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Federal Tax Gap: Size, Contributing Factors, and the Debate over Reducing It

Nature of the Federal Tax Gap

The federal tax gap is a measure of overall taxpayer noncompliance in a specified period. The Internal Revenue Service (IRS) provides two estimates of the federal tax gap: a gross measure and a net measure. The gross tax gap is the difference between the total amount of federal individual and corporate income, employment, and estate and gift taxes owed in a year and the total amount of those taxes paid voluntarily on time. The net tax gap is the difference between all taxes owed and taxes paid after accounting for late taxpayer payments and taxes collected through IRS enforcement actions. This estimate does not consider the deterrent effects of IRS enforcement on taxpayer noncompliance.

The federal tax gap has three main components: failure to file, income underreporting, and tax underpayment.

There are several reasons why the federal tax gap may be a concern for policymakers. The gap represents uncollected revenue that the federal government could use for many purposes, including reducing the budget deficit. The gap imposes costs on compliant taxpayers that are not borne equally by noncompliant taxpayers (e.g., higher taxes in the future, cutbacks in beneficial government programs, and larger interest payments on federal debt to finance budget deficits). Sustained growth in the tax gap may undermine public confidence in the fairness and integrity of the federal tax system, encouraging more noncompliance.

Estimating the Federal Tax Gap

The IRS has been estimating the size and composition of the tax gap since 1979. Until 1989, the estimates for tax compliance were based on data obtained through the Taxpayer Compliance Measurement Program (TCMP). The data came from comprehensive in-person audits by IRS examination officers of random samples of individual, corporate, and employment tax returns. Many audited taxpayers found them burdensome, as they were required to provide supporting documents for every tax return line item. The IRS suspended use of the TCMP in 1988.

In 2000, the IRS adopted a different method of collecting individual tax compliance data known as the National Research Program (NRP), which is still in use today. To estimate compliance, the NRP uses a random stratified sample of about 13,000 taxpayers deemed representative of the entire filing population to select tax returns for audit. Random sampling provides information on both compliant taxpayers and noncompliant taxpayers who otherwise might be difficult to identify using the IRS's income detection tools. To estimate other components of the tax gap (e.g.,

corporate income and employment taxes), the IRS relies on a variety of data sources and empirical methods.

There are some deficiencies with the IRS's estimation methods that have raised some questions about the accuracy of its tax gap estimates. In a March 2023 report, the Treasury Inspector General for Tax Administration found that the IRS does not include estimates of all sources of taxpayer noncompliance in its tax gap estimates. For instance, in estimating income underreporting, the IRS excludes excise taxes; estate and trust taxes; unrelated business income taxes; some employment taxes; subchapter S corporate income; and individual income taxes for U.S. taxpayers with foreign addresses. It is unclear how much larger the income underreporting estimate would be if those sources were included.

Size of the Tax Gap

The most recent tax gap estimate by the IRS covers tax years 2020 and 2021. According to the report, the average gross gap in that period was a projected \$688 billion, which yielded a taxpayer net compliance rate of 86.2% for all federal taxes owed. Late payments and IRS enforcement actions resulted in a projected average net gap of \$582 billion.

As **Table 1** shows, between 2001 and 2021, the net federal tax gap (2021 dollars) reached its lowest level in 2001 (\$444 billion) and its highest level in 2021 (\$582 billion), with some ups and downs in between. The net taxpayer noncompliance rate was the same in 2001 and 2021, with the highest rate in 2008-2010 and the lowest rate in 2014-2016.

Table 1. Net Federal Tax Gap Estimates from 2001 to 2021

Year(s)	Billions of Current Dollars	Billions of 2021 Dollars	Net Taxpayer Noncompliance Rate ^a (%)
2001	\$290	\$444	13.7%
2006	\$385	\$516	14.5%
2008-2010	\$406	\$508	16.3%
2011-2013	\$380	\$450	14.2%
2014-2016	\$428	\$486	13.0%
2017-2019	\$481	\$514	13.2%

2020-2021	\$582	\$582	13.8%
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Source: Internal Revenue Service, Tax Gap Estimates; and Bureau of Labor Statistics, Annual Average Consumer Price Indexes.

- The percentage of federal taxes owed in a year that were not paid on time, after IRS enforcement actions and late taxpayer payments.

Sources of the Federal Tax Gap

The federal tax gap has three main sources: (1) understatement of tax liability through unreported income or overstated deductions, credits, and other income adjustments; (2) failure to pay taxes owed on time; and (3) failure to file a return on time.

Table 2. Components of the Gross Federal Tax Gap (billions of current dollars)

Components	2011-2013	2020-2021
Nonfiling	\$37 (8%)	\$65 (10%)
Underreported Income	\$349 (80%)	\$511 (79%)
Underpayment of tax	\$52 (12%)	\$69 (11%)
Gross Tax Gap	\$438	\$644

Source: Internal Revenue Service; Research, Applied Analytics, and Statistics; *Tax Gap Projections for Tax Years 2020 & 2021*, Publication 5869; October 2023.

As **Table 2** shows, underreported income is by far the largest source of the federal tax gap, accounting for 80% of the gross tax gap in 2011-2013 and 2020-2021. The three components' shares shifted little between the two periods.

The main source of the gross tax gap is individual income underreporting. In 2021, it accounted for 73% of total underreported income and 58% of the gross tax gap. Unreported individual business and nonbusiness income made up 74% of total individual underreported income and over 42% of the gross tax gap. Much of individual business income is subject to little or no withholding and information reporting, making it more difficult for the IRS to detect than wage, interest, and dividend income. According to IRS estimates, in 2014 to 2016, the net misreporting percentage for wages and salaries was 1%, but it was 15% for partnership and S corporation income and 55% for sole proprietor income.

Contributing Factors

IRS Resources

The sizes of the IRS budget and staff, especially for enforcement activities and taxpayer services, affect the tax gap through their impact on taxpayer compliance. Substantial decreases in those resources since FY2010 have resulted in sharp declines in audit rates for high-income individuals, partnerships, and large corporations.

Between FY2010 and FY2022, the IRS budget (measured as total obligations in 2022 dollars) declined 18%. The IRS's full-time equivalent workforce declined 17% in the same period, with higher rates of decline among employees

involved in examinations and collections (58%) and prefilling assistance (28%).

Income Visibility

Another force is the IRS's ability to track down taxable income. Income is easiest to track when it is subject to information reporting by third parties. Compliance is even greater when income is also subject to employer withholding, as is the case for wages and salaries. According to IRS estimates, underreported tax liability in 2021 was \$167 billion for income subject to little or no information reporting (e.g., farm income, sole proprietor income, rents, and royalties), but only \$9 billion for income subject to substantial reporting and withholding.

Tax Code Complexity

The federal tax gap is also thought to be influenced by the federal tax code's complexity. Frequent changes in tax provisions complicate tax filing for many individuals, leading to unintended errors that add to the tax gap. Tax code complexity also creates opportunities for taxpayers who can afford to hire tax professionals to reduce their tax liability through questionable interpretations of the code.

Inflation Reduction Act

The 117th Congress passed legislation intended, in part, to reduce the federal tax gap. Under the law, commonly known as the Inflation Reduction Act (IRA; P.L. 117-169), the IRS was to receive nearly \$79 billion in mandatory funding through the end of FY2031, in addition to its annual appropriations. (That amount was later reduced by \$21 billion between FY2023 and FY2025 by the Fiscal Responsibility Act of 2023 [P.L. 118-5].) The IRA specified that \$3 billion was to improve taxpayer services, \$46 billion to expand enforcement actions, \$25 billion to maintain and upgrade the IRS's information systems, and \$5 billion to accelerate the IRS's efforts to modernize its information technology infrastructure.

As enacted, the IRA has the potential to boost revenue collection. The Congressional Budget Office has estimated that the IRA funding would increase revenue by \$180 billion between FY2022 and FY2031.

Critics say that too much of the IRA funding for the IRS is targeted at enforcement and not enough at taxpayer services and information systems modernization. This emphasis on enforcement raises at least two perennial issues. One is the return on investment (ROI) from new enforcement actions tied to IRA. Such actions vary in their cost-effectiveness. Some argue that the IRS should invest its IRA enforcement funds in actions with the highest ROI.

The other issue is the impact of increased investment in tax enforcement on taxpayer rights. Some are concerned that substantial increases in enforcement may lead the IRS to devote less attention to the protection of taxpayer rights. As the National Taxpayer Advocate recently noted, the IRS's added investments in enforcement should avoid increasing taxpayer filing burdens, prioritize the protection of taxpayer rights, and heed the concerns of compliant taxpayers.

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