CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

Phillip L. Swagel, Director

November 18, 2021

Honorable Lindsey Graham
Ranking Member
Committee on the Budget
United States Senate
Washington, DC 20510

Re: Estimated Revenue Effects of Increased Funding for the Internal Revenue Service in H.R. 5376, the Build Back Better Act

Dear Senator:

This letter responds to your request for information about the revenue effects of an increase in funding for the Internal Revenue Service (IRS) that would be provided by the current version of H.R. 5376, the Build Back Better Act (Rules Committee Print 117-18 incorporating a manager's amendment by Congressman Yarmuth). The Congressional Budget Office estimates that the funding for tax enforcement activities provided by the bill would increase outlays by $80 billion and revenues by $207 billion, thus decreasing the deficit by $127 billion, through 2031. That change in revenues is not included in CBO's estimate of the budgetary effects of the Build Back Better Act.

What Would the Legislation Do?

Sections 63001 and 138401 of H.R. 5376 would provide mandatory funding for the IRS and for related tax enforcement activities of the Departments of the Treasury and Justice. The funding would be for a variety of IRS activities (including enforcement), U.S. Tax Courts, the Department of Justice's Tax Division, and the Treasury Inspector General for Tax Administration. The provisions of H.R. 5376 are substantially similar to those in the Administration's budget proposal that CBO discussed in a blog post in September.[1]

How Would Outlays and Revenues Change?

CBO estimates that as a result of the funding provided by sections 63001 and 138401 of the bill, mandatory outlays for the IRS and related tax enforcement activities would increase by $80 billion over the 2022–2031 period. If tax enforcement spending from regular discretionary appropriations continued at the pace projected in CBO's baseline (which reflects the assumption that current laws generally do not change), the additional mandatory spending would yield additional revenues totaling $207 billion over those 10 years, CBO estimates. The net impact of the changes in tax enforcement activities in the bill would thus decrease the deficit by $127 billion through 2031.

Under long-standing guidelines agreed to by the legislative and executive branches, those increases in revenues were not included in the estimated budgetary effects of the Build Back Better Act that CBO has reported for budget enforcement purposes, but they would be reflected in CBO's baseline budget projections if the legislation was enacted.[2] To better inform the Congress, CBO has provided its estimate of the increases in revenues as a footnote to the cost estimate for title XIII, Committee on Ways and Means, H.R. 5376.[3] Those increases in revenues are as follows, shown in millions of dollars and by fiscal year:

										Total	
2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2022–2026	2022–2031
275	2,605	7,752	13,383	19,060	24,584	30,026	34,489	38,596	36,430	43,075	207,200

[1] For that discussion, see Congressional Budget Office, "The Effects of Increased Funding for the IRS," *CBO Blog* (September 2, 2021), www.cbo.gov/publication/57444. CBO also examined trends in the IRS's enforcement activities and how changes in its budget could affect federal revenues in a July 2020 report. See Congressional Budget Office, *Trends in the Internal Revenue Service's Funding and Enforcement* (July 2020), www.cbo.gov/publication/56422.

[2] For more information about those guidelines, see Congressional Budget Office, *CBO Explains Budgetary Scorekeeping Guidelines* (January 2021), www.cbo.gov/publication/56507.

[3] For the cost estimate and other publications related to the legislation, see Congressional Budget Office, "Fall 2021 Reconciliation," www.cbo.gov/topics/budget/fall-2021-reconciliation.

What Is the Basis for the Estimate?

CBO's estimate of revenues is based on the IRS's projected returns on investment (ROIs) for spending on new enforcement initiatives. The IRS estimates those ROIs by calculating the expected revenues that would be raised from taxes, interest, and penalties as a result of the new initiatives and dividing them by their additional cost. (The agency has provided ROIs over the past five years as part of its budget justification.) The IRS's ROIs ramp up over three years as staff become trained and fully productive, arrive at the peak level, and then stay there. In recent years, peak ROIs have ranged from 5 to 9. That is, a $1 increase in spending on the IRS's enforcement activities results in $5 to $9 of increased revenues.

CBO adjusts the ROIs so that they better reflect the marginal return on additional spending. First, CBO expects the IRS to prioritize the enforcement activities that it thinks will have the highest average return; additional enforcement spending would therefore have lower returns than previous spending. Second, CBO expects taxpayers to adapt to the IRS's enforcement activities and adopt new ways of evading detection, so an enforcement activity may have a lower return in later years. Finally, the productivity of the IRS's enforcement activities will also depend on the IRS's other capabilities. For example, modernized information technology that stored all of a taxpayer's information in digital form would increase the productivity of examiners (the employees who detect taxpayers' noncompliance).

CBO's estimate of revenues also accounts for the timing of collections resulting from enforcement activity by new hires. Taxes are assessed at the end of an audit; if taxpayers disagree with the assessment, they can appeal and continue to litigate. The length of each step depends on the complexity of the case. CBO estimates that an audit of medium complexity would take 24 months to complete. That time, combined with the expected training time for an experienced new hire, suggests that the IRS would begin to collect revenues 30 months after the new hire joined the agency. (The timing would be longer when cases were more complex or when the taxpayer did not agree to the assessment and appealed.)

The estimate also reflects CBO's expectation that the increased enforcement activities would modestly increase the voluntary compliance rate—that is, the share of taxes owed that are paid voluntarily and on time. The magnitude of that effect is highly uncertain, however, and the empirical evidence about the effects of audits on taxpayers' behavior is mixed, as the next section of this letter explains. CBO's estimate of the effect on the voluntary compliance rate reflects the likelihood that the proposed expansion of enforcement activities would prioritize business taxpayers and individuals with high income rather than individuals with lower income.

What Are the Deterrent Effects of Enforcement?

Research about the deterrent effects of enforcement has found varying responses, depending on the type of taxpayer. People generally increase their reported income in the years following an audit, but people with higher income generally do not, and neither do corporations.[4] Such effects are difficult to observe, and their magnitude is highly uncertain. They can be specific, influencing individuals who have been audited to change their behavior, or general, causing even taxpayers who were not audited to be more careful on their returns.

Audited taxpayers may change their behavior in positive or negative ways. They may become better informed about how to report their income and calculate their tax liability, thus increasing compliance in the future. Or they may use the opportunity to learn what the IRS is able to detect, which can reduce their tax payments in the future. In addition, audited taxpayers may expect their audit risk to be lower in the near future, further reducing their compliance with tax laws.[5]

Some researchers have found that for several years following an individual income tax audit, people tended to increase the amount of taxable wage and self-employment income they report on their tax returns.[6] The effects were largest for those who were assessed additional tax after the audit, and the longevity of the effect differed by income source. The researchers found a small but sustained positive effect on reported wage income over the six years following an audit. The positive effect on reported self-employment income was larger but quickly diminished. In contrast, those researchers found, corporate taxpayers tended to increase their tax aggressiveness and reduce their reported tax liability as a share of income immediately

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[4] This section reprises Congressional Budget Office, *Trends in the Internal Revenue Service's Funding and Enforcement* (July 2020), Box 1, www.cbo.gov/publication/56422.

[5] For an overview of recent studies on tax compliance, see Joel Slemrod, "Tax Compliance and Enforcement," *Journal of Economic Literature*, vol. 57, no. 4 (December 2019), pp. 904–954, https://doi.org/10.1257/jel.20181437.

[6] See Jason DeBacker and others, "Once Bitten, Twice Shy? The Lasting Impact of Enforcement on Tax Compliance," *The Journal of Law and Economics*, vol. 61, no. 1 (February 2018), pp. 1–35, https://doi.org/10.1086/697683.

following an audit, probably because they perceived a lower audit risk in the near future.[7]

Taxpayers' responses may also differ on the basis of their perceptions of an audit. Among claimants of the earned income tax credit (EITC), audited taxpayers were less likely to claim the EITC or file taxes for a refund in subsequent years than were similar taxpayers who were not audited, even though only a small share of audited taxpayers were determined to be ineligible for the EITC.[8] Other researchers have found that higher-income taxpayers lowered their reported income and tax liability after being notified that they would face an audit, perhaps because they viewed the eventual audit as a negotiation. (Lower-income taxpayers tended to increase their reported income after being notified of an audit.)[9]

Taxpayers may be more likely to comply with tax laws if they perceive a higher risk of being caught, even if they are not audited themselves. Among corporate taxpayers, an increase in the overall examination rate increased all taxpayers' reported effective tax rate.[10] Researchers have analyzed data from an experiment in which randomly selected firms with a high risk of noncompliance were contacted by the IRS. They found that although IRS contact increased the amount of employment tax remittances paid by other businesses with the same tax preparer, it also decreased remittances by subsidiaries of the contacted firm. In that analysis, on net, the indirect effects of such contact on the people who shared a tax preparer, ownership link, or geographic area with the contacted taxpayer were close to zero.[11]

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[7] See Jason DeBacker and others, "Legal Enforcement and Corporate Behavior: An Analysis of Tax Aggressiveness After an Audit," *The Journal of Law and Economics*, vol. 58, no. 2 (May 2015), pp. 291–324, https://doi.org/10.1086/684037.

[8] See John Guyton and others, *The Effects of EITC Correspondence Audits on Low-Income Earners*, Working Paper 24465 (National Bureau of Economic Research, March 2018, updated December 2019), www.nber.org/papers/w24465.

[9] See Joel Slemrod, Marsha Blumenthal, and Charles Christian, "Taxpayer Response to an Increased Probability of Audit: Evidence From a Controlled Experiment in Minnesota," *Journal of Public Economics*, vol. 79, no. 3 (March 2001), pp. 445–483, https://doi.org/10.1016/S0047-2727(99)00107-3.

[10] See Jeffrey L. Hoopes, Devan Mescall, and Jeffrey A. Pittman, "Do IRS Audits Deter Corporate Tax Avoidance?" *The Accounting Review*, vol. 87, no. 5 (2012), pp. 1603–1639, https://doi.org/10.2308/accr-50187; and Jason DeBacker and others, "Legal Enforcement and Corporate Behavior: An Analysis of Tax Aggressiveness After an Audit," *The Journal of Law and Economics*, vol. 58, no. 2 (May 2015), pp. 291–324, https://doi.org/10.1086/684037.

[11] See William C. Boning and others, "Heard It Through the Grapevine: The Direct and Network Effects of a Tax Enforcement Field Experiment on Firms," *Journal of Public Economics*, vol. 190 (October 2020), article 104261, https://doi.org/10.1016/j.jpubeco.2020.104261.

Why Are the Estimates Uncertain?

The change in revenues resulting from the proposed increase in the IRS's funding could be different from CBO's estimate. It would depend on a number of factors, including the IRS's ability to hire the appropriate personnel, the composition and productivity of the additional audits and other enforcement actions undertaken by the IRS, changes in taxpayers' behavior in response to greater IRS enforcement, and the effect of increased IRS spending in areas other than enforcement (such as technology).

I hope that this information is useful. If you have any questions, please contact me.

Sincerely,

Phillip L. Swagel
Director

cc: Honorable Bernie Sanders
Chairman

Honorable John Yarmuth
Chairman, House Committee on the Budget

Honorable Jason Smith
Ranking Member, House Committee on the Budget

Identical letter sent to the Honorable Mike Crapo.