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INSIGHT

The Internal Revenue Service's Enforcement Budget and Tax Compliance

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This Insight examines key considerations in the debate over whether the Internal Revenue Service's (IRS's) current enforcement budget is adequate to improve tax compliance—especially among high-income persons and pass-through business owners.

IRS Enforcement Budget

The IRS enforcement budget funds a variety of activities, including auditing tax returns, collecting unpaid taxes, getting tax returns from individuals who did not file on time, and verifying information reported on tax returns with similar information from third parties.

Federal tax collection is based on a system of voluntary compliance by taxpayers. Increases in tax noncompliance, especially among taxpayers with income that might be relatively easy to conceal from the IRS, have the potential to erode public trust in the fairness and integrity of the federal tax system. A 2019 survey by the Pew Research Center found that 6 in 10 Americans believe that corporations and high-income persons do not pay their fair share of the federal income tax.

Since FY2010, there has been a significant decline in the IRS's outlays for enforcement, as **Table 1** shows. From FY2010 to FY2019, the IRS enforcement budget fell by over 16% (in nominal dollars), and the number of full-time-equivalent (FTE) IRS employees involved in collection and examination dropped by 36%.

Table 1. IRS Enforcement Budget and Selected Audits in Fiscal Years 2010 and 2019

	FY2010	FY2019	Percentage Change 2010 to 2019
Enforcement: costs incurred (billions of dollars)	$5.5	$4.6	-16.4%
Collections and examination workforce (end of fiscal year)	46,667	29,867	-36.0%

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	FY2010	FY2019	Percentage Change 2010 to 2019
Overall examination rate for individuals (%)	1.1%	0.4%	-63.4%
Examination rate for individuals with $1 million or more in income (%)	8.4%	2.4%	-71.4%
Examination rate for individuals with $200,000 to under $1 million in income with business income	2.9%	1.0%	-65.5%
Examination rate for C corporations with $20 billion or more in assets	98.0%	49.9%	-49.1%

Source: Congressional Research Service and *Internal Revenue Service Data Book, 2010 and 2019*.

Tax Compliance

As shown in **Table 1**, one result of these cutbacks in enforcement resources has been a sharp decline during the past decade or so in examination rates. This is a concern not only because less revenue is collected, but also because studies have shown that audits increase future tax compliance among people who are audited, as well as people who are not audited.

The best available measure of the extent of tax noncompliance is the federal tax gap, which the IRS estimates at irregular intervals; the most recent estimate covers the period from 2011 to 2013. This gap, which is measured in gross and net amounts, is the difference between the total amount of federal taxes owed in a year and the amount of those taxes paid in full and on time. According to the IRS, the annual gross tax gap averaged $441 billion from 2011 to 2013, or 16% of federal taxes owed, which meant that the overall tax compliance rate was 84%. After allowing for late tax payments and revenue collected through IRS's enforcement actions, the average annual net tax gap totaled $381 billion in that period. One way to think about the tax gap is to view it as a measure of the potential revenue that could be collected if the IRS had sufficient resources. It is not clear to what extent declines in audit rates after 2010 contributed to the tax gap.

The tax gap has three components: nonfiling among taxpayers required to file a return (9% of the 2011-2013 gross gap); underpayment of taxes owed (11%); and underreporting of taxable income on returns filed on time (80%). Underreporting of taxes occurs when a taxpayer understates taxable income and overstates tax credits, deductions, or income adjustments. Unreported noncorporate (or pass-through) business income is the largest subcomponent of the federal gross tax gap: from 2011 to 2013, it averaged an estimated $110 billion each year, or 25% of the gross gap. This income is difficult for the IRS to monitor (and thus tax) because much of it is not subject to the third-party information reporting and withholding that applies to wage income.

Options for Improving Tax Compliance

Concern about recent decreases in the IRS's enforcement resources has led some to call on Congress to invest more in IRS enforcement over a multiyear period. Proponents of this approach say that after a decade of reductions in staff, a primary challenge facing the agency is rebuilding its workforce. Employee compensation accounts for about 70% of the IRS's overall budget. A hiring freeze from FY2011 to FY2018 kept the IRS from bringing in new employees, and

45% of current employees are eligible for retirement in the next two years. As proponents point out, a key to the success of this approach is for the IRS to replenish its staff of revenue agents and examiners. The IRS added 35 FTE employees in FY2019.

Proponents contend that large increases in IRS's enforcement budget are likely to improve tax compliance and reduce the net tax gap. According to a recent report by the Congressional Budget Office, a cumulative $40 billion increase in IRS's enforcement budget between 2020 and 2030 would increase revenues by an estimated $103 billion, resulting in a $63 billion reduction in the federal budget deficit. The estimate is based on an assumed return on investment of $6.40 of added revenue for each additional dollar spent on enforcement.

Not everyone agrees that the solution to declining audit rates and persisting large tax gaps is to provide the IRS with more resources for enforcement. Some maintain that the agency already has adequate resources to address those issues and must do a better job of using the funds if the IRS is to improve tax compliance. To illustrate their point, some opponents of large increases in IRS's enforcement resources cite the cost overruns and delays that have repeatedly beset the agency's business systems modernization program, which began in the early 1990s as the successor to two earlier failed modernization efforts.

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