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TAXPAYER COMPLIANCE

Reducing the Income Tax Gap

Statement of Jennie S. Stathis, Director
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TAXPAYER COMPLIANCE

SUMMARY OF STATEMENT OF
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One of the biggest challenges facing the Internal Revenue Service (IRS) is finding ways to reduce the gross income tax gap--the difference between income taxes owed and those voluntarily paid. IRS has estimated that taxpayers do not voluntarily pay more than $100 billion annually in taxes due on income from legal sources. While such a "tax gap" estimate is necessarily imprecise, it does indicate the size of the challenge confronting tax administration. GAO's statement makes the following points:

-- IRS information, while dated, suggests that U.S. taxpayers voluntarily pay 83 percent of the income taxes they owe--87 percent after IRS audits and other IRS programs. Although this compliance level may be relatively high by world standards, it translates into large sums of "tax gap" dollars because of the size of our economy.

-- Compliance is not uniform across groups of taxpayers. IRS estimates that wage earners report 97 percent of their wages; the self-employed report 36 percent of their income; and "informal suppliers"--self-employed individuals who operate on a cash basis--report just 11 percent of theirs.

-- Significantly, the IRS data show that compliance is highest where there is tax withholding, a little lower where there is information reporting to IRS, and much lower where there is neither. In addition to the relative visibility of the income to tax administrators, the complexity of tax rules, together with a number of other factors, also influence the level of tax compliance.

-- Some of the "tax gap" may not be collectible at an acceptable cost. Collection, in some instances, could require either more recordkeeping or reporting than the public is thought willing to accept or too costly an IRS effort. Thus, it is important that IRS measure compliance with the tax laws and use that information to effectively focus its resources.

Mr. Chairman and Members of the Committee:

We are pleased to be invited by the Committee to discuss the income tax gap. One of the biggest challenges facing the Internal Revenue Service (IRS) is finding ways to reduce the gross income tax gap--the difference between income taxes owed and voluntarily paid. IRS has estimated that taxpayers do not voluntarily pay more than $100 billion annually in taxes due on income from legal sources. While such a "tax gap" estimate is necessarily imprecise, it does indicate the size of the challenge confronting tax administration.

My statement covers four points:

-- IRS information, while dated, suggests that U.S. taxpayers voluntarily pay 83 percent of the income taxes they owe--87 percent after IRS audits and other IRS programs. Although this compliance level may be relatively high by world standards, it translates into large sums of "tax gap" dollars because of the size of our economy.

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-- Significantly, the IRS data show that compliance is highest where there is tax withholding, a little lower where there is information reporting to IRS, and much lower where there is neither. In addition to the relative visibility of the income to tax administrators, the complexity of tax rules, together with a number of other factors, also influence the level of tax compliance.

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I would like to begin with a discussion of the "tax gap" estimates and how they are derived.

TAX GAP ESTIMATES

Tax gap estimates, for the most part, begin with IRS' Taxpayer Compliance Measurement Program (TCMP). In this program, IRS audits a random sample of tax returns, examining every item to identify both under- and over-reporting. These results are then used to estimate compliance levels for the population as a whole. Other sources are used to estimate taxes not paid by large corporations, by those who do not file tax returns, and by those "informal suppliers" who operate cash-based businesses.

Excluded from the estimates are taxes that go uncollected from illegal activities such as drug dealing and prostitution. IRS researchers believe the data and methodology for including such estimates are lacking. Also excluded are other types of taxes--for example, employment and excise taxes.

IRS last estimated the gross tax gap in 1988, for tax years 1973 through 1992. (See table I.1.) The estimates relied on earlier TCMP results, the latest covering tax year 1982. Later TCMP results for tax years 1985 and 1988 (for individuals) and 1987 (for small corporations) have not yet been reflected in tax gap estimates. After making some adjustments for tax law changes and shifts in types of income, IRS estimated that taxpayers have been paying about 83 percent of the taxes they owe. Factoring in estimates of economic growth, IRS derived an income tax gap of as much as $127 billion for tax year 1992. Thus, regardless of the adequacy of IRS enforcement programs, the tax gap could continue to grow in current dollars because of economic growth and changes in tax law that could have the unintended effect of increasing opportunities for noncompliance.

By IRS' estimates, its enforcement programs have, on average, recovered about 4 percent of total income taxes due in any particular tax year. Thus, overall compliance has tended to reach about 87 percent after IRS audits and other IRS programs. But, because of the time consumed by IRS' activities and subsequent appeals and litigation, it may take a number of years to reach the 87-percent compliance level.

COMPONENTS OF THE TAX GAP

Tax administrators from other countries have told us that IRS' data suggest a relatively high level of tax compliance in the United States compared to other countries. Yet, within this overall average level of compliance, are a range of estimates by type of taxpayer or income.

As shown in table I.2, IRS attributes about three-fourths of the tax gap to individuals and one-fourth to corporations. The individual tax gap is due primarily to individuals not fully reporting their income (about $73 billion of the $94 billion estimate). In comparison, smaller estimates were attributed to individuals overstating their deductions ($8 billion) or not making full payment with their returns ($11 billion). The tax gap estimate for corporations is divided between large corporations ($24 billion) and small corporations ($7 billion).

Within these overall tax gap measures, however, compliance across groups of individual taxpayers is not uniform. (See table I.3.)

-- Wage earners whose salaries are subject to tax withholding (the most visible form of income to IRS) are estimated to report 97 percent of their wages.

-- Those with interest and dividends are estimated to report 90 percent of their interest income and 87 percent of dividends--income that for the most part is subject to tax information reporting but not to tax-withholding.

-- In contrast, IRS estimates that the self-employed report about 36 percent of their income--income that is neither subject to withholding nor necessarily covered by information reporting.

-- And finally, among the self-employed who operate informally and thus are even less likely to have income reported to IRS on information returns, compliance is estimated to be about 11 percent.

Similarly, variations in compliance patterns exist in the corporate sector. Small corporations, whose compliance level dropped to 61 percent in IRS' tax year 1987 TCMP, tend to mirror the compliance patterns of sole proprietors. Underreported income is the biggest compliance problem and sufficient documentation is often a problem. Large corporations, in contrast, tend to have issues associated with the ambiguity and complexity of the tax code. Upon audit, IRS auditors and corporations sometimes interpret tax provisions differently, leading to contested issues. For example, IRS has ultimately collected about 22 cents for each $1 of proposed audit assessments of the nation's 1,700 largest corporations.

Analyzing such tax gap patterns suggests a number of factors which influence the size of the tax gap.

SYSTEMIC FACTORS THAT INFLUENCE TAX COMPLIANCE

Tax administrators around the globe work to promote compliance with whatever tax regime is in place. Some common factors influence their success level.

First: The simpler the rules, the better. This reflects the basic principle that the simpler the tax code and the more certain the results in applying it, the fewer the opportunities for disagreement over the "fine points" of the law. However, very few would argue that the existing U.S. tax system is either simple or certain. For example, some paragraphs in the Internal Revenue Code have generated as much as 250 pages of implementing regulations.

Second: Collecting from fewer sources is easier. Tax withholding allows the tax collector to focus on the relatively small number of employers, rather than all employees. Congress also followed this reasoning in changing the collection point for diesel fuel taxes to the smaller number of businesses earlier in the production chain. Subsequent to this and other changes in the taxation scheme for diesel fuel, collections have risen significantly.

Third: More visible tax information promotes higher compliance. Tax-withholding and information reporting are two means of making income and some deductions visible to both the taxpayer and the tax administrator, which results in compliance rates that are significantly higher. Good records and other types of paper trails also lead to better results when the tax administrator audits a return or takes some other enforcement action. Other countries have transaction information from administering value-added taxes--information not readily available to IRS.

Fourth: Good information is critical to identifying compliance problems. This factor recognizes the importance of systematically estimating the extent of noncompliance and variations in taxpayer behavior. In this way, the tax administrator can identify areas warranting attention, tax returns to audit, and the results of any efforts to improve compliance.

Fifth: Focus compliance efforts where they will do the most good. Having information on the most significant compliance problems allows IRS to tailor its efforts accordingly. At present, the largest component of the income tax gap is attributable to individuals not fully reporting their income--an estimate that has led IRS to train its auditors to better detect such situations.

Sixth: Deal with problems quickly. Another potential byproduct of assessing problem areas is the ability to deal with them quicker. IRS has found that the longer it takes to reach a taxpayer, the less likely it will achieve a favorable outcome.

THE CHALLENGE FOR IRS

When some taxpayers do not pay all the taxes they owe, the burden of funding government programs shifts to taxpayers who do comply. Thus, maintaining high levels of compliance is important for equity reasons. Yet, it would not be realistic to assume that all of the tax gap revenues can be recovered. To do so would mean imposing burdens and costs that our society is unlikely to accept. While we do not know how much recovery is realistic, IRS' current plans are to improve compliance from the estimated 87-percent level to 90 percent by the year 2001.

One method by which IRS hopes to achieve such results is by increasing its compliance presence. And there is room for growth. Over the last 30 years, the rates at which IRS has audited income tax returns have declined over 75 percent. And, while alternative mechanisms such as document matching reach certain types of income, IRS has no such substitute for more complex issues.

This year IRS will also undertake another TCMP. This TCMP will be larger than earlier ones because it will cover four types of taxpayers. The most recent TCMP for individual taxpayers was tax year 1988, for small corporations tax year 1987, for partnerships tax year 1981, and for S corporations tax year 1984. The TCMP is very important because it is IRS' only tool for measuring compliance levels and developing formulas for objectively selecting returns to audit. The time and documentation requirements may be of concern to taxpayers selected for a TCMP audit. But TCMP audits will actually reduce the overall long-term burden[1] on taxpayers to the extent that they reduce the number of compliant taxpayers selected for other IRS audits.

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In concluding my testimony this morning, I would like to reiterate how important it is for IRS (or other tax administrators) to invest agency resources to measure noncompliance and use that information to balance efforts among the competing goals of (1) maximizing tax revenues, (2) promoting uniform compliance, and (3) minimizing taxpayer burden. I would welcome any questions you or Members of the Committee may have.

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[1]GAO's prior testimony Tax System Burden: Tax Compliance Burden Faced by Business Taxpayers (GAO/T-GGD-95-42, Dec. 9, 1994) discusses the difficulties of measuring tax system burden. An extract of that testimony is shown at Appendix II.

SELECTIVE TAX GAP SUMMARY STATISTICS

Table I.1: Range of Estimates of the Gross Legal-Sector Income Tax Gap and Voluntary Compliance Rates for Selected Tax Years 1973-1992

Tax year	Gross income tax gap[a] ($ billions)						Voluntary compliance rate[b] (percent)					
	Total		Individual income tax		Corporate income tax		Total		Individual income tax		Corporate income tax	
1973	27.9	32.0	22.0	22.7	5.9	9.3	83.9	82.0	83.0	82.6	86.6	80.3
1976	39.7	45.5	32.6	33.7	7.1	11.8	82.7	80.7	81.2	80.7	87.3	80.6
1979	61.0	69.0	51.5	53.2	9.6	15.9	81.9	80.0	80.3	79.8	87.2	80.4
1982	64.6	70.5	57.5	59.1	7.1	11.4	82.9	81.7	82.2	81.8	87.1	80.8
1984	83.0	91.3	73.5	75.7	9.6	15.6	81.6	80.1	80.4	80.0	87.2	80.6
1986	96.1	105.6	86.0	88.8	10.1	16.8	81.0	79.5	79.7	79.2	87.7	81.1
1988	84.5	96.8	70.3	72.6	14.2	24.3	84.0	82.0	82.7	82.3	88.1	81.2
1992	110.1	127.0	91.0	94.0	19.1	33.1	84.6	82.7	83.6	83.1	88.1	81.1

[a]The higher IRS estimates of the tax gap in the right hand columns are based on the amounts of additional tax recommended by IRS examiners, and the lower estimates of the gap in the left hand columns are based on the amounts of tax ultimately assessed after all appeals and litigation. Since IRS examiners cannot detect all tax deficiencies, IRS believes the actual tax gap lies between these two sets of estimates.

[b]The voluntary compliance rate is what taxpayers voluntarily pay as a percentage of their total tax liability. See note a for an explanation of the range of rates.

Source: Income Tax Compliance Research: Net Tax Gap and Remittance Gap Estimates, IRS Publication 1415 (4-90).

Table I.2: Gross Tax Gap Estimates for Tax Years 1992
(Dollars in millions)

Source of tax gap	Tax gap amount	Tax gap distribution (percent)
Individual tax gap	$93,994	73.9%
Unreported income	72,991	57.4
Sole proprietors	33,683	26.5
All other income	39,308	30.9
Overstated deductions[a]	8,081	6.4
Individual remittance gap	11,400	9.0
Math errors	1,521	1.2
Corporate tax gap	33,135	26.1
Small corporations	6,999	5.5
Large corporations	23,716	18.7
Other[b]	420	.3
Corporate remittance gap	2,000	1.6
Total tax gap[c]	$127,129	100.0%

[a]Includes subtractions for erroneous deductions, exemptions, credits, and other adjustments.

[b]Includes unreported income and overstated deductions for exempt organizations' unrelated business income and for fiduciaries.

[c] Totals may not add due to rounding.

Sources: Income Tax Compliance Research, IRS Publication 1415 (7-88); and Income Tax Compliance Research: Net Tax Gap and Remittance Gap Estimates, IRS Publication 1415 (4-90).

Table I.3: 1992 Individual Reporting Rates and Gross Tax Gap Estimates by Source

(Dollars in millions)

Description	Voluntary Reporting Rate[b]	1992 tax gap amount
Wages and salaries	96.6%	$3,667
Interest	90.1	2,680
Dividends	87.3	2,125
State tax refund	87.6	193
Alimony	65.2	279
Capital gains	85.0	10,232
IRS Form 4797	38.2	1,180
Pensions and annuities	84.6	2,809
Taxable unemployment	81.8	539
Farm income	c	6,775
Partnership income	67.5	2,371
Small business corporation	57.0	750
Estates and trusts	95.1	195
Rents and royalties	80.7	2,467
Nonfarm sole proprietors: Informal suppliers Other sole proprietors	36.0 11.4 44.3	33,683 10,410 23,273
Other income	39.3	3,003
Taxable Social Security	83.2	43
Adjustments to income	106.3	694
Deductions	104.4	3,889
Exemptions	104.1	2,224
Credits	113.0	1,274
Math errors	d	1,521
Nonremittance	d	11,400
Total individual tax gap[a]	e	$93,994

[a]Totals may not add due to rounding.
[b]The voluntary reporting rate is what taxpayers voluntarily report on their tax returns as a percentage of what they should have reported.
[c]Not computable, negative income reported.
[d]Not applicable.
[e]Voluntary compliance rate as computed by IRS is 83.1 percent (see table I.1).
Source: Income Tax Compliance Research, IRS Publication 1415 (7-88).

RELIABLE ESTIMATE OF OVERALL COMPLIANCE COSTS DIFFICULT TO DEVELOP

EXTRACT FROM DECEMBER 9, 1994 STATEMENT OF LYNDA D. WILLIS ASSOCIATE DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES GENERAL GOVERNMENT DIVISION U.S. GENERAL ACCOUNTING OFFICE

"As business taxpayers strive to comply with federal, state, and local tax requirements, they expend time, incur costs, and experience frustrations. GAO refers to this time, cost, and frustration as taxpayer compliance burden . . .

"GAO collected information on compliance burden from the management and tax staffs of selected businesses, tax accountants, tax lawyers, representatives of tax associations, and officials of the Internal Revenue Service. In addition, GAO reviewed academic research and other studies on compliance burden and tax simplification . . .

". . . **[With respect]** to the overall cost to businesses of complying with the tax code, we did not identify a readily available, reliable estimate of such costs. While there was a general consensus that compliance is burdensome and some businesses offered anecdotal examples of their costs, our discussions with businesses and review of available studies indicate that developing a reliable estimate would require that several practical and severe problems be overcome. These problems include working with a broad spectrum of businesses to accurately separate tax costs from other costs and obtaining accurate and consistent responses from businesses on tax burden questions. This would be an expensive and burdensome process in itself.

"In our interviews with business officials and tax experts, we found that business tax compliance strategies usually were not done in isolation from other business operations; few of their activities were done solely or even primarily for tax reasons. More often, tax considerations affected the timing or structure of a business action not whether the action would occur. For example, a business in acquiring equipment would consider tax implications in terms of whether to buy or lease the equipment.

"Few of the businesses we spoke with could readily separate tax compliance costs from other costs of doing business. The integration of the tax compliance activities with other business activities makes it difficult and time-consuming to collect the information necessary from businesses to generate reliable cost estimates. For example, businesses said it would be difficult to take payroll expenditures and isolate those associated with tax compliance.

"Further, business respondents said that they do not routinely need, thus it does not make sense for them to collect, information on compliance costs. And, to separate tax compliance costs from other costs of doing business would be burdensome and of questionable usefulness to them.

"A few business officials provided estimates of some compliance costs, such as legal fees, payroll management fees, and tax software expenditures, but expressed limited confidence in their ability to provide accurate, comprehensive cost data. In addition, those few businesses that said they could isolate some of their tax compliance costs indicated that even in their cases, it would be difficult to separate federal compliance costs from state and local compliance costs.

"We reviewed seven studies issued since 1980 that provide some estimate of compliance cost associated with the federal and some state tax systems. **[We reviewed only those studies that produced original-source estimates and excluded those that made projections from these original studies.]** None of these studies attempted to provide an overall compliance cost estimate. Rather, they focused on specific taxpayer populations, such as large corporations, or a limited range of compliance activities, such as record-keeping and filing tax returns. Because of the limited scope, it would not be appropriate to use the estimates from these studies as the basis for estimating the compliance costs for other taxpayer groups, or for different time periods.

"These studies were also subject to the general difficulties inherent in data collection and analysis that limit efforts to obtain reliable cost data. Most used a questionnaire survey approach, sometimes along with group interviews and diary-usage record-keeping, and each has significant limitations. Each of these techniques requires taxpayers to respond accurately, completely, and consistently to compliance burden questions that may be difficult to interpret. The difficulties faced by businesses in answering these types of questions may in part be reflected in the low--less than 50 percent--response rate these studies achieved. The low response rate also affects the reliability of the estimates generated by the studies we reviewed."

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Reducing the Tax Gap: Results of a GAO-Sponsored Symposium (GAO/GGD-95-157, June 2, 1995).

Tax Compliance: Status of the Tax Year 1994 Compliance Measurement Program (GAO/GGD-95-39, Dec. 30, 1994).

International Taxation: Transfer Pricing and Information on Nonpayment of Tax (GAO/GGD-95-101, April 13, 1995).

International Taxation: Problems Persist in Determining Tax Effects of Intercompany Prices (GAO/GGD-92-89, June 15, 1992).

Tax Administration: Estimates of the Tax Gap for Service Providers (GAO/GGD-95-59, Dec. 28, 1994).

Tax Administration: IRS Can Better Pursue Noncompliant Sole Proprietors (GAO/GGD-94-175, Aug. 2, 1994).

Tax Administration: Approaches for Improving Independent Contractor Compliance (GAO/GGD-92-108, July 23, 1992).

Tax Administration: Compliance Measures and Audits of Large Corporations Need Improvement (GAO/GGD-94-70, Sep. 1, 1994).

Tax System Burden: Tax Compliance Burden Faced by Business Taxpayers (GAO/T-GGD-95-42, Dec. 9, 1994).

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