

Gross Tax Gap Trends According to New IRS Estimates, Income Years 1973–1992

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According to new Internal Revenue Service (IRS) estimates, the gross tax gap for individuals increased from \$19.7 billion for 1973 to \$63.5 billion for 1987. Over the same period, the gross gap for corporations increased from \$8.8 billion to \$21.4 billion. These estimates reflect the effects of new legislation which causes a reduction in the individual tax gap and a rise in the corporate gap. The estimates also reflect the latest compliance data which show that the individual compliance rate had risen for Income Year 1982 [1].

INTRODUCTION

The IRS defines the gross tax gap as the amount of income tax owed for a given year, but not voluntarily paid. The gap is measured net of overpayments. This comprehensive measure of tax compliance provides valuable information about the challenges faced by Federal tax administration officials and tax policymakers. The net tax gap equals the gross tax gap less taxes paid as a result of IRS enforcement activity. Although the net tax gap may be useful for some purposes, it is not analyzed here because it is not a measure of voluntary compliance.

The gross tax gap is comprised of unpaid income taxes on legally-earned individual and corporate income. Some individuals and corporations have created the gap by overstating deductions, credits, or exemptions; understating income; or making math errors on their tax returns. The gap also exists because some individuals and corporations fail to file obligatory tax returns and because some do not voluntarily pay taxes they report. (The most recent IRS estimates, however, do not include estimates for corporate nonfilers or for taxes reported, but not paid.)

Unreported income does not correspond to income earned in the "underground economy." The latter term usually refers to both illegal and legal transactions while the former covers only the legal sector. Income from illegal transactions is taxable, but extremely difficult to measure and tax. At present, IRS does not include illegal income in its tax gap estimates. The IRS estimates do account, however, for the legal portion of the so-called underground economy, such as unreported tip income, which forms part of the unreported wages and salaries, and unreported informal supplier income [2]. (Informal suppliers operate with no regular business addresses; generally keep no

formal books or records; and do not necessarily conform to formal requirements for licensing, permit filing, or other performance codes.)

Many believe that this underground economy has assumed large proportions in the United States and elsewhere—and that it continues to grow in relation to the regular economy [3]. Examining both press reports and scholarly works on the subject reveals, however, that different people define the underground economy in different ways [4]. Specifically, it is not at all clear what particular types of business activities should fall into the proper definition. This and other ambiguities make this "economy" more a figure of speech than a concept with operational meaning.

ANALYSIS OF THE GAP

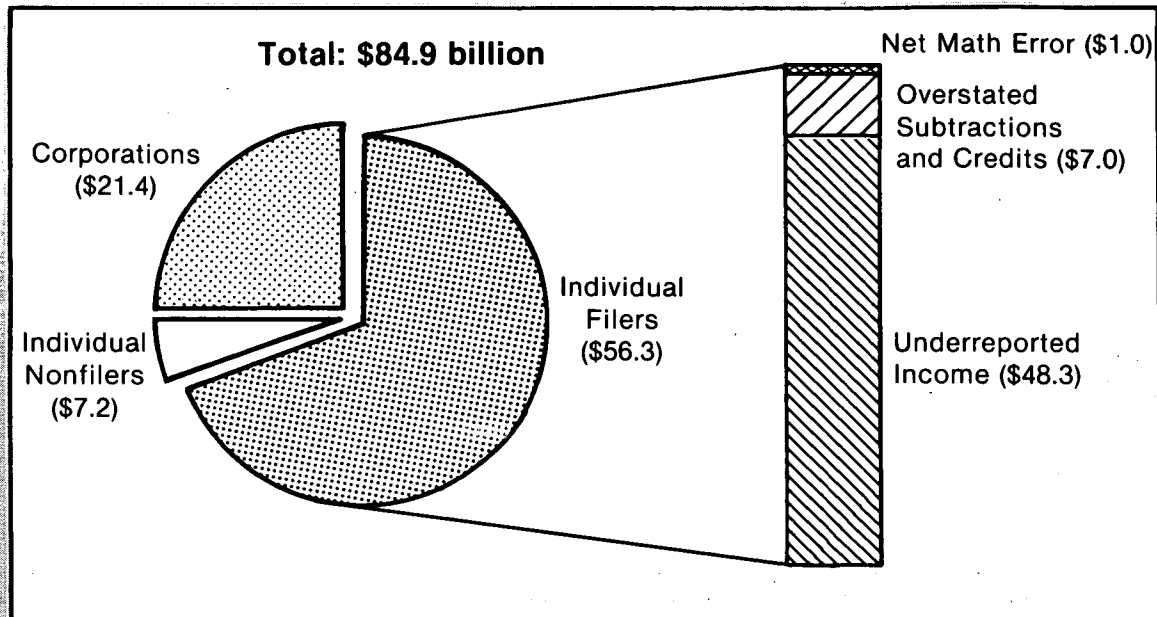
For 1987, the total gross income tax gap amounted to \$84.9 billion. Noncompliant individuals were responsible for \$63.5 billion of this total; corporations accounted for virtually all of the remaining \$21.4 billion [5]. The amounts, summarized in Figure A, represent only income tax gaps, and do not include gaps resulting from failure to report employment or excise taxes, or any other non-income tax.

As Figures A and B illustrate, individuals who file returns but underreport their tax liabilities (either by underreporting income or by overstating deductions, credits or exemptions) account for most of the tax dollars lost to noncompliance. For 1987, this filer tax gap is estimated to be \$56.3 billion—almost eight times as large as the gap resulting from individuals who do not file the required tax returns. The nonfiler tax gap is relatively small mainly because employers and other payers of income withhold tax from nonfilers' incomes.

The tax gap due to underreported income of individual filers (\$48.3 billion) accounts for well over half of the total \$84.9 billion tax gap for 1987. Underreported farm and nonfarm proprietor income (\$26.3 billion) makes up more than half of all underreported individual income. This \$26.3 billion includes an estimated \$7.7 billion of underreported proprietor income believed to have been earned by informal suppliers who tend to operate "off the books." Informal suppliers include roadside or sidewalk vendors, moonlighting craftsmen or mechanics, unlicensed providers of child or elderly care services, and similar operators with informal business styles.

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Figure A
Revised Estimates of the Gross Tax Gap, Income Year 1987
 Billions of dollars



Other areas contributing significant amounts to the tax gap include the failure of individuals to report all capital gains (\$6.6 billion), interest and dividends (\$3.2 billion), income distributions from partnerships and S Corporations (\$3.2 billion), and rents and royalties (\$3.1 billion) [6]. The shortfall in reported tax stemming from underreporting of wages and salaries and pensions and annuities is estimated to be about \$1.5 billion. The remaining \$4.2 billion is attributed to taxable social security and unemployment insurance payments, alimony, State income tax refunds, estate and trust income, and other income.

In contrast to the tax gap for individuals, the corporate tax gap for 1987 (shown in Figure B) is divided into only a few components because sufficient data do not exist to prepare detailed estimates. In particular, data are not available to distinguish the portion of the total corporate tax gap that is due to underreported income from the portion that is due to overstated deductions or credits. Such data are available only for small corporations (i.e., corporations with assets under \$10 million), which account for less than a quarter of the corporate tax gap. The internal financial controls established by larger corporations to help protect the interests of their stockholders make it difficult to hide corporate income from the tax agencies. As Figure B shows, even for small corporations, less than half of the tax gap is estimated to be underreported income. The comparable percentage for individuals is 86 percent.

The corporate tax gap is mainly attributable to overstated expenses and credits rather than to underreported income or nonfiling. Particularly for large corporations, noncompliance usually involves aggressive tax planning that exploits the imprecise language of some tax laws. Tax law may also be circumvented by using improper accounting practices, especially in sourcing incomes and expenses associated with multinational operations involving several geographic regions or business entities.

TRENDS

Figure C presents estimated and projected tax gaps and voluntary compliance rates (VCR's) for selected years. The VCR measures the relationship between the total amount of tax that is voluntarily reported for any given year and the corresponding amount that should have been reported for that year. Figure D shows what should have been reported if measured on the basis of actual additional tax assessed, rather than on the basis of additional tax audit examiners recommend (Figure C).

The estimates of the total tax gap (in current dollars) increased from \$28 billion for 1973 to \$62 billion for 1979 to \$85 billion for 1987. The gap is projected to increase to \$114 billion for 1992. The estimated and projected growth of the tax gap is due in large part to the growth of income tax liabilities through real expansion of the economy and through inflation.

Figure B.—Gross Tax Gap by Source, Income Year 1987

[All figures are estimates—money amounts are in millions of dollars]

Source of gap	Tax gap ¹	Percentage of total
Total income tax gap	\$84,874	100.0%
Individual income tax gap, total ...	63,475	74.8
Filers of tax returns, total	56,301	66.3
Underreported income, total.....	48,292	56.9
Wages and salaries.....	1,417	1.7
Interest and dividends.....	3,227	3.8
Capital gains.....	6,650	7.8
Informal suppliers ²	7,739	9.1
Other nonfarm proprietor income.....	16,646	19.6
Farm income.....	1,904	2.2
Income from partnerships and S Corporations	3,216	3.8
Pensions and annuities.....	123	0.1
Rents and royalties.....	3,141	3.7
Estate and trust income.....	64	0.1
State income tax refunds.....	86	0.1
Alimony income.....	173	0.2
Taxable unemployment and social security benefits.....	338	0.4
Other income.....	3,566	4.2
Overstated subtractions, total	6,062	7.1
Deductions	3,478	4.1
Personal exemptions.....	2,039	2.4
Statutory adjustments	545	0.6
Overstated credits.....	899	1.0
Math errors.....	1,049	1.2
Nonfilers of tax returns	7,174	8.4
Corporation income tax gap, total	21,399	25.2
Small corporations (total assets under \$10,000,000), total	5,225	6.2
Underreported income	2,519	3.0
Overstated deductions.....	2,706	3.2
Large corporations (total assets \$10,000,000 or more)	15,845	18.7
Other ³	329	0.4

¹ The gap and its components are measured net of overpayments.² Informal suppliers are sole proprietors who operate with informal business styles; see text for examples.³ Consists of \$164 million gap for fiduciaries reporting income of estates and trusts and \$165 million gap for tax-exempt organizations reporting "unrelated business income," both classified under corporations for purposes of this analysis.

Note: Detail may not add to totals because of rounding.

Changes in voluntary compliance, however, also exert an important influence on the trend in the individual tax gap. Corporate compliance data over time are quite limited. Consequently, in estimating and projecting the corporate tax gap, essentially one composite VCR was used to represent corporate compliance for all years.

The growth rate in the individual gap is fairly rapid from 1973 to 1979, but much slower from 1979 to 1982. These trends reflect changes in the VCR for individuals—which decreased from 84.6 percent for 1973 to 81.8 percent for 1979, and then increased to 83.7 percent for 1982. From 1982 to 1986, the combined influence of real economic growth and inflation dominate the trends in both individual and corporate tax gaps. From 1986 to 1988, the Tax Reform Act of 1986 (TRA) causes the individual gap to decline and the corporation gap to increase even as economic factors continue to exert their normal influences on the tax gap.

None of the trend changes after 1982 can be attributed to changes in compliance. This is because the data needed

to determine improvements or declines in voluntary compliance do not exist. The most recent year for which IRS has data from the Taxpayer Compliance Measurement Program (TCMP) for individuals is 1982 [7]. Consequently, for years after 1982, it was assumed that the voluntary reporting percentage for each source of income, such as sole proprietor income or wage income, remained constant. Similarly, after 1982, the reporting percentage for each deduction, exemption, adjustment, or credit claimed is also assumed to remain constant.

Even though the reporting percentage for every individual income source and every subtraction from individual income or tax is held constant, the overall VCR for the individual income tax may fluctuate. This is because the relative weights of the various income and subtraction items, which contribute to the overall noncompliance rate, change over time in response to changing economic conditions. It is known that some types of income are not reported as well as others. Consequently, if, in response to changing economic conditions, the relative importance of the more poorly reported types (e.g., proprietor income) increases, the VCR's for total individual income for those years decline. For example, the individual VCR declined from 83.7 percent for 1982, a recession year, to 81.6 percent for 1985, a year of expansion.

As Figure E shows, the combined influence of a prosperous period, which enlarged the tax base, and a decline in the VCR, accelerated the growth rate of the individual tax gap from 1982 to 1985. The drop in the individual tax gap from \$79.3 billion for 1986 to \$63.5 billion for 1987 is primarily due to the 1986 tax reform. This new law lowered marginal tax rates and repealed or limited many deductions, thereby reducing the possibility for taxpayers to overstate these deductions.

As mentioned above, in estimating and projecting the total corporate tax gap, for the most part one composite VCR was used to represent the corporate sector's compliance behavior for all years. The decline in the corporate gap from \$15.0 billion for 1979 to \$10.7 billion for 1982 reflects a drop in corporate tax liabilities due to the two back-to-back recessions in 1980 and 1981 to 1982, in addition to the tax cuts contained in the Economic Recovery Tax Act of 1981. The increase in the corporate tax gap, from an estimated \$15.6 billion for 1986 to an estimated \$21.4 billion for 1987, is attributable to the new law enacted in 1986 and to higher corporate profits, which together increased corporation tax liabilities for 1987.

TRA had a minor impact on the rate of change in the total tax gap from 1987 to 1988. After 1988, the increases in the individual and corporate tax gap estimates reflect little more than projected increases in tax (liabilities) of individuals and corporations.

Gross Tax Gap Trends According to New IRS Estimates, Income Years 1973-1992

Figure C.—Estimated Gross Tax Gaps and Voluntary Compliance Rates After Audit Examination, Selected Income Years, 1973-1992¹

[All data are estimates—money amounts are in billions of dollars]

Source of gap	1973	1976	1979	1982	1985	1986	1987	1988	1992
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Total tax gap	\$28.4	\$40.7	\$61.7	\$62.6	\$87.8	\$95.0	\$84.9	\$87.1	\$113.7
Individuals, total.....	19.7	29.6	46.8	51.9	73.3	79.3	63.5	64.3	82.6
Filers.....	17.9	26.8	42.3	46.2	65.5	71.2	56.3	56.9	72.4
Understated income.....	15.4	24.6	36.4	38.1	54.6	60.0	48.3	48.5	62.8
Overstated subtractions.....	2.4	2.0	4.7	6.5	8.6	8.9	6.0	6.1	6.8
Overstated credits.....	-.1	-.3	.6	.9	1.2	1.3	.9	1.1	1.3
Math errors.....	.2	.2	.5	.7	1.0	1.0	1.0	1.1	1.5
Nonfilers.....	1.8	2.8	4.5	5.7	7.8	8.1	7.2	7.3	10.2
Corporations ²	8.8	11.1	15.0	10.7	14.4	15.6	21.4 ³	22.8	31.1
Total voluntary compliance rate (VCR)	83.7%	82.4%	81.7%	83.4%	81.6%	81.1%	83.2%	83.6%	84.2%
Individuals.....	84.6	82.6	81.8	83.7	81.6	81.0	83.5	84.0	84.9
Corporations ²	81.3	81.6	81.3	81.8	81.7	81.7	82.5	82.4	82.5

¹ The gap and its components are measure net of overpayments.

² Includes the tax gaps for fiduciaries reporting income of estates and trusts and for tax-exempt organizations reporting "unrelated business income," both classified under corporations for purposes of this analysis.

³ The increase in the corporate tax gap from 1986 to 1987 is attributable to the increase in corporate tax liabilities due to tax law changes enacted in 1986 and to the increase in corporate profits.

Figure D.—Estimated Gross Tax Gaps and Voluntary Compliance Rates After All Appeals, Selected Income Years, 1973-1992¹

[All data are estimates—money amounts are in billions of dollars]

Source of gap	1973	1976	1979	1982	1985	1986	1987	1988	1992
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Total tax gap	\$23.7	\$34.2	\$52.0	\$53.9	\$75.5	\$81.1	\$71.2	\$72.8	\$95.0
Individual.....	17.5	26.3	41.4	46.3	64.8	70.1	56.1	56.8	73.1
Corporations ²	6.2	7.8	10.6	7.6	10.7	11.0	15.1 ³	16.0	21.9
Total voluntary compliance rate (VCR)	86.0%	84.8%	84.1%	85.3%	83.8%	83.4%	85.6%	85.9%	86.6%
Individuals.....	86.1	84.3	83.6	85.2	83.4	82.9	85.1	85.6	86.4
Corporations ²	85.9	86.2	86.0	86.3	85.8	86.4	87.0	86.9	87.1

¹ The gaps shown are net of overpayments.

² Includes the tax gaps for fiduciaries reporting income of estates and trusts and for tax-exempt organizations reporting "unrelated business income," both classified under corporations for purposes of this analysis.

³ The increase in the corporate tax gap from 1986 to 1987 is attributable to the increase in corporate tax liabilities due to tax law changes enacted in 1986 and to the increase in corporate profits.

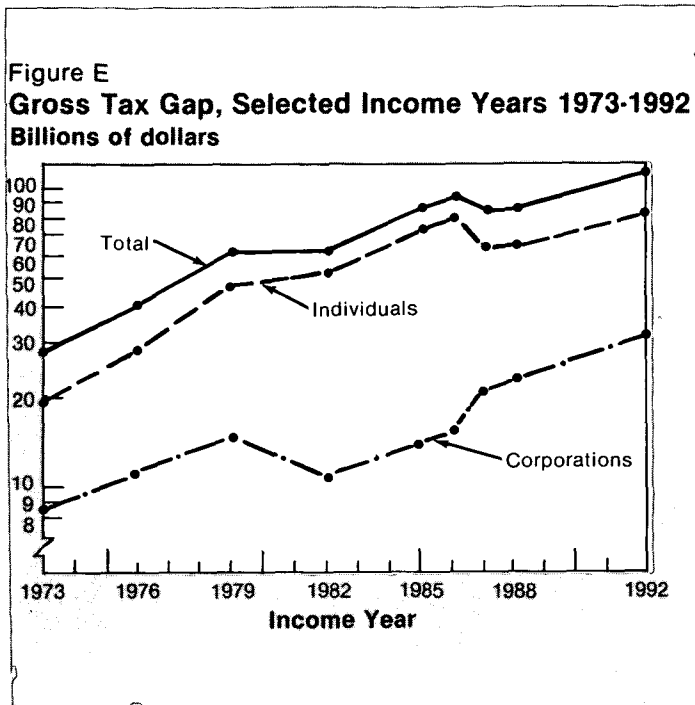
EFFECTS OF RECENT TAX LAWS

The widespread publicity given in recent years to problems of tax evasion culminated in a series of remedial measures. Among these are the compliance provisions of the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, the Interest and Dividend Tax Compliance Act of 1983, the Deficit Reduction Act of 1984, and the TRA of 1986. These provisions taken together have enhanced IRS capabilities to detect and correct noncompliance with income tax laws.

As a result of the above legislation, brokers and barter exchanges must file information returns on their customers' stock sales, large food and beverage establishments must allocate and report tips their employees receive equal to 8 percent of their sales, State and local Governments must file information reports on the tax refunds they issue, and alimony payers must report the names and taxpayer identification numbers of persons receiving the alimony payments. Information reporting also expanded to include real estate transactions, direct sales, sales of precious metals, and deductions individuals claim for mortgage interest

payments. Receivers of charitable contributions in kind must now report on the disposal value of contributions initially valued at \$5,000 or more. Moreover, individuals must report the social security numbers of all their dependents who are age 5 or older.

Although TEFRA's withholding provisions on interest and dividends were repealed before they took effect, backup withholding reinforced the interest and dividend information reporting system. Greater penalties for filers of inadequate information returns and for individuals who substantially understate their liabilities should help to contain noncompliant behavior, although it is not feasible to estimate what impact these penalties will have on the tax gap. The main thrust of the Tax Reform Act of 1986 was to reduce marginal tax rates and, at the same time, broaden the tax base to make the overall effect of reform "revenue neutral." Because the tax value of every dollar of unreported income or overstated deduction depends on the marginal tax rate, however, tax reform automatically reduced the individual tax gap. In addition, by lowering tax liabilities for individuals and raising them for corporations, tax reform shifted some of the gap from the household to the corporate sector.



IRS gross tax gap estimates do not reflect those effects, mostly behavioral ones, of the law which are difficult to quantify. For example, it is possible that compliance may improve in response to the lowered individual and corporate marginal tax rates. On the other hand, the extensive changes in the law may cause some initial confusion, which could cause compliance to deteriorate temporarily. Another unquantifiable factor is the extent to which some of the tax gap may shift from the corporate to the household sector as small corporations reorganize as proprietorships and partnerships. Such a shift may be expected because TRA lowered most individual marginal tax rates to less than 34 percent, the new maximum rate for corporations. Before TRA, high income individuals were taxed at 50 percent on their marginal income, which was higher than the maximum corporate tax rate of 46 percent.

SUMMARY

The experience of the past 15 years demonstrates that the individual voluntary compliance rate (VCR) decreased from 1973 to 1979 and increased from 1979 to 1982. The tax gap responds both to business conditions and to changes in individuals' propensity to comply with tax law. The effect of business conditions is demonstrated by the approximately 40 percent increase in the individual gap from 1982 to 1985—a period in which the voluntary reporting percentage for each income and deduction item was assumed to remain constant. From 1986 to 1987, the 20 percent drop in the individual gap and the almost 40 percent increase in the corporate gap dramatize how changes in law can have a large impact on the tax gap.

Tax gap estimation is not a precise science. As new information becomes available, and as new studies and improved methods shed more light on the data, IRS conceptions of the size, composition of, and trends in the tax gap may change.

NOTES AND REFERENCES

- [1] See also, U.S. Department of the Treasury, Internal Revenue Service, *Income Tax Compliance Research; Gross Tax Gap Estimates and Projections for 1973-1992*, Research Division, March 1988.
- [2] See McCrohan, Kevin F., and Smith, James D., "Informal Suppliers in the Underground Economy," *Statistics of Income Bulletin*, Summer 1983, Volume 3, Number 1, and Pearl, Robert B., and McCrohan, Kevin F., "Estimates of Tip Income in Eating Places," *Statistics of Income Bulletin*, Winter 1983-1984, Volume 3, Number 3; also, Pearl, Robert B., "Tipping Practices of American Households: 1984," Survey Research Laboratory, University of Illinois, October 1985, (unpublished report written under contract to the Internal Revenue Service) and U.S. Department of the Treasury, Internal Revenue Service, "Restaurant Tipping Study: Consumer Based Estimates for 1979," Research Division, February 1983 (unpublished).
- [3] See, for example, Batt, William, "The Underground Economy: What Is It? How Big Is It? And How Is It Measured?," *Manhattan College Journal of Business*, Fall 1985; *The Underground Economy in the United States and Abroad*, edited by Vito Tanzi, Lexington, Massachusetts, and Toronto, Canada, Lexington Books, D.C. Heath and Company, 1982; Feige, Edgar L., "How Big Is the Irregular Economy?" *Challenge*, Nov/Dec 1979; and Gutmann, Peter M., "Off the Books," *Across The Board*, August 1978.
- [4] For a description of the activities covered by the term "underground economy," see Carson, Carol S., "The Underground Economy: An Introduction," *Survey of Current Business*, U.S. Department of Commerce, Bureau of Economic Analysis, May 1984.
- [5] Actually, about \$0.3 billion of the \$21.4 billion "corporate" tax gap is due to underreported taxes on the income of estates and trusts that fiduciary agents report and on the "unrelated business income" that tax-exempt organizations report, both of which were classified as corporate taxes for purposes of this report.
- [6] The net income of a qualified S Corporation (defined in section 1371 of the Internal Revenue Code), whether or not distributed, is taxed through each stockholder.

Therefore, its tax treatment is quite similar to that of partnership income.

- [7] In the Taxpayer Compliance Measurement Program (TCMP), the Internal Revenue Service audits a representative sample of individual income tax returns and then "weights" the results to provide estimates of the aggregate error that would be found for each tax

return line item if *all* such returns were audited. However, audit examiners are not as successful in detecting income not reported (especially income earned "off the books") as they are in uncovering deductions or credits that are overstated. As a result, TCMP results must be supplemented by special compliance studies and surveys to measure some of the components of the tax gap.