The Daily Dish

Closing the Tax Gap; How Much and How Fast?

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Eakinomics: Closing the Tax Gap; How Much and How Fast?

One of the most striking claims regarding that American Family Plan (AFP) is that it will be paid for in part by an additional $700 billion (over 10 years) in revenue that comes from improved tax compliance. Thus, mechanically, the gap between taxes properly owed and taxes actually paid – the "tax gap" – would get closed to the tune of nearly three quarters of a trillion dollars.

How?

A close look at the budget documents and the Treasury's green book (that explains the revenue proposals) shows that there are two main proposals:

- Provide additional funding for tax administration, and
- Introduce comprehensive financial account reporting to improve tax compliance.

The former is projected to raise $266 billion over 2022-2031, while the latter is estimated to raise $463 billion, for a total of $729 billion. Let's take a look at them in turn.

As explained in "The American Families Plan Tax Compliance Agenda," the additional funding would total roughly $80 billion over the 10 years. The roughly $8 billion a year is a substantial increase over the fiscal 2021 Internal Revenue Service budget of $12 trillion. What would the funds do? According to the Treasury, "The IRS would grow manageably (no more than around 10% annually) but also have certain funding in place to make investments with large fixed costs—like modernizing information technology, improving data analytic approaches, and hiring and training agents dedicated to complex enforcement activities."

That's great, but how does $80 billion out the door turn into $266 billion in revenue? The estimate is based on an assumed gross return on investment (ROI) of 4-1; that is, every $1 spent raises $4 in tax collections. The Treasury defends these assumptions as based on historical performance. Indeed, it argues that "These numbers are conservative because IRS ROI estimates are only available for the subset of enforcement investments, and not technology or service improvements that are likely to improve compliance." Perhaps, but the Congressional Budget Office estimates that spending $40 billion more will raise roughly $100 billion, which is closer to a 2.5-1 ROI.

The "comprehensive financial account reporting" is described thusly:

> The new reporting regime would build from the framework of the Form 1099-INT reports that taxpayers already receive from financial institutions when they earn more than $10 in interest from

> a bank, brokerage, or other financial institution. Financial institutions would simply report additional data on the financial accounts of these existing information returns. Specifically, the annual return would report gross inflows and outflows on all business and personal accounts from financial institutions, including bank, loan, and investment accounts but carve out exceptions for accounts below a low de minimis gross flow threshold.
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> Other accounts that are similarly situated to financial institution accounts would also be covered under this new reporting regime — for example, payment settlement entities would also be required to report gross receipts and gross purchases. The reporting regime would also cover foreign financial institutions and crypto asset exchanges and custodians.

Note the key words: all business and personal accounts at all financial institutions (domestic and international) and similarly situated entities. It is an enormous and enormously invasive information gathering proposal. For perspective, recall that the Affordable Care Act included an expansion of 1099 information reporting to include any payment of over $600. The backlash was immediate, enormous, and the provision was repealed a year later.

Suppose that somehow this provision makes it into law and survives. How does Treasury arrive at its estimate of $463 billion?

> To arrive at a revenue estimate for the impact of a comprehensive information reporting regime, the Office of Tax Analysis began with an estimate of the tax gap for business income which included Schedule C proprietorship income, Schedule E rent and pass-through income, and small corporation income as well as the portion of the employment tax gap associated with business incomes. This tax gap estimate was then reduced to reflect the expected increase in voluntary compliance once taxpayers realize that the IRS has a lens into business income. The revenue estimate added two assumptions: first, a reduction in the steady state share of the tax gap due to increased voluntary compliance as taxpayers react to increased information reporting; and second, a gradual increase of voluntary compliance that phases in over time.

That, my friends, is budget-speak for: "we guessed."

Upon closer inspection, $700 billion doesn't seem very solid or very likely. Indeed, the information reporting looks to be dead on arrival and the additional funding likely to raise $200 billion at best. The moral is simply that there are not trillions of uncollected dollars waiting to be scooped up and spent.