

CED Trustee Briefing

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A Tool to Reduce Growing Budget Deficits? The Collection of Unpaid Taxes

In 2019, there was roughly \$574 billion of uncollected income taxes – an amount equal to 87 percent of what the government spent on all its domestic programs, and more than what the bottom 90 percent of taxpayers ranked by income paid collectively.

In a conversation with Trustees earlier this week, **Charles O. Rossotti**, Senior Adviser, The Carlyle Group, and former Commissioner, Internal Revenue Service, shared his perspective on how we can close the country's tax gap, and thereby mitigate our worsening budget deficits.

Among the takeaways:

The nation's income tax gap (i.e., the difference between how much we collect in taxes each year and how much is legally owed) has grown in recent years because of a weakness of tax administration. The failure to pay legally owed income taxes is not spread evenly across the population. For typical taxpayers with income from wages and salaries, income is reported directly to the tax authorities, and tax is withheld at the source. Compliance on such income is at least 95 percent. Income from businesses and capital gains is not subject to information reporting, and compliance is much less.

Noncompliance breeds further noncompliance. Taxpayers who observe failure to pay see both the opportunity to evade tax liability, and the inequity if they pay while others do not.

As income inequality worsens, the tax gap is likely to continue to grow, because the most rapid income growth occurs via the low-visibility income from businesses including pass-through entities, which is not subject to information reporting, and where the IRS systems are notably incapable of processing the data needed to verify compliance. Raising statutory tax rates will by definition bear on income that is reported, and not on the low-visibility income that is hidden from the tax authorities. That will aggravate the current perceptions of inequality, which could defeat the purpose of tax increases for deficit reduction.

Rossotti champions a three-part program to collect more of the income tax that is legally owed. First, he would broaden the current information reporting system and its requirements. Second, he would make investments in IRS technology, to make use of the additional data and to facilitate tracking low-visibility income. And finally, he would expand the IRS staff to increase the capacity to audit and examine tax returns. Increasing IRS capacity would also improve its ability to provide

routine taxpayer service and reduce public frustration with long telephone wait times on calls seeking assistance. Over time, the evidence of sound IRS tax administration can be expected to increase compliance by taxpayers who see reduced odds in the “audit lottery.” Given the enormous size of both the tax gap and the budget deficit, Rossotti sees this as a sensible first step in shrinking both the tax gap and the budget gap.

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