How Can the Federal Government Reduce the Tax Gap?

What is the tax gap?

The tax gap is the difference between how much money taxpayers owe and how much money they actually pay in taxes. This difference is known as the Tax Gap. For instance, on average during 2008–2010, taxpayers owed about $3.3 trillion in federal taxes but paid only about $2 trillion. This failure to pay tax dollars adds up to hundreds of billions per year, and contributes to the unsustainable growth in federal debt.

This figure shows the tax gap in billions of dollars for 2008–2010. The tax gap is divided into three main categories: underreporting, underpayment, and nonfiling. Underreporting accounted for 84% ($387 billion) of the average annual tax gap for 2008–2010. Underpayment accounted for 68% ($264 billion) of the average annual tax gap for 2008–2010. Nonfiling accounted for 11% ($41 billion) of the average annual tax gap for 2008–2010. The remaining 9% ($39 billion) of the average annual tax gap for 2008–2010 was due to other factors.

So, why doesn’t everyone fully pay their taxes?

There are three main types of tax noncompliance.

- Underreporting is the failure to report all income that is subject to tax.
- Underpayment is the failure to pay the full amount of taxes owed.
- Nonfiling is the failure to file a tax return at all.

Reducing the tax gap could:

- Reduce the deficit and/or raise less money to support federal programs.
- Reduce the deficit and/or raise more money to support federal programs.
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Is there a way to eliminate the tax gap?

Maybe not—doing so could involve more intrusive recordkeeping or reporting than the public is comfortable with, or more resources than IRS can commit. But, since even modest reductions in the tax gap could yield huge financial benefits to the country, here are some ideas that could help.

IRS could:

- Use tax gap and other data to develop strategic ways to address noncompliance.
- Regulate paid tax return preparers to help improve the accuracy of tax returns.
- Make the tax code less complex—so that it is easier for people and businesses to understand and comply with tax laws.

Congress could:

- Require more taxpayers and businesses to file tax returns electronically.
- Establish a central database to track tax payments and reduce the tax gap.
- Increase penalties for those who fail to pay their taxes.

And, although IRS estimated that it could collect about $26 billion/year through late payments and enforcement actions, it also estimated that $100 billion/year will never be collected.