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The Tax Gap Mirage

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Despite rapidly rising federal revenues, Congress is considering actions to close the "tax gap" to increase the flow of tax dollars to Washington. The tax gap is the difference between taxes owed and taxes actually collected. According to the Internal Revenue Service, the net tax gap is $290 billion, or 14 percent of taxes owed.[1] Some politicians view the tax gap as a pain-free source of new funding, but they should consider the following:

1. The tax gap in the United States is extraordinarily small by global standards.
2. Lower tax rates and fundamental tax reform are the best ways to improve compliance.
3. Further enforcement efforts would lead to punitive harassment of small business owners and farmers.
4. Tax code complexity is a big problem, but it generally leads to tax avoidance rather than tax evasion.
5. More funding of enforcement and new IRS regulations are very inefficient ways of increasing revenues.

It is theoretically possible to improve compliance with any law. Murder rates could be reduced if governments tripled their police forces and put cameras in private homes. But officials do not take such steps because of concerns about civil liberties, even though murder is far more important than America's modest tax evasion problem. Unfortunately, many policymakers are acting as if the tax gap is a national crisis requiring unprecedented actions that would trample civil liberties.

The United States Has a Small Tax Gap

By global standards, the United States has very little tax evasion. According to the world's leading expert, Friedrich Schneider of Austria's Johannes Kepler University, the U.S. shadow economy accounts for just 8 percent of gross domestic product, which compares to an average of 16 percent for 21 major industrial countries he examined.[2] Indeed, Schneider finds that the United States has the smallest shadow economy of 145 nations analyzed.

A comparatively modest tax burden is perhaps the main reason why American taxpayers are less likely to evade taxes than are their foreign counterparts. Table 1 shows that lower-tax nations such as the United States, Singapore, and Switzerland have the least tax evasion. With lower tax burdens, taxpayers have less incentive to hide their money from tax authorities. However, some U.S. taxes have high marginal rates, which undermines compliance. One study found that a 1 percentage point increase in marginal tax rates is associated with a 1.4 percentage point increase in the underground economy.[3]

Table 1. Size of the Shadow Economy as a Share of GDP

Low-Tax Nations		High-Tax Nations	
Hong Kong	17%	India	26%
Singapore	14%	Germany	17%
Switzerland	9%	Italy	26%
United States	8%	Sweden	18%
Ireland	15%	Greece	28%

Source: Friedrich Schneider, "Shadow Economies of 145 Countries All Over the World," May 2006. Data for 2003.

Tax Reforms and Rate Cuts Would Reduce Tax Gap

High tax burdens are the main cause of tax evasion. Writing for the International Monetary Fund, Schneider and a colleague explained that "macroeconomic and microeconomic modeling studies based on data for several countries suggest that the major driving forces behind the size and growth of the shadow economy are an increasing burden of tax and social security payments . . . the bigger the difference between the total cost of labor in the official economy and the after-tax earnings from work, the greater the incentive for employers and employees to avoid this difference and participate in the shadow economy."[4] These findings are echoed by researchers at the World Bank, the

Organization for Economic Cooperation and Development, and elsewhere.[5]

Declaring War on Small Businesses

According to the IRS, small businesses are responsible for most of the tax gap.[6] A Treasury official testified that "individuals operating cash-based businesses report only 19 percent of their income."[7] And a Treasury report noted that "about 54 percent of net income from proprietors (including farms), rents, and royalties is misreported."[8]

Improving tax compliance among small business owners is a daunting task, however, that would require massive oversight and greater intrusiveness. Such an approach would be unfeasible in cost-benefit terms, and almost surely would result in a backlash that would cause policymakers to end the initiative.

Tax Complexity Leads to Tax Avoidance

Although the biggest effect would be to reduce avoidance rather than evasion according to the academic literature, politicians should simplify the tax system. According to PricewaterhouseCoopers, only four nations have more pages of "primary tax legislation" than does the United States.[9] The World Bank's www.doingbusiness.org ranks 61 nations as having tax systems friendlier to business than does the United States.[10] The World Economic Forum puts the U.S. tax system in 107th place in a ranking of the efficiency of 117 national tax regimes.[11] And the U.S. tax system keeps getting worse—the Treasury Department reports that there have been more than 14,400 changes to the tax code since 1986.[12]

It is also worth noting that there is a reverse tax gap of people who overpay, because of either fear or confusion. According to former IRS commissioner Shirley Peterson, this includes 3.5 million taxpayers who would be eligible for refunds.[13] More recent IRS documents admit that about 25 percent of audited taxpayers are either due a refund or are found to owe no additional tax.[14]

The IRS Budget: A Perpetual-Motion Machine

There is a self-serving argument from the government that more funding for the IRS would reduce the tax gap. Treasury officials even have complained about "reduced IRS enforcement resources."[15] Yet, since 2000, the IRS budget has increased by more than 35 percent and the enforcement budget has jumped by more than 50 percent.

All this money seems to have little impact. IRS researchers have confessed that "random audit studies show little variation in the overall noncompliance rate in the last forty years despite audit rates ranging from less than 0.01 at present to 0.05 during the 1960s."[16] Indeed, a Treasury official confessed that "enforcement is the most costly option and delivers only limited revenue."[17]

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[1] See U.S. Department of the Treasury, "A Comprehensive Strategy for Reducing the Tax Gap," September 26, 2006, www.ustreas.gov/press/releases/reports/otptaxgapstrategy%20final.pdf.

[2] Friedrich Schneider, "Shadow Economies of 145 Countries All Over the World: What Do We Really Know?" May 2006, www.econ.jku.at/Schneider/ShadEconomyWorld145_2006.pdf.

[3] Richard Cebula, "An Empirical Analysis of the Impact of Government Tax and Auditing Policies on the Size of the Underground Economy: The Case of the United States, 1993–94," *American Journal of Economics and Sociology* 56, no. 2 (1997): pp. 173–185, 1997.

[4] Friedrich Schneider with Dominik Enste, "Hiding in the Shadows: The Growth of the Underground Economy," International Monetary Fund, March 2002, www.imf.org/external/pubs/ft/issues/issues30/index.htm.

[5] See Juan Braun and Norman V. Loayza, "Taxation, Public Services, and the Informal Sector in a Model of Endogenous Growth," World Bank, August 1994; Organization for Economic Cooperation and Development, "Forces Shaping Tax Policy," June 1998; and Simon Johnson et al., "Regulatory Discretion and the Unofficial Economy," *American Economic Review* 88, no. 2 (1998): 387–392.

[6] Internal Revenue Service, "The Tax Gap," undated, www.irs.ustreas.gov/pub/irs-utl/tax_gap_facts-figures.pdf.

[7] J. Russell George, "A Closer Look at the Size and Sources of the Tax Gap," Testimony before the U.S. Senate Committee on Finance, Subcommittee on Taxation and IRS Oversight, July 26, 2006.

[8] U.S. Department of the Treasury.

[9] PricewaterhouseCoopers and World Bank, "Paying Taxes: The Global Picture," 2006, www.doingbusiness.org/documents/DB_Paying_Taxes.pdf.

[10] World Bank, "Doing Business 2007: How to Reform," 2007, www.doingbusiness.org/documents/Doing_Business_2007_Country_pages.pdf.

[11] World Economic Forum, "Global Competitiveness Report," 2005–2006, www.weforum.org/en/initiatives/gcp/Global%20Competitiveness%20Report/index.htm.

[12] George.

[13] Shirley Peterson, "Death to the Tax Code," *New York Times*, July 29, 1995.

[14] Internal Revenue Service, "Individual Income Tax Gap Estimates for 1985, 1988, and 1992," April 1996.

[15] George.

[16] Charles Christian, "Voluntary Compliance with the Individual Income Tax: Results from the 1988 TCMP Study," Internal Revenue Service, May 1994.

[17] George.