detected is an important factor in deterring noncompliance. Given the expected opposition by businesses, many of them may be willing to risk being fined for not using a meter. The proposal also assumes that Congress would approve large fines even though existing tax penalties for noncompliance are much smaller than those under the proposal or are based on the amount of the noncompliance.

Assumption 5: The federal government will approve a national lottery. According to the State of Virginia's 1992 annual lottery report, 34 states and the District of Columbia already operate lotteries. These states would likely oppose the competition of a national lottery. Opponents of state lotteries might also oppose a national lottery. In addition, given the pressure to control federal spending, justifying start-up and annual operating costs for the proposal may be difficult considering the revenue uncertainties.

Assumption 6: The proposal would work in the United States because it is increasingly being used in Europe. The proposal is assumed to have merit because it is similar to a system used in Italy for several years and other European countries have adopted it. Although we could not readily obtain information on the degree of the system's success in Italy, concerns about serious tax noncompliance in Italy still exist. Tax noncompliance in Italy, as reported in a 1989 article in the Financial Times, is much worse than in the United States. Even if the system has improved tax compliance in Italy, its positive effects may diminish when tax compliance is already comparatively high, as in the United States.

#### INSUFFICIENT DATA TO ESTIMATE PROPOSAL'S COST

The costs to implement and run the proposal would largely depend on numerous unmeasured factors that could cost billions of dollars to establish and operate. These factors include:

1. The size of the tax credit. The size of the tax credit for purchasing meters would depend on the number of meters needed and their price. IRS received almost 21 million business tax returns for 1990; some of these businesses would need one meter and others with numerous points of sale at one location (e.g., a department store) would need many meters.

Businesses may also need to buy backup meters to replace meters that break.

While the proponent believes that meters would sell for about \$350, our review of computer literature and discussions with representatives of manufacturers of electronic devices similar to the proposed meter indicated that the price could be between \$500 to \$1,000. The price could be higher, depending on the technology needed for additional safeguards and for more durable meters in high volume businesses. According to the manufacturer's representative, the least expensive meter used in Italy sells for at least \$1,400.

2. Technical enhancements would increase costs. Several concerns were raised about the proposed system's vulnerability to fraud and abuse. Responding to these concerns would likely require technical enhancements to be built into the meter and the computerized lottery network. Such enhancements would increase costs.

For example, to ensure the integrity of sales data stored in the memory, meters would need to be truly tamper-proof; otherwise, the government would need to have the resources to periodically inspect the millions of meters in use. Because the proponent did not have technical data and specifications on the meter envisioned, we could not determine whether the technical measures adequately safeguarded the memory.

However, an official of the firm that sells the meter used in Italy believed that memories were not truly tamper-proof. Rather, the meter was sealed in such a way that an inspector could determine whether it had been tampered with. Unless the government periodically inspected meters, the accuracy of reported sales income could not be assured.

Likewise, the computerized lottery network would need controls to protect the integrity of the lottery. For example, before issuing lottery tickets, lottery computers would need to validate that the meter receipts were genuine and had not already been used. One validation method could enable meters to encrypt and transmit transactions on a daily basis to the lottery database. The lottery computer would check the database to confirm the transactions before redeeming receipts and issuing tickets. We believe that validating receipts and issuing tickets would require enormous computer capacity to confirm the huge number of sales that would be generated each day and to interact with a vast nationwide network of ticket-issuing terminals.

3. Lottery management and magnitude of the lottery prizes. A new government entity would be needed to manage and administer the lottery. In addition, the odds, amount, and frequency of lottery prizes would need to be set at a level that would compel customers to want receipts and maintain a significant level of participation.
4. Extent of government resources needed. The amount of government resources needed for enforcement and administration could be significant, particularly given the opposition expressed by representatives of business associations. For example, businesses could attempt to use unauthorized (bootlegged) or stolen meters to issue receipts for sales that they do not want entered into their official meter. Assuming the lottery computers have sufficient technical features, such receipts would not pass validation and government resources would be needed to follow-up on them to identify the issuer. Further resources would be needed to investigate customer complaints on businesses that refuse to issue receipts. The government would also need to do random inspections to induce business use of meters.

Additional government resources would be needed to process the information from the meters. For example, the government would need to (1) maintain controls on the millions of meters in use to ensure that each business reports sales from each of its meters, (2) review the meter information on sales to ensure that this income is properly included on tax returns, and (3) resolve discrepancies resulting from this process.

#### OUR OBJECTIVES AND ANALYSES

Our objectives were to analyze the proposal's feasibility and its revenue raising potential and costs.

To analyze the proposal's feasibility, revenue potential, and cost, we discussed the proposal with officials of IRS, two states, a local government, an association that represented state governments, two associations that represented business, and the proponent. Further, our analyses included a number of other steps as discussed below.

Given the proposed lottery features, we attempted to gain an understanding of lottery operations, technology, and costs by reviewing financial, management, and statistical reports on state lotteries. We also obtained information on computerized gaming machines and systems from leading manufacturers and interviewed an official of a major association representing state lotteries.

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To determine the degree of public participation in free drawings, we talked to an official of a major free nationwide sweepstakes.

To determine the success of the system used in Italy as well as the costs and technical features of its meter, we obtained information from the Italian government, from the firm that sells the portable meter used in Italy, and from various GAO staff who had observed the system in Italy during travel unrelated to our review.

To better understand Italian and United States rates of tax compliance, we obtained data from published articles, various statistical publications, and IRS tax gap studies. We also collected IRS data on the number of businesses filing federal income tax returns.

The proponent did not have a prototype of the meter or detailed specifications and pricing data that we could review. Therefore to obtain an understanding of the technology that could be used in a meter and estimate its price, we obtained information from various firms that sell off-the-shelf basic portable computers similar to the proposed meter. We also reviewed the technical aspects and requirements of the meter with knowledgeable computer staff in GAO.

We did our analysis between October 1993 and April 1994. If you have additional questions or need more information, please call Tom Short of my staff on (202) 512-9074.



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