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Finance

[Don’t Raise Taxes. Collect the Billions Not Being Paid.]

By filling in holes in reporting to the IRS and upgrading the agency’s technology, we can avoid punishing the taxpayers who follow the rules.

By
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When the Covid-19 crisis recedes, the federal government will still be left with a grand canyon of annual deficits averaging at least 40% of total tax revenue — before any new spending or tax-reduction programs. Regardless of what else we do about this challenge, now is the time for decisive action to collect the taxes already on the books effectively and fairly.

Last year the federal government failed to collect $574 billion in taxes that were legally due. That’s equal to all the income taxes that were paid by 90% of individual taxpayers.

Shrinking this tax gap is possible if our leaders take two key actions: Fill the holes in the sources of income reported by third parties to the Internal Revenue Service and direct the IRS to make full use of newer technology.

Over the last 25 years, presidential administrations and governments of both parties have steadily cut funding to the IRS, reducing enforcement resources by 28% even as returns increased by 31%. Most taxes are collected through employer withholding from taxpayers’ paychecks, or their incomes are clearly reported. But a massive amount of income is not reported by taxpayers and therefore not collected by the IRS.

This ever-increasing tax gap benefits only noncompliant taxpayers, and it is unfair to those who do pay what they owe. Simply raising taxes on already compliant taxpayers would only increase this kind of unfairness.

Most taxpayers receive reports such as W-2s from their employers. This information helps taxpayers file accurately and allows the IRS to check compliance efficiently. About 95% of income that is fully reported by third parties is accurately filed by taxpayers, but only 45% of income that is not reported at all by third parties, such as most business income, is filed by taxpayers.

To account for that missing 55% of reported income, taxpayers with more than $25,000 in business income should be required to report on their tax returns the bank accounts in which their income is deposited. Banks would then be required to report these deposits to the IRS, just as employers report wages for their employees. This provision would be part of a larger legislative initiative to improve compliance.

Past experience shows that when additional specific data is required, taxpayers improve their reporting. For example, in 1988, when taxpayers were first required to list the Social Security numbers of dependents claimed as exemptions, 42 million fewer dependents were claimed than in 1986. Where'd they go? They never existed.

By itself, however, more reporting of more complex forms of income would not be practical, because the IRS's technology cannot use all the information it already receives, and significant areas of noncompliance are barely addressed. Requiring the use of newer technology would enable the IRS to rapidly assess all tax returns to identify deficiencies with much greater accuracy.

The IRS is already using updated technology on a limited scale. The Government Accountability Office reported that a modernized IRS program to stop fraudulent refunds saved $6.5 billion over three years after an investment of $419 million — a return of 15 times its investment.

These reforms will over time reduce the level of unreported income closer to that of income that is reported by third parties, gaining approximately $1.6 trillion in revenue in the first 10 years, and will improve the way all taxpayers interact with the IRS. Revenue gained would be 12 to 25 times the cost.

Far from singling out any group of taxpayers for undue attention from the IRS, it would put all taxpayers on a more equal footing. Taxpayers with small amounts of business income — 70% of businesses — would be exempt from additional reporting. The improved technology would enable the IRS to focus enforcement on tax returns that it knows have deficiencies.

This proposal is not a fiscal elixir, but it would mark serious progress. For example, without increasing taxes on compliant taxpayers, it would raise nearly as much revenue over 10 years as the individual income and Social Security tax increases proposed by presidential candidate Joe Biden.

Before raising taxes on any person or business, it is only fair that we collect the taxes that are already owed. It's time to mandate that the IRS shrink the tax gap.

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