THE EFFECT OF TAX ENFORCEMENT ON REVENUES

Statement of
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before the
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Ways and Means Committee,
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MINDING THE TAX GAP: IMPROVING TAX ADMINISTRATION FOR THE 21ST CENTURY

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* The views expressed are my own and should not be attributed to the Urban-Brookings Tax Policy Center, the Urban Institute, the Brookings Institution, their boards, or their funders.
Chairman Pascrell, Chairman Thompson, Ranking Member Kelly, Ranking Member Smith, and members of the committee, thank you for having me here today to talk about the tax gap and improving tax administration for the 21st century. The views I express today are my own and should not be attributed to the Urban-Brookings Tax Policy Center, the Urban Institute, the Brookings Institution, their boards, or their funders.

In this short testimony, I’d like to make four main points:

1. A decade of deep cuts to the Internal Revenue Service (IRS) budget has hindered its ability to administer an increasingly complicated tax code.
2. Increasing the IRS enforcement budget would generate more revenue than it would cost.
3. Boosting the number of audits is not a sufficient revenue-raising measure, however, without improvements in the selection and operation of examinations.
4. Before the IRS can hire and train new staff and invest in 21st century technology, the agency must be assured of sustained funding not only for this year but for future years as well.

**A Decade-Long Reduction in the IRS Budget**

Since 2010, Congress has cut the IRS budget 23 percent after adjusting for inflation. The biggest cuts have occurred in the enforcement account, with funding falling by nearly $2 billion (26 percent) from 2010 levels.

Those reductions have been accompanied by other developments that affect the IRS’s efficiency, including significant expansions of the agency’s role, the steady departure of its most skilled staff, and the depreciation of its computer systems. Those cutbacks contribute to a steep decline in audit rates and potential increase in noncompliance.

**Funding for New Responsibilities**

As IRS appropriations declined, Congress enacted legislation that assigned new responsibilities to the agency, including

- administration of new tax credits for health insurance coverage and the enforcement of health coverage mandates (through the Affordable Care Act in 2010);
- processing of reports of financial assets held abroad by US citizens and related enforcement actions (through the Foreign Account Tax Compliance Act in 2010);

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1 The 2010 amounts were adjusted to 2021 levels. For personnel costs, inflation was measured using the employment cost index for wages and salaries of private industry workers; for all other spending, the measure of inflation was the chain-type price index for the US gross domestic product. The 2021 funding level does not include an additional $2.4 billion in appropriations authorized by the COVID-Related Tax Relief Act of 2020 (part of the Consolidated Appropriations Act, FY 2021) and the American Rescue Plan of 2021. Over 60 percent of that amount was earmarked for the implementation of the second and third rounds of the economic impact payments and the development of advance payments of the child tax credit. The remaining portion was primarily for computer modernization.
acceleration of processing and matching of W-2s to tax returns combined with a delay of payments of certain refundable tax credits so that claimants’ earnings could be verified (through the Protecting Americans from Tax Hikes Act in 2015);

major changes to the tax code in the Tax Cuts and Jobs Act, or TCJA, in 2017; and

three rounds of economic impact payments (the Coronavirus Aid, Relief, and Economic Security Act and the Consolidated Appropriations Act, FY 2021, both in 2020, and the American Rescue Plan in 2021).

In some cases, Congress provided the IRS with funds to implement those new responsibilities. The most recent example was the economic impact payments. During 2020 and 2021, the IRS received nearly $1.5 billion for the roll-out of those payments to over 160 million recipients, many of whom received their payments within two weeks of enactment of each round of payments.

In contrast, the IRS only received about $400 million in start-up funds for the implementation of the TCJA in 2018 and 2019. But that funding was not sustained, even as the Treasury and the IRS continued through 2020 to publish new guidance to taxpayers. For examiners, the TCJA means auditing pre-2018 tax returns under one set of tax laws and post-2017 returns under a different set. Moreover, examiners must take time away from audits to receive training and guidance on the new law.

**Decline in Staffing**

Even before the recent cutbacks in IRS funding, the agency’s workforce was shrinking. The average number of full-time-equivalent staff fell from about 112,000 in 1990 to nearly 95,000 in 2010. From 2010 to 2019, however, the number of full-time equivalent staff decreased by more than it had in the prior 20 years—a drop of an additional 21,000 full-time equivalent staff—in large part because of the combination of a seven-year hiring freeze and a workforce reaching retirement age.

Over two-thirds of the decrease in personnel occurred in examinations and collections, with full-time equivalent staff declining from about 45,000 in 2010 to fewer than 30,000 in 2019. Revenue agents and officers are trained to conduct the most difficult types of audits and collections, but their numbers fell by almost half, from nearly 20,000 in 2010 to about 11,500 in 2019.

**Outdated Technology**

The IRS’s ability to enforce the tax code is also closely linked to the state of its computers and the long-term challenges of the IRS’s computer modernization program. A 2016 report from the

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Government Accountability Office found that the IRS’s individual master file and business master file still relied on computer programming language developed more than 50 years ago.\(^5\)

**Falling Audit Rates**

In total, the number of audits fell from 1.7 million in 2010 to 771,000 in 2019.\(^6\) The audit rate, defined as the ratio of the number of audits closed in a fiscal year to the number of tax returns filed in the prior tax year, fell from 0.9 percent in 2010 to 0.4 percent in 2019.

The simplest type of audit is conducted through correspondence with the taxpayer and focuses on a small number of selected items (such as whether a child is related to and resides with the taxpayer, which are criteria for determining eligibility for child-related tax benefits). In response to a letter from the IRS, taxpayers must provide documentation to support their claims. Taxpayers who claim the earned income tax credit (EITC) are the subject of about half of correspondence audits, and most EITC audits are conducted through correspondence.\(^7\)

Other audits are conducted in person, such as in an IRS office, the taxpayer’s home or place of work, or elsewhere. The scope of the in-person audits can extend to all items reported on the tax return. Although audit rates have fallen for both types of audits, about a quarter of audits in both 2010 and 2019 were conducted in person.

The overall audit rate of less than 1 percent masks large differences among the affected taxpayers. Certain segments of the population are more likely to be targeted for audits than others, although the percentage-point drop in audit rates has been higher for some groups than others.

- In 2010, the audit rate was 0.5 percent for taxpayers with relatively simple returns: they had positive income under $200,000, no self-employment income, and did not claim the EITC. That rate fell to 0.1 percent by 2019.
- Among EITC claimants, the audit rate was 2.4 percent in 2010, dropping by 1.3 percentage points between 2010 and 2019, to 1.1 percent.
- For individual taxpayers with positive income of $1 million or more, the audit rate fell from 8.4 percent in 2010 to 2.4 percent in 2019.
- And nearly all the largest corporations (those with $20 billion or more of assets) were subject to audits in 2010. By 2019, about half were audited.

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Impact of Reduction in Audits on Compliance

We do not know how the drastic cutbacks in the IRS budget have affected compliance. Using data from various sources, including random audits of individual taxpayers and operational audits of other taxpayers, the IRS estimated that the annual tax gap (i.e., the difference between what taxpayers paid on time and what they truly owed) was, on average, $441 billion from 2011 through 2013. Taking into account late payments and the IRS’s enforcement actions, that amount dropped to $381 billion, or about 14 percent of total taxes owed.⁸

Last month, IRS Commissioner Charles Rettig suggested that the size of the annual tax gap could be as much as $1 trillion.⁹ He based that assessment largely on a study by IRS and academic researchers, who determined that the official estimates understated overseas evasion and underreported partnership income.¹⁰ That study has sparked a lively debate among tax analysts as to the methodology used to measure the tax gap.

That discussion, however, does not address a fundamental question for policymakers: Has the reduction in audits led to an increase in noncompliance, and how much would that increase be? We will not be able to address that question for several years because of the lag in audit data, but generally theory and evidence concludes, reasonably, that a reduction in enforcement leads to more noncompliance. A sense of civic duty and concerns about getting caught may keep most people honest.¹¹ However, the extensive press coverage of declining audit rates has revealed vulnerabilities in tax enforcement that are likely to encourage more noncompliance.

Investing in IRS Resources Would Raise More Revenue Than It Would Cost

The IRS measures enforcement revenue as the sum of revenue from the examination program, the collection program, and the automated underreporting program. The agency’s measure includes the amount collected in a fiscal year, which will include tax, interest, and penalties from multiple years. As enforcement funding fell after 2010, enforcement revenue also declined, from $68 billion in 2010 to $51 billion in 2020 (2020 dollars).¹²

Nonetheless, a decline in resources could cause enforcement revenues to increase relative to the costs of audits and related enforcement actions. For any level of appropriations, the IRS could—ignoring all other considerations—select the cases known to have the highest return on investment

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(ROI) to be audited. Therefore, as appropriations fall, the average return on investment would increase.

Dr. Jamie McGuire and I have been exploring this question in our research. In our most recent work, we used the Enforcement Revenue Information System, a confidential IRS database that follows enforcement actions from inception to collections, to compare the costs of examinations that were initiated or in progress in 2010 and 2017. For comparability between those two years, we followed each audit through the end of March in 2012 and 2019, respectively. The ratio of collections to costs is the ROI.

Excluding interest and penalties, the average ROI for 2010 audits was 3.6:1 for all types of audits. But the ROI just for correspondence audits was 11.1:1, a sizable difference from the 3.3:1 ROI for in-person audits.

From our analysis, we observed two reasons for those differences. First, correspondence audits required, on average, much less time than in-person audits, taking two hours compared with 34 hours for in-person audits. Another difference was in the pay grades of examiners assigned to a case. The highest-paid examiners—typically at the general schedule grades ranging from 12 to 14—were responsible for most of the hours worked on in-person audits. For correspondence audits, nearly all the hours were attributed to IRS personnel at general schedule grades 5 through 8. That finding is indicative of how difficult it would be to shift IRS employees from correspondence audits to in-person audits.

We find, on average, that ROIs fell slightly between 2010 and 2017. The average ROIs for the low-cost correspondence audits increased to 14.9:1, but those for the more expensive, face-to-face audits declined to 2.8:1. Driving those changes were greater reliance on workers at lower pay grades for correspondence audits and a greater reliance on higher-grade examiners for in-person audits, and a 24 percent increase in the average hours per in-person audit.

To put ROIs into perspective, it’s worth noting that the amount of revenues associated with in-person audits is significantly higher than the amount collected from correspondence audits. For an in-person audit conducted in the field—the most intensive type of audit—the amount of taxes per audit, on average, was about 10 times that for correspondence audits in 2010; for audits conducted in 2017, field audits collected an average of 8 times as much as those conducted through correspondence.

Separately, we computed the ROI for 2010 audits, inclusive of penalties and interest and collections through March 2019. The overall ROI was 5.7:1.

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14 Because of difficulties in identifying pre-refund audits, we omitted EITC audits from our analysis. Outliers—defined as audits resulting in collections in the top 0.5 percent for each audit type—were also dropped from our analysis.
Both Quantity and Quality of Audits Matters

Our analysis thus far has focused on the cost portion of ROI. However, other data reveal some disturbing trends in audit assessments that might have contributed to the fall in the returns since 2010.15

A “no change” audit happens when taxpayers substantiate the income, deductions, and credits they claimed on their tax returns. Because the IRS spends money to conduct the audit and receives no additional payments, those audits generate zero return on investment for the government.

On average, the no-change rate was 11 percent for audits of individual income taxpayers in 2019, a drop of 3 percentage points from 2010. In contrast, the average no-change rate for large corporations (those with $10 million or more in assets) rose from 28 percent in 2010 to 38 percent in 2019. In other words, nearly 40 percent of audits of large corporations did not change the tax bill for those businesses.

Some audits end even more favorably for taxpayers. Overall, 3 percent of taxpayers received a refund after an audit in both 2010 and 2019. But the share of large corporations receiving a refund after an audit rose from 16 percent to 18 percent. In both 2010 and 2019, roughly 38 percent of audits ended favorably—either with no change or with a refund—for taxpayers with positive income in excess of $1 million, although the share of those favorable audits resulting in refunds grew between 2010 and 2019.

From the available data, we cannot discern why so many audits ended favorably for large corporations and wealthy individuals. Indeed, the favorable results would likely have been higher after appeals and litigation. Was that because of poor targeting? Or was it because highly skilled tax advisers successfully framed their clients’ very aggressive tax positions as legal avoidance rather than illegal evasion?

More generally, are these high no-change rates indicative of shortcomings in the IRS’s enforcement actions targeted to taxpayers with complicated returns and the resources to afford skilled advisors? Improving the quality of those enforcement activities—perhaps in combination with additional clarity in tax law and regulations—may help improve compliance as much as increasing the number of audits.

Administration’s Budget Proposal

President Biden has proposed a special investment in the IRS of $79.2 billion over the next 10 years, comprising $6.7 billion for a program integrity initiative and $72.5 billion for a new mandatory

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program. The funding for the mandatory portion would be increased incrementally each year, in recognition that the IRS cannot absorb billions of additional dollars immediately.\(^{16}\)

Of this amount, roughly 70 percent would be allocated to enforcement activities. Over the next decade, the administration estimates that the plan would yield $320 billion, producing a net reduction in the deficit of $240 billion: a 4:1 return on the total proposed investment in the IRS over the next 10 years. Relative to the funding earmarked solely for enforcement, the average ROI over the decade would be between 5.5:1 and 5.9:1. Based on my research with Dr. McGuire, those ROIs seem reasonable once the programs are fully in place.

But all estimates are uncertain. What would cause the actual ROI to differ from the administration’s or our estimates?

**How long it will take for the new programs to be fully in place.** It takes as long as five years to hire and train a new employee to become an expert revenue officer;\(^{17}\) perhaps less than half that time if the IRS can lure midlevel professionals from their more lucrative private-sector jobs.\(^{18}\) Experienced examiners will do much of that training, limiting their ability to audit the complex returns filed by the wealthy and big businesses.

Sophisticated computer algorithms can help detect fraudulent claims, but they also take time to develop. And the IRS must continue to update them with new information about taxpayers’ evasion strategies.

The IRS assumes that the return on investment for its program integrity proposal does not peak until at least the third year of the initiative, with the ROI on expansions in audits and collections growing from 2.3:1 in fiscal year 2022 to 8.5:1 in fiscal year 2024. The longer it takes the IRS to staff up and improve its detection strategies, the lower the 10-year average ROI will be.

**The components of the plan.** For its fiscal-year 2022 program integrity proposal, the IRS has provided some details on how the additional funding will be allocated among audits and collections and the ROIs for each component. The Biden administration has not provided more information on how mandatory enforcement funds would be used other than for audits of individuals and businesses with the highest incomes and corporations and that audit rates would not rise relative to recent years for those earning less than $400,000. Unanswered still is how high-income taxpayers would be distinguished from those with actual incomes below $400,000, as actual income cannot be determined until the audit is completed. The success of this effort may rest on much-needed (but uncertain) technological innovations funded under the proposal.

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Whether the IRS can outgun the competition. It's not enough for the IRS to increase audits; the audits must also be productive. As I noted, many audits of large corporations result in favorable findings for large corporations and wealthy individuals. The IRS needs to figure out the causes of these unproductive audits so that it can efficiently allocate its resources.

A related worry is that targeting wealthy individuals and corporations will encourage some tax evaders to find new ways to stay under the IRS’s radar. Catching them will require ever-more sophisticated detection skills.

Finally, improvements in tax administration could be facilitated by changes in tax laws and regulations that would eliminate gray areas in the tax code. Those gray areas enable sophisticated taxpayers and their tax advisers to successfully argue in disputes with the IRS that their aggressive positions constitute legal avoidance rather than illegal evasion.

How multiyear budgeting will work. Currently, the IRS receives nearly all its funding through the annual appropriations process. That process provides no guarantee of sustained funding in future years. What happens to the president’s investment plan if the IRS’s funding continues to be provided mainly through the annual appropriations process? If Congress agreed to appropriate funding for the FY 2022 investment plan, the IRS would receive the $417 million increase in enforcement funding for that year but no assurance of funding in the following year. The ROI for that one-year increase would be less than 2:1, yielding about $725 million, with just about half collected immediately.

The president is proposing multiyear budgeting by removing part of the IRS’s budget from Congress’s annual appropriations process and making that portion of funding automatic. That’s a very smart move. The IRS needs to make long-term commitments for staffing and capital investments and must be able to pay the bills for, say, multiyear information technology projects that come due in later years.

But making just a portion of the IRS’s budget mandatory would require safeguards. Without some guardrails, future administrations and congresses might bow to temptation and shift funding for base activities to the mandatory portion of the budget.

Whether voluntary compliance will increase? The Treasury’s estimates do not assume that people will voluntarily become more compliant as a result of audits. Just as I am concerned that recent reductions in audits may have reduced compliance, I can envision scenarios in which voluntary compliance would increase in response to a higher risk of audit. The lack of details on the IRS’s plans for the funding, though, make that assessment difficult, as well as insufficient evidence from economic research on which to base those estimates.

Conclusion

Regardless of those concerns, one thing is certain: Increasing the IRS’s enforcement budget will yield revenues far in excess of costs. And those savings will show up where it matters the most—an increase in actual federal revenues, a smaller deficit than would otherwise be the case, and perhaps an increase in public confidence in the integrity and fairness of the US tax system.