Less is More? Limits to Itemized Deductions and Tax Evasion

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Abstract

Deductions for personal expenses such as health care or education are a common feature of the income tax in many tax systems. In most cases, the burden of proof for the legitimacy of the deduction is on the taxpayer through an itemization process. Typically, itemized deductions feature thresholds above which additional documentation is needed. For example, in many countries including the US, when individuals deduct personal expenditures above a standard deduction, expenses have to be itemized in an additional tax form. Other tax administrations feature no standard deductions but require individuals to itemize deductible expenditures if they exceed a threshold. These thresholds have two well–established roles. First, taxpayers who take more substantial deductions are required to provide extra information: in practice, this means that there is a non-monetary cost to the extra tax benefit, so itemizing the deductions can be understood as an ordeal. Second, itemizing deductions transfers the burden of proof of the legality of the deduction to the taxpayers, who have to provide extra information that can be used by the tax authority to crosscheck the claims across tax returns. Accordingly, the imposition of deduction thresholds should increase tax revenues. This paper documents for the first time that there is an additional role for the threshold of itemizing rules, which is to disclose information about the tax authority's audit procedures. If deduction thresholds change individual's perceptions about enforcement rules, its effect on tax liability is uncertain. I show in a simple conceptual framework how the introduction of an itemizing rule could increase reported deductions, which leads to a decrease in tax liability. To test the hypothesis of the model I use a natural experiment in Ecuador, where an itemizing rule was implemented retroactively for a fiscal year that had already been declared, and taxpayers were allowed to amend their tax returns. For the fiscal year 2008, Ecuadorians were allowed to deduct up to $10,250 of their expenses in healthcare, food, clothing, housing, and education from their taxable income. To take the deduction, individuals did not need to fill out any additional forms nor itemize their expenses. In June 2009–several months after the fiscal year was over and the tax returns have been declared–the tax authority retroactively required itemization for people who had made a deduction over $7,500. These taxpayers needed to detail the information from their purchases in an additional tax form. The tax benefit remained unchanged; only the reporting rules were affected. A relatively large portion of taxpayers amended their income tax returns for 2008 after the change in the deduction rules. I observe a substantial increase in the deductions reported under the itemizing threshold, so the overall effect of the reform was a *decrease* in reported tax liability. In the case of itemized personal deductions in Ecuador, it seems that stronger regulations leads to less tax collection.

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