US Rates Strategy

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Mind the tax gap

In 2022, the Treasury estimated it collected just 87% of the taxes it was owed – missing about $600bn in additional revenue. The biggest source of this gap is underreported income – particularly from the self-employed and gig workers. As this type of work grows, the Treasury's AI models are becoming more sophisticated.

- The Treasury estimates it collected on average about 84% of the taxes it was owed since 2001. **Enforcement actions and late payments push the compliance rate higher (to about 87%). But in 2022, this still meant it was missing $600bn – equivalent to 42% of that year's deficit**.

- **Underreported income (including misstatements of deductions) is the largest source of the Treasury's tax gap, accounting for 74% or $515bn of missing (gross) revenue in 2022**.

- **Most underreporting comes from sole proprietor and gig income**. This reflects a lack of third-party reporting, tax form complexity and, in some cases, low audit rates.

- There are few estimates of the gig economy or its growth. **A University of Michigan survey suggested that perhaps as many as 25-30% of workers are self-employed or gig workers**.[1] Alternative work studies from the BLS point to a smaller share of perhaps 12%.[2] However, these work arrangements have increased since 2017.

- **There are few estimates of how much income these workers earn**. The Michigan survey suggests that for most workers this might be about $4,000 annually, however for some, their "side-hustles" could generate more than $20,000/year.

- **Examination rates for most returns are around 0.2% of filings**.[3] But these rates are much higher for some types of income – particularly sole proprietors and earnings above $10m/y. Despite low examination rates, most audits result in higher taxes collected.

- **The Treasury uses AI to flag suspicious returns based on matching and scoring algorithms**.

Mostly voluntary

The Treasury compares estimates of what it thinks it should collect in tax revenue against what it collects. The ratio between the two is defined as the voluntary compliance rate or VCR. **Since 2001, the average**

[1] See, "University of Michigan: Self Employment Income is Widely Underreported", February 20, 2025.
[2] See "Contingent and Alternative Employment Arrangements", Bureau of Labor Statistics, November 8, 2024.
[3] In 2021.

VCR has been 84% with relatively little change over the tax year sample periods (Figure 1). As tax revenues have grown with the size of the economy, the steadiness of the VCR means that the Treasury's missing revenue has grown from $345bn in 2001 to nearly $700bn in 2022. Because of the complexity and time-consuming nature of estimating hypothetical revenues, the Treasury's updates do not include each tax year.

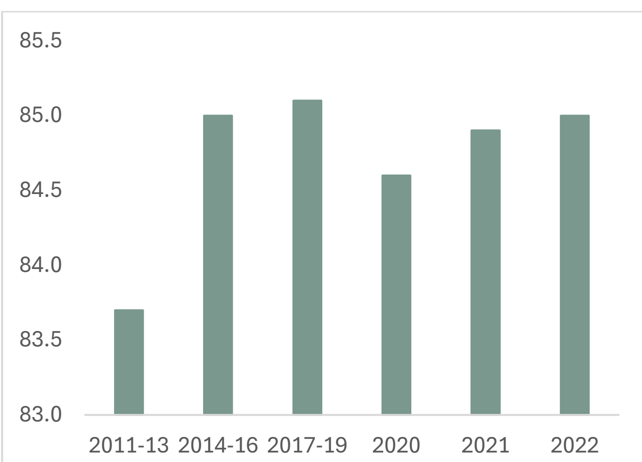
It uses past voluntary compliance rates to forecast future missing revenues which it later updates to reflect enforcements (after audit examinations) as well as late payments. **This net compliance rate is higher, averaging 86.6% since 2011 and 86.9% in 2022.** In 2022, enforcements and late payments pulled in an additional $90bn in tax revenue. And while this was nearly 13% of the gross tax gap, the Treasury was still missing over $600bn in revenues. **Indeed, if it had captured just half of the gross gap (that is, before enforcements), its 2022 deficit might have been -4.1% of GDP rather than -5.4%.** Full recapture would have lowered the deficit to -2.8%.

Mind the gap

There are three sources of the tax gap: nonfiling, underreporting, and underpayment. **By far, most of the Treasury's revenue gap (~78% in 2022) comes from the underreporting of income (or the overstatement of deductions)** rather than households and businesses forgetting to file or underpaying what they owe. As a share of the gross tax gap, underreporting has declined recently while underpayments have increased (Figure 2). It is not clear what clear what accounts for this shift or whether it will continue.

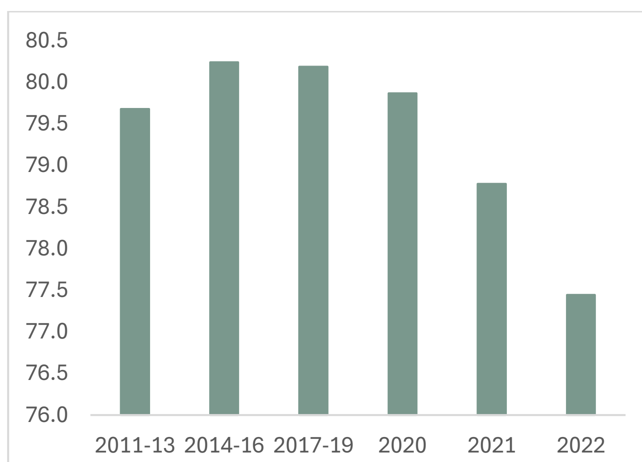
That said, most underreporting comes from just two sources: business income (that is from unincorporated businesses) and self-employment income. Indeed, these alone accounted for 56% of the gross tax gap in 2022. Income from these sources includes work like transportation and delivery work as well as online retail and more traditional forms such as independent contractors.

Figure 1: Voluntary compliance rate (%)



Source: US Treasury, SMBC Nikko

Figure 2: Underreporting (% gross gap)



Source: US Treasury, SMBC Nikko

Sole proprietor and self-employment income tax reporting typically have lower voluntary compliance rates than other sources of income. Unlike employee wages or interest and dividend income, there is no third-party reporting (or withholding) of this income to the Treasury. The informal nature of this work as well as cash payments mean that employers frequently don't file tax forms like the 1099-K. Even for the more formal gig arrangements, there may be *de minimis* income exemptions where the employer is not required to send out tax reporting forms.[4] That said, the worker is still obligated to pay income tax – often quarterly – on the entire amount earned. As a result, the Treasury has to rely on the documentation provided by the taxpayer. At the same time, complex tax rules governing deductions and expenses allow for some broad interpretive differences favoring the taxpayer.

Gig work

Growth in gig work might cause underreported income from these sources to increase. In 2023, the BLS identified 11.9m workers who indicated they were independent contractors of whom 85% were self-employed. Similarly, another 6.9m workers said they were in contingent or gig jobs – jobs that were not expected to last or that were temporary. Combined this is about 12% of the employed labor force – higher than in 2017 when the survey was last conducted.

Other studies suggest that percentage of workers involved in gig work might be higher. **A 2021 Federal Reserve study noted that 27% "of people" earned some income from gig activities like paid childcare, selling goods, or renting out property**.[5] These higher numbers may reflect two key differences from the BLS data. First, workers involved in the gig economy may only do this work irregularly to earn a little extra money and as a result don't consider it "work" in the traditional sense of a "9-to-5" job. Second, some of these activities – like renting out rooms or property – are not easily defined as traditional work.

The Fed's survey indicated that just 8% of respondents did regular gig work – that is, more than 20h in the prior month. Instead, roughly half of gig workers had full-time jobs. Only a small percentage (3%) relied on gig work for more than half of their income. Most of the reported gig work was done outside online platforms like Uber and Airbnb pointing to more informal arrangements. A significant portion of gig work involves selling goods – online or through flea markets and at consignment shops.

The University of Michigan compares self-reported income from its Health and Retirement surveys against Treasury data.[6] Self-reported income is higher than what is reported to the IRS. Workers between the 5th and 75th income percentiles reported about $4,000 in self-employment income. But, gig income was considerably higher in the tails of the distribution. Self-employment incomes below the 5th percentile or above the 95th percentile were $21,000 and $27,000 respectively.

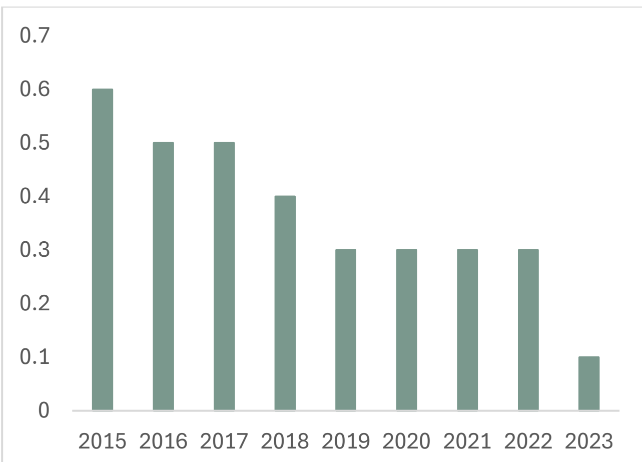
Audit rates across all individual tax returns are low. In 2023, just 0.1% of the 161m tax returns filed were examined. In figure 3, we plot the examination rate across all income buckets over time. In earlier years, the rate is higher than in 2023. This reflects two factors. First, the statute of limitations for tax violations has not run out yet and there will be more 2023 returns that will be examined in the future. Second, and more fundamentally, examinations are costly and the number of examiners has declined over time; in 2025 there were about half as many examiners as in 2000. The Inspector General for Tax

[4] Some ride share apps will not send 1099-K reports to workers if their income is less than $20,000 or they have fewer than 200 rides.
[5] Not all these people are in the labor force. See "The Economic Well-Being for US Households in 2020-May 2021, Federal Reserve Board of Governors.
[6] See, University of Michigan, February 2025

Administration observed that the IRS workforce shrank by roughly a quarter in 2025 because of the administration's workforce efficiency efforts.[7]

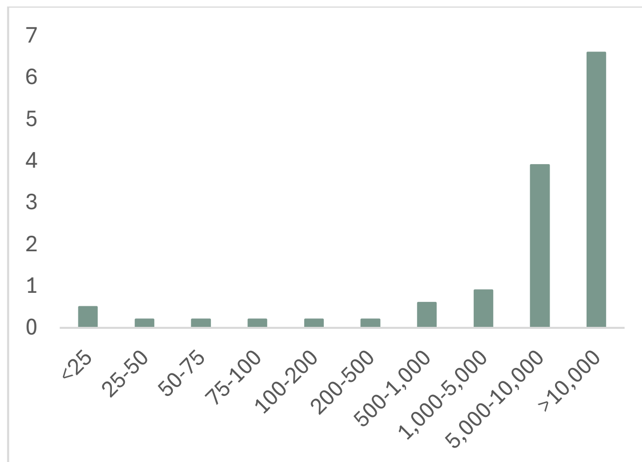
As a result, the Treasury focuses its efforts on filings in which there is a high likelihood of understatement and where the recaptured revenue is likely to be large. High-income returns have higher examination rates – returns with over \$10m in reported income had a 6.6% examination rate in 2021 (Figure 4). Similarly, sole proprietorships with income over \$100,000 are audited at a rate of about 2.5%. By contrast, the examination rate for individual income of between \$25,000 and \$200,000 is just 0.2%.

Figure 3: Individual return examination rate (%)



Note: Percent of individual tax returns filed. Source: IRS Data Book 2023, SMBC Nikko

Figure 4: Examination rate by income (%)



Note: Income in thousands of dollars. Percent of returns filed. Source: IRS Data Book 2023, SMBC Nikko

While the Treasury's overall examination rate is low, it is very skilled at identifying which returns might have underreported income. Of the roughly 500,000 returns that were audited in 2021, just 65,000 resulted in unchanged collections. Our suspicion is that the bulk of the remaining 87% resulted in higher tax bills. **Indeed, despite the reduction in staff, the Treasury's tax enforcement efficiency may be improving as the IRS uses more AI-based algorithms to detect under-reported income**. Their AI tools make it easier to flag suspicious returns in two ways. First, they allow the Treasury to compare a return against what it thinks a similar business or individual's return should look like. This is fed into a scoring model where the most dissimilar returns relative to the Treasury's expectations get flagged for review. Similarly, AI helps the IRS match individual items on tax returns against data collected from other sources, like the 1099's filed by online gig platforms.

[7] See, "Inspector General for Tax Administration memo", July 22, 2025.

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