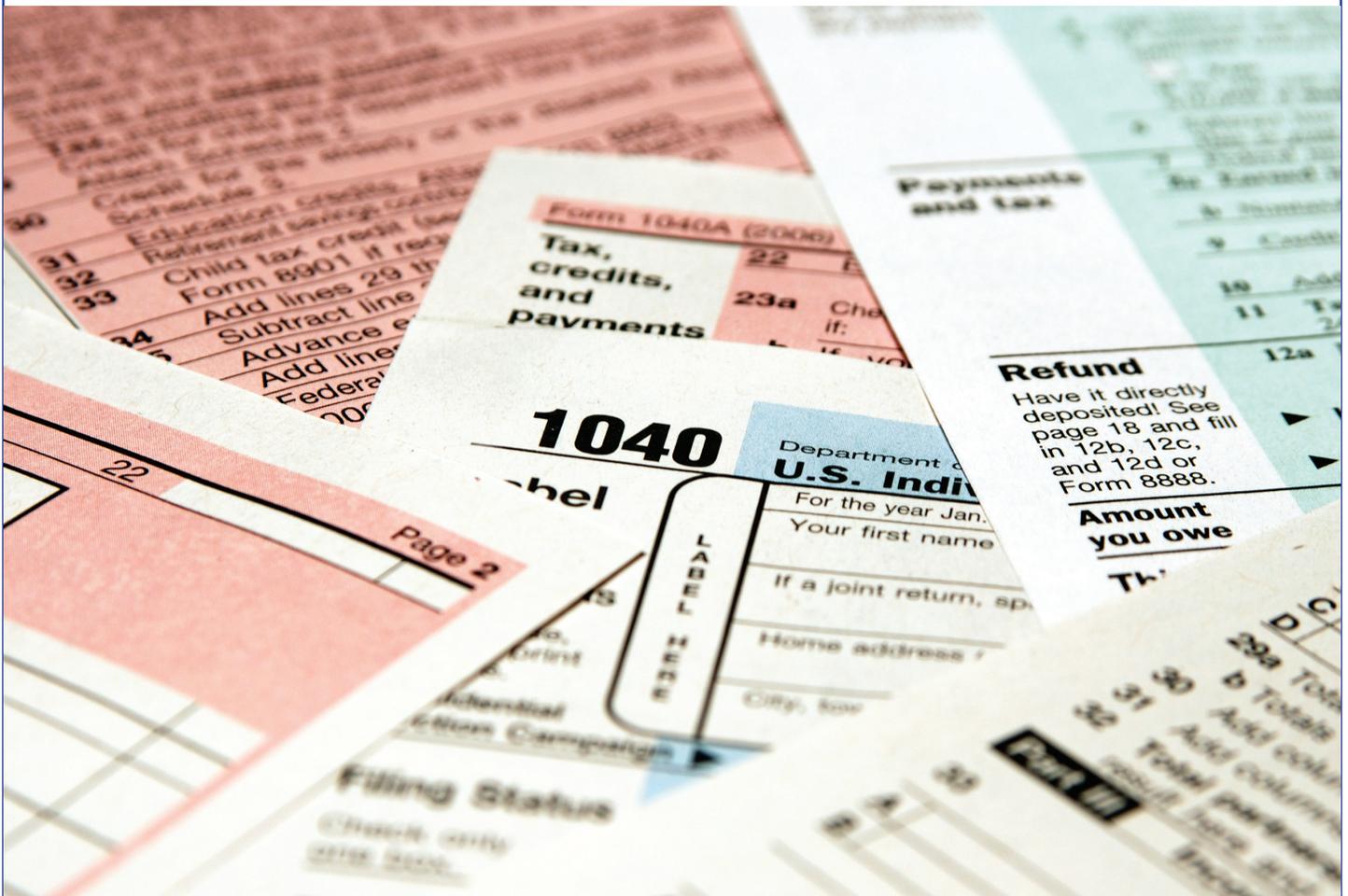


# Bridging the Tax Gap

The Case for Increasing the IRS Budget



# Acknowledgements

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# Introduction

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A significant and pernicious problem facing the nation is the tax gap, the difference between what is owed in taxes and what is paid. Estimated to be over \$300 billion annually, the tax gap represents an enormous revenue loss for the government. This lack of revenue often causes unnecessary increases in annual deficits and the national debt, increasing national interest payments and adding pressure to cut vital government services. Unfortunately, much of the gap must be made up eventually by honest taxpayers through higher taxes and by beneficiaries of federal investments through service cuts.

The Internal Revenue Service (IRS) is responsible for enforcing tax laws and collecting taxes, and therefore, it has the greatest capacity and responsibility to reduce the tax gap. The extent to which the IRS can influence the tax gap is mostly a product of the resources and powers lawmakers in Congress provide the agency and how well IRS administers those resources and powers.<sup>1</sup>

Congress has given considerable lip service to doing something about the tax gap for years but has done little to actually give the IRS the tools to make significant progress in closing it. Despite this fact, Congress has demanded the IRS close the tax gap without making more resources available for the agency to do so. Thus, the IRS has been forced to make difficult choices as to how to use the limited resources it has been allocated. As a result, at the very least, the tax gap remains a large problem, and most experts believe it has probably increased in size as the IRS has largely scaled back tax law enforcement over the last ten years.

The IRS can reduce the size of the tax gap – progress that would yield billions in additional revenue each year. In order to accomplish this, Congress and the IRS will need to invest more in three areas of the IRS budget: audits, collections, and tax preparation services for low-income taxpayers eligible for the Earned Income Tax Credit. With sufficient resources, the IRS should be able to implement effective and efficient tax enforcement policies and programs that will have a real impact on reducing the tax gap.

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<sup>1</sup> Significant changes to tax laws have reduced the IRS's influence over tax enforcement, and many proposals have been made to increase tax compliance with authorizing legislation. For one in-depth overview, see Max Sawicky's *Bridging the Tax Gap: Addressing the Crisis in Federal Tax Administration* (Washington, DC: Economic Policy Institute, 2005).

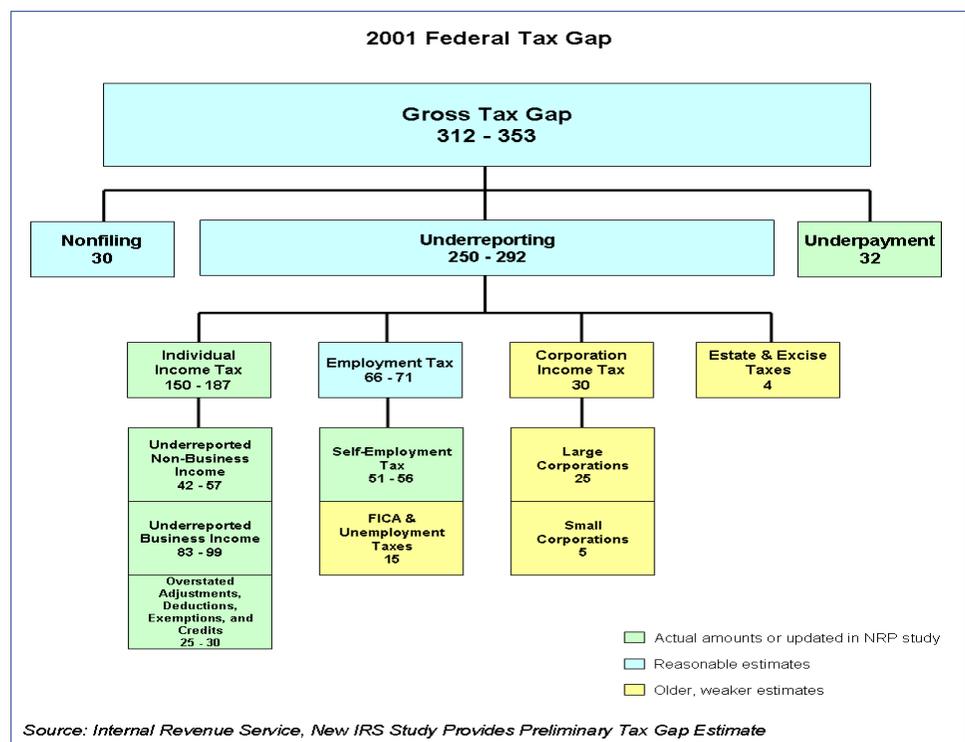
# The \$300 Billion Problem: The Tax Gap

IRS defines the tax gap in two ways. The *gross* tax gap is the total amount of taxes that were not paid when tax returns were first filed, while the *net* tax gap consists of taxes that are not paid after the IRS takes steps to enforce tax laws. The most recent data on the gross tax gap comes from the IRS National Research Project, which evaluated tax returns from FY 2000. It put the gross tax gap at between \$312 billion and \$353 billion annually, or about 16 percent of all taxes owed. Although the percentage of the economy the tax gap represents has not changed significantly, the absolute size of the gross tax gap has in all likelihood grown in step with the economy.<sup>2</sup> Most of the tax gap results from taxpayers underreporting their income.

It is unclear, however, how much the tax gap has increased as a percentage of the total amount of taxes owed. In the last two decades, IRS has only measured the tax gap three times. Each time, it found the tax gap represented between 16 and 20 percent of total revenues owed.<sup>3</sup> On the other hand, anecdotal evidence, particularly the work of Pulitzer Prize-winning journalist David Cay Johnston, suggests the tax gap has grown as wealthier taxpayers have responded to and requested reductions in the IRS enforcement presence.

In any case, the IRS can influence both the net and

the gross tax gap by encouraging and requiring tax compliance. The IRS recovered \$48.7 billion of the tax gap in FY 2006, which, coupled with late payments, brought the net tax gap to between \$257 billion and \$298 billion.<sup>4</sup> Enforcement efforts also have a strong impact on the gross tax gap, because voluntary compliance tends to increase when enforcement programs are more active. More enforcement increases the fear of being audited and perhaps heightens the public sense of civic responsibility, both of which are thought to promote voluntary compliance. But the exact extent of the impact is subject to debate. Some studies have found the increase in voluntary compliance is many times greater than the money the IRS directly recovers through enforcement programs.<sup>5</sup>



<sup>2</sup> Internal Revenue Service, “New IRS Study Provides Preliminary Tax Gap Estimate,” <http://www.irs.gov/newsroom/article/0,,id=137247,00.html> (accessed October 10, 2007).

<sup>3</sup> Eric Toder, “Reducing the Tax Gap: The Illusion of Pain-Free Deficit Reduction,” Urban-Brookings Tax Policy Center, [http://www.taxpolicycenter.org/UploadedPDF/411496\\_reducing\\_tax\\_gap.pdf](http://www.taxpolicycenter.org/UploadedPDF/411496_reducing_tax_gap.pdf) (accessed October 10, 2007).

<sup>4</sup> Internal Revenue Service, “IRS Enforcement Activities Continue To Recover,” [http://www.irs.gov/pub/newsroom/11-06\\_stat\\_charts.pdf](http://www.irs.gov/pub/newsroom/11-06_stat_charts.pdf) (accessed October 10, 2007).

<sup>5</sup> Eric Toder, “Reducing the Tax Gap: The Illusion of Pain-Free Deficit Reduction,” Urban-Brookings Tax Policy Center, [http://www.taxpolicycenter.org/UploadedPDF/411496\\_reducing\\_tax\\_gap.pdf](http://www.taxpolicycenter.org/UploadedPDF/411496_reducing_tax_gap.pdf) (accessed October 10, 2007).

# Impact of the Tax Gap

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The tax gap affects the public in two ways. Mainly, it reduces what compliant taxpayers *already* have. Because this revenue is intended to be collected and used by the government, not collecting it makes implementing government services and investments more difficult. The existence of the tax gap is kind of like a recurring and permanent tax cut, in the sense it generally must be paid for by either shifting the tax burden to others (in this case, compliant taxpayers), curtailing government services, or increasing debt. The IRS National Taxpayer Advocate (NTA), for example, has testified before Congress that unpaid taxes shift the tax burden onto compliant taxpayers. If all compliant taxpayers were to assume an equal portion of the tax gap, it would add \$2,200 to their annual tax bills.<sup>6</sup> Looked at another way, if the IRS eliminated the tax gap, Americans could receive the same level of services and programs while paying significantly less in taxes. The actual impact of the tax gap on the taxes paid by each individual most likely depends on personal circumstances and future policy decisions.

But unlike a tax cut, the tax gap creates a patently perverse set of winners and losers – taxpayers who do not follow the law benefit and taxpayers who do lose out. Larger burdens also tend to fall on lower- and middle-income taxpayers, whose compliance rates are higher than other income levels. Higher-income taxpayers, small business owners, and corporations are the main beneficiaries, as their compliance rates are lower. Because of this, on the whole, the tax gap makes the tax code less progressive than the statutory structure indicates, though by exactly how much has not been quantified.<sup>7</sup>

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<sup>6</sup> National Taxpayer Advocate, “National Taxpayer Advocate’s 2006 Annual Report To Congress,” Internal Revenue Service, <http://www.irs.gov/advocate/article/0,,id=165806,00.html> (accessed October 10, 2007).

<sup>7</sup> Jason Furman, Lawrence H. Summers, and Jason Bordoff, “Achieving Progressive Tax Reform in an Increasingly Global Economy,” Brookings Institution, [http://www3.brookings.edu/views/papers/furman/200706bordoff\\_summers.pdf](http://www3.brookings.edu/views/papers/furman/200706bordoff_summers.pdf) (accessed October 10, 2007).

Secondly, and perhaps more importantly, the tax gap reduces what the public *could* have. The tax gap deprives the government of more revenue to finance the expansion of government services and investments, a reduction in the annual deficit, or payments to reduce the national debt. If the tax gap were reduced or eliminated, the additional revenue brought into the government would, in most circumstances, make the tax code much more progressive. There are surely many different proposals about how to invest the revenue owed, but regardless of how the \$300 billion would be used, the federal government is never afforded the opportunity to decide.

On a less practical, but equally important level, the tax gap also represents the eroding integrity of the tax system and could reduce public support for the federal government. Such a large amount of unpaid taxes makes the tax system appear ineffective and unfair, since the tax gap regressively favors wealthier people and businesses who have the means to avoid and evade tax law. These perceptions of unfairness in the tax system may have large-scale effects on public policy, undermining public confidence in government as a fiscal manager.<sup>8</sup> Compliant taxpayers may also object to tax increases on the grounds they would be paid arbitrarily and regressively, and, as a corollary, new government services or investments financed by tax increases may receive less support. Taxpayers may also view ineffective tax enforcement as indicative of government incompetence generally and, therefore, oppose expansion of the government’s role. Too many citizens may see no option but to favor tax cuts as a way to restore the integrity of revenue collection and protect themselves from bearing unjust burdens as compliant taxpayers.

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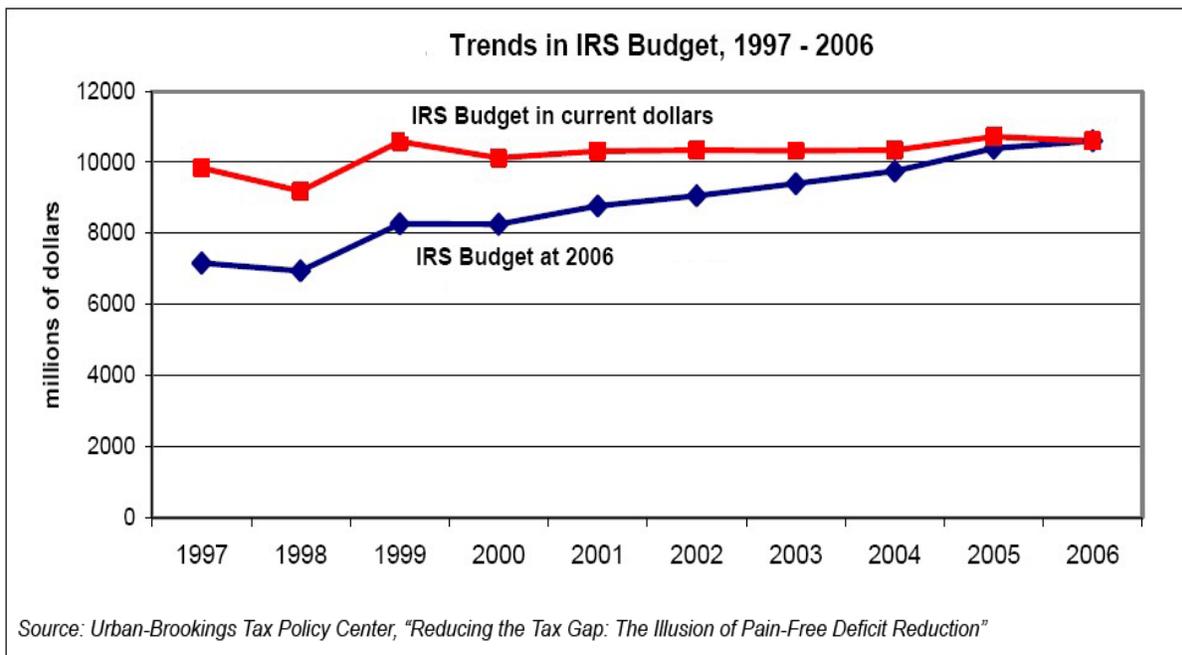
<sup>8</sup> Alison Kladek and Will Friedman, “Understanding Public Attitudes about the Federal Budget: A Report on Focus Groups,” Public Agenda, [http://www.publicagenda.org/research/pdfs/understanding\\_public\\_attitudes\\_about\\_the\\_federal\\_budget.pdf](http://www.publicagenda.org/research/pdfs/understanding_public_attitudes_about_the_federal_budget.pdf) (accessed October 10, 2007).

# A Primary Cause: Lack of Resources at the IRS

While it is widely established that increased resources at the IRS could help to reduce the tax gap, IRS funding levels have not kept up with growing demands on its budget. The total IRS budget has remained static after adjusting for inflation since the mid-1990s. The funding decline has been most pronounced in the enforcement account of the IRS budget, which includes funding for tax return examinations, tax collections, and document matching services that compare financial records with tax returns. In FY 1995, IRS had \$4.43 billion in its enforcement account. By FY 2006, this budget had only risen to \$4.65 billion – less than a five percent increase. During the same period:

- lion to 228 million;<sup>11</sup> and
- Hundreds of changes to the IRS's authority and tax laws gave the agency more work.<sup>12</sup>

Experts inside and outside government have recognized the resource problem at IRS. IRS National Taxpayer Advocate Nina Olson, who operates independent of the IRS, believes funding shortages have become so problematic, she has called for the creation of special rules for IRS budget bills. Charles Rossotti, former commissioner of the IRS, told the IRS Oversight Board in 2002 that much of the tax gap is a result of the failure of Congress to provide enough resources for tax law administration:



- Inflation had eroded the value of this funding by 36 percent;<sup>9</sup>
- The size of the economy grew 42 percent;<sup>10</sup>
- The number of tax returns the IRS processed increased 11 percent, from 205 mil-

The source of this problem are two conflicting, long term trends: one, ever increasing demands on the tax administration system due to rapid growth in the size and complexity of the economy; and two, a steady decline in IRS resources due to budget constraints. The cu-

<sup>9</sup> Bureau of Labor Statistics. "Inflation Calculator," U.S. Department of Labor, <http://www.bls.gov/cpi/> (accessed October 10, 2007).

<sup>10</sup> Bureau of Economic Analysis, "National Economic Accounts" U.S. Department of Commerce, <http://www.bea.gov/national/index.htm#gdp> (accessed October 10, 2007).

<sup>11</sup> Internal Revenue Service, "SOI Tax Stats -- IRS Data Books," <http://www.irs.gov/taxstats/article/0,,id=102174,00.html> (accessed October 10, 2007).

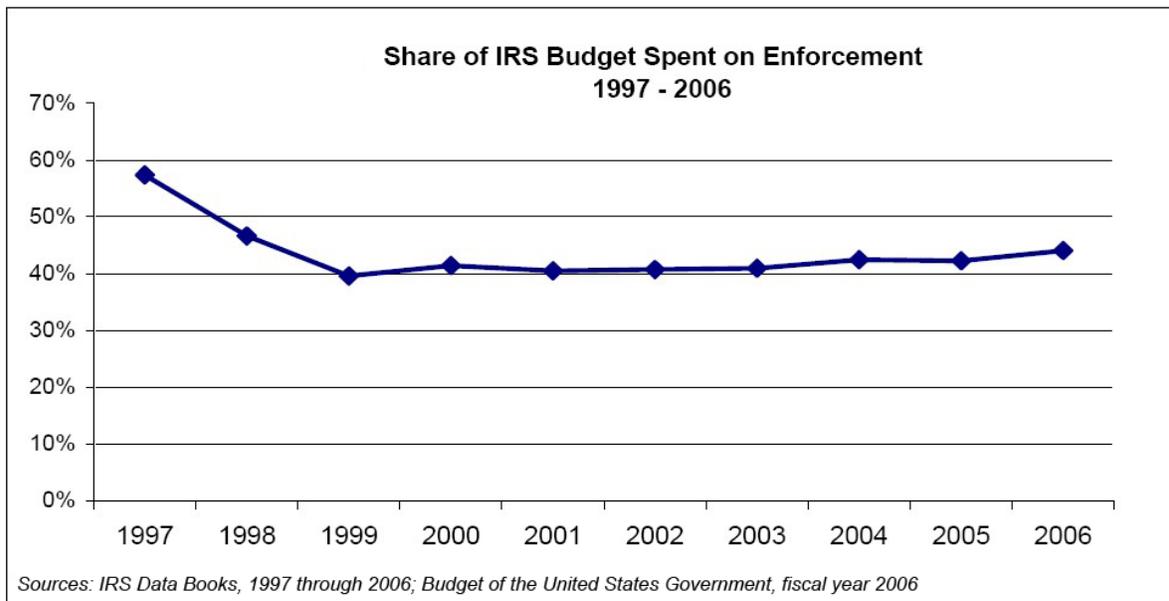
<sup>12</sup> Charles O. Rossotti, "Report to the IRS Oversight Board: Assessment of the IRS and Tax System," <http://nteuirswatch.org/documents/numbers/Rossotti%2002%20report%20to%20Oversight%20board.pdf> (accessed October 10, 2007).

mulative effect of these conflicting trends over a 10-year period has been to create a huge gap between the number of taxpayers who are not filing, not reporting or not paying what they owe, and the IRS' capacity to require them to comply.

The resources crunch can be seen more apparently in staffing levels: the number of IRS employees is down sharply from ten years ago. Between 1995 and 2006, the total number of IRS employees shrunk 18 percent – falling from 114,000 to less than 92,000. The number of revenue agents and officers – IRS employees who perform audits – has decreased even faster, by 40 and 30 percent,

Office,<sup>16</sup> the IRS Oversight Board, Max Sawicky, then of the Economic Policy Institute,<sup>17</sup> Robert McIntyre of Citizens for Tax Justice,<sup>18</sup> Eric Toder of the Urban-Brookings Tax Policy Center,<sup>19</sup> and former IRS Commissioner Donald C. Alexander.<sup>20</sup>

IRS needs additional funding to fulfill its mission as the guarantor of tax compliance. Where funding is needed most is in the IRS enforcement budget, particularly for audits of high-income taxpayers and corporations, the collection function, and services for low-income taxpayers who receive the Earned Income Tax Credit (EITC).



respectively.<sup>13</sup> Those categories of employees have decreased from 8,139 to 5,665 for revenue agents and 16,078 and 12,859 for revenue officers.<sup>14</sup> Fewer staff at the IRS has a direct impact on the auditing function at the agency.

There have been many experts who have called for increased funding for the IRS, including the Treasury Inspector General for Tax Administration,<sup>15</sup> the Government Accountability

<sup>13</sup> Internal Revenue Service, "SOI Tax Stats -- IRS Data Books."

<sup>14</sup> Ibid.

<sup>15</sup> Treasury Inspector General for Tax Administration. "Trends In Compliance Activities Through Fiscal Year 2006," U.S. Department of the Treasury, <http://www.treas.gov/tigta/auditreports/2007reports/200730056fr.html> (accessed October 10, 2007).

<sup>16</sup> Michael Brostek, "Tax Compliance: Multiple Approaches Are Needed To Reduce The Tax Gap," Government Accountability Office, <http://www.gao.gov/new.items/d07488t.pdf> (accessed October 10, 2007).

<sup>17</sup> Max Sawicky, "Do-it-yourself tax cuts: The crisis in U.S. tax enforcement" in *Bridging the Tax Gap: Addressing the Crisis in Federal Tax Administration* (Washington, DC: Economic Policy Institute, 2005).

<sup>18</sup> Robert McIntyre, "Statement of Robert S. McIntyre Before the Senate Budget Committee, January 23, 2007," Senate Budget Committee, [http://budget.senate.gov/democratic/testimony/2007/McIntyre\\_TaxGap012307.pdf](http://budget.senate.gov/democratic/testimony/2007/McIntyre_TaxGap012307.pdf) (accessed October 10, 2007).

<sup>19</sup> Eric Toder, "Reducing the Tax Gap: The Illusion of Pain-Free Deficit Reduction," Urban-Brookings Tax Policy Center, [http://www.taxpolicycenter.org/UploadedPDF/411496\\_reducing\\_tax\\_gap.pdf](http://www.taxpolicycenter.org/UploadedPDF/411496_reducing_tax_gap.pdf) (accessed October 10, 2007).

<sup>20</sup> Max Sawicky, "Interview: Former IRS Commissioner Donald C. Alexander" in *Bridging the Tax Gap: Addressing the Crisis in Federal Tax Administration* (Washington, DC: Economic Policy Institute, 2005) 52.

# Increase Resources For Audits

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One of the most disturbing trends in enforcement policy over the last ten years has been a sharp decline in audits, which are an essential tool in the fight against unpaid taxes. Most of the gross tax gap – between \$250 and \$260 billion – results from individuals and businesses underreporting their income. The IRS determines who inaccurately reported their income and how much they owe in taxes through a variety of means. Examinations, or audits, are one way the IRS makes this determination. In FY 2006, IRS audits showed that an additional \$43.95 billion was owed on all tax returns that were audited.<sup>21</sup> The IRS performed 1.4 million audits, resulting in an audit coverage rate of 0.8 audits per 100 tax returns, or less than one percent.<sup>22</sup>

In the last decade, there has been a general decline in most types of audits. In FY 1996, the audit rate for all individual income tax returns was 1.67 percent.<sup>23</sup> In FY 2006, the rate had dropped to 1.0 percent of all individuals, after reaching a low of 0.5 percent in 2000.<sup>24</sup> The recent upswing in audits is encouraging, but the rate is still far below earlier levels and even farther below historic and adequate levels, according to tax administration experts.<sup>25</sup>

Making things worse, the general decrease in audits has been unequally distributed by taxpayer income – with audits of higher-income earners falling faster than the overall decrease. The decline in audits has been the steepest among taxpayers reporting an income over \$100,000. Audits of these filers have dropped from 2.85 percent in FY 1996 to 1.3 percent in FY 2006. Decreases in these audits before 1996 were even more drastic: in FY 1992,

<sup>21</sup> Internal Revenue Service, “SOI Tax Stats -- IRS Data Books.”

<sup>22</sup> Ibid.

<sup>23</sup> Government Accountability Office, “Tax Administration: Audit Trends and Results for Individual Taxpayers,” <http://www.gao.gov/archive/1996/gg96091.pdf> (accessed October 16, 2007).

<sup>24</sup> Internal Revenue Service, “SOI Tax Stats -- IRS Data Books.”

<sup>25</sup> Sawicky, “Interview: Former IRS Commissioner Sheldon S. Cohen,” 25.

higher-income filers were audited 5.28 percent of the time.

Furthermore, business income has been insufficiently audited. Business income, which is reported on individual income tax returns, has been audited at a relatively steady rate since FY 1995. Nevertheless, more audits are needed, as the IRS National Research Project identified the underreporting of income by small businesses as the category that contributed the most to the tax gap, accounting for more than \$109 billion in unpaid taxes annually. \$68 billion of these unpaid taxes are owed by self-proprietorships, known more commonly as the self-employed, and another \$22 billion came from partnerships, S corporations, estates, and trusts. In order to close the tax gap, the IRS will need the necessary resources to *expand* its investigation and enforcement of tax laws related to these returns, not hold them steady.

## *Decline in Quality and Quantity of Corporate Audits*

Individual taxpayers are not alone in experiencing a decrease in the likelihood of being audited. Audits related to the corporate income tax for all sizes of corporations have declined significantly. The overall corporate audit rate has been cut in half, dropping from 2.4 percent in 1996 to 1.2 percent in 2006.<sup>26</sup> What’s more, new data from the last five years obtained by the Transactional Records Access Clearinghouse (TRAC) show that the quality of those audits has also suffered.

Disturbingly, the decline has been most pronounced among the largest corporations. Audits of corporations with assets between \$5 and \$10 million dropped from 14 percent in FY 1995 to 3.4 percent in FY 2006 – a 70 percent drop.<sup>27</sup> Slightly

<sup>26</sup> Transactional Records Access Clearinghouse, “IRS Spending More Time on Face-to-Face Corporate Audits that Produce No Revenue,” Syracuse University, <http://trac.syr.edu/tracirs/newfindings/current/> (accessed October 16, 2007).

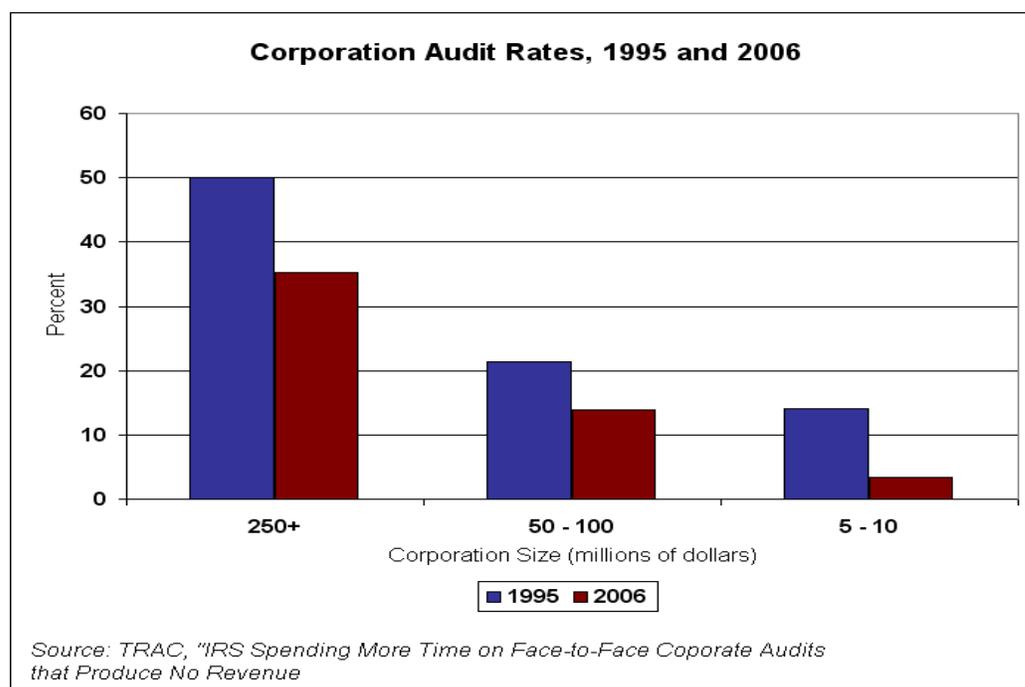
<sup>27</sup> Internal Revenue Service, “SOI Tax Stats -- IRS Data Books.”

larger corporations – with assets of \$50 million to \$100 million – were audited at a rate of 13.8 percent in FY 2006, down from 21.3 percent in FY 1996 – a 35 percent decline. Audits of the largest corporations, those with assets of \$250 million or more, have declined by almost a third, from 50 percent in FY 1995 to 35.2 percent in FY 2006.<sup>28</sup> While companies with over \$250 million in assets are small in number – they filed only 0.2 percent of corporate tax returns in 2002 – they accounted for a staggering 90 percent of all corporate assets and 87 percent of all corporate income during that year.<sup>29</sup> The decrease in audits among these corporate tax filers must be reversed.

Audits of the largest corporations inexplicably vary by sector, which seems to be an inefficient method of tax enforcement. In FY 2006, only 15 percent of financial services corporations were audited, compared to 100 percent of all large manufacturing and transportation corporations.<sup>30</sup> Yet companies in the financial sector make up a large part of the economy. The largest corporations in the financial sector account for 25 percent of total receipts of large corporations and over 62 percent of total net income – more than 2.5 times

the next highest sector.<sup>31</sup>

What’s more unfortunate, however, is that the audits that have been done for corporate filers have been increasingly unproductive, particularly among face-to-face corporate audits – the most thorough and intense audits the IRS conducts. The number of nonproductive auditing hours, which is defined by the IRS as face-to-face examination hours that produce a “no change” result in the amount of tax owed, has increased for every corporate asset class over the last five years.<sup>32</sup> The average increase in



<sup>28</sup> Transactional Records Access Clearinghouse, "IRS Spending More Time on Face-to-Face Corporate Audits that Produce No Revenue."

<sup>29</sup> Transactional Records Access Clearinghouse, "Relatively Few Corporations Have Most Income and Assets," Syracuse University, <http://trac.syr.edu/tracirs/trends/v10/corpassets.html> (accessed October 17, 2007).

<sup>30</sup> Transactional Records Access Clearinghouse, "Corporate Audit Rates -- Wide Disparities Found for Different Industries," Syracuse University, <http://trac.syr.edu/tracirs/latest/127/>. (accessed October 16, 2007).

unproductive hours across all corporate asset classes between FY 2001 and FY 2006 was 40 percent. If the IRS audited a high percentage of corporations, a rise in unproductive hours could be interpreted as a good thing, with companies increasingly paying the taxes they owe. However, because the IRS audits too few corporations and because the tax gap points to large amounts of taxes not being collected, a rise in unproductive hours shows the IRS

<sup>31</sup> Transactional Records Access Clearinghouse, "Net Income of Largest Corporations," Syracuse University, <http://trac.syr.edu/tracirs/trends/v10/netincsecG.html> (accessed October 16, 2007).

<sup>32</sup> Transactional Records Access Clearinghouse, "Net Income of Largest Corporations."

is being inefficient in selecting which corporations it chooses to audit – a waste of valuable enforcement resources and a missed opportunity to collect more tax revenues.

The rise in unproductive auditing hours increased at faster rates as the size of the corporation increased, especially for large corporations (those with assets over \$10 million). While all four asset classes over \$10 million saw increases in unproductive hours well above the average of 40 percent, as the asset class grows larger, the increases are even more pronounced. At the low end, audits of corporations between \$10 million and \$50 million saw a 61 percent increase in unproductive hours, while audits of corporations above \$250 million in assets saw the largest increases, at 109 percent – more than double the rate from five years earlier.<sup>33</sup>

Another alarming trend is the decrease in the number of hours spent per corporate audit. In the last five years, every corporate asset class except one (\$10-\$50 million) has seen double-digit decreases in the average length of audits, with the average corporate audit lasting 21 fewer hours.<sup>34</sup> This represents almost a ten percent drop in the length of corporate audits.

IRS data on corporate audits, combined with the new data obtained by TRAC on audit length, depict disturbing trends in both the quality and quantity of corporate audits – particularly those of the largest corporations. Not only is the IRS performing fewer corporate audits overall than it did ten years ago, the ones they do perform are done too quickly and are poorly targeted. Due to the size and complexity of the business transactions of large corporations, those returns are likely to produce more reporting errors, and therefore, the IRS should be

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<sup>33</sup> Transactional Records Access Clearinghouse, “IRS Corporate Audit Hours Spent on Nonproductive Examinations Increasing,” Syracuse University, <http://trac.syr.edu/tracirs/trends/v12/audittimechange.html> (accessed October 16, 2007).

<sup>34</sup> Transactional Records Access Clearinghouse, “Change in Average Audit Length FY 2001 vs FY 2006,” Syracuse University, <http://trac.syr.edu/tracirs/trends/v12/auditlengthchange.html> (accessed October 16, 2007).

auditing more of those companies (not less) and spending more time (not less) on each audit.

There have been a few reports that some of the changes within the corporate auditing section (the Large and Mid-Sized Business Division) have been forced on IRS auditors by senior level managers at the IRS. These changes put a strong focus on completing more audits by pre-set deadlines in order to drive up total audit numbers regardless of the quality of the audit or of auditors’ opinions about possible serious tax violations they had not had time to investigate during audits. David Cay Johnston reported in *The New York Times* on March 20, 2007, that almost two dozen revenue agents had been pressured by their managers to close open audits too soon – actions the auditors said could cost the government billions of dollars in unpaid taxes.<sup>35</sup>

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***Two dozen revenue agents had been pressured by their managers to close open audits too soon, which could cost the government billions of dollars in unpaid taxes.***

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This phenomenon was recognized by Colleen Kelley, President of the National Treasury Employees Union, in testimony before the House Appropriations Committee on Financial Services and General Government. Kelley testified the pressure put on IRS auditors was not a recent occurrence but had been happening since 2002. Kelley believes it was the result of a new IRS policy called Limited Focused Examination (LIFE) and said the union had heard directly from its members that the policy was undermining both efforts to make sure companies were paying all the taxes they owed and employee morale at the IRS.<sup>36</sup>

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<sup>35</sup> David Cay Johnston, “IRS Agents Feel Pressed To End Cases,” *New York Times*, March 20, 2007. <http://www.nytimes.com/2007/03/20/business/20tax.html>.

<sup>36</sup> Colleen Kelley, “Statement of Colleen Kelley, National President, National Treasury Employees Union on ‘Internal Revenue Service Budget FY2008,’” National Treasury Employees Union, <http://nteuirswatch.org/documents/numbers/CMK%20Testimony%20to%20House%20FService%20sub%203-29-07.pdf> (accessed October 18, 2007).

The combination of a decrease in overall corporate audit rates, and reports that those audits being done are closed too soon, will encourage tax evasion behavior among corporations, which may have more cause to believe they will not be audited, and that audits themselves are not to be feared.

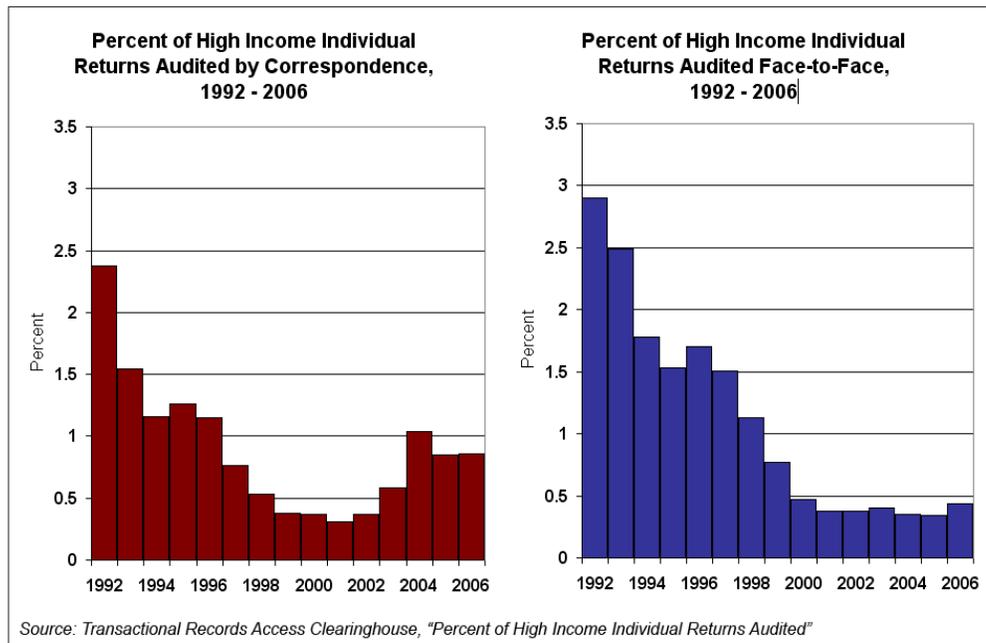
*Wrong Strategy: Relying on Correspondence Audits*

As far as reducing the tax gap is concerned, the *type of audit* being administered is equally, if not more important than *who* is being audited. There are two types of audits: a traditional face-to-face audit, which can happen inside an IRS office or at a taxpayer's home or business, and a correspondence audit. Traditional face-to-face audits involve comprehensive reviews of assets and records, requiring more time and effort for both the taxpayer and the IRS. Correspondence audits consist of the IRS sending a letter to a non-compliant taxpayer in which he or she is asked a few questions about his or her tax return. Striking the right balance between these two types of audits is essential to effective tax enforcement.

Face-to-face audits typically generate far more revenue than correspondence audits, and ones on high-income earners in particular produce the highest yields. In FY 2006, face-to-face audits of high-income earners generated an average of \$54,934.<sup>37</sup> Face-to-face audits on individuals earning between \$50,000 and \$100,000, in contrast, only averaged a \$3,877 yield, yet these taxpayers were audited almost as much (0.23 percent) as their higher-in-

come counterparts (0.44 percent).<sup>38</sup> Even face-to-face audits on returns with business income over \$100,000 yielded less than half as much (\$25,787) as audits of high-income filers.<sup>39</sup> The high yields on face-to-face audits of high-income filers show both that they are a good investment and also that there are significantly more taxes due among those filers.

Despite the high yields of these audits, the IRS is performing them too rarely. IRS administered face-to-face audits for 0.44 percent of all high-in-



come filers in FY 2006, compared to 2.9 percent in FY 1992 and 1.7 percent in FY 1996.<sup>40</sup> Yet the IRS claims, and rightly so, that overall audit rates have been gradually increasing in the last few years. These additional audits have increased the yield on tax enforcement, from a ten-year low of \$32.9 billion in FY 1999 to \$48.7 billion in FY 2006.

Unfortunately, the details behind the IRS data on increased audits tell a different story. Much of the

<sup>37</sup> Internal Revenue Service, "SOI Tax Stats -- IRS Data Books."

<sup>38</sup> Ibid.

<sup>39</sup> Ibid.

<sup>40</sup> Transactional Records Access Clearinghouse, "IRS 'Face-to-Face' Audits of Federal Income Tax Returns Filed by Individuals," Syracuse University, [http://trac.syr.edu/tracirs/highlights/current/audpctcompare\\_ind.html](http://trac.syr.edu/tracirs/highlights/current/audpctcompare_ind.html) (accessed October 16, 2007).

increase cited by the IRS has been due to an emphasis on *correspondence audits*, not the more effective *face-to-face audits*. Overall, in FY 2006, 77 percent of all audits – more than three out of four – were by correspondence.<sup>41</sup> What’s more, correspondence audits – not face-to-face audits – have accounted for 74 percent of the recent increase in audits among high-income individuals.<sup>42</sup> Face-to-face audit levels have increased only modestly over that time.

This trend is problematic because correspondence audits are less effective than face-to-face audits, partly because this type of audit can only spot problems that are evident from information submitted by the taxpayer or from information reported by third parties (employers, banks, and other sources). For comparison, in FY 2006, face-to-face audits on individual income tax returns for earners over \$100,000 yielded an average of \$54,934, while correspondence audits brought in \$31,912.<sup>43</sup> For other types of tax returns, such as large corporations, the difference was even more dramatic. The average yield of a face-to-face audit for large corporations in FY 2006 was \$2.6 million, but correspondence audits of similarly sized companies averaged a meager return of \$285,000.<sup>44</sup>

The IRS seems to have chosen to use correspondence audits so much mainly because administering them requires less staff time and resources. In FY 2006, correspondence audits took an average of only 1.4 auditor hours each, drastically lower than the hundreds of hours face-to-face audits can

take.<sup>45</sup> Indeed, IRS data shows even as overall audit rates have increased in the last few years, few additional staff have been added.

The IRS has decided, perhaps because of limited resources, to shift to less efficient and effective processes for auditing. If Congress and others in government are serious about creating a robust tax enforcement system and closing the tax gap, additional resources are crucial. Increased funds could be used to raise staffing levels enough that IRS may gradually perform more high-yield face-to-face audits, which would have a greater impact on reducing the tax gap.

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<sup>41</sup> Transactional Records Access Clearinghouse, “Targeting of Correspondence Audit Improves,” Syracuse University, <http://trac.syr.edu/tracirs/newfindings/current> (accessed October 16, 2007).

<sup>42</sup> Treasury Inspector General For Tax Administration, “Trends in Compliance Activities Through Fiscal Year 2006,” U.S. Treasury Department, <http://www.treas.gov/tigta/auditreports/2007reports/200730056fr.html> (accessed October 16<sup>th</sup>, 2007).

<sup>43</sup> Internal Revenue Service, “SOI Tax Stats -- IRS Data Books.”

<sup>44</sup> Ibid.

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<sup>45</sup> Transactional Records Access Clearinghouse, “Targeting of Correspondence Audit Improves,” Syracuse University, <http://trac.syr.edu/tracirs/newfindings/current> (accessed October 17, 2007).

# Expand Internal Tax Collection

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Tax law enforcement does not end once an audit has been completed. The IRS will have to actively pursue unpaid taxes it identifies if they are not paid voluntarily. IRS collection officers may make an agreement with the taxpayer to pay the taxes, or issue levies, liens, or property seizures. Agents are also charged with identifying taxpayers who do not file a tax return and collecting the taxes owed. To do these things, significant staffing and resources are required.

Billions are lost annually because Congress does not sufficiently finance the IRS collection department. In 2002, former IRS Commissioner Charles Rossotti reported to the IRS Oversight Board that an annual investment of under \$400 million in IRS collections could generate over \$11 billion each year.<sup>46</sup> This additional funding could be used to hire more full-time employees to pursue cases the IRS has not taken action on due to insufficient personnel. Even without additional resources, NTA

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***Former IRS Commissioner Charles Rossotti reported in 2002 that an annual investment of under \$400 million in IRS collections could generate over \$11 billion each year.***

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Nina Olson has recently stated the IRS can tackle many of those additional cases by implementing improvements to its current collection regimes.

Since Rossotti issued the 2002 report, activity in the collection function has increased modestly. Some key measurements have been on a steady upward trajectory, including the quantity of liens and levies issued by IRS collection staff.<sup>47</sup> However, the level of liens and levies is still down sharply

<sup>46</sup> Charles O. Rossotti, "Report to the IRS Oversight Board: Assessment of the IRS and Tax System."

<sup>47</sup> Transactional Records Access Clearinghouse, "IRS Collection Enforcement Trends," Syracuse University, <http://trac.syr.edu/tracirs/highlights/current/collenfG.html> (accessed October 16, 2007).

from FY 1996 levels, even excluding growth in the economy and tax returns. Some measures – such as the quantity of seizures – have not increased at all. Indeed, a 2007 Treasury Inspector General for Tax Administration (TIGTA) report found a robust collection function continues to be hampered by inadequate resources, as staffing for collection activities remains 30 percent below FY 1997 levels.<sup>48</sup>

## *Wrong Strategy: Private Debt Collection*

In 2004, Congress enacted – and in September 2006, the IRS implemented – a program to outsource the responsibility of collecting small tax debts to private debt collection firms. The principle rationale for creating the program was that its funding would not show up in the IRS budget. Although the government still spends resources, using private collectors does not require additional annual appropriations. Under the program, private collectors get to keep a portion of the taxes they collect as payment. Therefore, given limited budgets, the IRS would be afforded an opportunity to collect taxes it otherwise could not.

However, the private tax collection program is wasteful and dangerous. Private collection agencies (PCAs) yield a return-on-investment (ROI) of 4:1, whereas – as former IRS Commissioner Mark Everson has acknowledged – federal employees at the IRS produce a 13:1 ROI. Even more efficient, the IRS' Automated Collection System currently collects about \$20 for every \$1 spent on staffing, according to the NTA.<sup>49</sup>

Furthermore, despite claims the program has no costs, as of May 23, 2007, the IRS had spent \$71 million in appropriated funding to set it up. If that money had instead been spent on those high-yield automated functions, an additional \$1.4 billion in

<sup>48</sup> Treasury Inspector General for Tax Administration, "Trends In Compliance Activities Through Fiscal Year 2006."

<sup>49</sup> National Taxpayer Advocate Service, "National Taxpayer Advocate's 2007 Annual Report to Congress," Internal Revenue Service, <http://www.irs.gov/advocate/article/0,,id=177301,00.html> (accessed January 9, 2008).

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***If money spent on the private collection program had been used for other IRS functions, an additional \$1.4 billion in revenues could have been collected in just one year. The private collection program is expected to yield only around \$1.1 billion over the next ten years.***

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revenues could have been collected in just one year. Yet for all those missed opportunities, the private collection program is expected to yield only around \$1.1 billion altogether over the *next ten years*.

Initial data on the program are now available for the first year of operation, and the *Washington Post* has reported the PCAs averaged a 4.5:1 ROI, collecting \$29 million, from which they were paid \$6.34 million – far below both the IRS’ ROI levels and initial revenue projections for the program.<sup>50</sup>

Regardless of the program’s cost, many experts continue to worry PCAs might violate taxpayer rights. Olson has expressed a great deal of concern that profit-motivated companies could abuse taxpayers. According to Olson, PCAs have the opportunity to use “trickery, device, and belated Fair Debt Collection Practices Act warnings to take advantage of taxpayers,” and yet they are not obligated to disclose their “operational plans” regarding practices, letters, or scripts they will use.<sup>51</sup>

Indeed, anecdotal reports on the program’s operations have borne out many of the concerns Olson voiced regarding abusive practices. At a May 23, 2007, hearing of the House Ways and Means Committee, Rep. John Lewis (D-GA) presented tapes of conversations between PCA employees

and taxpayers.<sup>52</sup> Due to IRS privacy protections, PCA employees did not identify themselves, the nature of their business, or the purpose of their calls, and haggled with taxpayers to obtain their Social Security numbers. The taxpayers in the conversations refused to reveal their Social Security numbers and responded angrily when PCA employees asked repeatedly for the numbers but did not disclose the purpose of the conversations.

Olson reiterated her concerns about the ability of the program to operate efficiently and effectively in the recently released 2007 NTA report, stating tax collection is an inherently governmental function that should be handled only by government employees trained to protect taxpayer rights. Olson argues the IRS could currently collect the outstanding debts given to the PCAs by improving its collection strategy and use of currently available resources, enabling the IRS to reach “most, if not all, of these cases [given to PCAs] at less cost to taxpayers and less risk to taxpayer rights.”<sup>53</sup>

The sum of the evidence supports the need to shut down this program immediately. In 2007, Ways and Means Chairman Charles Rangel (D-NY) requested the IRS not issue any new contracts for the program, and the House passed a bill in October 2007 to end it entirely. This would be a wise change in IRS policy. Unfortunately, the IRS is moving forward with soliciting bids from additional PCAs for the second part of the program – full implementation. While Olson has pushed the IRS to include more transparency and taxpayer safeguards in the solicitation of new contracts, she continues to voice strong concerns and recommends Congress end the program.

Congress needs to act immediately to end this program and instead should make more resources available to the IRS to expand existing internal collection efforts.

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<sup>50</sup> Business Section “Collectors Get \$29 Million for IRS,” *Washington Post*, January 9, 2008, <http://www.washingtonpost.com/wp-dyn/content/article/2008/01/08/AR2008010804439.html>.

<sup>51</sup> National Taxpayer Advocate Service, “National Taxpayer Advocate’s 2006 Annual Report to Congress,” Internal Revenue Service, <http://www.irs.gov/advocate/article/0,,id=165806,00.html> (accessed October 16, 2007).

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<sup>52</sup> For a transcript of the tapes, see <http://waysandmeans.house.gov/media/pdf/110/07%2005%2023%20Debt%20Collector%20call%20transcript.pdf>.

<sup>53</sup> National Taxpayer Advocate Service, “National Taxpayer Advocate’s 2007 Annual Report to Congress,” Internal Revenue Service, <http://www.irs.gov/advocate/article/0,,id=177301,00.html> (accessed January 9, 2008).

# Increase Services for EITC Taxpayers

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Re-establishing a robust auditing regime at the IRS is crucial to closing the tax gap. But focusing on enforcement at every turn, particularly having that focus land disproportionately on low-income taxpayers, is not the best solution. The IRS has taken an approach to overseeing and enforcing the Earned Income Tax Credit (EITC) that relies far too much on audits and not enough on services. This is unfair to those taxpayers who claim the EITC, who are held to a higher standard by the IRS than any other taxpayer group, and it fails to address EITC over-claims caused by errors, not malfeasance.

The EITC is a refundable tax credit for low-income workers. In tax year 2005, the EITC provided more than \$41 billion to over 21 million families and individuals.<sup>54</sup> It lifts more working families out of poverty than any other work support; in 2003, the EITC helped raise 4.4 million people, including 2.4 million children, above the poverty line.<sup>55</sup>

Since it is a tax credit, the IRS administers the EITC and is responsible for maintaining its integrity. In 1999, the IRS estimated the EITC noncompliance rate at between 27 and 32 percent, resulting in between \$8.5 to \$9.9 billion annually in overpayments, or about three percent of the tax gap (though the NTA believes that rate is overstated).<sup>56</sup>

## *Wrong Strategy: Punishing EITC Taxpayers*

Mostly by congressional mandate, the IRS has taken a punitive approach to EITC error reduction. Congress designates a portion of the annual IRS budget specifically for EITC compliance. In FY 2006, Congress allocated \$167 million for EITC compliance, which the IRS used on several initia-

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<sup>54</sup> Center on Budget and Policy Priorities, “EIC Participation for Tax Year 2005, by State,” <http://www.cbpp.org/eic2008/docs/EIC%20participation%20prelim%20ty%202005.pdf> (accessed October 17, 2007).

<sup>55</sup> Robert Greenstein, “The Earned Income Tax Credit: Boosting Employment, Aiding the Working Poor,” Center on Budget and Policy Priorities, <http://www.cbpp.org/7-19-05eic.htm> (accessed October 17, 2007).

<sup>56</sup> Ibid.

tives that focus disproportionate enforcement efforts on EITC taxpayers.

With this funding, Congress has instructed the IRS to heavily audit EITC taxpayers. Under the EITC compliance initiative in FY 2006, almost 517,617 audits were performed on tax returns where the EITC was claimed. These audits constituted about 40 percent of all audits performed on individual tax returns in FY 2006.<sup>57</sup> The examination rate for EITC recipients was 2.25 percent, compared to 1.0 percent for all individual income tax returns, and 1.3 percent of all individuals making over \$100,000.<sup>58</sup> Yet EITC audits yield only a fraction of the total revenues recovered by IRS examinations. EITC audits identified nearly \$1.5 billion in excess payments, resulting in a yield of only \$2,895 per audit – the lowest rate of return for any type of audit performed by the IRS.<sup>59</sup>

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***[EITC] audits constituted about 40 percent of all audits performed on individual tax returns in FY 2006, even though EITC errors account for only three percent of the tax gap.***

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Aside from a disproportionately large number of audits, EITC taxpayers are subject to a set of additional enforcement programs. First, the IRS applies a unique type of examination – called “recertification” – only to EITC taxpayers. The recertification program requires taxpayers to “recertify” if they had the EITC denied during an examination. This denial places recertification indicators on a taxpayer’s account until the taxpayer proves he or she is eligible to receive the credit again. Once the taxpayer has provided sufficient evidence, he or she is deemed “recertified,” and the taxpayer is once again eligible for the EITC. The number of taxpayers subject to this recertification tripled from

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<sup>57</sup> Internal Revenue Service, “SOI Tax Stats -- IRS Data Books.”

<sup>58</sup> Ibid.

<sup>59</sup> Ibid.

326,000 in September 1999 to almost 1 million by December 2003.<sup>60</sup> No other tax credit, deduction, or exemption requires such a high burden of proof.

The IRS has also put holds on millions of refunds to crack down on EITC errors. Beginning in 2005, the Criminal Investigations Division of the IRS began a program that postponed sending EITC refunds to people suspected of fraud. The NTA's 2005 Report to Congress revealed that of the 1.6 million taxpayers who had their refunds frozen, 75 percent were EITC recipients.<sup>61</sup> In 80 percent of the frozen refund cases brought to the NTA last year, the IRS ended up paying full or partial refunds, indicating a very large percentage of innocent filers had to face hardships resulting from delayed refunds.

Moreover, anecdotal evidence indicates the fear of punitive action by the IRS discourages workers from claiming the EITC. Currently, one in five workers who is eligible for the EITC does not claim it. Much of the energy and funding the IRS devotes to EITC compliance programs could be better spent by offering the helping hand of taxpayer services rather than punitive enforcement.

#### *Expanded Assistance Would Reduce Error Rates*

The EITC error rate could be significantly reduced by increasing the capacity of nonprofit or government tax preparation services to assist EITC-eligible taxpayers.<sup>62</sup> EITC error rates do not distinguish taxpayers who intentionally cheated on their returns from those who simply made mistakes. EITC filings are complicated, requiring a 50-page

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<sup>60</sup> Treasury Inspector General for Tax Administration, "The Earned Income Credit Recertification Program Continues to Experience Problems," U.S. Department of Treasury, <http://www.treas.gov/tigta/auditreports/2005reports/200540039fr.html> (accessed October 17, 2007).

<sup>61</sup> National Taxpayer Advocate Service, "National Taxpayer Advocate's 2005 Annual Report to Congress," Internal Revenue Service, <http://www.irs.gov/advocate/article/0,,id=152735,00.html> (accessed October 17, 2007).

<sup>62</sup> Another effective approach is to simplify the credit. See Max Sawicky, "Where the Money Isn't," Economic Policy Institute, [http://www.epinet.org/content.cfm/issuebriefs\\_ib183](http://www.epinet.org/content.cfm/issuebriefs_ib183).

instruction manual,<sup>63</sup> and therefore, many EITC over-claims are the result of mistakes that could be prevented. In fact, as much as 50 percent of all tax returns with errors are thought to be unintentional and have been linked to the complexity of EITC eligibility requirements.<sup>64</sup> These errors could be addressed principally by simplifying tax laws and, when necessary, giving taxpayers help in preparing what may unavoidably be a complicated application process.

Through its nationwide network of Taxpayer Assistance Centers (TACs), the IRS makes tax return preparation services available for low-income tax filers on a walk-in basis. Studies have found IRS-prepared returns from these centers are substantially more accurate than both self-prepared and commercially prepared returns.<sup>65</sup> Audits show that TAC-prepared EITC returns resulted in between \$640-1,300 less in erroneous payments than unprepared returns.<sup>66</sup>

Yet the IRS has decided to reduce the quantity and quality of services available at TACs. The number of tax returns TACs prepared declined from 665,868 in FY 2003 to a projected 406,612 in FY 2006.<sup>67</sup> A 2006 report by TIGTA also found more than ten percent of TACs (47 of 400) were critically understaffed.<sup>68</sup> As the sheer volume of returns processed

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<sup>63</sup> See the IRS web site for the manual: <http://www.irs.gov/pub/irs-pdf/p596.pdf>.

<sup>64</sup> Max Sawicky, "Where the Money Isn't," Economic Policy Institute, [http://www.epinet.org/content.cfm/issuebriefs\\_ib183](http://www.epinet.org/content.cfm/issuebriefs_ib183) (accessed October 17, 2007).

<sup>65</sup> Nina Olson, "The IRS and the Tax Gap," Testimony before the Committee on the Budget, U.S. House of Representatives, [http://www.house.gov/budget\\_democrats/hearings/2007/08Olsontestimony.pdf](http://www.house.gov/budget_democrats/hearings/2007/08Olsontestimony.pdf) (accessed October 16, 2007).

<sup>66</sup> Ibid.

<sup>67</sup> Nina Olson, "Hearing on Internal Revenue Service FY2008 Budget Request" Written Statement before the Subcommittee on Financial Services and General Government Committee on Appropriations, U.S. Senate, April 9, 2007.

<sup>68</sup> Treasury Inspector General for Tax Administration, "The Field Assistance Office Has Taken Appropriate Actions to Plan for the 2006 Filing Season But Challenges Remain for the Taxpayer Assistance Program." U.S. Department of Treasury, <http://www.treas.gov/tigta/auditreports/2006reports/200640067fr.pdf> (accessed October 16, 2007).

by TACs has decreased, the range of services they provide has also been narrowed.<sup>69</sup> For example, in North Dakota, where farming is a major industry, the TACs have been instructed not to answer questions related to reporting farm income on tax returns.<sup>70</sup> As more evidence of the detrimental combination of limited resources and unwise decisions at the IRS, employees at TACs have also been re-assigned to jobs unrelated to taxpayer assistance, including being instructed to perform collection activities. This change diverts additional resources away from services offered at TACs.<sup>71</sup>

Even more worrisome, the IRS has also been attempting to close TACs. In 2005, the IRS announced plans to shut down 68 of the 400 TACs nationwide. Before the IRS could carry out these plans, Congress passed a bill prohibiting the IRS from closing the TACs until TIGTA could evaluate the potential impact the closures would have on taxpayers. In March 2006, TIGTA completed the report, which concluded the data concerning TAC usage, on which the IRS based its plans for TAC closures, was unreliable. IRS has so far delayed the closures.<sup>72</sup>

Dedicating additional resources to low-income services would have the benefit of reducing EITC error rates, closing the tax gap, and expanding needed services to more low-income taxpayers. At a minimum, the IRS and Congress should dedicate sufficient resources to maintain existing TACs. Even more funding would make the TAC network more responsive to taxpayer needs, both by open-

ing more centers around the country and expanding the scope of services offered to taxpayers.

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<sup>69</sup> National Taxpayer Advocate Service, “National Taxpayer Advocate’s 2005 Annual Report to Congress,” Internal Revenue Service. <http://www.irs.gov/advocate/article/0,,id=152735,00.html>

<sup>70</sup> Nina Olson, “Hearing on Internal Revenue Service FY2008 Budget Request.”

<sup>71</sup> National Taxpayer Advocate Service, “National Taxpayer Advocate’s 2005 Annual Report to Congress,” Internal Revenue Service. <http://www.irs.gov/advocate/article/0,,id=152735,00.html>

<sup>72</sup> Treasury Inspector General for Tax Administration, “The Taxpayer Assistance Center Closure Plan Was Based on Inaccurate Data.” U.S. Department of Treasury, <http://www.treas.gov/tigta/auditreports/2006reports/200640061fr.pdf> (accessed October 16, 2006).

# Tax Enforcement Has to be a Priority

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The tax gap is an eminently solvable problem. If Congress were to prioritize funding for IRS examination, collection, and tax preparation services, it would drastically reduce the tax gap. The practical effect of expanding these activities at the IRS would be to make the tax code more equitable, and it would bring in additional revenue that could responsibly finance new programs and services. If implemented in the right way, closing the tax gap could also help to increase public confidence in the tax system and the federal government.

Congress needs to enact sustained increases in the IRS budget immediately and should make a commitment to continue to provide the IRS with the extra resources that are so crucial to effective tax enforcement.

This report has only highlighted a few sections of the IRS budget that merit additional funding and reforms. However, it refrains from specifying the dollar amounts needed to address these concerns and recommends a thorough congressional review of the entire IRS budget. We believe Congress, IRS administrators, and outside experts, upon whose research and expertise this report mainly relies, should come together to find common ground on what an appropriate funding increase would look like, how quickly it should be implemented, and how it could be sustained in coming years. Most experts, both inside the IRS and out, prefer gradual increases in funding, as opposed to a sudden increase. A sudden increase would likely overwhelm the IRS and be implemented inefficiently and with too little oversight. Despite this recommendation, we believe the IRS funding shortage is an urgent matter and should be addressed as quickly as possible.

Ultimately, as with most fiscal issues, the root of the problem is political. The case must be made that fears of an IRS run amok are, in a way, a self-fulfilling prophecy. Attempting to curtail the powers of the IRS through inadequate funding levels has had unintended consequences – it has forced the

IRS to institute policies and enforcement practices detrimental to tax collection, taxpayers' rights, and the progressivity of the tax code. So long as the IRS is underfunded, it will be forced to enforce the tax code unfairly and punitively. However, if the IRS is properly funded and administered correctly, the federal government will have the opportunity to make substantial progress in reducing the tax gap and to ensure the tax system is as progressive in practice as it is in law.

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