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# Flying Above the Law and Below the Radar: Instilling a Taxpaying Ethos in Those Playing by Their Own Rules

Richard Lavoie\*

These days it really does seem like “only the little people pay taxes.”<sup>1</sup> Whether they are from the world of politics,<sup>2</sup> sports,<sup>3</sup> or entertainment,<sup>4</sup> the elites of this country are demon-

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1. This statement is reputed to have been uttered by hotel magnate Leona Helmsley. See Jeffrey L. Yablon, *As Certain as Death – Quotations About Taxes* (2008 Ed.), TAX NOTES TODAY, Jan. 8, 2008, available at 2008 TNT 5-23 (part 2) (LEXIS) (attributing quoted language to Leona Helmsley); *Maid Testifies Helmsley Denied Paying Taxes*, N.Y. TIMES, July 12, 1989, at B2.

2. The political realm has been vividly on display in 2009 as President Obama has had to do damage control after several of his Cabinet picks were discovered having tax problems. See, e.g., Jonathan Weisman, Laura Meckler & Naftali Bendavid, *Obama on Defense as Daschle Withdraws*, WALL ST. J., Feb. 4, 2009, at A1. Obama proclaimed that “[u]ltimately it’s important for this administration to send a message that there aren’t two sets of rules. You know, one for prominent people and one for ordinary folks who have to pay their taxes.” *Id.* Other high profile politicians have also recently been reported as having tax problems. James V. Grimaldi, *Palin Now Owes Taxes on Payments for Nights at Home, State Rules*, WASH. POST, Feb. 19, 2009, at A4 (reporting on Sarah Palin, former Alaska Governor and 2008 Republican Vice Presidential candidate); Martin Weil, *Barry Says Kidney Issues Kept Him From Filing Taxes*, WASH. POST, Feb. 11, 2009, at B4 (reporting on former Washington, D.C. mayor Marion Barry); posting of Gerald F. Seib to Capital Journal Blog, *Rangel Hits Obama Closer to Home*, <http://blogs.wsj.com/capitaljournal/2008/12/12/rangel-hits-obama-closer-to-home/> (Dec. 12, 2008, 10:52 EST) (reporting on Rep. Charles Rangel, Chairman, House Ways and Means Committee).

3. Some of the recent sports personalities reportedly encountering tax problems include former NBA player Carl Herrera, see *United States v. Herrera*, No. 08-50028, 2009 WL 323184 (5th Cir. Feb. 11, 2009); former NFL punter Joseph Propkop, see Press Release, Dep’t of Justice, *Former NFL Player, Ex-Casino Owner and Nevada Businessman Indicted in Massive Tax Fraud Scheme* (Jan. 29, 2009), available at <http://www.usdoj.gov/tax/txdv09072.htm>; and race car driver and Dancing with the Stars champion Helio Castroneves, see Press Release, Dep’t of Justice, *Indianapolis 500 Winner and Two Others Indicted on Tax Evasion Scheme* (Oct. 2, 2008), available at <http://www.usdoj.gov/tax/txdv08884.htm>.

4. Some of the recent entertainment celebrities reportedly dealing with tax issues include 1995 Best Actor Oscar winner Nicolas Cage, see Neil Weinberg, Janet Novack & William P. Barrett, *Nicolas Cage Hits Some Turbulence; An-*

strating a penchant for not paying their taxes.<sup>5</sup> Nevertheless, Americans in general continue to exhibit a high degree of tax compliance.<sup>6</sup> Why do most people pay their taxes? What distinguishes them from those who cheat?<sup>7</sup> What can we learn from these differences that could promote greater compliance among noncompliant segments of the populace?

This Article examines these questions in light of the relevant social science literature. As a general matter, empirical research regarding tax compliance finds that the conventional analysis of compliance in terms of penalties and enforcement activity only represents a piece of the overall compliance dynamic.<sup>8</sup> Beyond such deterrence mechanisms, an individual's taxpaying behavior is shaped by a wide variety of cultural, institutional, and individual factors.<sup>9</sup> When a confluence of such factors exists within a society they create a cultural norm in favor of honoring one's tax obligations that is persistent and self-reinforcing, a "taxpaying ethos."<sup>10</sup> This Article highlights

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*ticorporate Crusaders Shortchanging Their Own Workers?*, FORBES, Mar. 10, 2008, at 28; actor Wesley Snipes, *see Actor Snipes Appeals Tax Conviction*, WALL STREET J., May 3, 2008, at A7; pornographic video entrepreneur Joseph Francis, *see Josh Friedman, Raunch Mogul Denies Charges; The IRS Accuses the Producer of the "Girls Gone Wild" Video Series of Concealing Millions in Income*, L.A. TIMES, July 22, 2008, at C3; and Grammy winning blues singer Koko Taylor, *see Taylor v. Comm'r*, 97 T.C.M. (CCH) 1109 (Feb. 5, 2009) (mem.).

5. Of course, these segments of the population are not the only ones avoiding their taxpaying obligations. *See infra* Part IV (discussing in detail self-employed individuals and small businesses who exhibit very high degrees of noncompliant behavior).

6. Internal Revenue Service (the "Service") estimates of taxpayer compliance since the mid-1980s have remained fairly stable at about 82-84%. *See, e.g.*, George Guttman, *IRS Updates Estimates On Individual Tax Gap*, TAX NOTES TODAY, May 13, 1996, available at 96 TNT 93-95 (LEXIS) (reporting an 81.5% rate for 1985 and 83% rate for both 1988 and 1992); Dustin Stamper, *Everson Pledges to Narrow Growing Tax Gap*, 110 TAX NOTES 807 (2006) (reporting an 84% rate for 2001).

7. This Article focuses primarily on those engaged in intentional tax avoidance, rather than taxpayers who underpay due to mistakes or legitimate uncertainty regarding the appropriate application of the law.

8. *See infra* Part I; Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1782 (2000) ("A widespread view among tax scholars is that law enforcement does not explain why people pay taxes.").

9. *See infra* Part II.

10. As discussed later, *see infra* Part I.B, this Article coins the phrase "taxpaying ethos" to connote a widely held societal belief that one should not cheat on his or her taxes. The tax compliance literature often refers to an analogous concept of a society's "tax morale." *See, e.g.*, Benno Torgler, TAX COMPLIANCE AND TAX MORALE: A THEORETICAL AND EMPIRICAL ANALYSIS (2007) (exhaustively reviewing the

the most relevant factors contributing to the creation of a tax-paying ethos and utilizes them to create a framework for promoting increased tax compliance among historically reticent groups of taxpayers. Part I of this Article reviews the inadequacy of the traditional deterrence approach to tax compliance and contrasts it with the taxpaying ethos explanation. Part II examines the empirically identified factors influencing a society's taxpaying commitment. Part III translates these factors into general policy prescriptions aimed at cultivating a taxpaying ethos in a society. Part IV then moves from these general prescriptions to the more specific question of how the government could attempt to utilize this approach to modify the particular sub-culture of sole proprietors and small business owners, who constitute a historically noncompliant segment of our society. Part V concludes that while our understanding of how to cultivate a taxpaying ethos is still in its infancy, enough is known to warrant testing the practical efficacy of the basic tenets of the theory in the context of a targeted effort to reduce noncompliance in a traditionally problematic segment of society.

## I. Why Do People Pay Taxes?

### A. *The Inadequacy of Deterrence Explanations*

Up until the late 1980s, most scholars considered the question of tax compliance using a deterrence model.<sup>11</sup> Under this

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empirical studies exploring the nature of tax morale). For instance, a country with high tax morale exhibits a relatively low rate of noncompliance with its tax laws, while a country with low tax morale exhibits fairly widespread tax evasion. As commonly used, "tax morale" is a way of referring in the aggregate to all the varied factors that strongly influence a taxpayer's voluntary compliance with the tax law. See Marjorie E. Kornhauser, *A Tax Morale Approach to Compliance: Recommendations for the IRS*, 8 FLA. TAX REV. 599, 601 (2007). Since the focus of this Article is on how to promote high tax morale within a society or cultural sub-group, it employs the phrase "taxpaying ethos" to describe the existence of a high tax morale situation. Further, using the phrase "ethos" more clearly embodies the idea of a mere prevailing cultural norm without raising any unintended inferences regarding the morality of paying or not paying the legally imposed taxes. For instance, it may be moral to evade legally imposed taxes if they support a brutal dictatorship where tax revenues are used to torture and enslave the citizenry.

11. See, e.g., John T. Scholz, *Trust, Taxes, and Compliance*, in TRUST AND GOVERNANCE 135 (Valerie Braithwaite & Margaret Levi eds., 1998) ("A decade ago compliance studies focused primarily on the coercive aspect of government."); TAX-

approach, citizens paid their taxes primarily out of fear that the government would catch and penalize them, either with fines or incarceration.<sup>12</sup> This theory analogized tax compliance to the general economics underlying gambling<sup>13</sup> or crime.<sup>14</sup> Consequently, the deterrence paradigm was appealing because its economics could be readily modeled and seemed to provide clear policy prescriptions for optimizing penalties and audit rates to maximize compliance and tax collections.<sup>15</sup> For example, under the basic deterrence model, tax compliance is explained as a function of the risk of detection and the penalty applied to discovered noncompliance.<sup>16</sup> Taxpayers weigh whether the expected return from cheating on their taxes outweighs the expected cost of the punishment (i.e., the punishment discounted by the chance of non-detection). If the benefits outweigh the potential penalties, then a rationale wealth-maximizing taxpayer should cheat.<sup>17</sup> As can be readily ob-

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PAYER COMPLIANCE (Jeffrey A. Roth & John T. Scholz eds., 1989) (providing an early attempt to seriously examine the underpinnings of tax compliance beyond traditional deterrence considerations); James Andreoni, Brian Erard & Jonathan Feinstein, *Tax Compliance*, 36 J. ECON. LIT. 818, 835 (1998) (stating that there were only a few empirical studies on tax compliance before 1980); Kornhauser, *supra* note 10, at 603 n.2 (“[T]he majority of knowledge in this area [tax morale] has occurred only in the past 5-7 years . . .”).

12. See, e.g., Michael G. Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J. PUB. ECON. 323 (1972).

13. Michael W. Spicer, *Civilization at a Discount: The Problem of Tax Evasion*, 39 NAT'L TAX J. 13, 14 (1986).

14. Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1454, 1463 (2003) (“The basic model of tax compliance is based on an economic model of crime advanced by Gary Becker.”). See generally Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

15. John T. Scholz, *Contractual Compliance: Tax Institutions and Tax Morale in the U.S.*, in TAX EVASION, TRUST AND STATE CAPACITIES 51, 101 (Nicolas Hayoz & Simon Hug eds., 2007).

16. See Allingham & Sandmo, *supra* note 12.

17. For instance, if we assume a 50% tax rate, a 1% audit rate, and a 25% penalty for noncompliance, then a taxpayer faced with the choice of whether to omit a \$20,000 item from her taxable income would compare the following values: (1) a \$9,900 expected benefit (\$10,000 x 99% chance of non-detection) from not paying the tax owed, versus (2) an expected cost of \$25 (\$10,000 x 25% penalty x 1% chance of detection). Because the taxpayer's expected net return is \$9,875, a rational wealth-maximizing taxpayer should omit the income item from his or her tax return.

served, this approach ends up prescribing greatly increased rates of audit and/or very high levels of sanctions.<sup>18</sup>

The United States exhibits a fairly high degree of tax compliance that appears to have remained stable over at least the last twenty years.<sup>19</sup> The audit rate in the United States is, however, currently only about 1%<sup>20</sup> and the typical understatement penalty rate is only 20%.<sup>21</sup> Consequently, the deterrence model wildly over-predicts the level of noncompliant behavior based on these rates. Some of the discrepancy can be explained by adjusting the model to reflect individual perceptual biases. For instance, individuals have been shown to systematically overestimate the likelihood of a risk that is contingent on multiple factors, which implies they overestimate their audit risk.<sup>22</sup> Similarly, many individuals exhibit a degree of risk aversion, which could indicate that the net expected benefit from tax avoidance would need to be significantly above zero before they would engage in tax-avoidance behavior. Even when these factors are crafted into the deterrence model, it persists in predict-

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18. Lederman, *supra* note 14, at 1465. This can be easily demonstrated using the example in the previous footnote. In order for the taxpayer's expected net return from cheating to be zero, either the penalty rate would need to be increased to 9,900% (that is, 99 times the tax deficiency!) or the chance of detection would need to be 80%. Intermediate solutions based on adjusting both variables are also possible. So, increasing the penalty rate to 100% and raising the risk of detection to 50% would also zero out the taxpayer's utility from cheating.

19. See *supra* note 6.

20. The audit rate for individual returns was 1.03% in 2007, a marked increase from the 0.49% audit rate in 2000. IRS, FISCAL YEAR 2007 IRS ENFORCEMENT AND SERVICE STATISTICS 3, available at [http://www.irs.gov/pub/newsroom/irs\\_enforcement\\_and\\_service\\_tables\\_fy\\_2007.pdf](http://www.irs.gov/pub/newsroom/irs_enforcement_and_service_tables_fy_2007.pdf). Of course the audit rate is somewhat understated as it omits errors detected by information matching and other computer screening techniques that are typically rectified through written correspondence only. See TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, TRENDS IN COMPLIANCE ACTIVITIES THROUGH FISCAL YEAR 2007, at 7 (2008), available at <http://www.treas.gov/tigta/auditreports/2008reports/200830095fr.pdf>.

21. I.R.C. § 6662 (2006) (levying a 20% penalty rate in most situations). Of course the penalty rate increases to 75% for fraud, but that finding requires the Service to prove an intentional disregard of a known legal duty by clear and convincing evidence. *Id.* § 6663(a).

22. Jeff T. Casey & John T. Scholz, *Beyond Deterrence: Behavioral Decision Theory and Tax Compliance*, 25 LAW & SOC'Y REV. 821, 833 (1991) ("[P]eople consistently overestimate the probability of an outcome which can occur only as the result of a particular series of events.").

ing much higher levels of noncompliance than are actually evident in the United States and other industrialized nations.<sup>23</sup>

### B. *A Taxpaying Ethos Explanation*

Because the deterrence model fails to accurately predict tax evasion levels, other forces must be influencing citizens to comply despite the apparently overwhelming economic utility of cheating. The hodgepodge of non-coercive forces and behavioral traits that influence the degree of tax evasion are generally referred to under the umbrella rubric of a society's "tax morale."<sup>24</sup> This term serves as a convenient way to refer to the aggregate counterbalance necessary to bring the deterrence model into equilibrium with the observed levels of compliance. The actual components of tax morale, as well as their relative significance, remain ill-defined.<sup>25</sup> The empirical behavioral and economic research into the nature of tax morale is still in its infancy.<sup>26</sup> The research is further slowed by the relatively rare opportunity to conduct actual field experiments in conjunction with taxing authorities.<sup>27</sup> Consequently, most of the relevant research falls either into the category of (1) laboratory experiments designed to test particular hypotheses regarding the behavior of a representative group of individuals or (2) statistically analyzed survey data from representative populations.<sup>28</sup>

Nevertheless, despite the newness of the inquiry and the limits of the empirical research techniques, a number of elements have been identified, and generally accepted, as impor-

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23. See Andreoni, Erard & Feinstein, *supra* note 11, at 846 (noting that misperceptions of audit rate cannot explain observed compliance rate); Torgler, *supra* note 10, at 4 (noting that estimated level of risk aversion in the United States is between one and two on the Arrow-Pratt risk aversion scale, while relevant empirical studies indicate a level of thirty would be needed to explain the observed United States tax compliance rate).

24. See Torgler, *supra* note 10.

25. Kornhauser, *supra* note 10, at 601.

26. *Id.*

27. Because such field studies require significant advance preparation and the cooperation of the taxing authority, and typically involve a significant period of time before the receipt of the relevant raw data, there are comparatively few such studies. See Torgler, *supra* note 10, at 16. Recently, however, it has been suggested to the Service that it should establish a "behavioral science unit" to promote and undertake just this type of research. Kornhauser, *supra* note 10, at 626.

28. See Torgler, *supra* note 10, at 5-17 (providing an extended discussion of the pros and cons of each type of research in the context of tax compliance).

tant factors in promoting tax compliance. Before delving into these factors in Part II below, however, it is important to contrast the broad tax morale concept with the conception of a taxpaying ethos as used in this Article. Tax morale represents a conglomeration of factors that have an impact, either positive or negative depending on the circumstances, on taxpaying attitudes. In contrast, a taxpaying ethos represents a pervasive cultural norm that is internalized by members of the society and therefore strongly influences their behavior in favor of faithfully complying with the tax laws. Stated another way, taxpaying ethos is a descriptive phrase identifying a cultural dynamic that values adhering to (and disfavors disobeying) the tax laws, while tax morale refers to the various factors that may contribute to creating such a taxpaying ethos within a particular society.<sup>29</sup>

Because a taxpaying ethos is merely descriptive of a cultural trait, the specific genesis of a taxpaying ethos in a given society could be as varied as the cultures in which it happens to arise. Nevertheless, this Article will present a probable framework on which a taxpaying ethos could take hold, as a means of better understanding the significance of the most relevant empirically identified tax morale factors described in Part II below. While the following approach to conceptualizing the foundations of a taxpaying ethos is by no means the only way to explain the relevance of the research findings, it is a highly plausible one to posit in the context of a Western democracy.

One of the key failings of the deterrence model is that it assumes taxpayers will act as rational wealth-maximizers. People do not, however, act rationally.<sup>30</sup> Further, individuals may eschew pure wealth-maximization strategies when they perceive that they are in fact receiving a valid quid pro quo in exchange for their taxes. In Western democracies tax receipts are not just hoarded by the government for accumulation's sake.

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29. Of course there is some potential circularity in this explanation of the concepts because once a taxpaying ethos is established, its existence creates cultural pressures on members of society, which reinforce the existing taxpaying ethos. Consequently, a taxpaying ethos itself can be a tax morale factor.

30. John S. Carroll, *A Cognitive-Process Analysis of Taxpayer Compliance*, in *TAXPAYER COMPLIANCE* 229, 234-36 (Jeffrey A. Roth & John T. Scholz eds., 1989) (describing some of the behavioral studies indicating that human actions often diverge from rational economic utility predictions).



Taxes provide for a wide array of government services that benefit the entire society. As such, it might be posited that taxpayers generally should be predisposed to paying a fair price (i.e., taxes) for the services they receive, which would mitigate some of the inclination to merely maximize their personal wealth by cheating on their taxes. A counter to this supposition is that most of the government services provided take the form of public goods, so there is a large free-rider problem because taxpayers enjoy the benefit of such goods even if they fail to contribute for them.<sup>31</sup> Consequently, the deterrence model generally ignores the existence of a quid pro quo for paid taxes on the theory that individuals will not willingly pay for public goods absent the threat of being penalized for noncompliance.<sup>32</sup>

Experimental evidence, however, refutes the deterrence position. That is, humans do not necessarily act “rationally” to maximize their personal wealth when faced with public-good situations.<sup>33</sup> Individuals often make decisions based on heuristics that have worked and benefited them in the past.<sup>34</sup> One such heuristic is based on cooperation and reciprocity.<sup>35</sup> As a

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31. See, e.g., Richard A. Posner, *ECONOMIC ANALYSIS OF LAW* 523 (1998) (discussing whether taxes are warranted because of free-rider problems associated with public goods); John O. Ledyard, *Public Goods: A Survey of Experimental Research*, in *THE HANDBOOK OF EXPERIMENTAL ECONOMICS* 111, 112 (John H. Kagel & Alvin E. Roth eds., 1995) (discussing the economic prediction of free-riding).

32. Lederman, *supra* note 14, at 1477.

33. See, e.g., Colin F. Camerer & Ernst Fehr, *Measuring Social Norms and Preferences Using Experimental Games: A Guide for Social Scientists* 2 (Inst. for Empirical Res. in Econ., Working Paper No. 97, 2002), available at <http://www.iew.unizh.ch/wp/iewwp097.pdf>.

34. See Russell Korobkin & Thomas Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1127-34 (2000) (providing a systemic discussion of a variety of heuristics and their influence on human decision-making); Amos Tversky & Daniel Kahneman, *Judgment under Uncertainty: Heuristics and Biases*, 185 SCI. 1124, 1124-36 (1974).

35. The existence of this reciprocity heuristic is evidenced by simple “ultimatum” experiments. See, e.g., Werner Guth, Rolf Schmittberger & Bernd Schwarze, *An Experimental Analysis of Ultimatum Bargaining*, 3 J. ECON. BEHAV. & ORG. 367 (1982). In these experiments, subjects are paired up and one (the proposer) is given a sum of money to divide between them. The proposer has complete discretion regarding how much of the sum to give to the other subject (the responder), but if the responder rejects the offer then *neither* is allowed to keep the money. From a purely economic standpoint the responder should accept *any* amount proposed since he gets nothing if he rejects it. Nevertheless, these experiments typically show that the most typical offer is 50/50, the mean offer is approxi-

result, experiments attempting to replicate the public-good situation find that people typically cooperate to create and contribute to the public good despite the wealth-maximizing incentives to free-ride.<sup>36</sup> For instance, assume ten people are each given \$10 and told that they can either keep the money or can contribute some or all of it into a community fund that will then be doubled and redistributed equally among them.<sup>37</sup> So, if everyone contributes their full \$10, then they maximize their aggregate benefit and each ultimately receives \$20. From an individual perspective, however, the optimal wealth maximization strategy is to contribute nothing. That is, if one person contributes nothing and the other nine contribute their full \$10 stake, each subject receives \$18 from the community fund regardless of their contribution, and therefore the free-rider retains \$28 rather than the \$20 he would have otherwise retained. Of course, if everyone free-rides, which would be the expected result from a pure economic-maximization perspective, then no public good would be created and each subject would just retain their \$10 stake. This type of experiment typically finds that subjects do make contributions despite the strong economic incentives to free-ride.<sup>38</sup> Contrary to the

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mately 60/40, and the smaller the offer, the more likely that it is rejected. Phrased differently, the average retained by the proposer is usually less than 70% and about 20% of the offers are rejected. Jack Ochs & Alvin E. Roth, *An Experimental Study of Sequential Bargaining*, 79 AM. ECON. REV. 355 (1989); Alvin E. Roth, *Introduction to Experimental Economics*, in THE HANDBOOK OF EXPERIMENTAL ECONOMICS 1, 50 (John H. Kagel & Alvin E. Roth eds., 1995). Effectively, the subjects bring to the experiment a norm of cooperative fair sharing that is generally recognized by the proposer in making his offer and that the responder is willing to enforce, even at an economic penalty to him.

36. See John O. Ledyard, *Public Goods: A Survey of Experimental Research*, in THE HANDBOOK OF EXPERIMENTAL ECONOMICS 111, 112-13 (John H. Kagel & Alvin E. Roth eds., 1995); Dan M. Kahan, *Trust, Collective Action, and Law*, 81 B.U. L. REV. 333, 335-36 (2001).

37. This type of experiment is often used to explore various aspects of public-good theory. See, e.g., Li-Chen Hsu, *Experimental Evidence on Tax Compliance and Voluntary Public Good Provision*, 61 NAT'L TAX J. 205, 205-06 (2008). While the example discussed in the text is very simple, this basic experiment can be modified to be more realistic and specific to the tax arena by adding and controlling for any number of variables, such as informing subjects of (1) their tax rate versus the average tax rate, (2) the audit rate, (3) potential penalties, or (4) the number of "taxpayers" who cheat on, or comply with, their tax obligations.

38. Elinor Ostrom, *Collective Action and the Evolution of Social Norms*, 14 J. ECON. PERSP. 137, 140 (2000).

wealth-maximization prediction of zero, the subjects typically contribute between 40% and 60% of their initial stake to the community fund.<sup>39</sup> These experiments demonstrate the cooperation heuristic. This type of experiment is typically continued for a number of iterations to test how the cooperative behavior of the subjects changes over time. Such iterative experiments demonstrate that many individuals are “conditional cooperators” who start out using a middle-ground cooperative position and then adjust their behavior to be less or more cooperative based on the observed actions of others in contributing to the community fund.<sup>40</sup> In this way, the cooperation heuristic can be seen as a more rational approach to a given situation than a pure economic wealth-maximizing approach because it provides overall better results over a wide range of potential situations by permitting more opportunities for cooperative behavior.<sup>41</sup>

The apparent existence of such a cooperation heuristic has led some to posit a fiscal-exchange paradigm in which taxpayers act as “adaptive contractarians” that will pay their taxes “only if other taxpayers and the state also meet their obligations to the implicit tax contract.”<sup>42</sup> That is, taxpayers pay because they believe that they receive a benefit from the government for paying their taxes, and they are willing to keep paying as long as the government keeps providing valued services and other citizens are not shirking their duties. So, this fiscal-exchange concept, while certainly not the only approach available, can serve as an illustrative framework on which a taxpaying ethos could be built. Consequently, it is a useful approach to keep in mind to assist in contextualizing the relevance and operative significance of the factors, discussed below in Part II, which seem to have an important impact on tax compliance.

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39. *Id.*

40. See Joep Sonnemans, Arthur Schram & Theo Offerman, Strategic Behavior in Public Good Games: When Partners Really Become Strangers 9 (Dec. 1996) (unpublished manuscript, on file with University of Amsterdam), available at <http://www1.fee.uva.nl/creed/pdf/strat.pdf>.

41. Indeed, studies have shown that people exhibiting greater degrees of conditional cooperation are more successful in prisoner dilemma games than people who are less trusting of others. See John Orbell & Robyn M. Dawes, A “Cognitive Miser” Theory of Cooperators’ Advantage, 85 AM. POL. SCI. REV. 515, 524-26 (1991).

42. Scholz, *supra* note 15, at 105.

## II. Uncovering the Foundations of a Taxpaying Ethos

Because levels of observed tax compliance in Western democracies cannot be explained by the level of penalties and percentage of audits conducted, other factors must constitute the building blocks on which the taxpaying ethos of such countries is founded. This section first discusses the role of coercion generally in promoting tax compliance and fostering a taxpaying ethos, and then explores some of the more salient non-coercive forces that have been found to be positively correlated with tax compliance.

### A. *Contextualizing the Role of Coercion*

As discussed above, the deterrence model does not accurately describe the relationship between penalty and audit rates and the observed level of tax compliance. Nevertheless, that does not mean that the degree of enforcement and punishment is an irrelevant consideration in influencing tax compliance. Studies have demonstrated that generally tax compliance does increase as penalties and enforcement activity escalate.<sup>43</sup> Further, it is clear that some level of enforcement activity and associated sanctions is necessary to ensure that individuals have faith that the tax system is being fairly and evenhandedly enforced. Consequently, one might suppose that simply increasing penalties or audit rates would provide a ready means for increasing tax compliance even though the deterrence model does not itself fully describe the tax compliance dynamic.

But is there a point where increased coercion yields insignificant compliance benefits? Or worse, might heightened levels of coercion become counterproductive in terms of compliance? In this regard, some have argued that “far from promoting compliance, simply increasing the penalties for evasion has

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43. See, e.g., Paul J. Beck, Jon S. Davis & Woonoh Jung, *Experimental Evidence on Taxpayer Reporting under Uncertainty*, 66 ACCT. REV. 535 (1991); Charles T. Clotfelter, *Tax Evasion and the Tax Rates: An Analysis of Individual Returns*, 65 REV. ECON. STAT. 363 (1983); Mehemiah Friedland, Shlomo Maital & Aryen Rutenberg, *A Simulation Study of Income Tax Evasion*, 10 J. PUB. ECON. 107 (1978); Robert Mason & Lyle D. Calvin, *Public Confidence and Admitted Tax Evasion*, 37 NAT'L TAX J. 489, 493 (1984); Michael W. Spicer, *Civilization at a Discount: The Problem of Tax Evasion*, 39 NAT'L TAX J. 13, 15 (1986); Ann D. Witte & Diane F. Woodbury, *The Effect of Tax Laws and Tax Administration on Tax Compliance: The Case of the U.S. Individual Income Tax*, 38 NAT'L TAX. J. 1 (1985).

been shown to undermine it, at least in societies that otherwise enjoy relatively compliant norms.”<sup>44</sup> However, others have strongly questioned the validity of such assertions.<sup>45</sup> The studies in this regard are mixed.<sup>46</sup> One possible reason for the unclear impact may be that while increased coercion has a positive influence on compliance in isolation, it may also have a negative impact (or crowding-out effect) on an existing taxpaying ethos, so any overall impact of increased coercion may be negligible and may leave the society vulnerable to increased noncompliance if the coercion levels are subsequently reduced.<sup>47</sup> In this regard, a survey of the relevant empirical studies reveals that typically no significant correlation exists between penalty levels and audit rates and the level of tax compliance.<sup>48</sup> Where significant correlations have been found, they tend to show weak positive correlations for increased enforcement activity, but negative correlations for increased penalties.<sup>49</sup> One explanation for this can be found by returning to the conditional-cooperator concept described above.<sup>50</sup> Increased audit rates assure taxpay-

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44. Dan M. Kahan, *Signaling or Reciprocating? A Response to Eric Posner's Law and Social Norms*, 36 U. RICH. L. REV. 367, 377 (2002). See also Heidi Glenn & Allen Kenney, *Olson: Increased Enforcement Could Erode Taxpayer Trust*, TAX NOTES TODAY, May 11, 2004, available at 2004 TNT 91-3 (LEXIS); Marjorie E. Kornhauser, *Doing the Full Monty: Will Publicizing Tax Information Increase Compliance?*, 18 CAN. J.L. & JURISPRUDENCE 95, 97-98 (2005); Torgler, *supra* note 10, at 26.

45. Lederman, *supra* note 14, at 1484-87.

46. See Lars P. Feld & Bruno S. Frey, *Tax Compliance as the Result of a Psychological Tax Contract: The Role of Incentives and Responsive Regulation* 9-11 (Inst. for Empirical Res. in Econ., Working Paper No. 287, 2005), available at <http://www.iew.unizh.ch/wp/iewwp287.pdf> (discussing mixed results found in numerous studies).

47. In an analogous vein, one study added incentives for cooperation in the first round of a prisoner's dilemma game and then removed those incentives in subsequent rounds of the game. The study found that the change in incentives substantially undermined subsequent cooperation and actually left the players worse off in the second round than a control group that had no positive incentives in the first game. See Norman Frohlich & Joe A. Oppenheimer, *Experiencing Impartiality to Invoke Fairness in the n-PD: Some Experimental Results*, 86 PUB. CHOICE J. 117, 117-35 (1996).

48. See Torgler, *supra* note 10, at 156-59, 285 (reviewing the relevant experimental work and analyzing several sets of survey data).

49. *Id.*

50. *Id.* at 158 (suggesting audits may be perceived as policing the tax system, while the penalty rate may be seen as a more evident indication of the need for external sanctions to obtain compliance, and therefore could crowd out any intrinsic motivation to comply).

ers that a mechanism exists to detect and police against shirking. Consequently, taxpayers have more confidence in the system and correspondingly increase their level of cooperation with it. That is, just because a lot of audits are conducted does not necessarily imply that a large percentage of the population is currently shirking.<sup>51</sup> On the other hand, increased penalties may be seen as evidence that such measures are required to create compliance, giving a conditional cooperator reason to believe that a large number of people are either cheating or would cheat in the absence of the high sanction.<sup>52</sup>

Given the uncertain state of the empirical research in this regard, it does not seem prudent to merely escalate enforcement activity and penalties in a generally tax compliant society as a means of promoting increased compliance. This may not, however, be true in the context of a noncompliant society.<sup>53</sup> Where a taxpaying ethos exists, it should be self-maintaining due to the internalization of the cultural norm and the continued operation of the forces which produced it to begin with. Consequently, drastically altering the coercion levels runs a risk of upsetting that equilibrium and would not be warranted based on the current empirical research. In the converse situation, where the cultural norm is *noncompliance*, increasing the coercion levels could be an effective means of unsettling *that* cultural equilibrium and prompting the cultural norm to gravitate toward increased compliance.<sup>54</sup> Several commentators have suggested such a dynamic might exist and that increased enforcement could be an effective means of jolting a static noncompliance norm toward a more compliant one.<sup>55</sup>

The foregoing discussion has indicated that some median level of coercive activity is likely a prerequisite for creating a

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51. However, if increased enforcement activity is publicized as being necessitated by a need to close a large gap between taxes owed and those actually collected, then a negative compliance impact might result since it undermines the perception of the average taxpayer that compliance is in fact the norm in their society. Cf. Roberta Mann, *Beyond Enforcement: Top 10 Strategies for Encouraging Tax Compliance*, 111 TAX NOTES 919, 920 (2006) (suggesting any advertising of the magnitude of the United States tax gap is counterproductive to actually closing the tax gap due to its negative behavioral impact on taxpayers).

52. See Torgler, *supra* note 10, at 158.

53. Lederman, *supra* note 14, at 1509-10.

54. *Id.*

55. *Id.*

taxpaying ethos since it demonstrates to taxpayers that the laws will be fairly and uniformly enforced. Arbitrarily increasing the coercive force in a generally compliant society could, however, be counterproductive. Conversely, in a society with an established noncompliance norm, significantly increased coercive measures may serve to push the established norm out of equilibrium and provide the foundation for cultivating a taxpaying ethos by demonstrating to individuals that the law is now being adequately enforced.

### B. *The Demonstrated Influential Factors*

As discussed above, while a threshold level of coercive activity is likely a necessary prerequisite to cultivating a taxpaying ethos, the predictive deficiencies of the deterrence model clearly indicate other forces must also be present. While the relevant empirical research on the elements of tax morale is still in its infancy, this research has identified at least two basic categories of forces having a significant positive influence on tax compliance: trust in government and trust in taxpayers.

#### 1. Trust in Government

The first area of significant importance in promoting tax compliance can be loosely referred to as trust in government. Or, viewed through the fiscal-exchange lens, is the government upholding its end of the fiscal-exchange whereby it provides services in exchange for taxes being paid? Within this rubric are such factors as whether the uses to which taxes are put are seen as appropriate and of equivalent value to the tax cost, and whether the tax laws are perceived as representing an equitable sharing of the tax burden. A central component of both of these factors is whether members of society have had input, either directly by specific public referendums or indirectly by electing representatives, in making the tax and expenditure decisions. To the extent citizens participate in the creation of the laws, the more invested they are in them and the more willing they are to comply. Similarly, this “trust in government” category includes perceptions regarding the fairness and uniformity with which the laws are enforced. Consequently, how the administrative agency charged with collecting the imposed taxes conducts itself can be a crucial factor in promoting tax compliance.

A number of studies present empirical evidence that governments that adhere to the principle of providing public services according to citizen preferences at a reasonable tax cost achieve more tax compliance.<sup>56</sup> Conversely, levels of tax evasion rise more as a citizen's desires regarding public goods diverge from the actual goods, levels, and quality provided.<sup>57</sup> As might therefore be expected, tax compliance also increases with reductions in perceived government waste.<sup>58</sup> In short, where the perceived exchange between the tax paid and the government services performed is seen as equitable, tax compliance is strengthened.<sup>59</sup> If, however, the perceived tax burden is too

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56. See, e.g., James Alm, Betty R. Jackson & Michael McKee, *Estimating the Determinants of Taxpayer Compliance with Experimental Data*, 45 NAT'L TAX J. 107 (1992); James Alm, Betty R. Jackson & Michael McKee, *Fiscal Exchange, Collective Decision Institutions and Tax Compliance*, 22 J. ECON. BEHAV. & ORG. 285 (1993); James Alm, Betty R. Jackson & Michael McKee, *Institutional Uncertainty and Taxpayer Compliance*, 82 AM. ECON. REV. 1018 (1992); James Alm, Gary H. McClelland & William D. Schulze, *Why Do People Pay Taxes?*, 48 J. PUB. ECON. 21 (1992); Thomas M. Porcano, *Correlates of Tax Evasion*, 9 J. ECON. PSYCHOL. 47 (1988); M.W. Spicer & S.B. Lundstedt, *Understanding Tax Evasion*, 31 PUB. FIN. 295 (1976).

57. Werner W. Pommerehne, Albert Hart & Bruno S. Frey, *Tax Morale, Tax Evasion and the Choice of Policy Instruments in Different Political Systems*, 49 PUB. FIN. 52 (Supp. 1994).

58. Feld & Frey, *supra* note 46, at 15. See Valerie Braithwaite, *Communal and Exchange Trust Norms: Their Value Base and Relevance to Institutional Trust*, in TRUST AND GOVERNANCE 46, 53-54 (Valerie Braithwaite & Margaret Levi eds., 1998).

59. It should be noted here that an "equitable" tax burden for the provided services does not necessarily require a one-to-one equivalence for each citizen. That is, higher taxes may be accepted by some citizens as a contribution to the benefit of society as a whole. This might especially be true of wealthy individuals who may equate their financial success in part to the intangibles of the business and economic environment fostered by the government's actions or inactions. This conjecture finds support in the empirical studies. See, e.g., A.M. Ali, *Economic Freedom, Democracy and Growth*, 13 J. PRIVATE ENTERPRISE 1 (1997) (indicating a high degree of economic freedom in society correlates with higher legal compliance); James Alm, Gary H. McClelland & William D. Schulze, *Why Do People Pay Taxes?*, 48 J. PUB. ECON. 21 (1992) (same); Thorsten Beck, Ross Levsine & Norman Loayaza, *Finance and the Sources of Growth*, 58 J. FIN. ECON. 261 (2000) (indicating strong financial markets correlate with higher legal compliance); Jong Hag Choi & T.J. Wong, *Auditors' Governance Functions and Legal Environments: An International Investigation*, 24 CONTEMPORARY ACCT. RES. 1 (2007) (same); Bruno Frey, *Direct Democracy: Politico-Economic Lessons From Swiss Experience*, 84 AM. ECON. REV. 338 (1994) (indicating legal environment allowing effective competition correlates with increased legal compliance); B.E. Hermalin, *The Effects of Competition on Executive Behavior*, 23 RAND J. ECON. 350 (1992) (same); R. La Porta et al.,



high, then this lessens the commitment to pay and tax evasion tends to increase, perhaps justified as a type of self-defense.<sup>60</sup>

Similarly, perceptions regarding the equitable allocation of the tax burden can impact tax compliance. Citizens who believe their share of the tax burden is too high are more likely to attempt to evade that burden as a self-help measure.<sup>61</sup> Because most income tax systems involve some degree of tax rate progressivity and often represent a form of wealth redistribution among members of the society, one might conclude that rate progressivity would have a negative impact on tax compliance, and some experimental evidence supports this view.<sup>62</sup> Such negative impacts, however, may be mitigated if those in the higher tax brackets feel the progressive rate structure is legitimate, for example, because they were indirectly involved in structuring or approving the progressive rate system.

The empirical data indicates that participation in the formulation of a tax law increases the perceived legitimacy of the

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*Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997) (indicating strong financial markets correlate with higher legal compliance).

60. Torgler, *supra* note 10, at 17.

61. See, e.g., Wilbur J. Scott & Harold G. Grasmick, *Deterrence and Income Tax Cheating: Testing Interaction Hypotheses in Utilitarian Theories*, 17 J. APPLIED BEHAV. SCI. 395 (1981) (reporting evidence that deterrence was more effective for taxpayers who perceived the tax system to be unfair).

62. See, e.g., C. Clotfelter, *Tax Evasion and Tax Rates: An Analysis of Individual Returns*, 65 REV. ECON. & STAT. 363 (1983) (finding evidence that evasion increased with both income levels and tax rates); David Joulfaian & Mark Rider, *Tax Evasion in the Presence of Negative Income Tax Rates*, 49 NAT'L TAX J. 553 (1996) (same); Karyl A. Kinsey & Howard G. Grasmick, *Did the Tax Reform Act of 1986 Improve Compliance? Three Studies of Pre- and Post-TRA Compliance Attitudes*, 15 L. & POL'Y 239 (1993) (reporting progressive rates increase tax evasion); Michael L. Roberts & Peggy A. Hite, *Progressive Taxation, Fairness and Compliance*, 16 L. & POL'Y 27 (1994) (same). However, the evidence is not unambiguous. For instance, in a study based on Jamaican data, the surprising result that evasion declines with marginal tax rates was found. James Alm, R. Bahl & M.N. Murray, *Audit Selection and Income Tax Underreporting in the Tax Compliance Game*, 42 J. DEV. ECON. 1 (1993). See also J.S. Feinstein, *An Econometric Analysis of Income Tax Evasion and its Detection*, 22 RAND J. ECON. 14 (1991) (finding a significant negative correlation between marginal tax rates and evasion). At least one problem that may contribute to these mixed results is the difficulty in obtaining data on evasion. To control for this problem, several studies have used laboratory experiments where subjects were asked hypothetical questions about their behavior. See, e.g., P. WEBLEY ET AL., *TAX EVASION: AN EXPERIMENTAL APPROACH* (1991); James Alm, B.R. Jackson & M. McKee, *Estimating the Determinants of Taxpayers Compliance with Experimental Data*, 45 NAT'L TAX J. 107 (1992). Typically, these results find a positive association between tax rates and evasion.

resulting law and creates increased compliance even in those who voted against the law.<sup>63</sup> For instance, in experiments where the subjects are permitted to vote on the fine structure used in the experiment, compliance is higher than in a control group where the fine is imposed exogenously.<sup>64</sup> Further, even subjects who vote to reject the fine demonstrate a higher tax compliance rate than those in the control group.<sup>65</sup> Field studies conducted in Switzerland also support this experimental data.<sup>66</sup> Those studies primarily examined tax evasion data in Swiss cantons over a number of years and concluded that the more the decision-making procedures involve direct democracy, the lower the tax evasion rate.<sup>67</sup> Consequently, believing that the tax laws are legitimate, even though they may not personally be to one's liking, appears to increase tax compliance.

Similarly, another factor that impacts the perceived legitimacy of the tax law is how fairly it is administered.<sup>68</sup> Fairness

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63. See, e.g., James Alm, Betty R. Jackson & Michael McKee, *Fiscal Exchange, Collective Decision Institutions and Tax Compliance*, 22 J. ECON. BEHAV. & ORG. 285 (1993) (finding higher compliance when a matter is voted on and when the outcome has wide support). Accord T.R. TYLER, WHY PEOPLE OBEY THE LAW (1990) (arguing that people comply with the law in general if they perceive the process that leads to this law as fair).

64. See, e.g., James Alm, Gary H. McClelland & William D. Schulze, *Changing the Social Norm of Tax Compliance by Voting*, 52 KYKLOS 141, 163 (1999); Bruneo Feld & J.R. Tyran, *Tax Evasion and Voting: An Experimental Analysis*, 55 KYKLOS 197, 218 (2002); Benno Torgler & C. A. Schaltegger, *Tax Amnesties and Political Participation*, 33 PUB. FIN. REV. 403 (2005); Benno Torgler, *What Do We Know about Tax Morale and Tax Compliance?*, 48 INT'L REV. ECON. & BUS. 395 (2001) (surveying literature on political participation and compliance).

65. Feld & Tyran, *supra* note 64, at 218. It is also interesting to note that in an experiment where a majority of subjects vote against a higher tax enforcement level, post-vote compliance levels deteriorate even if they had been high before the vote. See Alm, McClelland & Schulze, *supra* note 64, at 163. This provides further evidence of the importance of an individual taxpayer's perception regarding how honest his peers are in paying their taxes.

66. Werner W. Pommerehne & Hannelore Weck-Hannemann, *Tax Rates, Tax Administration and Income Tax Evasion in Switzerland*, 88 PUB. CHOICE 161 (1996); Benno Torgler, *Tax Morale and Direct Democracy*, 21 EUR. J. POL. ECON. 525 (2005).

67. Lars P. Feld & Bruno S. Frey, *Tax Compliance as the Result of a Psychological Tax Contract: The Role of Incentives and Responsive Regulation*, 29 L. & POL'Y 102, 113 (2007) (examining the periods between 1965 to 1978 and 1985 to 1995).

68. Tom Tyler & P. Degoe, *Collective Restraint in Social Dilemmas: Procedural Justice and Social Identification Effects on Support for Authorities*, 69 J. PERSONALITY & SOC. PSYCHOL. 482 (1995) (demonstrating that individual willingness

in this context has both a procedural aspect (was the decision-making process fair?) and an outcome aspect (was the ultimate result fair?).<sup>69</sup> The result that voluntary cooperation with an authority increases with its perceived legitimacy is a widely accepted finding in empirical psychological studies.<sup>70</sup> The finding is also specifically demonstrated in the relevant tax compliance studies.<sup>71</sup> This is particularly important in a tax system that relies heavily on self-reporting, as in the United States.

With regard to procedural fairness issues, the audit procedures utilized should be transparent and understandable to the taxpayer. When faced with arbitrary procedures, taxpayers may feel the game is rigged against them and that they have no true ability to air their positions before an unbiased party. On a personal level, procedural fairness requires that taxpayers be treated with respect by auditors and other tax officials. As discussed earlier, studies have demonstrated a cooperation or reciprocity norm that predisposes people to cooperate, but that can also cause them to seek retribution for past bad behavior.<sup>72</sup> Consequently, treating taxpayers with disrespect (e.g., assuming they are cheaters unless proven honest) can reverse the normal inclination toward voluntary compliance.

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to voluntarily cooperate with existing authorities in order to solve social dilemma problems rises with the perceived legitimacy of these authorities).

69. *Id.*

70. See, e.g., Y. Cohen-Charash & P. E. Spector, *The Role of Justice in Organizations: A Meta-Analysis*, 86 *ORG. BEHAV. & HUMAN DECISION PROCESSES* 278 (2001); E.A. Lind et al., *Procedure and Outcome Effects on Reactions to Adjudicated Resolutions of Conflicts of Interest*, 39 *J. PERSONALITY & SOC. PSYCHOL.* 643 (1980); M.W. Spicer & L.A. Becker, *Fiscal Inequity and Tax Evasion: An Experimental Approach*, 33 *NAT'L TAX J.* 171 (1980); J. Thibaut, N. Friedland & L. Walker, *Compliance with Rules: Some Social Determinants*, 30 *J. PERSONALITY & SOC. PSYCHOL.* 792 (1974); T.R. Tyler & A. Caine, *The Role of Distributional and Procedural Fairness in the Endorsement of Formal Leaders*, 41 *J. PERSONALITY & SOC. PSYCHOL.* 642 (1981).

71. See, e.g., H. Elffers, R.H. Weigel & D.J. Hessing, *The Consequences of Different Strategies for Measuring Tax Evasion Behavior*, 8 *J. ECON. PSYCHOL.* 311 (1987) (magnitude of tax evasion depends on the satisfaction of the taxpayer with the tax system as well as the system of tax administration); Lars P. Feld & Bruno Frey, *Trust Breeds Trust: How Taxpayers are Treated*, 3 *ECON. GOVERNANCE* 87 (2002) (evasion will tend to lower the relationship based on trust that exists between the tax administration and the taxpayer); Werner W. Pommerehne & Hannelore Weck-Hannemann, *Tax Rates, Tax Administration and Income Tax Evasion in Switzerland*, 88 *PUB. CHOICE* 161 (1996).

72. See *supra* note 35 (discussing ultimatum games).

The fair outcome aspect of administrative legitimacy may be conceptually more difficult to pursue in the tax area. Taxes are forced impositions by the government, and at the core, the tax administrator is charged with collecting those taxes for the benefit of the fisc. Nevertheless, viewing the role of the tax agency as maximizing government receipts should be rejected as ultimately counterproductive to voluntary tax compliance. If taxpayers believe that the government is always going to tip the scales in its favor, they will certainly not view the ultimate outcomes of any audit as legitimate. Consequently, it is important for the taxing authority to focus on obtaining “correct” results under the law, rather than revenue-maximizing ones. Audit rules should grant a fair degree of discretion to auditors so that they are not just mindlessly applying inflexible rules without an appreciation of their overall purpose or their impact in a particular case.<sup>73</sup> If taxpayers believe that the auditor was really striving to apply the law correctly and impartially, then they should be able to grant the agency a high degree of legitimacy even if the ultimate result is in the government’s favor.

## 2. Trust in Taxpayers

The other area of significant importance in promoting tax compliance can be loosely referred to as trust in taxpayers. Or, viewed through the fiscal-exchange lens, are taxpayers generally upholding their end of the fiscal-exchange bargain by actually paying the taxes imposed to fund the government’s services? Within this rubric are such factors as whether other taxpayers are perceived as being generally compliant, the ability to place social pressure on noncompliant taxpayers, and the ability to create incentives or rewards linked to compliant behavior.

No one wants to feel like a chump for paying taxes when they believe everyone else is freeloading.<sup>74</sup> While this fact is easily grasped at a gut level, empirical studies consistently demonstrate that perceptions about whether others are comply-

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73. PHILIP SELZNICK, *THE MORAL COMMONWEALTH: SOCIAL THEORY AND THE PROMISE OF COMMUNITY* 330-33 (1992).

74. Janet Novack, *Are You a Chump?*, *FORBES*, Mar. 5, 2001, at 122.

ing with their tax obligations strongly impact tax compliance.<sup>75</sup> From a psychological standpoint, this derives from the cooperation norm and the fact that conditional cooperators, while initially willing to satisfy their tax obligations, will alter that behavior in response to the non-cooperation of others. Consequently, a society's perception of the level of noncompliance has a significant impact on taxpayer behavior.

Similarly, the research in this area indicates that, in addition to lessening cooperation, retaliation may also be a legitimate response to non-cooperation.<sup>76</sup> Consequently, compliant taxpayers may exert pressure on the noncompliant to alter their behavior. In this regard, studies have consistently shown that shame can be a potent factor in promoting compliance with the tax laws.<sup>77</sup> Essentially, society can place a certain stigma on

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75. See, e.g., James Alm & Jorge Martinez-Vazquez, *Institutions, Paradigms, and Tax Evasion in Developing and Transition Countries*, in PUBLIC FINANCE IN DEVELOPING AND TRANSITIONAL COUNTRIES 146, 151 (James Alm & Jorge Martinez-Vazquez eds., 2003) ("If the perception becomes widespread that the government is not willing to detect and penalize evaders, then such a perception legitimizes tax evasion. The rejection of sanctions sends a signal to each individual that others do not wish to enforce the tax laws and that tax evasion is in some sense socially acceptable, and the social norm of compliance disappears."); Bruno Frey & Benno Torgler, *Tax Morale and Conditional Cooperation*, 35 J. COMP. ECON. 136 (2007) (demonstrating that tax morale decreases when tax evasion is perceived as common in Western and Eastern Europe); Steven M. Sheffrin & Robert K. Triest, *Can Brute Deterrence Backfire? Perceptions and Attitudes in Taxpayer Compliance*, in WHY PEOPLE PAY TAXES 193 (Joel Slemrod ed., 1992) (perceiving other taxpayers as dishonest significantly increases the likelihood a person will avoid taxes); Michael P. Vandenbergh, *Beyond Elegance: A Testable Typology of Social Norms in Corporate Environmental Compliance*, 22 STAN. ENVTL. L.J. 55, 113 (2003) ("The effect of perceptions of widespread [tax] noncompliance on intentions to comply in the future may result from the norm of conformity, or may simply be the product of a perceived reduction in the risk of formal or informal sanctions.").

76. See *supra* note 35.

77. See, e.g., Eliza Ahmed & Valerie Braithwaite, *A Need for Emotionally Intelligent Policy: Linking Tax Evasion with Higher Education Funding*, 10 LEGAL & CRIMINOLOGICAL PSYCHOL. 1 (2005); B. Erard & J.S. Feinstein, *The Role of Moral Sentiments and Audit Perceptions in Tax Compliance*, 49 PUB. FIN. 70 (Supp. 1994); Harold G. Grasmick & Robert J. Bursick, *Conscience, Significant Others, and Rational Choice: Extending the Deterrence Model*, 24 L. & SOC'Y REV. 837 (1990); Harold G. Grasmick, Robert J. Bursik & J.K. Cochran, *"Render Unto Caesar What Is Caesar's": Religiosity and Taxpayers Inclinations to Cheat*, 32 SOC. Q. 251 (1991); Marta Orviska & John Hudson, *Tax Evasion, Civic Duty and the Law Abiding Citizen*, 19 EUR. J. POL. ECON. 83, 87 (2002); S.G. Tibbetts, D. Joulfaian, & M. Rider, *Shame and Rational Choice In Offending Decisions: Tax Evasion In The Presence Of Negative Income Tax Rates*, 24 CRIM. JUST. & BEHAV. 234 (1997); Kris-

exposed tax evasion. Unfortunately, the ability to use shame as an operative factor requires first discovering the malfeasance, which may be difficult in the tax setting. Even if a taxpayer is found by the government to have underpaid his taxes, that information is generally not made public. Indeed, the United States tax laws go to great lengths to ensure that taxpayer privacy is maintained.<sup>78</sup> Consequently, only criminal prosecutions are made public as a matter of course. So, the effectiveness of shame in the tax context is normally weakened by the lack of sunshine on the noncompliant taxpayers.<sup>79</sup>

Even if shame proves to be a less potent influence on taxpaying behavior as a practical matter, guilt is likely to retain its impact. The relevant studies have shown that guilt can also influence taxpaying behavior.<sup>80</sup> Unlike shame, which requires some form of group shunning or stigma, guilt represents an internal force residing within each taxpayer.<sup>81</sup> Guilt arises when people realize that they have acted inappropriately in the context of a social norm that they have personally accepted. Consequently, even if the noncompliance is unlikely to ever be detected or publicly disclosed, guilt can be a potent influence on behavior.<sup>82</sup>

Of course, guilt only results if one has internalized the relevant social norm. Nevertheless, the degree of the required socialization might not be as great or as difficult to instill as one could suppose. Returning to the fiscal-exchange framework, if a taxpayer believes that his tax burden is roughly commensurate to the government's public goods, he is likely to be invested in

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tina Murphy, *Procedural Justice, Shame and Tax Compliance* (Centre for Tax System Integrity, Working Paper No. 50, 2004), available at <http://ctsi.anu.edu.au/publications/WP/50.pdf>.

78. See I.R.C. § 6103 (2006) (mandating strict rules to protect the confidentiality of tax return information and severely circumscribing the situations where disclosure would be appropriate).

79. It should be noted, however, that there is a tension between the desire to publicize noncompliant taxpayers so they can be subjected to a social stigma and the desire to create a general perception that most people pay their taxes.

80. See *supra* note 77.

81. See generally JUNE PRICE TANGNEY & RONDA L. DEARING, *SHAME AND GUILT* (2002).

82. Jon S. Davis, Gary Hecht & Jon D. Perkins, *Social Behaviors, Enforcement, and Tax Compliance Dynamics*, 78 ACCT. REV. 39, 42 (2003) ("When someone violates a standard, they incur a psychological cost—guilt—whether or not others discover the behavioral violation.").

the bargain and would feel some reluctance to shirk his duty when the government has fulfilled its end of the bargain. The recognition that a taxpayer's failure to fulfill the fiscal-exchange bargain could jeopardize the provision of the public goods to society as a whole may create substantial internal pressures that are completely unrelated to the risk of detection for the contemplated noncompliance. Or phrased differently, the existence of trust in government itself may serve to legitimize the tax obligation and serve as the prerequisite norm internalization to create a pang of guilt that could promote compliance. Thus, the "trust in government" factors are not only important in their own right as influences on tax compliance, but they can also serve as the basis on which a significant guilt constraint on noncompliance can be established.<sup>83</sup>

Alternatively, the required internalization of the taxpaying norm might even be totally separate from any beliefs about the legitimacy of the fiscal-exchange. The mere fact that self-esteem is reinforced or increased by knowing that you are complying with a social norm may be a sufficient internalization to create a compliance incentive. This approach derives from terror management theory, which posits that individuals manage the risk of facing the unavoidable fears that are part of the human condition (most significantly their own mortality) by creating and protecting their self-esteem.<sup>84</sup> The theory is supported by numerous empirical studies.<sup>85</sup> Consequently, merely knowing that a taxpaying norm exists in a society may provide a sufficient internalization for a taxpayer to comply with the norm as a means of protecting her self-esteem as a participant

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83. Jan Schnellenbach, *Tax Morale and the Legitimacy of Economic Policy* 11 (July 8, 2005) (unpublished manuscript, on file with Univ. of Heidelberg, Alfred Weber Inst. for Econ.) ("The less legitimate the actions taken by the government are perceived to be, the easier it is for a tax evader to justify his illegal activity against the objections coming from his own conscience.").

84. T. Pyszczynski, J. Greenberg & S. Solomon, *A Dual Process Model of Defense against Conscious and Unconscious Death-Related Thought: An Extension of Terror Management Theory*, 106 *PSYCHOL. REV.* 835 (1999); T. Pyszczynski et al., *Why Do People Need Self-Esteem? A Theoretical and Empirical Review*, 130 *PSYCHOL. BULL.* 435 (2004).

85. Empirical support for the terror management theory comes from over 300 separate experiments conducted by independent researchers in at least fifteen different countries. See, e.g., Mark J. Landau et al., *On the Compatibility of Terror Management Theory and Perspectives on Human Evolution*, 5 *EVOLUTIONARY PSYCHOL.* 477, 478 (2007).

in a thriving and important society. Shirking a taxpaying obligation represents an immediate psychic cost to the individual from the reduction in self-esteem that (unlike an economic penalty or social stigma) occurs even if the action is never uncovered. So, whether the concept is phrased as guilt or self-esteem, it is reasonable to believe that the concept could, as a practical matter, influence behavior in the tax context.

Finally, experimental data suggests that providing positive incentives or rewards to compliant taxpayers can positively influence their compliance.<sup>86</sup> In one experiment, four alternative types of compliance rewards were compared:<sup>87</sup> (1) a lottery,<sup>88</sup> (2) a fixed reward,<sup>89</sup> (3) a public good, and (4) a reduction in future audit rates. The alternative rewards are listed in order of their positive compliance impact. Of interest is that the lottery mechanism showed the largest compliance impact even over a fixed reward having the same expected value and over a public good having a *higher* expected value. The experimenters concluded that to have a significant impact a reward should be immediate and salient to the subject.<sup>90</sup>

The structure and requirements for a reward must be carefully considered for other reasons as well. First, a poorly crafted reward could have negative impacts on compliance. If the reward were to focus on changing the behavior of previously noncompliant taxpayers, then it might create an incentive for compliant taxpayers to become noncompliant in order to gain eligibility for the reward.<sup>91</sup> Second, insufficient empirical work has been done to determine whether a reward might have a

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86. See, e.g., James Alm, Betty R. Jackson & Michael McKee, *Deterrence and Beyond: Toward a Kinder, Gentler IRS*, in *WHY PEOPLE PAY TAXES* 311 (Joel Slemrod ed., 1992); J. Falkinger & H. Walther, *Rewards Versus Penalties: On a New Policy Against Tax Evasion*, 19 *PUB. FIN. Q.* 67 (1991); Feld & Frey, *supra* note 67, at 110. See generally J. NUTTIN & A.G. GREENWALD, *REWARD AND PUNISHMENT IN HUMAN LEARNING* (1968).

87. Alm, Jackson & McKee, *supra* note 86.

88. If the subject was "audited" and shown to be in compliance for five consecutive "rounds" in the experiment, then she was entered into a lottery with a 1 in 25 chance of winning. *Id.*

89. The fixed reward was set to have the same expected value as the lottery. So, a certain fixed reward of \$1 would equate to the expected value of having a 1 in 25 chance of winning \$25. *Id.*

90. *Id.*

91. Feld & Frey, *supra* note 67, at 110.



crowding out effect on a prevailing compliance norm.<sup>92</sup> That is, the incentive may merely replace the intrinsic motivation for little net compliance impact. However, it has been suggested that, as long as rewards are reserved only for good behavior, a crowding out effect is less likely because the reward is reinforcing the initial positive compliance behavior (unlike a deterrence approach where the penalty is aimed at noncompliant taxpayers and functions as a replacement for the intrinsic motivation that would otherwise encourage compliance). Finally, linking the reward directly with the amount of tax owed is likely to be counterproductive. Sliding-scale rewards applied to all conforming taxpayers are likely to be viewed as, in substance, differential tax rates and may, therefore, have consequences more akin to penalties. Consequently, a one-size-fits-all reward is more likely to be seen as a token of appreciation or respect from the government rather than as an implicit tax reduction that the taxpayer is entitled to.<sup>93</sup> Such a gift from the government could also be interpreted as reinforcing the fiscal-exchange relationship between the taxpayer and the government.<sup>94</sup> This also implies that using a non-monetary reward may provide the best long-term results in a tax situation.<sup>95</sup> Overall, while more empirical work is required on the optimum structure for a reward system, it seems clear that properly tailored rewards can have a significant positive impact on tax compliance.

### III. Cultivating a Taxpaying Ethos

It is demonstrable that the existence of trust in government and other taxpayers exerts a positive influence on tax compliance. This section explores how such trust can be fostered to cultivate a pervasive taxpaying ethos in a society, with a particular emphasis on how to generally strengthen the existing taxpaying ethos present in the United States.

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92. *Id.*

93. *Id.*

94. Ernst Fehr, Simon Gächter & Georg Kirchsteiger, *Reciprocity as a Contract Enforcement Device*, 65 *ECONOMETRICA* 833 (1997).

95. Feld & Frey, *supra* note 67, at 110.

A. *Making the Law and its Administration Objectively Fairer*

The forgoing discussion of the trust in government factors indicates the importance of increasing the legitimacy of the tax system and the deemed fiscal-exchange. Taking steps to elevate and safeguard this legitimacy will promote increased compliance and contribute to the establishment of a pervasive taxpaying ethos in a society. Therefore, a government needs to make sure that its fiscal choices are in line with the society's desires, that the tax burden imposed is equitable, and that the tax administration is fair.

As discussed earlier, the level of voluntary tax compliance in the United States is already quite high and indicates the existence of a well-established taxpaying ethos.<sup>96</sup> In particular, due to the nature of our longstanding democracy, the basics of the fiscal-exchange dynamic are solidly in place. The government's fiscal choices are determined by elected officials and are subject to public scrutiny. Similarly, while United States citizens like to complain about their tax burden (after all, paying lower taxes is always better), in general, the tax burden in this country is perceived as generally equitable.<sup>97</sup> Consequently, while drastic changes to the tax system (e.g., moving to a value-added tax or to a flat-income tax) might be considered by some as potentially useful in improving compliance, this Article will not dwell on systemic tax reform as a means for improving tax compliance.

Nevertheless, there are a number of smaller adjustments to the United States tax laws and administration that could help to incrementally increase trust in government. A common complaint about the current tax code is its complexity. This complexity is especially troubling in a tax system that is premised on voluntary compliance, which presupposes an understanding

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96. See *supra* note 6 and accompanying text.

97. In 2006, the effective tax burden in the United States was actually below that of most European countries and below the OECD average when aggregate tax receipts were measured as a percentage of gross domestic product. *Tax Revenue: Setting the Bar High*, ECONOMIST.COM, Oct. 25, 2007 (unpublished article, on file with author). Further, the continued existence of progressive tax rates is generally not viewed as unfair. But see Jeffrey A. Schoenblum, *Tax Fairness or Unfairness? A Consideration of the Philosophical Bases for Unequal Taxation of Individuals*, 12 AM. J. TAX POL'Y 221 (1995) (arguing that progressive tax rates are inherently unfair).

of one's obligations under the law. So if systemic tax reform is rejected, real attempts at simplification could yield important compliance benefits. While any number of specific simplification proposals could be pursued,<sup>98</sup> a subtle shift in drafting technique might also yield benefits. One reason for the complexity of the current code and associated regulations is that they must address and provide guidance for a wide variety of economic activity. As a result, the Code often employs specific rules rather than general principles. While specific rules are arguably more predictable in future application, they can be detrimental in that they expand the opportunities to game the tax system by crafting transactions to skirt the literal rule or by applying such rules to unanticipated situations to achieve unwarranted results.<sup>99</sup> To the extent the judiciary believes the tax laws must be applied literally or construed strictly against the government, the problem is exacerbated.<sup>100</sup> Consequently, consciously drafting tax statutes in terms of general principles or standards may be a more prudent drafting approach.<sup>101</sup> Using principles or standards has the added benefit of lessening the need to constantly revise the Code to address new factual situations, and

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98. See, e.g., IRS, REDUCING THE FEDERAL TAX GAP: A REPORT ON IMPROVING VOLUNTARY COMPLIANCE 50, 50-51 (2007) [hereinafter TAX GAP COMPLIANCE REPORT] (listing several tax simplification measures that could be adopted); U.S. DEP'T OF THE TREASURY, A COMPREHENSIVE STRATEGY FOR REDUCING THE TAX GAP 15 (2006), available at <http://www.ustreas.gov/press/releases/hp111.htm> (noting that a number of tax gap related simplification proposals have been made or are under consideration); STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES (Comm. Print 2005) (discussing numerous tax simplification changes).

99. See Richard Lavoie, *Subverting the Rule of Law: The Judiciary's Role in Fostering Unethical Behavior*, 75 U. COLO. L. REV. 115, 152-54 (2004).

100. See *id.*

101. See David A. Weisbach, *Formalism in the Tax Law*, 66 U. CHI. L. REV. 860, 871 (1999) ("[Rules present] an easy target for tax planning . . . . To reduce this potential, rules must become more complex, and greater complexity creates additional opportunities for planning, and onward and onward. Standards are fuzzy at the borders, reducing this problem."); Richard Lavoie, *Reclaiming a Tax Code Mired in Complexity: The Use of Standards Versus Rules in Creating Sustainable Tax Reform* 3 (July 25, 2007) (unpublished manuscript, on file with author) (advocating for a principles-based approach to drafting the Internal Revenue Code). But see Lawrence A. Cunningham, *A Prescription to Retire the Rhetoric of "Principles-Based Systems" in Corporate Law, Securities Regulation, and Accounting*, 60 VAND. L. REV. 1411 (2007) (arguing that a standard-based approach is unworkable when applied to a complex statutory structure like the Internal Revenue Code).

therefore provides citizens with a greater impression of legal stability.<sup>102</sup> Principles and standards are also potentially beneficial because, as opposed to strict rules, it may be easier for the average person to understand their intent and apply that intent to his or her particular situation.

Beyond the law itself, compliance benefits are likely to result from changes in the way the law is administered by the Service. As a starting point, saber rattling by the Service about increased enforcement efforts seems misplaced.<sup>103</sup> Despite generating positive cash returns,<sup>104</sup> such efforts have only an incremental impact on compliance at the margin and may even be counterproductive.<sup>105</sup> As discussed above, it has been argued that using too much coercion harms tax compliance either due to a crowding out effect or because it encourages taxpayers to believe that a significant portion of the population does not pay their full taxes. Consequently, the Service should refrain from engaging in and publicizing general increases in enforcement activity.<sup>106</sup>

More generally, the Service clearly needs to reform its image. Many Americans feel that the audit process is capricious.<sup>107</sup> While the Service has taken steps in this regard in

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102. Lavoie, *supra* note 99, at 153.

103. For example, the Commissioner of the Internal Revenue Service recently stated that the Service “need[s] to have rigorous enforcement programs” and that a major focus during his term “will be to reduce the tax gap through continued emphasis on strong compliance programs.” *Shulman Emphasizes Continuity of Enforcement, Service Priorities*, 119 TAX NOTES 120 (2008). See also TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, TRENDS IN COMPLIANCE ACTIVITIES THROUGH FISCAL YEAR 2007, at 3 (2008) (discussing the greatly increased enforcement efforts of the Service in recent years, but warning that “despite [the] work the IRS is doing to improve its enforcement efforts, the Government Accountability Office continued to include enforcement of tax laws (collection of unpaid taxes and Earned Income Tax Credit noncompliance) as one of the twenty-six high-risk areas in the Federal Government in its most recent (January 2007) update”).

104. As a result of increased enforcement efforts, enforcement revenue increased sharply from 2002 to 2007, and was 68% higher in 2007 than it was in 1998. TREASURY INSPECTOR GEN. FOR TAX ADMIN., TRENDS IN COMPLIANCE ACTIVITIES THROUGH FISCAL YEAR 2007, at 22 (2008), available at <http://www.treas.gov/tigta/auditreports/2008reports/200830095fr.html>.

105. See discussion *supra* Part II.A.

106. However, specifically targeted enforcement initiatives may be beneficial. See *infra* Part IV.

107. See, e.g., IRS, PUB. AFF. DIV., TAXPAYER ATTITUDES SURVEY: FINAL REPORT (1984).

response to Congressional prodding,<sup>108</sup> the changes have been subject to some criticism.<sup>109</sup> Most of this recent effort has been focused on procedural reforms and shifts in internal organizational structure to make the Service more efficient and focused.<sup>110</sup> To the extent such changes result in greater procedural fairness, they represent a positive step in terms of promoting compliance. Recent reforms have, however, done little to attack the Service's broader image problem beyond creating a greater emphasis on customer service.<sup>111</sup> To this end taxpayers are now thought of as "customers" and the Service is dedicated to providing them with "good service" based on timely and accurate responses to questions and the distribution of information via the Internet, phone, and other avenues. At its base, this type of customer service is focused on those taxpayers whose noncompliance rests on legitimate confusion regarding the law and their obligations, or those whose failure derives from being despondent over the complexity of the filing requirements. While a focus on customer service may well be useful to such taxpayers, it likely has little impact on those whose noncompliance is intentional. Further, it can be argued that even using the terminology of "customer" in the tax context is

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108. In 1997, the Senate Finance Committee held televised hearings regarding alleged abuse of taxpayers by the Service. *See, e.g.,* Ryan J. Donmoyer, *Three Days of Hearings Paint Picture of Troubled IRS*, 76 TAX NOTES 1655 (1997). In retrospect, much of the testimony at those hearings was one-sided, exaggerated and generally unfair to the Service. *See* GEN. ACCOUNTING OFFICE, OFFICE OF SPECIAL INVESTIGATIONS, GAO REPORT ON ALLEGATIONS OF IRS TAXPAYER ABUSE (1999); *Conference Panel Ponders Finance Hearing Horror Stories*, 83 TAX NOTES 1854 (1999). Nevertheless, the hearings led Congress to adopt legislation that mandated an enormous reorganization of the Service and was aimed at trying to make the Service more "customer" friendly with a renewed focus on taxpayer rights. Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685.

109. *See, e.g.,* Bryan T. Camp, *Tax Administration as Inquisitorial Process and the Partial Paradigm Shift in the IRS Restructuring and Reform Act of 1998*, 56 FLA. L. REV. 1 (2004); Wm. Brian Henning, *Reforming the IRS: The Effectiveness of the Internal Revenue Service Restructuring and Reform Act of 1998*, 82 MARQ. L. REV. 405 (1999); Leandra Lederman, *Tax Compliance and the Reformed IRS*, 51 U. KAN. L. REV. 971 (2003); Eric A. Lustig, *IRS, Inc. – The IRS Oversight Board – Effective Reform or Just Politics? Some Early Thoughts from a Corporate Law Perspective*, 42 DUQ. L. REV. 725 (2004); Heather B. Conoboy, Note, *A Wrong Step in the Right Direction: The National Taxpayer Advocate and the 1998 IRS Restructuring and Reform Act*, 41 WM. & MARY L. REV. 1401 (2000).

110. Lederman, *supra* note 109, at 996.

111. *Id.*

counterproductive since it removes the focus from the fiscal-exchange dynamic and implies that tax evasion by “dissatisfied” customers is appropriate.<sup>112</sup>

In terms of promoting tax compliance, a more fruitful type of “customer” focus would be to better modulate communications with the taxpayer in the audit context. As discussed earlier, empirical research demonstrates that trust in government derives in part from perceptions that the taxpayer is being fairly treated. A crucial element of fair treatment is feeling like you are being treated with respect.<sup>113</sup> Consequently, the Service potentially could promote voluntary compliance by building a regulatory approach where the tax administrator is willing to take all aspects of the taxpayer’s situation into account in resolving tax questions and provides the taxpayer with low-key judgment-free opportunities to address or correct suspected errors.<sup>114</sup> This mode of tax administration is typically referred to as “responsive regulation” and has been adopted by the taxing authorities in a number of jurisdictions, most notably Australia.<sup>115</sup> Responsive regulation is generally based on a “tit for tat” approach, where the regulatory action adjusts in response to a taxpayer’s behavior. The aim is for most issues to be resolved in a cooperative manner with more coercive actions applied only to those taxpayers demonstrating continued resistance to meeting their tax obligations. The responsive-regulation model requires substantial effort on the part of the taxing authority to effectively implement it. In addition to requiring a mind-set change on the part of many of its employees, the model is premised on allowing substantial discretion in dealing with particular taxpayers to dynamically encourage their compliance. Such flexibility runs some risk of creating arbitrary and non-uniform tax administration, which could harm compliance by fostering a be-

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112. *Id.* at 992.

113. This can be seen as an outgrowth of the reciprocity norm discussed above in Part II.B.1 because positive behavior by the taxing authority increases the likelihood of compliance due to the tendency for people to try to treat others in the same manner others treat them. See Kent W. Smith, *Reciprocity and Fairness: Positive Incentives for Tax Compliance*, in *WHY PEOPLE PAY TAXES* 223, 225 (Joel Slemrod ed., 1992). See also Dan M. Kahan, *Logic of Reciprocity*, 102 MICH. L. REV. 71 (2003).

114. Kornhauser, *supra* note 10, at 615-16.

115. *Id.* at 622.

lief that the system is unfair and perhaps irrational.<sup>116</sup> Further, the system runs some risk of adversely affecting compliance by being too lenient. If people come to believe that there are never any coercive consequences for failure to honor their tax obligations, then they may lose faith in the administrator's ability to effectively police the tax law against the intentionally noncompliant. Despite these implementation concerns, the potential compliance benefits from moving away from a highly authoritarian deterrence-based regulatory model should cause the Service to seriously contemplate making such a paradigm shift.<sup>117</sup>

Beyond procedural fairness issues and generally improving respectful relations between taxpayers and the Service, repairing the Service's image requires addressing issues of outcome-fairness. In short, many people believe that the Service is not a fair arbiter of tax disputes. This perception is perpetuated by the lack of clear guidelines for when the Service should assert positions on audits.<sup>118</sup> Because the standards applicable to taxpayer-reporting positions are fairly well defined, the absence of reciprocal standards for the Service gives the perception that the system is slanted in the government's favor. This perception is exacerbated by the fact that the Service instructs examining agents to assert all "meritorious" issues, even if they ultimately feel the taxpayer's position is on balance the proper one.<sup>119</sup> Adopting clear standards for when the Service should raise an issue would be perceived as leveling the playing field and would also actually increase the uniformity and equality of

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116. Some have questioned the threshold assumption of responsive regulation that the tax law is sufficiently determinate so that taxpayers and the government could in fact agree regarding when a tax is owed or whether the taxpayer is being resistant. See, e.g., Mark Burton, *Responsive Regulation and the Uncertainty of Tax Law – Time to Reconsider the Commissioner's Model of Cooperative Compliance?*, 5 *EJOURNAL TAX RES.* 71 (2007), [http://www.atax.unsw.edu.au/ejtr/content/issues/previous/paper4\\_v5n1.pdf](http://www.atax.unsw.edu.au/ejtr/content/issues/previous/paper4_v5n1.pdf). This problem is, however, mitigated if the parties use a common interpretive approach. See discussion *infra* notes 120-22.

117. See Kornhauser, *supra* note 10, at 630.

118. Richard Lavoie, *Analyzing the Schizoid Agency: Achieving the Proper Balance in Enforcing the Internal Revenue Code*, 23 *AKRON TAX J.* 1, 3 (2008).

119. See Rev. Proc. 64-22, 1964-1 C.B. 689; Frederic G. Corneel, *The Service and the Private Practitioner: Face to Face and Hand in Hand – a Private Practitioner's View*, 11 *AM. J. TAX POL'Y* 343, 359-60 (1994); IRS, *IRS Releases 'Oral History Interview' of Former Commissioner Caplin*, *TAX NOTES TODAY*, June 22, 1994, available at 94 TNT 120-25 (LEXIS).

treatment between taxpayers. Adopting such standards presupposes the Service's use of a comprehensive approach for evaluating the meaning of the tax law and resolving indeterminate meanings.<sup>120</sup> Obviously, increases in perceived outcome-fairness only result if taxpayers employ a similar interpretive approach to that of the Service. Because significant differences of opinion currently exist regarding whether tax statutes should be interpreted literally or given a more dynamic reading, achieving real benefits in perceived outcome-fairness may be dependent on resolving this controversy.<sup>121</sup> Nevertheless, by explicitly stating and consistently applying its chosen interpretive approach, the Service can educate taxpayers—and the judiciary—on the merits of its approach with the intent of creating a commonly shared interpretive baseline to be used in resolving tax disputes between the government and taxpayers.<sup>122</sup>

### B. *Altering Perceptions and Strengthening Social Constraints*

Beyond fostering trust in government, taxpayers must also have faith that their cooperation with the tax laws is justified on a personal level. To some extent, the forces impacting an individual's personal calculus are not amenable to government direction. The government cannot change the gender of its citizens or alter the past events that have contributed to the formation of their psyche. Nevertheless, there are influences that the government can attempt to channel. A key prerequisite for building a taxpaying ethos is a widely held perception that most people fulfill their tax obligations.<sup>123</sup> A government should foster and strengthen this perception in its communications.<sup>124</sup> Indeed, the government should consider creating communications solely for the purpose of communicating such information.<sup>125</sup>

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120. Lavoie, *supra* note 118, at 13-16.

121. *Id.* See also Lavoie, *supra* note 99, at 183-85.

122. To the extent there is agreement regarding the interpretive approach, a key criticism of the responsive regulation approach is substantially mitigated.

123. See discussion *supra* Part II.B.2.

124. Mann, *supra* note 51, at 920.

125. See Kornhauser, *supra* note 44, at 13 (recommending the Service provide more educational information to taxpayers, including giving each taxpayer a yearly statement containing information about tax revenues and collections and compliance generally, as well as personal information about the individual's past tax history).



Publicized high profile enforcement actions should be described through a lens that clearly indicates their aberrational status. Further, discussions concerning the tax magnitude of uncollected taxes,<sup>126</sup> if publicized at all, should stress the generally high compliance level and give context to the shortfall by demonstrating the manageable confines of the noncompliance problem.

Beyond public-relations efforts, the empirical research demonstrates that shame and social stigma can be influential factors on tax compliance.<sup>127</sup> As discussed earlier, however, utilizing this factor in the tax arena presents the double-edged issue of bringing noncompliance into the public realm without creating the general impression that noncompliance is widespread.<sup>128</sup> As a result, merely disclosing the identities of the noncompliant seems ill advised.<sup>129</sup> An alternative approach would be to make all tax returns a matter of public record.<sup>130</sup>

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126. It is estimated that the amount of federal income tax due but not paid each year (commonly referred to as the "tax gap") currently exceeds \$345 billion. News Release, IRS, IRS Updates Tax Gap Estimates, (Feb. 14, 2006), *available at* <http://www.irs.gov/newsroom/article/0,,id=154496,00.html> (estimating the tax gap for 2001 at \$345 billion). This 2006 report represents the Service's most recent estimate of the gross tax gap in the most recent year for which the relevant data is available (2001). *Id.* Given the economic growth since then, the actual tax gap is presumably greater today. In any event, it should be noted that measuring the degree of noncompliance is a difficult task as it relies on making assumptions regarding the extent of non-filing in a system based largely on voluntary self-reporting and extrapolating the under-reporting by filing taxpayers based on compliance audits conducted periodically by the Service. *See generally* Eric Toder, *What Is The Tax Gap?*, 117 TAX NOTES 367 (2007) (discussing methods used by the Service to estimate the tax gap and highlighting various measurement issues).

127. *See* discussion *supra* Part II.B.2.

128. *See supra* note 79.

129. Nevertheless, some commentators have advocated such disclosures. *See, e.g.,* Jay A. Soledad & Dennis J. Ventry, Jr., Opinion, *A Little Shame Might Just Deter Tax Cheaters*, USA TODAY, Apr. 10, 2008. Of course, disclosure of federal tax noncompliance would require congressional action to overturn the strict confidentiality rules currently in place under the Internal Revenue Code. *See* discussion *supra* note 78. The practice, however, has been used at the state level where more than twenty states maintain websites publicizing the names and addresses of taxpayers with outstanding tax liabilities. Soledad & Ventry, *supra*. In any event, it should also be noted that merely disclosing deficiency information is a blunt instrument since many deficiencies may be the result of honest error. Consequently, in the absence of strong evidence regarding its efficacy, merely disclosing such outstanding tax liability information seems unwarranted.

130. Obviously such full disclosure would be diametrically opposed to the current norm of high confidentiality, but the United States has in fact had full disclo-

While this would bring the tax arena into the full light of day, it would face strong opposition from privacy advocates and, as a result, could ultimately create adverse perceptions regarding government intrusiveness that might harm tax compliance.<sup>131</sup> A middle ground would be to allow a more limited form of tax return disclosure information.<sup>132</sup> For instance, it has been suggested that taxpayers could be required to file an additional single page tax return, containing limited information that would become a public record.<sup>133</sup> To protect privacy further, income and deduction levels could be reported only as falling within certain predetermined ranges, unless they represented an aberrational deviation from the median for similarly situated taxpayers, in which case the actual return figure would be required to be placed on the public form.<sup>134</sup> Consequently, taxpayers would have the choice of whether to publicly disclose their outside-the-norm position. They could either limit the amounts claimed on their full tax return to fall within the median ranges

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sure regimes in place for tax returns during limited periods of time on several occasions before the mid-1930s. See Kornhauser, *supra* note 44, at 7 (discussing the particulars of these occasions). Commentators have also occasionally advocated for full tax return disclosure. See, e.g., Marc Linder, *Tax Glasnost for Millionaires: Peeking Behind the Veil of Ignorance Along the Publicity-Privacy Continuum*, 18 REV. L. & SOC. CHANGE 951, 976 (1991) (raising the possibility of full disclosure of the returns of millionaires); George Guttman, *The Confidentiality Statute Needs Rethinking*, 86 TAX NOTES 318, 318-19 (2000). Most recently, television commentator Andy Rooney advocated in favor of full public disclosure of all federal income tax returns in an editorial on the April 19, 2009 broadcast of the news show *60 Minutes*. *60 Minutes* (CBS television broadcast Apr. 19, 2009), available at [http://www.youtube.com/watch?v=dpaQqX4xBCg&feature=player\\_embedded](http://www.youtube.com/watch?v=dpaQqX4xBCg&feature=player_embedded).

131. Kornhauser, *supra* note 44, at 9.

132. Israel experimented with such a system in the 1950s by publishing a yearly register including the names and reported income of self-employed individuals, corporations, and wage-earners who earned more than 25% of their income from sources other than wages. See, e.g., Assaf Likhovski, *Training in Citizenship: Tax Compliance and Modernity*, 32 LAW & SOC. INQUIRY 665, 674 (2007).

The goal of the register was to publicize the reported income of taxpayers, so that those taxpayers who underreported their income would be revealed by their acquaintances and be subject to community censure. It was meant to “stir public indignation against taxpayers who had grossly underreported their income,” to shame them and thus to increase tax compliance.

*Id.* at 674. Ultimately the system was abandoned due largely to difficulties in publishing accurate information and to public resistance. *Id.*

133. Kornhauser, *supra* note 44, at 19.

134. *Id.*

or they could elect to claim the full amounts knowing that these amounts would then require public disclosure of the exact figures involved.<sup>135</sup> While such an approach would likely still garner some hostility, it would provide enough information to make shame a viable alternative. Also, it heightens the ability to control taxpayer behavior through a guilt mechanism by providing taxpayers with the average expected ranges for their tax items and allowing them to make a call regarding whether to report a figure exceeding those ranges.

Finally, a government may be able to influence compliance behavior on the individual level by providing incentives for accurate reporting. The use of carrots is usually a more effective mechanism to promote voluntary compliance than the threat of a stick.<sup>136</sup> Again, planning with regard to the nature and requirements for such rewards would be crucial. The reward must be of interest to taxpayers, not be tied to their income level, and viewed in the nature of a recognition award or a token of appreciation, rather than as a rebate or reduction of taxes owed.<sup>137</sup> Further, the reward must not be linked to past noncompliance or it could create counterproductive incentives in favor of noncompliance.

While many structures could be fruitfully employed, one possibility would be for any audited taxpayer who has a zero tax deficiency to be honored at yearly awards dinners held around the country. At these dinners, one of the honorees could be randomly selected for some additional non-cash prize of significant value (e.g., a Caribbean cruise). Of course, there would be publicity announcing the honorees each year.

Such a mechanism not only has the potential to address individual compliance motivation, but also could take some of the personal dread and stigma out of being audited. The Service generally does not randomly select taxpayers for audit.<sup>138</sup> In-

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135. *Id.*

136. *See supra* text accompanying notes 86-95.

137. Feld & Frey, *supra* note 67, at 110.

138. The Service only conducts truly random audits in connection with data gathering aimed at helping it measure the magnitude of noncompliance and refining its criteria for selecting tax returns for audit. Historically, these compliance audits were conducted under its Taxpayer Compliance Measurement Program ("TCMP"), which involved an audit of a random sample of 50,000 tax returns every three years. *See* Robert E. Brown & Mark J. Mazur, *The National Research Pro-*

stead, audits are conducted based on some indication that the taxpayer's return is not accurate.<sup>139</sup> While this approach is an efficient way to select returns for audit and can markedly increase the direct return for dollars invested in enforcement,<sup>140</sup> it reinforces the dread many people feel when notified of an audit due to the implication that the Service believes they may have cheated. By conducting some percent of its audits randomly, or perhaps conducting audits of returns where *overpayments* are suspected, the Service could attempt to erode this perception. Receiving an audit notice might not seem so bad if it is viewed as an opportunity to prove your compliance and potentially win a prize. Instead of hearing people discussing how little taxes they pay at cocktail parties, you might instead hear people gossiping about Harriett, who just spent a week in Paris courtesy of the Service. Given the large resources currently being devoted to increased enforcement efforts by the Service, such a modest reward program would represent a very reasonable cost for potential long-term compliance benefits.

#### IV. Combating Noncompliance by Cultivating a Taxpaying Ethos

Part III outlined some general approaches for bolstering the taxpaying ethos in the United States. Regrettably, given the apparent extent and stability of United States tax compli-

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*gram: Measuring Taxpayer Compliance Comprehensively*, 51 U. KAN. L. REV. 1255, 1261-62 (2003). The TCMP ran from 1964-88. *Id.* In 2000, the Service began development of a more streamlined random audit program, the National Research Program ("NRP"). *Id.* at 1264.

139. The indication often is identified by a computer screening process that flags discrepancies in a filed return from what the Service would normally expect. While the exact audit selection process is shrouded in secrecy by the Service, a key element is a computer program called the Discriminant Function System ("DIF") that scores returns based on criteria gleaned from TCMP and NRP audits. Courts have routinely upheld the secrecy surrounding the DIF system because the "[r]elease of this information could compromise the integrity of the IRS and its regulatory function by allowing individuals to manipulate their DIF scores and possibly avoid a well-deserved audit." *Buckner v. IRS*, 25 F. Supp. 2d 893, 898 (N.D. Ind. 1998).

140. For instance, the use of TCMP data at one point helped the Service decrease the percentage of "no change" audits (i.e., those where the Service found no additional tax due) from 50% to only 20%. *See Brown & Mazur, supra* note 138, at 1262.

ance,<sup>141</sup> it is likely that such changes will only modestly impact the overall compliance level because the taxpaying ethos in the United States is already well established.<sup>142</sup> The general compliance level, however, masks real differences in compliance between different segments of the population.<sup>143</sup> For instance, while the net misreporting percentage is 16.3% of the aggregate tax gap,<sup>144</sup> the misreporting percentage for individuals' non-business income is only 4%.<sup>145</sup> On the other hand, the misreporting percentage for non-farm sole proprietor business income is 57% and it is 43% within all individual business income.<sup>146</sup> Consequently, it can be inferred that the taxpaying ethos is significantly weaker within this segment of society.<sup>147</sup> The significance of this level of noncompliance is highlighted by noting that this small-business category represents \$109 billion (or 32%) of the overall tax gap.<sup>148</sup> By cultivating a taxpaying ethos

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141. *See supra* note 6.

142. Of course, even modest changes could have a significant impact. Indeed, the Service's current goal is only to achieve an 86% compliance rate by 2009. TAX GAP COMPLIANCE REPORT, *supra* note 98, at 18.

143. Indeed, evasion even varies between occupations, with car dealerships, retail stores and restaurants typically evading the most. Andreoni, Erard & Feinstein, *supra* note 11, at 846.

144. The net misreporting percentage represents (1) the aggregate amount of income that was misreported, divided by (2) the aggregate amount that should have been reported. The figure is, therefore, the flip side of the compliance rate, so a compliance rate of 83.7% indicates a misreporting rate of 16.3%. TAX GAP COMPLIANCE REPORT, *supra* note 98, at 10.

145. *Id.* at 13.

146. *Id.*

147. Lederman, *supra* note 14, at 1507 (suggesting "that there may be somewhat more of an evasion norm among the self-employed than among taxpayers generally"); Smith, *supra* note 113, at 236 n.12 ("In a survey of Minnesota taxpayers, we have found that normative commitments concerning noncompliance are related to structural opportunity, suggesting occupationally and financially structured sub-cultures that are more likely to condone noncompliance . . .") (citing Loretta J. Stalans, Kent Smith & Karyl A. Kinsey, *When Do We Think About Detection? Structural Opportunity and Taxpaying Behavior*, 14 L. & SOC. INQUIRY 481 (1989)). The possibility of such an aberrant tax sub-culture existing in a society was posited early on in the tax compliance literature. *See* ALAN LEWIS, *THE PSYCHOLOGY OF TAXATION* 144 (1982) ("[A] tax subculture [may exist] with its own set of unwritten rules and regulations. Thus I am more likely to evade not only because I have friends who, I know, have got away with it (so why shouldn't I?) but also because evasion is ethically acceptable among my friends.").

148. TAX GAP COMPLIANCE REPORT, *supra* note 98, at 13. Note that this figure does not include \$39 billion of underreporting for self-employment taxes, which would also largely be attributable to this category of taxpayer.

in this sub-culture, a much more dramatic increase in compliance could be obtained.

Before discussing the actions that might be taken to cultivate a culture of compliance within this sub-group,<sup>149</sup> it is fruitful to touch briefly on several factors that have made the small-business community more resistant to the taxpaying ethos accepted by the broader society in the United States. The key factors relate to greater opportunity and personal disposition. Wage-earning individuals have an average misreporting percentage of approximately 1%.<sup>150</sup> Conversely, sole proprietor non-farm business income has a net misreporting percentage of 57% and farm income has a net misreporting percentage of 72%.<sup>151</sup> The big difference can be largely attributed to the lack of significant withholding or information reporting for business income. As a result, such businesses can operate in the underground economy by accepting cash payments for their services and neglecting to report them on their tax returns.<sup>152</sup> Further, small-business owners can also evade taxes by comingling their business and personal affairs. For example, the business can provide owners with cost-free services or have non-deductible personal expenses paid by the business and reported as deductible business expenses.<sup>153</sup>

There is also a potential self-selection dynamic inherent in the small-business community. First, entrepreneurs tend to take more risks than the general population.<sup>154</sup> This may make them even less susceptible than the general public to the traditional coercion-based compliance models typically employed.

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149. It should be noted that most of the proposals discussed in this Part will focus on attempts to change the prevailing noncompliance norm in this sub-culture rather than addressing the factors bearing on trust in government since those factors tend to be more macro in nature and applicable to all members of society.

150. TAX GAP COMPLIANCE REPORT, *supra* note 98, at 13. See also Charles P. Rettig, *Nonfilers Beware: Who's That Knocking at Your Door?*, 8 J. TAX PRAC. & PROC. 15, 15-16 (2006).

151. TAX GAP COMPLIANCE REPORT, *supra* note 98, at 13.

152. See Torgler, *supra* note 10, at 24 (noting that a significant correlation exists between tax morale in a society and the size of the society's underground economy).

153. Lederman, *supra* note 14, at 1504 n.268.

154. Guido Calabresi, Commentary, *The Passage of Time: The Implications for Product Liability*, 58 N.Y.U. L. REV. 939, 941 (1983) ("In an entrepreneurial society like ours, those who choose to be entrepreneurs can properly be assumed to be less risk averse than others.").

Second, individuals predisposed to tax evasion may be attracted to the small-business area since it presents greater opportunities for evasion. That is, individuals rejecting the taxpaying ethos may, by making similar tax-motivated choices, effectively form a sub-culture that reflects their views on tax evasion. Finally, competitive pressure may force individuals into noncompliance. A business engaged in an underground economy can charge customers less due to the tax savings from not reporting cash transactions.<sup>155</sup> Consequently, businesses that comply with their tax obligations find themselves at a competitive disadvantage and may need to follow the noncompliance norm of the small-business sub-culture if they are to survive.<sup>156</sup>

#### A. *Targeting Enforcement Efforts*

As discussed earlier, while some level of enforcement activity is a necessary prerequisite for any voluntary compliance system, increasing coercive measures beyond a basic level has been shown to be largely ineffective in increasing overall tax compliance.<sup>157</sup> Indeed, excessive amounts of coercion may prove counterproductive in the long run by reducing a society's intrinsic inclination to satisfy its tax obligation.<sup>158</sup> But, do these findings apply in the context of small-business taxpayers?

The noncompliance rate among small-business taxpayers indicates that a noncompliance norm exists within that subgroup of the population. Just as a taxpaying ethos, once established, should become internalized and self-reinforcing, the same is likely true of a noncompliance norm. Such accepted beliefs are likely to be maintained by members of the group even in the face of challenges to the accepted norm. Phrased differ-

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155. Indeed, they may also offer a direct tax savings to customers by suggesting that they will not charge any state sales tax if payment is made in cash.

156. See Joseph Bankman & Stewart Karlinsky, *Developing a Theory of Cash Businesses' Tax Evasion Behaviour and the Role of Their Tax Preparers*, in 5TH INTERNATIONAL CONFERENCE ON TAX ADMINISTRATION: CURRENT ISSUES AND FUTURE DEVELOPMENTS 136 (Michael Walpole & Rodney Fisher eds., 2002). See also Christopher Bergin, *CID to Employment Tax Evaders: 'We Will Catch You'*, TAX NOTES TODAY, May 15, 2001, available at 2001 TNT 94-9 (LEXIS) (noting that with respect to employment taxes, "some employers turn to evading taxes to stay competitive in their industry. It is apparently a serious problem in the construction industry").

157. See *supra* Part II.A.

158. *Id.*

ently, such stable-equilibrium states maintain themselves until a tipping point is reached, and then the new norm becomes the accepted one.

This tipping point paradigm derives from the psychological concepts of cognitive dissonance and confirmation bias. Cognitive dissonance refers to the tendency of people to use rationalization to bring their actual behaviors into closer proximity with their beliefs, as a means of minimizing the incongruity of having done something contrary to their beliefs. So, a child ordered not to play with a particular toy may convince himself that the toy is not really that appealing after all, as a means to reconcile his obedience with his initial desire for the toy. Confirmation bias refers to the tendency of individuals to discount information contrary to their pre-existing beliefs while highlighting confirming facts.<sup>159</sup> As a consequence of these traits, people tend to resist or disregard information that would conflict with their pre-existing beliefs. Ignoring these facts permits them to continue acting in conformity with their established habit and avoid any cognitive dissonance. So, taxpayers with a noncompliance norm are likely to ignore information regarding the increased risks of noncompliance and to discount examples of changed compliance behavior among their peer group. If, however, it ultimately becomes impossible to ignore the reality and they start paying their taxes, then the cognitive frame itself is forced to change to reconcile the cognitive dissonance of the situation.<sup>160</sup>

Because a noncompliance norm apparently exists in the small-business community, it may take a substantial force to disrupt that stable equilibrium, overcome the confirmation bias and trigger sufficient cognitive dissonance to tip the culture into a compliance mode. While increased enforcement generally has little impact on overall compliance in a compliant culture, some evidence suggests that deterrence considerations may be significantly more relevant to a noncompliant culture.<sup>161</sup> Conse-

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159. C.R. Mynatt, M.E. Doherty & R.D. Tweney, *Confirmation Bias in a Simulated Research Environment: An Experimental Study of Scientific Inference*, 29 Q. J. OF EXPERIMENTAL PSYCHOL. 85-95 (1977).

160. Joshua D. Rosenberg, *The Psychology of Taxes: Why They Drive Us Crazy, and How We Can Make Them Sane*, 16 VA. TAX REV. 155, 201 n.113 (1996).

161. Kent W. Smith, *Integrating Three Perspectives on Noncompliance: A Sequential Decision Model*, 17 CRIM. JUST. & BEHAV. 350, 364-65 (1990).



quently, targeting sufficiently increased coercive measures at this particular noncompliant sub-group could provide a significant portion of the force required to tip the cultural equilibrium.<sup>162</sup> Additionally, while increased enforcement activity may have a counterproductive effect when used in a compliant culture due to crowding out intrinsic motivations to comply, this should not be a concern when dealing with a sub-culture where little or no taxpaying ethos exists to be crowded out.<sup>163</sup> Further, if the focus of the increased coercion is mainly to create a tipping point, then presumably its duration can be limited so as not to crowd out the taxpaying ethos resulting from the flip. Based on this analysis, a targeted increased enforcement effort should be undertaken as a first step in trying to cultivate a taxpaying ethos among small-business taxpayers.

### B. *Rewarding Compliance*

As discussed above, it is clear from psychological studies that you really do catch more flies with honey than with vinegar.<sup>164</sup> Consequently, even if increased enforcement activity is undertaken as a first step in changing the small-business culture, it is prudent to leaven that approach with a bit of honey as well. The difficulty is crafting a reward that is relevant to the group without being seen as a tax rebate and without causing initial noncompliance to be a requisite for the reward. While any number of potential programs could be developed to satisfy these criteria, the following approach is illustrative.

In the small-business situation, just relying on a number of random audit selections may not yield sufficient numbers of honest taxpayers due to the prevalence of a noncompliance norm. Additionally, because the norm is noncompliance, it would be helpful to in some way promote the reward program as a positive inducement towards compliant behavior. One approach to achieve these ends would be to encourage taxpayers

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162. Lederman, *supra* note 14, at 1508-11.

163. Of course, the risk exists that even a targeted enforcement effort would have ripple effects on the broader culture in terms of indicating that rampant non-compliance exists in segments of the society. If, however, the increased enforcement activity is not generally publicized beyond members of the targeted group, this risk should be minimized.

164. See Alm, Jackson & McKee, *supra* note 86.

to self-select for an audit. Taxpayers could be told that if they volunteer to be audited and the audit shows only a de minimis tax deficiency over say the past three years, then they will receive a benefit.<sup>165</sup> Obviously, only taxpayers that believe they have correctly fulfilled their obligations would opt for such an audit. Therefore, to protect the Service from having to waste its resources by auditing *every* honest taxpayer, the Service would randomly select only a small portion of the volunteers for audit. The percentage of volunteers selected in any year would need to be refined based on the number of volunteers and the payoff rate determined to create optimal participation, but perhaps a selection rate of as little as 1% would be sufficient to induce small businesses to alter their compliance behavior to be eligible for the potential reward. Such a lottery selection method also greatly decreases the risk that taxpayers would view the reward as an entitlement owed to all honest taxpayers.

In terms of making the reward salient to the small-business community, one possibility is to craft some business related benefit not generally available to a business. For instance, a new Small Business Administration loan program could be developed specifically to serve as the carrot for steady compliance. The contours of such a program could be defined in many ways, but might involve a government interest rate subsidy, relaxed lending criteria, or speedier loan approval. Crafting the reward to be synergistic to a small business also has the added benefit that it could serve as a counterbalance to competitive pressures toward noncompliance. As discussed previously, if a taxpayer's competitors are operating in the cash economy and failing to pay their true taxes, the taxpayer is placed at a competitive disadvantage by not also cheating. A taxpayer may be better situated to resist this competitive race to the bottom if full tax compliance can yield him a competitive advantage as well, say lower financing costs than his competitors. Given the potential benefits of a well designed reward program targeted specifically at small business owners, the Service should seriously consider pursuing this approach as a means of fostering more tax compliance.

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165. While the requirement could be that there be a zero deficiency, setting the threshold slightly lower may encourage more compliance since it reassures the taxpayer that small honest errors will be excused.

### C. *Co-opting Agents of Cultural Change*

A central theme of this Article is that efforts to cultivate a taxpaying culture can have a meaningful impact on tax compliance. One argument that could be made against this proposition is that the culture of noncompliance in the small-business community is so well established that it simply cannot be changed. This argument derives from the idea that cultural beliefs are typically the result of a person's upbringing and cumulative life experiences and therefore are not susceptible to alteration by any governmental action. It is not clear, however, that taxpaying norms follow the same pattern, at least in the small-business setting.

First, small-business owners are subject to the general culture that surrounds them. Returning to the basic foundations of a taxpaying ethos, business people are likely to have been raised in their formative years to generally believe the government can be trusted and that the fiscal-exchange in the United States is equitable. As a result, there is no need to attempt to alter the impact of such formative influences as they already trend toward a compliance norm. Conversely, the more individualized influences relating to trust in taxpayers (i.e., perceptions regarding the compliance level of others and pressure from others for disregarding the cultural norm) are predominantly responsible for the rise of the noncompliance norm in the small-business setting. Specific attitudes regarding taxation are likely to have arisen once an individual enters the small-business culture. The business world generally represents a distinct sub-culture of American society. It is common for a person's conduct in personal relationships to differ from what she considers ethically required in a business setting.<sup>166</sup> Here the

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166. See, e.g., Gene R. Laczniak & Patrick E. Murphy, *Incorporating Marketing Ethics into the Organization*, in *MARKETING ETHICS: GUIDELINES FOR MANAGERS* 97, 100 (1985); Michael Bommer et al., *A Behavioral Model of Ethical and Unethical Decision Making*, 6 *J. BUS. ETHICS* 265, 268 (1987) (referring to employees as "ethical segregationists" for this reason); Linda Klebe Trevino, *Moral Reasoning and Business Ethics: Implications for Research, Education, and Management*, 11 *J. BUS. ETHICS* 445, 450 (1992). The situational factors constraining a behavior in a personal setting may not exist in a business setting, leading to markedly different behavior. See also Thomas W. Dunfee, *Business Ethics and Extant Social Contracts*, 1 *BUS. ETHICS Q.* 23, 30 (1991) ("Most individuals are concurrently members of multiple communities and, as a consequence, they regu-

forces at work are fairly clear. The greater opportunities to evade taxes in the small-business setting, coupled with competitive pressures to exploit those opportunities, lead to the widely held perception that most similarly situated small-business owners engage in tax evasion. The result is a noncompliance norm.<sup>167</sup> Fortunately, these influences are likely to be of a much more recent vintage and therefore more amenable to change.

Second, while it is true that the government cannot change a cultural norm just by legislating that it not exist, it can influence such a change indirectly. Phrased differently, it is much easier to alter any cultural norm by fomenting an evolution in the belief from within the group than by trying to impose the change from the outside. A prime means for the government to attempt to insert stronger tax compliance values into the small-business culture is by co-opting lawyers and other professional advisors as its agents of change.<sup>168</sup> Such advisors can stand-up for a taxpaying norm and, given their perceived status as experts, their views may have particular weight with the business people they advise.<sup>169</sup> This is not to say that advisors currently counsel against obeying the law, but due to zealous advocacy norms and the desire to further their client's desires, they may

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larly confront conflicting or competing ethical norms. Coherent communities having social contracts could include one's professional, family, religion, employer, nation, business generally, industry, colleagues, peers and so on.").

167. This norm may also be reinforced by shunning or shame within the sub-culture. For example, painters who provide their sub-contractors with tax information returns are often subject to informal censure within their community. Robert A. Kagan, *On the Visibility of Income Tax Law Violations*, in 2 TAXPAYER COMPLIANCE: SOCIAL SCIENCE PERSPECTIVES 76, 90 (Jeffrey A. Roth & John T. Scholz eds., 1989).

168. In previous articles this author has advocated for co-opting professional advisors as a vehicle for inserting tax compliance concerns into an insular business culture. See Richard Lavoie, *Deputizing the Gunslingers: Co-opting the Tax Bar into Dissuading Corporate Tax Shelters*, 21 VA. TAX REV. 43 (2001); Lavoie, *supra* note 99. See also Joshua Joseph, *Integrating Business Ethics & Compliance Programs: A Study of Ethics Officers in Leading Organizations*, 107 BUS. & SOC'Y REV. 309 (2002) (discussing the role and effect of ethics officers in large organizations); Tanina Rostain, *Sheltering Lawyers: The Organized Tax Bar and the Tax Shelter Industry*, 23 YALE J. ON REG. 77 (2006).

169. See, e.g., Roy D. Simon, *Legal Ethics Advisors and the Interests of Justice: Is an Ethics Advisor a Conscience or a Co-Conspirator?*, 70 FORDHAM L. REV. 1869 (2002) (discussing the weight that clients place on the advice of ethics advisors in the law firm context).

turn a blind eye toward aggressive applications of the law. For instance, advisors may explain to business owners the general rules regarding whether expenses are personal or business related, without bothering to scrutinize how the taxpayer actually applies that standard.<sup>170</sup>

Historically, tax practitioners have been considered to have competing duties to their clients and to help preserve the fairness of the tax system. This gate-keeping duty should mitigate their zealotry in advising taxpayers on prospective ac-

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170. The case of John Edwards, the 2004 Democratic Party vice-presidential nominee, is illustrative. In the course of the campaign it came to light that Edwards had engaged in a tax planning strategy during his time as a trial attorney specifically to avoid certain taxes. A lively debate then ensued in the editorial pages of *Tax Notes* magazine regarding the appropriateness of Edwards's actions and the advice he had been given. See Linda Carlisle, *S Corporations and Abusive Tax Shelters*, 104 TAX NOTES 870, Aug. 23, 2004; Tom Daley, *Edwards's S Corporation, Medicare Tax, and Fair Share*, 104 TAX NOTES 1577, Sept. 27, 2004; Tom Daley, *Edwards's S Corp: Can We Get The Numbers Right?*, 104 TAX NOTES 1310, Sept. 13, 2004; Kip Dellinger, *Edwards's S Corp. Can Be Abusive Even If It's Not a Tax Shelter*, 104 TAX NOTES 1092, Sept. 6, 2004; Kip Dellinger, *Edwards's S Corp.: The Revised Numbers Are Still Absurd*, 104 TAX NOTES 1456, Sept. 20, 2004; Kip Dellinger, *Edwards's S Corp.: The Beat Goes On*, 105 TAX NOTES 253, Oct. 11, 2004; Kenneth A. Gary, *Despite Media Reports, Sen. Edwards' S Corp. Not Abusive Tax Shelter*, 104 TAX NOTES 365, July 26, 2004; Michael Kulkosky, *What Should Edwards Do Now?*, 104 TAX NOTES 774, Aug. 16, 2004; Harry D. Shapiro, *Not an Abusive Tax Shelter? Think Again*, 104 TAX NOTES 669, Aug. 9, 2004. While the exact facts were subject to some dispute, a fair summary of the essential facts gleaned from this exchange is as follows: In the late 1990s Edwards placed his law practice into a subchapter S corporation based on advice that this structure could minimize his Medicare tax liability. Over a four-year period, he avoided approximately \$600,000 of taxes by formally paying himself only \$360,000 a year as compensation income despite the fact that his efforts directly created on average approximately \$6 million of net profit each year for his corporation. If he had not incorporated, the 2.9% Medicare tax would have applied to the full amount of such earnings. This structure is widely encouraged by advisors based on the accepted legal principles holding that Medicare taxes are only imposed on compensation, and not on returns from capital investments. The structure, however, while technically legal, presents serious opportunities for abuse by severely understating the true compensation element and overstating the capital element. Many conservative practitioners would counsel a client that in a context where services are the key component in generating the income, the reasonable compensation element should reflect between 70 and 90% of the total net profits. Mr. Edwards and his advisors reported the transaction based on treating only about 5% of his total profits as compensation. For the reasons discussed in the text accompanying this note, such an aggressive application of the law should be dissuaded by practitioners to prevent legal tax structuring from being perverted in operation into an abusive transaction.

tions.<sup>171</sup> Further, this duty requires advisors to be proactive in indicating to their clients the importance of maintaining accurate books and records and fulfilling their legal obligation to correctly report and pay their taxes. The Service can and should undertake actions aimed at strengthening this traditional gate-keeping function by publicly emphasizing its belief that this duty exists and encouraging the ethical bodies regulating attorneys and accountants to more explicitly incorporate this duty into their ethical codes.<sup>172</sup> Further, the Service should make this duty explicit in its own rules governing practice before the Service.

D. *Exerting Pressure from the Overarching Culture on the Aberrant Sub-Culture*

As discussed earlier, the small-business community represents an aberrant sub-culture in our society in terms of not having internalized the prevailing taxpaying ethos. Normally in this situation the aberrant sub-culture can be strongly influenced toward conformity with the broader societal norm through the use of shame and stigma emanating from members of the broader culture. In the tax realm, however, this is difficult due to the privacy generally accorded tax matters. Even if this restraint is relaxed by publishing information about taxpayers with large tax deficiencies, there is reason to believe that it might ultimately be counterproductive since it could cause the broader society to believe that cheating on one's taxes is common and thereby erode a pillar on which the society's taxpaying ethos is based. Consequently, directly utilizing shame may not be an available or advisable means for attacking non-compliance in the small-business community.

Still, an alternative means of utilizing the taxpaying ethos of the broader culture might be feasible. One of the contributing reasons for noncompliance in the small-business community is the ability to operate in the cash economy, thereby leaving the Service with no easy means of verifying the true income of such a business. The evidence is clear that evasion activity in-

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171. Lavoie, *supra* note 168, at 89-90.

172. *Id.*

creases as third-party information reporting decreases.<sup>173</sup> Third-party information reporting is effective because it creates a structural impediment to noncompliance by eliminating the informational asymmetries between the taxpayer and the Service.<sup>174</sup> Such information reporting requirements are also cost effective and efficient because the government can rely on large institutions to effectuate them.<sup>175</sup> The lack of such entities as central participants in the cash economy presents an impediment to adopting an information-reporting compliance strategy in the small-business context.<sup>176</sup>

To be effective in reducing the ability of small businesses to underreport their cash receipts, an information-reporting system would need to place the reporting burden on the consumers using those small businesses, largely individuals.<sup>177</sup> Obviously, this may be a politically daunting proposition.<sup>178</sup> In order to make such information-reporting more palatable, the system would have to be tailored to be as simple as possible for individuals to fulfill.<sup>179</sup> For instance, rather than require the typical duplicate reporting (i.e., sending a copy of the information to

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173. TAX GAP COMPLIANCE REPORT, *supra* note 98, at 12-15 Fig. 6 (“[R]eporting compliance is strongest in the presence of substantial information reporting and withholding.”).

174. Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play In Tax Compliance*, 60 STAN. L. REV. 695, 699 (2007); Pirooska E. Soos, *Self-Employed Evasion and Tax Withholding: A Comparative Study and Analysis of the Issues*, 24 U.C. DAVIS L. REV. 107, 121-22 (1990).

175. Edward K. Cheng, *Structural Laws and the Puzzle of Regulating Behavior*, 100 NW. U. L. REV. 655, 666 (2006) (“[A] chief advantage of structural laws is that they regulate centralized institutions rather than individuals. Institutions, usually in the form of corporations, are easier to regulate because they are smaller in number, have known locations, and have significant economic incentives to comply with government mandates. Individuals, in contrast, are dispersed and difficult to track.”).

176. *Id.* at 679.

177. Joseph Bankman, *Eight Truths about Collecting Taxes from the Cash Economy*, 117 TAX NOTES 506, Oct. 29, 2007.

178. Cheng, *supra* note 175 (asserting that political resistance explains why structural constraints are not employed in more areas of the law); Joann M. Weiner, *Shulman Promotes Transparency, Information Reporting*, TAX NOTES TODAY, June 11, 2008, available at 2008 TNT 114-5 (LEXIS) (noting the IRS Commissioner’s stated desire to push for expanded third party information reporting despite expected political resistance).

179. While these reporting requirements would also apply to businesses obtaining goods and services from small businesses, the discussion here focuses on individuals since individuals are least suited to the information reporting task.

both the Service and the taxpayer being reported on), individuals would only be required to report to the Service. Similarly, rather than do multiple filings for each taxpayer being reported on, a single form could be created to report multiple transactions and be filed as an attachment to the individual's personal tax return. Finally, the reported information would need to be easy for the individual to obtain and report. In this regard, the information-reporting requirement could be as simple as a list of the names and identifying numbers<sup>180</sup> of all persons or businesses paid more than a threshold dollar amount during the last calendar year.<sup>181</sup> The requirement would also specifically exclude a number of common transactions to further reduce the reporting burden. For example, payments made to utility companies, financial institutions, religious institutions, and government offices would be excluded.<sup>182</sup> For most individuals, this list could be easily compiled by flipping through their checkbook entries for the preceding year to see which recipients received payments exceeding the aggregate threshold.<sup>183</sup> Of course, any large payments in cash would need to be considered as well, but sufficiently large payments in physical currency should be sufficiently unusual that they would be easier for the individual to recall or provide an impetus to make a specific notation about it at the time of payment.

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180. Presumably a correlative requirement would need to be created requiring small businesses to provide customers with their tax identification numbers as a standard practice. This creates some privacy and potential identity theft issues for sole proprietors, whose social security numbers double as their tax identification numbers. This problem could, however, be addressed by requiring the Service to issue special business identification numbers to sole proprietors reporting business income on Schedule C of the individual returns.

181. Determining the exact dollar threshold to be used would require input from the Service regarding the level of payments typically omitted in the small-business context. An aggregate yearly threshold of say \$2,000 would, however, likely be sufficient to capture a significant amount of potentially undeclared income while being sufficiently large for an individual to recall and report. *See generally* Bankman, *supra* note 177 (discussing some possible structures and implications for such a system).

182. Payments made to family members or other individuals intended as gifts would also be excluded.

183. To make the reporting more useful for the Service, a second threshold might be added requiring the individual to note the approximate dollar amount paid if a second threshold is exceeded, say \$10,000.



The downside of using such a simplified information system is that the information provided to the Service is significantly reduced. Rather than having an exact amount of income to attribute to a small business, the information reporting will just give the Service a rough idea of the magnitude of the income a business should be reporting. Further, there will certainly be cash transactions that will not be reported at all, either because the reporting individual honestly forgot the transaction or miscalculated the threshold or because the payment was made by an individual whose income level did not require the filing of a tax return.<sup>184</sup> Consequently, the information reporting may prove to be of most use in conducting a small-business audit, rather than as a tool for flagging audit targets.

Nevertheless, merely knowing that information is being provided to the Service may be a significant inducement to compliance for small businesses whose prior noncompliant behavior was based on the near impossibility of the Service detecting cash omissions. Further, even if the Service gets no direct enforcement benefit from such information, it could yield compliance benefits based on forcing small-business owners to confront the prevailing taxpaying ethos of the broader society. Providing their tax identification number to customers and knowing that the customers will notify the Service increases the chances that the small-business taxpayer may experience more twinges of guilt if they then consider omitting that income from their tax return. Consequently, even though enacting an information-reporting system applicable to individuals may be difficult politically and may not even yield direct detection benefits,

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184. There is also the possibility that items may not be reported due to collusion between the customer and the small business. See Lederman, *supra* note 174 (generally discussing risk that collusion can defeat structural statutory schemes). A small business would, however, need to affirmatively split its tax avoidance benefit with the consumer to induce him to cooperate in the tax evasion by not reporting because most individual customers will obtain no tax benefit or detriment from the reporting. While this might occur occasionally, it seems unlikely to be the norm. A small business pursuing this strategy would need to raise this offer with every client they dealt with and would greatly increase the chances that their pattern of evasion would come to the attention of the Service. Further, since most customers can be expected to follow the general society's taxpaying ethos, a significant number of them would likely be unwilling to aid the willful tax evasion of a small business in any event.

it is worth considering as another means of inserting the prevailing compliance norm into the small-business sub-culture.

### E. *Harnessing Competitive Forces*

While creating a formal information-reporting system aimed at dissuading underreporting of cash transactions may be politically unpalatable, using whistleblowers would not be. Indeed, the Service has always been willing to accept unsolicited leads on noncompliant taxpayers<sup>185</sup> and has a longstanding tradition of rewarding tipsters out of the revenues collected as a result of a tip.<sup>186</sup> In 2006, Congress expanded the Service's authority in this regard by substantially increasing the potential reward and making the rewards for fruitful information mandatory if certain eligibility requirements are met.<sup>187</sup> Consequently, individuals who suspect that a small business is cheating on its taxes, perhaps because the proprietor stressed different pricing if cash was paid, could turn that information in to the Service.

The likelihood of such voluntary tips may not be great. Individuals often are unaware of the Service's whistleblower programs. Even if they are cognizant of these programs, they may be reluctant to report mere suspicions if they lack any concrete proof of wrongdoing.<sup>188</sup> Further, they may have ongoing dealings with the business which could be soured if it came to light

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185. The Service even has a specific form for this purpose, Form 3949-A, which can be used by anyone to anonymously report suspected tax evasion.

186. This authority has existed since 1867 and is currently codified in section 7623(a) of the Code and Treas. Reg. 301.7623-1. See IRS, History of the Whistleblower/Informant Program, <http://www.irs.gov/compliance/article/0,,id=181294,00.html> (last visited Oct. 23, 2009). Under the current program the Service has discretion whether to reward any tip leading to a recovery of additional taxes and may award any amount up to the lesser of \$10 million and 15% of the tax recovered.

187. Tax Relief and Health Care Act of 2006, § 406(a), Pub. L. No. 109-432, 120 Stat. 2922 (codified at I.R.C. § 7623(b)). Section 7623(b) creates a mandatory reward of between 15 and 30% of the recovered amounts if the tip relates to a disputed amount that exceeds \$2 million and a few other qualifications are met. If the case deals with an individual, his or her annual gross income must be more than \$200,000. If reported misconduct is not eligible for a mandatory award, then it may still be eligible for a traditional discretionary reward under section 7623(a).

188. In this regard, the relevant Service guidelines require "specific and credible information concerning" the alleged tax owed. Notice 2008-4, 2008-2 I.R.B. 253, Section 3.03(7), (7)(vi), (7)(vii).

that the individual had put the Service on the proprietor's trail. While customers of a small business may be reluctant to tattle on the businesses they use, competitors of such businesses would, however, have no such compunction.

If the Service were to increase awareness of its whistleblower programs within the small-business community it would have several beneficial impacts. First, it would increase the perceived risk of detection for these taxpayers. Second, it would alert small businesses that they could attempt to level the playing field going forward by turning in competitors who gained competitive advantages by pricing their products and services with an implicit discount for their ill-gotten tax savings. Additionally, if a reward were paid by the Service, then the tipping business would be compensated for some of the potential earnings it lost due to the competitor's past inappropriate competitive advantage. Of course, under the current programs, the tipping business would still need some proof of its competitor's tax evasion. A competitive business might, however, decide that undertaking some independent investigation might be economically justified depending on the benefits that would accrue from leveling the playing field and the likelihood of receiving a reward from the Service.

Obtaining concrete evidence of tax evasion would still be difficult because information regarding a competitor's tax reporting is not a matter of public record. If, as suggested earlier,<sup>189</sup> Congress changes the privacy rules to require taxpayers to release basic information regarding their aggregate income and deductions, then the potential for competitor whistleblowing is greatly increased. A small business is likely to have an understanding of the nature and size of its competitor's operations and may have direct knowledge of customers lost to the competitor. Using this knowledge and their own income information as a baseline, a small business may well be able to analyze whether a competitor's publicly disclosed tax information makes sense.<sup>190</sup> Effectively, the Service could co-opt small busi-

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189. See *supra* text accompanying notes 130-35.

190. It should be noted that the Service typically does not pay rewards for tips based on publicly available information. Consequently, this policy would need to be amended to enable small businesses to become eligible for rewards for tips based on an analysis of the publicly reported information.

nesses to vet the public reporting of their competitors and help the Service identify noncompliant small businesses more quickly and efficiently.<sup>191</sup> Further, the mere knowledge that small businesses have economic incentives to closely scrutinize the reporting of their competitors should act as a constraint on small-business noncompliance. Based on the foregoing, the Service should place a greater emphasis on publicizing its whistleblower programs in the small-business context and should seriously consider revising and extending those programs to increase the benefits from any new laws requiring public disclosure of tax return information.

## V. Conclusion

This Article has demonstrated that a broad array of factors beyond the traditional deterrence approach is necessary to explain the puzzle of tax compliance. The high level of compliance seen in most Western democracies is attributable to the existence of a taxpaying ethos within those societies. While the empirical research regarding the influences giving rise to such a taxpaying ethos is still in its infancy, the central concepts of trust in government and trust in other taxpayers clearly emerge as major forces. Based on this understanding of the factors that shape a taxpaying ethos, it is possible to posit steps that governments can take to cultivate a taxpaying ethos or strengthen an existing one. Lastly, the Article argues that using this approach the Service could significantly reduce the level of noncompliance in the United States by focusing on measures aimed at flipping the noncompliance norm in segments of society that have been reticent to embrace the country's generally strong taxpaying ethos.

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191. Indeed, the impact may go beyond small businesses vetting the filings of their competitors and spawn law firms, accountants and entrepreneurs specializing in doing such vetting. This has occurred even under the current whistleblower programs with at least one law firm affirmatively advertising on the Internet as a specialist in bringing whistleblower cases to the attention of the Service. IRS Tax Whistleblower Attorneys, Ferraro Law Firm, <http://www.tax-whistleblower.com> (last visited Oct. 23, 2009). Indeed, on June 13, 2008, this firm filed a \$4.4 billion whistleblower claim with the Service, the largest such claim ever submitted. Press Release, The Ferraro Law Firm, Friday the 13th Poses \$4.4 Billion of Bad Luck for Fortune 500 Company (June 13, 2008), *available at* [http://taxprof.typepad.com/tax-prof\\_blog/2008/06/page/3/](http://taxprof.typepad.com/tax-prof_blog/2008/06/page/3/).

