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Highlights

Highlights of GAO-06-1000T, a testimony to the Subcommittee on Taxation and IRS Oversight, Committee on Finance, U.S. Senate

TAX COMPLIANCE

Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches

Why GAO Did This Study

The tax gap—the difference between the tax amounts taxpayers pay voluntarily and on time and what they should pay under the law—has been a long-standing problem in spite of many efforts to reduce it. Most recently, the Internal Revenue Service (IRS) estimated a gross tax gap for tax year 2001 of $345 billion and estimated it would recover $55 billion of this gap, resulting in a net tax gap of $290 billion. When some taxpayers fail to comply, the burden of funding the nation's commitments falls more heavily on compliant taxpayers. Reducing the tax gap would help improve the nation's fiscal stability. For example, each 1 percent reduction in the net tax gap would likely yield $3 billion annually.

GAO was asked to discuss the tax gap and various approaches to reduce it. This testimony discusses to what extent the tax gap could be reduced through three approaches—simplifying or reforming the tax system, providing IRS with additional enforcement tools, and devoting additional resources to enforcement—as well as various factors that could guide decision-making when devising a strategy to reduce the tax gap. This statement is based on prior GAO work.

What GAO Recommends

GAO is not making any new recommendations but highlights new areas for possible attention.

www.gao.gov/cgi-bin/getrpt?GAO-06-1000T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

What GAO Found

Simplifying the tax code or fundamental tax reform has the potential to reduce the tax gap by billions of dollars. IRS has estimated that errors in claiming tax credits and deductions for tax year 2001 contributed $32 billion to the tax gap. Thus, considerable potential exists. However, these provisions serve purposes Congress has judged to be important and eliminating or consolidating them could be complicated. Fundamental tax reform would be most likely to result in a smaller tax gap if the new system has few, if any, exceptions (e.g., few tax preferences) and taxable transactions are transparent to tax administrators. These characteristics are difficult to achieve, and any tax system could be subject to noncompliance.

Withholding and information reporting are particularly powerful tools to reduce the tax gap. They could help reduce the tax gap by billions of dollars, especially if they can make currently underreported income transparent to IRS. These tools have been shown to lead to high, sustained levels of taxpayer compliance. Using these tools can also help IRS better allocate its resources to the extent they help IRS identify and prioritize its contacts with noncompliant taxpayers. As GAO previously suggested, reporting the cost, or basis, of securities sales is one option to improve taxpayers' compliance. However, designing additional withholding and information reporting requirements may be challenging given that many types of income are already subject to reporting, there are many forms of underreporting, and withholding and reporting requirements impose costs on third parties.

Devoting additional resources to enforcement has the potential to help reduce the tax gap by billions of dollars. However, determining the appropriate level of enforcement resources for IRS requires taking into account many factors such as how well IRS is currently using its resources, how to strike the proper balance between IRS's taxpayer service and enforcement activities, and competing federal funding priorities. If Congress decides to provide IRS more enforcement resources, the amount the tax gap could be reduced would depend on factors such as the size of budget increases, how IRS manages any additional resources, and the indirect increase in taxpayers' voluntary compliance resulting from expanded enforcement. Increasing IRS's funding would enable it to contact millions of potentially noncompliant taxpayers it identifies but does not have resources to contact.

Finally, using multiple approaches may be the most effective strategy to reduce the tax gap, as no one approach is likely to fully and cost effectively address noncompliance. Key factors to consider in devising a tax gap reduction strategy include periodically measuring noncompliance and its causes, setting reduction goals, leveraging technology, optimizing IRS's allocation of resources, and evaluating the results of any initiatives.