

Focus on the Tax ‘Avoidance’ Gap

By Eric Toder

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President Obama’s tax reform task force has been asked to propose ways to close the \$300 billion per-year tax gap by simplifying the tax code, reducing evasion, closing loopholes, and reducing corporate tax breaks. That \$300 billion figure is an IRS estimate of the “net tax gap” for tax year 2001. The IRS defines the net tax gap as the difference between the amount taxpayers owe for a given tax year and the amount they pay on time, less what the IRS expects to recover in the future from voluntary late payments and enforcement activities.

The apparent focus on the IRS-defined tax gap is the wrong agenda for a tax reform panel. The United States faces two tax gaps: the IRS measure of tax evasion and a second gap that may be called the legal avoidance gap. This second gap — the difference between taxes under an income tax without special preferences and taxes under current law — is much larger than the evasion gap, and there are ways to reduce it substantially, if the political will exists.

Comparing the Two Tax Gaps

Government agencies estimate both the “evasion” and “avoidance” gaps. There are major technical and conceptual problems in measuring both gaps, but the evasion gap is much harder to estimate. Reducing the evasion gap requires better monitoring of the behavior of individual and corporate taxpayers, but the perpetrators of the avoidance gap are legislators, not taxpayers.

Both evasion and avoidance impose costs on the rest of us (higher tax rates to raise the same revenue, larger deficits, and less funding of public services). But measures to reduce them also have economic costs. Reducing evasion requires measures that increase the IRS budget and impose costs on audited

taxpayers and third parties required to supply more data to the IRS. Closing tax preferences reduces whatever social and economic benefits some tax incentives provide. And the most costly of those preferences — provisions such as the mortgage interest deduction, exemption of employer-provided health benefits, and exemption of income accrued in section 401(k) plans — are widely used and have strong political backing.

The IRS periodically updates its estimates of the tax gap, most recently in 2006 for tax year 2001. That evasion gap consists of three components: nonfiling, underreporting (by filers who underreport liability), and underpayment (failure to pay the full amount of tax reported). Underreporting is by far the largest component, and its biggest source is the individual income tax — especially for income sources not subject to withholding or document matching.

Information about the size of the avoidance gap comes from annual lists of tax expenditures published by the Office of Management and Budget and the Joint Committee on Taxation. Tax expenditures are defined as “revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability” (OMB). Whether labeled as disguised expenditures or structural defects in the tax system (Kleinbard, 2008; Shaviro, 2004), those provisions represent departures from a normative concept of a broad-based income tax.

There are serious problems in measuring both gaps. But the avoidance gap is easier to measure than the evasion gap because it derives from visible transactions that would generate different revenue under alternative tax rules, while the evasion gap comes mostly from transactions people fail to report accurately and is therefore less visible. (For a discussion of issues in measuring the evasion tax gap, see Toder, 2007[a]. The OMB discusses some of the issues in measuring tax expenditures.)

The IRS is responsible for enforcing the tax laws and thereby limiting the size of the evasion gap. Treasury’s Office of Tax Policy has traditionally assumed responsibility for resisting proposals that would erode the tax base. But the combination of strong political and institutional forces pushing for special tax

breaks and a weakening of the Office of Tax Policy's influence since the 1980s suggests continued problems in controlling the avoidance gap.

How Big Are the Tax Gaps?

The IRS estimates a gross tax gap of \$350 billion for tax year 2001, of which it expects to recover \$50 billion eventually. If it maintained the same fraction of fiscal year receipts over time, the gross tax gap would increase to about \$410 billion by 2010. In contrast, the OMB's 2010 budget lists tax expenditures totaling \$934 billion for fiscal 2010. Adding the separate estimates introduces errors by ignoring interactions, but Burman, Toder, and Geissler, 2008, find that the cost of most individual tax expenditures estimated simultaneously exceeds the sum of the separate provisions. However one measures it, the avoidance gap is at least twice the size of the evasion gap.

The evasion gap is much harder to close than the avoidance gap. Expanded information reporting and more IRS examination resources could improve compliance, but the additional amount that those measures could raise is fairly modest (Toder, 2007[b]). Some recently advanced proposals (broker reporting of cost basis, third-party reporting of credit card sales) have already been enacted, and additional compliance proposals in the Obama administration's budget proposal would raise just \$10 billion in the next decade. Reducing or closing preferences in the individual and corporate income taxes could raise much more money (for examples, see Congressional Budget Office, 2007).

Conclusions

The tax reform panel's apparent mandate to focus on tax evasion is misplaced. The avoidance gap — the additional revenue that could come from broadening the income tax base — is much larger than the evasion gap and much easier to close, with sufficient political will. Congress should certainly give the IRS the appropriate tools to catch tax evaders, but the real erosion of revenue comes from legislation that lets favored taxpayers who engage in favored activities pay less than others with the same income. The panel's main focus should be on finding appropriate ways to close that second tax gap.

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