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Floor Statement of Sen. Chuck Grassley
Tax Gap: Blue Smoke
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Mr. President, I want to speak about the tax gap. The tax gap is the difference between what is paid voluntarily in taxes and what is actually owed. It does not include the underground economy or illegal earnings. The tax gap is certainly not a new issue. It has been an issue for previous administrations. In fact, I suspect the tax gap has been an issue for as long as we have had taxes.

However, I would say that in recent years the Finance Committee has certainly brought a new focus on the tax gap. This has been very much a bipartisan effort. But I believe the level of attention given to the tax gap certainly reflects the energy and focus of Chairman Baucus. Chairman Baucus should be commended for his work in this area. I also want to praise the Chairman of the Budget Committee, Senator Conrad, for putting a spotlight on the tax gap problem.

The Finance Committee has been doing the hard work in this area – encouraging greater research by the IRS; asking for detailed reports and recommendations from Treasury and the Joint Committee on Taxation; investigating specific aspects of the tax gap; holding hearings to explore the details of the tax gap; and, most difficult of all, actually passing significant legislation to address certain pieces of the tax gap.

It has not been easy. I find that the tax gap is one of those issues here in Congress that is a little like the weather: Everyone wants to talk about it but no one is doing anything about it. But the way people talk around here, they view that the tax gap is a "cure-all." Have to pay for AMT? Tax gap. Want to expand spending on health care? Tax gap. Balance the budget? Tax gap. Given the amount of faith people have put into it, tax gap has suddenly become one of those magic elixirs the peddlers used to sell in the old west. "It will cure what ails you" was the slogan the slick salesmen used to say. And so the tax gap has become the elixir for all fiscal problems. I'm surprised folks don't think the tax gap can cure baldness.

So let's get behind the dreams, and get to the real story of the tax gap. Mr. President, I want to now talk about three issues. First, what is the estimate of the tax gap?; second, what are the elements of the tax gap?; and, finally, how do we reduce the tax gap?

First, how is the tax gap estimated and what is it. The Senate Finance Committee's Subcommittee on Taxation and IRS Oversight held a hearing in July 2006, chaired by Senator Kyl, that heard extensive testimony from senior IRS officials about how the tax gap is estimated.

The tax gap has been based on reporting compliance efforts, known as the Taxpayer Compliance Measurement Program (TCMP). As many colleagues will recall, these efforts were viewed as too intrusive into the lives of taxpayers.

So the last TCMP that was done was in 1988. Senator Baucus and I recognized the need for updated research and encouraged the IRS to look at research that could provide useful data and information without unduly burdening taxpayers. The IRS responded with the National Research Program (NRP).

It is important to realize that the NRP only dealt with a portion of the entire tax gap – primarily focusing on individual income taxes. There are still significant portions of the tax gap that are based on very old material – particularly in the area of pass-through entities.

This is easily brought to focus on the IRS chart we have here (Tax Year 2001 Federal Tax Gap). You can see that it is only those items in bold that have been updated from the recent NRP, primarily in the area of individual income tax and self-employment tax.

With the colors, you can see that it is only with the green – underpayment of taxes – that we have high confidence.

The light blue has been recently updated so that we have some better sense of what the costs are.

Unfortunately, it is the yellow that is dependent on older numbers – sometimes going back years and years.

In terms many can understand better, think of the yellow estimates as being the broad side of the barn in terms of accuracy.

So there we have it, at the end of the day, the tax gap, based on many old estimates, is thought to be $345 billion for tax year 2001. That reflects a noncompliance rate of 16.3%. So basically 84% of the tax dollars come in as required, and we have a tax gap with the remaining 16%.

Now let me turn to what are the elements of the tax gap. Again, the chart from the IRS provides a useful blueprint. Nonfiling is $27 billion – these are people who don't even file their taxes. Then there is "underreporting" of $285 billion.

The IRS divides that into four categories of individual income tax at $197 billion; employment taxes at $54 billion; corporate income tax at $30 billion; and, estate and excise taxes of $4 billion. Underpayment of taxes – which is the amount people admit they owe on their returns but don't pay on time – is $33 billion.

So clearly, individuals make up the biggest part, with individuals underreporting non-business income and business income; and overstating adjustments, deductions and exemptions being the elements of the tax gap for individuals. A good deal of this is concentrated in the area of self-employment and the Schedule C of the tax return.

Now that we have talked about how we measure the tax gap and what makes up the tax gap – what can be done? I believe that the real question is, is this: What steps can be taken that are effective and will not unduly burden taxpayers? We have to bear in mind that most taxpayers do comply with the law and a significant amount of noncompliance is unintentional.

I think that all members recognize that in our zeal to get at the tax gap we cannot wreck the lives of the honest taxpayers. We can't be like a fellow who tears down his house to get at a mouse.

The members on the other side should be particularly sensitive to this mindset, given that this was effectively what was being promoted in 1994 with wholesale reform of health care. Proponents in 1994 wanted to change the health care system for 85% of the people for which the system worked to help the 15% for whom the system didn't work. The voters were right to tell the politicians in 1994 that this didn't make any sense.

First, we need to recognize that the IRS is already, through enforcement, doing quite a bit to deal with the tax gap.

The chart here reflects the IRS testimony before the Budget Committee and estimates that IRS activities will reduce the tax gap – the $345 billion number – by nearly $70 billion in 2007.

This reflects $17 billion in direct enforcement revenue and the rest in indirect compliance effects. So we start with that as a base -- that the work of the IRS is already reducing by approximately 20% the tax gap. This is in keeping with Commissioner Everson's statements last year that the IRS could bring in somewhere between $50 billion and a $100 billion a year without dramatically changing the relationship between the IRS and taxpayers. Well, the IRS is already doing that, according to the Commissioner of the IRS.

So where does that leave us? Can we do more in enforcement? The administration has proposed an increase in funding for the IRS. That increase looks toward the tax gap, with funds directed for increased data matching and improved research as well as more auditors. I would suggest colleagues might also want to make certain that if we consider adding more IRS employees, that we have greater confidence that the IRS is utilizing current resources effectively. The IRS has hundreds of employees, according to a Treasury Inspector General for Tax Administration report, that do part- or full-time union work. This is thousands and thousands of work hours that could be spent going after the tax gap. What could we gain if we directed all those union hours to actually working on the tax gap?

So we have proposals for increased enforcement. Let me remind my colleagues, though, the Joint Committee on Taxation will not give us a score for additional dollars based on increased enforcement.

So that isn't going to get senators anywhere in terms of reducing projected deficits, or paying for tax cuts. And it is important to emphasize that the commissioner of the IRS made it clear to the Budget Committee a few days ago, at a hearing, that we cannot audit our way out of the tax gap.

The commissioner also warned about increasing the IRS budget too quickly. He said a big increase in staffing would harm taxpayer rights if the IRS were not able to grow in a controlled manner.

Now we can look at what we can possibly do legislatively. The Democratic leadership hasn't proposed really anything new here but the administration has put forward some proposals in the budget.

As you can see in this chart, many of the administration's proposals deal with information reporting. Now, information reporting is an important way to improve tax compliance. That is very clear from all the work that has been done on the tax gap.

However, information reporting places additional burdens on taxpayers and it is very frustrating that we often find that the IRS is not doing enough to match or review the documents that taxpayers are already providing. Needless to say, this greatly limits the benefits information reporting provides.

But setting those concerns aside, the administration has proposed: 1) information reporting on payments to corporations; 2) basis reporting on security sales; 3) broker reporting; 4) reporting of merchant payment card reimbursement; 5) increase information return penalties; 6) taxpayer identification number verification for independent contractors; and, 7) information reporting on certain government payments.

That is just the information reporting proposals, with nine other proposals including increased penalties; expanding IRS access to information; and, required electronic filing as some of the other new proposals. This is certainly a comprehensive list of proposals. Is it everything? No, but it is a serious start.

If senators who have attacked the Secretary of Treasury and the IRS believe more can be done, I would suggest that they should come forward with their own proposals.

I think senators will find that while it's easy to complain about what is coming out of the Treasury's kitchen, it's a lot harder to get in there and do it yourself. So I think senators need to be very careful about just putting out pie-in-the-sky numbers for what can be achieved by reducing the tax gap without at the same time putting forward their own detailed, concrete, Joint Tax-scored proposals that show how it can be done.

As this chart shows, there is a lot of smoke and mirrors when it comes to the tax gap. But you can't use smoke and mirrors to pay for tax cuts or to decrease the deficit. You've got to have proposals that are in detailed black and white and are scored by JCT. Tax gap proposals shouldn't be used for spending. The tax gap is appropriately viewed as unfairly placing a heavier burden on compliant taxpayers. So if we enact tax gap closers, they should be used to reduce taxes, or reduce the deficit – not increase spending.

Mr. President, let me conclude by saying you can have a blue moon, you can have blue cheese, you can even have blue suede shoes, but when it comes to balancing the budget you can't do it with blue smoke. And that unfortunately is what so much of the tax gap is right now – blue smoke. I strongly encourage the Budget Committee chairman and other senators not to use blue smoke during the upcoming budget resolution debate.

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