The Inflation Reduction Act’s Impact on Tax Compliance—and Fiscal Sustainability

Natasha Sarin and Mark J. Mazur

Introduction

The passage of the Inflation Reduction Act (IRA) represents a seismic shift in the American economy. It includes investments to generate climate security progress by investing in domestic clean energy production and manufacturing. It makes prescription drugs more affordable to many American families. And it finances these crucial investments, in large part, through a once-in-a-generation investment in the Internal Revenue Service (IRS) to modernize America’s tax administration and, by doing so, meaningfully increase compliance with the Nation’s tax laws.

This new funding for the IRS is a substantial opportunity for the agency and for the nation’s fiscal situation. The vast majority of taxpayers want to comply with their tax obligations, and an underfunded IRS has not had the capacity to deliver the services and assistance they need. For instance, many taxpayer and tax preparer calls have gone unanswered (the fraction of telephone calls actually answered by the IRS was less than 15 percent during the 2022 tax filing season).\(^1\) Taxpayer assistance centers, where taxpayers can receive in-person help from IRS employees, have been understaffed and sometimes even unstaffed, particularly in rural and low-income communities where the need for in-person assistance is greatest.\(^2\) The average American spends 13 hours and $250 on filing their taxes each year.\(^3\) This is a large burden, especially when compared with other countries. In some jurisdictions, tax filing is free and easy. For example, in Estonia and Australia, income tax returns are pre-filled, and taxpayers can meet their filing obligations simply by using their phone.\(^4\)

The difference between what the IRS of the present day can deliver and what a modernized IRS will do for taxpayers is monumental. Just one quick example helps illustrate this point. The IRS uses technology that is decades out of date; millions of returns filed on paper are transcribed (keypunched) by IRS employees by hand so that this information can be included in


a tax return database. With new funding, the IRS is already deploying new technology to automatically scan received paper returns and increase tax administration efficiency.\(^5\)

Investing in the IRS is not just about good government. It is also a unique moment to improve our nation’s fiscal situation at a time when doing so matters. The latest Congressional Budget Office (CBO, the official government scorekeeper) projections suggest that federal budget deficits will be $1.4 trillion in 2023 (and will average around $2 trillion per year over the next decade).\(^6\) The tax gap—the difference between owed and unpaid taxes—accounts for about 40% of that total in 2023, or about 2 percent of GDP on an annualized basis.\(^7\) We are facing the first moment in 40 years when the Social Security trust fund is expected to be depleted within the coming decade.\(^8\) The revenue needs ahead are substantial for the federal government, even before considering the desire for additional and worthy investments, in our children, in shoring up the social safety net, and in bolstering the labor force.

The importance of this fiscal moment provides greater urgency to the Inflation Reduction Act’s historic investment in the IRS. It also demonstrates the importance of accurately assessing the revenue potential of long-term investment in the IRS. Today about 15% of the taxes that are owed under our tax laws are not voluntarily remitted and ultimately not collected.\(^9\) That amounts to a tax gap of around $600 billion annually. As we have stated previously, given the scope of the noncompliance challenge the agency faces, investing in the IRS certainly has a high return. But the question remains, exactly how high?\(^10\)

This is a question that official government scorekeepers (staff who estimate the fiscal effects of legislative changes) grappled with throughout the legislative process around the Inflation Reduction Act. In our view, they reached an overly pessimistic conclusion. We agree with their conclusion that losses from tax evasion are significant and that additional dollars invested in the IRS will generate a substantial positive return on that investment. Where we disagree is with respect to the magnitudes.

The conclusion of CBO is that the nearly $80 billion investment in the IRS made by the IRA will increase tax revenue collected by the agency by nearly $200 billion (nearly $115 billion

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net of the $80 billion investment) over the course of the next decade.\textsuperscript{11} That is a large number. But it is miniscule when compared to the scope of the evasion problem that the IRS faces, representing around 2\% of the estimated tax gap over the course of the next decade.

We believe this conclusion understates the likely return to the substantial long-term investments in the IRS that are contemplated in the Inflation Reduction Act. Instead, our rough estimate suggests that IRS funding will raise at least $560 billion ($480 billion, net) over the course of the next ten years—and, depending on the extent of taxpayer’s behavioral response to greater enforcement presence, could easily raise closer to $1 trillion. Our conservative base estimate, then, is that the IRS will capture about more than 3 times what the CBO estimates.

To be clear, our conclusion is not that the tax gap will be resolved by these investments—indeed far from it, tax evasion will still total hundreds of billions of dollars per year even after this substantial enhancement of the IRS’s enforcement capacity. But if the agency invests the resources provided by the Inflation Reduction Act wisely, it will inevitably make much more progress than the official legislative scorekeepers have predicted, and because these investments build on themselves, the revenue impact of bolstering the ability of the IRS to fairly administer the Nation’s tax laws in the decades beyond the ten-year budget window will be exponentially greater.

This is a timely inquiry given the high-profile debates around the importance of these additional resources for the IRS and their revenue-raising potential. For example, in the context of the debt ceiling negotiations, some Congressional Republicans have proposed rescinding the IRA’s investment in the IRS, citing its limited revenue potential and an (inaccurate) view that increased enforcement efforts will inevitably cause an uptick in burden for ordinary taxpayers. There also is concern that the annual appropriations process could take steps to undermine the IRA’s long-term funding by short-changing the annual IRS appropriations in ways that make it challenging for the agency to fund improvements and modernization efforts with the longer-term resources provided by the IRA. If instead those longer-term investment resources have to be diverted to plug shortfalls in ongoing year-to-year operations, this would bear meaningfully on the revenues that the agency is ultimately able to collect.

Our paper proceeds in five parts: First, we first lay out the scale of the noncompliance problem facing the IRS today and point out that the existing tax gap estimates likely underestimate

\textsuperscript{11} CBO has released multiple estimates of the additional tax revenue that can be collected by investing in the IRS. In 2021, CBO estimated the returns to a roughly $80 billion investment in the agency and concluded it would generate almost $200 billion in new tax revenue (for a net figure for revenue raised of $114 billion over the 10-year budget window). (Swagel, Phil, and Congressional Budget Office. 2021. “The Effects of Increased Funding for the IRS.”). In 2022, after the Inflation Reduction Act’s passage, CBO updated its estimate largely for changes in the legislative language, saying that the IRA’s investment in the IRS would increase tax revenues by approximately $180 billion over the decade. (See Congressional Budget Office. 2022. “Additional Information About Increased Enforcement by the Internal Revenue Service”). Most recently, in 2023, in scoring a potential rescission of the majority of these funds, CBO came to a slightly different revenue estimate of $186 billion, likely related to changes in the ten-year budget window. We use this most recent number for purposes of comparison. See Congressional Budget Office. 2023a. “Estimated Budgetary Effects of H.R. 23, the Family and Small Business Taxpayer Protection Act | Congressional Budget Office.” January 9, 2023.

the scale of tax evasion in the economy. Second, we detail what the IRA did for the IRS, and also what it did not do. We then lay out our alternative approach to revenue estimation, concluding that the IRA’s investments are likely to raise at least $560 billion in new tax revenue over the first decade; and by our conservative estimate, around $1.5 trillion over the next two decades. Third, we explain the reason for the differences between our estimates and the official governmental tallies: particularly, their exclusion of the changes in taxpayer behavior that will arise following investment in the IRS’s capacity; their understatement of direct revenue effects and their overstatement of diminishing returns; their assumption that IRS investments in services and technology have no direct returns; and their failure to fully incorporate the impact of improving the IRS’s ability to verify whether taxes are paid accurately with existing third-party reporting requirements. Fourth, we contextualize our estimate with respect to the size of the tax gap and prior academic work on the gains from additional enforcement activities. Finally, we conclude by considering why investing in the IRS is valuable even beyond the substantial revenue at stake, given the impact on addressing existing inequities in tax administration and the effect of those steps on taxpayer morale.

Scope of noncompliance

The IRS releases estimates of the federal tax gap typically once every three years. The most recent estimates cover tax years 2014-2016, where the IRS reports a gross tax gap (the difference between taxes legally owed and taxes voluntarily paid on time) of around $500 billion per year. IRS projections, more recently released to provide a more dynamic estimate of noncompliance, suggest the tax gap grew to $540 billion per year for 2017-2019. Given that the tax gap can be expected to grow with the overall economy, that means that noncompliance in 2022 was closer to $640 billion.12

The gross tax gap measures the amount of true tax liability that is not paid voluntarily and timely. The estimated voluntary compliance rate is approximately 85%—so about 15% of federal taxes owed are not received when they are due. Around $70 billion in additional tax collection was received through enforcement efforts and through other late payments, bringing the net annual tax gap from 2014-2016 closer to $430 billion (or an annual average of $470 billion for the period 2017-2019).

Post-filing activities by the IRS raise the overall compliance rate to 87% once all IRS enforcement effects are accounted for. It is this lever that the IRS hopes to directly impact through the IRA resources that increase the agency’s enforcement capacity—more compliance activities (notices of apparent mistakes, audits, and collection activities, for example) will translate into more revenue collected. Incidentally, the gross tax gap will also be impacted because additional enforcement activity has a known impact on taxpayer behavior that encourages more accuracy with respect to tax payments, the so-called deterrent effect of enforcement activities, which we discuss below.

Table 1: Decomposition of the Tax Gap

<table>
<thead>
<tr>
<th></th>
<th>2011-2013</th>
<th>2014-2016</th>
<th>2019</th>
<th>2022</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated True Tax</td>
<td>$2,688</td>
<td>$3,307</td>
<td>$3,615</td>
<td>$4,315</td>
</tr>
<tr>
<td>Gross Tax Gap</td>
<td>$438</td>
<td>$496</td>
<td>$540</td>
<td>$643</td>
</tr>
<tr>
<td>Voluntary Compliance Rate</td>
<td>83.7%</td>
<td>85.0%</td>
<td>85.1%</td>
<td>85.1%</td>
</tr>
<tr>
<td>Enforced and Other Late Payments</td>
<td>$58</td>
<td>$68</td>
<td>$70</td>
<td>$82</td>
</tr>
<tr>
<td>Net Tax Gap</td>
<td>$380</td>
<td>$428</td>
<td>$470</td>
<td>$561</td>
</tr>
<tr>
<td>Net Compliance Rate</td>
<td>85.9%</td>
<td>87.0%</td>
<td>87.0%</td>
<td>87.0%</td>
</tr>
</tbody>
</table>

Source: The data from this table comes from the IRS most recent tax gap estimates. To arrive at 2022 estimates, the IRS’s 2019 projections are adjusted for intervening growth and inflation.13

To estimate compliance with the individual income tax, the IRS’s National Research Program (NRP) uses a random sample of a few thousand individual income tax returns each year that are representative of the returns filed for that year. Random sampling is valuable because it provides a range of information about both compliant and non-compliant taxpayers which can be extrapolated to paint a realistic picture of noncompliance as the difference between the income tax liabilities reported by this population and true income tax liabilities. These randomly selected tax returns are audited by trained examiners who attempt to document all instances of noncompliance, The IRS then adjusts detected noncompliance from the NRP for differences in auditor skill to attempt to estimate how much additional tax liability that was unreported would have been discovered by the most skilled type of auditor. When all these estimates are combined, this is the agency’s measure of the individual income tax gap.

For other components of the tax gap, (e.g., corporate income tax, noncompliance by pass-through entities, employment taxes), the IRS relies on different data sources that have known empirical limitations. None are as robust as the estimates that the agency is able to extrapolate from the NRP studies of the individual income tax. Indeed, the IRS is explicit that its ability to measure noncompliance in other areas of the tax system is limited by a lack of data, noting that it is unable to “fully represent noncompliance in some components of the tax system, particularly as they relate to corporate income tax, income from flow-through entities, foreign or illegal activities, and digital assets.”14

That’s not to say that the IRS doesn’t strive to measure noncompliance across the entire tax code. For example, the IRS does provide estimates of the corporate income tax gap based on

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actual corporate audits that the agency conducts. But in the absence of random sampling, these results cannot be reliably projected to the overall population, which bears on their accuracy. The net corporate income tax gap measured for 2014-2016 was just $37 billion (which translates to just a 10 percent noncompliance rate). IRS officials have noted that this number is likely a substantial underestimate that misstates the scale of the compliance problem related to corporate taxpayers.

The agency has also tried in the past to estimate the tax gap associated with flow-through entities, but studies of partnerships and S-corporations are costly to undertake and may require specialized IRS audit resources that are in scarce supply. This lack of comprehensive compliance studies implies that the IRS currently has unreliable estimates of the overall noncompliance by these entities. To illustrate this, note that the IRS audited 0.05% of partnerships in 2019. Similarly, the IRS has little information today on which to base estimates of the amount of tax evasion with respect to trades of digital assets. Illegal activities are kept out of the tax gap by definition, since the focus is on taxes owed as a result of legitimate economic activities.

Overall, for such reasons, the agency itself acknowledges that its tax gap measure may significantly understate the scope of noncompliance in the economy today. Former Commissioner Rettig famously speculated that adjusting for these measurement challenges could lead to a conclusion that the actual size of the tax gap today was closer to $1 trillion annually rather than the $600 billion or so that is arrived at by extrapolating the official IRS estimate. This speculation is premised on noting that the areas of greatest emerging challenge for the IRS—where noncompliance is likely rampant—are precisely areas that are hard for the agency to capture in its estimates using its traditional tax gap methodology.

A few examples can be informative: cryptocurrency’s market capitalization today is over $1 trillion, with more than 8,000 exchanges operating worldwide. By construction, cryptocurrency transactions are structured to avoid financial intermediaries that may trigger

15 Ibid.
19 “For example, the estimated Tax Gap for TY2011-2013 might be understated to the extent that they don’t fully reflect the noncompliance associated,” from Charles Rettig’s testimony. (Rettig 2022) In recent years, IRS researchers have worked with outside academics to try and address some of these gaps creatively, for example see Guyton, John, Patrick Langetieg, Daniel Reck, Max Risch, and Gabriel Zucman. 2021. “Tax Evasion at the Top of the Income Distribution: Theory and Evidence.” SSRN Electronic Journal. https://doi.org/10.2139/ssrn.3809528.
regulatory scrutiny. This structure has tax implications as well. Opaque income streams where the voluntary reporting by taxpayers is not accompanied by third-party reports to the IRS that help verify their accuracy have a compliance rate of around 55%. This is perhaps why even a small shift to bring this income into the sunlight by legislating an information reporting requirement to require that cryptocurrency exchanges report on transactions like financial intermediaries report on sales to stock today was estimated to raise around $30 billion over the course of a decade. Scaling that by the size of the cryptocurrency market and the efficacy of this reporting regime suggests that even official government revenue estimators believe there is a significant problem in this arena that current estimates of the tax gap are not currently capturing.

Similarly, the IRS’s most recent random audit program for pass-through entities was conducted in the 1980s. That outdated work has implications for the amount of misreporting that the tax gap estimates are able to capture. The underreporting rate estimates for pass-through income from these studies suggested that less than 5% of income from these entities is underreported. But this pales in comparison to the under-reporting rate for sole proprietorship income which is closer to 40%—and which is much more readily captured by NRP audits. As pass-through businesses have grown in importance over the course of the last decade (the share of business income earned by businesses using this structure has increased from less than 5% in 1990 to more than 35% today), the importance of this type of potential tax evasion has risen. But the capacity of the IRS to devote resources to even studying the scope of the problem, let alone what steps could best address it—has dwindled, not grown, over the last three decades.

This misestimation has real consequences. For one, it leads to an understatement of the scale of true tax noncompliance in the economy. That is especially relevant for the exercise in this paper, because the base that official government revenue estimators use to form their assessment of the revenue potential of IRS enforcement efforts is the IRS estimate of the tax gap. Therefore, this underestimate of the tax gap has significant consequences for revenue estimation. As the total amount of unreported taxes is greater than official estimates, targeted measures to address the tax gap have the potential to raise even more additional revenue.

Mismeasurement of the ultimate size of the tax gap could also cause IRS enforcement resources to be poorly targeted and focused on addressing the parts of the tax gap that are well-measured. A better approach would be to focus resources based on the true tax gap, which appropriately captures areas of noncompliance that are understated, like pass-through income. This is a concern the IRS is beginning to carefully address, as it is targeting additional enforcement resources on the areas of known challenges. These areas include very high-income taxpayers where noncompliance has been challenging for the traditional tax gap measures to

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estimate. For example, recent research suggests global high net-worth individuals may be able to
shield income from audit and may use pass-through business entities to increase the difficulty for
the IRS to trace and accurately measure income subject to tax and other items such as tax
credits.25 This mismeasurement will pose challenges for interpretation going forward as one of
the perverse effects of additional IRS investment to address areas of noncompliance where data
is currently limited is that the estimated tax gap will rise—not fall—in some of these areas as the
IRS detects previously unknown strategies for tax noncompliance. These revised estimates will
be a sign of the IRS’s progress in measuring non-compliance because the scope of the
noncompliance challenge has been underestimated in the past.

Distribution of noncompliance

The consequence of the misestimation of the tax gap is not solely an incomplete picture
that understates the revenue lost to tax evasion today—and consequently, the budgetary
implications of a robust attack on the tax gap. Mismeasurement of the tax gap also bears on our
understanding of the distribution of tax noncompliance across the economy. Because income for
corporations, pass-through businesses and high-income individuals engaging in tax evasion is
understated, the distribution of the tax gap as measured overstates the share of tax evasion that is
attributable to the bottom and the middle of the income distribution. While existing estimates
suggest that individuals in the top 1% of the income distribution are responsible for nearly 30%
of unpaid taxes, the actual number is likely higher.26 This problem is compounded by the fact
that it is challenging to assign the amounts of detected corporate and business noncompliance to
individual taxpayers to enable a comprehensive income distribution of tax evasion.

It is worth noting that another challenge with respect to distributional analysis in this
domain is how to classify individuals across the income distribution for the purpose of analysis.
Official government scorekeepers do not impute unreported income in the individual tax model,
so current analyses do not provide an overall distribution of unreported income. In the context of
recent legislative debates, the Joint Committee on Taxation (JCT) provided an assessment of
estimated tax assessments related to underreporting of Schedule C and Schedule E income,
covering sole proprietor business and rental income respectively, concluding that nearly 60% of
Schedule C income accrues to those making less than $50,000 annually27. But those estimates
are based on classifying taxpayers by their reported income, rather than their true income
including the results of an audit. And the premise of tax evasion, of course, is to underreport
income and thus diminish tax liability owed. A distribution of Schedule C income that adjusts the
income measure used to classify individuals to account for unreported income concludes only
around 10% of proprietorship income is earned by those making less than $50,000 a year.28

28 (Sarin 2021)
The failure to think about the true distribution of the tax gap in a comprehensive way has sown confusion about the focus of new enforcement efforts that the IRS is undertaking. The Secretary of the Treasury has directed the IRS to use additional resources to focus on noncompliance at the top of the income distribution, noting that these new long-term resources should not be used to increase audit activity on those making under $400,000 annually relative to the levels of recent years. Many critics have argued that there simply is not a large enough tax gap at the top of the income distribution for the IRS to concentrate new resources on this portion of the taxpaying population.

But that is clearly an error. Using current IRS estimates (which understate the amount of tax evasion by high-income individuals), the federal government is on track to lose around $2 trillion to tax evasion by the top 1% of the income distribution over the coming decade. Some analysts arrive at a different conclusion about the tax gap’s distribution by focusing on reported rather than true income. But this approach would inaccurately classify wealthy evaders as low earners by failing to account for the effects of their tax evasion: the fact that they underreport income on tax returns in order to pay less than they owe under the federal income tax laws.

What does the IRA do

The Inflation Reduction Act provides more than $79 billion over the coming decade to modernize the IRS and improve compliance efforts. The breakdown of those resources is as follows (all figures for FY 2023-2032):

- Taxpayer services: $3,181,500,000;
- Enforcement: $45,637,400,000;
- Operations support: $25,326,400,000;
- Business systems modernization: $4,750,700,000;
- Task force to design free, direct e-file system: $15,000,000;
- Treasury Inspector General for Tax Administration: $403,000,000;
- Treasury Office of Tax Policy: $104,533,803;
- Tax Court: $153,000,000;
- Treasury departmental offices for oversight and implementation support to help the IRS implement the IRA: $50,000,000.

As the totals above make clear, the vast majority of additional resources for the IRS are in the enforcement account, which, roughly speaking, funds compliance-related activities like hiring new auditors and collections officers.

The magnitude of this investment in part reflects the significant tax administration needs facing the IRS with respect to enforcement activities. The agency’s enforcement budget decreased by 30 percent in the decade leading up to the passage of the Inflation Reduction Act, resulting in a similar decline in enforcement staffing. The result of this precipitous decline is that the agency today has fewer field revenue agents than at any time since World War II. And all this took place while the U.S. economy was growing and was certainly growing more complex.

Unsurprisingly, the decrease in available enforcement resources has had a discernible impact on the actual levels of enforcement activities that the IRS is able to undertake. The agency’s audit coverage rates have declined across-the-board since 2010. The decline has been most severe for complex enforcement work which requires a significant investment of time by the most-skilled enforcement personnel at the agency. This portion of the IRS workforce has been declining at a relatively rapid rate as skilled revenue agents retire or leave the IRS for other jobs. Given funding and staffing shortfalls, there simply are not similarly skilled employees able to quickly fill these openings. One example can help make this clear: Audit rates of individuals making $10 million or more annually declined by nearly 80%, while audit rates of low-earning recipients of the Earned Income Tax Credit (EITC) declined by about 15%.

**Chart 1: Personnel Losses and Tax Return Increases at the IRS**

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So, needs in enforcement are great, and the significant stream of multi-year funding contained in the IRA will help the IRS make the necessary investments to ramp up enforcement activities, particularly in the most challenging areas: high-income individuals, large corporations, and partnership audit work.

But the IRS has experienced budget reductions over the past decade in ways that have affected the agency’s work across-the-board. In taxpayer service, resources available to support telephone and in-person assistance shrank, leading to a 10% decline in the IRS’s workforce devoted to providing taxpayer services. A similar situation occurred in operations support—which covers investments in operational and administrative functions like IT support, training, research and human resources. The same situation exists in business systems modernization, where resources are invested in modernizing antiquated information technology, for example by supporting the retirement and replacement of the individual master file that houses historical tax data for the entire population and is the oldest IT system in the U.S. government. As discussed below, these IT shortcomings make it nearly impossible for the IRS to make effective use of all the data provided to the agency today.

Table 2: Decline in Audit Rates Across Filer Categories

<table>
<thead>
<tr>
<th>Filer Category</th>
<th>Percent Audited</th>
<th>Percent Decline (2010 - 2019)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2010</td>
<td>2019</td>
</tr>
<tr>
<td>All Filers</td>
<td>0.93%</td>
<td>0.39%</td>
</tr>
<tr>
<td>Individuals</td>
<td>1.11%</td>
<td>0.40%</td>
</tr>
<tr>
<td>EITC Recipients</td>
<td>2.39%</td>
<td>2%</td>
</tr>
<tr>
<td>$1 million - $5 million</td>
<td>6.67%</td>
<td>1.02%</td>
</tr>
<tr>
<td>$5 million - $10 million</td>
<td>11.55%</td>
<td>1.40%</td>
</tr>
<tr>
<td>$10 million +</td>
<td>18.38%</td>
<td>3.90%</td>
</tr>
<tr>
<td>Corporations</td>
<td>1.39%</td>
<td>0.70%</td>
</tr>
<tr>
<td>with assets over $20 billion</td>
<td>97.99%</td>
<td>49.90%</td>
</tr>
<tr>
<td>Employment</td>
<td>0.21%</td>
<td>0.10%</td>
</tr>
<tr>
<td>Estates</td>
<td>10.12%</td>
<td>6.90%</td>
</tr>
</tbody>
</table>

In these other areas, the IRA’s investments are relatively smaller than the resources provided for enforcement. Compared to the IRS’s FY2022 appropriations in the annual funding process, the agency received nearly 5 times its annual base funding in enforcement (over the ten-year 2023-2032 period). This compares to the approximately one year’s funding in taxpayer service (received over the same 10-year period). The difference in resource reductions in each of these categories over the course of the last decade is considerably less stark. So, what drives this difference in the IRA funding decisions?

In part, it is a function of the government scorekeeping process itself. The way official revenue estimators approach the question of how much additional revenue can be generated by an investment in the IRS, as we detail below, is by applying historical returns to different types of enforcement activities (examination, collection, etc.) and then computing the direct increase in additional tax liability collected based on these historical return-on-investment figures. These historical returns on investment can range from 2 to 30 depending on the year and type of activity described.

Importantly, these scorekeepers do not count the value of additional investments made in improving taxpayer service in ways that can help taxpayers accurately fulfill their taxpaying obligations or in overhauling IT systems in ways that will improve the quality of enforcement activity that the agency undertakes (and thus, should affect the expected ROI). As one example, if the IRS was able to match partnership information provided on Forms K-1 to the corresponding individual income tax returns, the IRS would be better able to select individual pass-through owners for additional scrutiny. These potential gains are not captured by government scorekeepers’ estimates.

Official government scorekeepers have long grappled with this question and are hesitant to incorporate gains from IT and service improvements given the inherent uncertainty of these estimates. But failing to include them is an implicit conclusion that those investments do not deliver any return—and therefore are just a net cost, not a revenue generator, for the agency.

Beyond understating the revenue impact of investments in the IRS, the failure to account for revenue gains or other benefits from service and IT spending distorts the incentives for legislators’ investments in the IRS. This is particularly true in the budget reconciliation process, where revenue that is estimated to be raised from funding IRS enforcement operations can be used to finance other sorts of activities undertaken by the federal government (for example, the

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$270 billion in tax incentives for activities to mitigate climate change in the IRA). The failure to account for revenue raised through service and IT types of expenditures affected the ability to generate enthusiasm for these investments in the IRA, because it decreased the officially estimated return on the overall IRS investment. Said another way, just spending $45.6 billion on increasing IRS enforcement activities related to high earners would have been scored as generating approximately the same $114 billion (net) over the course of the decade. The remaining $34 billion was treated as pure cost in the reconciliation process, despite the likely substantial revenue impact through increased tax receipts.

It is helpful to contextualize the total $80 billion in IRA funding made available to the IRS over the coming decade to the agency’s budgetary decline over the course of the last decade. One way to do so is to take the FY 2010 budget provided by Congress and adjust it for inflation that has occurred since 2010. Rather than declining by 20 percent between 2010-2021, the agency’s budget would have increased by about 15 percent over this period if it were simply indexed to the overall change in prices over this period. In addition, if the IRS budget was also indexed for growth in the size of the U.S. economy since 2010, it would have had $9.5 billion more resources than the actual FY 2022 levels. This would have translated to a drastic difference in the size of the IRS’s labor force. Although total employees shrunk by 25 percent over this period, in hits alternative, the agency would have grown relative to 2010 with about 35,000 more total employees, 7,000 more in customer service, 7,000 more in enforcement relative to current totals, 3,000 more in IT, and even about 500 more in the Chief Counsel’s office focused on writing regulations that help more quickly and appropriately implement the tax law.

One way to understand part of the multi-year funding that the IRS received through the IRA is that it seeks to reverse decades-long underinvestment by plugging holes in the activities that the agency has traditionally undertaken. But the funding in the IRA goes beyond that, because the legislative goal is to modernize the agency, not to simply plug longstanding holes in the current system of tax administration. The IRA includes funding that the IRS requested for modernizing its outdated IT infrastructure, and it also includes the resources that the agency requested to improve enforcement capacity in areas of concern. But these IRA resources will need to be supplemented through the annual appropriations process or progress could be undermined. For instance, the Administration’s FY 2024 Budget Request shows zero dollars requested for Business Modernization. This seems shortsighted because the work of modernizing IT systems is never fully finished.

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Overall, the IRS estimates that the agency will significantly ramp up its enforcement scrutiny on the top of the income distribution, e.g., individuals making more than $400,000 annually in true income, as well as large corporations and partnerships. The agency’s newly published strategic plan highlights these as areas of focus where the IRS has not had the tools historically that it has needed. Simply returning to 2010 activity levels simply is not sufficient from the IRS’s perspective for these segments of the economy in part because for 2010, the audit rate for partnerships still rounded to zero.39

The lack of any real enforcement presence for large groups of business entities impacts not only direct tax revenue collected but also taxpayer behavior and taxpayer morale in meaningful ways. In essence, not having a tax cop on the beat engenders more malfeasance in a way that the agency must address to prevent further erosion of tax compliance. Lack of an enforcement presence can also spur activity into segments of the economy because the limited enforcement presence gives an economic advantage to certain sectors or business forms that facilitate tax evasion, and it can place compliant taxpayers at a competitive disadvantage. New IRA investments will enable the IRS to focus resources on types of business activity (like S-corporations, partnerships, sole proprietorships, and limited liability companies (LLCs)) where IRS scrutiny has historically been lacking.

Official government estimates suggest that giving the IRS all that it needs to address noncompliance—both to get back to 2010 levels with respect to enforcement activities but to go beyond that in areas of known challenge—will increase net revenue collection by $186 billion ($114 billion, net) over the course of the next decade: collecting just 2% of the aggregate 10-year tax gap from this robust set of efforts. Given the scope of the tax evasion problem plaguing the economy, that seems to be quite a severe underestimate. We next propose an alternative approach to revenue estimation that arrives at a significant upward revision to the expected net revenue raised and that more fully reflects the true potential of IRA’s resource infusion.

**How much revenue is at stake from IRA investments**

It is helpful to create a highly simplified version of a revenue estimate to help build intuition for how the results are affected by incorporated assumption about relevant components and their magnitudes. Our approach is to create a highly-simplified version of a revenue estimate to help build intuition for how the results are affected by assumption about the relevant components to include in the analysis and their magnitudes.

For the simplest case, start with the IRS adding enforcement staff costing $1 billion in the first year of the IRS investment program. The cost of these resources will grow over time, so assume a 5 percent annual growth rate. With the annual growth built in, by the end of the 10-year budget window, these resources would cost about $1.55 billion. At the beginning of the second year, suppose $2 billion is invested in new enforcement resources. And assume the same 5 percent annual growth rate applies to the cost of these resources, so by the end of the 10-year budget window (with 9 years of growth), these resources would cost about $2.95 billion. At the beginning of the third year, suppose that $1.2 billion is invested in enforcement resources. With the same 5 percent annual growth rate, by the end of the 10-year budget window, these resources would cost about $1.69 billion. Over the ten-year budget window, the first tranche of enforcement resources would cost about $12.58 billion, the second tranche about $22.05 billion, and the third tranche would cost about $11.45 billion. Added together, the direct cost of these resources for the ten years is about $46 billion, and the 10th year total cost is about $6.2 billion, showing the effect of the annual cost increases.
Over the years the IRS has provided several estimates of the return on investment for increased enforcement activities. One recent estimate indicates a range of 4:1 to 5:1, meaning that for each dollar invested in enforcement activity, the IRS collects around $4 or $5 in taxes that had been unpaid. Using the lower estimate to start and assuming that it take a couple years for IRS enforcement employees to become fully effective, we might see a pattern of returns like $1 for each dollar invested in the first year, $2 for each dollar invested in the second year, and the estimated $4 return for each dollar invested in years 3 and after. So $1 billion invested in enforcement staff in year 1 and then maintaining these staff indefinitely (while their cost increases by the 5 percent growth rate) would return $45.2 billion over the 10-year budget window. Continuing this simple scenario, the second tranche of enforcement personnel would start out at $2 billion in year 2, and grow at 5 percent per year, and would return about $78.01 billion over the ten-year budget window. In a similar fashion the enforcement investments begun in year 3 would cost $1.2 billion in the third year and grow at 5 percent per year, and return about $39.72 billion over the budget window. The pattern continues, with the enforcement investments starting in year 6 returning $16 billion over the remainder of the 10-year budget window. (See Table X.)

When fully accounting for the costs of enforcement programs, we need to account for the costs of supporting the enforcement staff. This includes things like data support, systems support, legal support, research activities, and other expenditures that make the enforcement processes effective. These can easily add up to 20 percent of personnel costs, and clearly these expenditures would have a similar return to the investments in personnel. Applying this 20 percent support fraction to the total costs shown above would yield another $9.22 billion in costs, totaling about $55.3 billion in overall costs and about $198 billion in aggregate returns over the 10-year budget window. (See Table X.)

The revenues generated over the 10-year budget window are very close to the amounts of additional revenue estimated by CBO (the official governmental scorekeeper) associated with the increased IRS investments contained in the IRA. This similarity will provide a good jumping off point to see the effects of using more realistic magnitudes and more comprehensive responses to the increased IRS investments.

A straightforward place to start is the assumed return to IRS enforcement activities. The actual rate of return is likely to be greater than the conservative 4:1 ratio used above. Suppose that the average investment in enforcement activities yields a 5:1 return on average, which is in the range previously estimated by IRS. Then the total returns from the $46 billion in enforcement personnel and the 20 percent indirect costs would be almost $250 billion over the 10-year budget window.

Given the decades-long underinvestment in IRS enforcement activities, a 5:1 return on investment is quite reasonable in the historical context and could even be an underestimate. Given the decades-long underinvestment in IRS enforcement activities, a 5:1 return on investment is quite reasonable in the historical context and could even be an underestimate. This is particularly true since the IRS will be focused on additional audit scrutiny on high-income taxpayers and those with complex returns, where examinations are time consuming but yield
high returns: as Treasury Inspector General for Tax Administration Russell George has pointed out in the past, an extra hour spent auditing a taxpayer who makes $5 million or more annually generates thousands of dollars (his 2013 estimate was over $4,500). And as discussed later, there are good reasons to expect greater returns on these investments when additional aspects are incorporated into the calculations.

There is another direct effect on revenues that should be associated with the remaining $23 billion (non-enforcement) investment in the IRS over the ten-year budget window. The additional resources for taxpayer services will be used, in part, to staff telephone call centers and walk-in taxpayer assistance sites. These resources will make it easier for taxpayers to get answers to tax-related questions, helping to avoid common mistakes that would otherwise need to be resolved using enforcement personnel. These service resources will also help taxpayers and tax preparers who need to communicate with the IRS over taxes due or potential issues that IRS discovered when processing tax returns. These service personnel can also help IRS resolve issues like identity theft, which clearly can have negative consequences for tax collections.

In the area of Operations Support, the investments in IRS will make it possible to hire new employees, bring them on board, train new and existing employees, and undertake the research necessary to focus IRS enforcement actions where they will have the biggest impact on overall compliance.

The investments in Business Modernization will allow the IRS to develop modern data systems that can be used both to improve services (for instance by providing accurate and up-to-date depictions of taxpayer accounts) and improve enforcement (for instance by using multiple databases to help detect mismatches of reported income or deductions). Modernized IT systems would also allow IRS to deploy machine learning techniques to increase the efficiency of a wide range of operations. In the financial sector, these sorts of investments can have extraordinarily large rates of return. As one recent example, the IRS’s investment in developing new fraud protection technology to prevent fraudulent refunds cost the agency resulted in around $4.4 billion in a filing season, at a cost of just $90 million—around a 50:1 return.40

Clearly, these non-enforcement investments will generate a positive return for the IRS. While there is no precise set of agreed-upon estimates of the size of these effects, a conservative estimate would be that each dollar invested in these activities would return at least two dollars in cost savings or extra tax revenue. So we can be reasonably confident that these $23 billion invested in non-enforcement IRS operations will return at least $23 billion over the 10-year budget window. When added to the previous total of nearly $250 billion, the amount of estimated returns grows to more than $270 billion over the budget window.

If anything, these direct effects are understated because of the scope of the compliance challenge the IRS faces today. In order to arrive at ROI estimates, the agency relies on returns from historical examination activities. But in the last several years, because of resource constraints, the agency’s ability to pursue noncompliance has dropped off, particularly for high-

end income and complex taxpayers: Partnership audit rates dropped from 0.5% to just 0.05%; and audit rates of millionaires similarly declined, falling from about 10% to 2% between 2010 and 2019.  

Historical ROI figures fail to fully capture this decline, as the situation today, relative to a decade ago, is that there is a lot of potentially high-return work that resource constraints have eliminated. The historical ROIs that the IRS relies upon are virtually unchanged over the course of this decade even though baseline coverage has declined significantly, which suggests that today’s environment should yield higher returns to the new enforcement activity the agency will take on.

Further, because these estimates are historical, they also fail to consider the efficacy—in a forward-looking manner—of an IRS that is tooled to better make use of the information that it receives on compliance today, as well as new information collection that is on the horizon.

Specifically, the additional investments in IRS activities will surely make better use of the wide range of information that the IRS already gets from third party providers and information that will be received under recently enacted laws. For instance, the IRS has received information on Forms 1099-K from issuers of credit and debit cards for the annual payments they make to businesses. Recently, the thresholds for reporting this type of information to the IRS were reduced (there is little increased burden on the information providers because this information already was being provided to the businesses). But this broadening of information reporting will mean that gig workers, transportation providers, and vacation home landlords (among others) will now have their revenues more visible to the IRS. This should help IRS select returns for audit or other types of inquiry and also should help business taxpayers more accurately report their revenues from operations. Recent legislation also began requiring some reporting on cryptocurrency transactions, an area where the IRS has precious little information about taxpayer activities (largely by design of these markets). This information will help IRS select income tax returns that appear to have under-reported income and also will help remind taxpayers to accurately report income they earn from trading in cryptocurrencies.

All these are gains from new information that recent legislative changes should provide the agency. But there are also significant gains for the IRS from information that it today has access to, but that it has not been able to utilize because of gaps in the agency’s technological infrastructure. For example, in 2010 Congress passed the Foreign Account Tax Compliance Act (FATCA) to provide better visibility to the IRS about foreign accounts used by taxpayers. This law included new information reporting requirements by foreign financial institutions. The idea was that by providing visibility to the IRS about assets housed and income earned abroad, the agency’s ability to monitor taxpayers conducting business abroad would meaningfully improve. But the IRS has been hampered in its ability to make use of this data: both because data limitations make it challenging for the IRS to link data provided by taxpayers to that provided by financial institutions; and because of the agency’s lack of a comprehensive data strategy to
deploy this information. Similarly, the IRS receives 40 million K-1 forms associated with partnership income but does not have the infrastructure to match that information with individual tax filings in a way that allows it to be leveraged to make enforcement decisions ex-ante (typically, data from Form K-1s are used today only when the IRS has already opened an examination of an individual with a partnership stake, not to actually make a choice about whether a taxpayer’s return is deserving of additional scrutiny).

As part of the IRS’s recently released Strategic Operating Plan, the agency outlines a vision over the course of the next several years for addressing these deficiencies with the new resources it has received: a key initiative is a plan to “maximize data utility” that is focused on establishing a comprehensive data platform to ensure that the information that the IRS receives is securely stored and appropriately utilized to improve service and compliance objectives. This will help the IRS to target resources where they belong, on taxpayers who appear likely to be underpaying their liabilities. In addition to increasing the returns associated with enforcement efforts, these investments will also decrease taxpayer burden associated with enforcement activities by making it less likely that taxpayers who are making good on their obligations will be swept up by IRS enforcement efforts.

The additional revenue from these types of complementarities between the additional IRS investments and additional information to be reported to the IRS could easily total $10-20 billion per year by the end of the ten-year budget window. And these amounts would be expected to grow over time in line with the overall economy. If we take the midpoint of this estimation, we would say that this additional return from information reporting could add $15 billion to the aggregate return over the next decade. When we add this to the previous total of $295 billion, the amount of estimated revenue generated grows to $310 billion. (See Table 3).

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Table 3: Direct Return from IRA Investment

<table>
<thead>
<tr>
<th></th>
<th>Aggregate Investment over 10 Years</th>
<th>Aggregate Return over 10 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enforcement Year 1</td>
<td>$13 Billion</td>
<td>$57 Billion</td>
</tr>
<tr>
<td>Enforcement Year 2</td>
<td>$22 Billion</td>
<td>$98 Billion</td>
</tr>
<tr>
<td>Enforcement Year 3</td>
<td>$11 Billion</td>
<td>$50 Billion</td>
</tr>
<tr>
<td>Enforcement Support</td>
<td>$9 Billion</td>
<td>$44 Billion</td>
</tr>
<tr>
<td>Service and IT</td>
<td>$23 Billion</td>
<td>$46 Billion</td>
</tr>
<tr>
<td>Additional Returns from Information Reporting</td>
<td></td>
<td>$15 Billion</td>
</tr>
<tr>
<td>Total</td>
<td>$78 Billion</td>
<td>$310 Billion</td>
</tr>
</tbody>
</table>

Source: Authors’ calculations. The numbers in this table follow from the calculations detailed in the text above.46

Role of deterrence in revenue estimates

All of these estimates account only for the direct effects of enforcement activities. They fail to incorporate any behavioral changes when taxpayers become aware that there are more tax police on the IRS beat. Historically, Treasury has viewed the deterrence effects as roughly three times the size of direct effects.47

Deterrence has two component parts. First, self-deterrence: consider a driver who is pulled over for blazing through a red light. She will be less likely to run the next several red lights she sees. Second, community deterrence: consider a driver with a friend who mentioned how police are often waiting by a local intersection to patrol unsafe driving. She’ll be extra careful when driving on that road.

The academic literature supports the importance of both types of deterrence in understanding the revenue impacts associated with tax compliance investments. Recent work by William Boning, Nathan Hendren, and Benjamin Sprung-Keyser on individual-specific or self-deterrence finds that audits lead to an increase in future taxes that are 3.2 times the direct effect of an initial

46 We apply a 5:1 return estimate for aggregate tax revenue generated from enforcement spending in the first three years and spending in support. For service and IT, we take a conservate estimate of a 1x net return, and we take the midpoint on estimates for returns from information reporting.
Interestingly, they find this effect persists over the 14 years they observe in the data, unlike past work which has found that self-deterrence decreases as individuals or firms are removed from the recency of their compliance infractions.

With respect to community deterrence, recent work by William Boning, John Guyton, Richard Hodge, and Joel Slemrod finds that in person collection visits raise as much revenue from firms sharing tax preparers as from the visited firm itself. These network effects are relevant for the community of tax practitioners writ large: when certain types of taxpayers are audited, those taxpayers change their behavior (self-deterrence), and also other tax payers may notice and change their behavior as well (for instance by exchanging observations in business associations or even just through neighbors talking). This is how community deterrence works. And there are strong information flows through the tax preparer community, which means that increased IRS scrutiny on specific items will lead to increased preparer scrutiny of the same items for the taxpayers they are assisting to be sure that the claims are warranted. There is a wide range of estimates in the academic literature about the size and duration of this effect, but there is little disagreement on its existence.

When trying to develop estimates of the deterrence effect, it seems likely that it occurs with a lag, so we can build in a one-year delay. And to be conservative, we can start with a deterrence effect that mirrors the increased revenue effect from the enforcement activity, essentially a deterrence multiplier of 1. Using the revenue generated by enforcement investments (including the support costs of direct enforcement costs) and lagging the effects by a year, we would find that about $211.9 billion of revenue would be paid over the ten-year budget window by taxpayers who were deterred from cheating on their taxes.

Applying Treasury’s 3-to-1 estimate of indirect effects, which is in line with the recent academic literature, to our direct effect of $250 billion (composed of the returns from enforcement years 1 through 3 and enforcement support) suggests additional tax collection of $500 billion in indirect gains associated with the Inflation Reduction Act’s investment in the IRS—meaning a total impact (direct + indirect) of $1,050 trillion over the course of the next decade, and $930 billion in net-of-investment gains. (See Table 4).

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48 Boning et al. 2023. This is directionally consistent with prior work by Debacker et al. (2018), as well as studies in UK and Denmark that find similar effects.
51 To calculate these estimates, we applied a 1:1 or 3:1 deterrence effect on our returns for enforcement investments started in years 1, 2, and 3, plus the returns to enforcement support.
Table 4: Direct and Indirect Returns from IRA Investment

| Source: Authors’ calculations. We only apply the deterrence factor just to enforcement investments and enforcement support costs, not to the anticipated compliance gains from service, IT, and information reporting. |
|---|---|---|
| **Direct Revenue** | $55 Billion | $310 Billion |
| **1:1 Deterrence** | $55 Billion | $560 Billion |
| **3:1 Deterrence** | $55 Billion | $1050 Billion |

As our naïve sketch above lays out, failing to grapple with the importance of indirect effects on taxpayer behavior dramatically understates the revenue impact of the investments that the IRS will undertake with the mandatory, multi-year funds provided by the Inflation Reduction Act. While there are reasons to quibble with the magnitude of the ROI estimates we use, our rough sketch of the direct effects of these resources is similar in magnitude to estimates arrived at by official scorekeepers. But we also include a number of indirect effects. Had we failed to consider indirect effects—for example because of their uncertainty and the inconsistent estimates in the growing literature in the space—we would have assumed them zero, and missed out on what is likely the most sizable impact of the IRA’s investment in IRS enforcement activities.

**Long-term revenue impact**

The revenue effects of the additional multi-year investments will grow over time, as long as these investments are maintained at least at their real, inflation-adjusted, levels. This revenue growth will occur as the investments in enforcement and other IRS operations continue to deliver their substantial returns and as the complementarities of the investments streams and various policy initiatives grow. For example, under our base case, by the tenth year after the beginning of the IRS investment plan, the projected amount of revenue raised by these investments is about $80 billion. And with very plausible interaction effects, this figure could easily be up to $150 billion in 2033.

This additional revenue will make a sizable contribution to the nation’s fiscal posture. By way of comparison, these additional revenues would be between 75 percent and 140 percent of total excise tax revenues expected to be collected in 2033 or about 140 percent to 250 percent
of the total estate and gift tax revenues expected to be collected that year.\textsuperscript{52} This is greater than the total revenue that will be raised from all the other tax changes in the IRA put together, so will have a more significant impact on our fiscal sustainability than any other aspect of the legislation.

A similar picture arises if the real level of investments in the IRS is maintained over the subsequent decade. By the end of the second decade, the annual increase in federal revenues would be more than $110 billion (and over the 2033-2043 period would total about an additional $1 trillion). Under more optimistic, but still very plausible assumptions, the annual increase in revenues for 2043 could be $224 billion (and over the 2033-2043 period would total an additional $2 trillion). Clearly, these returns are not sufficient by themselves to balance the federal budget. But they do make a sizable down payment toward addressing America’s fiscal imbalances. And all this additional revenue comes from simply collecting a bit more of the taxes that already were owed under laws enacted by Congress.

\textsuperscript{52} Congressional Budget Office. 2023. “The Budget and Economic Outlook: 2023 to 2033.”
https://www.cbo.gov/publication/58946#:~:text=The%20deficit%20is%20projected%20to,in%20interest%20rates%20during%202022..
Chart 3: Year-By-Year and Cumulative Projected Revenue from IRA Investment

Projected Revenue from Enforcement Investment, 2024-2043

Projected Cumulative Revenue from Enforcement Investment, 2024-2043

Source: Authors’ calculations.
Contextualizing our revenue estimate

Our revenue estimate suggests a significantly higher return to the IRA’s investment in the IRS than that of CBO scorekeepers. Specifically, we estimate a gross revenue effect in the first decade of $560 billion (net $480 billion), relative to their around $200 billion (net $115 billion) total. And because investments in the agency’s capacity to build up enforcement scrutiny of high earners, large corporations, and partnerships require high fixed-costs to hire and then train new personnel and to build up new data analytic capacities, these are investments that are even more powerful in the second decade, with an expected $1,080 billion ($1 trillion net) yield from 2033-2043 (and third and fourth decade estimates that would be even larger). That is both because fixed costs take years to pay out in full (IRS estimates suggest a new hire takes four years of training before delivering their highest ROI), and because the tax gap, left unaddressed, will grow mechanically over the course of the decade because of the growth of the economy.

Importantly, these out-of-budget-window gains require that funding be in place to support the IRS’s enforcement efforts after the mandatory stream of funding ends in 2031. We believe that this is a likely outcome given that it seems implausible that the agency would scale up over the course of the next decade and invest in building up a meaningful enforcement presence in proprietorship and partnership audits, only to end the decade being forced to retire those high-ROI investments. Given the inertia in the political system, that seems a likely base case. There are also obvious political reasons why needs for additional revenue in future budget reconciliation procedures will push in the direction of further investments in the IRS for decades to come, which will produce revenue gains of the magnitude that we describe in this short paper.

To be sure, our revenue estimate is large. By year 2033, we estimate that investing in the IRS means an extra about 1.5 percent of GDP that is today owed to the agency will be captured. But again, scaling by the scope of evasion helps to put this number in context. Over this decade, through the large-scale investments made by the IRA, the IRS will capture 7% percent of the nearly $8 trillion tax gap. That is sizable and meaningful progress—but it is also modest and attainable in ways that will reap benefits for the nation’s fiscal position.
Although we arrive at far larger estimates of the IRA’s revenue potential than official scorekeepers, we are if anything conservative relative to academic estimates that have considered the potential impact on the tax gap of a robust attack on noncompliance. Over the course of the

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last several years, much has been written about the impact of modernization on the agency’s ability to collect unpaid taxes. One of us, writing with former Treasury Secretary Larry Summers, estimated that a commitment to restoring tax compliance efforts was likely to generate over $1 trillion over the course of the next decade, about $500 billion more than our baseline estimate here. An even larger estimate of revenue potential came from the work of former IRS Commissioner Charles Rossotti and IT executive Fred Forman, who concluded it was possible to recover $1.6 trillion in uncollected taxes in the next decade from improvements to our system of tax administration.

We offer a different type of estimate than the careful bottom-up estimates of likely returns from different types of enforcement activities taken by these authors, as in this paper we provide more of a top-down assessment of the likely impact of the agency’s increased enforcement efforts based on the IRA’s provision of funds to the agency.

Further, while an IRS funding increase was an important part of these prior authors’ proposed strategies for IRS modernization, bringing income into the light with new information reporting was as well. Indeed, the Biden Administration eventually proposed new reporting by financial institutions on account inflows and outflows that resembled what had previously been suggested by these authors; however, this provision was ultimately not enacted. As such, in our revenue estimate we do not include the potential gains from such a reform, which is an important driver of the differences in revenue estimates. It is worth noting though that although bank reporting would have been an impactful change to the tax system to bring important sources of income into the light, there are new reporting provisions that the IRS is soon to implement (e.g., digital asset reporting, payment provider reporting) that, as we describe above, will have an impact on compliance as well, as will the ability to better deploy data that the agency already receives.

Comparing with CBO estimates

As described above, we come to a revenue estimate that is significantly larger than that offered by official scorekeepers. The bottom-up approach we undertake helps point out key drivers of those differences. First, the CBO approach to deterrence—which the agency has modified over the course of the last several years—does not significantly adjust direct effects for the behavioral effects associated with IRS enforcement activities. In the past, CBO has been explicit about ignoring those effects, noting that their estimates are “subject to considerable uncertainty and only capture the direct effects of enforcement activities.” More recently, CBO has included the “expectation that increased enforcement activities would change the voluntary

compliance rate…only modestly.” Given that CBO estimates have not changed meaningfully despite the inclusion of modest indirect effects, it is evident that the official estimate relies on an infinitesimal deterrence factor relative to our, explicitly conservative, estimate of 1.

An additional explanation for the differences between our estimates relates to varying assumptions of the importance of diminishing marginal of additional dollars spent on IRS enforcement activities. As our rough revenue estimate above makes clear, we do not believe there are substantial diminishing returns that are relevant to the IRS’s efforts in the years ahead. That is largely about the baseline and how substantially enforcement efforts have decreased due to budget cuts of recent years. Audit rates are down across-the-board over more than a decade, with the most sizable declines for the important high-income individual and large corporate taxpayer work that the IRS will prioritize in the years ahead. In our analysis, the current deficiencies in enforcement suggest that, although the agency may approach a point where diminishing returns are a relevant consideration in its enforcement efforts, it is far from that point today. And it has gotten even farther in recent history as resources and workforce have dwindled.

That is not the same assumption made by official scorekeepers, whose view of diminishing returns has not shifted despite the agency’s substantial drop off in enforcement activity in recent years—which have moved it further from the diminishing returns frontier in a way that should impact this adjustment. Specifically, CBO assumes that the first $20 billion invested on the IRS will net $41 billion (a 2:1 return), but that the next $60 billion will net just $63 billion (about a 1:1 return).

That seems surprising given the drop off in enforcement capacity that the agency has experienced in recent years. One way to understand the issue with the CBO’s approach to diminishing returns is to consider the following: as the IRS’s enforcement efforts have declined, it has seen a 1:1 drop off in additional taxes collected. If diminishing returns were sizable, that decline should have been less precipitous—because the agency would have stopped doing the least profitable enforcement work as its resources declined. As prior work points out, that is not the trend that we observe in the data.

Even with a sizable haircut for diminishing returns of 10-15% would still produce a budget impact of the IRS investment of $500 billion in the first decade, and about $1 trillion in

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the ten years thereafter. It is hard to see how a larger adjustment is justified given the substantial hole the agency finds itself in today with respect to its enforcement capacity.

Conclusion

Our short paper has focused primarily on the revenue impact of investments in the IRS’s enforcement capacity. This is explained by the fact that there are sizable losses to the fisc that are attributable to the IRS’ depleted enforcement capacity today. The revenue at stake is clearly an important argument for these investments, and indeed, was the rationale most frequently marshalled by policymakers during the debate around the IRA.

But it is a mistake to think that revenue alone justifies this historic investment in the IRS, as this rationale understates the importance of adequately resourcing our tax administrator. Today, the nation faces a two-tiered tax system: typical American workers earn wages and find their taxes automatically withheld, and so their tax obligations on that income generally are paid in full. However, those with much higher incomes and greater access to resources who accrue income from opaque sources often do not completely fulfill their tax obligations. These disparities are exacerbated by the fact that the IRS has historically been unable to expend resources on enforcing the tax laws against the latter group.

It is also worth noting that evasion opportunities create inefficiencies in the economy by funneling more activity than is optimal to industries which are tax-advantaged. Further, even within a sector of the economy, the possibility of evasion creates competitive distortions: Imagine two business owners, one who is civically responsible and pays her taxes in full; the other who does not and undercuts her competitor with her tax savings. Addressing evasion alleviates this tax on compliant taxpayers—and the broader tax that arises from the fact that, in the presence of significant evasion, future government funding needs that result in tax increases are borne narrowly only by the segment of the population that is law-abiding.

Even beyond revenue, then, the fairness of the tax system can usefully be enhanced by these investments. A critical piece of that overhaul will be shifting norms for taxpayers who today evade their tax liabilities intentionally. It is imperative that going forward, sophisticated taxpayers bear costs associated with this noncompliance that are sufficient to deter malfeasance, aside from the (often minor) monetary penalties paid by their business entities. The tide is already starting to turn on this dimension, with high-profile criminal indictments and prison sentences associated with multi-million dollar tax fraud cases. With its new resources, the agency will be able to invest more in this work going forward, which will be a positive feedback loop: improving the morale of taxpayers in general by making clear that the noncompliance of high-income evaders is appropriately addressed will lead everyone to be more diligent in future dealings with the IRS.

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So, addressing tax evasion does much more than raising revenue—it also creates a fairer and more efficient economy. Given that the IRS touches just about every household and every business each year, a demonstrably more equitable system of tax administration also has the virtue of restoring trust in tax administrators—proving the value and importance of good government to the American populace.