

How to Think About IRS Tax Enforcement Provisions in the Inflation Reduction Act

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Perhaps one of the most controversial pieces of the Inflation Reduction Act (IRA) is the expansion of the Internal Revenue Service (IRS). There is a compelling case for strengthening the enforcement of existing taxes, rather than creating new ones, as a way to raise revenue. The economic costs of enforcing existing taxes are likely lower than the costs of the numerous tax increases that have been proposed over the past two years. Still, increased IRS tax enforcement is not a free lunch, as it will likely impose additional compliance costs for the revenue raised.

Furthermore, the whole debate skirts around the more substantive issue of an increasingly complex tax code. Tax reform should simplify tax administration for the IRS, while having the salutary effect of making life easier for taxpayers in terms of tax filing and compliance costs.

What's In the Package

The Inflation Reduction Act increases the IRS budget by roughly \$80 billion over 10 years. The money is broken into four main categories—enforcement, operations support, business system modernization, and taxpayer services—as well as a few other small items such as an exploratory study on the potential of a free-file system.

Table I: IRS Funding Increases by Category

Function	IRS Budget Increase
Enforcement	+\$45.6 billion
Operations Support	+\$25.3 billion
Business System Modernization	+\$4.8 billion
Taxpayer Services	+\$3.2 billion
Other	+\$0.7 billion
Total	+\$79.6 billion
Source: Inflation Reduction Act of 2022, https://www.democrats.senate.gov/07/27/2022/inflation-reduction-act-of-2022 . May not sum due to rounding.	

The largest increases, relative to previous IRS budget projections, come for business system modernization and enforcement.

Table II: Contextualizing IRS Funding Increases

	Previous 10-Year Projections	Additional 10-Year Funding	Percentage Increase
Enforcement	\$66.0 billion	+\$45.64 billion	69%
Operations Support	\$47.6 billion	+\$25.33 billion	53%
Business System Modernization	\$3.1 billion	+\$4.75 billion	153%
Taxpayer Services	\$33.6 billion	+\$3.18 billion	9%
Total	\$150.3 billion	+\$78.90 billion	+52%
Source: Congressional Budget Office, Inflation Reduction Act, via Brendan McDermott, "IRS-Related Funding in the Inflation Reduction Act," Congressional Research Service, updated Aug. 9, 2022, https://crsreports.congress.gov/product/pdf/IN/IN11977 ; author's calculations.			

The new business modernization funding will go towards several projects, including “development of callback technology and other technology to provide a more personalized customer service but not including the operation and maintenance of legacy systems.”

Enforcement funding has several functions: “to determine and collect owed taxes, to provide legal and litigation support, to conduct criminal investigations (including investigative technology), to provide digital asset monitoring and compliance activities, to enforce criminal statutes related to violations of internal revenue laws and other financial crimes, to purchase and hire passenger motor vehicles.”

IRS funding for operations support will support taxpayer services and enforcement programs, including “rent payments; facilities services; printing; postage; physical security; headquarters and other IRS-wide administration activities; research and statistics of income; telecommunications; information technology development, enhancement, operations, maintenance, and security; the hire of passenger motor vehicles.”

IRS funding for taxpayer services will go towards programs such as “pre-filing assistance and education, filing and account services, and other services.”

In Abstract

The trade-offs in IRS tax enforcement can be understood with an error matrix. There are four types of results: true positives, true negatives, false positives (also known as type I errors), and false negatives (also known as type II errors). This idea is often applied to diagnostic medical tests, but it can also be a useful framework for understanding the results of expanded IRS enforcement activity.

Table III: Trade-offs in IRS Tax Enforcement

	Audited	Not Audited
Underpaying Taxes	True Positive	Type I Error (drives the tax gap, lost revenue, loss of horizontal equity)
Paying Full Liability	Type II Error (raises compliance costs for law-abiding taxpayers)	True Negative

Type II Error is how increased enforcement rates can end up hurting taxpayers already following the law and paying their full liability. At the same time, increased enforcement should help reduce Type I Error by catching more non-payers. Ideally, the IRS would be able to reduce both kinds of errors simultaneously, by better assessing which tax returns are inaccurate. This can be achieved through investments in new software programs that can better determine where to direct the IRS’s existing enforcement resources.

There is, of course, a level of increase in Type II Error that ought to be accepted in exchange for reductions in Type I Error (in other words, catching more nonpayers). But the existence of Type II Error shows that increased enforcement is not without costs. This cost-benefit framework can be applied to all forms of enforcement questions, not just tax enforcement.

In Practice

The Congressional Budget Office (CBO) estimated a similar IRS tax enforcement package in 2021, and found the \$80 billion package would raise \$207 billion in gross revenue, resulting in \$127 billion in net additional revenue. The existing package is projected to raise \$203 billion in gross revenue and \$123 billion in net revenue.

However, as the CBO notes, these estimates are very uncertain. On one hand, the CBO does not consider deterrence effects. Increased audit rates could reduce future tax nonpayment as well as present tax nonpayment, suggesting that the revenues will be higher than \$123 billion. On the other hand, there is some evidence that increased scrutiny can produce a kind of backlash that reduces the revenue raised.

Conversely, the CBO must make difficult assumptions regarding declining marginal returns on additional enforcement spending. Under current IRS funding levels, the CBO estimates an additional dollar of enforcement spending will yield between \$5 and \$9 in additional revenue, as they focus on the highest-return activities. However, the return on investment of each additional dollar of IRS funding should fall over time. With such a substantial increase in enforcement, it is difficult to estimate how far the marginal return of the last (for example) \$10 billion in spending would be.

It is also difficult to estimate the effect of the reform on compliance costs from audits on taxpayers that ultimately owe no additional liability. Raising IRS tax enforcement and audit rates broadly should raise this type of error, and thus impose additional costs, but investments in better information technology and business systems should improve audit targeting and thus reduce that kind of error and the costs associated with it.

However, considering the lack of focus on taxpayer service relative to enforcement, with taxpayer service seeing a 9 percent budget increase while enforcement funding rises by 69 percent, increased compliance costs for taxpayers is a legitimate concern.

The Big Picture: Structural Reform Needed

The IRS funding increase should raise additional revenue and help shrink the tax gap, while imposing some additional compliance costs along the way. The package has some win-win propositions, such as investment in informational technology, that should reduce the tax gap and reduce compliance costs for taxpayers at the same time.

However, the biggest win-win from the perspective of reducing both the tax gap and taxpayer compliance costs is simplification. A simpler tax code is both easier for taxpayers to follow and the IRS to enforce. And unfortunately, the bill does not take significant steps towards simplification—instead, it adds several credits along with a complicated new corporate book minimum tax.