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Late Edition - Final**Filling in the Tax Gap****BYLINE:** By Stephen J. **Dubner** and Steven D. Levitt.

Stephen J. **Dubner** and Steven D. Levitt are the authors of "Freakonomics: A Rogue Economist Explores the Hidden Side of Everything." More information on the research behind this column is at www.freakonomics.com.

SECTION: Section 6; Column 2; Magazine; THE WAY WE LIVE NOW: 4-02-06: FREAKONOMICS; Pg. 26**LENGTH:** 1313 words**Mr. Szilagyi's Billion-Dollar Idea**

This is the time of year when American citizens inevitably think about the Internal Revenue Service and, also inevitably, about how deeply they hate it. But most people who hate the I.R.S. probably do so for the wrong reasons. They think it is a tough and cruel agency, but in fact it is not nearly as tough and cruel as it should be.

The first thing to remember is that the I.R.S. doesn't write the tax code. The agency is quick to point its finger at the true villain: "In the United States, the Congress passes tax laws and requires taxpayers to comply," its mission statement says. "The I.R.S. role is to help the large majority of compliant taxpayers with the tax law, while ensuring that the minority who are unwilling to comply pay their fair share."

So the I.R.S. is like a street cop or, more precisely, the biggest fleet of street cops in the world, who are asked to enforce laws written by a few hundred people on behalf of a few hundred million people, a great many of whom find these laws too complex, too expensive and unfair.

And yet most Americans say they are proud to pay their taxes. In an independent poll conducted last year for the I.R.S. Oversight Board, 96 percent of the respondents agreed with the statement "It is every American's civic duty to pay their fair share of taxes," while 93 percent agreed that everyone "who cheats on their taxes should be held accountable." On the other hand, when asked what influences their decision to report and pay taxes honestly, 62 percent answered "fear of an audit," while 68 percent said it was the fact that their income was already being reported to the I.R.S. by third parties. For all the civic duty floating around, it would seem that most compliance is determined by good old-fashioned incentives.

So which of these incentives work and which do not? To find out, the I.R.S. conducted the National Research Program, a three-year study during which 46,000 randomly selected 2001 tax returns were intensively reviewed. (The I.R.S. doesn't specify what these 46,000 people were subjected to, but it may well have been the kind of inquisition that has earned the agency its horrid reputation.) Using this sample, the study found a tax gap -- the difference between taxes owed and taxes actually paid -- of \$345 billion, or nearly one-fifth of all taxes collected by the I.R.S. This sum happens to be just a few billion dollars less than the projected federal budget deficit for 2007; it also amounts to more than \$1,000 worth of cheating by every man, woman and child in the U.S.

But most people aren't cheating. And when you take a look at who does cheat and who doesn't, it becomes pretty clear just why people pay their taxes at all. The key statistic in the I.R.S.'s study is called the Net Misreporting Percentage. It measures the amount that was misreported on every major line item on those 46,000 returns. In the "wages, salaries, tips" category, for instance, Americans are underreporting only 1 percent of their actual income. Meanwhile, in the "nonfarm proprietor income" category -- think of self-employed workers like a restaurateur or the boss of a small construction crew -- 57 percent of the income goes unreported. That's \$68 billion in unpaid taxes right there.

Why such a huge difference between the wage earner and a restaurateur? Simple: The only person reporting the restaurateur's income to the I.R.S. is the restaurateur himself; for the wage earner, his employer is generating a W2 to let the I.R.S. know exactly how much he has been paid. And the wage earner's taxes are automatically withheld from his every check, while the restaurateur has all year to decide if, and how much, he will pay.

Does this mean that the average self-employed worker is less honest than the average wage earner? Not necessarily. It's just that he has much more incentive to cheat. He knows that the only chance the I.R.S. has of learning his true income and expenditures is to audit him. And all he has to do is look at the I.R.S.'s infinitesimal audit rate -- last year, the agency conducted face-to-face audits on just 0.19 percent of all individual taxpayers -- to feel pretty confident to go ahead and cheat.

So why do people really pay their taxes: because it is the right thing to do, or because they fear getting caught if they don't? It sure seems to be the latter. A combination of good technology (employer reporting and withholding) and poor logic (most people who don't cheat radically overestimate their chances of being audited) makes the system work. And while it sounds bad to hear that Americans underpay their taxes by nearly one-fifth, the tax economist Joel Slemrod estimates that the U.S. is easily within the upper tier of worldwide compliance rates.

Still, unless you are personally cheating by one-fifth or more, you should be mad at the I.R.S. -- not because it's too vigilant, but because it's not nearly vigilant enough. Why should you pay your fair share when the agency lets a few hundred billion dollars of other people's money go uncollected every year?

The I.R.S. itself would love to change this dynamic. In the past few years, it has increased significantly its enforcement revenue and its audit rate, despite a budget that is only fractionally larger. A main task of any I.R.S. commissioner (the current one is Mark Everson) is to beg Congress and the White House for resources. For all the obvious appeal of having the I.R.S. collect every dollar owed to the government, it is just as obviously unappealing for most politicians to advocate a more vigorous I.R.S. Michael Dukakis tried this during his 1988 presidential campaign, and -- well, it didn't work.

Left to enforce a tax code no one likes upon a public that knows it can practically cheat at will, the I.R.S. does its best to fiddle around the edges. Once in a while, it hits pay dirt.

In the early 1980's, an I.R.S. research officer in Washington named John Szilagyi had seen enough random audits to know that some taxpayers were incorrectly claiming dependents for the sake of an exemption. Sometimes it was a genuine mistake (a divorced wife and husband making duplicate claims on their children), and sometimes the claims were comically fraudulent (Szilagyi recalls at least one dependent's name listed as Fluffy, who was quite obviously a pet rather than a child).

Szilagyi decided that the most efficient way to clean up this mess was to simply require taxpayers to list their children's Social Security numbers. "Initially, there was a lot of resistance to the idea," says Szilagyi, now 66 and retired to Florida. "The answer I got was that it was too much like '1984.'" The idea never made its way out of the agency.

A few years later, however, with Congress clamoring for more tax revenue, Szilagyi's idea was dug up, rushed forward and put into law for tax year 1986. When the returns started coming in the following April, Szilagyi recalls, he and his bosses were shocked: seven million dependents had suddenly vanished from the tax rolls, some incalculable combination of real pets and phantom children. Szilagyi's clever twist generated nearly \$3 billion in revenues in a single year.

Szilagyi's immediate bosses felt he should get some kind of reward for his idea, but their superiors weren't convinced. So Szilagyi called his congressman, who got the reward process back on track. Finally, five years after his brainstorm became the law, Szilagyi, who earned about \$80,000 annually at the time, was given a check for \$25,000. By this point, his idea had generated roughly \$14 billion.

Which suggests at least one legitimate reason to dislike the I.R.S.: if the agency hadn't been so stingy with Szilagyi's reward back then, it probably would have attracted a lot more of the anti-cheating wizards it really needs today.

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