THE STATES' STAKE AND ROLE IN CLOSING THE FEDERAL "TAX GAP"

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For the calendar year 2001, the most recent year for which tax data were analyzed for this purpose, the Internal Revenue Service (Service) estimated that the gross "tax gap" was $345 billion. The tax

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The tax gap is defined as the difference between the aggregate amount that taxpayers pay voluntarily and on time and what they should pay under the law. A taxpayer contributes to the tax gap when he underreports his tax liabilities on a tax return, underpays taxes due from a filed return, or fails to file a required tax return altogether or on time. The tax gap is premised on legal activity only and does not include the "underground economy."

Members of Congress recognize that a federal tax gap exists. There is also general consensus that Congress and the Service should seek to address this problem.

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2 Id.
3 Id. at 3, 4.
4 See, e.g., Mark J. Mazur & Alan H. Plumley, Understanding the Tax Gap, Vol. LX, No. 3 NAT'L TAX J. 569, 570 (Sept. 2007) ("The Internal Revenue Service limits its estimates of the tax gap to tax due on legal-sector activity only. That is, taxes that may be due on income from activities such as illegal gambling, prostitution, and drug dealing are not included in the estimates of the tax gap.").
5 Id. ("The tax gap is not synonymous with the so-called "underground economy," though there is some overlap. The underground economy is made up of activities that are not very visible to tax and other government authorities.").
7 Most commentators agree that a multi-faceted approach is necessary to close the gap. Steps in such an approach include improved services, enforcement, legislative steps to reduce avoidance opportunities, and tax simplification. See, e.g., Jason Furman, Closing the Tax Gap, POLICY ANALYSIS (Center on Budget and Policy Priorities, Washington, D.C.), Apr. 10, 2006. At least one commentator seems to concede the absolute size of the gap, but deems it to be primarily a by-product of high tax rates and tax code complexity. In this writer's view, "[f]urther enforcement efforts would lead to punitive harassment of small business owners and farmers." For that reason, he argues that the only feasible way to narrow the tax gap is to simplify the tax system. See Daniel Mitchell, The Tax Gap Mirage, TAX & BUDGET BULL. (Cato Inst., Washington, D.C.), No. 44, Mar. 2007, at 1.
States' Role in Closing the Federal "Tax Gap"

Closing the gap is important for both fiscal and administrative reasons. Since the present expected budget deficit of $1.38 trillion exceeds the 2001 estimated tax gap, closing or at least narrowing the tax gap could contribute to improving the nation's fiscal picture. Narrowing the gap could also contribute indirectly to taxpayer relief. Individual taxpayer compliance failure results in a reallocation of tax burden that imposes greater liability on compliant taxpayers. Improved compliance with enhanced collections would, thus, more fairly distribute the tax burden. Further, improved compliance would reinforce the public perception of agency administrative efficiency—an extremely important message for a taxing system that ultimately relies upon voluntary taxpayer compliance for success.

With only a few exceptions, agency officials, politicians, and commentators all agree that enhanced collection—narrowing the gap—is an appropriate and important objective. The Office of Tax Policy at the Department of Treasury has crafted what it deems to be a comprehensive and integrated long-term strategy to accomplish this end through a combination of enforcement and educational initiatives. The strategy focuses primarily on improving enforcement and services and is premised upon four key principles:

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9 There is general agreement that closing the tax gap is unlikely. See, e.g., George K. Yin, Chief of Staff, Joint Comm. on Tax'n, Address to the Exempt Organizations Comm. of the A.B.A. Sec. of Tax'n (May 20, 2005).

10 See, e.g., U.S. GOV'T. ACCOUNTABILITY OFFICE, TAX COMPLIANCE: BETTER COMPLIANCE DATA AND LONG-TERM GOALS WOULD SUPPORT A MORE STRATEGIC IRS APPROACH TO REDUCING THE TAX GAP, GAO-05-753 at 2 (2005) [hereinafter GAO Report]. (As a result of taxpayers' noncompliance, whether intentional or unintentional, “the burden of funding the nation's commitments, including funding growing budget deficits, falls more heavily on taxpayers who voluntarily pay their taxes.”). In 2006, Nina Olson, the National Taxpayer Advocate, estimated that the tax gap amounted to a per-taxpayer “'surtax' of some $2,000 per year to subsidize noncompliance.” The Causes of and Solutions to the Federal Tax Gap: Hearing Before the S. Comm. on the Budget, 109th Cong. 2 (2006) (statement of Nina E. Olson, National Taxpayer Advocate, IRS).

11 Id.

12 See, e.g., Understanding the Tax Gap, POLICY PAPER (U.S. Senate Republican Policy Committee, Washington, D.C.), Sept. 12, 2006 (“Regardless of its precise amount, the tax gap threatens taxpayer confidence in the voluntary nature of our tax system and raises the issue of fundamental fairness. The tax gap is also a problem that hampers fiscal sustainability.”).

13 There is common agreement that legislative steps and tax simplification also play a role in narrowing the tax gap, but neither is under either state or Service
Both unintentional taxpayer errors and intentional taxpayer evasion should be addressed.

Sources of noncompliance should be targeted with specificity.

Enforcement activities should be combined with a commitment to taxpayer service.

Policy positions and compliance proposals should be sensitive to taxpayer rights and maintain an appropriate balance between enforcement activity and imposition of taxpayer burden.\(^\text{14}\)

The policy has seven components:

- Reduce Opportunities for Evasion.
- Make a Multi-Year Commitment to Research.
- Continue Improvements in Information Technology.
- Improve Compliance Activities.
- Enhance Taxpayer Service.
- Reform and Simplify the Tax Law.
- Coordinate with Partners and Stakeholders.\(^\text{15}\)

I am particularly interested in the last of these seven objectives: coordination with partners and stakeholders. The report recognizes the need for “closer coordination” between the Service and “partners and stakeholders.” Through these associations, the Treasury will share information and compliance strategies,\(^\text{16}\) as well as seek “to maintain and improve mechanisms to ensure that advisors provide appropriate tax advice.”\(^\text{17}\)

The formulation in the report suggests that the Treasury would share information and strategize, as well as making appropriate educational efforts, with states and foreign governments (partners), while undertaking more purely educational initiatives with practitioner organizations, including bar and accounting associations (stakeholders). This distinction, had the Treasury maintained it, would have been entirely appropriate. Characterizing state and foreign governments as partners would have implicitly recognized the control. For that reason, tax simplification is beyond the scope of this article.


\(^{15}\) See Bickley, supra note 6, at CRS-6, 7.

\(^{16}\) Id. at CRS-6.

\(^{17}\) Id. at CRS-7. This bifurcated approach falls squarely within the parameters of empirical research outcomes. See John Hasseldine & Peggy Hite, Key Determinants of Compliance and Noncompliance, 117 TAX NOTES 379 (Oct. 2007) (reviewing tax enforcement research and suggested strategies derived therefrom).
fundamental difference between the interests of other governmental
entities (regulators of comparable often dependent systems) and the
interests of stakeholders (the regulated and those who advise them).

This delineation of interests, however, has not characterized the
manner in which the Treasury has formalized associations to date. To
be sure, the Treasury recently reported that the Service is "partnering
and leveraging resources with local, state, and federal agencies across
the country" and listed a number of objectives that these associations
are presently addressing. These include centralizing the process for
Service assessments based on state audit reports; implementing a
Questionable Employment Tax Practices (QETP) Initiative with
seventeen states that, when developed, will use a federal and state
interagency approach to combat employment tax schemes and
increase voluntary compliance; and utilizing state and federal data for
Combined Annual Wage Reporting (CAWR)/Federal
Unemployment Tax (FUTA) matches. The Treasury is also taking
steps to develop partnerships with foreign tax agencies in this effort.

Further, the report describes agreements with "stakeholders such as
state licensing agencies and local business licensing agencies to
distribute educational information to small business applicants" and
"a robust outreach and education program accomplished through
relationships with national and local payroll, practitioner, small
business, and industry stakeholder organizations." The report then,
however, comments on the Service work "with partners to disseminate
tax information on subjects such as the EITC, child tax credit, e-file,
life-cycle events, and compliance issues" including such organizations
as "AARP, Armed Forces Tax Council, United Way, Health &
Human Services, Annie E. Casey, and the Kellogg Foundation"
(emphasis added).

From this it is clear that the Treasury has not explicitly made each
entity's role dependent upon whether it holds partner or stakeholder
status, as I have defined those terms. This is unfortunate for several
reasons. First, notwithstanding the absence of comprehensive analysis
on the state level, there is reason to believe that states generally are
also experiencing a tax gap that parallels the federal tax gap. At least

\begin{footnotes}
\footnote{IRS Report, supra note 14.}
\footnote{Id. at 53.}
\footnote{Id. at 53.}
\footnote{Id. at 53–54.}
\footnote{Id. at 55.}
\footnote{See James Alm, Brian Erard & Jonathan S. Feinstein, The Relationship Between State and Federal Tax Audits, in EMPIRICAL FOUNDATIONS OF HOUSEHOLD}
\end{footnotes}
two states, California and New York (both of which are very sophisticated in tax matters), have undertaken studies that demonstrate the extent of the problem in each of these states. Each state found high levels of noncompliance by individual taxpayers, which parallels the noncompliance on the federal level. The more expansive California report concludes that a combination of “soft” and “hard” approaches, much like those contemplated in the federal plan of action, could achieve some progress in narrowing the gap. Significantly, both state reports note limitations on the ability both to analyze data and to develop recommendations. This difficulty is no doubt attributable at least in part to each state’s lack of access to relevant information collected by the Treasury. Second, as will be argued below, states have recently developed increased administrative expertise in tax matters that, if properly tapped, could well contribute significantly to the effort to narrow the tax gap on both the federal and state levels. Further, and in light of this increasing capacity, to the extent that state and foreign governments have currently been assigned or have assumed a specific role in assisting in the formulation of strategies likely to prove effective in narrowing the tax gap, that role, with particular regard to the states’ taxation of individual incomes, is not presently as robust as it might be. States are in fact


25 See CALIFORNIA PLAN, supra note 24, at 4; NEW YORK REPORT, supra note 24, at 3; MINN. DEPT. OF REV., supra note 24, at 1.

26 “Our approach to reduce California’s tax gap is to address the primary causes—not just the symptoms—of the tax gap. We developed goals to address those primary causes and appropriate initiatives to achieve those goals. This approach balances “soft” approaches and enforcement-oriented approaches.” CALIFORNIA PLAN, supra note 24, at 6.

27 The California study was based on the Service federal tax gap estimate adjusted for California. It notes that it was based on incomplete data. CALIFORNIA PLAN, supra note 24, at 5. The New York study was based upon the federal American Community Survey (compiled by the Bureau of the Census) and data developed by its own Department of Revenue. NEW YORK REPORT, supra note 24, at 3.
increasingly able and quite likely willing to assume more expansive roles in this effort. Indeed, as will be shown, states are the ideal partners for the federal government in this effort. Finally, an enhanced state role in closing the tax gap will do no harm to fiscal federalism. Instead, a state-federal partnership would, at the end of the day, strengthen revenue systems at both levels without detracting from the capacity or power of either.

I. IMPRECISE ROLE DEFINITION: PARTNER VS. STAKEHOLDER

A Little Background: The States' Stake in the Efficacy of the Federal System

State taxation of individual incomes is unquestionably economically important. Forty-three of the fifty states tax individual income and, on average, that effort generates one-third of all revenues for those states. Importantly, particularly in recent years, states have achieved this level of return by piggy-backing—conforming state systems to the federal system. States use this structure for two reasons: first, the federal government has had superior capacity to explain and secure compliance with the income tax, and second, piggy-backing has enabled states to maximize the return from this revenue effort (in accordance with state objectives, of course) with minimal state infrastructure investment. Indeed, depending upon the extent to

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28 Again, the more expansive California report comments on this particular point: "We must leverage federal efforts. . . . Because federal income tax law generally serves as the basis for California tax law, California stands to benefit significantly from these federal tax gap activities." CALIFORNIA PLAN, supra note 24, at 14. As has been noted in numerous Treasury publications, narrowing the tax gap has international as well as interstate dimensions and extends to entity taxation. A discussion of the states' interest and role with regard to these additional issues will not, however, be addressed in this essay. Further, since levels of noncompliance in terms of percentages are highest for individual taxpayers, focusing on this group for both federal and state purposes seems quite reasonable.


30 See David A. Super, Rethinking Fiscal Federalism, 118 HARV. L. REV. 2544, 2576 (June 2005).

31 See Ronald Alt & Harley T. Duncan, The Impact of Federal Tax Changes on State Tax Systems, 2 ST. TAX NOTES 308 (Mar. 2, 1992) (discussing how the strategic decision to conform state income and corporate tax systems to the federal system has been driven by twin concerns: simplicity and compliance); see also Super, supra note 30, at 2594 (noting that advantages of coordination include reduced costs of
which it piggy-backs, an individual state might well avoid infrastructure investment almost entirely.\textsuperscript{32} Clearly, states benefit to the extent that they realize significant revenue with relatively minimal investment.\textsuperscript{33} Before the 1980s, when revenue adequacy was the dominant issue for states, their primary concerns were ease of administration and certainty of returns. Increasing conformity with the federal income tax system appeared to be an ideal way to proceed.\textsuperscript{34}

Yet this arrangement has a huge potential disadvantage. Simply put, revenue inflow stability on the state level is directly related to statutory stability on the federal level.\textsuperscript{35} States have been directly affected by federal tax reform over the last several decades and have experienced both windfalls\textsuperscript{36} and wipeouts.\textsuperscript{37} The following two examples are illustrative.

The Tax Reform Act of 1986 generated windfalls to state coffers as a result of conformity with federal tax legislation. In addition to compliance with state systems, increased likelihood of compliance with state tax rules, and state reliance on the Service's superior capacity for enforcement. There was likely also a psychological component to this strategy: taxpayers already shell-shocked by the federal filing effort with its attendant complexity, expense, and liability would be less likely to object to the simplified determination of state tax liability, which is usually comparatively significantly lower.\textsuperscript{32}

For example, a state that predicated state income tax liability on actual federal tax liability would need very little in the way of infrastructure. Postcards directed to a designated state-maintained post office box would almost suffice.\textsuperscript{33} See Harvey Galper & Stephen H. Pollock, \textit{Models of State Income Tax Reform, in The Unfinished Agenda for State Tax Reform} 125 (Steven D. Gold ed., 1988) (noting that the beauty of taxing income is that an income tax is relatively elastic. As long as the economy expands, collections will increase without any legislative action. Further, "bracket-creep"—liability determined in accordance with higher marginal rates as taxable income increases—is less likely to be a consideration on the state level because of the compressed marginal rate structure generally in place in the states. Note, however, that states with few marginal rates that top out quickly may sacrifice elasticity.).

\textsuperscript{34} See Steven D. Gold, \textit{Introduction, in The Unfinished Agenda for State Tax Reform} 1 (Steven D. Gold ed., 1988). Gold notes that during the 1930s, the states were concerned with enacting new income and sales taxes and that a variation on that theme followed during the 1960s and 1970s. States also enacted additional taxes during the 1970s, broadening tax bases and increasing tax rates. \textit{Id.}

\textsuperscript{35} See Super, \textit{supra} note 30, at 2596–98.

\textsuperscript{36} A "windfall" is increased revenue to the states resulting from conformity. See Steven D. Gold, \textit{A Review of Recent State Tax Reform Activity, in The Unfinished Agenda for State Tax Reform} 14 (Steven D. Gold ed., 1988).

\textsuperscript{37} A "wipeout" is the converse: decreased revenue to the states resulting from conformity.
repealing the capital gains exclusion, the 1986 Act broadened the base for federal income tax purposes by repealing or restricting a number of itemized deductions, changing the standard deduction and personal exemptions, and changing tax rates, as well as by making a number of other miscellaneous changes.\(^\text{38}\) Because state income tax systems piggy-backed on the federal system, federal tax reform changed state revenues. For most states, the federal changes caused a windfall in tax collections, the size of which varied depending on how each state linked its tax system to the federal one.\(^\text{39}\)

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTTRA 2001) is an example of wipeout. In the wake of the 2001 changes, many states projected revenue shortfalls as Congress initiated a phaseout of the federal estate tax. This phaseout would, over time, eliminate that source of revenue for states that had piggy-backed state statutes in place. "Wipeout" was also the issue for states when Congress enacted and then further expanded bonus depreciation—a change that reduced federal adjusted gross income for taxable entities, reducing the tax base for states that were linked at the time.\(^\text{40}\)

In the face of major federal tax changes of this magnitude, as well as myriad less sweeping changes, states have been compelled to react. Importantly, states' reactions have increasingly gone beyond mere administrative fixes—conformity, either automatic or with minimal state legislative oversight, to federal change.\(^\text{41}\) The passage of the Tax Reform Act of 1986, with its attendant windfalls, was a watershed moment for states. Many states seized that moment to undertake meaningful reform of their income tax systems.\(^\text{42}\) To be sure, much of


\(^{39}\) In general, states that linked their tax systems to adjusted gross income experienced the greater windfall. States linking to federal taxable income experienced much smaller changes, while states linking to federal income tax liability (North Dakota, Rhode Island, Nebraska, and Vermont) actually suffered wipeouts. Id. at 3-5, 12-13.


\(^{41}\) See Alt, supra note 31, at 312-13. Automatic or prospective conformity occurs when state statutes change as federal law changes. It was this feature that caused the 1986 Act's windfall/wipeout effect.

\(^{42}\) See Gold, supra note 36, at 11-15. ("Federal tax reform touched off an unprecedented burst of state tax reform activity, with more important reforms enacted in 1987 than in any other year within recent memory. . . . [T]here was so much
this activity resulted in substantially greater conformity with the federal statute. State policy makers' embrace of the considerations underlying the 1986 Act resulted in even greater conformity.\footnote{43} In short, the character of state deliberations in the fiscal sphere shifted in a major way from merely achieving revenue adequacy to doing so in the shadow of policy objectives. The details of state statutes have been increasingly informed by careful policy research and discussion in the wake of the 1986 Act.\footnote{44}

Serendipitously, meaningful reform after the 1986 Act did not impose additional compliance costs on states. States remained almost totally dependent upon the Service for oversight. The Service shared information about taxpayer noncompliance on the federal level with state departments of revenue. States could then determine whether to take local action to secure compliance with state law. Conversely, states could report noncompliance on the state level to the Treasury. Historically, however, the direction of information flow has been federal to state.\footnote{45}

The 2001 Act caused states to take a harder look at the costs of conformity. If states conformed to the federal changes, revenue losses would inevitably follow. States could avoid the revenue impact of the federal act only by choosing nonconformity—"decoupling"\footnote{46}—and then implementing a purely state-based tax. To pursue this course, states would have to invest in infrastructure. Further, a pure state tax would certainly lead to increased complexity for taxpayers—an important compliance issue.\footnote{47} Finally, "decoupling" could also carry with it the risk of "exit." For example, if states A, B, and C all piggyback onto the federal system and then state A alone decides not to allow bonus depreciation, there might be some flight of the tax base

\footnote{43} Id. at 14.
\footnote{44} Id. at 11–16. See also Galper, supra note 33, at 107–27.
\footnote{45} See Alm, supra note 23, at 236–37.
\footnote{47} Alt, supra note 31, at 313.
from state A to states B and C.\textsuperscript{48} Many states continue to grapple with these and related questions.

In the meantime, states that administered their own special rules or statutes found that the reactive state oversight that had sufficed as long as the federal and state systems were synchronized was now ineffective. As decoupling has progressed in ways small and large, individual states have responded to varying degrees by developing significant administrative capacity and increased individual auditing expertise.

For purposes of this discussion, however, the most important point is not the outcome of these and comparable discrete events, nor states' reaction to them, but rather the fact that federal tax statutory volatility has cumulatively affected state administrative capacity in significant ways. As states have sought to cope with windfalls and wipeouts, they have in the aggregate signaled both commitment to the federal scheme and willingness to act independently if their own policy objectives so dictate. Continued conformity means that states have a stake in a smoothly-functioning federal system that achieves the highest rates of compliance possible, and they have individually invested in such a system. States do not undertake nonconformity lightly and, when it occurs, it will more and more often be the product of legislative debate informed by computer-modeled policy choices. Further, nonconformity will quite likely necessitate state infrastructure investment. As a result, even as federal-state systems have remained closely interlinked, state tax administration has matured significantly in terms of both capacity and sophistication.

To summarize, first, states unquestionably have had and continue to have a direct financial and philosophical stake in a federal system that is as stable and as well-administered as possible. Second, federal change has destabilized complete state conformity with the federal system. As a result, states have gained experience in modeling income tax reform, have decoupled from the federal system as appropriate, and have developed individual audit capacity with concomitant enhanced state expertise. Finally, in spite of the progress they have made, states have been unable to narrow the tax gap independently

\textsuperscript{48} On a related point, see Mildred Wigfall Robinson, \textit{State and Local Governments Are Depending More on Regressive Revenue Sources}, 42 State Tax Notes 2, at 117, 123 n.50 ("Efforts by state and local governments to levy higher taxes on high income individuals and to distribute public services in a manner favoring the poor will be ineffective because high income individuals can migrate to political jurisdictions with more favorable fiscal climates."探访。
on the basis of information peculiar to state systems.\textsuperscript{49} This combination of factors causes states to be uniquely committed, interested, increasingly sophisticated players with significant administrative capacity that are likely to be receptive to a federal invitation to participate more fully in this effort. As such, states constitute a powerful, heretofore relatively untapped, resource in the federal effort to narrow the tax gap.

II. THE STATES' ROLE IN NARROWING THE TAX GAP AS PRESENTLY ENVISIONED BY THE SERVICE

The Service's Present Administrative Morass

To date, there is little to indicate that the Treasury is moving to develop a real partnership with the states in this effort. Despite the Treasury's clearly-stated intent to partner with and leverage resources with state and local, as well as federal, agencies in its efforts to narrow the tax gap, its interaction with the states to date constitutes much less than a full-fledged partnership, especially with regard to taxpayer compliance. Instead, the Treasury appears to perceive the states as being dependent upon federal resources and unable to act either independently or in a collaborative role—a perception more true of pre-1980 state administrative agencies than those of today.

This slant may prove quite perverse since, at least with regard to individual compliance, it may well be that the source of the problem and the key to its resolution are emphatically local. The Service estimates that underreporting of individual income taxes represented about one-half—$150–$187 billion of an estimated $312–$353 billion—of the tax gap for 2001.\textsuperscript{50} This amount includes underreporting of business income such as sole proprietor, informal supplier, and farm income—activity that is likely heavily, if not predominantly, intrastate. This is a potentially important point for it strongly suggests that "decoupling" would be less likely to result in a significant "exit" problem.\textsuperscript{52} Nevertheless, the Service strategies proposed to date suggest that the Service will ultimately continue to "go it alone" on essentially all compliance matters, treating their resolution as necessarily centrally based. To paraphrase an old saying,

\textsuperscript{49} See discussion supra note 27 and accompanying text.
\textsuperscript{50} See, e.g., GAO Report, supra note 10, at 7.
\textsuperscript{51} Id.
\textsuperscript{52} See supra note 48 and accompanying text.
at least in the present strategy design, all roads [will still] lead to the Service.\textsuperscript{53}

The Service’s recent difficulties with its efforts to assure compliance, largely exclusive of tax gap considerations, illustrate both the present dimensions of the challenge and the likely pitfalls that the Service will encounter. The Service’s own data show decreased agency effectiveness dating from the passage of the Internal Revenue Service Restructuring and Reform Act in 1998.\textsuperscript{54} That act, passed in the wake of the Senate Finance Committee hearings of 1997 and 1998 looking into Service practices, contained the “Taxpayer Bill of Rights.”\textsuperscript{55} The Taxpayer Bill of Rights “tilted the playing field in tax disputes in favor of taxpayers suspected of noncompliance.”\textsuperscript{56} Congressional instruction to emphasize taxpayer rights at the expense of enforcement likely diluted the enforcement effort.\textsuperscript{57} Service resources were consequently stretched thin. Enforcement became more difficult as decreased budgetary support\textsuperscript{58} led to staffing problems,\textsuperscript{59} which depressed audit levels further.\textsuperscript{60} Finally, the Service’s recent downsizing unfortunately targeted some of the Service’s most productive employees.\textsuperscript{61}

\textsuperscript{53} This is a paraphrase of the old adage “all roads lead to Rome.”
\textsuperscript{56} Sawicky, \textit{supra} note 55, at 11. The law specified rules for misconduct by Service employees that, if violated, could result in termination.
\textsuperscript{57} Id.
\textsuperscript{58} A Service budget that has been static since the mid-1990s has proven most damaging to enforcement efforts. From 1995 to 2006, Congressional support for enforcement efforts had increased by only about five percent. See OMB WATCH, BRIDGING THE TAX GAP: THE CASE FOR INCREASING THE IRS BUDGET 5 (Jan. 2008), available at http://www.ombwatch.org/budget/irstaxgap2008.pdf [hereinafter OMB WATCH].
\textsuperscript{59} The total number of Service employees declined by approximately eighteen percent during the same period, falling from 114,000 to 92,000. The percentage of revenue agents and offices—and employees performing audits—fell even more dramatically: forty and thirty percent. Id. at 6.
\textsuperscript{60} “In fiscal year 1996, the audit rate for all individual income tax returns was
In light of these staffing difficulties, it is not surprising that, even with regard to completed audits, the Service was not always able to collect tax debts. In an effort to remedy this problem, Congress authorized the use of private collection agencies (PCAs) in 2004. The Service moved to implement the program in 2006. Using PCAs to collect delinquent taxpayer accounts proved to be controversial and of questionable effectiveness, so much so that in March 2009, the IRS announced that it would not renew the two remaining contracts with PCAs, effectively stopping the initiative. On March 11, 2009, President Obama signed the Omnibus Appropriations Act of 2009 that contains a provision barring the IRS from using any appropriated funds for fiscal year 2009 to operate the private tax debt collection initiative. It is nevertheless important to understand, first, why the IRS could not and should not have relied upon the use of PCAs in its effort to close the tax gap.

Economically, the program was costly, and inordinately so. The Service projected the return on investment under the program to be about $3.20 to $3.60 in April of 2007. The report noted by contrast that for every additional one dollar invested in Service enforcement...
programs, the expected return ranged from three to fourteen dollars. One source reported that during the first year of operation, the PCAs "averaged a 4.5:1 [return on investment], collecting $29 million, from which they were paid $6.34 million—far below both the Service’s return on investment levels and initial revenue projections for the program." Projections for fiscal year 2008 promised little improvement. Indeed, former Commissioner Mark Everson believed "that it would cost more to use PCAs to collect delinquent individual tax debt that to hire additional Service employees for the same purpose."

Further, PCA’s treatment of taxpayers caused concern. There had been numerous reports of taxpayer abuse by PCAs in spite of PCAs’ contractual obligation to respect and protect taxpayers’ rights. Moreover, the Service lacked the ability to oversee PCAs exercised vis-à-vis agency employees.

In combination, these factors led to a number of legislative proposals to bar the Service from using private collection agencies. Both the 109th and 110th Congresses introduced bills to modify or bar Service use of PCAs. None of those proposed bills passed. As has been noted, the use of PCAs was brought to an end in March 2009.

Congress has recently begun to restore some of the monetary support needed to reestablish agency effectiveness. In the present context, however, such support may not be so easily allocated to the effort to close the tax gap. Congress faces tremendous financial pressure from a number of competing demands and will quite likely be unable in the near term to fund the agency at a level sufficient to enable it to recapture must less improve upon prior levels of

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66 Id.
67 See OMB Watch, supra note 58, at 13.
68 Guenther, supra note 65, at 22.
69 "In 2006, the FTC received 69,204 complaints from consumers alleging that PCAs were engaging in activities by the FDCPA, or 19.9% of all complaints related to the act; in 2005, PCAs were the target of 19.1% of all consumer complaints received by the FTC." Id. at 20.
70 Id. at 19–21.
71 Id. at 23–26.
72 Supra note 55.
efficiency. This will be true particularly since the agency has now been barred from relying upon private collection agencies. Further, the 111th Congress has already indicated that possible enforcement areas should include tax shelters, the earned income tax credit, tax exempt organizations, and tax havens as well as the private debt collection programs. In short, the Service probably will not be able to reduce the tax gap even modestly in the conceivable future if it continues to rely exclusively on its own resources. It will, rather, be very much occupied with maintaining the status quo much less restoring the status quo ante. In an enforcement environment in which an increased individual audit rate is necessary to increase compliance, the status quo will simply not be good enough.

III. EXPANDED STATE PARTICIPATION: STATES AS PARTNERS

In light of the prior history of federal/state administrative linkage, moving toward a deeper partnership in the effort to narrow the tax gap would be more a matter of degree than of novelty. A deeper collaborative effort would also accord with notions of what constitutes an acceptable relationship in this sphere both between agency and taxpayer (collection of taxes is an inherently governmental function) and between federal and state agency (sharing of information is appropriate and mutually beneficial). For example, in their 1987 study of the relationship between federal and tax audits with particular attention to the state of Oregon, Alm and associates determined that overlap between the state and federal agencies was less than complete and concluded that the each agency could improve its enforcement

74 Former Service Commissioner Rossitti put it this way in 2004: "If the IRS staff grew by 2% per year through 2010 [then] the total staff would still be smaller than it was 20 years earlier (1990), while the economy is projected to be 86% larger and the tax system far more complex." SAWICKY, supra note 53, at 10.

75 See Mark T. Resnick, Outsourcing Federal Tax Collection, 5 HOUS. BUS. & TAX L.J. 128, 156 (2005) ("Due to the enormous backlog in uncollected taxes that has built up over recent years, there still is a place for a PCA program in conjunction with increased IRS funding. PCAs should not be used in lieu of increased IRS funding, but could be used to augment the IRS collection program. The sheer volume of uncollected taxes makes it unlikely that any increase in IRS funding would be sufficient to collect all of those taxes due.").

76 Bickley, supra note 1.

77 See Joseph Bankman, Eight Truths About Collecting Taxes From the Cash Economy, 117 TAX NOTES 506, 514 (Oct. 29, 2007) ("I don't see any way to significantly reduce the cash sector tax gap without more audits, or more thorough audits.").
activities by sharing more information.\textsuperscript{78} Deeper cooperation seems especially appropriate here given that federal and state systems have substantially comparable statutory content, agree on underlying principles, and have comparable administrative cultures and practices. Consider the following.

\textit{Both Congress and state legislatures share the belief that income tax systems should be equitable, simple, and efficient.}

As indicated previously, beginning especially after the Tax Reform Act of 1986, states became much more attentive to policy matters in exercising taxing authority.\textsuperscript{79} This change has made increased resonance between state and federal taxing systems more likely.

\textit{There is substantial overlap between federal and state statutory language with regard to taxation of individual incomes.}\textsuperscript{80}

\textit{The question of the legality of outsourcing federal tax collection would not arise in a federal/state partnership.}

Whether the Service can legally outsource federal tax collection to PCAs was an issue that had been hotly debated.\textsuperscript{81} Opponents of the use of PCAs argued that tax collection is an “inherently governmental” function and thus should not be delegated to a non-governmental actor.\textsuperscript{77} Supporters of PCA use relied on the nature of the accounts delegated—PCAs are assigned only cases involving uncontested liability—asserting that since PCA agents were not exercising discretion, there was no delegation of governmental responsibility.\textsuperscript{82}

Clearly, if collections—whether contested or not—were conducted solely by a federal or state agency acting to enforce its own laws regardless of the source of information leading to assessment, this issue would have no resonance.

\textit{Start-up costs would be less likely for states if a federal/state partnership were formalized for this purpose.}

\textsuperscript{78} See Alm, supra note 23, at 270. While the authors were careful to limit the findings of their model to practices in Oregon, they opined that cooperative efforts could well be more productive in other states. \textit{Id.} at 271.

\textsuperscript{79} See Galper, supra note 33, at 107–08.

\textsuperscript{80} See discussion and text at notes 30, 31 and 34.

\textsuperscript{81} Guenther, supra note 65, at 17.

\textsuperscript{82} \textit{Id.} at 18.
In a recently reported interview, former Commissioner Donald Alexander noted that significant start-up costs had to be incurred in getting into the business of collecting outstanding tax liabilities,\(^{83}\) a judgment with which former Commissioner Sheldon Cohen did not disagree.\(^{84}\) In fact, the Service expected to spend $71 million in appropriated funding to set up the private collection initiative.\(^{85}\)

States, on the other hand, have at least some infrastructure in place. Thus, states generally will not have the same "start-up" costs that PCAs had and have. Even if states need to enhance infrastructure in order to better participate in this effort, federal resources formerly directed to private sector collection would now be better directed to state use.

Moreover, most states have been investing increasing amounts in their local enforcement efforts. States would almost certainly be interested in developing greater administrative expertise.

*Federal and state tax administrative agencies likely have a common culture.*

PCAs entered these collection contracts with the Service because they expected to make a profit. Under existing contracts, they were entitled to retain up to twenty-five percent of the revenue collected.\(^{86}\) PCAs' profit motives meant that, as former Commissioner Cohen observed, PCAs and the Service were likely to effectively operate under two separate sets of rules. Service employees are not promoted on the basis of collections or assessments; by contrast, the effectiveness of PCA employees was determined on that basis.\(^{87}\)

Collections or assessments per se will not form the basis for evaluation of performance for employees in state departments of revenue. State employees, like their federal counterparts, are

\(^{83}\) See Sawicky, *supra* note 55, at 65 ("There is a large fixed cost. The IRS is already in the business. Given as much money as they're going to be taking in this private collection initiative . . . the IRS could do much more than a private collector would.").

\(^{84}\) Id. at 31 ("I don't know that there is or there isn't. There are private bill collectors and they have a lot of the systems set up. Now what additional systems or controls the IRS may require of them, I don't know.").

\(^{85}\) Guenther, *supra* note 65, at 22.

\(^{86}\) Id. at 21.

\(^{87}\) See Sawicky, *supra* note 55, at 30 ("The problem with that is that we have entirely different sets of rules for [PCAs] than we do have for IRS people. That is, IRS people, by law, may not be judged for promotion on the basis of what they collect or what they assess. We know that people in private industry are going to be judged on the basis of what they collect.").
expected to respect the rights of taxpayers even as they pursue enforcement strategies necessary to ensure individual taxpayer compliance.

*Federal/state partnerships can more easily assure respect for the rights of taxpayers underscored by appropriate employee oversight.*

It would be easier to assess the effectiveness of public sector vs. private sector employees if all of the employees involved in the collection effort were subject to the same rules controlling interaction with taxpayers. Theoretically, that is the case. By virtue of the contract between the PCA and the Service, PCA employees were to be familiarized with taxpayer rights and Service procedures. Further, PCA employees were subject to the same rules as were Service employees—the “Taxpayer Bill of Rights.”

It is unclear, however, how effective the Service had been in monitoring the training and oversight of PCA employees. It is clear that, while the Service can sanction its own employees, it had no authority to terminate PCA employees accused of acting unlawfully or abusively. The Service could only take action deemed appropriate against the PCA itself—for example, revoking the PCA’s contract or barring the PCA from bidding on future contracts. Realistically, the Service was likely to invoke a sanction of this severity only in the most egregious cases.

States do not pose the same difficulties with regard to either inculcating respect for taxpayer rights or overseeing employees. States routinely monitor their employees’ conduct and hold them individually accountable where appropriate for failing to perform in accordance with expectations. In short, the federal agency understands the challenges of state oversight, and states have better sanctions available for employee breach than did PCAs. Parallel federal/state agency practices and procedures should prove conducive to mounting a mutually acceptable approach to this effort within normative protocols governing revenue agencies.

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88 See Sawicky, supra note 55.
89 Guenther, supra note 65, at 15–16.
90 Id. at 3–4.
A federal/state partnership would more readily and acceptably answer questions of cost-effectiveness.

As noted earlier, the anticipated return on investment (ROI) for Service enforcement programs ranges from $3 to $14 for every additional dollar invested.\(^{92}\) The ROI for PCAs had been roughly $4.50 for each dollar invested.\(^{93}\)

The ROI for state departments of revenue correlates closely with that of the federal agency. One commenter notes that “states administer their tax systems with an impressive degree of efficiency” and that state income tax collection costs range “from 0.2 to 1.5 cents per dollar of tax revenue collected.”\(^{94}\) Another study reported impressive ROIs enjoyed by several states: (1) from 1985 to 1987, Michigan invested $7.6 million in increased audit resources and collected nearly $110 million in new revenues, a return of 13:1, and (2) Kansas found that a personal income tax compliance program returned over $10 million in its first three years on expenditures of less than $750,000.\(^{95}\) Finally, Massachusetts estimated that as a result of enhanced enforcement, revenue from increased voluntary compliance totaled $1.0 billion,\(^{96}\) a spillover effect that has been commented upon on the federal level.\(^{97}\)

These ROIs are all within the ranges for which the Service itself strives. This suggests that financial support provided for state efforts to close the tax gap would be money well spent.

**Federal and state systems have parallel “tax gap” objectives.**

A brief reprise of federal objectives highlights the main themes: to identify and eliminate taxpayer error, whether intentional or unintentional; to combine enforcement activity with a commitment to service; and to educate taxpayers and their advisors.\(^{98}\) The states share these objectives. The two most recent available studies—those of New York and California—are examples. The New York report speaks to recovering tax gap liability through “audit, compliance, and

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92 See Guenther, supra note 65, at 17.
93 Id.
96 Duncan, supra note 95, at 93.
97 Id.
98 See discussion, supra note 13.
The more expansive California study echoes and expands upon these themes. Importantly, both states also recognize that enhanced enforcement will generate positive externalities: voluntary compliance rates will likely increase.

With regard to taxation of individuals, states are particularly well positioned to enforce and educate. The local origin of a significant percentage of individual taxpayer compliance problems suggest that an agency closer to home may enjoy significant successes both in educating taxpayers and stakeholders and in collecting delinquent taxpayer accounts. The individual income tax is the single largest source of the annual tax gap and individuals are the dominant source of underreporting. States are quite literally closer to the problems insofar as these taxpayers are concerned. This proximity could well prove important in finally achieving real progress toward closing the tax gap.

A few examples of recent, novel initiatives intended to improve taxpayer compliance on the state and local levels provide intriguing indications of the possibilities. The New York Division of Taxation estimated a resident business’ sales tax liability by using “an audit method that was similar to the reporting method used by the corporation -- summary sheets indicating total gallons of fuel purchased by the corporation and pump prices as reflected on the shift reports -- but also used opening and ending inventories the corporation had supplied to its accountant.” Minnesota is publicizing its list of businesses with revoked sales tax permits in the

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99 NEW YORK REPORT, supra note 24, at 11.
100 Id. at 3.
100 See CALIFORNIA PLAN, supra note 24, at 8–14.
101 Kirk J. Stark, State Tax Shelters and U. S. Fiscal Federalism, 26 VA. TAX REV. 789, 795 (2007) (asserting that “the corporate income tax is uniquely ill-suited for use at the subnational level” (emphasis added)). Stark goes on, however, to comment on an important difference in taxing corporate incomes vis-à-vis individual incomes, making the following observation: “Unlike individuals, corporations generally have no cultural or social ties to a specific location and thus are more likely to make locational decisions based on pecuniary factors.” Id. (emphasis added). This suggests that, while states face considerable difficulty in today’s environment in taxing corporate incomes, the same does not hold true for states taxing individual incomes. Further, states may actually enjoy an advantage as compared to the Service with regard to taxing individual incomes, precisely because of taxpayers’ cultural and social ties to specific locations.
102 In re Straight Path Service Station, Inc., No. 821621 (N.Y. Dep’t of Taxation, Dec. 30, 2008.)
hope of shaming debtors into coughing up back taxes. Another town in Colorado is employing a Geographic Information System to determine whether taxable transactions occurred within city limits.

These examples of state (and local) action in purely intrastate tax matters suggest that much might be gained through closer federal-state links. Federal dollars earmarked for enhancing state revenue infrastructure would be money well spent as would permitting states to retain a portion of additional revenues timely collected. To put it slightly differently, federal investment could generate a ROI commensurate with what it would expect from its own efforts and clearly greater than the ROI realized in the agency's earlier reliance on PCAs. Finally, and of no less importance, this enhanced compliance effort would be achieved even as federal agency attention is necessarily directed to other equally pressing areas of compliance.

In sum, states are committed to respecting taxpayer rights. State income tax systems are imbued with the same attributes as is the federal system. Common modes of operation and shared objectives should mean that establishing common ground—an issue of such great sensitivity and deep dissatisfaction in the use of PCAs—need not be an insurmountable difficulty. States can do well what PCAs had been unable to do.

There is no more ideal time than the present to explore this partnership. The urgent national need to address and begin to meaningfully narrow the tax gap is a challenge requiring effective effort by competent and committed players. In short, states and their respective Departments of Revenue are likely to be the key to Service success in moving beyond even the status quo ante in narrowing the tax gap.

IV. STATES AS PARTNERS: NO HARM TO FISCAL FEDERALISM

There may be concern that a partnership as described would do violence to principles of fiscal federalism. That should not be the case.

103 Katie Humphrey & James Eli Shiffer, State Seizes Property of Biggest Sales Tax Scofflaw, MINNEAPOLIS STAR TRIB., June 27, 2009, at 3B.
One of the central tenets of fiscal federalism is that redistributive policies should be undertaken by the most central level of government rather than state or local governments. Partnering in order to more effectively address the task of narrowing the tax gap is not a matter of redistribution. Rather, this partnership's straightforward objective would be to enhance and improve compliance with both the federal and individual states' income taxes through narrowing the tax gap. Partnership would neither expand nor restrict the role of either entity in fiscal matters at the expense of the other. A partnering state would be motivated by the prospect of its own enhanced collections, as would the Service. Any state that partnered with the Service in this effort could receive direct federal assistance for state infrastructure, but only if a return to the federal counterpart were anticipated—surely a satisfactory exchange.

In addition to enhanced federal and state collections, a partnering state's overall administration of its own income tax would quite likely be enhanced. This possible outcome would importantly further fiscal federalism, short-circuiting what Super characterizes as the possible "collapse of the leadership and superior capacity models' ability to motivate federal tax policy decisions" as federal and state revenue systems diverge. Super viewed this possible collapse as an issue whose

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106 See Kirk J. Stark, Fiscal Federalism and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?, 51 UCLA L. REV. 1389, 1408 (2004) ("[P]ublic finance economists have traditionally asserted that all rehdistributive policies should be concentrated at the most centralized level of government."). See also Sawick, supra note 53. Though this characterization has been the subject of some debate, discussion of the efficacy of subnational redistribution is beyond the scope of this article. See generally Stark, supra, at 1408–10.

107 Super, supra note 30, at 2553 (quoting Super, with regard to dual sovereignty, "federalism concerns should not apply at all in fiscal matters.").

108 In this effort, there would be no "major transfers of responsibilities" issue that Super identifies as likely to cause "difficult financial and transitional problems." Each partner would be expected to continue to play its prior independent fiscal role, though with important new advantages accruing through shared enforcement information and complementary educational efforts. As noted in "Expanded State Participation—States as PARTNERS," the federal entity may need to provide the state some support, either in the form of appropriations or in training, in order to ensure that state operations have the increased infrastructure necessary to participate effectively in this effort as partners. See Guenther, supra note 61, at 11–16. Given, however, the clear quid pro quo and continuing clearly defined dual effort, the prospect of federal financial support should not constitute an insurmountable obstacle. See Super, supra note 30, at 2563–66.

109 Id. at 2597.
possible “long-term consequences... swamp those of the federal mandates that have been subject to far more public debate.” Improved administration on the state level as part of a cooperative federal-state effort would stave off and, if vigorously pursued, reverse possible collapse of effective administration at both the federal and state levels. Indeed, as one writer has suggested, this joint effort could help return the spirit of commitment to a common national enterprise.

Finally, the partnership would be unlikely to impose a disabling political cost upon partnering states. First, increased individual liability, when it resulted from enhanced compliance, would likely result from finding unreported income rather than from increased tax rates. Further, state income tax statutes are generally characterized by relatively few and significantly lower marginal brackets. Thus,

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10 Id. at 2597-98.

11 The Alm study notes presciently that the report addresses as one policy matter “questions about the relationship and balance between state and federal tax enforcement programs, questions that are especially relevant in an era in which the size of the federal government may be reduced and the role of state governments in providing basic goods and services may increase.” See Alm, supra note 23, at 236. That is precisely the present situation. The federal government is now unable to provide this type of service to the states to the extent that it did previously. Increased state capacity will inure to the benefit of both levels of government.

12 See Brian Galle, A Republic of the Mind: Cognitive Biases, Fiscal Federalism, and Section 164 of the Tax Code, 82 IND. L.J. 673 (2007) (“The tax literature, while recognizing in broad terms the significance of federalism for tax policy, has been slow to integrate the insights of regulatory theory, which profoundly changes traditional ideas of federal/state relations. And non-tax scholars have given little consideration to the extent that, in a very real sense, almost all important federalism questions are really questions about tax.... In short, what we should think about section 164 depends on much more than the bottom of a balance sheet. Any fully considered judgment must include our philosophy of mind, our plan for the individual states’ place in an international marketplace, and our optimal design for good local government.”).


14 See Robert Tannenwald, Fiscal Disparity Among the States Revisited, 23 NEW ENG. ECON. REV., July–Aug. 1999, at 3 (describing how among states, “a flat rate is closer to the norm than the degree of graduation exhibited by the federal rate structure. Of the 42 states that levy a broad-based, income tax, six impose a flat rate.
any increased income tax liability would likely be less than corresponding federal tax liability. Finally, in the case of more affluent taxpayers for whom liability may be significant, state income taxes paid are deductible for federal income tax purposes if taxpayers itemize.\textsuperscript{115} Overall, state income taxpayers have generally been agnostic with regard to the state tax despite the fact that it is piggy-backed onto the perennially unpopular federal tax.\textsuperscript{116} Agnosticism will likely continue—even if states move to make their income tax systems more progressive—as long as state tax liability is less than federal tax liability. The deduction for state income taxes paid surely sweetens the deal.

V. GAINS THUS REALIZED: A "WIN-WIN" SCENARIO?

There is virtually a unanimous belief that the federal tax gap is real. Further, there is general agreement that, if narrowing the tax gap

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Another 19 states set the lower limit of their top income tax bracket for married couples at between $3,000 and $25,000. In these 19 states, the estimated average federal taxable income of married joint filers in 1996 ranged from $36,300 to $58,200. Thus, in all of these states a large bulk of taxable income is subject to a single rate, the highest marginal rate. In another two states, the highest marginal tax rate is less than 150 percent of the lowest marginal rate. By comparison, the highest federal marginal rate is 264 percent of the lowest marginal rate.\textsuperscript{15} In fact, several studies suggest that this tax on the state level tends to be mildly regressive in spite of its potential for progressivity.

\textsuperscript{115} I.R.C. § 164 (1986). "Taxes. (a) General rule.—The following taxes shall be allowed as a deduction for the taxable year within which paid or accrued: . . . (3) State . . . income . . . taxes." Only the twenty-five percent or so of taxpayers who itemize can take this deduction. Importantly, as a number of commentators have observed, this twenty-five percent is also likely to be the most politically active and organized segment of the taxpaying public—the group most likely to protest against tax burdens that it perceives to be inordinately high. See, e.g., DAVID BRUNORI, \textit{STATE TAX POL'Y: A POLITICAL PERSPECTIVE} 50-51 (2001). "Legislative politics are more complex than electoral politics. Politicians use the legislative process to accomplish many goals. First, they must satisfy the needs and desires of constituents, \textit{particularly their political supporters}. Second, they must strive to make the state appear economically competitive relative to other states. A state that keeps tax burdens for businesses and individuals relatively low, \textit{especially for the politically influential}, is often perceived as competitive." \textit{Id.} (emphasis added).

\textsuperscript{116} See ADV. COMM. ON INTERGOVERNMENTAL RELATIONS, \textit{CHANGING PUBLIC ATTITUDES ON GOVERNMENT AND TAXES} 20-21 (1991). In its twentieth commissioned survey on public attitudes toward government and taxes, the ACIR found that the highest percentage of those polled, thirty percent deemed the property tax the least fair tax. In the same survey, only twelve percent of taxpayers characterized state income taxes as "least fair." \textit{Id.}
is not addressed effectively, this administrative lacuna will destabilize the federal system. For if public perception of effective administration decreases and that surmise remains unchecked, voluntary compliance with the statute could decrease as well. These same concerns exist on the state level.

This deterioration and—in the worse case scenario—collapse of the fiscal federalism system can be effectively addressed. The Service should, in the fullest sense of the word, partner with states that rely on state individual tax systems. In so doing, both the federal and state structures would be strengthened. Further, the Service should pursue this course even if Congress has to provide financial assistance to states in order to enable states to create appropriate infrastructure. Such funding would be money well spent. As this discussion has shown, efficient use of state resources will generate much more in returns than is likely to be expended for infrastructure.

There is still time to recast strategy. Federal-state partnership will yield substantial benefits, both for all governmental actors and for taxpayers. In short, better compliance will protect administrative efficacy and will inure to the benefit of all parties.