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# Senate Budget Resolution Fails to Address Tax Gap Problems

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The Senate's budget resolution assumes that the federal government will be able to raise tax revenues by reducing the "tax gap," the difference between taxes owed and taxes paid. While the resolution provides more money for IRS enforcement, it ignores the reality of the tax gap, which is that the complex and cumbersome tax code causes major compliance problems. By focusing on enforcement, the resolution ignores history and the bigger compliance problem and risks increasing IRS abuses. And because the budget resolution relies on revenues collected from the tax gap, the budget will not be in balance without hundreds of billions of dollars in other tax increases. If Congress wants to close the tax gap, it should focus on tax simplification.

**A Brief History of the Tax Gap.** The tax gap is the IRS's estimate of the difference between taxes voluntarily paid and taxes that should have been collected.[1] For example, a tax gap is created when individuals underreport income or improperly claim credits or deductions. The IRS uses a variety of models to estimate the tax gap but admits that its estimate may not be accurate due to a lack of data and outdated methodologies in its simulations.[2] The IRS estimates that the United States collects 83.7 percent of the total taxes due. After adjusting for delinquent taxes collected by existing compliance efforts, the IRS estimates that 86.3 percent of tax revenues are collected.[3]

This tax gap is not large by historical standards. Over the last several decades, the United States has collected between 81 percent and 84 percent of taxes due before compliance efforts.[4]

Most of the tax gap consisted of taxes owed by individual taxpayers, not corporations. The IRS estimates that 71 percent of the tax gap is in the individual income tax, 17 percent in employment tax, 2 percent in estate taxes, and only 9 percent in corporate taxes.

This is not the first time that the IRS has tried to reduce the tax gap. In 1993, the IRS set a goal of increasing taxpayer compliance to 90 percent by 2001.[5] This effort, called Compliance 2000, failed; the compliance rate remained within its historical range of 81 percent to 84 percent. Part of the reason this effort failed is that the tax code was not simplified; rather, the tax code became more complex as more credits and deductions were written into it. The IRS also determined that its models were inadequate to accurately measure the tax gap and guide compliance efforts.

**Complexity of the Tax Code.** One of the main reasons that the tax gap exists is that the tax code is too complex and confusing. Taxpayers receive conflicting advice from professional taxpayers and even IRS agents.[6] As a result, honest taxpayers contribute to the tax gap when they misunderstand tax regulations and file erroneous returns.

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*www.heritage.org/research/taxes/wm1419.cfm*

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The Government Accountability Office, the Treasury Department, and others have concluded that tax simplification is extremely important in reducing the tax gap. Over 10 percent of the tax gap is caused by taxpayers making mistakes in claiming improper deductions or credits. A simpler tax code, with lower marginal rates, would reduce this noncompliance. A simpler tax code would also reduce filers' ability to intentionally cheat on their tax returns, because there would be fewer complex tax provisions that would-be tax cheats could abuse. Other countries have simplified their tax system in an attempt to raise taxpayer compliance.[7]

Almost a third of the tax gap is caused by the underreporting of income from sole proprietorships, farmers, and cash-only contractors.[8] The latter group consists of dog walkers, handymen who remodel businesses on the side, babysitters, etc. It is very hard to track this group's income unless payers report their transactions. These groups also underreport wage income, contributing almost 20 percent to the tax gap.

Sole proprietorships and contractors are usually very small, with almost two-thirds of the 20 million small business tax filers reporting gross receipts of less than $25,000 per year.[9] These businessmen do not have the financial resources to pay for accountants to ensure full compliance with the complex tax code. Tax simplification would benefit these entrepreneurs by helping them meet their tax obligations in a cheaper, more efficient manner.

**Potential for IRS Abuse.** The Senate Budget Resolution provides $399 million for increased IRS enforcement.[10] The budget resolution's backers hope that the additional revenues collected as a result will greatly exceed the additional funding. In order to meet this expectation, IRS agents will face strong incentives to presume taxpayers guilty of tax avoidance and evasion. This can lead to taxpayer abuse as overzealous IRS agents audit taxpayers.[11]

Many of the taxpayers responsible for the tax gap are either working poor, who receive overpayment of the Earned Income Tax Credit, or small business owners. If the IRS targets these groups for audits, it will increase the burden on them. Even the working poor who legitimately receive the EITC and compliant small businesses will be caught up in the IRS dragnet: directed action against these groups will threaten both the law-breaking and the law-abiding.

The dangerous consequences of setting unrealistic revenue goals are plain from recent history. As late as 1998, the specter of enforcement quotas dogged the IRS in both the press and on Capitol Hill. After a government study indicated that the

1. Government Accountability Office, "IRS Tax Gap Studies: 1979, 1983 and 1988," March 1988, at *http://archive.gao.gov/d34t11/135439.pdf*.
2. Government Accountability Office, "Tax Compliance: Better Compliance Data and Long-Term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap," July 2005, at *www.gao.gov/new.items/d05753.pdf*.
3. Office of Tax Policy, U.S. Department of the Treasury, "A Comprehensive Strategy for Reducing the Tax Gap," September 26, 2006.
4. Statement of Michael Brostek, Government Accountability Office, "Tax Compliance: Multiple Approaches Are Needed to Reduce the Tax Gap," GAO-07-391T, January 23, 2007.
5. Government Accountability Office, "Tax Compliance: Better Compliance Data and Long-Term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap."
6. "A Code That Should be Broken," Editorial, *Investor's Business Daily*, August 2, 2006, p. A-12.
7. For example, Australia changed its tax code to include a national sales tax in an effort to increase compliance.
8. Testimony of David M. Walker, U.S. Comptroller General, "Tax Gap: Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions," February 25, 2006, at *www.gao.gov/new.items/d06453t.pdf*.
9. John S. Satagaj, Statement to the United States Senate Committee on the Budget, January 23, 2007.
10. Senate Budget Resolution for FY 2008.
11. William W. Beach, "Increasing IRS Tax Collection Powers Threatens More IRS Abuse: The New Congress Moves to Close the Tax Gap," Heritage Foundation *WebMemo* No. 1373, February 27, 2007, at *www.heritage.org/Research/Taxes/wm1373.cfm*.

Arkansas-Oklahoma IRS office had used enforcement quotas to compromise taxpayers' rights, then-Secretary of the Treasury Robert Rubin was led to remark that he was "seriously disturbed…that an emphasis on statistical goals and expectations could have affected taxpayers' rights to fair treatment and employees' rights to a fair evaluation system."[12] The IRS itself found that, as a result of these "statistical goals," there was an "over-emphasis on productivity" that "may have caused some employees to make sometimes serious mistakes of judgment."[13] Further investigation showed that this misconduct was not an aberration. Shortly before congressional hearings in January 1998, the IRS confessed that "offices across the country improperly treated revenue collection quotas with more importance than protecting the rights of taxpayers."[14]

IRS overreaching in such circumstances can be extreme and intrusive. In the 1990s, the IRS carried out what the agency called "lifestyle audits" that permitted tax collectors to rummage through taxpayers' personal belongings to see if they appeared to enjoy a lifestyle beyond what their income tax returns might have indicated. The agency was forced to withdraw this policy after complaints of privacy intrusions.[15]

**Conclusion.** It is a mistake to attempt to close the tax gap by focusing first on enforcement. Increased enforcement efforts will lead to overzealous IRS investigations and will force millions of Americans to keep track of more financial records to satisfy tax collectors. The Senate Budget Resolution adds to the burden of taxpayers instead of seeking to close the tax gap through tax simplification.

Tax simplification will help small businesses be more compliant and make the tax code more efficient. With a more efficient tax code, economic growth will be stronger and tax revenues will rise with a growing economy. The Senate should not expect increased revenues and a reduction in the tax gap simply by calling for more IRS enforcement agents and tax audits.

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12. Dave Skidmore, "Rubin Distrubed by IRS Violations," ABC News, December 13, 1997, at *www.abcnews.com/sections/us/irs1213/index.html*.

13. *Ibid.*

14. "Internal Report Faults IRS Practices," Washington Newswire

15. Daniel J. Mitchell, "More Snooping from the IRS?" Heritage *Commentary*, April 4, 2002, at *http://www.heritage.org/Press/Commentary/ed040402b.cfm*.