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

Federal Tax Gap

The federal tax gap is a measure of taxpayer noncompliance. The Internal Revenue Service (IRS) provides two estimates of the gap: a gross measure and a net measure. The gross federal 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 in full and on time. The net tax gap is the difference between all taxes owed and taxes paid after late taxpayer payments and taxes collected through IRS enforcement actions.

The federal tax gap may be a concern for policymakers for several reasons. First, the gap represents tax revenue that the federal government could use for many purposes, such as reducing the budget deficit or paying for new programs. Second, the gap imposes costs on compliant taxpayers that are not borne to the same extent by noncompliant taxpayers (e.g., higher taxes in the future, cutbacks in beneficial government programs, and interest payments on federal debt to finance budget deficits). Third, sustained growth in the tax gap can undermine public confidence in the fairness and integrity of the federal tax system.

Estimating the Federal Tax Gap

The IRS has been estimating the size and composition of the tax gap since 1979. Pre-1989 estimates were based on compliance data collected through the Taxpayer Compliance Measurement Program (TCMP). The data were collected through comprehensive in-person audits done by IRS examination officers; audited taxpayers had to provide documents supporting every tax return item.

Public and congressional opposition to the TCMP's burden on audited taxpayers led the IRS to adopt, in 2000, a different method of collecting compliance data known as the National Research Program (NRP). To estimate compliance with the individual income tax, the NRP employs a random sample of audits of about 13,000 taxpayers deemed representative of the entire filing population. Random sampling has the advantage of providing information on both compliant taxpayers and noncompliant taxpayers who otherwise might be difficult to identify using 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.

Recent IRS Research on the Tax Gap

The most recent tax gap study covers the years 2011 to 2013. According to the IRS, the average annual gross gap totaled $441 billion in that period, or about 16% of total average annual federal taxes owed. Late payments and IRS enforcement actions produced a net gap of $381 billion. This estimate makes no allowance for the extent to which IRS's enforcement actions deter taxpayer noncompliance, which some studies have suggested could be substantial.

As **Table 1** shows, the estimated net federal tax gap in 2020 dollars fluctuated within a range from 2001 to 2013, where the highest value ($491 billion) was about 11% larger than the lowest value ($423 billion). A similar result applied to estimated taxpayer noncompliance rates: the highest net taxpayer noncompliance rate (16.3%) was about 19% larger than the lowest such rate (13.7%). Although the table covers only four periods, the results do not show that the federal tax gap has steadily grown over time. Estimates for periods after 2013, which are not currently available, may produce a different pattern.

Table 1. Net Federal Tax Gap from 2001 to 2013

($ billions)

Year(s)	Current Dollars	Constant 2020 Dollars	Net Taxpayer Noncompliance Rate[a] (%)
2001	$290	$423	13.7%
2006	$385	$493	14.5%
2008-2010	$406	$491	16.3%
2011-2013	$381	$431	14.2%

Source: Internal Revenue Service, Tax Gap Estimates; and Bureau of Labor Statistics, Annual Average Consumer Price Indexes.

a. The percentage of total taxes owed in a year that were not paid in full and on time after IRS enforcement actions.

Components of the Federal Tax Gap

The federal tax gap has three main components. One is the understatement of tax liability through underreporting income or overstating deductions, credits, and other income adjustments. A second component is the failure to pay the full amount of taxes owed when filing a tax return on time, or tax underpayment. The third element is the failure to file a required return on time, or non-filing.

The IRS estimated that 80% ($352 billion) of the gross tax gap for 2011 to 2013 could be attributed to understated tax liability. Underpayment of taxes accounted for 11% ($50 billion) of the gap, and non-filing for 9% ($39 billion).

Individual taxpayers understated their average annual income tax liability by an estimated $245 billion from 2011 to 2013 (56% of the gross tax gap and 70% of total understated tax liability). According to the IRS, most of this understated tax liability stemmed from three sources: (1) underreported noncorporate business income ($110 billion or 45% of understated tax liability); (2) underreported nonbusiness income ($57 billion or 23% of understated tax liability); and (3) overstated tax credits ($42 billion or 17% of understated tax liability).

Contributing Factors

Several factors are thought to play key roles in the size and composition of the federal tax gap.

IRS Resources

The size of the IRS budget and its staff, especially for enforcement activities and taxpayer services, are likely to contribute to the tax gap through their impact on taxpayer compliance. Recent decreases in those resources have led some to express the concern that an underfunded IRS is setting the stage for rapid growth in the federal tax gap.

Between FY2010 and FY2019, IRS's enforcement budget and staff declined more than did the overall IRS budget and workforce. These cutbacks included a 40.5% reduction in the number of revenue agents, who handle the most complex enforcement cases, and a 45.5% reduction in the number of field collection officers. These declines resulted in declines in the audit rates during that period for all taxpayers. For example, in a development with implications for the federal tax gap, audit rates for individuals with incomes above $1 million fell 61% between 2010 and 2018.

IRS's prefiling assistance and education programs help individuals avoid the unintended errors that cause some taxpayers not to file a required return, pay less tax than they owe, and underreport their income. From FY2010 to FY2019, IRS's staffing for this purpose decreased 31.5%.

Income Visibility

Another factor is thought to be the visibility of income to the IRS. This refers to the extent to which the IRS can detect taxable income. Income is most visible when it is subject to substantial information reporting by third parties. Compliance is even greater when income is subject to employer withholding, as is the case with most wage income. According to IRS estimates, the amount of understated tax liability in 2011 to 2013 was an average $109 billion for income subject to little or no reporting (e.g., farm income, sole proprietor income, rents, and royalties). In contrast, understated tax liability was $9 billion for income subject to substantial reporting and withholding (e.g., wages and salaries).

Tax Code Complexity

The federal tax gap is also thought to be a product of tax code complexity. Complicated (and frequently changing) tax provisions likely make it difficult for many individuals to fulfill their tax obligations without committing errors that can contribute to the federal tax gap. Tax code complexity may also create opportunities for taxpayers who can afford to hire tax accountants and attorneys to reduce their tax liability through questionable tax law interpretations.

Policy Issues

The 117th Congress is considering options for decreasing the federal tax gap. Attention has largely focused on proposals to increase IRS's resources, especially for enforcement, over a multiyear period. For example, the Biden Administration has called for a multiyear $79.2 billion increase in IRS funding between FY2022 and FY3031 to help reduce the federal tax gap. Nearly 70% of those funds would be used to expand IRS's enforcement activities. The Administration estimates that the plan would collect $316 billion in gross revenue over that period. The plan would also regulate paid tax preparers and require new information reporting for certain taxpayer transactions with banks.

Proposals such as this raise several policy issues. One issue is the return on investment (ROI) of new enforcement actions. Although an increase in these actions is likely to raise more revenue than their cost, enforcement activities vary in their cost-effectiveness and the amount of revenue they collect. Some say the IRS should have a better understanding of the reasons for this variation so it can maximize its ROI on new enforcement activities.

The success of efforts to shrink the tax gap may depend, in part, on the size and composition of the gap. These details might be crucial in designing effective strategies for reducing taxpayer noncompliance. There is some dispute about the size of the current gap. An updated estimate from the IRS is unlikely to be released before 2022. In testimony given at a congressional hearing in April 2021, IRS Commissioner Charles Rettig stated that the current gross federal tax gap could total as much as $1 trillion. Not everyone agrees with this assessment, including former National Taxpayer Advocate Nina Olson.

Some argue that a permanent reduction in the tax gap involves more than giving the IRS more resources; the federal tax code should also be simplified. In their view, tax simplification would make it possible for more taxpayers to meet their tax obligations on their own with fewer errors. And clarifying ambiguous areas of the tax code may make it harder for corporations and high-income individuals to prevail in disputes with the IRS over the legality of their tax minimization strategies.

Another policy issue is the impact of tax-gap reduction proposals on taxpayer rights. Some argue that reducing the tax gap will also require major new investments in IRS's information technology and employee training, a greater emphasis on taxpayer services, and a redesign of its information systems. These changes, in their view, should be made without increasing taxpayer burdens, violating taxpayer rights, and disregarding the needs of compliant taxpayers.

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