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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 former 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. In effect, it represents the amount of federal taxes that never will be paid or collected.

The federal tax gap has three main components: nonfiling, income underreporting, and tax underpayment.

The federal tax gap may concern policymakers for several reasons. First, the gap represents uncollected 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 may 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 obtained through the Taxpayer Compliance Measurement Program (TCMP). The data were based on comprehensive in-person audits done by IRS examination officers. Audited taxpayers had to provide documents supporting every tax return item. Many found these audits burdensome.

Congressional opposition to the TCMP's audits 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 uses 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 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.

But there are some gaps in the IRS's estimation methods that raise questions about the accuracy of its tax gap estimates. In a March 2023 report, the Treasury Inspector General for Tax Administration reviewed the IRS's estimation methods for the tax gap. It found that the IRS does not include estimates of all sources of taxpayer noncompliance in its tax gap estimates. For instance, in its estimate of income underreporting, the IRS excludes excise taxes, estate and trust taxes, as well as some corporate income, individual, employment, and unrelated business income taxes.

Size of the Tax Gap

The most recent tax gap study by the IRS covers the years 2014 to 2016. According to the study, the average annual gross gap totaled $496 billion in that period, or about 15% of total average annual federal taxes owed. Late payments and IRS enforcement actions produced a net gap of $428 billion. This estimate does not consider the effect of IRS enforcement on taxpayer noncompliance.

As **Table 1** shows, between 2001 and 2016, the net federal tax gap (2021 dollars) reached its lowest level in 2001 ($444 billion) and its highest level in 2006 ($516 billion), and then trended downward to 2016. Similarly, the net taxpayer noncompliance rate rose 2.6 percentage points from 2001 to 2008-2010 and then fell 3.3 percentage points by 2014-2016.

Table 1. Net Federal Tax Gap Estimates from 2001 to 2016
($ billions)

Year(s)	Current Dollars	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	$488	13.0%

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

a. 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, or nonfiling.

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

	2011-2013	2014-2016
Nonfiling	$37	$39
Underreported Income	$349	$398
Underpayment of tax	$52	$59
Gross Tax Gap	**$438**	**$496**

Source: Internal Revenue Service; Research, Applied Analytics, and Statistics; *Tax Gap Estimates 2014-2016 (And Projections for 2017-2019)*, Publication 5364; August 2022.

As **Table 2** shows, unreported income is by far the largest source of the federal tax gap. In 2011-2013, it accounted for nearly 79.6% of the gross tax gap; income underreporting made up 80.2% of the gap in 2014-2016.

Noncompliance with the individual income tax underlies each component. In 2014-2016, this noncompliance accounted for 72% of the gross tax gap, with unreported individual income making up 56% of the gap. Of all the sources of unreported income, according to the IRS, the largest amount was $130 billion in unreported business income, which accounted for 26% of the gross tax gap. This income is subject to no withholding and little or no information reporting, making it harder for the IRS to track than wage, interest, and dividend income. There is reason to think that much of the unreported business income is attributable to sole proprietorships and partnerships, and thus subject to the individual income tax.

Contributing Factors

Several forces 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, affect the tax gap through their impact on taxpayer compliance. Decreases in those resources since FY2010 have fueled a concern that an underfunded IRS is setting the stage for further growth in the federal tax gap.

Between FY2010 and FY2019, the IRS budget (measured in 2021 dollars) declined 20.4%. The IRS's inflation-adjusted enforcement budget and staff declined more than the IRS budget and workforce did. 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 decreases in audit rates during that period for all taxpayers. This included a 61% drop in the audit rate from FY2010 to FY2018 for individuals with incomes above $1 million.

The IRS's prefiling assistance and education programs help individuals avoid the unintended errors that can contribute to the federal tax gap. From FY2010 to FY2019, the IRS's staffing for this purpose decreased 31.5%.

Income Visibility

Another factor is the ability of the IRS to track taxable income. Income is most visible to the IRS when it is subject to information reporting by third parties. Compliance is even greater when income is subject to employer withholding, as happens with most wage income. According to IRS estimates, the amount of understated tax liability in 2014 to 2016 was an average $126 billion for income subject to little or no reporting (e.g., farm income, sole proprietor income, rents, and royalties), but only $7 billion for income subject to substantial information 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, ever-changing tax provisions make it difficult for many individuals to pay their taxes owed without committing unintended errors that add to the federal tax gap. Tax code complexity also creates opportunities for taxpayers who use the services of tax professionals to reduce their tax liability through questionable interpretations of tax law and regulations.

Policy Issues

The 117th Congress passed legislation that is 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 is receiving nearly $79 billion in mandatory funding for its main activities through the end of FY2031. Of that amount, $3.2 billion will be used for improving taxpayer services, $45.6 billion for bolstering enforcement, $25.3 billion for operations support upgrades, and $4.75 billion for advancing the IRS's business systems improvement program. The IRS issued a "strategic operating plan" in early April 2023 that outlines how the agency expects to use those funds to achieve certain goals, mostly related to taxpayer services, enforcement, and information technology.

The IRA funding raises several issues. One is the return on investment (ROI) from new enforcement actions. Although such actions might raise more revenue than their cost, enforcement activities vary in their cost-effectiveness. Some say that the IRS should focus its added resources on actions with the highest ROI.

Another issue is the impact of greater investment in tax gap reduction on taxpayer rights. Many are concerned that IRA-funded increases in enforcement may lead the IRS to lower its regard for taxpayer rights. In their view, whatever investments the IRS makes in improving taxpayer compliance, it should avoid increasing taxpayer filing burdens, prioritize the protection of taxpayer rights, and heed the concerns of compliant taxpayers.

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