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Potential Impact of the Tax Gap

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Potential Impact of the Tax Gap

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Introduction

The tax gap is one of the topics that need more attention and research among tax issues. The impact of the tax gap that is already affecting society is huge, and the potential impact that the tax gap will bring going forward is even more immense. However, the importance and need that the tax gap should be studied is undervalued and underappreciated. There are several reasons that are underlying this undervalued and underappreciated importance of the tax gap. The biggest reason is the negative impact that the tax gap impacts on society and government revenue is not taken seriously, and also, the potential impact of this negative impact is not deeply researched. This thesis aims to delve into the tax gap by looking into its definition and composition, the trend of the tax gap, why the tax gap requires more attention, and solutions to reduce the tax gap.

Background

2.1 Definition of tax gap

Before analyzing the trend of the tax gap, why we should solve the tax gap issue, and ultimately finding the solution on how we can reduce the tax gap going forward, knowing what the tax gap exactly is and how it is composed in detail would be needed. According to the IRS, the tax gap is defined as the following: “ The gross tax gap is the difference between true tax liability for a given tax year and the amount that is paid on time.” Simply saying, the tax gap is the amount that is not collected. The tax gap is composed of three components and the following are three components: non-filing gap, underreporting, and underpayment gap, which is also called remittance gap. Before looking deeper into those three components, there is one more term that we should know: the net tax gap. According to the IRS, the net tax gap is a certain amount of the gross tax gap that will never be collected despite the enforcement or through late payments. Simply saying, the net tax gap is the amount that the IRS cannot collect

in any way. In order to have a more in-depth understanding of the tax gap, knowing more about the components of the tax gap is required.

First, the non-filing gap is the gap that is coming from the people who did not file on time. This represents the amount that is not collected on time, as people did not file on time. Second, the underreporting gap is the tax liability that occurs as taxpayers understate when they file on time. Lastly, the underpayment gap is the most intuitive in that the tax was reported on time; however, it was not paid on time. These are the components of the tax gap, and in order to know how we can reduce the tax gap, knowing the components are critical.

Other than knowing the official definition from the IRS and the components of the tax gap, there is one more thing that we should know to develop more practical and effective ways to reduce the tax gap going forward, and that is analyzing the trend of the tax gap. Before diving deeper into the trend, I would first make sure that the economic condition at that time, tax payer's psychological condition, and the IRS's new or changed enforcement are the factors that could affect the trend. Thus, even though we can see the pattern of the tax gap trend, the reason could be coming from all different factors. Despite the factors that drive the tax gap trend are all varied and complicated, we can still get to a conclusion on how we can reduce the tax gap while not arousing any social conflict or the making of taxpayers to have hostility toward the tax system or the IRS.

2.2 Trend of the tax gap

After knowing the definition of the tax gap and also its components, we would want to look into the trend of the tax gap and see where we are at this point and how the IRS has been doing to solve the tax gap issue. When looking deeper into a specific subject, in most cases, It is advisable to know where we are at and how the trend of the subject was in the past years in order to have a more in depth understanding.

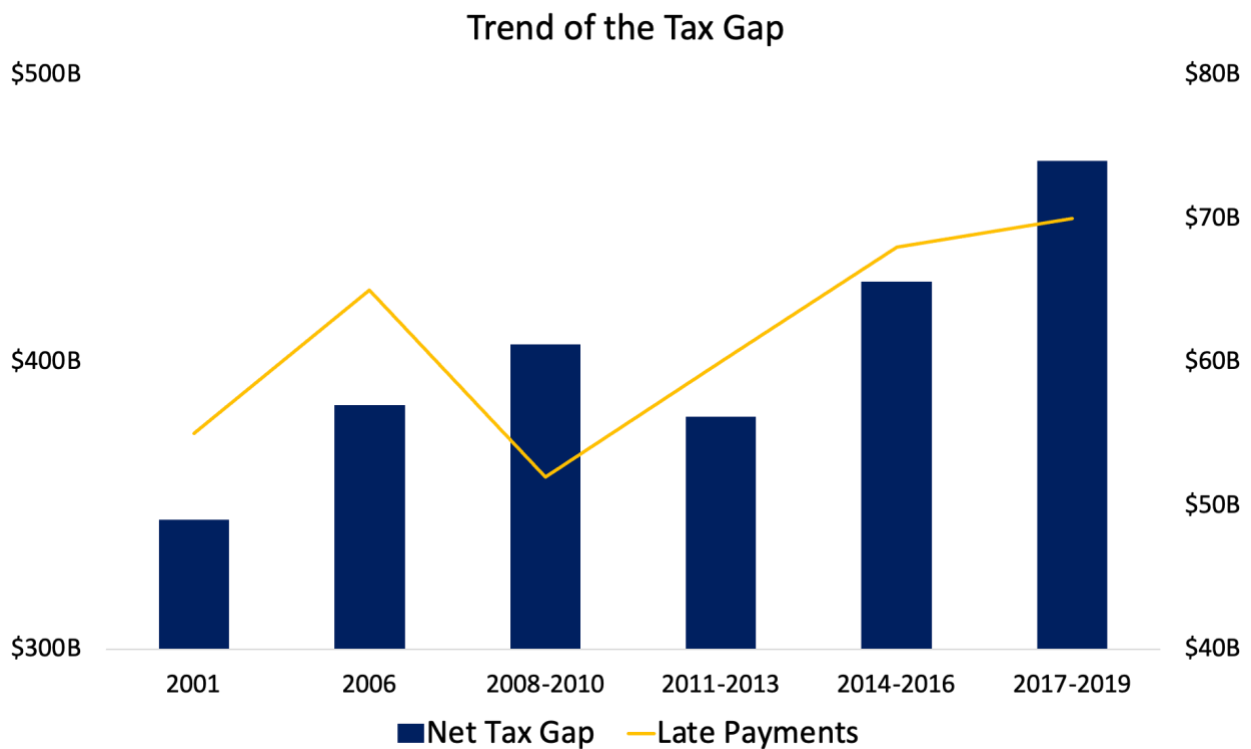


Figure1 Compiled by Author using IRS data

Figure 1 above is showing the trend of the tax gap and is made of the data that is released by the IRS (IRS). IRS typically does not disclose the tax gap data year by year. Instead, the IRS discloses the data that binds two to three years. Thus, it is hard to know the trend of the tax gap increasing and decreasing year by year, but through the reported data, we can still see the trend of it. From figure 1 named "Trend of the Tax Gap," we can see that both the net tax gap and late payments are in an upward trend. Before diving deeper into the figure and analyzing the trend, it would be necessary to mention that as the Figure is indicated in the

dollar amount, it does not reflect inflation. However, excluding the US recessionary and inflationary period, the normal inflation is around 3%. Considering the average inflation, the amount is still showing more than a 3% increase.

Now, we will look into the figure and see what that trend indicates and represents. As late payments represent the tax that has been paid not on time but late, and the net tax gap represents the amount that will never be collected, both represent entirely different categories. However, they both indicate the same thing, which is the taxpayer's recognition. The trend that we can see from the figure through both the net tax gap and late payment indicates that the taxpayers have less recognition and don't know the importance of paying taxes on time and paying the exact amount that they should pay is crucial. Simply saying, taxpayers are not following the tax law, and their awareness of why they should follow the tax law and the importance of following the tax law is reduced. This trend is also illustrated by the following figure below.

2.3 Tax Paid Voluntarily

Now, we might want to look into a more detailed tax gap and one of it would be collected tax but voluntarily paid tax. As the ultimate purpose of the IRS in solving the tax gap issue is increasing the voluntarily paid rate, it is great to see the trend of the voluntarily paid rate and see if we are getting improvements or not.

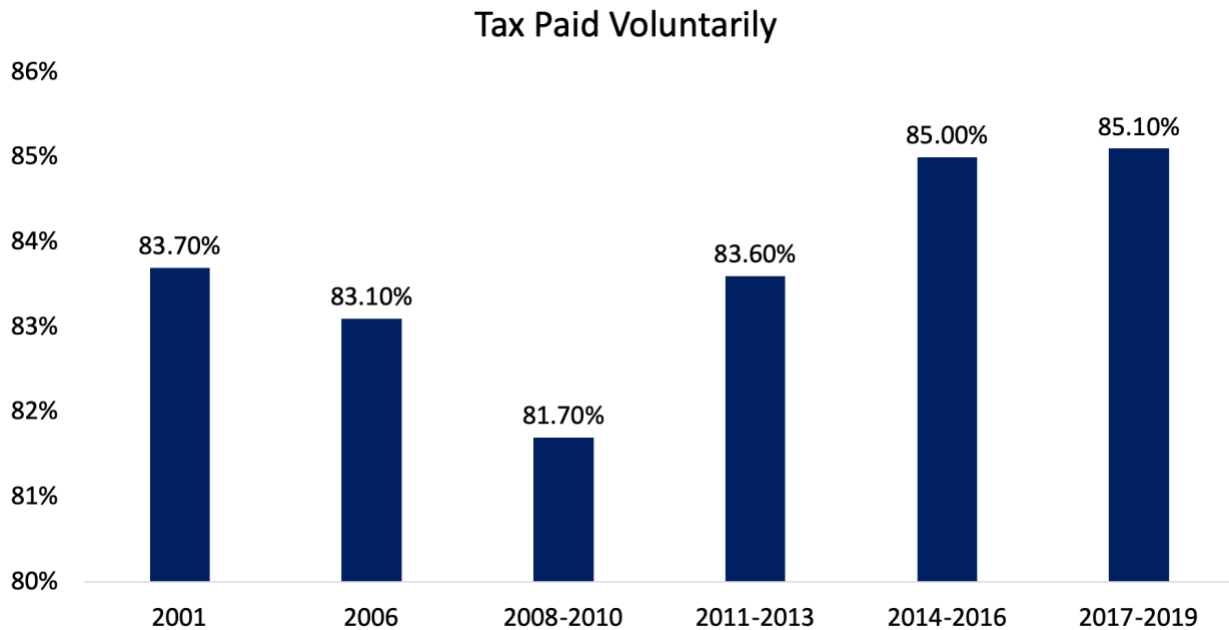


Figure 2 – Source: Committee for a Responsible Federal Budget

The trend of taxpayers not following the tax law more and more and having less recognition of why they should follow the tax law has also been illustrated from the rate of the tax paid voluntarily. It is obvious, and no need to say that the tax should be paid voluntarily. The rate of tax paid voluntarily shows how the tax law has been followed, and this is directly related to the trend of the tax gap. According to the data that has been released from the “Committee for a Responsible Federal Budget”, we could see the trend of voluntarily paid tax. The rate of tax paid voluntarily has increased since 2008, however, there is not much difference in the number as 83% and 85% could be considered considerably similar. Although the rate of tax paid voluntarily has increased, still the rest of the 15% of taxpayers do not pay tax voluntarily. With

15% of the entire taxpayers do not pay the tax that they should pay is huge if it is calculated in the total amount of the entire tax revenue. This also represents that the taxpayers have strong recognition that they do not need to follow the tax law and pay what they need to pay.

There are several factors that have led to this trend and circumstance, however, to pick up the possible factor is the following: the tax enforcement is weak, and also the penalty or fine that is imposed on the taxpayer in the case that they did not follow the tax law is also weak. Because of the weak enforcement and penalty or fine, the taxpayers may have reached the conclusion that there are more benefits and gains in the case that they do not pay the tax voluntarily, pay late, and even do not pay and make a net tax gap. If the taxpayers reach the conclusion that in the case that they do not comply with the tax law, there will be an immense disadvantage, whether it is a financial disadvantage or not, they will not have the recognition that we just looked into and will comply with the tax law and we will see a low tax gap eventually. This analysis is one of the factors that is reasonable and possible that leads to the increased tax gap. Both of the figures that we just checked to represent the recognition of taxpayers why they should pay tax on time and for the amount that they should pay has weakened. This can be considered as one of the direct driver of the increased tax gap.

2.4 Non-Compliance Breakdown

After looking into the trend of the tax gap and also the driver of it, it would be helpful to have an understanding of the composition of the tax gap that is the most recently reported. Combined data from 2017 to 2019 is the most recent one that has been released at the moment.

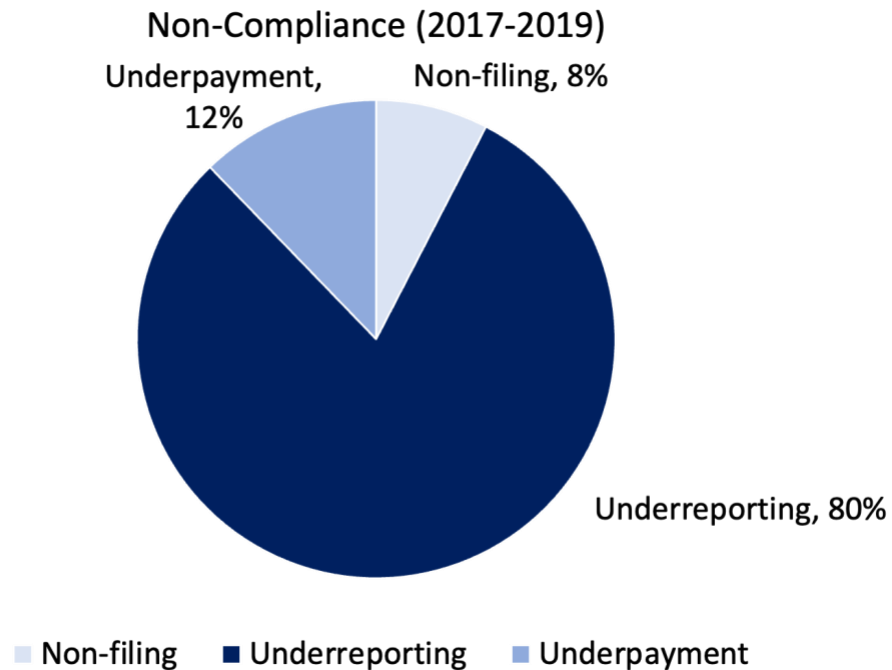


Figure 3 – Source: Committee for a Responsible Federal Budget

As you can see from figure 3, there is a huge discrepancy between the three components, underpayment, non-filing, and underreporting (Committee for a Responsible Federal Budget, 2017-2019). Based on the most recent data, underreporting takes 80% of the entire tax gap, followed by underpayment for 12% and non-filing for 8%. This percentage of composition is not coming from the one and only reason, however, just to pick up one of the biggest reasons why a single component, which is the underreporting gap, the following could be the potential answer: it is one of the easiest ways for tax evasion. It is so obvious to find the reason why taxpayers make a tax gap, especially the net tax gap. That is for tax evasion. It is hard to find a taxpayer who is so happy to pay tax, however, we all pay as it is the rule and law

that we should comply with to live under the system of the country and the state. However, some taxpayers want to evade the tax with the intended aim of tax evasion by underreporting the tax liability. Underreporting the income or tax liability, which ultimately leads to a tax gap, could also be unintentional and all by mistake, however, in the more often case, it is intentional underreporting to evade the tax.

By looking into the composition percentage for each component of the tax gap, we can confirm which component should be the target that should be focused on in order to get to the most effective way to reduce the tax gap going forward. Of course, the combined percentage of the underpayment gap and non-filing gap is 20%, and it does not mean that we need to disregard the underpayment gap and non-filing gap. However, there is no way to make the tax gap 0, and that is the same for any country and any society. In the circumstance where we have a considerably huge amount of tax gap, it would be best to focus on the part that takes the biggest portion of the tax gap. Once we can see the improvement and reduction in the underreporting gap, which means the IRS has solved the major part of the tax gap issue, it would be time that we should move on to the non-filing gap and underpayment gap and work on it. Thus, it would be more effective to focus on the part where most of the tax gap is arising first. This leads to the conclusion of why we should delve into the underreporting gap to achieve our goal at this point. We decomposed the tax gap to have a more in-depth understanding of the tax gap issue, and now we know which part of the tax gap should be focused on and which requires more research, and we should delve into the underreporting gap at this point.

2.5 Underreporting Gap Breakdown

As we just looked into more detailed components to know what should be focused on and be targeted to reduce the tax gap in the most effective and efficient way. The answer was in the underreporting gap. After finding the answer, in order to know what kind of action, enforcement, and strategy would be needed to reduce the tax gap, especially the tax gap that is coming from the underreporting gap, looking into the components that comprise the underreporting gap would be required.

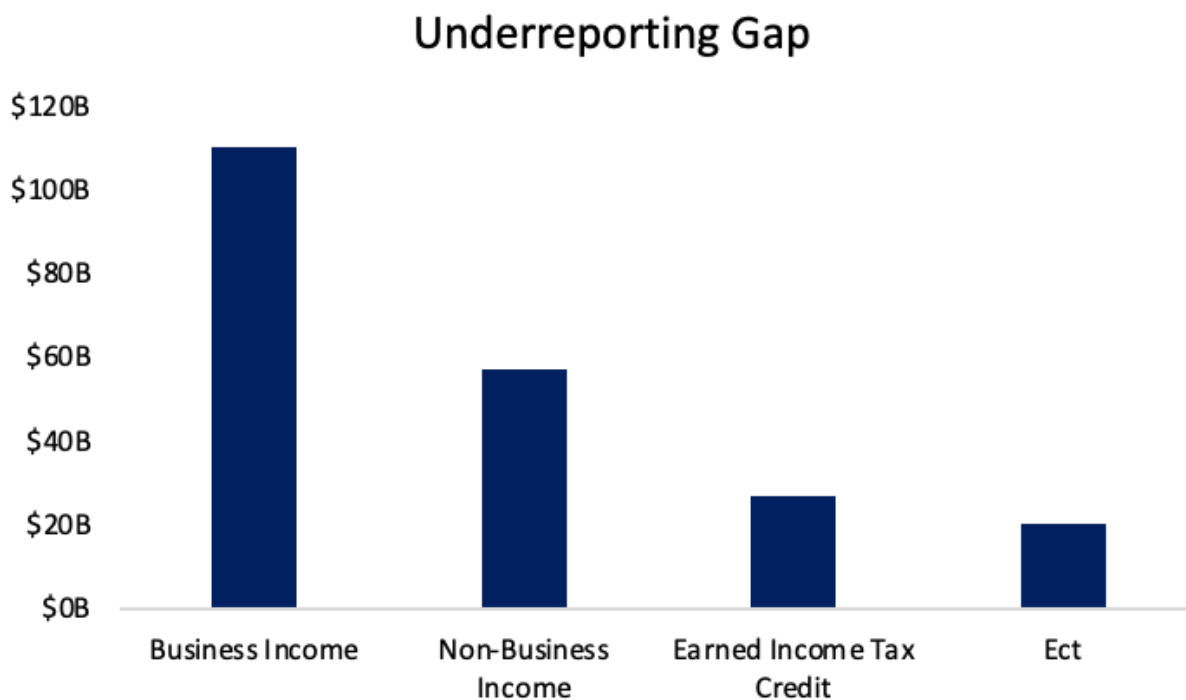


Figure 4 – Committee for a Responsible Federal Budget

As you can see from the figure 4, there are several different factors that comprise the underreporting gap, and among those, business income takes the biggest portion, followed by non-business income, and individual taxpayers' income takes the biggest part of it (Committee for a Responsible Federal Budget, 2011-2013). Simply saying by focusing on the key point, businesses that are owned and operated by an individual or small group of individuals are more likely to underreport their income and tax liabilities the most. It is reasonable to think that the

underpaid taxpayers have an intentional aim for tax evasion (U.S. Government Accountability Office, 2014-2016). The purpose of looking into the figure 4 is to know which part of the underreporting gap should be focused on to reduce the underreporting gap the most. We should focus on both small business and individual taxpayer's underreporting issues to solve the biggest portion of the tax gap issue.

Why the tax gap requires more attention

Before diving deeper into what we can do and what we should do to reduce the business and individual taxpayer's underreporting issue to solve the tax gap issue, we should first know the expected outcome of this trend and phenomenon in the case that we do not take any action at this point. There are several different expected outcomes of not taking any action that aims to reduce the tax gap. However, just like what we just discovered in the previous section, it is always effective and efficient to focus on the main part, not the small one that barely impacts the result. Simply saying, the expected outcome if we do not take any action to minimize the tax gap is that more and more taxpayers will have recognition that nothing actually happens when they do not pay the full amount of tax that they should have paid. There are no taxpayers, whether it is individual or corporate, who would enjoy and love paying taxes to the government. If it is an individual or small group of individuals who run a small business, they will try their best to pay less. If nothing happens and there is no negative impact on their financials or social status in the case that they intentionally or unintentionally do not pay the full amount of tax, then it will incite people to not pay the full amount. Fortunately, the tax compliance rate is not dropping, but still, there are a lot more ways to go as the uncollected amount is huge (Rubin, 2022). This is one of the main reasons why we need to find a solution to stop the trend that the tax gap is getting bigger.

3.1 Negative impact on society

In the previous sections, by looking into the data and also analyzing those data, we briefly covered why the tax gap is important and it should be the subject of being researched. In this section, we are trying to dive deeper into the reason why the tax gap requires more attention in more technical ways. The reason why the tax gap requires more attention can be divided into two big ones: the tax gap's negative impact on society and government income. It would be great to start with the tax gap's negative impact on society. If there is no new solution for the tax gap or if government and IRS do not take any action on the taxpayer who either intentionally or mistakenly pays less than the original amount that they should have paid, then society will start to have a perception that avoiding and paying less tax is acceptable by the government and will not bring any kind of negative consequence to them. Once society starts to have this perception, we will start to have a much bigger tax gap, and it will be extremely hard to make taxpayers think that they must comply with the tax law. This perception not only lowers the rate of tax compliance but also will lower other compliance rates in general as people will think that they do not need to follow the rules. The perception that brings negative impact is so easy to be made, but it is extremely difficult and requires much more work to remove or reduce that perception. Eventually, our society will face chaos that we have not faced before. The tax gap not only impacts the tax side, but it also impacts the general compliance rate across our society, and this is why the tax gap requires more attention and needs to be solved.

3.2 Negative impact on government income

We just looked into the tax gap's negative impact from a broader perspective, and now, we would want to move on to a more specific impact, and the biggest one that we can address would be how the tax gap negatively impacts government income. We all know that the tax gap reduces the government's income. Going above and beyond that, we would need to know what would be the expected result from reduced government income and why it is bad in order to realize why the tax gap requires more attention and thus, ultimately, can come up with a

solution going forward. It would be better to start from a broader perspective. According to the tax policy center, the impact can also be in the long term and would impact the economic resources allocation. Also, based on the tax policy center's analysis, it will also impact our economy in the short run. The impact on our economy is, of course, derived from the reduced government income. Simply saying, reduced government revenue will lower the quality of public service (Congressional Research Service, 2021). Also, it could hinder overall economic growth as the reduced government revenue will limit the government from investing in the areas that ultimately support economic growth. Thus, the infrastructure will struggle with getting some more improvement, and also, public education will face lower quality as the investment into it has decreased compared to the past.

As the tax is part of the government income and with the decreased government income, it is hard to avoid decreased government spending, thus, the increased tax gap can ultimately lead to lowered GDP and eventually hinder the overall economic growth (U.S. Department of the Treasury, 2021). This can also negatively impact the government in paying off its debt and refinancing plan. If the government starts to have some issues in paying off debt, as its balance is not reaching the amount where it should have reached, it could impact fiscal policy. We can see the obvious link, flow, and connection that starts from the tax gap to its negative impact on the government income to the expected outcome to our society in general.

Solution

4.1 How to prevent the tax gap

There are several suggested solutions in order to prevent and also reduce the tax gap. The word prevent and reduce could be considered to have a similar meaning. However, as we are dealing with the tax gap, preventing and reducing the tax gap would require different solutions.

Starting from preventing the tax gap, it can be considered into two parts. The first one would be tax evasion, which is intentionally avoiding tax, and the second one would be unintentionally paying less. For the tax evasion side, we would need to focus on the penalty side. As it is tax, suggesting benefits would be less effective and efficient in preventing the tax gap. In most cases, taxpayers would try their best to avoid paying taxes or at least want to reduce the amount that they should pay, although they know that they are not allowed to do so, and that is against the law. Thus, we should come up with penalties that will prevent people from evading taxes (Committee for a Responsible Federal Budget). Then, we should think about what kind of penalty we should consider to prevent tax evasion. After taking a deeper consideration, the solution that I came up with is that we should apply the bracket just like we apply to the income tax. Making a certain standard that includes specific evaded tax amounts would be more reasonable. If the same penalty and fine rates are applied to the entire evaded tax, then it would not be too effective in preventing another tax gap. If people needed to face a much bigger penalty and fine rate with the larger evaded amount, taxpayers would try to avoid that risk. For example, if the taxpayer gets caught for tax evasion and needs to pay five times the amount that was not paid, then the motivation for tax evasion would decrease.

For the unintentional underpayment case, mainly the reasons for it would come from the complexity and unawareness of complying with the tax law and filling out the form. For some who have plenty of experience in tax compliance and filing tax forms, tax reports, and returns are not an issue. However, there are some who are having some issues understanding the

concept and also have no idea what to do step by step. Those cases can lead to unintentional underpayment. For them, providing the walkthrough video on how to fill the form step by step and also providing an explanation of what is expected of taxpayers and why they should follow the tax law, and the point here is using as easy terms as possible. The IRS can make a video and can upload it to the website where the tax filing should be completed and also can send an email with a link to all of the taxpayers. Just making a video is not enough, and promoting to as many taxpayers as possible that there is a walkthrough video that helps taxpayers easily file their forms is extremely critical.

4.2 How to reduce the tax gap

The solution suggested in reducing the tax gap would be focused on reducing the existing tax gap that we already have. In order to do so, we would first announce that we will increase the auditing. Once underpayment, whether it is intentional or unintentional, the taxpayer will face a heavy penalty. With this announcement, we will expect the taxpayers to go back to their file and recalculate their payment or reconsider their decision if it was intentional underpayment. If the taxpayer finds that they are underpaid, then they can still pay for the rest of the amount that should have been paid earlier. If they pay like this before getting caught in auditing, we will not make them pay any penalty or fine. This solution would be helpful for us to reduce the existing tax gap. For the auditing process, we would need to have a system that can determine suspicious taxpayers based on its historical data and also can list the taxpayers in the order of their income. Investing in making a better system would also lead us to reduce the existing tax gap.

Conclusion

Based on the current circumstance, the necessity and importance of the tax gap to be researched have increased, as the government is currently having an issue with the debt ceiling, and also the tax that has been collected is also reduced. We had several attempts to reduce the tax gap, however, the data shows that it was not as effective as we originally intended. Thus, it is time to reconsider what causes this tax gap and what kind of specific solution would be required in order to solve the fundamental issue. We are suggesting making a penalty bracket based on the underpaid amount to reduce the motivation for tax evasion and making an easy walkthrough video to reduce the tax gap that arises as people are having some difficulties in filing the form, and also a new auditing system that will increase the possibility to detect the taxpayer who underpaid. Through the suggested solution, we can expect to have much improvement in solving the tax gap issue.

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