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Make Tax System Fairer, Easier for Taxpayers While Collecting $1.4 Trillion Owed But Not Paid

By Fred Goldberg and Charles Rossotti

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The Covid-19 crisis is creating a huge deficit. Two former IRS commissioners—Fred Goldberg and Charles Rossotti—who served during Democratic and Republican administrations, say the way to reduce that deficit is not by increasing tax rates, but by increasing tax collection.

Taming the Covid pandemic and restoring the economy dominate public discussion now. But these immediate issues only delay recognizing a giant financial dilemma.

Even when the economy recovers from the Covid-19 crisis, annual deficits will average about $2 trillion per year, equal to 40% of all tax revenue. Political pressures will push toward more spending and to continue tax cuts benefiting the middle class that are now scheduled to expire.

Whatever else is done to address these massive financial pressures, we must make the tax administration system more fair and more efficient for all taxpayers while collecting more of the taxes already owed but not paid under current law.

In 2019 the tax gap—taxes owed but not paid—was $574 billion. That's more than all the taxes paid by the lowest 90% of individual taxpayers. If we simply raise taxes without also fixing the system only taxpayers who are already compliant with bear the increase.

That is not fair or sustainable.

We believe that there is a practical bi-partisan way to address this dilemma by making tax collection fairer and easier for people who interact with the IRS while collecting an additional $1.4 trillion over 10 years—mostly from people in the upper brackets who don't pay all the taxes they owe. This amount is more than would be raised by President Biden's plan to raise individual income taxes. Increased compliance at the Federal level would also translate to increased revenue at the state and local level.

We can accomplish these goals by doing three things: building on third-party information reporting to the IRS in ways that do not burden taxpayers and make compliance easer; investing in technology that enables better use of this information; and scaling up but transforming auditing to be far more efficient for the IRS and less intrusive for taxpayers.

Most taxpayers don't need to be audited because they receive reports such as W-2's from their employers and 1099's from their banks. This information helps taxpayers file accurately and allows the IRS to check compliance efficiently. About 95% of income that is fully reported by employers and banks is accurately reported by taxpayers, but only 45% of income that is not reported by third parties is reported and taxed.

By filling the holes in the kinds of income reported by third parties to the IRS we can greatly increase compliance in an efficient way for both taxpayers and the IRS.

Recent reports by independent watchdogs have supported this conclusion with compelling findings. One report by GAO cited a 2019 National Bureau of Economic Research working paper that estimates increasing information reporting requirements even modestly for income that is currently subject to little or no information reporting requirements, including sole proprietor income, could generate roughly $115 billion in revenue in 2020.

What's critical here is that substantially all of the revenue increase does **not** come from IRS audits—it comes from taxpayers getting it right when they file their returns.

We have proposed a practical way to fill some of the holes in third party reporting by requiring banks to provide to the top earning 25% of taxpayers with business income a short annual summary of their deposits and withdrawals. Almost all these high income business taxpayers use professionals preparers who could use this information to help prepare accurate returns.

The IRS could use this and other information they receive to check these returns far more accurately and efficiently than in a traditional audit. Today, almost a quarter of IRS audits are unnecessary because they are based on statistical guesswork rather than actual data. This is highly inefficient for the taxpayer and the IRS. Indeed, even simple "correspondence audits" take six months to complete because much of the time is consumed simply gathering data.

By itself however, adding more information reports would not be sufficient because the IRS cannot use all the information it already receives due to outdated technology. For example, millions of reports, such as K-1'sfrom partnerships, can only be used manually in an audit.

Updating the IRS's outdated technology would enable rapid assessment of all tax returns using all available information to identify deficiencies with much greater accuracy and would greatly improve the efficiency of the audit process for the taxpayer and the IRS.

Notices sent to taxpayers would have more specific information. Case files the IRS employees use would be more complete. And the methods used to communicate with taxpayers would be faster and more convenient.

The effect of this transformation of the process is that audits would be more focused on cases that truly have significant underreported income and overstated deductions, and they would be resolved faster and more efficiently for the taxpayer and the IRS.

Yes, this program would require a multi-year commitment to increased spending, but over time it would produce revenue equal to 15 to 20 times its cost while increasing the fairness and sustainability of the tax system.

We believe that there is sufficient data available that the Congressional budget reconciliation process coming later this year can include specific authority and direction for the IRS to reduce the tax gap, to provide outlays required for incremental technology and staffing, and to estimate related revenue gains over a ten year period.

President Biden has emphasized a bi-partisan approach to solving problems. Fixing the tax system as we propose would be a great start toward resolving one of the government's most difficult dilemmas.

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