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Estimating the Revenue Effects of Proposals to Increase Funding for Tax Enforcement

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The information in this presentation is preliminary and is being circulated to stimulate discussion and critical comment as developmental work for analysis for the Congress.

The Tax Gap and the Budget Deficit

The Congressional Budget Office estimates that the budget deficit will be **$534 billion** in fiscal year 2016.

The "net tax gap" is the difference between the amount of tax that taxpayers should pay under the tax law and the amount they actually pay, either voluntarily or as a result of enforcement actions.

The Internal Revenue Service (IRS) estimates that the annual net tax gap from 2008 to 2010 was, on average, **$406 billion ($447 billion in 2016 dollars**).

The amount of budgetary savings from proposals to reduce the tax gap is uncertain.

Detection and deterrence probably improve compliance, but many types of tax evasion are difficult for the IRS to identify and prevent.

Businesses and people will try (often successfully) new ways to evade taxes.

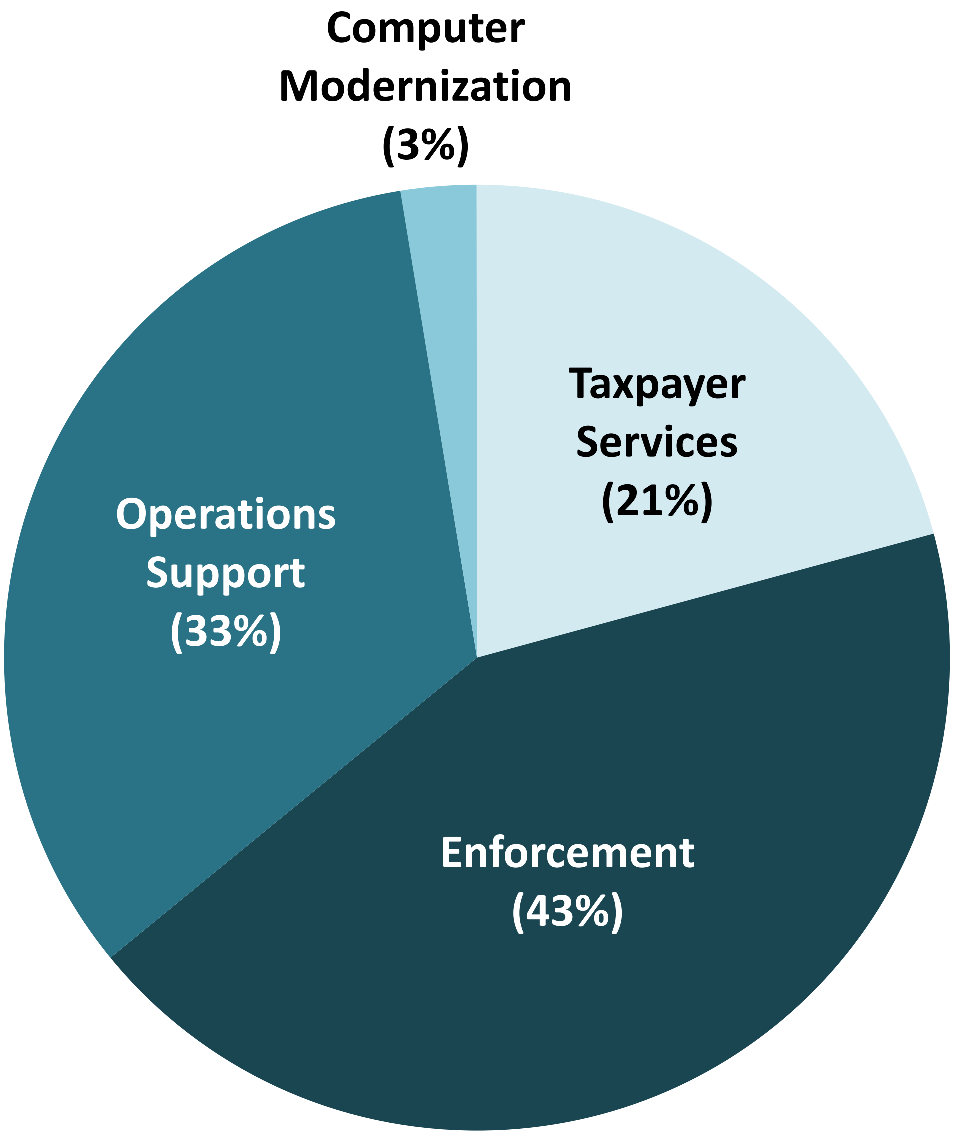
Another consideration is the size and allocation of the IRS budget.

IRS funding fell by **15 percent** from 2010 through 2016 (in real dollars).

The biggest cuts were in enforcement, but that activity still receives the largest share of the IRS budget.

The Internal Revenue Service's Budget, Fiscal Years 2000 Through 2016

Components of the IRS's 2016 Budget



As IRS funding declined, its costs of collecting an additional $100 of taxes also fell—from 53 cents in 2010 to 35 cents in 2015, the IRS estimates.

Budget Scorekeeping Guidelines

CBO estimates the net cost (including any revenue effects) of proposals to increase IRS funding.

The staff of the Joint Committee on Taxation (JCT) estimates the change in revenue from proposals to amend the tax code.

CBO, JCT, the Office of Management and Budget, and House and Senate budget committees adhere to the same budget scorekeeping guidelines.

The budget scorekeeping guidelines were developed over time and formalized in the conference report for the Balanced Budget Act of 1997.

The guidelines ensure consistent budgetary treatment across programs and over time.

Two guidelines, Rule 3 and Rule 14, are especially relevant to analysis of tax compliance proposals.

Budget Scorekeeping Rule 3:

> "Revenues, entitlements, and other mandatory programs (including offsetting receipts) will be scored at current law levels…unless Congressional action modifies the authorizing legislation."

Budget Scorekeeping Rule 14:

"No increase in receipts or decrease in direct spending will be scored as a result of provisions of a law that provides direct spending for administrative or program management activities."

In a hypothetical example of the application of budget scorekeeping rules, if a bill includes a provision to increase the IRS's budget to fund more audits...

- CBO’s estimate of the bill’s cost would *include* the additional funding for the new audits.
- Under Rules 3 and 14, CBO would *exclude* any revenue increases from the additional audits in its estimate of the bill’s budgetary effects.
- CBO might provide the Congress with an estimate of the “nonscorable” revenue increases that are not included in the estimate used for budget enforcement purposes.

Rules 3 and 14 do not apply to CBO's baseline budget projections or its analysis of the President's budget.

CBO will include the resulting revenue increases in its:

- Next estimate of the budget deficit under current law if an increase in IRS funding is enacted
- Analysis of the President's budget if it includes a proposal to increase IRS funding

A number of factors affect revenue estimates for compliance proposals:

- IRS infrastructure (technology and staff)
- Adjustment issues (flexibility and complexity)
- Compliance behavior (detection, deterrence, and learning curves)

Many of the IRS's activities probably increase compliance.

Customer service can reduce unintentional errors by taxpayers.

Enforcement enables detection and deterrence.

Computer modernization supports customer service and enforcement.

In its baseline projections, analysis of the President's budget, and estimates of nonscorable effects of legislation, CBO focuses on improvements in *detection* resulting from increases in *enforcement* funding.

Because of the substantial uncertainty about their effects, CBO does *not* estimate changes in revenue from:

- Increases in funding for customer service
- Increases in funding for computer modernization
- Changes in deterrence from increases in enforcement funding

Estimates of changes in revenues from changes in IRS funding are based on expected returns on investment (ROIs).

An ROI is equal to the additional dollar of revenues from an additional dollar of funding.

Typically, CBO starts with the IRS's estimates of ROIs.

IRS researchers have access to detailed data unavailable to CBO.

CBO makes adjustments to those ROIs if, in the agency's judgment, the estimates do not fully take into account some of the factors affecting compliance proposals.

An Example:

The President's Fiscal Year 2016 Budget Proposal— Additional Funding for Program Integrity Initiatives

The Budget Control Act of 2011 (Public Law 112-25) imposed caps on discretionary funding in 2013 and subsequent years. Those limits have been modified by subsequent legislation.

However, the caps are automatically adjusted to accommodate additional appropriations for certain program integrity activities.

The President's fiscal year 2016 budget contained a proposal to boost discretionary spending by $667 million in 2016 to fund IRS program integrity initiatives.

Of that amount, $421 million was for enforcement.

Most of the remainder was for operations support.

CBO estimated ROIs only for the enforcement initiatives.

The estimated ROIs on each component were different—ranging from 0 to 9.

Components of Proposed 2016 Funding Increase for Enforcement Initiatives

2016 IRS Enforcement Initiatives	Cost in 2016 (Millions of Dollars)	Return on $1 of Investment (Dollars)
Prevent Identity Theft and Refund Fraud	2.7	9.0
Increase Audit Coverage	150.7	2.6
Improve Audit Coverage of Large Partnerships	16.2	2.7
Address International and Offshore Compliance Issues	40.7	1.2
Enhance Collection Coverage	122.8	2.8
Other Initiatives	87.5	0
Total Cost	420.6	n.a.
Average Return on $1 of Investment	n.a.	2.0

The President proposed to continue the 2016 enforcement initiatives throughout the entire 10-year budget period.

The annual costs would rise to $435 million in 2018 and then stay at that level.

CBO estimated that the aggregate ROI on the increased funding for enforcement would gradually rise over three years.

CBO anticipated improvements in IRS technology and staff from 2016 through 2018 as a result of the additional funding.

CBO projected a drop in the ROI after 2018 as taxpayers found new ways to evade taxes.

Estimates of Return on Investment From Proposed Funding Increases for 2016 Enforcement Initiatives

Dollars

	Return on $1 of Investment
Year 1 (2016)	2.0
Year 3 (2018)	6.4
Year 6 (2021)	5.9
Year 10 (2025)	5.2

The fiscal year 2016 budget proposal would also increase discretionary funding by additional amounts through fiscal year 2020 to fund other new IRS enforcement initiatives.

The Administration did not provide any details on the components of those future initiatives.

In CBO’s judgment, ROIs would decline for each new initiative as the IRS tackled more difficult types of tax evasion.

Estimates of Return on Investment From Proposed Funding Increases for 2020 Enforcement Initiatives

Dollars

	Return on $1 of Investment
Year 1 (2020)	1.5
Year 3 (2022)	4.6
Year 6 (2025)	4.2

CBO estimated the total 10-year net budgetary gains from the proposed increase in funding for IRS program integrity efforts:

- Spending: $18.7 billion
- Revenues: $55.3 billion
- Net budgetary gains: $36.6 billion

ROIs vary by type of enforcement activity.

Thus, the ROI would probably not be the same for another budget proposal with different features.