

# COMPLIANCE

## BIENNIAL REPORT • MONTANA DEPARTMENT OF REVENUE



48 Compliance: Keystone to Fairness and Efficiency



### Montana Department of Revenue's Tax Collection: Two Interrelated Types of Revenue

Tax revenue collected by the Montana Department of Revenue (DOR) can be broken into two related forms of compliance: voluntary and active.

**Voluntary compliance** is met when taxpayers file timely returns, accurately reporting and paying tax obligations. The DOR provides the necessary framework for voluntary compliance by helping citizens understand and comply with the tax law.

The DOR does this by:

- *sending tax statements*
- *developing clearly written tax forms*
- *answering call center questions from taxpayers*
- *processing paper and electronic payments*
- *securely and confidentially storing sensitive information*
- *correctly assessing property values*
- *managing information provided on the DOR website*
- *developing understandable rules*
- *discussing tax law with constituents*
- *providing prompt refunds*
- *promptly and fairly applying active compliance, when appropriate.*

**Active compliance** occurs when taxpayers do not provide voluntary compliance, requiring the DOR to implement compliance measures.

The **Tax gap** is the estimate of cumulative tax payment noncompliance or, said another way, it is the gap between the amount of annual taxes due under the law and the amount voluntarily paid. Active compliance measures taken by the DOR collect some of these taxes and close the tax gap, which in turn promotes voluntary compliance and fairness.

Voluntary compliance and active compliance tax payments are related to one another by way of the **deterrent effect**. In a similar fashion to the enforcement of speed limits, active enforcement encourages voluntary compliance. When the highway patrol enforces the

speed limit, people tend to drive the posted speed limit. When the highway patrol isn't able to enforce the speed limit, people tend to exceed the speed limit. In the case of tax payment, the DOR's active compliance work creates an incentive to comply with tax laws, thereby increasing taxpayers' willingness to voluntarily comply with tax law, (Witte R. D. and Woodbury, 1985).

As the DOR's strategies for active compliance increase, voluntary compliance payments increase together with active payments. Similar to the afore-mentioned speeding example, the deterrent effect works in the counter direction, too. If the DOR reduces active compliance measures, payments for both voluntary compliance and active compliance are reduced.

### Montana Department of Revenue's Compliance Budgets, Revenue Collection Offer Significant Return on Investment

As a result of the recent recession, many states have experienced reduced budgets. Consequently, some states have conducted budget analyses in order to discover which portion of their operating costs can be cut with the least effect on services and total state budgets. Some states have reduced the budgets of their revenue collecting agencies, hampering active compliance efforts as a result.

The consistent finding is that state departments charged with collecting voluntary and active compliance tax revenue provide a return of between six and thirteen dollars of additional revenue for each additional dollar of budget. Inversely, collection of tax revenue decreases by eight dollars for every one dollar removed from the budget as active compliance is reduced and the deterrent effect is diminished.

### In 2009, California constituents lost an estimated \$465 million in tax revenue by reducing its Franchise Tax Board's compliance budget by \$65 million.

For example, according to the California Senate Office of Oversight and Outcomes, in 2009 the governor required furloughs of 5,300 workers at California's Franchise Tax Board in order to save an estimated \$65 million dollars in salaries. This resulted in an estimated 14% reduction in the number of hours spent on audit and collection activities and a corresponding reduction in personal, income, and corporate taxes of \$465 million, for an overall loss of \$400 million (a loss of \$7.15 for every dollar saved).

## Compliance: Keystone to Fairness and Efficiency

Between FY 2006 and FY 2009, Montana constituents received an additional \$29,585,364 in revenue by investing \$2,310,800 in DOR compliance efforts, a return rate of \$12.80 for each dollar invested.

In contrast, in 2005 the Montana Legislature approved a DOR increase of \$1.12 million (per biennium) to fund services and operating costs to add 8 full-time employees for compliance activities. The employees were added in areas where other states have found significant non-compliance, namely individual income tax and corporate license tax.

During the 2007 biennium, the DOR tracked the result of this investment and found in that biennium, the \$1,052,893 expenditure investment produced \$11,085,122 in additional revenue collected, a return of more than \$10.50 for each dollar invested.

During the 2009 biennium, the DOR continued tracking the return on investment in compliance. The results show expenditures of \$1,257,907, producing \$18,500,242 in additional revenue collected. This is a return of more than \$14.70 for each dollar invested.

### Choices for Revenue Agencies, Including the Montana Department of Revenue, Have Consequences

As a standardized practice, other states and the federal government collect information and develop estimates of the additional (or reduced) tax revenue received for each additional (or reduced) dollar in the compliance department's budget. The examples provided in the table below exemplify the benefits of investing in compliance and the consequences of cutting collecting agencies' budgets.

Revenue Generated (or Lost) From Additions (or Reductions) in Compliance Initiatives						
Government	Year	Investment or (Reduction)	Revenue or (loss)	Return on Investment	Source	
Federal (IRS)*	2007	\$11,100,000,000	\$44,400,000,000	4 to 1	1	
Arizona	2009	(\$10,800,000)	(\$54,000,000)	5 to 1	5, 6	
California - Board of Equalization	2009	(\$41,500,000)	(\$264,000,000)	6.4 to 1	2	
California - Franchise Tax Board	2009	(\$65,000,000)	(\$465,000,000)	7 to 1	2	
Idaho	2003	\$926,000	\$12,000,000	13 to 1	3	
Kansas	2002	\$6,000,000	\$54,000,000	9 to 1	3	
Kansas	2005	\$1,440,000	\$15,000,000	10.4 to 1	3	
Minnesota	2003	\$10,300,000	\$97,200,000	9.4 to 1	3	
Montana	2007	\$1,052,893	\$11,085,122	10.5 to 1	4	
Montana	2009	\$1,257,907	\$18,500,242	14.7 to 1	4	
New Mexico * (first year)	2009	\$5,000,000	\$29,000,000	5.8 to 1	3	
New Mexico * (ongoing)	2010	\$5,000,000	\$45,000,000	9 to 1	3	
Pennsylvania*	2009	(\$13,000,000)	(\$200,000,000)	15.4 to 1	7	
Washington *	2009	\$10,700,000	\$67,800,000	6.3 to 1	3	

\* Projected

Sources:

1. Reducing the Federal Tax Gap - A Report on Improving Voluntary Compliance - Internal Revenue Service, U.S. Department of the Treasury - 8/2/2007.
2. Furloughs at the Franchise Tax Board: Loss is Seven Times Greater than the Savings - California Senate Office of Oversight and Outcomes - 2/12/2010.
3. Idaho's Tax Gap, 2009 Estimating Idaho's tax Gap and Developing Strategies to Reduce It - Idaho Tax Commission - 11/2009.
4. Montana Department of Revenue 2007 Biennium Compliance Package Collections by Month and 2009 Biannual Compliance Package Collections by Month.
5. Stronger Arizona - An estimate of state general fund losses as a result of Arizona Department of Revenue budget cuts.
6. Arizona Department of Revenue - Office of the Auditor General, "division analysis indicates corporate income tax audits result in \$15 in assessments for each \$1 spent, while audits of individual income taxes result in \$5 in assessments for each \$1 spent."
7. The Pennsylvania Budget and Policy Center: 30 Ways in 30 Days: Revenue Collections - Proposed Cuts to Revenue Department Penny Wise and Pound Foolish.

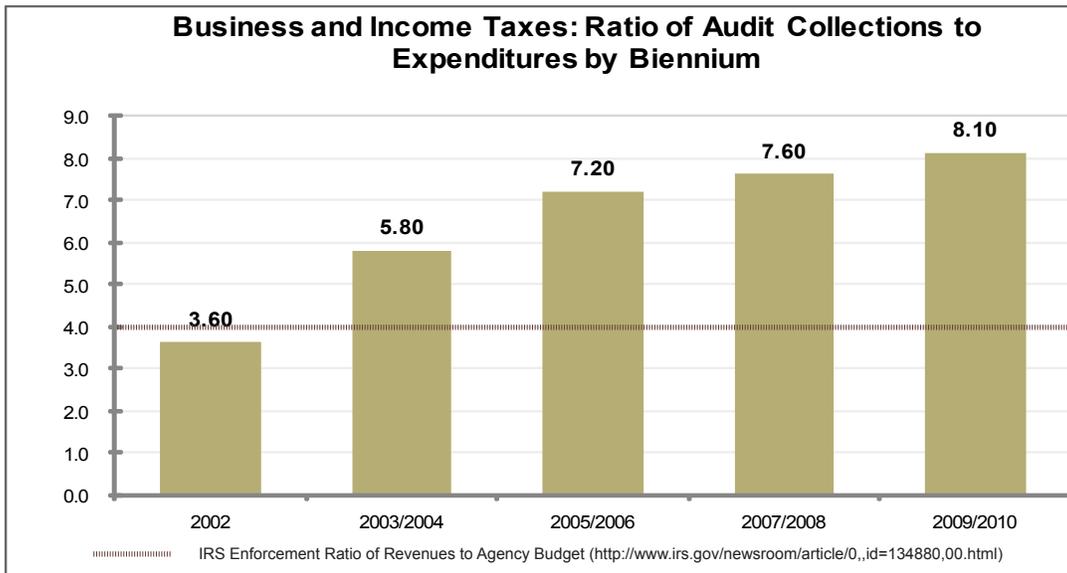
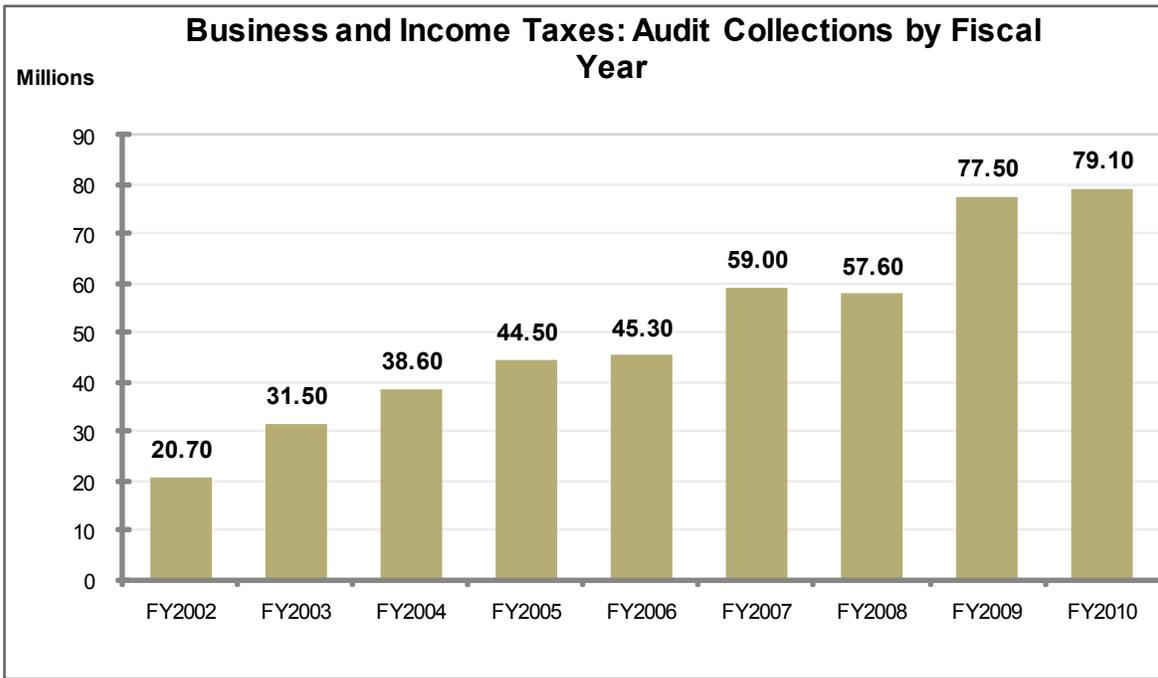
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## Overall Results of Montana Department of Revenue (DOR) Increased Compliance Efforts

Montana's recent compliance efforts have yielded increased tax collections. For each dollar the Montana Legislature has invested in compliance efforts, the DOR has returned from \$8 to almost \$15 in increased tax collections.

The first table below demonstrates how effective investments in compliance efforts has been.

The second table below illustrates the overall return on investment the DOR has experienced with its compliance efforts. This ratio takes the audit collections from the above table and divides it by the amount that was appropriated for the Business and Income Taxes Division for each biennium. The overall return on investment of the Business and Income Taxes Division is lower than the marginal return on investment, which measures just the collections and expenditures of specific compliance programs.



### Successfully Reducing the Tax Gap – Idaho’s Experiment

As a state level example, in November of 2009 the Idaho Tax Commission produced a report, *Idaho’s Tax Gap*, estimating Idaho’s tax gap at \$255,000,000 and developing strategies to reduce it. (In times of budget shortfalls, shrinking the tax gap is a common method employed to increase revenue without increasing taxes.) This report includes three separate methods for estimating Idaho’s tax gap, methods for reducing the tax gap, and a discussion of investments in tax compliance, proven return on investment, the multiplier effect, the opposite effect of reducing returns to investment, and the unintended consequences of “across the board” (including revenue collection agencies) budget cuts.

The major finding of Idaho’s research was that reducing the tax compliance budget leads to a projected reduction in tax revenue that is 10 times greater than the expenditure budget, a 10 to 1 ratio of revenue reduction.

### Federal Tax Gap and Compliance

In 2007, the Internal Revenue Service produced a report on improving voluntary compliance estimating, “the overall (federal) gross tax gap [estimated] to be approximately \$345 billion” and the “overall return from new investments in compliance averages 4:1” (page 2, IRS).

**“Investing in tax compliance to reduce the tax gap is a revenue-producing alternate to raising taxes”  
(Idaho Tax Commission, 2009)**