



**U.S. TREASURY DEPARTMENT  
OFFICE OF PUBLIC AFFAIRS**

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CONTACT Andrew DeSouza, (202) 622-2960

**TESTIMONY OF TREASURY SECRETARY  
HENRY M. PAULSON, JR.  
BEFORE THE SENATE FINANCE COMMITTEE ON  
WAYS TO REDUCE THE TAX GAP**

Chairman Baucus, Senator Grassley, Members of the Committee, thank you for considering this important topic and for inviting me to speak about it. It is very appropriate that we have this conversation the day after tax day. Over the last few months, millions of Americans have collected their W-2's, their 1099's, their home mortgage interest statements, and countless other pieces of paper to fill out their tax returns. This is an annual ritual for Americans, completed without great enthusiasm, but with remarkable honesty and effort. The vast majority of Americans pay their taxes without additional prodding by the IRS, out of a sense of fairness and civic duty. They understand the importance of paying what they owe, and they know that when people fail to pay their taxes, it serves as a de facto tax increase on everyone else.

While the current compliance rate is high, it can and should be improved. Our objective must be to increase tax compliance without over-burdening the tens of millions of taxpayers who already pay their taxes honestly and on time.

The amount of taxes that are owed but not paid is commonly referred to as the tax gap. An important part of addressing the tax gap is to understand not only the types of taxpayers – individuals, small businesses, corporations – that don't comply, but also why these taxpayers fail to comply. Answering these questions will help us improve taxpayer service and better target our enforcement efforts.

In September of last year, we released a comprehensive seven-point strategy to address the tax gap. The budget we put forward for 2008 is critical to implementing that strategy. It requests new funding for taxpayer services, research, improved technology, and targeted enforcement. We ask for your help in working with the Appropriations Committee to make sure the IRS has the resources it needs to improve compliance while maintaining its commitment to taxpayer service.

The budget also includes 16 legislative proposals that, if enacted, will help to narrow the tax gap without imposing excessive burdens on compliant taxpayers. Since I last appeared before this committee, my staff has been meeting with your staff on a regular basis to review the 16 legislative proposals. Treasury's Assistant Secretary for Tax Policy, Eric Solomon, and IRS Commissioner Mark Everson are here with me today to provide more detail about these proposals and the IRS's budget request.

Our legislative proposals attempt to balance the burden they impose on taxpayers against the impact they will have on improving compliance. Even so, some of the proposals have generated concern from those who could be affected by them. We must consider the impact of any new rules on the vast majority of Americans who already pay what they owe, and better target our enforcement efforts to minimize additional burdens.

Since I last testified before you, Treasury has explored ways to improve compliance. We held a public discussion a few weeks ago, and heard from a broad cross-section of stakeholders, including a former IRS Commissioner, tax preparers, and business representatives. Several insights emerged: first, we need to know more about the specific sources and causes of the tax gap so we can focus our efforts more precisely; second, great care must be given to ensure that those efforts do not impose unreasonable burdens on already compliant taxpayers; third, simplification of the tax code, as well as taxpayer education and services, would help improve compliance; and fourth, we need to manage expectations, recognizing that every potential solution carries consequences.

I know you have spent a great deal of time exploring this issue. And since I came to Washington, I have taken a hard look as well. The most recent data we have on the tax gap comes from 2001. It indicates that the vast majority of the tax gap was attributable to underreporting of income. Most of the underreporting is attributable to individuals with business income and corresponding self-employment tax liabilities. This includes small businesses, farms, and ranches. It's unclear whether this underreporting is the result of deliberate deception or a simple misunderstanding of what needs to be reported and how to do it.

To substantially improve compliance in this regard, Congress would have to mandate additional requirements, which would affect not only those who don't report all of their income, but also those who already do. I have come to the conclusion that there is a big part of the tax gap we simply won't be able to reach without adding draconian and painful requirements on all taxpayers. And I don't believe any of us really want to do that. We must remember that the tax gap is simply not a pot of gold that we can dip into every time we want to pay for a new or expanded program. Nor should it be viewed as an easy solution to existing challenges, such as the alternative minimum tax.

As you know, narrowing the tax gap is about improving compliance. It is not about changing the baseline to raise more revenue. The budget resolution passed by the Senate assumes revenue collections are raised by hundreds of billions of dollars. Some believe this level of revenue can be achieved largely through measures to reduce the tax gap. I believe it is unrealistic to assume that reducing the tax gap will yield that level of additional revenue.

In developing our 16 proposals, we focused on changes that would narrow the tax gap with minimal additional burdens. Some have suggested that far more expansive proposals should be put forward. Most of these proposals would require steps that I would not recommend because they are bad tax policy and would be unnecessarily painful, expensive, and time-consuming for taxpayers – for example, requiring individuals to file 1099's reporting their transactions with service providers, such as their

doctor, auto mechanic, and dry cleaner; eliminating cash transactions in favor of electronic transactions, with card issuers and banks providing statements to the IRS so the payments can be matched with a business's reported income; or doubling or tripling the number of IRS agents and audits. In theory, each of these measures could bring in some additional revenue, but the cost of compliance for individuals and businesses – most of whom already pay what they owe – would far outweigh the gains. In many cases, such measures would also raise privacy concerns due to the government's heavier focus on the daily transactions in each of our lives.

I hope we can all agree that such extreme measures are not the approach we should take. Instead, as a strong first step toward narrowing the tax gap, I hope you will work with us to approve the additional IRS funding and enact the legislative proposals the President has requested. I am pleased that Congress has recently taken up a number of these proposals. By capitalizing on the direct and indirect effects of IRS enforcement, and by making focused legislative changes, I am confident we can make measurable progress toward reducing the tax gap without adversely affecting already compliant taxpayers.

We should also look for ways to reduce the complexity of the U.S. tax code. Making the tax code simpler and fairer for the average American could help to improve compliance by reducing the number of honest mistakes, removing incentives for cheating, and providing fewer places for tax cheats to hide.

It is critical that we manage expectations and view efforts to reduce the tax gap over the long-term and with a clear understanding of both the costs and the benefits of any action. Making significant progress will require a sustained, focused effort by the Administration, Congress, and the American people. Honest American taxpayers are our allies in this effort, and we must always put their interests first.

Thank you, and I now welcome your questions.