

A New Era of Tax Enforcement: From 'Big Stick' to Responsive Regulation

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The operation of the Federal Government is heavily dependent on income taxes; in 2005, about 43 percent of Federal tax revenue in the United States came from individual income taxes and another 13 percent from corporate income taxes.¹ This amounts to \$927 billion and \$278 billion, respectively² and, compared with Fiscal Year 2004, an increase of 14.6 percent in individual income taxes and 46.9 percent in corporate income taxes.³ Every year, however, the Government collects billions of dollars less in tax money than it believes is owed. This difference between taxes owed and taxes collected--otherwise known as the "tax gap"⁴--is substantial and has nearly tripled over the past 2 decades.⁵ Estimates released in February 2006 indicate that the U.S. tax gap for the 2001 tax year stands at approximately \$345 billion dollars,⁶ corresponding to a noncompliance rate of 16.3 percent of taxes owed.⁷ Both of these numbers fall at the high end of the range of estimates provided by the IRS in the spring of 2005.⁸ Through enforcement activities and collection of other late payments, the IRS intends to eventually close some of this gap, still leaving an enormous net deficit of approximately \$290 billion for the 2001 tax year.⁹

Noncompliance with the tax law may occur in various ways, including taxpayers' failure to accurately report their tax bases, to correctly assess tax liability, to timely file tax returns, or to promptly pay taxes due.¹⁰ However, more than 80 percent of the tax gap comes from underreporting of taxes--mostly of income tax¹¹--meaning that many taxpayers either provide a partial report of their tax bases or completely fail to acknowledge an existing liability. Noncompliance may not be exclusively intentional and can stem from a wide range of causes, including "lack of knowledge, confusion, [or] poor record keeping."¹² These problems may arise because "the taxpayer is ignorant, lazy, careless...following common practices in occupational groups or workplaces, heeding incorrect advice from the IRS..., taking the advice of a tax professional who recommended strategies that shade into illegality, or many other reasons."¹³

Actions that challenge the integrity of the tax system can be categorized into three broad groups. On either end of the spectrum are tax evasion and

tax avoidance, while a third group, aggressive tax planning, is somewhere in between. Despite the fact that evasion and avoidance have much in common in the economic realm, from a legal standpoint, evasion differs significantly from avoidance in that evasion is unlawful and hence subject to legal punishment. Indeed, tax evasion is commonly defined as a deliberate failure to comply with one's tax obligation in a manner which *clearly* violates the law.¹⁴ This could include, for example, failure to submit tax returns or to report income that is received in cash. In comparison, tax avoidance (also known as "tax reduction") occurs when the taxpayer intentionally reduces her tax liability in a way that may be unintended by the legislator but is *permissible* by law.¹⁵ Avoidance may be accomplished by constructing business transactions such that tax liability is minimized, often through exhausting favorable tax treatments, including any of the deductions or credits available in the Tax Code.¹⁶ The third form of tax noncompliance is a specific--more extreme--type of tax avoidance commonly referred to as "aggressive tax planning" (sometimes known as "abusive tax shelters"). Taxpayers in this group seek to exploit deficiencies or uncertainty in the law in order to comply (only) with the letter of the law while ultimately undermining the policy intent or rationale behind it.¹⁷

Maintaining the integrity of the tax system is a difficult task in all societies.¹⁸ Tax noncompliance or, at times, creative compliance, furthers a climate of disrespect, antagonism, and selfishness in the relationship among citizens and between them and the Government.¹⁹ Moreover, when taxes are compromised, the tax system becomes a deficient means for raising money to pursue and implement Government goals, and actual tax collection fails to reflect the statutorily intended taxation plan.²⁰ This creates disturbing results such as upsetting the distribution of tax burdens and, more generally, wealth in society.²¹ For instance, when wealthy citizens have better opportunities and means to reduce their tax liabilities compared with other less well-off citizens, the taxes collected are likely to result in a more regressive and less equitable system than the legislative intention.²² Abusive tax practices also jeopardize horizontal equity when there exists an unequal distribution of opportunity to reduce or eliminate tax liability.²³ Furthermore, in a country with fixed revenue requirements, reducing the tax liability for any given sector of taxpayers, in effect, means that higher and more distortionary taxes are levied on others.²⁴ All of this, in turn, produces inefficiencies as market competition is affected by the unequal distribution of the tax burden and by economic practices motivated by tax abuse,²⁵ creating a deadweight loss to society.²⁶

Despite the benefits entailed in improving compliance, the complexity of the Tax Code and the magnitude and persistent levels of noncompliance make it so that no tax system can achieve perfect compliance.²⁷ Still, due to the size of the tax gap, even a small or moderate reduction in existing

noncompliance could yield substantial returns and improve the Government's ability to pursue its goals. According to a 2004 Government Accountability Office report, each 1 percent reduction in the net tax gap in the United States would likely yield more than \$2.5 billion annually.²⁸ Thus, a 10- to 20-percent reduction of the net tax gap could translate into \$25 billion to \$50 billion or more in additional revenue annually.²⁹

In recent years, the IRS has taken a number of steps to bolster enforcement and ease the tax gap. The IRS budget request for Fiscal Year 2005 was \$10.674 billion, \$490 million more than the amount proposed in Fiscal Year 2004.³⁰ Three hundred million dollars of this increase were allocated for enforcement.³¹ The enforcement budget was used to raise the audits of high-income taxpayers who are earning \$100,000 or more to 221,000 reviews in Fiscal Year 2005, the highest number of reviews in the past 10 years.³² Similarly, the number of audits of all taxpayers increased to 1.2 million in 2004, a 20-percent increase from the year before.³³ As a result of these steps and others, the IRS reported an increase in its enforcement revenue of nearly 40 percent from a total of \$33.8 billion in 2001 to \$47.3 billion in 2005.³⁴ Unfortunately, despite these recent increases in enforcement and revenue, the difference between taxes owed and taxes collected remains considerable, begging the question of whether there is something else that can be done to alleviate the problem of tax noncompliance.

This paper suggests that expansion of the traditional tax compliance analysis to include responsive elements of regulation, as illustrated in the Australian approach to tax enforcement, will lead to a more credible, effective, and forward-looking model of tax compliance and enforcement than available under alternative models. Given that responsive regulation was first introduced in the Australian tax administration during the late 1990s and has yet to produce an appreciable amount of verifiable information, compliance improvement data on this approach to tax are currently limited. This paper therefore focuses on fleshing out the underlying principles and rationales of the Australian approach to tax enforcement. In a few years, the Australian model can be evaluated against more comprehensive data and empirical work. In the meantime, interest of countries such as the United Kingdom and Canada in the Australian model and the implementation of this model in New Zealand may indicate that the responsive approach to tax enforcement is more than a passing phase.

The first part of this paper discusses the main reasons tax compliance is a challenge for tax administrations and the manner in which economic analysis can offer important insights into and methodological guidance for understanding noncompliance and improving compliance. The second part reviews the origins of the economic analysis of compliance, explains how the economic model was introduced into the area of tax enforcement, and

explores more recent developments in the economic model. The third part discusses key advantages and disadvantages of the economic approach to tax compliance, concluding that the economic model is persuasive in many respects yet flawed in others. The fourth part introduces the Australian approach to tax enforcement, explaining that this approach draws heavily on the economics of crime and compliance, yet it moves beyond the economic realm to rely on other theories and, as a result, has the potential to capture the strengths of the economic model while also addressing some of its drawbacks. The fifth part summarizes and concludes the paper, suggesting that the Australian approach to tax compliance may mark the beginning of a new era of tax enforcement. The main focus of this paper is personal income tax compliance although much of the discussion can also be applied to other areas of tax compliance. Regrettably, there are many important issues that fall outside the scope of this paper. Most notably, this paper does not examine the literature on the underground economy, or on the difficulties with collecting taxes internationally, nor does it consider the relative advantages and/or disadvantages of sales taxes or Value Added Tax (VAT) compared with income taxation in terms of their ease of enforcement. These issues, although important, are left for future inquiries.

The Problem and Modeling of Tax Compliance

The difficulties of tax enforcement emerge, to a great extent, because the variables that define the tax base are usually not observable.³⁵ That is, without detailed information about the taxpayer's various financial transactions and her overall financial (and other tax-related) standing, no one but the taxpayer can know her true tax liability and, therefore, whether she is truthful and accurate in her report to the tax authorities. To a certain degree, verifying information may be obtained by means of costly audits or third-party reporting, such as by banks and employers.³⁶ Assuming that this information can be acquired in a timely and cost-efficient manner and is found to be accurate and coherent, the tax base becomes verifiable.³⁷ In other cases, however, as when the taxpayer is involved in transactions that are beyond the reach of the tax authority and official statistics, including when income is received by way of cash transactions, the tax base is almost impossible to verify.³⁸

The taxpayer is able to use the unobservable nature of the tax base to her advantage or, in other cases, to make innocent mistakes by reporting a partial or otherwise incorrect figure on her tax return in a manner that is difficult to detect. At times, it can also be difficult for the tax administration to clearly

identify which taxpayer is most likely to be noncompliant. Some of the key influences for whether a taxpayer will comply, such as the perceived probability of detection and opportunities for evasion, can be rather tricky to capture and to compute. All these shortcomings make it extremely complicated to not only detect or correct noncompliant behavior but also to study and better understand its possible causes and facilitators. Amidst these difficulties, economic analysis can intervene and offer methodological guidance.

Over the past three decades, economic analysis of tax compliance has played an important role in elucidating the issue of compliance and, specifically, pinpointing those factors involved in the (lack of) compliance of taxpayers. As compliance issues are examined, analysts simplify the many complexities involved in order to produce a coherent framework that draws attention to the essential questions.³⁹ Modeling tax compliance further facilitates an important process in policymaking: examining and comparing the possible consequences of establishing alternative enforcement strategies.⁴⁰ This, in turn, allows policymakers to deliberate on and offer various policy alternatives to pursue.

Although valuable information may become available through economic analysis, economic models provide, at best, “a tentative guidance in well-defined circumstances.”⁴¹ Models simplify a much more complex reality, making them, almost by definition, unrealistic and, therefore, subject to criticism.⁴² To a certain extent, improvements in data and in methodology may help bring models closer to real-life scenarios. All models, however, have their shortcomings, and these must be recognized when models are implemented to generate policy recommendations. It is therefore not surprising that researchers generally agree that no one model can offer a complete picture of the tax compliance phenomenon but rather that each may illuminate a certain, or a few, aspects of the problem.⁴³ With these limitations in mind, the next part of this paper will introduce the basic elements of the economic model of compliance with the law.

Originating in the utilitarian paradigm, the economic model of compliance dates back to Jeremy Bentham and Cesare Beccaria and remains very influential to this day. This model suggests that criminal behavior is the result of a rational calculation of the costs and benefits of compliant versus noncompliant behavior, implying that compliance can be improved by policymakers tweaking these costs and benefits such that compliance becomes the beneficial or rational behavior to pursue. After introducing the economic model, the paper will move to explore its application to tax compliance and to discuss some of the later developments and challenges in that area.

Economic Analysis and Tax Enforcement

Becker's Approach to Criminal Law Enforcement and the Deterrence Hypothesis

“The profit of the crime is the force which urges man to delinquency: the pain of the punishment is the force employed to restrain him from it. If the first of these forces be the greater, the crime will be committed; if the second, the crime will not be committed.”⁴⁴

The principal model for analyzing compliance with the law is drawn from the classic work in utilitarianism by Jeremy Bentham and Cesare Beccaria who laid the foundation for a framework of economic analysis that is relatively simple and that generally fits with human and market behavior in useful ways.⁴⁵ The basic premise of the utilitarian framework is that people behave rationally in order to maximize their expected utility.⁴⁶ In the context of compliance, the assumption is that, facing a feasible set of possible courses of action, some of which are legal while others are not, individuals choose whether to commit a crime or not based on whether the one option or the other has the better prospect of increasing their well-being.⁴⁷ The economic approach to compliance, although influential at the time it was first developed, received very little attention from later theorists and policymakers until it reappeared and was modernized in Gary Becker's pathbreaking article entitled *Crime and Punishment*.⁴⁸

In the decades prior to the publication of Becker's paper on crime and punishment, discussions of crime were dominated by the opinion that criminal behavior is caused by mental illness and social oppression and that criminals are no more than victims of their life circumstances.⁴⁹ According to Becker, these attitudes began to have a major influence on social policy, as laws were enacted to expand the rights of those who were lawbreakers.⁵⁰ Becker not only rejected the presumption that criminals were helpless victims of their situations but also took issue with the associated policy implications, which, according to him, ultimately “reduced the apprehension and conviction of criminals and provided less protection to the law-abiding population.”⁵¹ Instead of adhering to theories of mental illness and social oppression, Becker's analysis explored the possibility that criminal behavior is in fact rational and that it should be handled as such by policymakers.⁵²

In a recent article, Becker explains that he first began to think about crime in the late 1960s after driving to Columbia University for an oral examination of a student in economic theory.⁵³ Becker was late and had to decide quickly whether to take the extra time to put his car in a parking lot or risk getting a ticket for parking illegally on the street.⁵⁴ Confronted with this dilemma,

Becker contemplated the faster solution of parking on the street and assessed the likelihood and severity of getting a ticket for violating the city parking regulations.⁵⁵ Based on this assessment, Becker reached the conclusion that it was worth it to take the risk and park on the street.⁵⁶ As he was walking away from his car to the examination room, it occurred to Becker that “the city authority had probably gone through a similar analysis”⁵⁷ and that “the frequency of their inspection of parked vehicles and the size of the penalty imposed on violators should depend on their estimates of the type of [rational] calculations potential violators like me would work.”⁵⁸

Becker clarifies: “[T]heories about the determinants of the number of offenses differ greatly, from emphasis on skull types and biological inheritance to family upbringing and disenchantment with society. *Practically all the diverse theories agree, however, that when other variables are held constant, an increase in a person’s probability of conviction or punishment if convicted would generally decrease, perhaps substantially, perhaps negligibly, the number of offences he commits.*”⁵⁹ Broadly stated, according to Becker, what ultimately governs the decision of individuals whether to commit an offense or not is their reasoned calculations of the costs and benefits they may face by committing a crime as opposed to obeying the law. Since the final consequences of criminal behavior are generally uncertain, Becker employs the common assumption that people act as if they are maximizing their *expected* utility and that utility is a positive function of income. In Becker’s words: “[A] person commits an offense if the expected utility to him exceeds the utility he could get by using his time and other resources at other activities. Some persons become ‘criminals,’ therefore, not because their basic motivations differ from that of other persons, but because their benefits and costs [resulting from compliance and noncompliance with the law] differ.”⁶⁰

Focusing on the costs and benefits entailed in human behavior, the “deterrence hypothesis” emerges suggesting that, if individuals are rational decisionmakers whose aim is to maximize their expected utility, then the way for the authorities to ensure compliance with the law is to deter individuals from acts of noncompliance by making the expected utility of noncompliance lower (i.e., less beneficial) compared with the expected utility of compliance.⁶¹ In particular, Becker advances the argument that public resources ought to be allocated to policy measures of two kinds: one aimed at detecting noncompliers (i.e., increasing the probability of enforcement) and the other designed to ensure devastating consequences for offenders (i.e., inflicting legal sanctions). He argues that finding the right (optimal) balance between the two measures can effectively deter offenders and make compliance the rational choice for individuals.⁶²

The Allingham-Sandmo Model of Tax Evasion

Compared with the general economic theory of crime, its tax noncompliance counterpart is a relatively recent development, dating back to a little over 30 years ago and, particularly, to the much cited article, *Income Tax Evasion: A Theoretical Analysis*, by Michael Allingham and Agnar Sandmo.⁶³ Allingham and Sandmo extended Gary Becker's work on the economics of crime to taxation using modern risk theory, and their 1972 publication serves as a cornerstone, leading to a large number of scholarly contributions either commenting or expanding on their insightful essay.⁶⁴

Like previous research in crime, Allingham and Sandmo build their analysis around the individual, this time the taxpayer, who becomes the potential criminal.⁶⁵ Their model explores the decision to evade at the moment when the taxpayer is filling in her tax return. The issue of compliance is presented as a portfolio allocation problem in which the taxpayer must decide what portion of her income to allocate to various activities, some of which are legal (i.e., income declared on the tax return), while others are illegal (i.e., income not reported).⁶⁶ Specifically, the model, which I will call the A-S model or framework, examines the way the decision whether to evade or comply relates to the manner in which the taxpayer perceives her economic opportunities and well-being to be affected by enforcement measures (i.e., audit probability and the severity of sanctions) as well as by the Tax Code (i.e., the tax rate).

Allingham and Sandmo begin their analysis by considering a basic model in which the authorities decide on the Tax Code and the enforcement mechanisms, while each taxpayer acts as if her actions do not influence these decisions.⁶⁷ The taxpayer is taken to be familiar with the tax legislation, the probability of an audit, the taxes she is liable for, and the penalty for failing to pay that amount in the event that she is caught and convicted.⁶⁸ Other important simplifications of the analysis include the assumption that the taxpayer is risk-averse,⁶⁹ that the tax system is income-based, and that the taxpayer's actual income is exogenously given and is known to the taxpayer but not to the Government's tax collector.⁷⁰ Tax is assumed to be levied at a proportional rate on declared income which represents the taxpayer's decision variable.⁷¹ With some constant probability, the taxpayer is subjected to investigation by the tax authority that may then reveal the actual amount of her income.⁷² If this happens, the taxpayer would have to pay tax on the undeclared income at a penalty rate which is higher than the tax rate.⁷³ Finally, the decision whether to evade or comply is analyzed as if it is the only dilemma with which the taxpayer is concerned,⁷⁴ and the analysis ignores possible interrelationships between this decision and other economic choices the taxpayer may face including, for example, decisions concerning labor

supply or tax avoidance (rather than evasion).⁷⁵ The basic A-S analysis also assumes that time is composed of a single period⁷⁶ and that only one form of evasion is available.⁷⁷

Patterned after the utilitarian paradigm, the taxpayer is assumed to follow expected utility theory and to make compliance decisions based solely on the consequences for her net income.⁷⁸ The A-S framework accordingly implies that the taxpayer is tempted to seize the opportunity of cheating on her taxes whenever it is worth the chance of being caught and bearing the associated penalties.⁷⁹ The taxpayer is therefore confronted by a classic dilemma of choice under uncertainty or what has also been described as a “lottery calculation” or a “gamble.”⁸⁰ This lottery calculation, or gamble, requires the rational, utility-maximizing taxpayer to ask herself whether given what she knows about her economic situation, her tax obligation, and the enforcement mechanisms, the likely rewards gained from evasion are worth bearing the risk of being caught and penalized.⁸¹ The taxpayer has a choice between two main strategies: She may declare her income in full or she may declare less than that amount, and, in that case, the taxpayer must decide what portion of her income to declare and what portion to conceal.⁸² If the taxpayer chooses to conceal some (or all) of her income, her payoff will depend not only on her decision regarding whether to evade (and to what extent) but also on whether she is investigated by the tax authorities and becomes subject to some (or all) of the associated penalties.⁸³ To decide which strategy to choose, the taxpayer must compare the expected utility gained from evasion--the taxes she will not pay--with the expected cost of the penalty--the nominal penalty discounted by the probability that this penalty will be imposed.⁸⁴ If caught, the taxpayer will need to pay not only the penalty for evasion but also the tax shortfall. When the expected value of evasion is positive, the taxpayer will evade, and, when it is negative, she will comply.⁸⁵

An illustration may be helpful. Consider an example given by John Carroll where a taxpayer contemplates an illegal deduction that reduces the tax she must pay by \$100 and where the probability of an audit is estimated to be 5 percent.⁸⁶ If audited, the taxpayer would have to pay the \$100 plus a penalty of 50 percent of the income owed (\$50).⁸⁷ To simplify the example, Carroll ignores interest rates and treats the taxpayer as risk-neutral.⁸⁸ According to this scenario, the analysis would involve two main alternatives: (1) not taking the deduction, in which case the result is some initial amount of income, W , and (2) taking the deduction. There are two possible outcomes to taking the deduction: (1) W plus \$100 if the taxpayer is not audited, and (2) W minus \$50 if she is audited.⁸⁹ The expected utility of being honest is $U(W)$, and the expected utility of cheating is $.95[U(W+100)]+.05[U(W-50)]$.⁹⁰ As a point of reference for a risk-neutral taxpayer, Carroll conveniently assumes that $U(W)=0$ and that $U(W+X)=X$, so that the expected utility of being honest

is 0 compared to 92.5 for cheating $(.95*100 - .05*50)$.⁹¹ With the expected utility for cheating significantly higher for noncompliance compared with compliance, Carroll concludes that the taxpayer in this example will cheat.⁹²

Examining the relationship among (1) actual income, (2) the tax rate, (3) the penalty rate, (4) the probability of detection, and (5) tax evasion, the analysis of Allingham and Sandmo leads to results that partly contradict available compliance data in that it suggests that there is no clear relationship among actual income, the tax rate, and evasion.⁹³ However, the results for the *penalty rate* for evasion and the *probability of detection* are unambiguous, and the A-S model confirms Becker's analysis concluding that a higher penalty rate and/or probability of detection tends to discourage tax evasion.⁹⁴ Allingham and Sandmo clarify that, while the expected tax yield would fall with a decrease in the probability of detection, the loss of tax revenue could be compensated by an increase in penalty rate,⁹⁵ such that the two enforcement alternatives are substitutes for one another.⁹⁶

The Economic Analysis of Tax Evasion

Beyond the Allingham-Sandmo Model

The economic approach to tax compliance, as it appears in the A-S framework, reduces enforcement to two key considerations: the penalty rate and the probability of detection. In other words, the A-S analysis suggests that, in order to control evasion, either detection has to be stepped up and/or penalties need to be increased. While this conclusion generally provides an intuitively appealing and straightforward description of the tax evasion phenomena, real-world tax compliance and enforcement are much more complex than this analysis suggests.⁹⁷ Efforts to add the necessary depth and realism to the study of tax compliance have resulted in the A-S framework being the subject of considerable research over the past three decades. This research has included attempts to endogenize various critical parameters involved in compliance and to incorporate additional and more diverse variables relating to taxpaying behavior.

Early attempts to add credibility to the A-S analysis are evident already in the original 1972 article where Allingham and Sandmo briefly analyze a dynamic case of tax evasion incorporating an element of time.⁹⁸ These attempts continued with later works of scholars such as Michael Landsberger, Isaac Melijson, Josef Greenberg, Eduardo Engel, and James Hines.⁹⁹ Advocating a departure from the static framework in which the taxpayer makes only one tax report independent from past or future tax filings, these scholars consider a more general and realistic framework whereby the taxpayer makes a sequence

of tax filings that become interdependent.¹⁰⁰ This modification of the basic A-S model of evasion was necessary, as recognized by Allingham and Sandmo, because, in real life, enforcement decisions are not made independently of one another. For instance, once a taxpayer is discovered to have cheated, the authorities are likely to investigate her honesty for other periods.¹⁰¹ Similarly, because income tax reporting is normally an annual event, it is possible that the taxpayer makes a decision regarding her present and future reports based on what she learns from her past reports and audit experience.¹⁰²

Another important development in the A-S framework involves efforts to further endogenize the probability of detection. Allingham and Sandmo originally assumed the probability of detection to be exogenous to the taxpayer.¹⁰³ However, as suggested above, actual audit probability is not random or fixed and generally depends on the particular characteristics of taxpayers. To give one obvious example, in the United States, the IRS developed formulas for selecting returns to audit based on their likelihood to contain suspicious items, and the tax administration also often focuses on the potential to maximize enforcement revenue through audit adjustments.¹⁰⁴ For these reasons, audit rates vary across taxpayers. Returns of high-income individuals are generally examined more frequently compared to those with lower incomes, and larger corporations are examined more often than smaller ones.¹⁰⁵ Based on the relationship evident in real-world enforcement between taxpayers' income levels and their audit probability, commentators on the A-S analysis suggested modifying the analysis so that the probability of audit would not be fixed but rather become a function of reported income and evasion.¹⁰⁶ The resulting analysis relaxes the unrealistic assumption that taxpayers and the tax administration ignore each other's actions and treats the interaction between them more as a strategic game--where each party makes the best response to the other's strategy in light of available information--rather than a static gamble.¹⁰⁷

Another variation of the A-S model worth noting incorporates labor-supply decisions as endogenous to the taxpayer's gross income.¹⁰⁸ This type of model recognizes that "it is unreasonable to believe that the taxpayer has not thought about the possibility of evading taxes before he sits down to fill out his income tax return"¹⁰⁹ and that "more probably, he has thought about this [matter] before making decisions about the allocation of his work and leisure hours or about the composition of his investment portfolio."¹¹⁰ Accordingly, models that incorporate labor-supply decisions look beyond the fairly simple A-S framework which offers only two behavioral responses on the part of the taxpayer--evasion or compliance--and consider that the taxpayer may respond to taxation in other ways. These responses generally include changing work effort, altering decisions about consumption and savings, and choosing legal (compared to illegal) tax reduction strategies.¹¹¹ Models in this group usually

focus on how variables such as the tax and wage rates affect the taxpayer's responses and the manner in which any one response affect the others.¹¹² Unfortunately, although this type of model adds realism to the analysis of tax compliance, incorporating labor supply considerations make uncertain the effect of changing the enforcement variables, thus eliminating the relatively simple computations of the original A-S framework such that "depending on the taxpayer's marginal disutility from labor and her risk attitudes, all predictions become possible."¹¹³

In an effort to obtain a more thorough understanding of tax compliance, researchers continue to develop more credible models of tax compliance that, among other things, introduce complex forms of evasion; include detailed tax penalty structures; account for imperfect information and randomness in the audit rate and in taxpayers' true tax liabilities; examine the role tax practitioners play in compliance; extend the number of items on which taxpayers report; and also address the possible impact of tax morale, justice, and fairness considerations on tax compliance. Although the traditional economic analysis of tax compliance has been expanded to include these and other more detailed and realistic explanatory variables, its focus on only two key enforcement tools, punishment and detection, remains unsatisfactory and does not reflect real-world enforcement practices or needs. Furthermore, the underlying assumption of the economics of compliance--that every person is engaged in some type of rational calculation where the taxpayer conceals income as long as the return on noncompliance is positive--does not always coincide with taxpaying behavior.¹¹⁴ According to survey information, the majority of people consider themselves to be honest in their tax reporting,¹¹⁵ and presumably they are, if the estimated noncompliance rate of 16.3 percent is accurate.¹¹⁶ In fact, it has repeatedly been suggested in tax compliance literature that "given the current mild sanctions and low probability of detection ... [one] would predict that virtually everyone should be evading tax." In other words, instead of asking "Why do people evade taxes?" we should be asking, "Why do people pay them?"¹¹⁷ The next section of the paper will explore the strengths and shortcomings of the economics of crime view of compliance, especially as it relates to enforcement, and will make a case for taking the necessary steps toward developing a more comprehensive interpretation of taxpaying behavior in order to better understand tax compliance and address noncompliance.

An Expanded View of Taxpaying Behavior

A Look at Enforcement Strategies: Deterrence and General Prevention

“If we put more police into a neighborhood, we are just as likely to increase the crime rate as to reduce it. The reason is that ... police do a lot of things that make crime worse (as well as a lot that makes it better).”¹¹⁸

As evident from the above discussion, to a considerable degree, the standard analysis of tax compliance continues to rely on conventional modern economic theory that views tax evasion as a special case of crime.¹¹⁹ According to this line of thinking, tax noncompliance is the result of a careful calculation in which the taxpayer chooses to cheat on her taxes when that course of behavior best satisfies her preferences (i.e., maximizes her expected utility or favorability of outcomes). This analysis generally presumes that the taxpayer is rational, pursues her self-interest, and possesses the same structure of stable preferences as other taxpayers represented by an expected utility function. Utility is assumed to increase with an increase in disposable income but at a decreasing rate. Working from these assumptions, it becomes relatively easy to test the effect of changing variables in the economic framework, particularly whether a change in enforcement efforts affects the level and extent of noncompliance with the tax law.

Empirical and experimental studies tend to support the economic model of compliance to the extent that they generally indicate a negative relationship between the probability and severity of punishment and the rate of crime. In other words, an increase in either the probability or the severity of punishment can change the expected utility of noncompliance from positive to negative, thereby deterring potential offenders and, overall, decreasing the level of crime.¹²⁰ This effect has also been identified in the area of tax compliance.¹²¹ The correlation between increased enforcement and compliance appears to be stronger when the probability of punishment is increased than when the punishment is more severe. In either case, however, enforcement efforts relying only on punitive strategies do not always alleviate the problem of noncompliance and, at times, might even worsen the situation.

More specifically, data on tax enforcement generally support the conclusion that taxpayers are responsive to perceived or actual risk of detection in their compliance decisions. According to the IRS's estimations, compliance is most likely where the risk of detection is significant, such as when there is third-party reporting or withholding. Approximately 1 percent of all wage, salary, and tip income is misreported, contributing about \$10 billion to the tax gap.¹²² In contrast, nonfarm sole proprietor income, which is subject to

little third-party reporting or withholding, has a significantly higher rate of misreporting at approximately 57 percent, which contributes about \$68 billion to the tax gap.¹²³ In terms of the punishment parameter, fines and other types of penalties also generally improve compliance. Studies, however, indicate that, when it comes to real-life behavior, small changes in penalties are easily overlooked and unlikely to affect compliance.¹²⁴ Some researchers go as far as to argue that heavy penalties do not always produce more compliance compared to lighter ones, especially when detection probability is high.¹²⁵ In certain studies, the effect of an increase in the severity of punishment was not statistically significant, and a statistically significant positive effect on criminal behavior was also occasionally identified.¹²⁶ Ultimately, it is generally the case that penalties serve as less of a deterrent for committing crimes than the probability of detection.¹²⁷ Edward Cheng summarizes this point nicely, reporting that the effect of deterrence decreases rapidly (and nonlinearly) with lower probabilities of enforcement, and tougher punishments are often unable to offset these losses.¹²⁸

Despite the heightened deterrent effect achieved through detection compared with punishment, a concern for low-cost tax administration may lead policymakers to favor raising penalties over increasing costly detection in order to improve compliance. In other words, given a fixed enforcement budget, efforts to maximize deterrence and raise the most revenue at minimal cost might dictate extreme but rare punishments.¹²⁹ One might especially endorse fines and monetary sanctions rather than other more resource-intensive forms of punishment, such as imprisonment and probation.¹³⁰ Unfortunately, however, an enforcement strategy of extreme and rare penalties may be a poor strategic choice because of the repercussions it will have outside of its ability to achieve compliance. For example, rare and extreme punishments can provoke community outrage. The idea that the Government doles out just punishment is undermined when extreme sanctions are disproportionately imposed on lesser offenses.¹³¹ Even when it comes to serious crimes, inflicting heavy penalties on a rare few is arbitrary, draconic, and highly discriminatory, especially when many individuals are undertaking similar acts of noncompliance but only a few are caught and punished.¹³² Such an approach may lead to underenforcement as tax administrators become conflicted between their legal obligations and moral judgments.¹³³ Imposing rare but severe sanctions may also lead to an increase in the severity of crimes committed as offenders realize that the sanctions imposed will be extreme regardless of the actual offence committed and attempt to maximize their gains from crime.¹³⁴ With extreme consequences for noncompliance, erroneous penalties and the punishment of those who violate the law because of ignorance or honest mistake also become particularly disturbing.

To be sure, taking any form of punitive enforcement to an extreme threatens the democratic nature of society and carries a risk of inflaming a broader conflict between citizens and the Government. Such an approach to tax enforcement can ultimately backlash by creating what Bruno Frey describes as a “crowding out effect” of whatever intrinsic motivations taxpayers have to comply and setting the tone for a taxpayer-tax authority relationship that is dominated by feelings of antagonism and distrust.¹³⁵ Ultimately, this type of interaction is likely to diminish taxpayers’ willingness to comply with their tax obligations and might also lead them to actively resist paying their taxes, either legally or illegally.¹³⁶ From an economic perspective, even where an increase in enforcement is feasible, conducive to democracy, and results in an increase in compliance, it might still not be optimal to raise these efforts to the maximum.¹³⁷ Enforcement expenditures are a real cost to the economy, while the revenue collected can be viewed as a mere transfer from the private to the public sector.¹³⁸ Furthermore, increased enforcement of the tax system can also have disincentive effects similar to an increase in tax rates and base and should thus be handled with caution and restraint.¹³⁹

In addition to the considerations that counsel against extreme enforcement measures, empirical evidence suggests that moderate means of enforcement may also fail to promote compliance. When researchers tested the rate and probability of punishment at moderate (compared to extreme) levels--consistent with those observed in actual tax enforcement practices--the deterrent effect was found to be quite small.¹⁴⁰ Taken as a whole, the findings suggest that a broad enforcement approach, where detection and punishment are complementary strategies (rather than extreme substitutions) for one another and, more importantly, where nonpunitive enforcement mechanisms are also considered, might be a superior alternative to relying only on authoritarian deterrence.

In fact, enforcement efforts that rely exclusively on punitive measures and the severity and probability of punishment are likely to be short-sighted at best and counterproductive at worst. In the area of tax, such attempts at shaping behavior often lead to “...a never ending process since each piece of legislation brings new opportunities for avoidance.”¹⁴¹ As John Carroll observed: People adapt, take up new strategies of noncompliance, and become increasingly sophisticated in their risk assessment of getting caught and penalized for wrongdoing.¹⁴² A broader, more constructive definition of deterrence than the one adopted by the traditional economic analysis of tax compliance should look beyond the use of threat and legal authority to encompass “any factor that exerts a preventive force against crime.”¹⁴³ This “general prevention” approach has been understood in the literature of crime to take into consideration not only the direct monetary costs and benefits of compliant and noncompliant behavior but also the external conditions that

affect the fostering of law-abiding norms and morals.¹⁴⁴ Such an expansive characterization of deterrence would seek to improve tax compliance not only by means of curbing illegal activity but also by encouraging legal behavior, such as by balancing authoritarian deterrence with positive encouragement and assistance. This balanced approach is a familiar practice in regulatory programs generally and it is considered a particularly appropriate technique in areas where, like taxation, compliance is difficult and is not always in the short-term self-interest of the regulated and where the detection of noncompliance is challenging as well.¹⁴⁵

The economic analysis of tax compliance has just recently begun to explore the practical needs and constraints of real-life tax enforcement, and it has more to do in order to stay aligned with the developments in the regulatory literature. If we wish to take the study and enforcement of tax compliance to the next level, it may be time for further research and modeling efforts. This could be done, first and foremost, by developing a broader, more detailed understanding of the many aspects of taxpaying behavior and the manner in which these may correspond with the idea of general prevention. This deeper understanding can then be incorporated into a more inclusive and realistic theory of tax compliance and enforcement than presently available under the economics of crime and compliance.

The Multiplicity of Taxpaying Behavior

“Common sense and everyday observations tell us that people refrain from tax evasion--as well as from speeding, shoplifting, and polluting the environment--not only because of their estimates of the expected penalty, but for reasons that have to do with social and moral considerations.”¹⁴⁶

The analysis of compliance that is patterned after the economics of crime theory provides an important starting point for thinking about tax compliance. However, although there is evidence to support this framework, it nonetheless represents only one piece of the tax compliance phenomenon. The focus of the economics of crime theory has traditionally been on the effect of enforcement variables on the actions of individual actors, and, especially, on illegal behavior (i.e., evasion compared with avoidance or aggressive tax planning). This analysis emphasizes deterrence and the severity and certainty of punishment as the most important aspects of achieving compliance. It therefore interprets the causes for compliant and noncompliant behavior very narrowly. Behavior, however, is multifaceted and is influenced by many different factors, including taxpayer disposition toward public institutions, ethics, morals, norms, and the perceived fairness of the tax system.¹⁴⁷ Moreover, enforcement policies

themselves are more complex than any combination of penalties and audit probabilities. Institutional and procedural factors, such as tax administrators, tax courts, and tax advisors, as well as the manner in which these bodies interact with the taxpaying community, affect the behavior of the taxpayer.¹⁴⁸ The standard economic analysis does not normally account for the effect of these various determinants of compliance. However, increasingly, scholars have been collecting empirical evidence about the role of nonmonetary parameters in impacting taxpaying behavior generally and in improving tax compliance and constraining noncompliance, in particular. At the same time, there have been growing attempts to incorporate these parameters into the more formal economic analysis.

The traditional economic literature on tax compliance examines taxpaying behavior through the decisions of a single individual.¹⁴⁹ Set in this way, the analysis fails to put the issue of tax compliance in its broader social setting and, consequently, misses important explanatory opportunities.¹⁵⁰ One example of this oversight is the limited range of goods examined in the standard analysis, which tends to portray individuals as concerned only with their private consumption while displaying total disregard for public goods and services.¹⁵¹ Evidence, however, shows that taxpaying behavior depends not only on private consumption capacity but also on what taxpayers believe they obtain from public goods and services. Taxpayers expect to receive some return on the taxes they pay, and, not only do they care about these returns, but they also evaluate whether the tradeoff is equitable compared to what other taxpayers appear to receive.¹⁵² James Alm, Betty Jackson, and Michael McKee, for example, find a greater willingness to comply with the tax law among taxpayers who believe that they benefit from public goods.¹⁵³ Michael Spicer and Lee Becker find that individuals who are told their taxes are heavier than others, evade by relatively high amounts, while those who are told their taxes are lower than others, evade by relatively small amounts.¹⁵⁴

One study that compared the impact of various information sources on taxpayers found that social influence and, specifically, perceived attitudes toward noncompliance of those people with whom taxpayers discuss taxes had the strongest impact on taxpayers' commitment to comply with their tax obligations.¹⁵⁵ That is, taxpayers' commitment to paying taxes is affected not only by what they believe they receive for paying taxes and by their relative gain or loss in consumption compared to that of others, but it may mostly rely on social interaction and the extent to which noncompliance is perceived to be prevalent in the taxpayers' social environment. When taxpayers believe that people around them generally cheat, they are more likely to cheat themselves, and, when taxpayers believe others are generally honest, they are more willing to pay their own taxes honestly.¹⁵⁶ As explained by James Andreoni, Brian Erard, and Jonathan Feinstein, when taxpayers notice that others disregard

statutory taxes, creating an unjust disparity in the allocation of the tax burden or leading to a reduction in the quality or quantity of public goods and services, they may rationalize resisting payment of their own taxes.¹⁵⁷ It becomes clear, therefore, that taxpaying behavior is not only the result of isolated calculations of the immediate monetary costs and benefits the taxpayer may incur from compliance versus noncompliance. Taxpaying behavior is also a social process where information, experience, attitudes, and patterns of behavior are shared among taxpayers, impacting their assessments of costs and benefits and, consequently, their actual compliance with the tax law.

Some scholars have gone as far as to argue that moral, ethical, and social factors play a role in compliance that may be more important than the threat of legal punishment.¹⁵⁸ Harold Grasmick and Scott Wilbur find, for example, that, while the relationship between the threat of legal punishment and intention to evade taxes is statistically significant, anticipated feelings of guilt and social stigma attached to tax evasion are more strongly associated with deterrence.¹⁵⁹ Similarly, Laurie Mason and Robert Mason argue that an appeal to taxpayer conscience or civic virtue can improve tax compliance more than the threat of sanctions.¹⁶⁰ Other scholars, such as Marsha Blumental, Charles Christian, Joel Slemrod, and Leandra Lederman, clarify that detection and punishment could be complementary strategies to moral, ethical, and social appeals, especially if they are applied to different groups of taxpayers.¹⁶¹ Regardless of the weight placed on particular enforcement considerations, incorporating nonmonetary parameters and influencers into the traditional economic analysis of tax compliance often results in a better description of real-world taxpaying behavior than a theory built only on selfish monetary assumptions.¹⁶² Staying within the economic paradigm, the rationality proposition no longer implies narrow materialism or pure self-interest. Instead, rationality now reflects the reality that most people are constrained by a range of considerations and that these considerations lead them to obey the law when the sum of all potential costs of noncompliance, including likely moral, ethical, and/or social sanctions, outweigh the expected gain.¹⁶³

In sum, although the standard economic approach to compliance serves as a useful starting point for understanding taxpaying behavior, the narrowness of this framework is restrictive and may lead policymakers to reach misguided conclusions that require enforcement that is too punitive and that might ultimately be counterproductive. When it comes to the behavior of the taxpayer, motives other than the desire to increase one's net income must be considered. Extending the analysis of tax compliance requires continuing efforts to gain a better understanding of the many influencers on taxpaying behavior and the manner in which enforcement efforts can properly and effectively address them. This process mandates incorporating into the

theory of tax compliance a much richer category of influencers than currently available and, accordingly, reassessing the role that enforcement policy should play in compliance. It is in this particular line of investigation that researchers in Australia have been involved during the past decade, with results that have important implications for the enforcement of tax compliance in Australia, as well as in other industrialized countries, including the United States. The next portion of the paper will review the research in motivations and, particularly, those motivational influencers that have been identified as commonly associated with taxpaying behavior. The paper will then introduce the concept of responsive regulation and explore the manner in which this approach to regulation may be utilized to bring key elements of tax enforcement together and effectively foster tax compliance.

The Australian Approach to Tax Enforcement

Motivational Postures: Attitudes, Behavior, and Service

“Regulating people through understanding the simultaneous emergence and retreat of various postures means that, at the most fundamental level, regulation rests on the art of managing relationships.”¹⁶⁴

Innovative research in regulation has identified a group of motivational influencers--best known today as “motivational postures”--that capture the way regulated entities position and think about themselves in relation to the regulatory authority.¹⁶⁵ The basic principle behind the concept of motivational postures is that the beliefs, values, and attitudes of regulated actors lead them to adopt a particular posture (or stance) toward the regulator.¹⁶⁶ In the context of compliance with tax law, motivational postures capture the manner in which taxpayers see themselves as they relate to the tax system and administration and, particularly, the amount of (social) distance they wish to place between themselves and the latter two.¹⁶⁷ This distance indicates the taxpayers’ degree of acceptance or rejection of the tax authority and, accordingly, the extent to which these taxpayers are open to the authority’s influence.¹⁶⁸

Strategies for inducing compliance are likely to vary in their effectiveness depending on the motivational posture of the targeted taxpayers. In other words, different regulatory and enforcement measures can be successful when dealing with taxpayers who see themselves as law-abiding citizens versus with taxpayers who see themselves as opportunistic. Moreover, taxpayers who feel insulted or treated disrespectfully by the tax authority may respond better to particular enforcement mechanisms than taxpayers who feel that they have been treated with dignity by an authority that acts with integrity

and legitimacy.¹⁶⁹ For this reason, tax administrations that seek to understand taxpayers' full range of motivational influencers may be better situated to effectively target and encourage taxpayers to "do the right thing" and comply with their tax obligations while, at the same time, monitor and constrain those motivations that may lead taxpayers to noncompliance.¹⁷⁰

The business, industry, sociological, economic, and psychological (BISEP) characteristics of taxpayers shed important light on the reasons that taxpayers hold the motivational postures they do and the possible causes for their compliant or noncompliant behavior including (but not limited to) issues of opportunity, ignorance, business norms, and compliance costs.¹⁷¹ By continually exploring the BISEP characteristics through empirical and experimental work and outreach to the taxpaying community, the tax authority can gain insight into how to improve tax compliance in a well-informed and comprehensive manner.¹⁷² Ongoing consideration of taxpayers' BISEP characteristics may also enhance the tax administration's understanding of the structural and environmental facilitators of noncompliance, and this increased understanding should allow tax administrators to deal with issues of noncompliance at the source. In other words, by investigating taxpayers' BISEP characteristics, the tax administration may obtain the knowledge necessary to tailor enforcement and regulation to meet particular compliance needs (in some cases) even before taxpayer defiance actually occurs.¹⁷³ This, in turn, can lead to the development of more effective enforcement strategies in the long run.

Five key motivational postures have been identified as relevant to the realm of tax compliance. They are: (a) commitment, (b) capitulation, (c) resistance, (d) disengagement, and (e) game playing.¹⁷⁴ The first two postures, commitment and capitulation, are compliant in nature, the former more than the latter. They suggest cooperative interaction with and acceptance of the tax system and authority by the taxpayer.¹⁷⁵ The latter three postures, resistance, disengagement, and game playing, represent an increasingly defiant state of mind with growing distance and dislike on the part of the taxpayer toward the tax authority, system of taxation, and what the taxpayer perceives they stand for.¹⁷⁶

When commitment and capitulation are high, the tax administration is more likely to gain taxpayer compliance. The posture of commitment expresses the taxpayer's understanding that the tax administration is a necessary institution for democracy and suggests a feeling of moral obligation to advance the common good and pay one's taxes voluntarily.¹⁷⁷ Capitulation reflects acceptance of the tax authority and its officials as legitimate and the belief that they are positively responsive to the taxpayer as long as the taxpayer behaves according to the law and obeys the authorities.¹⁷⁸ However, when

the defiant postures of resistance, disengagement, and game playing are high, things are rather different. As eloquently explained by Valerie Braithwaite, a leading scholar in the field of motivational postures, defiant postures are likely to coincide with feelings of being threatened by the tax system or administration, low satisfaction with democracy, antigovernment and pro market attitudes, relatively weak identification with being a citizen and an honest taxpayer, higher than average investment in aggressive tax planning, and a desire to abolish the tax system.¹⁷⁹ The defiant postures are also more likely to be unaffected by persuasion, as well as by the traditional punitive measures of being caught and punished for noncompliance.¹⁸⁰

Resistance, which is the first posture categorized as defiant, reflects doubts about the intentions of the tax office to cooperate with and be respectful of the taxpayer.¹⁸¹ It represents a state of mind in which the taxpayer is watchful and may feel the need to fight for her rights or to curb the power of the tax authority.¹⁸² The second defiant posture, disengagement, is an even more extreme attitude in that it results from a deep disenchantment with the tax system and the tax office.¹⁸³ The disengaged taxpayer does not see a point in challenging the tax authority, which leaves withdrawal from any interaction with the administration as her main objective.¹⁸⁴ Research indicates that disengagement is generally the posture most difficult for authorities to manage.¹⁸⁵ As demonstrated in the work of Valerie Braithwaite, John Braithwaite, Diane Gobson, and Tom Makkai on compliance in nursing homes, by mentally positioning themselves outside the regulatory reach, the disengaged can cut themselves off from attempts at persuasion and influence.¹⁸⁶ For similar reasons, disengaged taxpayers make it extremely difficult for the tax administration to gain compliance.¹⁸⁷ The third and final defiant posture is game playing. With a game playing posture, the taxpayer views the law as something to be respected or ignored based on what advances her interests.¹⁸⁸ Unlike disengagement, game playing takes place within the reach of the regulatory authority, but rather than comply with the spirit of the law, the player uses the letter of the law to undermine the law's intention.¹⁸⁹ This posture has traditionally been pervasive in elite groups.¹⁹⁰ However, as aggressive tax avoidance strategies become increasingly available to and acceptable by the general public, the game playing mindset is expected to spread and to become a more serious problem for enforcement.¹⁹¹ This posture is a reminder that compliance itself could become a major problem when it is defined as compliance with rules as written.¹⁹² In an area as dynamic, complex, and fundamental to society as taxation, the goal for tax enforcement might be better defined as securing long-term compliance with the intent--rather than with the black letter--of the law.¹⁹³

The more committed people are to paying taxes, the less likely they are to put effort into tax avoidance strategies.¹⁹⁴ The postures that have been found to be most strongly associated with aggressive forms of tax avoidance are game-playing and resistance, while evasion has been found to be a more likely option for those who are resistant or disengaged.¹⁹⁵ However, being committed or capitulated does not necessarily prevent taxpayers from misconduct.¹⁹⁶ Behavior is the result of a variety of inputs, only some of which are related to beliefs and attitudes, and so, consistency between taxpayers' mental states and behavior should not automatically be assumed.¹⁹⁷ The tax administration must acknowledge the disparity between motivational postures and behavior and be cognizant and responsive to both in order to effectively manage compliance. Crucially, the administration does not only serve as a passive observer of the behavior and attitudes of taxpayers, but it also affects them considerably.

In keeping with the influential work in compliance and procedural justice of Tom Tyler, Allan Lind, and others, it is well understood today that the perceptions taxpayers have of the procedural justice of the tax system--how the tax administration treats them and other similarly situated taxpayers--affect the legitimacy taxpayers attribute to the administration and the extent to which they accept its authority.¹⁹⁸ This, in turn, impacts taxpayers' levels of compliance. Taxpayers who believe that the tax administration and its officials make an effort to be fair and respectful are more likely than those with more negative perceptions to assign greater legitimacy to the tax system and administration, align with the administration, and, consequently, be more compliant with their tax obligations.¹⁹⁹ In addition, according to the reciprocity rule or norm, positive behavior by the tax administration increases the likelihood of compliance because of the tendency for people to try to treat others in the same manner others treat them.²⁰⁰ Helpful and respectful service may also, therefore, coax a broader normative commitment of compliance among taxpayers when taxpayers believe that the tax administration acts positively toward them as a general (ongoing) practice.²⁰¹

The result of taxpayer/tax-authority interaction may be different, however, for taxpayers who do not trust or respect the tax authority or for those who feel deeply threatened by it.²⁰² When the taxpayer feels uneasy with the tax authority, such as when the taxpayer anticipates or experiences an unpleasant interaction with tax officials or when she perceives that her self-interested goals are undermined by the administration or the rules it imposes, this taxpayer might adopt a coping mechanism to protect herself against the tax administration's disapproval.²⁰³ This coping mechanism often includes

interpreting the differences between the taxpayer and the administration as conflicts between “I” (or “us” when the taxpayer identifies herself as part of a group) and “them” (i.e., the tax authority and/or the government).²⁰⁴ To sustain this defensive response, the rift (social distance) between the tax administration and the taxpayer must grow.²⁰⁵ Under these circumstances, gaining compliance from the taxpayer can be difficult. When the tax administration employs punitive strategies that communicate disapproval, the distance and tension between the taxpayer and the administration are likely to increase with the rise in perceived disapproval, reinforcing and exacerbating any existing state of taxpayer defiance.²⁰⁶ The challenge for tax officials in this situation revolves around changing the motivational posture held by the taxpayer.²⁰⁷ Tax officials may be able to do this by offering the taxpayer cooperation, positive and helpful service, and open dialogue as a first response to conflicts.²⁰⁸ Importantly, when the offer of cooperation from the tax administration is met with compliance by the taxpayer, toxic feelings such as antagonism, resentment, and distrust between the two can be diffused, such that the ability of the tax authority to (re)connect with the taxpayer on a positive level, and to eventually elicit voluntary compliance, may be restored.²⁰⁹

In cases where the offer of cooperation from the tax administration is not met with compliance by the taxpayer, the tax administration must be firm, but also fair, in bringing to account those who are not compliant. Whatever steps the tax administration takes must not, as much as possible, adversely affect compliant taxpayers or escalate existing conflicts beyond what is necessary in order to gain compliance.²¹⁰ Maintaining open communication and positive and professional service, even through the toughest encounters with taxpayers, is important for the tax authority not only to preserve its integrity in the eyes of the defiant taxpayer and the broader taxpaying community but also because, in most cases, even when resentment, anger, and disobedience are present on the part of the taxpayer, there is also goodwill and, therefore, an opportunity to draw out the more cooperative motivational postures.²¹¹ The question therefore is not whether the tax authority should punish taxpayers who are noncompliant but how the tax authority should do so in a manner that prevents the emergence of widespread taxpayer resistance and fosters goodwill and cooperation.²¹² The next portion of the paper will draw on the Australian experience beginning in the late 1990s to suggest that an effective approach to achieving taxpayer compliance, mutual respect, and cooperation includes employing a hierarchy of lesser sanctions and regulatory interventions, the possibility of severe and certain sanctions for noncompliance, and the development of a broad understanding of taxpayers’ motivational postures and BISEP profiles.

Responsive Regulation and the Australian Compliance Pyramid

*“Through incentives and threats and public statements of what the community considers proper and improper, the law is used as an instrument to shape and maintain behavior.”*²¹³

*“The model of the regulatory pyramid suggests regulatory strategies, while the social rift model describes the posturing of those subject to regulation. The ATO Compliance Model brings these different sides of the regulatory relationship together to summarize the process of conflict escalation, not with the intention of avoiding conflict so much as managing it.”*²¹⁴

Until the mid-1990s, the regulatory style of the Australian Tax Office (ATO), like the regulatory approach of most tax administrations in the industrial world, was authoritarian.²¹⁵ This regulatory method, commonly referred to as “enforced compliance” or “command and control regulation,” developed out of the economics of crime and compliance paradigm. It called for the establishment of clear-cut rules for taxpayers to follow and the enforcement of these rules through threat of detection and legal punishment.²¹⁶ Despite its widespread dominance, opponents of command and control often argued that this strategy misinterprets human behavior and the meaning of noncompliance and that its one-solution-fits-all approach is poorly suited for regulating compliance.²¹⁷ The many complexities of the tax compliance problem suggest the need for a comprehensive strategy of enforcement that fosters long-term compliance. Yet “an approach which relies heavily on detecting noncompliance and imposing sanctions on identified offenders tends to be short-term in its effect and increasingly resource-intensive.”²¹⁸ Eventually, criticisms of the command and control method were taken to heart by the Australian tax administration where, starting with the release of the 1998 Cash Economy Task Force Report,²¹⁹ a new regulatory approach was taking form—one that moved from authoritarian deterrence to a method of “responsive regulation.”²²⁰

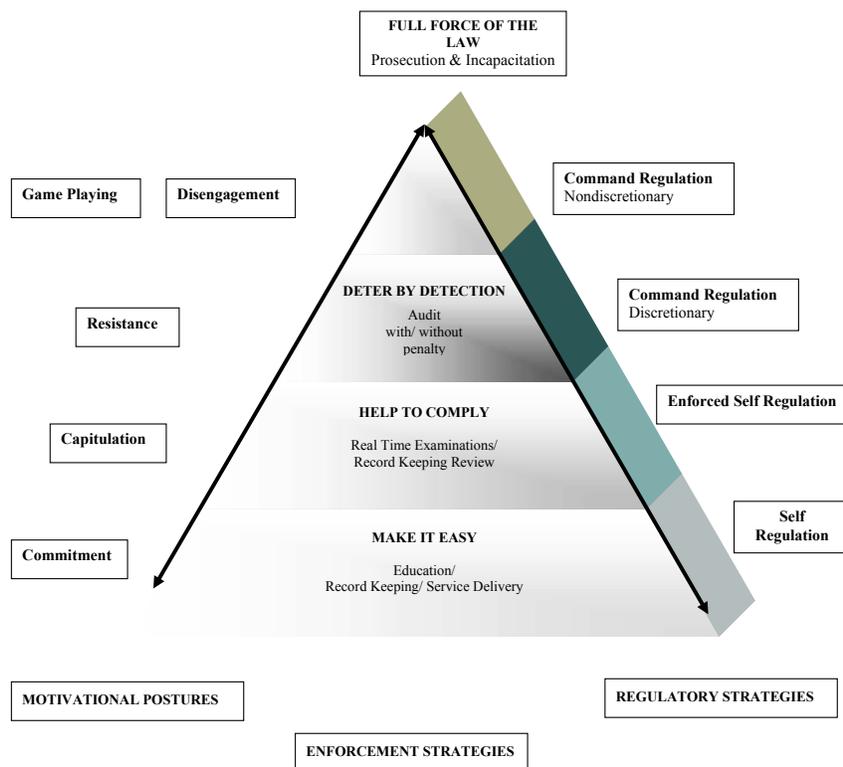
In their 1992 book entitled *Responsive Regulation: Transcending the Deregulation Debate*, Ian Ayres and John Braithwaite conceptualize responsive regulation as a form of regulation that is “responsive to industry structure in that different structures are subject to different degrees and forms of regulation.”²²¹ Responsive regulation is not “a clearly defined program or a set of perceptions concerning the best way to regulate”²²² but rather a method that advances the proposition that regulation should be context-dependent.²²³ In other words, “[f]or the responsive regulator, there are no optimal or best regulatory solutions, just solutions that respond better than others to the plural

configurations of support and opposition that exist at a particular moment in history.”²²⁴ An administration that adopts responsive regulation commits itself to investigating and taking into consideration the problems, motivations, and circumstances of the regulated parties. It is an administration that emphasizes dynamic operation, is committed to assisting the regulated actors in their particular compliance efforts, and strives to enforce compliance across the board, even when the regulated are highly resistant.²²⁵ At the same time, there is less reliance on strategies that are based only on threat of detection and legal penalties.²²⁶

Ayres and Braithwaite utilized the principles of responsive regulation to construct a holistic model for regulating compliance.²²⁷ An expanded version of their model was endorsed in the 1998 report of the Australian Cash Economy Tax Force, after which it was adopted across the board for regulating tax compliance in Australia.²²⁸ The Australian compliance model is represented graphically by a pyramid with each of its three faces addressing one key aspect of compliance.²²⁹ The three faces of the model are: (1) the range of

THE AUSTRALIAN COMPLIANCE PYRAMID

Source: Adapted from the 1998 Australian Cash Economy Tax Force Report



motivational postures taxpayers are most likely to display in their interactions with the tax administration;²³⁰ (2) the range of enforcement strategies available to the tax administration; and (3) the range of corresponding regulatory tools.²³¹ In this model, the motivational postures, regulatory measures, and enforcement strategies have a range of severity. The cooperative postures, lenient enforcement strategies, and less intrusive regulatory styles are set closer to the bottom of the pyramid, while the areas higher on the model are reserved for defiant taxpayers and for harsher, more punitive and authoritarian enforcement and regulatory practices.²³²

Ayres and Braithwaite introduced the strategy of tit-for-tat (TFT) into the compliance model as a means by which the administration can responsively manage the interaction with the taxpayer.²³³ In adopting the TFT approach, the Australian compliance model rejects a passive deterrence style where enforcement is grounded in a static calculation of the probability of compliance based on the expected size and risk of punishment.²³⁴ Instead, TFT prescribes that the tax administration balance positive persuasion and encouragement with punitive deterrence and incapacitation in a dynamic fashion. The Australian approach, modeled after the TFT strategy, embraces the understanding that people care about different things in different contexts and that they often possess multiple and contradictory selves.²³⁵ Most people have a caring, socially responsible self as well as an opportunistic self; they may be motivated by money considerations at one point and by a sense of social responsibility at another.²³⁶ Accordingly, an enforcement strategy based only on punishment or persuasion will ultimately fail. Ayres and Braithwaite eloquently explain: "People will exploit a strategy of persuasion and self-regulation when they are motivated by economic rationality. But a strategy based mostly on punishment will undermine the goodwill of actors when they are motivated by a sense of responsibility."²³⁷ Both persuasion and punishment have strengths and shortcomings in delivering compliance, and the key to successful regulation is not to decide between one approach or the other but to establish a workable compromise between the two such that these strategies complement each other.²³⁸

When utilizing the TFT methodology, the tax administration balances encouragement and persuasion with punitive deterrence through three stages of communication with the taxpayer: cooperation, toughness, and forgiveness.²³⁹ At the heart of this approach is the understanding that the tax office and the taxpayer are interrelated such that they impact and affect one another.²⁴⁰ Accordingly, the TFT strategy commands, among other things, that there be an open communication channel between the tax authority and the taxpayer in which the tax authority explains the legal obligations of the taxpayer and the consequences for noncompliance, and that the imposition

of these consequences depends on the behavior of the taxpayer.²⁴¹ The tax administration always starts at the bottom of the compliance pyramid by persuading and encouraging the taxpayer to cooperate.²⁴² If the taxpayer chooses to cooperate, tax officials must respond with cooperation.²⁴³ If the taxpayer decides not to cooperate, the compliance pyramid instructs the tax administration to gradually move to a higher level of enforcement and regulation.²⁴⁴ In other words, as conflicts between the tax office and the taxpayer emerge and escalate, the communication between them moves up the pyramid to a higher level of severity, mandating a transfer of power from the taxpayer to the tax office. As the tax authority reverts to a more authoritarian approach of command and control, the taxpayer loses her ability to affect the interaction with the tax office.²⁴⁵ However, the TFT strategy, by being both tough and forgiving, allows the tax administration to not only escalate enforcement and regulation in response--and in proportion--to taxpayer defiance but also to dynamically manage the relationship and conflict with the taxpayer in that it leaves the option of cooperation always within reach.²⁴⁶ As soon as the taxpayer chooses cooperation, the TFT strategy instructs the tax administration to “reward” cooperative behavior by responding with a gradual move down the pyramid and with de-escalation of enforcement and regulation.²⁴⁷

Crucially, with persuasion and encouragement at the bottom of the compliance pyramid, the tax administration must first appeal to the social responsibility of the taxpayer in order to foster compliance. In this way, the administration aims to cultivate relationships of trust and alliance, while avoiding the use of unnecessary punitive measures that might undermine the goodwill and intrinsic motivations of taxpayers to comply.²⁴⁸ By emphasizing measures such as education, good service delivery, and an open dialogue, the tax administration targets the taxpayer’s sense of social responsibility and seeks to bolster the prevention of noncompliance in the enforcement process, taking first steps towards establishing broad political and social support for voluntary compliance as a mainstream option.²⁴⁹ At the same time, by getting tough with cheaters, the tax administration taps into the economics of crime and compliance in that it encourages the taxpayer to choose her socially responsible, law-abiding selves over her opportunistic selves, increasing the effectiveness of persuasion and encouragement at the bottom of the pyramid.²⁵⁰

One important feature of the compliance pyramid is that--on its face--its application does not require the identification of the exact motives behind taxpayer behaviors.²⁵¹ The tax administration is simply required to look for cooperation from the taxpayer and, where the taxpayer fails to cooperate, escalate enforcement and regulation until compliance is achieved.²⁵² In doing

so, however, the compliance pyramid suggests only as much intervention by the tax administration as needed in order to deliver compliance.²⁵³ At this point, an assessment of the taxpayer's motivational postures and BISEP profile provides important insight about how much intervention is needed. The degree and nature of the regulatory intervention will ultimately depend on the level of resistance the taxpayer exhibits and on what the tax administration knows about the taxpayer given available BISEP information and the process of conflict escalation.²⁵⁴ As a result, while not explicitly required in the application of the compliance pyramid, information about taxpayer motivations plays an important role in determining the tax authority's range of appropriate responses.

In situations where persuasion fails, for example, examining the taxpayer's motivations may reveal that the taxpayer is being a rational calculator about the expected costs of law enforcement compared with the gains from breaking the law. At this point, progressive escalation of penalties can take the cost of noncompliance up to the point where it becomes rational to comply.²⁵⁵ In fact, in targeting the self-interested motivations involved in tax transactions, the escalating cost of sanctions and interventions is designed to encourage both the taxpayer and the tax administration to cooperate early in the regulatory conflict rather than opt for the more expensive option of escalation.²⁵⁶ On a broad scale, by engaging in less severe sanctions and interventions, the tax administration may save on costly enforcement and ensure that available resources are reserved for inducing compliance from the most defiant taxpayers.²⁵⁷ This, in turn, could assist in the prevention of a spread of uncontrollable crime and--by so doing--strengthen the legitimacy of the administration and increase the integrity of the tax system.²⁵⁸ When deterrence fails, such as when the taxpayer "irrationally" ignores the escalating costs of noncompliance or when she puts the credibility of the enforcement escalation threat to the test, the Australian compliance pyramid advises that the tax administration shift to incapacitation and hinder or remove the ability of the taxpayer to offend, such as through prosecution and imprisonment.²⁵⁹

The triangular structure of the Australian model with its wide base and pointy top implies that a substantial proportion of individual taxpayers are positioned closer to the bottom of the pyramid, or, in other words, that most people generally want to comply with their legal obligations.²⁶⁰ Fewer taxpayers are assumed to be involved in more serious forms of noncompliance and, therefore, located at the top of the pyramid.²⁶¹ Evidence on individual tax compliance suggests that these predictions are generally accurate. Survey information from the U.S. and Australia indicates, for example, that about two-thirds of individual taxpayers intend to pay their taxes in full,²⁶² results that appear to be supported by the current level of tax compliance, standing

as high as 83.7 percent.²⁶³ At the same time, however, this evidence suggests that approximately one-third of taxpayers do not necessarily plan to comply. For these taxpayers, as well as for the purpose of safeguarding a culture of obedience to the law, sanctions for noncompliance must be severe and certain.

The Australian model is designed to first and foremost promote voluntary compliance through self-regulation at the bottom of the pyramid.²⁶⁴ When the taxpayer is willing to meet her tax obligations with minimum interference by the tax administration, the Australian model instructs that she be left alone to do so. Under such conditions, educating the taxpayer, ensuring adequate recordkeeping, and providing good service become the main strategy for the tax office.²⁶⁵ When the relationship between the tax administration and the taxpayer becomes adversarial--such as when the taxpayer displays resistance, disengagement, or game playing, the motivational postures that reflect an interaction that is increasingly noncooperative--other strategies may be employed. Real-time business examination with record review and auditing with or without penalties may be applied.²⁶⁶ Ultimately, the tax office will use punitive enforcement and incapacitation if necessary to gain compliance.²⁶⁷ Initially, the tax office exercises discretion around using punishment to improve compliance.²⁶⁸ A stricter approach, including automatic sanctions, may follow when noncompliance continues, escalating to prosecution and incarceration.²⁶⁹ At the same time, however, dialogue and persuasion must be pursued by the tax administration to draw out the more cooperative postures so that--once possible--negotiations can be resumed at the bottom of the pyramid.²⁷⁰

Although the Australian approach emphasizes voluntary compliance, persuasion, encouragement, and the idea of self-regulation, adoption of the compliance model does not suggest that the tax administration is reluctant to identify and punish noncompliance. On the contrary, the height of the pyramid and the range of regulatory and enforcement measures demonstrate the ability and willingness of the tax administration to escalate enforcement and regulation as much as needed in order to induce compliance and signal a commitment of the administration "never to give in."²⁷¹ With this commitment, the tax authority communicates to taxpayers that it will be cooperative as its first choice but that, if the taxpayer resists cooperation, it will use its heaviest punishment until compliance is gained.²⁷² By first offering cooperation rather than disciplinary sanctions, tough enforcement is expected to be considered more (procedurally) fair by taxpayers, and this sense of fairness may better promote alignment and cooperation with the tax administration.²⁷³ Often, the mere knowledge of the tax administration's willingness and capacity to execute severe punishments will foster taxpayer confidence in the tax administration

and serve as a powerful form of persuasion that furthers a climate of voluntary compliance.²⁷⁴ In the words of Ayres and Braithwaite: “[R]egulators will be more able to speak softly when they carry big sticks (and, crucially, a hierarchy of lesser sanctions). Paradoxically, the bigger and more various are the sticks, the greater the success regulators will achieve by speaking softly.”²⁷⁵

Summary and Conclusions

“My work may have sometimes assumed too much rationality, but I believe it has been an antidote to the extensive research that does not credit people with enough rationality.”²⁷⁶

Over the past three decades, understanding the causes and facilitators of taxpayer compliance and noncompliance has been the focus of much analysis in tax administration research. These research efforts have been taken in the hope of gaining a better handle on how to foster tax compliance and minimize the tax gap. In this ever-expanding area of research, important advances have been made in modeling the taxpaying decisionmaking process and, more recently, exploring the relationship between the taxpayer and the tax authority and how this relationship shapes compliance. These developments were accomplished against the backdrop of a growing body of survey information, as well as empirical and experimental work. More than anything, the extensive research has demonstrated that tax noncompliance is a serious and complex problem, subject to a wide range of causes and influences.

To a great extent, efforts to enforce tax compliance are dictated by the economic paradigm. The economic model emphasizes the consequences of behavior and the extent to which these consequences serve people’s self-interest as the most important determinants for compliance. According to this model, taxpayers who fail to comply with their tax obligations are not people (or entities) with antisocial or deviant characteristics but rather rational actors who seek to maximize their expected utility given the costs and benefits attached to the courses of action available to them. Enforcement techniques drawing on the economic model, therefore, look to decrease the expected utility of noncompliance by increasing the probability and/or severity of punishment for offenders, thereby deterring potential lawbreakers and making tax compliance the “rational” (i.e., beneficial) choice of behavior.

While the research in compliance is far from conclusive, it does appear to support the economic model to the extent that taxpayers are generally sensitive to the expected payoffs of compliant and noncompliant behavior. Increasingly, however, there is a growing understanding among tax researchers and administrators that there is more to compliance than the probability and

severity of punishment. Taxpayers are influenced by a host of considerations, including the desire to comply with social norms, to be honest citizens, to avoid psychological stress or enjoy the thrill attached to the pursuit of illegal behavior, to correct perceived injustices in the tax system, and/or to maximize monetary gains.

Understanding the reasons for and influences on taxpaying behaviors has a direct impact on the design of enforcement policies and their potential to improve compliance. If taxpayers care about matters beyond narrowly defined self-interest, applying enforcement strategies that rely exclusively on monetary considerations--particularly through authoritarian deterrence of detection and punishment--might not only be ineffective but may also backfire by undermining the goodwill and the intrinsic motivations of taxpayers to comply, generating distrust and antagonism, and ultimately exacerbating rather than easing the problem of noncompliance. Instead of abandoning enforcement policies based on detection and punishment, these enforcement mechanisms should be balanced against other measures that will complement punitive deterrence and offset its negative repercussions. This paper advanced the argument that this balance can be achieved by broadening the definition of deterrence to include measures that nurture the social responsibility and ethics of taxpayers and that aim to encourage tax compliance as well as discourage noncompliance.

The Australian compliance model offers a framework that incorporates a balanced and broad approach in the enforcement of taxes such as just described. Drawing on the principles of responsive regulation and the motivational posture doctrine, the Australian model conceptualizes behavior not only as a result of the needs, desires, and constraints of an autonomous taxpayer but also considers that the taxpayer is heavily influenced by environmental conditions, including social norms, values, and habits, and by the nature of the taxpayer/tax-authority interaction. By focusing on the role which the taxpayer/tax-authority relationship plays in shaping taxpaying behaviors, the tax administration is empowered to own up to its administrative responsibilities and explore different ways that it can manage this relationship. The idea here is not only to enforce compliance where none is present but also to strengthen and manage compliance fairly and efficiently, such that voluntary reporting may improve. This emphasis on voluntary reporting is especially important in taxation given that the tax law is constantly changing and is often complex and filled with loopholes. Instead of putting endless effort into enforcing what is many times (realistically) unenforceable, enforcement policies might be more effective if they start with encouragement and persuasion.

The Australian compliance model makes a case for the superiority of an enforcement strategy that is gradual and proportional in its capacity

and willingness to apply sanctions. It represents a move away from static deterrence advocated by early economic theorists and embraces a dynamic framework that reflects the interplay of the taxpayer/tax-authority interaction. Accordingly, instead of looking for a particular formula of optimal deterrence, the regulatory goal is to find an optimal way to play “the enforcement game.”²⁷⁷ An administration that endorses the Australian approach plays the enforcement game responsively, using the TFT methodology. By implementing TFT, the tax administration works to protect the taxpaying community against lawbreakers while leaving room for fostering tax morale.

With growing interest around the world in tax administration that focuses on “customer” service and on embracing a dynamic approach to the study and enforcement of compliance, the Australian compliance model has the potential to generate different--possibly more effective--conclusions regarding tax enforcement than what we have seen thus far from the economic analysis of compliance. In fact, the Australian model can be viewed as yet another advancement of the economic paradigm to the extent that it draws on the principles of rational behavior. The Australian approach takes a step further, however, and supplements the economic paradigm with other theories, particularly those that involve identity, conflict escalation, and procedural justice. The extent to which the Australian approach yields different enforcement dynamics or better compliance results than the economic paradigm is, however, yet to be determined. The essence of the Australian pyramid lies in its underlying principles and dynamic methodology rather than in any specific enforcement and regulatory tools or mechanisms. And, while its flexibility is a key advantage of the Australian model, it might also become its main weakness.

The Australian model, by relying on a method that emphasizes the process of enforcement (“managing relationships”) rather than on any one defined regulatory or enforcement mechanism, presents challenges in its practical application; a considerable amount of resources (including time and effort) is needed to develop the range of regulatory and enforcement measures required for different industries, to test the effectiveness of each measure, and to fit the various measures into the model as a whole. It is unclear, for example, which regulatory and enforcement tools best encourage voluntary compliance at the bottom of the pyramid, how the tax administration can effectively (and efficiently) present the downsides of noncompliance to taxpayers such that they are encouraged to comply early in the regulatory process, which deterrent measures can be carried out (and to what extent) without alienating taxpayers to a greater extent than necessary, and how incapacitation can be achieved in taxation through measures other than prosecution and incarceration. In addition, to generalize the Australian model to tax administrations in other

countries, more work is needed to identify relevant compliance problems, to understand the characteristics of local taxpayers and industries, and to explore the existing and potential political and social support for different enforcement and regulatory strategies. All these issues and more may be addressed partly through the trial and error of enforcement efforts and partly through empirical and experimental work. The flexibility of the Australian model may become especially problematic, however, if tax agents and administrators execute the model in ways that are inappropriate or otherwise unintended by the supporting enforcement policy. This is a risk inherent in administrative practices generally, but the combination of an escalating range of enforcement and regulation, the complex and fluid nature of motivational postures, and the extent of discretion in a dynamic administrative interaction might increase the risk of imposing enforcement that is too lenient or too harsh compared to a more conventional enforcement approach.

At the end of the day, the main advantage of the Australian model may be its ability to offer tax administrators and researchers a broad, even if incomplete, road map for tax enforcement that incorporates a set of checks and balances on punitive deterrence. Furthermore, the Australian model touches on critical issues in compliance and regulation that are well deserving of policy attention and debate. The fact that this model does not come with a self-explanatory guide may not necessarily be a disadvantage, as it forces tax administrators and policymakers to debate and reach decisions in a deliberate and intentional manner. In a matter of a few years, as the Australian tax administration releases more compliance improvement data and different prototypes of the original compliance model, we may be in a better position to evaluate whether the responsive approach adopted in Australia actually increases the integrity of its tax system and to better assess the advantages and disadvantages of this method. In the meantime, more comparative work can be undertaken to investigate the relevance of the Australian model to the United States, to test the hypotheses of this model, and to generate important insights and advances in both the theoretical analysis and the empirical research of compliance. Until we have more data, we should be careful not to dismiss what could be the promising beginning of a new era of tax enforcement.

Endnotes

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- ¹ US TREASURY DEPARTMENT, COMBINED STATEMENT OF RECEIPTS, OUTLAYS, AND BALANCES (2005), *available at* <http://www.fms.treas.gov/annualreport/cs2005/receipt.pdf>.
- ² *Id.*
- ³ *Id.*
- ⁴ According to the IRS the tax gap is “the difference between what taxpayers timely and voluntarily should have paid and what they did pay.” INTERNAL REVENUE SERVICE, DEP’T OF TREASURY, IRS UPDATES TAX GAP ESTIMATES, IR-2006-28 (2006) *available at* <http://www.irs.gov/newsroom/article/0,,id=154496,00.html> [hereinafter IRS UPDATES]. *See also* INTERNAL REVENUE SERVICE, DEP’T OF TREASURY, UNDERSTANDING THE TAX GAP, FS-2005-14 (2005) (“The tax gap measures the extent to which taxpayers do not file their tax returns and pay the correct tax on time.”), *available at* <http://www.irs.gov/newsroom/article/0,,id=137246,00.html>. Others clarify that the tax gap is not equal to the amount of additional revenue that would be collected by stricter enforcement. *See* Luigi Alberto Franzoni, *Tax Evasion and Tax Compliance*, in 6 ENCYCLOPEDIA OF LAW AND ECONOMICS 52 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000).
- ⁵ Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjustment Penalty*, 106 COLUM. L. REV. 569, 574 (2006) (citations omitted).
- ⁶ IRS UPDATES, *supra* note 4.
- ⁷ *The Tax Gap and How to Solve It*, Written testimony of Mark Everson, Commissioner, Internal Revenue Service Before the S. Comm. on the

Budget (2006), available at http://www.senate.gov/~budget/democratic/testimony/2006/everson_taxgap021506.pdf#search=%22%22The%20Tax%20Gap%20and%20How%20to%20Solve%20It%22%22 [hereinafter *The Tax Gap*].

- ⁸ IRS UPDATES, *supra* note 4.
- ⁹ *Id.* Notice, however, the statement of the Commissioner of the Internal Revenue Service, Mark W. Everson, that “the vast majority of Americans pay their taxes accurately and are shortchanged by those who don’t pay their fair share.” *The Tax Gap*, *supra* note 7.
- ¹⁰ For example, a taxpayer could fail to file a tax return, underreport legal or illegal income, overstate deductions, report the wrong type of deduction, or refuse to pay the amount of tax owed. See John S. Carroll, *A Cognitive-Process Analysis of Taxpayer Compliance*, in 2 TAXPAYER COMPLIANCE 228 (Jeffrey A. Roth & John T. Scholz eds., 1989). See also Leandra Lederman, *Tax Compliance and the Reformed IRS*, 51 KANSAS L. REV. 971, 971-72 (2003); *The Tax Gap*, *supra* note 7, at 3.
- ¹¹ IRS UPDATES, *supra* note 4.
- ¹² INTERNAL REVENUE SERVICE, DEP’T OF TREASURY, PUBL’N NO. 3744, IRS STRATEGIC PLAN 2005-2009, at 18 (2004), available at <http://www.irs.gov>.
- ¹³ John S. Carroll, *How Taxpayers Think about Their Taxes: Frames and Values*, in WHY PEOPLE PAY TAXES 43, 43-44 (Joel Slemrod ed., 1992).
- ¹⁴ Franzoni, *supra* note 4, at 52; Agnar Sandmo, *The Theory of Tax Evasion: A Retrospective View*, 58 NAT’L TAX J. 643, 647 (2005).
- ¹⁵ Franzoni, *supra* note 4, at 54.
- ¹⁶ *E.g.*, Raskolnikov, *supra* note 5, at 599-600 (explaining that avoidance gives taxpayers more leverage to vary their compliance strategy than evasion).
- ¹⁷ See *e.g.*, Kristina Murphy, *Regulating More Effectively: The Relationship between Procedural Justice, Legitimacy, and Tax Non-compliance*, 32 J.L. & SOC’Y 562, 562-63 (2005). See also Joseph Banckman, *The Tax Shelter Problem*, 57 NAT’L TAX J. 925, 925 (2004); Michael L. Schler, *Ten More Truths About Tax Shelters: The Problems, Possible Solutions, and a Reply to Professor Weisbach*, 55 TAX. L. REV. 325, 384 (2002); and, generally, David Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215.
- ¹⁸ Joel Slemrod, *Why People Pay Taxes: Introduction*, in WHY PEOPLE PAY TAXES 1, 1 (Joel Slemrod ed., 1992).

- ¹⁹ Carroll, *supra* note 10, at 228. *See also* FRANK A. COWELL, CHEATING THE GOVERNMENT: THE ECONOMICS OF TAX EVASION 101-24 (1990) (claiming that existing levels of noncompliance and/or creative compliance may generate resentment, eventually escalating to taxpayers undertaking more acts of noncompliance as a form of protest against the government and the tax administration or as a means of equalizing the tax burden) [hereinafter CHEATING THE GOVERNMENT].
- ²⁰ *E.g.*, Slemrod, *supra* note 18, at 1 (“it is impossible to understand the true impact of a county’s tax system by looking only at the tax base and the tax rates applied to that base. A critical intermediating factor is how the tax law is administrated and enforced. What is apparently a highly progressive tax rate structure may, in fact, be proportional, or even regressive, if taxes levied on the wealthy are not collected. What is apparently a tax base finely tuned to reflect individual differences in ability to pay may, in fact, produce a capricious distribution of tax liabilities if the tax law is selectively enforced.”).
- ²¹ Louis Kaplow, *How Tax Complexity and Enforcement Affect the Equity and Efficiency of the Income Tax*, 49 NAT’L TAX J. 135, 135 (1996).
- ²² James Andreoni, Brian Erard & Jonathan Feinstein, *Tax Compliance*, 36 J. ECON. LIT. 818, 818 (1998).
- ²³ Franzoni, *supra* note 4, at 55.
- ²⁴ Andreoni, Erard & Feinstein, *supra* note 22, at 818.
- ²⁵ Franzoni, *supra* note 4, at 55.
- ²⁶ *See e.g.*, Andreoni, Erard & Feinstein, *supra* note 22, at 818.
- ²⁷ IRS UPDATES, *supra* note 4.
- ²⁸ U.S. GOV’T ACCOUNTABILITY OFFICE, PUBL’N No. CAO-05-527T, TAX COMPLIANCE: REDUCING THE TAX GAP CAN CONTRIBUTE TO FISCAL SUSTAINABILITY BUT WILL REQUIRE A VARIETY OF STRATEGIES 3,16 (2004), available at <http://www.gao.gov/new.items/d05527t.pdf>.
- ²⁹ *Id.* (adding that a significant reduction of the tax gap is likely to depend on improvement in the level of tax compliance).
- ³⁰ INTERNAL REVENUE SERVICE, U.S. DEP’T OF TREASURY, PUBL’N No. 9940, BUDGET IN BRIEF, FISCAL YEAR 2005, at 4 (2004), available at <http://www.irs.gov>.

- ³¹ The remainder of the increase, \$190 million, was intended to be used for reinvestments in consumer service, maintenance of existing levels of performances, and physical infrastructure consolidation. *See id.*
- ³² IRS UPDATES, *supra* note 4.
- ³³ *Id.*
- ³⁴ The increase in revenue between 2001 and 2005 due to examination measures is \$9.8 million and from document matching \$1.5 million, amounting to a total of \$11.3 million of additional tax money collected. This is compared with an increase in revenue of \$2.2 million due to other forms of collection during that time. *See id.* (enforcement revenue tbl.).
- ³⁵ Robert A. Kagan, *On the Visibility of Income Tax Law Violations*, in 2 TAXPAYER COMPLIANCE 76 (Jeffrey A. Roth and John T. Scholz eds., 1989). *See also* Franzoni, *supra* note 4, at 54-55 (adding that tax evasion and avoidance and their harmful consequences may in fact be worsened by laws or even constitutions when they are drafted as if the tax base is observable because this limits the corrective instruments available to the government, such as setting tax rates according to their degree of enforceability).
- ³⁶ Kagan, *supra* note 35, at 79.
- ³⁷ Franzoni, *supra* note 4, at 54.
- ³⁸ *Id.*; Kagan, *supra* note 35, at 88.
- ³⁹ John Creedy, *Tax Modelling*, in 1 TAXATION AND ECONOMIC BEHAVIOR: INTRODUCTORY SURVEYS IN ECONOMICS 133, 135-36 (John Creedy ed., 2001).
- ⁴⁰ *Id.*
- ⁴¹ *Id.* *See also* Frank Cowell, *Carrots and Sticks in Enforcement*, in THE CRISIS IN TAX ADMINISTRATION 230, 231 (Henry J. Aaron & Joel Slemrod eds., 2004) [hereinafter *Carrots & Sticks*].
- ⁴² Allingham and Sandmo have stated: “Even though we ignore these points, we hope to have retained enough of the structure of the problem to make the theoretical analysis worthwhile.” *See* Michael G. Allingham & Angus Sandmo, *Income tax Evasion: A theoretical analysis*, 1 J. PUB. ECON. 323, 325 (1972).
- ⁴³ *Carrots & Sticks*, *supra* note 41, at 231; Creedy, *supra* note 39, at 156-57.

- ⁴⁴ JEREMY BENTHAM, *PRINCIPLES OF PENAL LAW* (1788), *reprinted in THE WORKS OF JEREMY BENTHAM* 399 (John Hill Burton ed., 1843).
- ⁴⁵ *Id.* See also JEREMY BENTHAM, *THEORY OF LEGISLATION* (Harcourt, Brace 1931); CESARE BECCARIA, marchese di. *ON CRIMES AND PUNISHMENTS* (translated from Italian, Hackett Pub. Co. 1986) (1797); Gary S. Becker, *Nobel Lecture: The Economic Way of Looking at Behavior*, 101 J. POL. ECON. 385, 391 (1993) (“one reason why the economic approach to crime became so influential is that the same analytical apparatus can be used to study enforcement of all laws, including minimum wage legislation, clean air acts, insider trade and other violations of security laws, and income tax evasions.”).
- ⁴⁶ See, e.g., Marco R. Steenberg, Kathleen M. McGraw & John T. Scholz, *Taxpayer Adaptation to the 1986 Tax Reform Act: Do New Tax Laws Affect the Way Taxpayers Think About Tax?* in *WHY PEOPLE PAY TAXES* 9, 14 (Joel Slemrod ed., 1992) (suggesting a dominance of self-interest that is particularly pervasive in public choice theories of economics, as well as in motivational theories in psychology) [hereinafter *Taxpayer Adaptation*]. More broadly, according to the utilitarian model, people have preferences and choose among different alternatives in a manner that maximizes the likelihood of obtaining their preferred outcomes. The expected utility of any decision alternative is assessed by identifying the possible consequences or outcomes, assigning a desirability or utility to each outcome, and attaching likelihoods to the different outcomes. Each outcome is multiplied by its likelihood, and the discounted outcomes, or weight, are summed to “create” the expected utility of that alternative. The alternative with the most favorable expected utility is then selected and implemented. See Carroll, *supra* note 10, at 229.
- ⁴⁷ See, generally, BENTHAM, *supra* note 44 & 45; BECCARIA, *supra* note 45.
- ⁴⁸ Gary S. Becker, *Crime and Punishment: An Econometric Approach*, 76 J. POL. ECON. 169 (1968).
- ⁴⁹ Becker, *supra* note 45, at 390.
- ⁵⁰ *Id.*
- ⁵¹ *Id.*
- ⁵² *Id.* Despite Becker’s approach to crime, concepts like depravity, insanity, abnormality, deviance, and deprivation are still very much used to characterize those who commit crimes outside of the realm of the economic analysis, especially for hate crimes and crimes of passion. See Erling Eide, *Economics of Criminal Behavior*, in 5 *ENCYCLOPEDIA OF*

LAW AND ECONOMICS 345, 345 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000). For that matter, criminologists have generally been more interested in rehabilitation and treatment, and many are reluctant to accept studies of deterrence in general and models of criminal behavior based on rational choice in particular. However, these scholars still take interest in the empirical studies in the economics of crime literature, and sociologists have in recent years been inspired to carry out similar research. *See id.* at 346; Becker, *supra* note 45, at 391 (citing literature).

⁵³ Becker, *supra* note 45, at 389.

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ It is interesting to note that Becker did not get a ticket for his parking violation that day. *See id.* at 389.

⁵⁷ *Id.* at 390.

⁵⁸ *Id.* (italic and bold added).

⁵⁹ Becker, *supra* note 48, at 176 (italic and bold added).

⁶⁰ *Id.*

⁶¹ *Id.* at 176-79.

⁶² *See, e.g., id.* at 208 (“The conclusion that ‘crime would not pay’ is an optimality condition and not an implication about the efficiency of the police or courts; indeed, it holds for any level of efficiency, as long as optimal values of p and f [i.e., the probability and severity of punishment] appropriate to each level are chosen.”); *Id.* at 209 (“The main contribution of this essay, as I see it, is to demonstrate that optimal policies to combat illegal behavior are part of an optimal allocation of resources. Since economics has been developed to handle resource allocation, an “economic” framework becomes applicable to, and helps enrich, the analysis of illegal behavior.”).

⁶³ Allingham & Sandmo, *supra* note 42. Other early attempts to model tax evasion after the economics of crime include, for example, Serge-Christophe Kolm, *A Note on Optimum Tax Evasion*, 2 J. PUB. ECON. 265 (1973), and Balbir Singh, *Making Honesty the Best Policy*, 2 J. PUB. ECON. 257 (1973).

⁶⁴ Note that from the outset Becker’s intent was to offer a theory broadly applicable to compliance including compliance in the context of tax reporting. Becker, *supra* note 48, 170 (“[A]lthough the word “crime” is

used in the title to minimize terminological innovations, the analysis is intended to be sufficiently general to cover all violations, not just felonies – like murder, robbery, and assault, which receive so much newspaper coverage – but also *tax evasion ...*) (italic added). See also Allingham & Sandmo, *supra* note 42, at 323 (“On the one hand our approach is related to the studies of economics of criminal activities, as e.g. in the papers by Becker (1968) and by Tulkend and Jaquemin (1971). On the other hand it is related to the analysis of optimal portfolio and insurance policies in the economics of uncertainty, as in the work by Arrow (1970), Mossin (1968a) and several others.”).

- ⁶⁵ See, e.g., Allingham & Sandmo, *supra* note 42, at 323 (“Our objective in this paper is ... analyzing the individual taxpayer’s decision on whether and to what extent to avoid taxes by deliberate underreporting.”).
- ⁶⁶ Allingham & Sandmo, *supra* note 42, at 323. Unlike Becker’s model of compliance where the income of crime is a variable separate from other -legal- income, in the A-S framework the income of criminal activity is a function of the exogenous income not reported. That is, the value of taxpayer’s initial income becomes a point of reference where tax evasion will be undertaken if the expected utility from evasion is higher than the utility of the initial income. See Eide, *supra* note 52, at 347. A somewhat similar analysis to the portfolio allocation framework was construed such that a person allocates her time (compared with income or wealth) between legal and illegal activities. See, e.g., Kenneth I. Wolpin, *An Economic Analysis of Crime and Punishment in England and Wales 1984-1976*, 86 J. POL. ECON. 815 (1978); PETER SCHMIDT & ANN D. WITTE, *AN ECONOMIC ANALYSIS OF CRIME AND JUSTICE: THEORY, METHODS, AND APPLICATIONS* (1984).
- ⁶⁷ Allingham and Sandmo label this framework as “the static analysis.” See Allingham & Sandmo, *supra* note 42, at 324-30.
- ⁶⁸ *Id.* at 324. For a useful review of these assumptions see e.g., Brian Erard, *The Influence of Tax Audits on Reporting Behavior*, in *WHY PEOPLE PAY TAXES* 95, 96 (Joel Slemrod ed., 1992) (“[I]n these models, taxpayers are already aware of the (exogenous) probability of audit and detection; they know their true taxable incomes; and they are familiar with the penalties for noncompliance.”).
- ⁶⁹ In their analysis of compliance, Allingham and Sandmo take the common assumption that taxpayers’ behavior conforms to the Von Neumann-Morgenstern axioms for behavior under uncertainty where individuals’ cardinal utility function is increasing and concave, featuring income

as its only parameter. Accordingly, marginal utility is assumed to be positive and decreasing, so that taxpayers are generally risk averse. In other words, at some point, the taxpayer would not opt for evasion despite likely increases in expected utility because the risk would be too high for her taste. See Allingham & Sandmo, *supra* note 42, at 324.

⁷⁰ *Id.* at 324. According to Allingham and Sandmo, the analysis would not change much if we assume (more realistically) that a part of the actual income is known to the government because it would never pay to try to avoid taxes on that part. Accordingly, the analysis would then apply on that part of the income which remains unknown to the government. See *id.* n. 1.

⁷¹ *Id.* at 324.

⁷² *Id.*

⁷³ *Id.* at 324. But see Shlomo Yitzhaki, *A Note on Income Tax Evasion: A Theoretical Analysis*, 3 J. PUB. ECON. 201 (1974) (modifying the analysis such that the taxpayer pays penalty on the amount of tax missing due to evasion rather than on undeclared income, a practice that is common in countries such as United States and Israel).

⁷⁴ Allingham & Sandmo, *supra* note 42, at 324-32.

⁷⁵ *Id.* at 323.

⁷⁶ *Cf. id.* at 332-37 (laying out the dynamic case). See also *Carrots & Sticks*, *supra* note 41, at 240 (stating that with regards to the basic A-S model, one can imagine that each year essentially the same gamble takes place without there being any “memory” in the system).

⁷⁷ Allingham & Sandmo, *supra* note 42, at 324.

⁷⁸ *E.g., id.*

⁷⁹ *Id.*

⁸⁰ See, e.g., *Carrots & Sticks*, *supra* note 41, at 231-33.

⁸¹ The decision whether to evade or comply is therefore a lottery calculation or gamble in that a failure on the part of the taxpayer to report her true income to the authorities may not necessarily lead her to be subject to the full extent of the law in a way that would always make evasion an irrational course of action in terms of utility considerations. See, e.g., Allingham & Sandmo, *supra* note 42, at 324. In this context, an audit, for example, “is simply an instance of a taxpayer losing the “tax lottery.”” Erard, *supra* note 68, at 96.

- ⁸² Allingham & Sandmo, *supra* note 42, at 324.
- ⁸³ If the taxpayer is not investigated, she is better off when evading than when being honest. If she is investigated and penalized, she might be worse off – depending on the severity of the penalty imposed. *See id.*
- ⁸⁴ *See, e.g.*, Joel Slemrod & Shlomo Yitzhaki, *Tax Avoidance, Evasion, and Administration*, in HANDBOOK OF PUBLIC ECONOMICS 1423, 1451-52 (Alan J. Auerback & Martin Feldstein eds., 2002); Becker, *supra* note 48, at 176 (arguing the point that taxpayers consider expected penalties rather than nominal ones). *See also* Raskolnikov, *supra* note 5, at 576.
- ⁸⁵ Slemrod & Yitzhaki, *supra* note 84, 1432.
- ⁸⁶ Carroll, *supra* note 10, at 229.
- ⁸⁷ *Id.*
- ⁸⁸ *Id.*
- ⁸⁹ *Id.*
- ⁹⁰ *Id.*
- ⁹¹ *Id.* at 229-30.
- ⁹² *Id.* at 230.
- ⁹³ Allingham & Sandmo, *supra* note 42, at 329-30. As Sandmo explains, in the original A-S model an increase of the tax rate has an ambiguous effect on tax evasion because there is an income effect which is negative; higher taxes make the taxpayer poorer and, therefore, less willing to take risks. But there is also a substitution effect that works in the direction of increased evasion. The substitution effect on evasion in the A-S model occurs because the net penalty (i.e., the difference between the penalty rate and the regular tax rate) goes down when the tax rate increases due to the fact that the penalty rate is held fixed when the regular tax rate increases. The decrease in the net penalty in effect increases the incentive to underreport income. This substitution effect would be present under the more general but weaker assumption that the penalty rate increases less than proportionally with the tax rate. *See* Sandmo, *supra* note 14, at 647-48. However, if the fine is imposed on the evaded tax (instead of on the evaded income) the substitution effect disappears because the penalty increases with the tax rates. In this case, there remains only an income effect, which establishes a negative relationship between the tax rate and the amount of evasion. Yitzhaki, *supra* note 73. In other words, if absolute risk aversion decreases as income increases, higher

tax rates should lead to greater income declarations and a reduction in evasion. Unfortunately, this result goes against common intuition about the relationship between the marginal tax rate and evasion according to which an increase in tax rate provides a greater incentive to evade and also against much empirical evidence indicating a strong positive association between marginal tax rates and the amount of evasion. For surveys of empirical work in this area see Sandmo, *supra* note 14, at 647 n. 8. Similarly, when it comes to the relationship between actual income and evasion, “[i]t seems reasonable to assume that a higher gross income will increase evasion if one believes that people become more willing to engage in risky activities as they get richer. This is also predicted by the model if one makes the additional and common assumption that the measure of absolute risk aversion is decreasing.” *Id.* at 647. According to Erling Eide “[t]he reason why increases in various incomes and gains increases crime is that punishment in the case of decreasing absolute risk aversion produces a smaller reduction in expected (total) income. For risk-neutral people an increase in the probability or severity of punishment and a decrease in the gains to crime will reduce the supply of crime, whereas changes in exogenous income, and in the pay off of legal activity have no effect. Here, changes in the latter income components do not change the bite of punishment.” Eide, *supra* note 52, at 350-51. *But see id.* at 348 (“For the common assumption of decreasing absolute risk aversion an individual will allocate a larger proportion of his income to tax cheating the higher his exogenous income and the higher the gains from crime.”).

⁹⁴ Allingham & Sandmo, *supra* note 42, at 330. These two variables are of particular interest for policy purposes since “[t]he former is a parameter over which the tax authority exercises direct control; [while] the latter it may be assumed to control indirectly through the amount and efficiency of resources spent on detecting tax evasion.” *See id.* at 324, 332.

⁹⁵ *Id.* at 330. This result coincides with the gambling analogy where rational gamblers take fewer risks if the odds are worsened suggesting that adjustments to either the detection or punishment parameter can have a restraining impact on evasion.

⁹⁶ *Id.*

⁹⁷ *See, e.g., id.* at 324-25 (“The static model of the taxpayer’s choice situation is in some ways a significant simplification of the real world situation; in particular, the present formulation ignores some of the uncertainty elements. [For example] it abstracts from the fact that the tax

laws to some extent leave it to the discretion of the courts to determine the type of penalty levied and even that the penalty rate itself may be uncertain from the point of view of the taxpayer.”). Cf. Dick J. Hessing, Henk Elffers, Henry S. J. Robben & Paul Webley, *Does Deterrence Deter? Measuring the Effect of Deterrence on Tax Compliance in Field Studies and Experimental Studies*, in WHY PEOPLE PAY TAXES 291, 291 (Joel Slemrod ed., 1992) (referring to Allingham and Sandmo’s effort to incorporate risk aversion, reputation, and time into their analysis and stating that “the [A-S] model is not quite as simple as has sometimes been claimed.”).

⁹⁸ Allingham & Sandmo, *supra* note 42, at 333 (“The purpose . . . is to investigate the dynamic rather than the comparative static aspects of his declarations: for example whether for fixed parameters (tax rates, etc.) his declarations will increase or decrease over time, rather than whether in a fixed period the declaration will increase or decrease if a parameter changed.”). For more information on Allingham and Sandmo’s dynamic analysis see Allingham & Sandmo, *supra* note 42, at 332-37.

⁹⁹ Eduardo M.R.A. Engel & James R. Jr. Hines, *Understanding Tax Evasion Dynamics* (NBER, Working Paper No. 6903, 1999), available at <http://www.nber.org/papers/W6903>; Josef Greenberg, *Avoiding Tax Avoidance: A (Repeated) Game-Theoretic Approach*, 32 J. ECON. THEORY 1 (1984); Michael Landsberger & Isaac Meilijson, *Incentive Generating State Dependent Penalty System*, 19 J. PUB. ECON. 333 (1982).

¹⁰⁰ See *id.* See also Allingham & Sandmo, *supra* note 42, at 332.

¹⁰¹ Allingham & Sandmo, *supra* note 42, at 333.

¹⁰² Andreoni, Erard & Feinstein, *supra* note 22, at 824.

¹⁰³ Allingham & Sandmo, *supra* note 42, at 331. Note the dissatisfaction that Allingham and Sandmo expressed with respect to this feature of their 1972 analysis. See *id.* (“[T]his may not be entirely satisfactory, but a natural hypothesis on the nature of the dependence does not immediately suggest itself.”).

¹⁰⁴ Andreoni, Erard & Feinstein, *supra* note 22, at 819-20. See also Robert E. Brown & Mark J. Mazur, *The National Research Program: Measuring Taxpayer Compliance Comprehensively*, 51 KAN. L. REV. 1255, 1262-64, 1267 (2002).

¹⁰⁵ See *id.* See also Allen Kenney, *Everson Touts Increased IRS Enforcement in Fiscal 2004*, 105 TAX NOTES 1071, 1071 (2004).

- ¹⁰⁶ See, e.g., Jennifer F. Reinganum & Louise L. Wilde, *Income Tax Compliance in Principal-Agent Framework*, 26 J. PUB. ECON. 1 (1985); Jennifer F. Reinganum & Louise L. Wilde, *Equilibrium Verification and Reporting Policies in a Model of Tax Compliance*, 23 INT. ECON. REV. 739 (1986); Michael J. Graetz, Jennifer F. Reinganum & Louis L. Wilde, *The Tax Compliance Game: Toward an Interactive Theory of Law Enforcement*, 2 J. L. ECON. & ORG. 1 (1986).
- ¹⁰⁷ In this game, the IRS' aim is to maximize revenue collected while the taxpayer responds by deciding how much of her income to report. This approach to modeling compliance results in two basic classes of models according to the timing in which the tax authority can credibly commit to an audit strategy. In the first group of models, the tax agency announces and commits to an audit strategy using a cut-off rule before the taxpayers file their returns. All returns reporting an income below the cut-off point are audited with probability one, whereas those who report a higher income are not audited at all. In the second group of models, the tax agency does not commit to an audit strategy prior to the filing session, but instead decides which taxpayers to audit after all returns have been filed and based on the information that they reveal. This class of models takes the form of a sequential-move game with a number of possible equilibriums. See *supra* note 106. For a useful review of these models see Andreono, Erard & Feinstein, *supra* note 22, 827-831.
- ¹⁰⁸ E.g., John H. Pencavel, *A Note on Income Tax Evasion, Labor Supply, and Nonlinear Tax Schedules*, 12 J. PUB. ECON. 115 (1979); Frank Cowell, *Taxation and Labour Supply with Risky Activities*, 48 ECONOMICA 365 (1981).
- ¹⁰⁹ Sandmo, *supra* note 14, at 651.
- ¹¹⁰ *Id.*
- ¹¹¹ Slemrod & Yitzhaki, *supra* note 84, at 1436.
- ¹¹² *Id.*
- ¹¹³ Franzoni, *supra* note 4, at 58.
- ¹¹⁴ See, e.g., Michael J. Graetz & Louise L. Wilde, *The Economics of Tax Compliance: Fact and Fantasy*, 38 NAT'L TAX J. 355, 358 (1985) ("Application of the standard economic theory of crime to tax avoidance cases . . . produces an unambiguous prediction: throughout the 1970s *no one* should have paid the taxes they owed."). See also Jonathan Skinner & Joel Slemrod, *An Economic Perspective on Tax Evasion*, 38 NAT'L

TAX J. 345 (1985); Kent W. Smith & Karyl A. Kinsey, *Understanding Taxpaying Behavior: A Conceptual Framework with Implications for Research*, 21 LAW & SOC. REV. 639 (1987); Blumstein, *Model for Structuring Taxpayer Compliance*, in INCOME TAX COMPLIANCE: A REPORT OF THE ABA SECTION ON TAXATION, INVITATIONAL CONFERENCE ON INCOME TAX COMPLIANCE 159 (1983) (making the point that the penalties for overstating deductions or failing to report income are too low to deter potential evaders). It is important, however, to distinguish between different types of income that, if underreported, are subject to different probabilities of detection. For example, wage income is typically reported by the employer, and an attempt to underreport it by the taxpayer would, therefore, be detected with high probability. In that case the economic model predicts that there will be no attempt at evasion, a prediction that is generally supported by available compliance data. See *infra* note 122 and accompanying text. Moreover, a taxpayer's subjective assessment of the probability of audit is not necessary equal to the actual audit rate. In fact, studies indicate that people tend to overestimate the probability of detection, and this could go some way towards explaining non-evading behavior. See, e.g., James Alm, Gary H. McClelland & William D. Schulze, *Why do people pay taxes?*, 48 J. PUB. ECON. 21 (1992).

¹¹⁵ Michael Wenzel, *Misperceptions of Social Norms about Tax Compliance (I): A Prestudy* (Ctr. for Tax Sys. Integrity, Res. Sch. Of Soc. Sci., Austl. Nat'l Univ., Working Paper, 2001), available at: <http://eprints.anu.edu.au/archive/00000550/>.

¹¹⁶ See *The Tax Gap*, *supra* note 7.

¹¹⁷ Hessing, Elffers, Robben & Webley, *supra* note 97, at 292 (citations omitted).

¹¹⁸ JOHN BRAITHWAITE, RESTORATIVE JUSTICE AND RESPONSIVE REGULATION 186 (2003) [hereinafter RESTORATIVE JUSTICE].

¹¹⁹ See Allingham & Sandmo, *supra* note 42.

¹²⁰ See Eide, *supra* note 52, at 355-60 (reviewing empirical studies).

¹²¹ See, e.g., Mehemiah Friedland, Shlomo Maital & Aryen Rutenberg, *A Simulation Study of Income Tax Evasion*, 10 J. PUB. ECON. 107 (1978); Charles T. Clotfelter, *Tax Evasion and the Tax Rates: An Analysis of Individual Returns*, 65 REV. ECON. STAT. 363 (1983); 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); Paul J. Beck, Jon S. Davis & Woonoh Jung, *Experimental Evidence on Taxpayer Reporting under Uncertainty*, 66 ACC. REV. 535 (1991). These findings are not entirely conclusive. For a review of additional studies and some contradictory results see Hessing, Elffers, Robben & Webley, *supra* note 97.

¹²² IRS UPDATES, *supra* note 4.

¹²³ *Id.* See also, e.g., Kagan, *supra* note 35 (finding that compliance with the tax law is high for items that are most visible such as interest income and salary subject to withholding, but low for items that have little or no "paper trail" such as cash transactions, different types of business expenses, or charitable contributions).

¹²⁴ Edward K. Cheng, *Structural Laws and the Puzzle of Regulating Behavior*, 100 NW. U.L. REV. 655, 659 (2006) (citations omitted).

¹²⁵ See, e.g., Nehemiah Friedland, *A Note on Tax Evasion as a Function of the Quality of Information about the Magnitude and Credibility of Threatened Fines: Some Preliminary Research*, 12 J. APPLIED SOC. PSYCHOL. 311 (1982).

¹²⁶ See Eide, *supra* note 52, at 358-60 (reviewing literature).

¹²⁷ See, e.g., Becker, *supra* note 48, at 176 ("[A] change in the probability has a greater effect on the number of offences than a change in the punishment") (citing Lord Shawness (1965) ("Some judges preoccupy themselves with methods of punishment. This is their job. But in preventing crime it is of less significance than they like to think. Certainty of detection is far more important than severity of punishment.")). See also Dan M. Kahan, *Social Influence, Social Meaning, and Deterrence*, 83 VA. L. REV. 349, 380 (1997).

¹²⁸ Cheng, *supra* note 124, at 659.

¹²⁹ See e.g., Becker, *supra* note 48, at 180-81. See also Sandmo, *supra* note 14, at 648 (arguing in a different context that in modeling literature concerning policy optimization, it is usually assumed that the collection agency's objective is to maximize expected tax revenue).

¹³⁰ See, e.g., Becker, *supra* note 45, at 391 ("Fines are preferable to imprisonment and other types of punishment because they can deter crimes effectively if criminals have sufficient financial resources. Moreover, fines are more efficient than other methods because the cost to offenders is also revenue to the state."). Note that the underlying assumption here is that if extreme punishment would be effective in

terms of creating a deterrence force, there will be no actual need to impose penalties because people will not commit crimes. This, however, does not mean that such an approach would be politically or socially acceptable, feasible, or credible.

- ¹³¹ *E.g.*, Sandmo, *supra* note 14, at 660 (“for penalties to be socially acceptable, they probably must be set so that in the eyes of the general public, they ‘fit the crime.’”).
- ¹³² Cheng, *supra* note 124, at 659.
- ¹³³ *See, e.g.*, Dan M. Kahan, *Gentle Nudges vs. Hard Shoves: Solving the Sticky Norm Problem*, 67 U. CHI. L. REV. 607, 608 (2000).
- ¹³⁴ *Carrots & Sticks*, *supra* note 41, at 249-50.
- ¹³⁵ BRUNO S. FREY, NOT JUST FOR THE MONEY: AN ECONOMIC THEORY OF PERSONAL MOTIVATIONS (1997); Bruno S. Frey, *A Constitution for Knaves Crowds out Civic Virtue*, 107 ECON. J. 1043 (1997). *See Also* Lars P. Fled & Bruno S. Frey Ayres, *Deterrence and Morale in Taxation: An Empirical Analysis* (CESifo, Working Paper No. 760, 2002), available at http://www.cesifo-group.de/portal/page?_pageid=36,1&_dad=portal&_schema=PORTAL; Lars P. Fled & Bruno S. Frey Ayres, *Tax Evasion in Switzerland: The Role of Deterrence and Tax Morale* (CREMA Working Paper Series No. 284, 2006), available at <http://www.crema-research.ch/papers/papers.htm>.
- ¹³⁶ *See id.* In this context, noncompliance is particularly likely when the use of threat and legal authority is perceived by taxpayers to be illegitimate or unreasonable. Unreasonableness on the part of the regulator may involve disrespect for citizens or an arbitrary refusal to take their concerns into account in the enforcement process. *See* EUGENE BARDACH & ROBERT A. KAGAN, *THE PROBLEM OF REGULATORY UNREASONABLNESS: GOING BY THE BOOK* (1982). *See also* Robert A. Kagan & John T. Scholz, *The Criminology of Corporation and Regulatory Enforcement Strategies*, in *ENFORCING REGULATION* (Keith Hawkins & John M. Thomas eds., 1984); IAN AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION: TRANSCENDING THE DE-REGULATION DEBATE* (1992); TOM R. TYLER, *WHY PEOPLE OBEY THE LAW* (1990); ALLAN E. LIND & TOM R. TYLER, *THE SOCIAL PSYCHOLOGY OF PROCEDURAL JUSTICE* (1988). Several authors have written on the possibility of harmful effects of punitive enforcement more generally. *See, e.g.*, Carroll, *supra* note 10, at 234 (“Audits, withholding, and reporting requirements, and “Big Brother” data files that cross-check taxpayers with reports of income sources, charities, utility companies,

and so forth seem necessary to increase the risk of detection. However, such tactics may only create a larger under-ground economy and less visible ways to cheat.”); Karyl A. Kinsey, *Theories and Models of Tax Cheating*, in 3 CRIMINAL JUSTICE ABSTRACTS 402, 416 (1986) (arguing that deterrence based tools like tax audits frequently backfire by teaching tax cheaters how much is being overlooked by the tax administration); Valerie Braithwaite & John Braithwaite, *An Evolving Compliance Model for Tax Enforcement*, in CRIMES OF PRIVILEGE: READINGS IN WHITE-COLLAR CRIME 405, 406 (Neal Shover & John Paul Wright eds., 2001) (“tax enforcement is an area where the effects of deterrence and compliance approaches are unknown. When taxpayers are audited, for example, and a penalty is imposed, it is unclear whether they learn that they got away with a lot of things that the audit did not detect. . . . Sometimes an audit succeeds in deterring cheating in the long run, but in the year or two after audit taxpayers believe they are unlikely to be audited, and this has a dramatic negative effect on compliance in those two years.”).

- ¹³⁷ In this context, raising enforcement to the maximum means increasing enforcement until one dollar spent yields one dollar in revenue. See Slemrod, *supra* note 18, at 1-2.
- ¹³⁸ *Id.*
- ¹³⁹ *Id.* Cf. Franzoni, *supra* note 4, at 62 (suggesting that it is not obvious that curbing or eliminating evasion is necessarily a desirable goal since such efforts might be economically unsound in terms of shutting down beneficial economic activities which cannot bear the cost of taxation).
- ¹⁴⁰ James Alm, Betty R. Jackson & Michael Mckee, *Deterrence and Beyond: Toward a Kinder, Gentler IRS*, in WHY PEOPLE PAY TAXES 311, 322-23 (Joel Slemrod ed., 1992).
- ¹⁴¹ Valerie Braithwaite, *Dancing with Tax Authorities*, in TAXING DEMOCRACY: UNDERSTANDING TAX AVOIDANCE AND EVASION 15, 15 (Valerie Braithwaite ed., 2003). See also, generally, Doreen McBarnet, *When Compliance is not the Solution but the Problem: From Changes in Law to Changes in Attitude*, in TAXING DEMOCRACY: UNDERSTANDING TAX AVOIDANCE AND EVASION 229 (Valerie Braithwaite ed., 2003); Braithwaite & Braithwaite, *supra* note 136, at 406-07.
- ¹⁴² Carroll, *supra* note 10, at 258 (adding that this has been the case for efforts to regulate behavior in diverse areas such as shoplifting, drunk driving, and family violence). But see Cheng, *supra* note 124, at 668 (“[W]hen searching for solutions to undesirable conduct, legislatures

naturally incline toward establishing new rules that prohibit and punish the conduct. The machinery -- police, prosecutors, courts, prisons -- are already in place; the legislature might as well use it.”).

¹⁴³ Eide, *supra* note 52, at 353.

¹⁴⁴ *Id.* (citations omitted).

¹⁴⁵ Kent W. Smith, *Reciprocity and Fairness: Positive Incentives for Tax Compliance*, in *WHY PEOPLE PAY TAXES* 223, 223 (Joel Slemrod, ed., 1992) (stating that deterrence based on the detection and punishment of offenses is only one aspect of most enforcement and regulatory programs and that a mix of strategies has been found in several studies of regulatory agencies and the police).

¹⁴⁶ Sandmo, *supra* note 14, at 649-50.

¹⁴⁷ Some academics suggest, for example, that taxpayers may not process personal consequences, but, instead, focus on doing the “right thing” -- determined from legal, moral, social, utilitarian, or personal consequence viewpoints -- leading to a “norm-processing” rather than an “outcome-processing” model of decision making. *See, e.g.*, Carroll, *supra* note 13, at 47 (citations omitted).

¹⁴⁸ For example, when people are asked to justify their tax evasion, they commonly respond by saying that they have been treated unfairly by the tax system. Although this answer can be regarded as a mere defense of one’s own self-interested behavior, it may also indicate that taxpayers take into account institutional and environmental factors that go beyond the probability and severity of punishment. *See* Sandmo, *supra* note 14, at 651. *See also* Alm, Jackson & McKee, *supra* note 140, at 313 (“[D]etection and punishment cannot explain the compliance behavior of all individuals. The percentage of tax returns that are subject to detailed audit is quite small in most countries, and penalties are seldom more than a fraction of unpaid taxes. . . . However, compliance in many countries remains relatively high. Additional factors must play a role—perhaps a dominant one—in tax compliance.”); *see also supra* note 114 and accompanying text.

¹⁴⁹ *See, e.g.*, *supra* note 65 and accompanying text.

¹⁵⁰ *See, e.g.*, Sandmo, *supra* note 14, at 656 (suggesting that a careful analysis of evasion should take the social dimension of compliance more seriously and base policy predictions on a model that incorporates many

taxpayers and the interaction between them rather than the decision of only a single individual).

- ¹⁵¹ *Carrots & Sticks*, *supra* note 41, at 240.
- ¹⁵² In fact, it has been reported that perceptions of individual outcomes may play less of a role than perceptions of fairness and social outcomes associated with the tax law. *See, e.g., Taxpayer Adaptation*, *supra* note 46.
- ¹⁵³ James Alm, Betty R. Jackson & Michael McKee, *Estimating the Determinants of Taxpayer Compliance with Experimental Data*, 45 NAT'L TAX J. 107 (1992).
- ¹⁵⁴ Michael Spicer & Lee A. Becker, *Fiscal Inequality and Tax Evasion: An Experimental Approach*, 33 NAT'L TAX J. 17 (1980). Even though there is evidence that perceived inequalities in the tax system are related to noncompliance, the evidence is not entirely conclusive. For example, PAUL WEBLEY ET AL., *TAX EVASION: AN EXPERIMENTAL APPROACH* (1991) reached an opposite conclusion from Spicer and Becker. However, Robert Mason & Lyle D. Calvin, *Public Confidence and Admitted Tax Evasion*, 37 NAT'L TAX J. 489 (1984) found that dissatisfaction with the tax system is not directly related to reported noncompliance but that it changes other attitudes and beliefs that may impact compliance. For more information see *CHEATING THE GOVERNMENT*, *supra* note 19, at 219-20; Andreoni, Erard & Feinstein, *supra* note 22, at 851.
- ¹⁵⁵ Kathleen M. McGraw, John T. Scholz, & Marco R. Steenbergen, *Will Taxpayers Ever Like Taxes*, 13 J. ECON. PSYCH. 625 (1992) [hereinafter *Will Taxpayers Ever Like Taxes*]. *See also Taxpayer Adaptation*, *supra* note 46.
- ¹⁵⁶ *See id.* *See also, e.g., CHEATING THE GOVERNMENT*, *supra* note 19; John T. Scholz, *Trust, Taxes and Compliance*, in *TRUST AND GOVERNANCE* 135 (Valerie Braithwaite & Margaret Levi eds., 1998).
- ¹⁵⁷ Andreoni, Erard & Feinstein, *supra* note 22, at 851. According to Wenzel *supra* note 115, at 42-3, individual taxpayers may choose to evade taxes in order to maximize their personal outcomes and still enjoy a share of the public goods, which is not affected by any one defective choice. If many taxpayers evade or minimize their taxes, however, revenue would fall to a level where certain public goods might no longer be affordable and everyone's outcomes could be reduced. Taxpayers share a function of their combined behavioral choices (whether compliant or not) rather than being independent from one another. It is therefore rational for

taxpayers to evaluate what would be fair for them to pay in tax money not only based on their private consumption or relative share in the public goods and services but also in relation to their perception of other taxpayers' level of compliance.

- ¹⁵⁸ See, e.g., Dan M. Kahan, *Trust, Collective Action and Law*, 81 B.U.L. REV. 333 (2001). See also *Taxpayer Adaptation*, *supra* note 46, at 32 (concluding that perceptions of individual outcomes played less of a role than perceptions of individual fairness and social outcome associated with the 1986 Tax Reform Act).
- ¹⁵⁹ Harold G. Grasmick & Scott J. Wilbur, *Tax Evasion and Mechanisms of Social Control: A Comparison with Grand Petty Theft*, 2 J. J. ECON. PSYCHOL. 213 (1982) (suggesting that policies increasing the sense of moral duty to obey the law among taxpayers may significantly improve compliance).
- ¹⁶⁰ Laurie Mason & Robert L. Mason, *A Moral Appeal for Taxpayer Compliance: The Case for a Mass Media Campaign*, 14 L. & POL'Y 381 (1992).
- ¹⁶¹ See Marsha Blumenthal, Charles Christian & Joel Slemrod, *The Determinants of Income Tax Compliance: Evidence from a controlled experiment in Minnesota*, 79 J. PUB. ECON. 455 (2001); Marsha Blumenthal, Charles Christian & Joel Slemrod, *Do Normative Appeals Affect Tax Compliance? Evidence from a Controlled Experiment in Minnesota*, 54 NAT'L TAX J. 125 (2001); Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453 (2003). See also Kristina Murphy & Karen Byng, *Preliminary Finding From the Australian Tax System Survey of Scheme Investors* (Ctr. For Tax Sys. Integrity, Res. Sch. Of Soc. Sci., Austl. Nat'l Univ., Working Paper, 2002), available at <http://ctsi.anu.edu.au/publications/WP/WPlist.html>.
- ¹⁶² Note, for example, the incorporation of reputation already in the A-S analysis. Allingham & Sandmo, *supra* note 42, at 332-37. See also, e.g., Brian Erard & Jonathan S. Feinstein, *The Role of Moral Sentiments and Audit Perceptions in Tax Compliance*, 49 PUB. FIN. PUBLIQUES 70 (1994) (adding guilt and shame into the analysis of evasion).
- ¹⁶³ Cf. Becker, *supra* note 45, at 358-59 ("[T]he economic approach I refer to does not assume that individuals are motivated solely by selfishness or material gain. It is a *method* of analysis, not an assumption about

particular motivations. Along with others, I have tried to pry economists away from narrow assumptions about self-interest. Behavior is driven by a much richer set of values and preferences. The analysis assumes that individuals maximize welfare *as they conceive it*, whether they be selfish, altruistic, loyal, spiteful, or masochistic.”).

- ¹⁶⁴ Braithwaite, *supra* note 141, at 21.
- ¹⁶⁵ *See, particularly*, Valerie Braithwaite, *Games of Engagement: Postures within the Regulatory Community*, 17 L. & POL’Y 225 (1995); Valerie Braithwaite, John Braithwaite, Diane Gibson & Toni Makkai, *Regulatory Styles, Motivational Postures and Nursing Home Compliance*, 16 L. & POL’Y 363 (1994). People possess many beliefs, values, and attitudes that are often multi-dimensional, difficult to identify, and may appear to be inherently contradictory, especially when they translate to behavior. When it comes to strategic planning of enforcement, what was found to be helpful in understanding and determining the motivational influencers for taxpaying behavior was looking at motivations not in the abstract but in relation to adherence to the regulatory authority. *See* CASH ECONOMY TASK FORCE, AUSTRALIAN TAXATION OFFICE, *IMPROVING TAX COMPLIANCE IN THE CASH ECONOMY* 1, 22-24, 61-62 app.1 (1998); *see also* Braithwaite, *supra* note 141, at 24 (“motivational postures are proving to be useful markets of degree of consent, cooperation and commitment that underlies the human system as it comes into contact with the administrative/technical tax system.”).
- ¹⁶⁶ *E.g.*, Braithwaite, *supra* note 141, at 17-18 (explaining that individuals and groups regularly evaluate authorities in terms of what they stand for and how they perform). Over time, beliefs and attitudes for the authority are developed; they are socially shared and challenged. Individuals then develop rationalizations for their feelings and use values and ideologies to justify the motivational posture they possess. Braithwaite & Braithwaite, *supra* note 136, at 410 (“Motives shape the values and attitudes we publicly espouse to defend our position to ourselves and others. We all approach regulators with our own world view of how we want to and ought to engage with the regulatory system.”).
- ¹⁶⁷ Bogardus uses the term “social distance” to refer to the degree to which individuals (or groups) have positive feelings toward other ethnic groups and attribute status to them. *See* EMORY S. BOGARDUS, *IMMIGRATION AND RACE ATTITUDES* (1928). The contemporary work in motivational postures, however, examines the concept of social distance in the context of the regulator-regulated relationship. *See supra* note 165.

- ¹⁶⁸ Motivational postures can be viewed as indicators for the degree to which the taxpayer is giving consent to the tax authority to consider her as a participant in the tax system and to regulate her. Accordingly, a taxpayer's susceptibility to the influence of the administration means that she will not only be inclined to comply with the rules and regulations of the authority but also will cooperate once these are reformed. Braithwaite, *supra* note 141, at 18. *See also* Valerie Braithwaite & Jenny Job, *The Theoretical Base for the ATO Compliance Model 1*, 10 (Ctr. for Tax Sys. Integrity, Res. Sch. Of Soc. Sci., Austl. Nat'l Univ., Research Note 5), available at <http://ctsi.anu.edu.au/publications/researchnotes.html>.
- ¹⁶⁹ *See, e.g.*, CASH ECONOMY TASK FORCE, *supra* note 165, at 61-62 app.1. *Cf.* Carroll, *supra* note 13, at 48.
- ¹⁷⁰ CASH ECONOMY TASK FORCE, *supra* note 165, at 23, 62 app.1.
- ¹⁷¹ Braithwaite & Job, *supra* note 168, at 4 (explaining that BISEP characteristics represent what tax researchers and administrators know about those who engage in acts of noncompliance and those who do not). *See also* CASH ECONOMY TASK FORCE, *supra* note 165, at 20-22; Braithwaite & Braithwaite, *supra* note 136, at 414.
- ¹⁷² *Id.*
- ¹⁷³ *Id.*
- ¹⁷⁴ CASH ECONOMY TASK FORCE, *supra* note 165, at 22-24 (discussing only the first four postures). For complementary reviews see Braithwaite, *supra* note 141, at 18; Braithwaite & Braithwaite, *supra* note 136, at 410-11, and, more generally, *supra* note 165, and *infra* note 176.
- ¹⁷⁵ *See id.*
- ¹⁷⁶ *See id.* Taxpayers usually have a basic "comfort zone" that reflects their general stance toward the tax administration and the law. However, motivational postures are the result of a dynamic interaction between the taxpayer and the administration. Accordingly, the taxpayer can demonstrate more than one posture in any specific encounter, and she may also vary her attitude depending on the nature of a given interaction. There is some compatibility among the postures. Commitment and capitulation are generally compatible postures. Where these postures exist, disengagement and resistance are unlikely to be present. Disengagement is a posture that is compatible with resistance and also with game playing. According to Valerie Braithwaite, none of these correlations, however, is sufficiently high to conclude that taxpayers

can be placed on a simple adversarial-cooperative dimension. See Braithwaite, *supra* note 141, at 22-24. See also Valerie Braithwaite & Monika Reinhart, *The Taxpayers' Charter: Does the Australian Tax Office comply and who benefits?* (Ctr. for Tax Sys. Integrity, Res. Sch. Of Soc. Sci., Austl. Nat'l Univ., Working Paper, 2000), available at <http://ctsi.anu.edu.au/publications/WP/WPlist.html>; Valerie Braithwaite, *The Community Hopes, Fears and Actions Survey: Goals and Measures* (Ctr. for Tax Sys. Integrity, Res. Sch. Of Soc. Sci., Austl. Nat'l Univ., Working Paper, 2001), available at <http://ctsi.anu.edu.au/publications/WP/WPlist.html>; Valerie Braithwaite, Monika Reinhart, Malcolm Mearns & Rachele Graham, *Preliminary findings from the Community Hopes, Fears and Actions Survey* (Ctr. for Tax Sys. Integrity, Res. Sch. Of Soc. Sci., Austl. Nat'l Univ., Working Paper, 2001), available at <http://ctsi.anu.edu.au/publications/WP/WPlist.html>.

¹⁷⁷ See *supra* note 165.

¹⁷⁸ *Id.*

¹⁷⁹ Braithwaite, *supra* note 141, at 24.

¹⁸⁰ *Id.* (explaining that persuasion measures may include, for example, education and open dialogue).

¹⁸¹ See *supra* note 165.

¹⁸² *Id.*

¹⁸³ *Id.*

¹⁸⁴ *Id.*

¹⁸⁵ Braithwaite, Braithwaite, Gibson & Makkai, *supra* note 165.

¹⁸⁶ *Id.*

¹⁸⁷ See Braithwaite & Job, *supra* note 168, at 11 (making the point that when the taxpayer cuts himself off completely from the authority, the only regulatory option left to the authority is to make non-compliance impossible).

¹⁸⁸ McBarnet, *supra* note 141, at 229-33. The game playing posture emerged from discussions with tax officials and taxpayers over matters of compliance. Although this type of behavior has been previously studied in the context of economic regulation, it has yet to be extensively examined in other regulatory contexts, especially by social scientists. See Braithwaite, *supra* note 141, at 18-19; Valerie Braithwaite, Monika Reinhart & Jason McCrae, *Game Playing with Tax Law* (Ctr. for Tax Sys.

Integrity, Res. Sch. Of Soc. Sci , Austl. Nat'l Univ., Research Note 8), available at <http://ctsi.anu.edu.au/publications/researchnotes.html>.

- ¹⁸⁹ McBarnet, *supra* note 141, at 229-33. “With disengagement and game playing, citizens see the power of government as irrelevant to their lives. The question is whether they acknowledge the authority or step outside its reach.” See Braithwaite & Job, *supra* note 168, at 10.
- ¹⁹⁰ Braithwaite, *supra* note 141, at 23. Thirteen percent of the recipients of the 2000 national survey conducted by the Centre for Tax System Integrity at the Australian National University were identified as game players. On the other hand, approximately 92 percent of the survey respondents indicated the posture of commitment and 73 percent recognized themselves in the posture of capitulation. Fifty-five percent of the respondents reported holding a resistance posture. Least pervasive was disengagement with only 7 percent of respondents identifying themselves that way. See *supra* note 176.
- ¹⁹¹ Braithwaite & Braithwaite, *supra* note 136, at 406-07 (“increasingly, the problem for large business firms is not tax evasion, but adoption of sophisticated strategies for circumventing tax laws. . . . [W]hat is true for tax avoidance is also true for the wealthiest individuals.”). Braithwaite & Braithwaite report that the Big Five accounting firms in the United States have been able to increase their profits substantially through offering their clients more aggressive tax minimization strategies. Ernst & Young and Deloitte & Touche, for example, reported a 29 percent jump in their profits from tax service in the United States in 1997 and, overall, since 1993, tax revenue for the Big Five has grown at twice the pace of audit revenue. The worry with these recent expansions is that they will trigger a race to the bottom where lesser players will assume that adopting aggressive tax practices is the only way to stay competitive. *Id.*; see also Braithwaite & Job, *supra* note 168, at 10 (arguing that “the public response of dissociation [of taxpayer from the tax authority and their tax obligations] has the potential for posing a major threat to the regulatory effectiveness of tax authorities, and more broadly democratic government.”).
- ¹⁹² One option is to regulate through laws that allow wide discretion to impose compliance with policy, such as by deeming activities that comply only in form but not in substance as illegitimate. See Doreen McBarnet, *The Construction of Compliance and the Challenge for Control: The Limits of Noncompliance Research*, in *WHY PEOPLE PAY TAXES* 333 (Joel Slemrod ed., 1992).

- ¹⁹³ *Id.*; see also Murphy, *supra* note 17, at 564.
- ¹⁹⁴ Braithwaite, *supra* note 141, at 33 (discussing the findings from the Australian 2000 *Community, Hopes, Fears and Actions Survey*). Cf. PAUL WEBLEY ET AL, *supra* note 154 (finding that taxpayers who indicate alienation from or negative attitudes toward laws and the government are considerably more likely to engage in evasion). On the relationship between attitudes and behavior more generally see also *infra* notes 198 & 199.
- ¹⁹⁵ Braithwaite, *supra* note 141, at 33.
- ¹⁹⁶ *Id.*
- ¹⁹⁷ *Id.* at 35 (“All too often, authorities make the assumption of consistency between attitude and behavior: People who do the wrong thing are bound to be nasty pieces of work, and need to be treated like the villains they are.”). In fact, empirical evidence indicates that the relationship between motivational postures and behavior is empirically weak in that motivational postures do not, necessarily, lead to acts of obedience or disobedience. According to Valerie Braithwaite, disparities between motivational postures that taxpayers hold and the compliance related actions they take are likely to reflect the taxpayers’ responsiveness to different environmental conditions such as their reference group and/or the nature of their interaction with the tax administration. Braithwaite adds that the conceptualization of attitudes and behavior as distinct is in keeping with empirical findings in the area of tax enforcement and the broader realm of human behavior, demonstrating that people do not always obey the law, even when they believe in it. See *id.* at 16-17, 33 (commenting that this inconsistency goes against the expectation that attitudes and behavior be related and consistent and that such an expectation implies rationality, comprehension, and thought that are not always present in human behavior).
- ¹⁹⁸ See, e.g., LIND & TYLER, *supra* note 136; TYLER, *supra* note 136; Tom R. Tyler & Kathleen M. McGraw, *Ideology and the Interpretation of Personal Experience: Procedural Justice and Political Quiescence*, 42 J. SOCIAL ISSUES 115 (1986); Tom R. Tyler, *Justice, Self-Interest, and the Legitimacy of Legal and Political Authority*, in BEYOND SELF-INTEREST 171 (Jane J. Mansbridge ed., 1990).
- ¹⁹⁹ See *id.*; see also CHEATING THE GOVERNMENT, *supra* note 19 (reviewing the attitudinal and experimental literatures and finding that individual attitudes and perceptions of the tax system are generally related

to compliance behavior). For findings supporting the claim that procedurally just administrative practices positively affect compliance among taxpayers see Murphy & Byng, *supra* note 161, and Kristina Murphy, *Turning Resistance into Compliance: Evidence from a Longitudinal Study of Tax Scheme Investors* (Ctr. For Tax Sys. Integrity, Res. Sch. Of Soc. Sci., Austl. Nat'l Univ., Working Paper, 2005), available at <http://ctsi.anu.edu.au/publications/WP/WPlist.html>.

²⁰⁰ Smith, *supra* note 145, at 225 (citations omitted); see also CASH ECONOMY TASK FORCE, *supra* note 165, at 62 app.1 (indicating that, ideally, if the tax authority treats the taxpayer with fairness and respect, the taxpayer will try to comply because it is “the right thing to do”).

²⁰¹ Smith, *supra* note 145, at 227. For a good discussion of the role that administrative practices play in affecting taxpayer compliance see also Lederman, *supra* note 10.

²⁰² Taxpayer distrust or hostility toward the tax administration could be the result of experiences taxpayers had directly with the tax administration or due to other, indirect interactions, such as what taxpayers observe from the experiences of others or based on norms and habits of a reference group. Direct contact with the tax administration can be gained, for example, while the taxpayer is being audited and resenting the intrusive treatment or even the failure to be audited when such failure is viewed as a weakness on the part of the administration. Note, for example, that there is evidence to suggest that personal experience with audits might increase tax resistance. Michael W. Spicer & Lundstedt, *Understanding Tax Evasion-An Experimental Approach*, 33 NAT'L TAX J. 171 (1976).

²⁰³ See Braithwaite & Job, *supra* note 168, at 8, 11.

²⁰⁴ Braithwaite & Braithwaite, *supra* note 136, at 411-12 (advancing the argument that the way to understand the interaction between the taxpayer and the tax administration as well as the taxpayer need for a coping mechanism in certain circumstances is through theories of shame and identity). For a useful review of some of the theories relevant to the regulator-regulated relationship, in a different context, see RESTORATIVE JUSTICE, *supra* note 118, at 79-90.

²⁰⁵ Braithwaite & Braithwaite, *supra* note 136, at 411.

²⁰⁶ *Id.* at 412.

²⁰⁷ *Id.* at 411.

- ²⁰⁸ *Id.* at 412 (explaining that trying cooperation remains the best first choice for achieving the goal of changing motivational postures to more compliant ones but adding that offering cooperation to non-compliers may not always be the response that regulators want to make). *See also* the literature on reciprocity *supra* notes 200 & 201 and accompanying text.
- ²⁰⁹ Braithwaite & Braithwaite, *supra* note 136, at 412.
- ²¹⁰ CASH ECONOMY TASK FORCE, *supra* note 165, at 57.
- ²¹¹ Braithwaite, *supra* note 141, at 35.
- ²¹² *See, generally*, JOHN BRAITHWAITE, TO PUNISH OR PERSUADE (1985). *See also* Braithwaite & Braithwaite, *supra* note 136, at 405 (“decades of research on regulatory rule enforcement prompted a battle of sorts between those who favor a deterrence approach and those who promote compliance approaches, between punishment and persuasion. Now the debate has changed focus to ‘how to get the right mix of the two.’”); Murphy, *supra* note 17, at 564, 589.
- ²¹³ Carroll, *supra* note 13, at 44.
- ²¹⁴ Braithwaite & Braithwaite, *supra* note 136, at 413.
- ²¹⁵ Valerie Braithwaite, *Tax Compliance*, in TAXING DEMOCRACY, UNDERSTANDING TAX AVOIDANCE AND EVASION 1, 1 (Valerie Braithwaite ed., 2003) [hereinafter *Tax Compliance*]; Jenny Job & David Honaker, *Short Term Experience with Responsive Regulation in the Australian Taxation Office*, in TAXING DEMOCRACY, UNDERSTANDING TAX AVOIDANCE AND EVASION 111, 111-13 (Valerie Braithwaite ed., 2003).
- ²¹⁶ Job & Honaker, *supra* note 215, at 112.
- ²¹⁷ *See, e.g.*, EUGENE BARDACH & ROBERT A. KAGAN, GOING BY THE BOOK: THE PROBLEM OF REGULATORY UNREASONABLENESS (1982); NEIL GUNNINGHAM & PETER GRABOSKY, SMART REGULATION: DESIGNING ENVIRONMENTAL POLICY (1998); MALCOLM K. SPARROW, THE REGULATORY CRAFT (2000); AYRES & BRAITHWAITE, *supra* note 136; RESTORATIVE JUSTICE, *supra* note 118.
- ²¹⁸ CASH ECONOMY TASK FORCE, *supra* note 165, at 57.
- ²¹⁹ *See, generally, id.* The ATO started by examining enforcement in the building and construction industries where evidence suggested a high level of cash transactions. *See* Neal Shover, Jenny Job & Anne Carroll, *The ATO Compliance Model in Action: A Case Study of Building and*

Construction, in TAXING DEMOCRACY, UNDERSTANDING TAX AVOIDANCE AND EVASION 159 (Valerie Braithwaite ed., 2003); Job & Honaker, *supra* note 215.

²²⁰ *See, generally*, AYRES & BRAITHWAITE, *supra* note 136.

²²¹ *Id.* at 4.

²²² *Id.* at 5.

²²³ *Id.*

²²⁴ *Id.*

²²⁵ *Id.* at 35-40, 47-51.

²²⁶ *Id.* at 4-5.

²²⁷ *See, e.g., id.* at 35-40.

²²⁸ CASH ECONOMY TASK FORCE, *supra* note 165, at 22-26.

²²⁹ *Id.*

²³⁰ These postures are discussed in pages 261-65 of this paper.

²³¹ *See supra* note 228. *But see* AYRES & BRAITHWAITE, *supra* note 136, at 36; John Braithwaite, *Large Businesses and the Compliance Model*, in TAXING DEMOCRACY, UNDERSTANDING TAX AVOIDANCE AND EVASION 177, 178 (Valerie Braithwaite ed., 2003) (explaining that the idea behind the compliance model is to offer strategies and knowledge as to how to go about enhancing tax compliance. It is not a recipe but a model to guide strategic thinking) [hereinafter *Large Businesses*]. *See also* Braithwaite & Braithwaite, *supra* note 136, at 408-09 (“[what is important] is not the content of the enforcement pyramid but its form. Different kinds of sanctions are appropriate to different regulatory arenas.”).

²³² CASH ECONOMY TASK FORCE, *supra* note 165, at 24-26; *see also* AYRES & BRAITHWAITE, *supra* note 136, at 35-40.

²³³ *See, generally*, AYRES & BRAITHWAITE, *supra* note 136, at 19-53.

²³⁴ *E.g., id.*, at 51.

²³⁵ *Id.* at 30-35.

²³⁶ *Id.* *See also* Braithwaite, Braithwaite, Gibson & Makkai, *supra* note 165; *supra* note 176.

²³⁷ AYRES & BRAITHWAITE, *supra* note 136, at 24 (citing JOHN BRAITHWAITE, TO PUNISH OR PERSUADE (1985)).

- ²³⁸ *Id.* Cf. Smith, *supra* note 145, at 229 (“if a balance of strategies emphasizing both positive incentives and the detection and punishment of non-compliance is to be effective, then the two strategies must symbiotically reinforce each other, rather than detract from each other.”).
- ²³⁹ AYRES & BRAITHWAITE, *supra* note 136, at 21. Note that the method of balancing positive service with punitive deterrence coincides quite nicely with the general prevention approach discussed in *supra* notes 143 & 144 and accompanying text.
- ²⁴⁰ Cf. CASH ECONOMY TASK FORCE, *supra* note 165, at 57.
- ²⁴¹ AYRES & BRAITHWAITE, *supra* note 136, at 38-39.
- ²⁴² *Id.* at 21; *see also* RESTORATIVE JUSTICE, *supra* note 118, at 30.
- ²⁴³ AYRES & BRAITHWAITE, *supra* note 136, at 21.
- ²⁴⁴ *Id.*
- ²⁴⁵ *Tax Compliance*, *supra* note 215, at 5.
- ²⁴⁶ AYRES & BRAITHWAITE, *supra* note 136, at 21.
- ²⁴⁷ *Id.*; *see also* RESTORATIVE JUSTICE, *supra* note 118, at 30-31.
- ²⁴⁸ AYRES & BRAITHWAITE, *supra* note 136, at 26-27.
- ²⁴⁹ *Id.* (explaining that compared with punitive deterrence persuasion is less likely to generate taxpayer resentment and a “cat-and-mouse” quality of relationship where the taxpayer seeks to exploit loopholes and the tax administration needs to apply more and more specific regulation to close them).
- ²⁵⁰ *Id.*
- ²⁵¹ Braithwaite & Braithwaite, *supra* note 136, at 410.
- ²⁵² *Id.*
- ²⁵³ AYRES & BRAITHWAITE, *supra* note 136, at 49-50.
- ²⁵⁴ CASH ECONOMY TASK FORCE, *supra* note 165, at 58 (indicating that the range of regulatory and enforcement strategies and the pace of their escalation depend on the particular circumstances and characteristics of the taxpayers and industries involved).
- ²⁵⁵ AYRES & BRAITHWAITE, *supra* note 136, at 27, 29-30; RESTORATIVE JUSTICE, *supra* note 118, at 32 (suggesting that defiance by the regulatee will often occur when the regulatee is being a rational actor, aiming to maximize her gain from noncompliance).

- ²⁵⁶ AYRES & BRAITHWAITE, *supra* note 136, at 38-39. Here, the ATO Compliance Model captures the importance of building a broad base to the pyramid “where there is considerable consensus on what compliance means, strong commitment to doing the right thing, and communication networks that reinforce the importance of law abiding behavior.” Braithwaite & Braithwaite, *supra* note 136, at 414. *See also* Braithwaite & Job, *supra* note 168, at 2-3.
- ²⁵⁷ RESTORATIVE JUSTICE, *supra* note 118, at 33, 39-40.
- ²⁵⁸ *Id.*
- ²⁵⁹ CASH ECONOMY TASK FORCE, *supra* note 165, at 22-26; AYRES & BRAITHWAITE, *supra* note 136, at 35-40.
- ²⁶⁰ Braithwaite & Job, *supra* note 168, at 2; *Tax Compliance*, *supra* note 215, at 5.
- ²⁶¹ *Id.*
- ²⁶² *Large Businesses*, *supra* note 231, at 179 (citation omitted).
- ²⁶³ *See supra* note 7 and accompanying text. Interestingly, the current rate of compliance remains consistent with the rate estimated almost twenty years ago. *See, e.g.*, Leandra, *supra* note 10, at 1009 (indicating that, using TCMP data, the rate of tax compliance in the United States in 1988 was 83 percent).
- ²⁶⁴ The Compliance model recognizes that encouraging voluntary compliance via self-regulation is the most effective regulatory strategy in most cases. *See* AYRES & BRAITHWAITE, *supra* note 136, at 38.
- ²⁶⁵ CASH ECONOMY TASK FORCE, *supra* note 165, at 58.
- ²⁶⁶ *Id.*
- ²⁶⁷ *Id.*; *see also Tax Compliance*, *supra* note 215, at 3-4 (explaining, for example, that when it comes to disengagement, and sometimes game-playing, the taxpayer holds such distrust and dislike for the system that the chances of persuasion or other cooperative strategies being effective are low).
- ²⁶⁸ CASH ECONOMY TASK FORCE, *supra* note 165, at 58.
- ²⁶⁹ *Id.*
- ²⁷⁰ Braithwaite & Braithwaite explain, for example, that for a taxpayer showing the posture of disengagement, a strategy that results in a move to resistance would improve the tax office’s prospects for gaining

compliance. A further improvement would be achieved through inducing the motivational postures of capture or accommodation. See Braithwaite & Braithwaite, *supra* note 136, at 414. Braithwaite & Job, *supra* note 168, at 2 (“as regulatees resist compliance and move up the regulatory pyramid, a regulatory agency will use persuasion, moral appeal and deterrence to talk them down to bottom again.”).

²⁷¹ AYRES & BRAITHWAITE, *supra* note 136, at 40-41 (adding that “the greater the heights of punitiveness to which an agency can escalate, the greater its capacity to push regulation down to the cooperative base of the pyramid.”). According to Ayres and Braithwaite, the most severe enforcement and regulatory strategies should be visible so that taxpayers will perceive the tax administration as having an “aura” of power. *Id.* at 44-47. See also CASH ECONOMY TASK FORCE, *supra* note 165, at 24-25.

²⁷² See, e.g., CASH ECONOMY TASK FORCE, *supra* note 165, at 26, 63 app.1 (suggesting that individual personalities matter less when everyone knows that the role of the regulator is to be cooperative first and then to introduce sanctions only when there is no cooperation).

²⁷³ Braithwaite & Braithwaite, *supra* note 136, at 409; see also *supra* note 198.

²⁷⁴ AYRES & BRAITHWAITE, *supra* note 136, at 40-51; CASH ECONOMY TASK FORCE, *supra* note 165, at 25. Cf. Steven M. Sheffrin & Robert K. Triest, *Can Brut Deterrence Backfire? Perceptions and Attitudes in Taxpayer Compliance*, in *WHY PEOPLE PAY TAXES* 193 (Joel Slemrod ed., 1992) (suggesting the importance of effective enforcement that is visible to the taxpaying community).

²⁷⁵ AYRES & BRAITHWAITE, *supra* note 136, at 19.

²⁷⁶ Becker, *supra* note 45, at 402.

²⁷⁷ AYRES & BRAITHWAITE, *supra* note 136, at 51.