

THE PSYCHIC COST OF TAX EVASION

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Abstract: Each year, the government loses hundreds of billions of dollars in tax revenue due to underreporting by individual taxpayers. According to standard deterrence theory, policymakers should be able to reduce tax evasion by increasing tax penalties, raising the audit rate, or some combination of the two. This Article refers to these strategies as increasing the “monetary cost” of tax evasion. To date, budgetary limitations and political hurdles have made these strategies difficult for the government to employ. There is, however, another potential means by which the government can improve tax compliance, apart from raising the monetary cost of evasion. Empirical evidence shows that people experience some form of psychological discomfort when they are dishonest, which may deter them from cheating. This Article proposes employing subtle behavioral interventions that encourage more honest tax reporting by raising the level of psychological discomfort experienced from underreporting. I refer to this approach as increasing the “psychic cost” of tax evasion. Adopting measures designed to increase the psychic cost of tax evasion, such as making small adjustments to the way that taxpayers fill out their tax forms, could generate much needed tax revenue. Moreover, these measures would impose very little administrative expense to the government as compared to traditional deterrence mechanisms like audits and penalties. While further empirical research is needed to test how to increase the psychic cost of tax evasion in the most cost-effective manner, this Article proposes a roadmap for beginning that process.

INTRODUCTION

There is untold wealth in America—especially at income tax time.

—Anonymous

For many individuals, cheating on one’s taxes is perfectly rational.¹ The overall odds of being audited are quite low² and the penalty for un-

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derreporting is typically just a fraction of the tax owed.³ It should come as no surprise, then, that many taxpayers cheat. But this creates an expensive problem. Individual tax evasion costs the government over \$250 billion in lost revenue per year, before taking into account revenue lost by corporate tax shelters or legal tax loopholes.⁴ This is troubling in any economy, but is particularly problematic in light of the current budget deficit.

Why, then, does the government not invest more resources in cracking down on individual tax evasion? Standard deterrence theory indicates that tax compliance can be improved by raising the expected monetary cost of evasion to taxpayers. This expected cost is a simple function of the probability of detection and the fine for evasion: If the government makes it more likely that an individual will be caught cheating or more expensive if that individual is caught, then she should be less likely to cheat. For example, a rational actor would not evade \$100 of taxes if she had a fifty percent chance of incurring a \$400 penalty (expected penalty of \$200) or a five percent chance of incurring a \$4,000 penalty (same).⁵ Thus, according to deter-

¹ This is particularly true of individuals who generate income not subject to any third-party reporting, such as a small business owner who earns self-employment income. Underreporting income that is not reported by third parties (e.g., a bank reporting on a Form 1099 or an employer reporting on a W-2) can be incredibly difficult for the IRS to detect. *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-1014, TAX GAP: THE STRATEGY FOR REDUCING THE GAP SHOULD INCLUDE OPTIONS FOR REDUCING SOLE PROPRIETOR NONCOMPLIANCE, REPORT TO THE SENATE FINANCE COMMITTEE 12 (2007) [hereinafter "GAO STRATEGY"].

² On average, the IRS audits about one percent of individuals each year. *See* IRS, INTERNAL REVENUE SERVICE FISCAL YEAR 2013 ENFORCEMENT AND SERVICE RESULTS 2, available at <http://www.irs.gov/PUP/newsroom/FY%202013%20Enforcement%20and%20Service%20Results%20--%20WEB.pdf>, archived at <http://perma.cc/PG9W-2CCH> (noting individual audit rate for 2013 was 0.96%). The chance of being audited, however, varies depending on individual characteristics. For example, individuals who are self-employed and not subject to third-party withholding on their business income have an overall audit rate closer to three percent. *See* GAO STRATEGY, *supra* note 1, at 23. Nevertheless, even for individuals that are audited, there is no guarantee that the IRS will detect unreported income.

³ A typical civil tax penalty for underreporting is twenty percent of the tax due. *See, e.g.*, I.R.C. § 6662(a), (b)(1) (2012) (negligence penalty). The Internal Revenue Code ("IRC") also provides for a seventy-five percent civil fraud penalty, as well as criminal fines and other criminal sanctions. *See, e.g.*, I.R.C. §§ 6663, 7201–7203 (2012). These more serious measures, however, are rarely applied. For example, in 2013, the Internal Revenue Service ("IRS") asserted over 700,000 accuracy-related civil penalties (generally twenty percent of the tax owed) against individuals, trusts, and estates, compared to less than 4000 civil fraud penalties. *See* IRS, INTERNAL REVENUE SERVICE DATA BOOK 2013, at 42–43 (2013). The number of cases referred for criminal prosecution by the IRS was just 4364. *Id.* at 44–45.

⁴ *See* Tax Gap for Tax Year 2006, IRS, 2 (Jan. 6, 2012), http://www.irs.gov/pub/newsroom/overview_tax_gap_2006.pdf, archived at <http://perma.cc/5D2W-DCGV> (estimating that individuals underreported \$235 billion in income taxes and \$57 billion in self-employment taxes in 2006, the most recent year studied by the IRS).

⁵ This example is somewhat oversimplified. For example, it ignores risk aversion, which many standard deterrence theory models account for. Varying levels of risk aversion would cause some individuals to behave more cautiously than others even if penalties and audit rates remained

rence theory, policymakers should be able to reduce tax evasion by raising the audit rate, increasing tax penalties, or some combination of both.

At first blush, it is puzzling why the government has not employed this seemingly obvious strategy. The answer, in large part, is because it is not necessarily cost-effective from the government's perspective. Audits can require relatively large amounts of time and financial resources,⁶ and raising the audit rate beyond its current level is generally seen as politically infeasible. Increasing tax penalties imposes more subtle costs, but many scholars have argued that increasing penalties much beyond their current levels is cost prohibitive due to both high administrative costs (such as increased litigation) and the potential "crowding out" of voluntary compliance.⁷

But there is another cost to tax evasion incurred by taxpayers, which may provide a more promising means by which the government can improve tax compliance. Apart from the potential monetary costs, individuals may also experience some form of psychological discomfort when they are dishonest, which may deter them from cheating. This discomfort—we might think of it as guilt—imposes an additional utility cost not accounted for by the standard deterrence model. I refer to this cost as the "psychic cost" of tax evasion, and argue that it should be factored into our understanding of the taxpayer's cost-benefit analysis along with the monetary costs.

The idea that guilt might deter people from cheating is not new. The tax literature has long recognized that individual ethics play some role in tax compliance. But past scholarship has portrayed honesty as a fixed personal characteristic, generally assuming that individuals are either inherently honest or dishonest. Recent empirical studies by psychologists and behavioral economists, however, have demonstrated that individual honesty is actually a malleable trait, influenced heavily by environmental factors. While a minority of individuals are completely honest in all circumstances (even if it would be economically advantageous to lie), and a minority of individuals are dishonest whenever it financially benefits them, most fall somewhere in

constant. See, e.g., Kathleen DeLaney Thomas, *Presumptive Collection: A Prospect Theory Approach to Increasing Small Business Tax Compliance*, 67 TAX L. REV. 111, 124 n.82 (2013).

⁶ For every tax dollar collected, the IRS estimates that it spends \$0.006 on average. Joel Slemrod & Shlomo Yitzhaki, *Tax Avoidance, Evasion, and Administration*, in 3 HANDBOOK OF PUBLIC ECONOMICS 1449 (A.J. Auerbach & M. Feldstein eds., 2002). Some audits, however, will inevitably be more costly than others. For example, auditing a taxpayer with a cash-based business may consume a lot of time and resources because the taxpayer may be unable to provide reliable or accessible paper documentation of income and expenses.

⁷ See *infra* notes 16–37 and accompanying text.

the middle of the spectrum and may or may not cheat depending on the circumstances.⁸

Notably, the level of expected monetary gain derived from cheating is not the sole factor in the decision to be honest (contrary to what deterrence theory would predict), nor is it the most influential. Rather, researchers have identified several non-economic factors that influence the decision to be honest.⁹ First, individuals tend to be more honest when they pay attention to their own moral standards at the time of decision-making. For example, subjects who were asked to recall the Ten Commandments before completing a task cheated significantly less at that task than controls, regardless of how many Commandments they could recall and regardless of their religious beliefs.¹⁰ The results of the study suggest that the mere act of having to think about the Ten Commandments influenced subjects' honesty.

Secondly, individuals tend to be *less* honest when they are able to justify their actions to themselves as something other than cheating (a process referred to as "categorization").¹¹ Psychologists have posited that this tendency stems from two competing desires: the desire to obtain economic benefits from cheating and the desire to maintain one's self-concept as an honest person.¹² Because individuals experience discomfort when they act contrary to their self-concept, they tend not to cheat unless they can convince themselves that what they are doing is not really cheating. For example, people might be more willing to take office supplies from an employer than to take the equivalent amount of cash (although there is no economic difference) because they can categorize the former as something other than stealing.

Third, individuals tend to be *more* honest when they perceive that there is a victim who will be directly harmed by their dishonesty. For example, studies show that subjects cheat less when they are told that their financial payoff will reduce the payoff to a counterparty, as compared to when there is no counterparty.¹³ However, the unselfish motive diminishes as the wealth

⁸ See, e.g., Uri Gneezy, *Deception: The Role of Consequences*, 95 AM. ECON. REV. 384, 391–92 (2005); Nina Mazar et al., *The Dishonesty of Honest People: A Theory of Self-Concept Maintenance*, 45 J. MARKETING RESEARCH 633, 642–43 (2008); Nina Mazar & Dan Ariely, *Dishonesty in Everyday Life and Its Policy Implications*, 25 J. PUB. POL'Y & MARKETING 117, 117–18 (2006).

⁹ Although this Article will focus on three factors for which there is a substantial amount of empirical support, this list of factors that influence honesty is by no means exhaustive.

¹⁰ See *infra* notes 77–98 and accompanying text.

¹¹ See Mazar et al., *supra* note 8, at 634–35.

¹² See *id.* at 634.

¹³ See Gneezy, *supra* note 8, at 385.

of the counterparty increases (e.g., people are more accepting of employees cheating employers than vice versa).¹⁴

This Article applies these three empirical findings to taxpayer behavior and argues that policymakers should use this evidence regarding individual honesty to reduce tax evasion. I begin by proposing a simple theoretical model of tax compliance that supplements the standard deterrence model by accounting for the psychic cost of tax evasion. I then argue that the three factors described above should be incorporated into our understanding of the psychic cost of cheating. For example, paying attention to moral standards should be seen as increasing the psychic cost of tax evasion (resulting in less cheating) while categorizing dishonest behavior as acceptable should be seen as decreasing the psychic cost of tax evasion (resulting in more cheating). The latter half of this Article then focuses on the tax policy implications of this approach.

By understanding the psychic cost of tax evasion as malleable, rather than a fixed trait of a particular taxpayer, this cost becomes another policy tool—along with audits and penalties—that can be utilized by the government in an effort to increase tax compliance. In the same way that raising penalties or increasing the audit rate would make the expected monetary cost of evasion higher for taxpayers (thus improving compliance), undertaking policies designed to raise the psychic cost of tax evasion could have a similar impact. The core argument of the Article is that the government should raise the psychic cost of tax evasion by employing subtle behavioral “nudges”¹⁵ that encourage taxpayers to be more honest. For example, the IRS might incorporate brief statements on income tax returns that are designed to call attention to the taxpayer’s moral standards. More honesty in tax reporting equates to more tax revenue raised. Moreover, adopting measures to increase the psychic cost of tax evasion should impose a relatively small administrative cost to the government compared to expending resources to audit more taxpayers, and should avoid the crowding out effects and other costs imposed by high penalties.

This Article makes a unique contribution to the existing tax literature by identifying the psychic cost of tax evasion as an additional policy tool that can and should be exploited by the government to improve tax compliance. It then offers realistic tax policy applications for the existing behavioral economics literature on honesty. While further empirical research is

¹⁴ It also diminishes as the payoff to the cheating party increases, suggesting that rational forces still come into play, notwithstanding the presence of a victim. *See id.* at 391.

¹⁵ *See generally* RICHARD THALER & CASS SUNSTEIN, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS* (2d. ed. 2009) (coining the term “nudge” to describe modest behavioral interventions).

needed to test how to implement behavioral nudges in the most cost-effective manner, this Article proposes a roadmap for beginning that process.

To be clear, this Article is aimed only at intentional tax evasion by individuals when the relevant law is unambiguous. For example, the behavioral interventions suggested herein would be aimed at a taxpayer who wins cash income at a casino, is aware that it is reportable, but is contemplating not reporting it. This Article is not intended to reach taxpayers who employ legal avoidance strategies or those who take an aggressive but legally defensible position with respect to a murky area of law.

The Article proceeds as follows: Part I describes the standard deterrence model of tax compliance, along with some of the existing literature on non-economic factors that contribute to tax compliance. Part II describes the results of recent empirical research on honesty, which reveal that honesty tends to be a malleable and context-specific trait in most individuals. Part III proposes a simple tax compliance model that supplements the standard deterrence model by incorporating a “psychic cost” to evading taxes and argues that we must understand this psychic cost as one that varies based on external factors. Part IV explores the policy implications of a tax compliance model that incorporates a psychic cost of tax evasion. It argues that the government can and should take steps to increase this psychic cost through behavioral nudges, and offers concrete policy recommendations for doing so. It then addresses potential objections to those proposals.

I. ECONOMIC AND NON-ECONOMIC THEORIES OF TAX COMPLIANCE

Current tax compliance policies in the U.S. are based, in large part, upon standard deterrence theory. This Part provides a brief overview of that theory and examines some additional, non-economic compliance theories proposed by tax scholars. By asserting that tax evasion should be understood as imposing a psychic cost, this Article does not advocate abandoning standard deterrence theory, but rather supplementing it with an updated understanding of the non-economic factors that encourage individuals to comply with their tax liability.

A. Standard Deterrence Theory: The Rational Actor Model

Standard deterrence theory, as applied to tax compliance, assumes that taxpayers are rational actors seeking to maximize their expected utility.¹⁶

¹⁶ The rational model was famously applied in the legal arena by Gary Becker, who hypothesized that rational actors decide whether to comply with the law by weighting the expected fines from noncompliance against the expected benefit of noncompliance. Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 176–79 (1968). Becker’s work was subsequently extended to the tax law by Michael Allingham and Agnar Sandmo, whose work has

Accordingly, a taxpayer who is deciding whether to comply with the tax law will weigh the expected cost of tax evasion against the cost of complying and choose the cheaper option.¹⁷ The cost of complying is simply the amount of tax owed. The cost of evasion, however, is somewhat more complex. If a taxpayer evades and is caught, she will have to pay the tax owed and will also have to pay a penalty, which is usually some fraction of the tax owed (e.g., twenty percent). Together, this penalty added to the tax owed can be thought of as the total fine for evasion (F). There is a chance, however, that the IRS will not detect the taxpayer's evasion, in which case the taxpayer incurs no cost. Thus, the *expected* cost of tax evasion is the total fine for evasion discounted by the probability of detection (P):¹⁸

$$\begin{aligned} \text{Cost of Compliance} &= \text{Tax Owed} \\ &\text{v.} \\ \text{Expected Cost of Evasion} &= P \times F^{19} \end{aligned}$$

For example, if the probability of detection were one percent (which is the current overall audit rate)²⁰ and the penalty for evasion were twenty percent of the tax due, the expected cost of evading \$100 of tax would be the \$100 of tax due plus a \$20 penalty ($F = \$120$), discounted by one percent chance of being detected (P). The resulting \$1.20 expected cost would be substantially cheaper than the cost of complying (i.e., the \$100 of tax owed). In that case, a rational taxpayer would cheat.

become the dominant model of tax compliance for both economists and legal scholars. See Michael G. Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J. PUB. ECON. 323, 323–24 (1972).

¹⁷ See Allingham & Sandmo, *supra* note 16, at 324.

¹⁸ *Id.* The Allingham-Sandmo model assumes probability of detection p , tax rate r , declared income of X , and actual income of W . If the taxpayer's evasion is discovered, she will have to pay tax on the undeclared amount ($W - X$) at some penalty rate f , which is higher than r . The individual will choose X so as to maximize utility (U):

$$E[U] = (1 - p)U(W - rX) + pU(W - rX - f(W - X)).$$

Shlomo Yitzhaki subsequently updated this model by pointing out that the penalty in most systems is based on the underpayment of tax, not unreported income. See Shlomo Yitzhaki, *A Note on Income Tax Evasion: A Theoretical Analysis*, 3 J. PUB. ECON. 201, 201–02 (1974).

¹⁹ This is a simplified version of the Allingham-Sandmo model. See *supra* note 18. The Allingham-Sandmo model dictates that the expected utility of the evasion decision is the sum of the expected benefit if not detected plus the expected cost if detected, and both of these are measured by reference to the taxpayer's total wealth, W . See *supra* note 18 and accompanying text. Most versions of the model also assume a risk-averse taxpayer, whereas the above model assumes risk neutrality for the sake of simplicity and brevity. The Allingham-Sandmo model also simplifies the true "costs" of tax evasion. For example, there may be additional monetary costs imposed on a taxpayer besides tax penalties and the tax due, such as the costs of undergoing an audit or hiring a lawyer.

²⁰ See *supra* note 2 and accompany text.

A policymaker seeking to deter a rational taxpayer from evading tax can do so by raising the expected cost of evasion, with the goal of making it more expensive than the cost of compliance. It follows from the model that raising either the probability of detection or the penalty for evasion, or some combination of the two, can increase the expected cost of evasion. In the context of tax compliance, this means higher tax penalties, raising the audit rate, or finding some other method to increase the rate of detection.

At first glance, raising tax penalties appears to be a simple and potentially cost-effective solution for increasing tax compliance. Current civil tax penalties in the United States range from just twenty percent to seventy-five percent of the tax due,²¹ resulting in sub-optimal expected penalties if the risk of detection is small.²² If Congress increased nominal penalties significantly, it could potentially deter tax evasion without investing more resources in ferreting out noncompliant taxpayers.

Raising tax penalties, however, presents a number of hurdles. First, at a one percent rate of detection, optimal penalties would have to be set at more than ninety-nine *times* the tax evaded.²³ Such a departure from the current status quo is likely to be politically infeasible.²⁴ Moreover, costs associated with significantly increasing nominal penalties counsel against such an approach. Extremely high tax penalties would likely be perceived as unfair in the case of inadvertent errors, and may be perceived as disproportionate even in the case of intentional evasion.²⁵ In fact, harsh penalties may actual-

²¹ See *supra* note 3 and accompanying text. In reality, the twenty to seventy-five percent penalty rates understate the true amount of the “fine” for noncompliance, because most taxpayers will likely incur some additional costs such as interest and/or advisor fees if they contest the penalty.

²² In the example in the text above, the expected penalty for evading \$100 of tax was just \$1.20 when the risk of detection was one percent and the penalty was twenty percent.

²³ See Leandra Lederman, *The Interplay Between Norms and Enforcement*, 64 OHIO ST. L.J. 1453, 1468 n.77 (2003). To see why this is so, consider again the taxpayer who is considering evading \$100 of tax. For the expected cost of evasion to outweigh the cost of compliance (\$100), the nominal penalty would have to be more than \$9900 ($[\$9900 + \$100 \text{ (tax owed)}] \times 0.01 \text{ (chance of detection)} = \100).

Most versions of the rational actor model assume some level of risk aversion, which places an effective ceiling on penalties. See Daniel Shaviro, *Disclosure and Civil Penalty Rules in the U.S. Legal Response to Corporate Tax Shelters*, in TAX AND CORPORATE GOVERNANCE 229, 239 (Wolfgang Schon ed., 2008). For example, although a risk-neutral taxpayer would need to incur a \$9900 penalty to be deterred from evading \$100 of tax with a one percent chance of detection, a risk-averse taxpayer might be sufficiently deterred at a lower penalty. Taxpayers, however, are generally not thought to be so risk-averse that they would be deterred by current penalty levels (0.2 to 0.75 of the tax) at a risk of detection of only one percent. See, e.g., Terrance Chorvat, *Trust in Taxation*, in BEHAVIORAL PUBLIC FINANCE 210 (McCaffery & Slemrod eds., 2006); Sanjit Dhami & Ali I-Nowaihi, *Why Do People Pay Taxes? Prospect Theory Versus Expected Utility Theory*, 64 J. ECON. BEHAV. & ORG. 171, 172 (2007).

²⁴ See Lederman, *supra* note 23, at 1466; Thomas, *supra* note 5, at 124.

²⁵ Joel Slemrod, *Cheating Ourselves: The Economics of Tax Evasion*, 21 J. ECON. PERSP. 25, 43 (2007).

ly result in *lower* tax compliance if they foster resentment in taxpayers and “crowd out” their intrinsic motivations to comply.²⁶ Higher tax penalties may also impose greater administrative costs, as there may be more procedural hurdles before the IRS could assert them,²⁷ more resources expended by the government in prosecuting them,²⁸ and more costs incurred by taxpayers in contesting them. Finally, at a certain level, high penalties will become uncollectible to the extent that they exceed taxpayers’ resources.

Given the obstacles to raising tax penalties, the government might instead focus on increasing the probability of detection, which could be achieved by increasing the audit rate or the thoroughness of current audits. But such a strategy would likely face public resentment and political hurdles, as evidenced by the backlash against prior efforts by the IRS to boost its auditing program.²⁹ Additionally, many view the IRS’s resources as too constrained to expand audits significantly.³⁰

Another method by which the government has increased the rate of detection is through third-party information reporting. The IRS collects information about taxpayers from third parties such as employers and financial institutions, compiles the data in an internal database, and then electronically matches the data with information that the taxpayers report on their tax returns.³¹ If the IRS finds a discrepancy in the income reported by the taxpayer, the taxpayer may be flagged for audit.³² The vast majority of income that is reported to the IRS by third parties is also reported accurately by taxpayers on their tax returns (approximately ninety-two percent),³³ which is consistent with standard deterrence theory. Because the rate of detection for

²⁶ See Bruno S. Frey, *A Constitution for Knaves Crowds Out Civic Virtues*, 107 *ECON. J.* 1043, 1044–45 (1997); Alex Raskolnikov, *Revealing Choices: Using Taxpayer Choice to Target Tax Enforcement*, 109 *COLUM. L. REV.* 689, 704 (2009).

²⁷ For example, applying a relatively new forty percent strict liability penalty for tax shelters requires special procedures such as managerial approval. See I.R.C. § 6662(b)(6) (2012); IRS LB&I Directive, IRS, *Guidance for Examiners and Managers on the Codified Economic Substance Doctrine and Related Penalties* (Jul. 15, 2011), available at <http://www.irs.gov/Businesses/Guidance-for-Examiners-and-Managers-on-the-Codified-Economic-Substance-Doctrine-and-Related-Penalties>, archived at <http://perma.cc/Q5NB-83T2>.

²⁸ See Slemrod, *supra* note 25, at 43.

²⁹ The unpopularity of the Taxpayer Measurement Compliance Program (“TCMP”), an intensive series of audits conducted by the IRS for research purposes, is a prime example. The TCMP was formally abandoned in 1995, due in part to its cost and in part because of the perception that the audits were overly-intrusive. See Joseph M. Dodge & Jay Soled, *Debunking the Basis Myth Under the Income Tax*, 81 *IND. L.J.* 539, 563 (2006).

³⁰ U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-13-151, *TAX GAP: IRS COULD SIGNIFICANTLY INCREASE REVENUES BY BETTER TARGETING ENFORCEMENT RESOURCES 1* (Dec. 2012).

³¹ *Id.* at 4. For example, when a taxpayer receives a Form 1099 from a bank showing interest income, the IRS also receives the information from the bank.

³² See *id.*

³³ See Tax Gap for Tax Year 2006, *supra* note 4, at 3 (noting an eight percent noncompliance rate for amounts subject to substantial information reporting).

evading taxes on such income is extremely high, the expected cost of evading taxes on that income is also high. Accordingly, if more types of income could be subject to third-party information reporting, compliance could be improved.³⁴ The bulk of underreported income, however, arises out of transactions for which there are no viable third-parties to report to the IRS, such as a cash sale between a retailer and a consumer.³⁵ For these types of transactions, which make up a substantial portion of the tax gap,³⁶ the IRS must find an alternative means to promote better compliance.

The standard deterrence model provides a powerful mechanism by which the government can improve compliance, namely, by making evasion more costly for the taxpayer. Although nominal tax penalties have remained fairly stable over the past several decades,³⁷ policymakers have had great success in enhancing tax compliance by increasing the rate of detection for some types of income, largely through third-party information reporting. Most of the tax gap, however, is attributable to noncompliance among individuals where information reporting is not feasible. Moreover, as discussed above, increasing penalties or auditing more individuals are not viable solutions to decreasing tax evasion. Thus, to improve tax compliance, policymakers may need to look outside of the standard deterrence model. As will be discussed in Part IV, adopting behavioral nudges that increase the psychic cost of tax evasion may prove to be an additional method to make evasion more costly to taxpayers while minimizing expense to the government.

B. Non-Economic Theories of Tax Compliance

Although tax compliance policies in the United States are largely modeled on deterrence theory, many tax scholars have argued that non-economic factors play an additional, important role in tax compliance. A common thread in this literature is that norms—either social or personal—influence tax compliance decisions. Social norms relate to taxpayers' perceptions of

³⁴ See, e.g., Leandra Lederman, *Reducing Information Gaps to Reduce the Tax Gap: When Is Information Reporting Warranted?*, 78 *FORDHAM L. REV.* 1733, 1759 (2010).

³⁵ See *id.* at 1752–53; Thomas, *supra* note 5, at 113.

³⁶ See Thomas, *supra* note 5, at 113.

³⁷ Under the 1954 Internal Revenue Code, accuracy penalties ranged from five percent for negligence to fifty percent for fraud. See DEP'T OF TREASURY, REPORT TO THE CONGRESS ON PENALTY AND INTEREST PROVISIONS OF THE INTERNAL REVENUE CODE 21 (Oct. 1999). Penalties were strengthened in the 1980s (twenty percent for negligence and seventy-five percent for fraud), but the rates have remained relatively stable since. See *id.* at 24, 26–27. The most recent movement in civil penalties has occurred in the realm of tax shelters, where rates have climbed from twenty percent to forty percent of the tax due over the past two decades. See Kathleen DeLaney Thomas, *The Case Against a Strict Liability Economic Substance Penalty*, 13 *U. PA. J. BUS. L.* 445, 445–47, 449–54 (2011). Although most penalty rates have not increased in recent decades, there are more penalties in the tax code than in previous years and the IRS collects more revenue from penalties than it did previously. See DEP'T OF TREASURY, *supra*, at 19, 51.

whether other taxpayers are compliant. Personal norms involve one's individual sense of right and wrong. This Section discusses the effect of both social norms and personal norms on tax compliance.³⁸ Although the two theories may be interrelated, this Article focuses on personal norms—also referred to as “taxpayer honesty” herein.

This Article seeks to draw attention to taxpayer honesty because past legal scholarship has devoted more attention to understanding how social norms relate to tax compliance,³⁹ with relatively little attention paid to personal norms. While many scholars have recognized that personal norms play some role in tax compliance, they have been described as a “black box”—something we cannot understand because we cannot get inside the heads of taxpayers.⁴⁰ Thus, research and policy recommendations have tended to focus more on cultivating social norms. Yet, there does not appear to be a strong empirical case for favoring appeals to social norms over personal norms.

For example, in a recent IRS survey, eighty-six percent of respondents surveyed cited “personal integrity” as having the greatest amount of influence on their tax compliance decisions, as compared to twenty-two percent citing belief that their neighbors are honest.⁴¹ Additionally, as discussed

³⁸ This is by no means an exhaustive list of factors outside of standard deterrence theory that may influence tax compliance. For example, some scholars have suggested that taxpayers are more likely to cheat if they believe that the tax burden is unfairly distributed, that the government has treated them unfairly, or that other taxpayers are unfairly advantaged. *See, e.g.*, James Andreoni et al., *Tax Compliance*, 36 J. ECON. LIT. 818, 850–51 (1998); Marjorie Kornhauser, *A Tax Morale Approach to Compliance: Recommendations for the IRS*, 8 FLA. TAX REV. 599, 614–15 (2007); Slemrod, *supra* note 25, at 39. In a similar vein, others have theorized that compliance is higher when taxpayers approve of how the government spends their tax dollars. *See, e.g.*, Andreoni et al., *supra*, at 851; Yair Listokin & David M. Schizer, *I Like to Pay Taxes: Taxpayer Support for Government Spending and the Efficiency of the Tax System*, 66 TAX L. REV. 179, 179–81 (2013); Slemrod, *supra* note 25, at 39. Additionally, taxpayers' subjective perceptions about the probability that they will be audited or the fines they will incur may play a role in their compliance decisions. *See* Andreoni et al., *supra*, at 844–46 (discussing studies showing that taxpayers overestimate the probability of audit). Additionally, framing effects (i.e., whether taxpayers are claiming a refund or owe a balance) have also been found to play a role in tax compliance. *See* Paul Corcoro & Peter Adelsheim, *A Balance Due Before Remittance: The Effect on Reporting Compliance*, in RECENT RESEARCH ON TAX ADMINISTRATION AND COMPLIANCE: SELECTED PAPERS GIVEN AT THE 2010 IRS RESEARCH CONFERENCE 107, 109 (Martha Eller Gangi & Alan Plumley eds., 2010).

³⁹ *See infra* notes 44–55 and accompanying text.

⁴⁰ Michael Doran, *Tax Penalties and Tax Compliance*, 46 HARV. J. ON LEGIS. 111, 137–38 (2009).

⁴¹ IRS OVERSIGHT BOARD, 2012 TAXPAYER ATTITUDE SURVEY 14 (Feb. 2013) [hereinafter “TAXPAYER ATTITUDE SURVEY”]. Forty percent of respondents reported fear of audit as having a great amount of influence. *Id.* Of four factors presented to participants (personal integrity, fear of audit, third-party reporting, and belief that neighbors are paying), the one that most people indicated had “no influence” on their compliance decisions was belief that neighbors are paying hon-

below, a number of empirical studies have indicated that appeals to conscience can have a positive impact on tax compliance,⁴² and that feelings of moral obligation have more influence on compliance decisions than fear of social stigma.⁴³ Further, as discussed in Part II, a growing body of recent research has shed light on the “black box” of personal norms that can provide useful insight into what drives taxpayer honesty.

1. Social Norms

A number of scholars have posited that tax compliance is partly attributable to social norms.⁴⁴ Adherence to social norms generally describes a desire to reciprocate the good behavior of others⁴⁵ or to send a positive signal to others.⁴⁶ If there is a social norm of tax compliance, then individuals will be more likely to comply because their neighbors are complying. Such norms may deter tax evasion if taxpayers perceive a threat of social stigma from violating the norm.⁴⁷

There have been a number of empirical studies of the effect of appeals to social norms on tax compliance. For example, one frequently cited study conducted by the Minnesota Department of Revenue examined whether taxpayers would be positively influenced by the knowledge that other individuals are highly compliant.⁴⁸ To that end, the authors of the study sent a letter to a group of taxpayers informing them that the vast majority of individuals

estly (thirty-seven percent, compared to two percent saying personal integrity had no influence). *Id.*

One limitation of survey studies such as the Taxpayer Attitude Survey, however, is that they assume that taxpayers give honest or otherwise reliable responses as to what actually drives their tax compliance decisions. It is possible, for example, that some respondents cite personal integrity as the most influential factor because they fear doing otherwise would make them appear dishonest. However, the fact that personal integrity has been the most influential factor “by far” in multiple studies of different groups of respondents (the IRS reports annual results from 2005–2012) indicates that it is likely a significant factor in taxpayers’ compliance decisions. *See id.* at 6, 14.

⁴² *See, e.g., infra* notes 58, 64 and accompanying text.

⁴³ *See, e.g., infra* notes 66–67 and accompanying text.

⁴⁴ *See, e.g.,* Andreoni et al., *supra* note 38, at 850–52; Doran, *supra* note 40, at 131; Kornhauser, *supra* note 38, at 612–17; Lederman, *supra* note 23, at 1468–69; Slemrod, *supra* note 25, at 38–41.

⁴⁵ *See* Dan M. Kahan, *The Logic of Reciprocity: Trust, Collective Action, and Law*, 102 MICH. L. REV. 71, 81 (2003) (arguing that individuals are more likely to comply if they believe that other taxpayers are compliant, and vice versa).

⁴⁶ *See* Eric Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA L. REV. 1781, 1819 (2000). *But cf.* Dan M. Kahan, *Signaling or Reciprocating? A Response to Eric Posner’s Law and Social Norms*, 36 U. RICH. L. REV. 367, 367–69 (2002).

⁴⁷ *See* Harold G. Grasmick & Wilbur J. Scott, *Tax Evasion and Mechanisms of Social Control: A Comparison with Grand and Petty Theft*, 2 J. ECON. PSYCHOL. 213, 215 (1982).

⁴⁸ *See, e.g.,* STEPHEN COLEMAN, MINN. DEP’T OF REVENUE, THE MINNESOTA INCOME TAX COMPLIANCE EXPERIMENT: STATE TAX RESULTS 5, 18 (1996).

comply with their tax obligations.⁴⁹ The authors reported a “modest” improvement in tax compliance among taxpayers who received the letter,⁵⁰ although authors of a subsequent study of the same data concluded that the impact was not statistically significant.⁵¹ In a similar study conducted in Australia, taxpayers who were informed about high compliance rates were less likely to overstate non-work related deductions, but there was no effect on work-related deductions.⁵² Another field study conducted in Switzerland examined the effect of a normative appeal (again, through a letter) on the timeliness of filing and paying, as opposed to the amount reported.⁵³ That study found that the normative appeal had no significant effect on the timeliness of taxpayers’ returns or payment.⁵⁴

Despite mixed results in the data, the idea that social norms encourage tax compliance has been a relatively popular theory among tax scholars, a number of whom have made policy recommendations aimed at cultivating these norms.⁵⁵ Others, however, have expressed skepticism that social norms affect compliance because tax return information is confidential and generally cannot be observed by others.⁵⁶ Arguably, individuals cannot respond to a social norm to comply with their tax liability without the threat of a social sanction for violating it.⁵⁷

⁴⁹ *Id.* at 5–6. To compare the effect of the normative appeal with the effect of standard deterrence measures, another group of taxpayers received a letter informing them that they were likely to be audited. Compliance generally improved among this risk-of-audit group. *See id.* at 2–3, 10–12.

⁵⁰ *Id.* at 25.

⁵¹ See Marsha Blumenthal et al., *Do Normative Appeals Affect Tax Compliance? Evidence from a Controlled Experiment in Minnesota*, 54 NAT’L TAX J. 125, 132 (2001).

⁵² See Michael Wenzel, *Misperceptions of Social Norms About Tax Compliance: From Theory to Intervention*, 26 J. ECON. PSYCHOL. 862, 877–78 (2005).

⁵³ Benno Torgler, *Moral Suasion: An Alternative Tax Policy Strategy? Evidence from a Controlled Field Experiment in Switzerland*, 5 ECON. GOV. 235, 239 (2004). The letter attempted to highlight the “closeness” of the local community (by explicitly mentioning the number of residents) and the relationship of trust between the government and the community. *Id.* at 240–41.

⁵⁴ *Id.* at 250.

⁵⁵ *See, e.g.*, Kahan, *supra* note 45, at 83–84; Kornhauser, *supra* note 38, at 602; Lederman, *supra* note 23, at 1501; Susan Morse, *Tax Compliance and Norm Foundation Under High Penalty Regimes*, 44 CONN. L. REV. 675, 735–36 (2012).

⁵⁶ *See, e.g.*, Doran, *supra* note 40, at 135–37; Kahan, *supra* note 46, at 378.

⁵⁷ *See, e.g.*, Doran, *supra* note 40, at 135–37; Stephen Mazza, *Taxpayer Privacy and Tax Compliance*, 51 U. KAN. L. REV. 1065, 1083 (2003). While federal tax return information is confidential, many states make individual taxpayer noncompliance public in an effort to “shame” such individuals and promote compliance. *See* Joshua D. Blank, *What’s Wrong with Shaming Corporate Tax Abuse?* 62 TAX L. REV. 539, 539–43 (2009).

2. Personal Norms

In addition to attributing compliant behavior to social norms, scholars have also recognized that taxpayers are likely driven by an internal motivation to comply, arising out of one's innate sense of honesty, ethics, or civic obligation.⁵⁸ These intrinsic motivations, sometimes called "personal norms," have also been the subject of a number of empirical studies. In one seminal field experiment, researchers compared the effect of "appeals to conscience" on a group of taxpayers to the effect of the threat of legal sanctions on another group.⁵⁹ Both groups were interviewed during the month prior to the filing of their returns and asked questions intended to emphasize certain motives for payment.⁶⁰ For example, members of the "sanctions" group were asked about their opinion regarding the severity of various sanctions for tax evasion. The "conscience" group was asked questions such as whether citizens have an obligation to the government and whether one should feel guilty for not paying their taxes.⁶¹ In cooperation with the IRS, the authors subsequently examined changes in tax compliance among the treated groups for the year under study by examining tax return information.⁶² While both treated groups demonstrated an improvement in tax compliance, the conscience appeal had a much stronger effect than the threat of sanctions, with a mean increase in income reported of \$804 in the conscience group⁶³ as compared to \$181 in the sanctions group.⁶⁴

Another study surveyed individuals to compare the effects of legal sanctions, social stigma, and guilt on tax compliance.⁶⁵ Participants were asked about past tax noncompliance and whether they expected to be non-compliant in the future. To gauge the effect of different sources of deterrence, the participants responded to questions regarding their views on the likelihood of legal sanctions for tax evasion, whether they believed the peo-

⁵⁸ See, e.g., Andreoni et al., *supra* note 38, at 850; Doran, *supra* note 40, at 132; Michael W. Spicer, *Civilization at a Discount: The Problem of Tax Evasion*, 39 NAT'L TAX J. 13, 16 (1986).

⁵⁹ Richard D. Schwartz & Sonya Orleans, *Appeals to Conscience*, 34 U. CHI. L. REV. 274, 284 (1967).

⁶⁰ *Id.* at 285–88.

⁶¹ *Id.* A placebo group was given a basic interview without any "accentuation questions," while a fourth group served as an untreated control. *Id.* at 288.

⁶² By providing compliance data on a group-wide rather than individual basis, the IRS did not violate taxpayer confidentiality. *Id.* at 285.

⁶³ This amount, in 1962 dollars, would be greater today when adjusted for inflation. See *id.* at 296.

⁶⁴ *Id.* at 295. The authors of the study cautioned that "results obtained from the experiment are not of a magnitude which uniformly produces statistically significant differences." *Id.* at 294. There were approximately ninety taxpayers in each group. See *id.* at 285.

⁶⁵ See Grasmick & Scott, *supra* note 47, at 213–14. Whereas violations of a social norm may result in perceived stigma, the authors noted that guilt results from a violation of a personal norm. *Id.* at 215.

ple close to them evaded tax, and whether they felt it is “wrong” to evade taxes.⁶⁶ The authors of the study concluded that “[t]he threat of guilt feelings . . . is noticeably greater than the effect of stigma . . . which, in turn, is greater than the effect of legal punishment”⁶⁷ Another similar survey study that also examined the impact of guilt (attributable to personal norms), embarrassment (attributable to social norms), and legal sanctions on tax compliance found that the effect of guilt was 1.5 times as great as the effect of legal sanctions, and that there was no significant effect found from embarrassment.⁶⁸

Personal versus social rationales for tax compliance are not necessarily alternative theories, nor are they likely to be independent of one another. For example, a taxpayer’s personal norms may be influenced by her perceptions of social norms of tax compliance.⁶⁹ Once those perceptions of social norms have been internalized, however, violations of a taxpayer’s personal norms are associated with feelings of guilt and/or discomfort from acting outside of one’s own moral code, which should be distinguished from embarrassment or fear of social stigma.⁷⁰ In other words, empirical studies showing that personal norms influence compliance suggest that taxpayers may comply with their tax liability simply because they believe it is the right thing to do. Regardless of whether they believe their neighbors are complying, some taxpayers may choose not to cheat because doing so would be inconsistent with their belief system.⁷¹ This may be the case even for tax-

⁶⁶ *Id.* at 218.

⁶⁷ *Id.* at 225.

⁶⁸ Harold G. Grasmick & Robert J. Bursik, Jr., *Conscience, Significant Others, and Rational Choice: Extending the Deterrence Model*, 24 *LAW & SOC’Y REV.* 837, 851–52 (1990). The authors of the study used the term “shame” to describe feelings associated with guilt from violating personal norms, a term which others have attributed to violations of social norms. *See id.* at 846.

There have been additional studies finding a link between ethical beliefs and tax compliance, as well. *See, e.g.*, Philip M. J. Reckers et al., *The Influence of Ethical Attitudes on Taxpayer Compliance*, 47 *NAT’L TAX J.* 825, 825–26 (1994); Dipanker Ghosh & Terry L. Crain, *Ethical Standards, Attitudes Toward Risk, and Intentional Noncompliance: An Experimental Investigation*, 14 *J. BUS. ETHICS* 353, 353 (1995).

⁶⁹ *See, e.g.*, Kahan, *supra* note 45, at 81; Kornhauser, *supra* note 38, at 612; Lederman, *supra* note 23, at 1469–70.

⁷⁰ *See, e.g.*, Brian Erard & Jonathan S. Feinstein, *The Role of Moral Sentiments and Audit Perceptions in Tax Compliance*, 49 *PUB. FIN.* 70, 74–76 (1994) (discussing the difference between guilt for violating a personal norm versus shame for violating a social norm); Grasmick & Bursik, *supra* note 68, at 840–41 (contrasting feelings of guilt from violating personal norms with feelings of embarrassment from violating social norms).

⁷¹ However, research suggests that certain attitudes may “neutralize” taxpayers’ feelings of guilt from tax evasion. For example, people who believe that the government wastes their tax dollars may feel less guilt from evading tax than they otherwise would from being dishonest. *See* Quint C. Thurman, Craig St. John & Lisa Riggs, *Neutralization and Tax Evasion: How Effective Would a Moral Appeal Be in Improving Compliance to Tax Laws?* 6 *LAW & POL’Y* 309, 311 (1984).

payers who perceive that the expected monetary sanction for cheating would be very low.

II. RECENT EMPIRICAL RESEARCH ON HONESTY

Psychologists have long recognized that, in addition to responding to economic incentives, individuals respond to internalized norms of conduct in making decisions.⁷² These personal norms create in individuals a self-concept that generally guides their actions.⁷³ For example, most people consider themselves to be honest, and acting according to that self-concept would generally result in honest behavior.⁷⁴ Acting contrary to one's self-concept, by being dishonest for example, imposes a psychological cost such as guilt or some other feeling of discomfort.⁷⁵

In recent years, psychologists have updated our understanding of the role of self-concept in honest behavior by examining external factors that tend to result in individuals behaving more or less honestly. Although studies indicate that most people view themselves as honest (i.e., most peoples' self-concept is that they are honest), studies also indicate that, when given the opportunity to cheat, most people will cheat by a small amount.⁷⁶ The presence of certain non-monetary external factors, however, appears to make it more difficult for individuals to act contrary to their self-concept, thus resulting in more honest behavior. Although this is not an exhaustive discussion of that research, this Part discusses several of those factors.

A. Attention to Moral Standards

One external factor that has been shown to influence honesty is whether, at the time of decision making, an individual is paying attention to her own ethical standards. If a person is not mindful of such standards, presumably she can more easily act contrary to her self-concept without generating negative feelings.⁷⁷ Indeed, studies show that people are more likely to be dishonest if they are not asked to think about moral standards. On the other hand, when an individual's moral standards are specifically called to mind

⁷² See Mazar et al., *supra* note 8, at 633.

⁷³ *Id.* at 634.

⁷⁴ *Id.*; see also SHELLEY DUVAL & ROBERT A. WICKLUND, A THEORY OF OBJECTIVE SELF AWARENESS 82 (1972) (describing the tendency of individuals to "avoid the negative affect generated by [one's] awareness of a discrepancy between a standard of correctness and the actual attitude or behavior").

⁷⁵ Mazar et al., *supra* note 8, at 633.

⁷⁶ *Id.*

⁷⁷ *Id.* at 635. For example, an individual might believe it is wrong to lie, but not think about his belief and compare it to his behavior at the time a decision is made. *Id.*

or made salient in some other way at the time of decision-making, individuals tend to be more honest.⁷⁸

In one lab study of attention to moral standards, a group of subjects were asked to recall the Ten Commandments immediately prior to performing a numeric problem-solving exercise, while a control group was asked to recall ten books they had read in high school.⁷⁹ Subjects had a financial incentive to solve as many problems as possible in the allotted time.⁸⁰ Within each of these two groups, an instructor checked the answers of one subgroup of subjects, which gave them virtually no opportunity to cheat.⁸¹ Another subgroup of subjects, however, was told to tear up and recycle their answer sheet and self-report the number of problems solved, giving them a high opportunity to cheat.⁸² The authors of the study then compared the average number of problems solved among those who had the opportunity to cheat and those that did not.

In the subgroups that did not have an opportunity to cheat, the average number of problems correctly solved was the same whether or not they had been asked to recall the Ten Commandments. This was expected, since individuals in those groups were presumably honest given their low opportunity to cheat.⁸³ In the subgroups that had an opportunity to cheat, however, the results were different. The subgroup that was asked to recall ten books from high school claimed to have solved more problems than the other groups, a likely indicator of cheating.⁸⁴ On the other hand, the subgroup asked to recall the Ten Commandments reported the same average number of problems solved as the groups with no opportunity to cheat, an indicator of honesty.⁸⁵ Notably, it made no difference if the subject could actually recall all or any of the Ten Commandments.⁸⁶ It appears that the mere act of having to think about the Ten Commandments—a proxy for moral standards—encouraged people to be more honest.

Another similar lab study involved the same problem solving task with the same no opportunity/high opportunity to cheat conditions. In this study, rather than recalling the Ten Commandments, subjects were asked to sign

⁷⁸ *See id.*

⁷⁹ *Id.* at 635–36. The exercise involved a sheet of twenty matrices made up of three-digit numbers between one and ten (e.g., 1.65 or 8.23). Subjects were given four minutes to “solve” as many matrices as possible. To solve a matrix, the subject had to find two numbers in the matrix that added up to ten. *Id.*

⁸⁰ Subjects were told two randomly selected participants would receive \$10 per matrix solved. *Id.* at 636.

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Id.* at 635.

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ The average number recalled was 4.3. *Id.*

an honor code statement before the task.⁸⁷ Additionally, some subjects were paid fifty cents per correct problem while others were paid \$2 per correct problem.⁸⁸ The results were similar to the Ten Commandments experiment. Subjects who recycled their answer sheets cheated more than those who had their answers checked, but among those with the opportunity to cheat, the group that signed the honor code cheated significantly less than the group that did not.⁸⁹ Interestingly, among those in the high opportunity group who cheated, there was little variation between those who received \$2 per problem and those who received fifty cents per problem, suggesting that the change in economic incentive had virtually no impact.⁹⁰

The significance of attention to moral standards was further demonstrated through a field study of actual auto insurance consumers.⁹¹ The authors of that study examined whether signing one's name *before* reporting information, rather than afterwards, would call attention to moral standards and induce more honest behavior.⁹² In cooperation with an auto insurance company, the authors used a form that asked customers to self-report the odometer mileage of their car and moved the signature line from the bottom to the top, so that customers would sign before they reported the number of miles.⁹³ Half of the customers received the new form (signature at the top) and half received the old form (signature at the bottom).⁹⁴ A review of 13,488 forms revealed that customers who signed at the top reported 10.25% *more* miles than those that signed at the bottom, suggesting that moving the signature line resulted in more honest reporting.⁹⁵

The authors of the study reached a similar result in a lab experiment that also tested the effect of moving a signature line.⁹⁶ In the study, which involved solving math puzzles for financial compensation, subjects were given a tax form to report their earnings (based on the amount of puzzles solved) and to claim deductions for travel expenses to the laboratory.⁹⁷ As in the insurance study, subjects who signed the top of the tax form *before*

⁸⁷ *Id.* at 636–37.

⁸⁸ *Id.* at 636.

⁸⁹ *Id.* at 637.

⁹⁰ *Id.*

⁹¹ Lisa L. Shu et al., *Signing at the Beginning Makes Ethics Salient and Decreases Dishonest Self-Reports in Comparison to Signing at the End*, 109 PROC. NAT'L ACAD. SCI. 15197, 15198 (2012), available at <http://www.pnas.org/content/109/38/15197.full.pdf+html>, archived at <https://perma.cc/7KKN-S2QS?type=pdf>.

⁹² *Id.*

⁹³ *Id.* Customers have an incentive to underreport the number of miles, because fewer miles driven means lower insurance premiums. See *id.*

⁹⁴ *Id.*

⁹⁵ *Id.* This amounted to an average of 2428 more miles per car.

⁹⁶ *Id.* at 15197–98.

⁹⁷ *Id.* at 15197.

reporting information cheated significantly less than subjects who signed at the bottom.⁹⁸

B. Ability to Categorize Behavior

At first blush, it may appear to be a paradox that most individuals consider themselves to be honest,⁹⁹ yet most people will cheat to some degree when given the opportunity to do so.¹⁰⁰ This is particularly surprising given that individuals generally are averse to acting contrary to their self-concept. Studies reveal, however, that individuals tend to adopt strategies to “categorize” dishonest behavior as something other than cheating. Categorization is the process by which an individual constructs an internal narrative that allows him to view his behavior as consistent with his self-concept.¹⁰¹ For example, if an individual took \$1 from a friend’s wallet without asking, he might tell himself “I am borrowing this and it will all even out eventually” instead of “I have stolen \$1.” Doing so might allow the individual to perform the dishonest act (taking the \$1) without incurring any discomfort from acting contrary to his self-concept.

Some behaviors are more susceptible to categorization than others, and psychologists have posited that the presence of certain external factors influences the degree of that susceptibility. For example, transactions that involve money tend to be less susceptible to categorization while transactions that involve some non-monetary medium tend to be more susceptible.¹⁰² Consider for example, the difference between taking \$10 in office supplies from one’s place of work versus taking \$10 from a petty cash box at work.

⁹⁸ *Id.* Unlike the field study of auto insurance customers, the lab environment allowed the authors to detect actual cheating on the math puzzles by coding the forms with unique identifiers that were undetectable by the participants. *Id.* With respect to over-claimed income from the math puzzles, thirty-seven percent of subjects cheated when they signed at the top compared to seventy-nine percent when they signed at the bottom. *Id.* With respect to overstated deductions, those who signed at the top reported fewer expenses (average of \$5.27) compared to those that signed at the bottom (average of \$9.62). *Id.*

⁹⁹ Mazar et al., *supra* note 8, at 638. In one study, subjects were asked to complete a task where some had the opportunity to cheat and some did not. *Id.* As in other similar studies, performance on the task with an opportunity to cheat was higher, suggesting subjects were being dishonest. When subjects in both groups were given a personality questionnaire after the task, however, those who had cheated rated their level of honesty and morality just as highly as those who had not. The results suggest that there are circumstances in which individuals do not “update their self-concept” despite acting dishonestly. *Id.* at 638–39.

¹⁰⁰ See Mazar & Ariely, *supra* note 8, at 120. Although many subjects cheat in studies in which the chance of detection is low or zero, the magnitude of cheating for most subjects is small. *See id.*

¹⁰¹ See Mazar et al., *supra* note 8, at 634; cf. Andrew T. Hayashi, *Occasionally Libertarian: Experimental Evidence of Self-Serving Omission Bias*, 29 J. LAW, ECON. & ORG. 711, 712–13 (2013) (finding evidence that individuals select behavioral norms that serve their self-interest).

¹⁰² See Mazar et al., *supra* note 8, at 634, 637–38.

If neither transaction is authorized, then there is no economic difference between the two. But it is not difficult to imagine that an individual who would never consider taking the \$10 in cash might take the \$10 in office supplies without a second thought.¹⁰³ The individual might consider the former to be “stealing,” but might successfully categorize the latter as something other than stealing.

A study of the effect of a non-monetary medium on cheating was conducted using the same problem-solving task as the Ten Commandments study.¹⁰⁴ The same no opportunity/high opportunity to cheat conditions involving recycled answer sheets and checked answer sheets also applied.¹⁰⁵ In this study, some participants were told they would receive fifty cents per correct answer and some were told they would receive a token for each correct answer, which could be subsequently exchanged for fifty cents.¹⁰⁶ Not only did participants who had the opportunity to cheat claim to have solved more problems than those that did not, but the magnitude was even higher among those who were paid in tokens, suggesting that the presence of the tokens allowed for “categorization” and induced more dishonest behavior.¹⁰⁷

C. *The Presence of a Victim*

A third external factor that appears to influence individuals’ willingness to be dishonest is whether the individual perceives that a victim will be harmed by her dishonesty. For example, an individual might not feel guilty for telling a lie intended to make someone happy (e.g., “you look nice today”), but might feel guilty for telling a lie that benefits the liar at the expense of the other party (e.g., “there are no cookies left in the cookie jar”).¹⁰⁸

One study examined the willingness of individuals to lie if the monetary payoff from dishonesty directly decreased the payoff to a counterparty.¹⁰⁹ The experiment involved a game with two players, each of whom did not know the identity of the other.¹¹⁰ Player 1 had information about potential payout scenarios, while Player 2 did not. This allowed Player 1 to manipulate the outcome by conveying either truthful or untruthful information

¹⁰³ Cf. *id.* at 634 (describing how it is easier for a person to steal a ten cent pencil from a friend than to steal ten cents out of a friend’s wallet).

¹⁰⁴ *Supra* notes 79–86 and accompanying text.

¹⁰⁵ Mazar et al., *supra* note 8, at 638.

¹⁰⁶ *Id.*

¹⁰⁷ *See id.* The authors of the study note that there are other factors that influence categorization, as well, such as the magnitude of dishonesty. *See id.* at 634–35 (“[I]t may be possible to ‘stretch’ the truth and the bounds of mental representations only up to a certain point . . .”).

¹⁰⁸ *See* Gneezy, *supra* note 8, at 385–86.

¹⁰⁹ *See id.* at 385.

¹¹⁰ *Id.* at 387.

to Player 2.¹¹¹ If Player 1 lied, she would receive a larger payoff and Player 2 would receive a smaller payoff.¹¹² When the gain for Player 1 for lying was \$1 and the loss to Player 2 was also \$1, 36 percent of the subjects lied.¹¹³ But when the gain for lying was \$1 and the loss to Player 2 was \$10, the number that lied dropped to seventeen percent, suggesting that subjects were less willing to lie as the harm to the other party increased. When the gain to Player 1 for lying was \$10 and the loss to Player 2 was \$10, fifty-two percent of subjects lied.¹¹⁴ This suggests that, although the harm to a counterpart influences individuals' willingness to lie, increasing economic benefits from lying diminish that influence.

In another study, participants were asked to judge a hypothetical scenario in which an individual selling a car chooses not to disclose knowledge of a faulty oil pump that will cost the buyer \$250 to repair when discovered.¹¹⁵ Seventy percent of the participants responded that the seller's action was "unfair" and eighteen percent responded that it was "very unfair."¹¹⁶ When the scenario was changed so that the buyer would incur \$1000 of damage (no change in seller's payoff for selling the car), however, thirty-two percent responded "unfair" and sixty-six percent responded "very unfair."¹¹⁷ The results again suggest that individuals are less comfortable with dishonesty as the harm to another party increases.

Studies also reveal that individuals' willingness to lie depends on their perception of the wealth of the victim. In general, the wealthier the victim, the more acceptable people think it is to be dishonest. For example, subjects surveyed thought lying to a lawyer was more acceptable than lying to a law student.¹¹⁸ Similarly, subjects considered a lie from an employee (individual) to an employer (bank) to be more acceptable than a lie from the same employer to the employee.¹¹⁹

¹¹¹ *Id.* at 386. Player 1 had information about an Option A scenario (e.g., \$6 to Player 1 and \$5 to Player 2) and an Option B scenario (e.g., \$5 to Player 1 and \$6 to Player 2). Player 1 communicated a message to Player 2 about which option was more beneficial (e.g., "Option A will earn you more money than Option B"), which was either truthful or not, and Player 2 ultimately chose the option with no further information. About eighty percent of Player 2's followed Player 1's suggestion. *Id.* at 387–88, 392.

¹¹² *Id.* at 387.

¹¹³ *Id.*

¹¹⁴ *Id.* at 387–88.

¹¹⁵ *Id.* at 389.

¹¹⁶ *Id.*

¹¹⁷ *Id.* at 390.

¹¹⁸ See Uri Gneezy, *Deception: The Role of Consequences* 32 (Apr. 8, 2002), http://www.econ.pitt.edu/seminar_docs/uri.pdf, archived at <http://perma.cc/9W7R-3K57?type=pdf>.

¹¹⁹ *Id.* at 30–32.

III. A NEW THEORY OF THE PSYCHIC COST OF TAX EVASION

Although some legal scholars have recognized that personal norms influence tax compliance, personal norms have received relatively little attention in the tax literature. This Part argues that violating personal norms imposes a psychic cost that should be incorporated into our understanding of a taxpayer's cost-benefit analysis when making tax compliance decisions. Further, the recent empirical work discussed in Part II provides an updated understanding of the external factors that influence personal norms. While economists have traditionally assumed that the psychic cost of evading taxes is a constant function that increases as the amount evaded increases, studies have shown that *non-monetary* factors also influence this psychic cost. Accordingly, this Part argues that we should understand the psychic cost of tax evasion as one that can be increased or decreased based on factors such as attention to moral standards, categorization, and the presence of a victim.

A. The Role of "Psychic Cost" in the Standard Deterrence Model

This Section introduces an updated model of tax compliance that accounts for the psychic cost of tax evasion. It then discusses the limitations of the model and the merits of incorporating the concept of psychic costs into the standard deterrence model.

1. The Model

As discussed above in Part I, standard deterrence theory posits that taxpayers make compliance decisions by comparing the expected cost of compliance with the expected cost of evasion. In the traditional model, these expected costs are monetary, determined by the nominal penalty discounted by the probability of detection.¹²⁰ If the monetary cost of noncompliance (i.e., the expected penalty) is higher than the tax saved from noncompliance, then presumably a taxpayer will choose not to evade tax.¹²¹

Research shows, however, that taxpayers also incur non-monetary utility costs when they evade tax. The guilt or psychological discomfort a taxpayer may feel from violating her personal norms imposes an additional, psychic cost of evading taxes.¹²² Because studies have demonstrated that

¹²⁰ The model may also account for risk aversion. *See supra* notes 5, 23 and accompanying text.

¹²¹ This assumes risk neutrality. *See supra* note 19 and accompanying text.

¹²² *See, e.g.*, Joseph G. Eisenhauer, *Ethical Preferences, Risk Aversion, and Taxpayer Behavior*, 37 J. SOCIO-ECON. 45, 48–50 (2008); Joseph G. Eisenhauer et al., *Experimental Estimates of Taxpayer Ethics*, 69 REV. SOC. ECON. 29, 33–34 (2011); Erard & Feinstein, *supra* note 70, at 74–76; James P.F. Gordon, *Individual Morality and Reputation Costs as Deterrents to Tax Evasion*,

this psychic cost influences individual decision-making, it should be viewed as part of a taxpayer's overall utility calculus along with expected penalties. In its simplest form, we can add an additional cost (call it Z where Z represents the psychic cost of evasion) to the basic deterrence model and arrive at the following cost-benefit comparison for a taxpayer deciding whether to comply or evade:

$$\text{Cost of Compliance} = \text{Tax Owed}$$

v.

$$\text{Expected Cost of Evasion} = (P \times F) + Z^{123}$$

It remains the case that when deciding whether to comply or evade, a taxpayer will evaluate the utility she derives from paying the full tax as compared to the utility she derives from evading. Under this modified model, however, the utility costs of evasion are both the expected penalty she will incur (the monetary cost), as well as the additional psychic cost imposed from being dishonest. This means that even in cases where the monetary benefit of evasion outweighs the expected penalty, taxpayers might choose to comply because the psychic cost is too high. The psychic cost is presumably incurred regardless of whether the taxpayer's evasion is detected, and thus is not discounted by P (the probability of detection).¹²⁴ On the other hand, a compliant taxpayer does not incur the psychic cost of dishonesty.¹²⁵

2. Defining the Psychic Cost

One challenge presented by the above simplified model is in defining Z .¹²⁶ Those economists who have addressed the possibility of a psychic cost of tax evasion have traditionally assumed that it is a linear function of the

33 EUR. ECON. REV. 797, 798 (1989); Grasmick & Bursik, *supra* note 68, at 840; Spicer, *supra* note 58, at 17.

¹²³ Where P = the probability of detection and F = the total fine for evasion (tax due + penalty due). See *supra* note 18 and accompanying text. The model assumes that the taxpayer incurs a psychic cost for evasion (Z) regardless of whether she is caught.

¹²⁴ It is possible, however, that when some taxpayers are caught and penalized for evasion, the sanctions would effectively "crowd out" guilty feelings. For those taxpayers, the psychic cost of evasion would only be incurred when tax evasion went undetected and/or was not subject to monetary sanctions.

¹²⁵ Tax compliance could impose other kinds of psychic costs, however, such as those generated by resentment about having to pay taxes to the government.

¹²⁶ Another potential oversimplification in the model as presented is that it assumes there is no interaction between deterrence and the psychic cost of tax evasion. In reality, there could be such an interaction. For example, individuals might perceive that the IRS's efforts to promote honesty by increasing the psychic cost of tax evasion are a result of their inability to detect evasion through audits. The result could be lower deterrence accompanied by a higher psychic cost of tax evasion (which could offset one another).

amount of tax evaded.¹²⁷ Under such a view, evading more tax imposes a higher psychic cost and evading less tax imposes a lower cost. The standard presumption has also been that the amount of psychic cost that taxpayers incur from cheating is heterogeneous across taxpayers, but not within a taxpayer.¹²⁸

Heterogeneity across taxpayers is to be expected. Different taxpayers are bound to have different ethical standards, which may be a product of any number of factors such as internalization of social norms, attitudes about fairness or government spending, or religious beliefs.¹²⁹ These variations in personal norms likely result in taxpayers incurring varying levels of psychic cost when they cheat. The traditional assumption in the literature, however, has generally been that for each individual taxpayer with her unique set of personal norms, the level of psychic cost she incurs when she evades her tax liability will vary only based on how much tax she evades.¹³⁰

The recent empirical work on honesty, however, calls into doubt this assumption that the psychic cost of evasion is fixed within an individual and varies only in response to the amount of tax evaded. As discussed above in Part II, studies have shown that the presence of certain external factors at the time of decision-making can influence an individual's willingness to be dishonest. These factors have been shown to increase or decrease honesty without a corresponding increase in monetary incentives or the probability of detection.¹³¹ Further, the studies indicate that certain of these factors are

¹²⁷ See, e.g., Eisenhauer, *supra* note 122, at 49; Gordon, *supra* note 122, at 798–99. Erard and Feinstein model the utility of cost of guilt from evading taxes as proportional to the ratio of the taxpayer's underpayment (the amount of tax evaded over the amount of tax owed). Erard & Feinstein, *supra* note 70, at 75–76.

¹²⁸ See, e.g., Eisenhauer, *supra* note 122, at 49; Erard & Feinstein, *supra* note 70, at 71; Gordon, *supra* note 122, at 801. As is the case with any economic model that assumes a single, rational actor, the assumption of homogeneity is a simplifying one, rather than an intended description of the real world.

¹²⁹ See, e.g., Erard & Feinstein, *supra* note 70, at 76.

¹³⁰ See *supra* note 128 and accompanying text. In another work modeling a tax compliance game with honest and dishonest taxpayers, Erard and Feinstein assume (for purposes of their model) that at each level of income, there is a fraction of taxpayers that are "inherently" honest. Brian Erard & Jonathan S. Feinstein, *Honesty and Evasion in the Tax Compliance Game*, 25 J. ECON. 1, 2–4 (1994).

¹³¹ Experiments showing the effect of attention to moral standards demonstrated similar effects when the monetary incentive was constant (e.g., the Ten Commandments Study) and when it was manipulated (e.g., the Honor Code study). See Mazar et al., *supra* note 8, at 635–37. In the Honor Code study, there was a substantial change in compliance based upon whether or not subjects signed the honor code, but there was not a significant variation between participants compensated fifty cents per correct problem versus those compensated \$2.00. *Id.* at 636–37.

The experiments described in Part II generally involved two variations of the probability of detection: high opportunity to cheat (recycled answer sheets) and no opportunity to cheat (answers checked). *Id.* at 635–36. However, other studies have shown little change in dishonesty at varying levels of detection. See *id.* at 640–41. For example, in one study in which participants answered

truly “external” in that they appear to be independent of things like social norms. For example, informing participants in honesty studies about the average number of problems solved by other participants had no effect on the number of problems those participants claimed to solve.¹³²

External factors that encourage honesty can be viewed as raising the psychic cost of evasion, while those that result in more dishonesty can be viewed as lowering the psychic cost of evasion. Thus, the psychic cost should be understood as a cost that increases or decreases depending on the presence of factors such as attention to moral standards, categorization, or the presence of a victim. These variations will be discussed further in the next Section.

3. Why Model the Psychic Cost?

The interactions of the various factors that influence the psychic cost of tax evasion are likely too complex to express with a simple function.¹³³ Is there any benefit, then, to incorporating the psychic cost of tax evasion into a simplified deterrence model? Even if we can’t define Z with precision, viewing taxpayer dishonesty as imposing a utility “cost” from a cost-benefit standpoint is still helpful from a policy perspective. While the idea that personal norms play some role in tax compliance is fairly uncontroversial, those norms may be perceived as too intangible, and their effects too untested, to have appeal to policymakers. In contrast, audits and penalties impose distinct costs, with which we are familiar and can understand from a tradi-

fifty multiple choice questions and were promised ten cents per correct answer, there were four different conditions representing different levels of detection for cheating. *Id.* In the first condition (no opportunity), the experimenter checked the answer sheet. In the second condition (some chance of detection), the subject graded her own answers but then handed both the test sheet and the answer sheet (showing the number of correct answers) to the experimenter at the time of payment. In the third condition (lower chance of detection), the subject graded her own answers, shredded her test sheet, and handed her answer sheet to the experimenter at the time of payment. In the fourth condition (no chance of detection), the subject graded her own answers, shredded both the answer and test sheets, and paid herself. Although there was significantly less cheating in the first condition, the level of cheating in the other three conditions was not significantly different. *Id.*; see Mazar & Ariely, *supra* note 8, at 119–20.

¹³² See Mazar et al., *supra* note 8, at 639–40. The study involved the same matrix task involved in the other honesty studies, in which some answers were checked (no opportunity to cheat) and some answered sheets were recycled (opportunity to cheat). Additionally, some subjects were correctly informed about the average number of problems correctly solved (4) and some were given an exaggerated number (8). Although more subjects cheated in the recycle condition than the answers checked condition, there was no significant variation in cheating between those told the correct average problems solved and those told the inflated number. The authors concluded that “[t]his finding argues against drive toward achievement, threshold due to external costs, or norm compliance as alternative explanations for our findings.” *Id.* at 640.

¹³³ This is further complicated by the fact that the psychic cost likely varies from person to person.

tional cost-benefit approach. By viewing dishonesty as imposing another “cost” that can be incorporated into a cost-benefit analysis, we can situate honesty-based policy recommendations in a context familiar to policymakers, and provide a frame of reference to evaluate and compare such proposals with current compliance initiatives.¹³⁴

Further, and more importantly, by understanding the psychic cost of tax evasion as malleable, rather than a fixed trait of a particular taxpayer, this cost becomes another policy tool—along with audits and penalties—that can be manipulated by the government in an effort to increase compliance. In the same way that raising fines, expanding information reporting, or increasing the audit rate would make the expected cost of evasion higher for taxpayers (thus improving compliance), adopting behavioral nudges that are designed to raise the psychic cost of tax evasion could have a similar impact. These policy implications are explored further in Part IV.

B. Updating the Model

Because taxpayer honesty may play a role in tax evasion, it is helpful to reexamine the external factors that influence honesty in this context. These factors include: drawing attention to moral standards, categorizing behavior, and the presence of a victim. This Section explores how these three factors relate to taxpayer behavior and evaluates the effect of the factors on the psychic cost of tax evasion.

1. Attention to Moral Standards and Tax Evasion

As detailed in Part II, a number of empirical studies have demonstrated that individuals are less likely to cheat if they are paying attention to their personal norms at the time that they make the decision whether to be honest. In the context of tax compliance, this means that individuals should be less likely to report inaccurately on their tax returns if their moral standards are made salient at the time of reporting.

Policies designed to increase attention to moral standards have been shown to reduce cheating without any change in either the opportunity to cheat or the financial incentive to cheat. Rather, such policies appear to have a purely psychological impact on individuals, outside of the standard

¹³⁴ Cf. On Amir et al., *Behavioral Economics, Psychology, and Public Policy*, 16 *MARKETING LETTERS* 443, 451 (2005) (suggesting the use of behavioral economics to influence policy by using “the established path from economics to policy—attempting to modify economics to be more descriptively accurate, and from there influencing policy”); Sarah B. Lawsky, *How Tax Models Work*, 53 *B.C. L. REV.* 1657, 1693 (2012) (contending that economic models cannot provide certainty to tax policy discussions, but noting that they are important because they help refine ideas and shape arguments that enhance policymakers’ understanding of issues).

deterrence model of decision-making. Attention to moral standards, then, can be viewed as increasing the psychic cost of evasion. In the same way that raising audit rates and penalties would make evasion more expensive for taxpayers, drawing attention to personal norms appears to make evasion more expensive from a utility standpoint. In the context of the model, attention to moral standards should be viewed as increasing Z in a taxpayer's cost-benefit calculus, where Z represents the psychic cost of tax evasion.

The empirical data indicates that attention to moral standards may have as strong of an impact on honesty as increasing the risk of detection. For example, in studies in which subjects performed a problem-solving task for a cash reward, recall that subjects claimed to solve twice as many problems when they had a high opportunity to cheat as compared to when they had no opportunity to cheat.¹³⁵ This difference suggests that risk of detection clearly plays a significant role in the decision to be honest. When subjects with a high opportunity to cheat signed the honor code, however, they reported the same number of correctly solved problems as those who had no opportunity to cheat.¹³⁶ In other words, the honor code diminished cheating to the same degree that having an experimenter check the answer sheets did. Further, increasing the monetary reward (from \$0.50 per correct problem to \$2 per correct problem) for cheating had virtually no impact among subjects who had signed the honor code, suggesting again that attention to moral standards increases compliance in a manner that is not accounted for by the rational model.¹³⁷

The notion that there is more cheating in the absence of attention to moral standards is consistent with the relatively high level of tax evasion that exists among individuals with a high opportunity to cheat (i.e., those who are not subject to third-party information reporting), who in the aggregate report only forty-four percent of their income.¹³⁸ On a paper version of Form 1040, the taxpayer signs a statement at the bottom of the form, under penalties of perjury, verifying that the information is accurate.¹³⁹ Thus, a taxpayer presumably will not sign the return until *after* she has reported her total taxable income (calculated by reporting gross income and accounting

¹³⁵ See Mazar et al., *supra* note 8, at 637. Subjects claimed to have solved an average of approximately three matrices in the control condition in which their answers were checked. Subjects who were allowed to throw away their answer sheets without having them checked claimed to have solved about six problems on average. *Id.*

¹³⁶ *Id.* The average number of matrices that subjects claimed to have solved in the honor code condition was approximately three. *Id.*

¹³⁷ *Id.* The average number of matrices solved among honor code subjects was 3.1 when the reward was \$0.50, and 3.0 when the reward was \$2. *Id.*

¹³⁸ See Tax Gap for Tax Year 2006, *supra* note 4, at 3.

¹³⁹ See IRS, Form 1040 (2012), available at <http://www.irs.gov/pub/irs-pdf/f1040.pdf>, archived at <http://perma.cc/NWZ8-HJSF>.

for various exemptions, deductions, and credits).¹⁴⁰ Similarly, nothing in the Instructions to Form 1040 appears designed to call attention to moral standards before the form is filled out.¹⁴¹ Additionally, the use of electronic filing software, signing returns with electronic signatures, and the use of return preparers may further aid taxpayers in reporting without having to think about their personal norms.

2. Categorization and Tax Evasion

Whereas attention to moral standards makes individuals less likely to cheat, categorization—the process by which individuals rationalize dishonesty—leads to more cheating. If individuals do not consider tax evasion to be “cheating” or “stealing”, then they are not forced to update their self-concept when they evade, making evasion less costly from a utility standpoint. Thus, categorization effectively decreases the psychic cost of evasion, potentially diminishing it to zero (or close to zero) when individuals can completely rid themselves of any psychological discomfort from dishonesty. In the context of the formal model, categorization should be viewed as reducing Z in a taxpayer’s utility calculus. This is analogous to reducing fines or penalties, which would similarly make evasion less costly for taxpayers.

Categorization likely plays an important role in the low rate of tax compliance (less than fifty percent) observed among those taxpayers, such as individuals with self-employment income, who have a high opportunity to cheat. For example, studies indicate that individuals do not perceive tax evasion to be as serious as stealing. One survey study compared attitudes about tax evasion with attitudes about petty theft, defined as stealing something worth less than \$20, and grand theft, defined as stealing something worth more than \$20.¹⁴² In the study, subjects were asked to rank the various forms of deception as “always wrong, usually wrong, sometimes wrong, seldom wrong, or never wrong.”¹⁴³ While the vast majority of people in the study believed that both grand theft (90.2%) and petty theft (86.2%) are always wrong, significantly fewer people (61.1%) believed that tax cheating is always wrong.¹⁴⁴ Other studies have yielded similar results. For example, one survey revealed that individuals ranked tax fraud as less

¹⁴⁰ See *id.*

¹⁴¹ See IRS, FORM 1040 INSTRUCTIONS (2012), available at <http://www.irs.gov/pub/irs-pdf/i1040.pdf>, archived at <http://perma.cc/DD45-P67U>. Page ninety-five of the current instructions does contain information about penalties for misreporting. It is unlikely, however, that this is intended to serve anything other than informational purposes since it is somewhat buried in over 200 pages of instructions.

¹⁴² Grasmick & Scott, *supra* note 47, at 217–18.

¹⁴³ *Id.* at 218.

¹⁴⁴ *Id.* at 221.

serious than embezzlement and bribery and that “the typical taxpayer apparently considers tax evasion only slightly more serious than ‘stealing a bicycle.’”¹⁴⁵

A simple thought experiment demonstrates categorization in the context of tax evasion with an anecdotally familiar scenario. Consider the following hypothetical:

Peter is a schoolteacher who considers himself to be a morally upstanding citizen. If he is given too much change at a cash register, he will point out the error and return it, no matter the amount. He once found \$20 in an ATM and returned it to the bank. However, when Peter earns cash from odd jobs on weekends, he never reports it on his tax return.

Peter might categorize keeping the extra change or the money found at the ATM as stealing, and simultaneously categorize underreporting his tax liability as something other than stealing.¹⁴⁶ This categorization may occur even if the dollar amounts to be gained from the various forms of deception are identical. If he categorizes his behavior in such a manner, Peter would not be forced to update his self-concept (that he is a morally upstanding person) and would not experience psychological discomfort from failing to pay tax on the cash from the odd jobs.

Studies have shown that certain factors, such as the immediacy of a cash reward versus a substitute such as a token, can influence the likelihood that an individual will re-categorize dishonest behavior as acceptable.¹⁴⁷ For Peter, the presence of an immediate cash benefit at the cash register or ATM might make it harder for him to categorize his actions as honest in those scenarios. On the other hand, simply reducing his tax bill (instead of receiving immediate cash) might make it easier for Peter to categorize not reporting the income from the odd jobs as acceptable, akin to the experiments showing that people cheat more when dealing with tokens than with cash.

3. The Presence of a Victim and Tax Evasion

The empirical data discussed above in Part II also reveals that individuals tend to be more honest when they perceive that another individual will be directly harmed by their dishonesty.¹⁴⁸ Although the influence of a poten-

¹⁴⁵ Young-dahl Song & Tinsley E. Yarbrough, *Tax Ethics and Taxpayer Attitudes: A Survey*, 38 PUB. ADMIN. REV. 442, 445 (1978). The vast majority of subjects (87.7%), however, said that they disagreed with the following statement: “[S]ince tax dodging hurts no one but the government, it is not a serious offense.” *Id.*

¹⁴⁶ The example assumes that Peter knows that the income from the odd jobs is reportable.

¹⁴⁷ See *supra* notes 104–107 and accompanying text.

¹⁴⁸ See *supra* notes 109–117 and accompanying text.

tial victim is not entirely divorced from the economic incentive to cheat,¹⁴⁹ individuals appear to incur a psychological cost when their dishonesty inflicts economic harm on another party, which makes them less likely to cheat even when there is a financial reward for cheating. Thus, a perceived victim can be viewed as increasing Z , or raising the psychic cost of tax evasion, in the taxpayer's cost-benefit analysis.

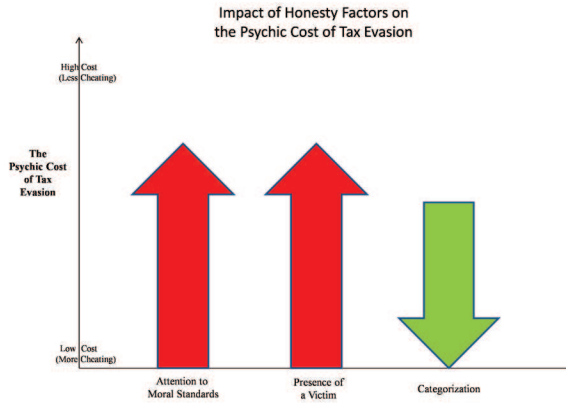
For example, in the thought experiment above, Peter might perceive that keeping an extra \$10 of cash from a store clerk is stealing at the expense of the storeowner. The psychic cost he might incur from feeling that he harmed the storeowner might outweigh his economic incentive to keep the \$10, causing him to decide to return it. But he might feel that underreporting his tax liability by \$10 is essentially a "victimless" crime. Or, he might feel that the only victim is the government, and that the government is too wealthy of a victim to alter his behavior. In either case, he would likely incur a lower psychic cost from "stealing" \$10 of tax as compared to keeping the \$10 in change from the store.

4. Effect of Honesty Factors on the Psychic Cost of Tax Evasion

The factors discussed above—attention to moral standards, categorization, and the presence of a victim—can be seen as influencing Z , the psychic cost of tax evasion. Although traditional economic analyses of tax evasion tended to view Z as increasing only as the amount of tax evaded increases, an updated understanding of taxpayer behavior indicates that the variation in Z is more complex. Specifically, attention to moral standards and the presence of a victim likely increase Z , making evasion more costly and taxpayers less likely to evade. On the other hand, categorization likely decreases Z , making the psychic cost of evasion lower and resulting in more evasion. Studies indicate that these factors operate independently from financial incentives to cheat, and, in some cases, can be just as powerful of a motivator or deterrent. Although the relationship between these factors and the psychic cost of tax evasion likely cannot be modeled with precision, it is useful to understand how these factors contribute to compliance or evasion in the tax context. These relationships are summarized in the table below:¹⁵⁰

¹⁴⁹ Individuals display more willingness to cheat at the expense of another as the financial reward increases. *See supra* note 14 and accompanying text.

¹⁵⁰ *Supra* notes 135–149 and accompanying text.



IV. TAX POLICY IMPLICATIONS

Given that increasing the psychic cost of tax evasion could be a more cost-effective approach to improving tax compliance than raising the risk of detection or the fine for evasion, the next question is how policymakers might go about raising this cost. The empirical work on dishonesty provides a broad framework for how external factors influence the psychic cost of evasion. The more difficult challenge involves translating this high level knowledge of what influences the psychic cost of dishonesty into realistic policies designed to improve tax compliance. This Part offers concrete policy applications for increasing the psychic cost of tax evasion, identifies areas for future study, and addresses potential objections to the policy proposals.

A. Policy Proposals

In light of empirical evidence indicating that honesty can be induced by simple, external measures like signing a form at the top, researchers have suggested that the IRS move the signature line to the top of individual tax forms.¹⁵¹ Yet, while the notion of having individuals sign tax forms at the top rather than the bottom has garnered media attention,¹⁵² it does not appear that the government has been receptive to the suggestion.¹⁵³

¹⁵¹ See DAN ARIELY, *THE (HONEST) TRUTH ABOUT DISHONESTY* 47–48 (2012).

¹⁵² See, e.g., Carmen Nobel, *An Easy Trick to Mitigate Tax Cheating*, FORBES, Apr. 15, 2013, <http://www.forbes.com/sites/hbsworkingknowledge/2013/04/15/an-easy-trick-to-mitigate-tax-form-cheating>, archived at <https://perma.cc/4KSH-DAFK?type=pdf>; Dan Ariely, *Why We Lie*, WALL ST. J., May 26, 2012, at C2.

¹⁵³ See ARIELY, *supra* note 151, at 47–48.

The particular challenge presented by incorporating the findings of behavioral economics studies into tax policy is how to translate measures that successfully induce honesty in laboratories or field experiments into measures that will be relevant in the reality of present-day taxpayer behavior. For example, simply moving the signature line on Form 1040 may have little or no impact on actual taxpayer compliance for a number of reasons. First, the vast majority of taxpayers electronically file their tax returns (seventy-eight percent in 2011),¹⁵⁴ which does not require a physical signature at all. Additionally, roughly sixty percent of tax returns are prepared by tax professionals,¹⁵⁵ which would make it even more difficult to build in a mechanism at the beginning of the filing process (such as an electronic signature) to bring moral standards to mind. Further, those individuals with the biggest opportunity to cheat—the self-employed, who demonstrate the highest levels of evasion—must make estimated tax payments during the year, and thus have likely already made the decision whether to cheat by the time they file their year-end tax return on Form 1040.

Although translating the results of empirical studies into feasible policy applications is no easy task, this does not mean the government should abandon increasing the psychic cost of tax evasion as a policy matter. Raising the cost of tax evasion through other, more traditional means presents other challenges of potentially equal magnitude. Legal scholars have a role here to supplement the social science research on dishonesty by helping to translate principles (such as attention to moral standards) into practice in a manner that reflects realistic taxpayer practices. With that aim, this Section offers proposals for behavioral nudges designed to encourage more honest tax reporting.

1. Attention to Moral Standards on Electronic Forms

Although physically signing a self-prepared Form 1040 may not be relevant for most taxpayers, the IRS could incorporate similar mindfulness principles into electronic returns. The goal would be to find an electronic method of calling moral standards to mind *before* a taxpayer reported information on an electronic return. For example, a taxpayer could be prompted to check a box confirming that a short statement has been viewed before she

¹⁵⁴ IRS, *Top 10 Helpful Features on the IRS Website* (Jan. 24, 2012), <http://www.irs.gov/uac/Top-10-Helpful-Features-on-the-IRS-Website>, archived at <http://perma.cc/PEC7-G4SN>.

¹⁵⁵ See Sandra Block, *More Taxpayers Are Preparing Their Taxes on Their Own*, USA TODAY, Apr. 14, 2010, http://usatoday30.usatoday.com/money/perfi/taxes/2010-04-14-1Ataxprep14_CV_N.htm, archived at <https://perma.cc/XQ9B-B6QT?type=source> (sixty-four percent of tax returns filed electronically were prepared by professionals in 2010); IRS, *IRS Releases the Dirty Dozen Tax Scams for 2012* (Feb. 16, 2012), <http://www.irs.gov/uac/IRS-Releases-the-Dirty-Dozen-Tax-Scams-for-2012>, archived at <http://perma.cc/F47F-E6SY>.

can proceed to filling out her electronic form. The statement could be a version of the statement on the Form 1040 signature block,¹⁵⁶ or contain a more concise statement intended to call attention to personal norms against tax evasion. For example, it might simply read: “Reporting false or incorrect information on a federal tax return, including failing to report income that you have earned, is illegal.”¹⁵⁷

It may be the case that electronic signatures (or simply checking a box on a computer screen) may not cause individuals to examine their moral standards in the same manner that physically signing an identical statement would, however. Further research would aid our understanding of this potential nuance in behavior, as discussed below. An additional consideration is whether taxpayers would actually read a simple statement such as that described in the text above, or whether they would ignore it or become so familiar with it that the statement no longer triggered actual mindfulness. To mitigate these potential effects, policymakers could keep the statement as short as possible, display it prominently and boldly with no surrounding text, and vary it from year to year. In the alternative, taxpayers might pay more attention if they are required to read and then type out a short jurat in order to electronically sign.¹⁵⁸

As another possibility, the IRS could target specific tax items that are commonly evaded by taxpayers and institute policies to trigger mindfulness among electronic filers with respect to those particular items. A taxpayer might have to read a statement and check a box at several points during the filing process verifying that they do *not* have certain types of income or tax to report. For example, one commonly evaded¹⁵⁹ item is paying employment taxes on household employees like babysitters, house cleaners, or yard maintenance workers.¹⁶⁰ For a taxpayer who is considering not reporting household employee wages, having to affirmatively indicate that they did

¹⁵⁶ The text immediately above the signature line on Form 1040 reads: “Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.” *Supra* note 141 and accompanying text.

¹⁵⁷ Statements that highlight the illegality of tax evasion might also deter taxpayers from cheating by making the sanctions for noncompliance more salient.

¹⁵⁸ Requiring taxpayers to type out a jurat before filling out their tax return is analogous to requiring witnesses to take an oath before testifying in a judicial proceeding.

¹⁵⁹ See IRS Notice 2007-35, 2007-15 I.R.B. 940 (“Common Mistakes on Tax Returns”).

¹⁶⁰ For certain household employees, taxpayers may have to pay social security, Medicare, and federal unemployment taxes. See I.R.C. §§ 3111, 3301 (2012). Whether a household worker constitutes a taxable “employee” or an independent contractor depends on a number of factors including, but not limited to, the amount paid for the services, the period of time spent working during the year, and the amount of control the employer has over the worker’s services. See IRS Publ’n 926, *Household Employer’s Tax Guide*, 2–3 (2013), available at <http://www.irs.gov/publications/p926/ar02.html>, archived at <http://perma.cc/5CDV-2DJ3>.

not have an eligible household employee might impose a higher psychic cost than simply omitting the tax liability from their return. Alternatively, having to read a statement about the potential penalties that could be imposed for failing to report taxes on household employees might similarly raise the psychic cost of evading such taxes. Presumably, reminding taxpayers of penalties for cheating would make their personal norms of compliance more salient.¹⁶¹

For taxpayers filing electronically directly with the IRS, the IRS could easily institute such measures. For taxpayers self-preparing with return preparation software, such as TurboTax, the IRS would have to encourage or somehow require the software companies to include the relevant statements as part of the filing process on the software. One method of inducement might include requiring software companies to present the statements in the software (before any information is filled in) as a condition of the government accepting electronic filing from those companies.¹⁶²

2. Taxpayer Surveys

Researchers have had success inducing honesty through a number of different mechanisms designed to call attention to moral standards, from signing forms at the top, to signing honor codes, to the simple act of having to recall the Ten Commandments. With this breadth of approaches in mind, tax policymakers might also seek to make taxpayers' moral standards salient through mechanisms other than electronic signatures, checking boxes to "agree" to online statements, or typing out a jurat.

For example, the IRS might ask taxpayers to fill out a brief survey before they file an electronic tax return. The survey could be designed to call attention to taxpayers' ethical attitudes about tax evasion. Or, the survey could make salient to taxpayers the fact that tax evasion is not a "victimless" crime. Calling to mind a potential victim of tax evasion should also increase the cost of such evasion, in the same manner that calling attention to moral standards would.

¹⁶¹ Making the monetary sanctions salient might also serve as a deterrent independent of calling attention to the taxpayer's moral standards. *See supra* note 157 and accompanying text.

¹⁶² Tax return preparers would continue to present a challenge. The government could choose to focus solely on taxpayers who are currently self-preparers (a significant portion of taxpayers). Or, it might institute policies to further encourage self-preparation (for example, by extending free software services to a larger number of taxpayers). Another possibility would be to require tax return preparers to have their clients sign a statement affirming the truth of the information they are providing at the time they turn over their records to the preparer.

To complete the survey, taxpayers might be asked to rate the degree to which they disagree or agree with brief statements¹⁶³ such as: (i) “it is morally wrong to underreport one’s tax liability, no matter how small the amount,” (ii) “it is a crime to underreport one’s tax liability, no matter how small the amount,” or (iii) “tax evasion results in honest taxpayers having to pay higher taxes.”

To induce taxpayers to fill out the survey immediately before they file their tax return, the IRS might offer free e-filing software to taxpayers who complete the survey.¹⁶⁴ Alternatively, the IRS might offer a few dollars of tax credit (applied against the taxpayer’s balance due or added to the taxpayer’s refund) for any taxpayer who fills out the survey. Additionally, the IRS could induce software companies such as TurboTax to include the survey at the beginning of the software program by making it a condition of accepting electronic filing. Finally, the survey could be included along with paper returns to be filled out by hand and mailed in with the completed return.

3. Targeting Self-Employed Taxpayers

In considering policies designed to increase the psychic cost of tax evasion, policymakers would be well-advised to focus on the group of taxpayers with the highest rate of noncompliance: the self-employed. Self-employed individuals earn income that is generally not subject to third-party withholding or information reporting and, as a group, are estimated to report less than half of their tax liability to the IRS.¹⁶⁵ Income earned by cash-based businesses is particularly easy to conceal from the IRS.¹⁶⁶ The

¹⁶³ The format could be modeled after the Taxpayer Attitude Survey, which asks taxpayers to indicate whether they “Completely Agree”; “Mostly Agree”; “Mostly Disagree”; or “Completely Disagree” with a number of statements. See TAXPAYER ATTITUDE SURVEY, *supra* note 41, at 13.

¹⁶⁴ Currently, all taxpayers can file their return electronically with the IRS free of charge, but only taxpayers with adjusted gross income under \$60,000 can also access free software to help them prepare their returns. See IRS, *Free File: Do Your Taxes for Free* (last visited Feb. 22, 2015), <http://www.irs.gov/uac/Free-File:-Do-Your-Federal-Taxes-for-Free>, archived at <http://perma.cc/VNLS-4HPZ>. The IRS might waive the adjusted gross income ceiling for any taxpayer who fills out the survey. Although this may require the government to compensate the software companies that offer the filing software (e.g., TurboTax), the cost could be offset by compliance gains resulting from the survey. A more cost-effective solution might be for the federal government to develop its own tax preparation software that it could provide for free to taxpayers. This would give the IRS a significant degree of control over compliance mechanisms like taxpayer surveys that are designed to induce honesty.

¹⁶⁵ See *supra* note 138 and accompanying text.

¹⁶⁶ See Thomas, *supra* note 5, at 115 n.32.

IRS estimates that failure to report self-employment income costs the government \$179 billion in unpaid tax each year.¹⁶⁷

Unlike employees whose taxes are withheld by employers, self-employed taxpayers generally must submit quarterly estimated tax payments to the IRS during the year or face a penalty.¹⁶⁸ To avoid the penalty, the estimated payments must total ninety percent of the current year's tax liability (four payments of 22.5%) or one hundred percent of the previous year's liability (four payments of 25%).¹⁶⁹ Presumably, self-employed taxpayers who intend to underreport their business income to the IRS take this intention into account when they make their estimated tax payments and underreport on those payments accordingly.¹⁷⁰

For example, a storeowner who expects to owe \$100,000 of tax for a particular year could make estimated tax payments totaling \$90,000 (ninety percent of \$100,000) during the year to avoid an estimated tax penalty. But if the storeowner plans to report only \$50,000 of his \$100,000 in tax liability, then he would likely make estimated tax payments totaling just \$45,000 (ninety percent of \$50,000).

Suppose now that our storeowner was exposed to one of the above-described mindfulness policies. For example, suppose the storeowner paid \$45,000 of estimated tax during the year, and then when he self-prepared his Form 1040 in April, he was required to fill out a short survey inquiring about his attitudes regarding tax evasion. It is possible that the survey would make the psychic cost of underreporting his business income significantly higher, but it is also likely that the storeowner feels pre-committed to the tax evasion he has already engaged in during the estimated tax process. The storeowner has paid estimated taxes on only \$50,000 of tax liability (\$45,000 in estimated tax representing ninety percent of \$50,000), yet he has actually incurred \$100,000 of tax liability. To report such a high number on his Form 1040 would be a drastic departure from his behavior during the year and would subject him to estimated tax penalties for failing to report

¹⁶⁷ IRS, *Tax Gap "Map"* (Dec. 2011), available at http://www.irs.gov/pub/newsroom/tax_gap_map_2006.pdf, archived at <https://perma.cc/R2QJ-HR2Z?type=pdf> (\$122 billion of unpaid tax on individual business income and \$57 billion of unpaid self-employment tax).

¹⁶⁸ See generally I.R.C. § 6654 (2012) (providing that estimated tax payments are due on April 15, June 15, September 15, and January 15).

¹⁶⁹ I.R.C. § 6654(d)(1). The ninety percent threshold is increased to 110% for taxpayers with net income over \$150,000 in the prior year. *Id.*

¹⁷⁰ It may be the case that estimated taxes, by their very nature, contribute to tax evasion because they allow taxpayers to more easily categorize underreporting at the time of the estimated tax payment as something other than cheating. For example, a taxpayer might tell herself that she is not cheating at the time of the quarterly payment because she can make it up later by fully reporting at the end of the year. When the end of the year comes, however, that same taxpayer likely will not want to make up for any underreporting during the year because doing so may subject her to an estimated tax penalty.

more income during the year. It would seem, in this example, that the policies to induce honesty came into the picture too late for this taxpayer.

To avoid this problem, policymakers should focus on inducing honesty at the time that self-employed taxpayers are likely to make a meaningful decision about whether to be honest—when making estimated tax payments—rather than at the time of filing the year-end tax return. Currently, taxpayers who owe estimated taxes are required only to submit payments on a quarterly basis, either through the mail, by phone, or electronically, and are not required to submit and sign a form until they file their annual tax return on Form 1040. For example, taxpayers who mail in their estimated tax payments are instructed to fill out and return an estimated payment voucher, which requires identifying information but does not require a signature.¹⁷¹ Taxpayers can also forgo completing estimated payment vouchers by paying their estimated taxes online using the Electronic Federal Tax Payment System.¹⁷² Accordingly, the IRS would likely have to alter the current system to incorporate mindfulness or other honesty-inducing policies into process of paying estimated taxes.

The IRS could incorporate many of the above-described policies into the estimated tax process. Taxpayers could be required to sign a statement on an estimated tax voucher verifying that the submitted amount is an honest and good faith estimate of the taxpayer's income. Or, for those paying electronically, they could be required to electronically sign a statement or type out a jurat, check boxes verifying accuracy, read statements about tax evasion, or fill out a brief survey along the lines suggested above. By calling attention to taxpayers' moral standards, the presence of a victim of tax evasion, or both *at the time of the estimated tax payments*, policymakers may be able to raise the psychic cost of tax evasion at the most meaningful time for self-employed taxpayers.¹⁷³

¹⁷¹ See IRS Form 1040-ES, Estimated Tax For Individuals (2013), available at <http://www.irs.gov/pub/irs-pdf/f1040es.pdf>, archived at <http://perma.cc/V8S5-QVVF>.

¹⁷² See EFTPS (Electronic Federal Tax Payment System) website, at <https://www.eftps.gov/eftps/>, archived at <https://perma.cc/NF9W-24P6?type=image> (last visited Feb. 21, 2015). A taxpayer can also avoid filling out a payment voucher by paying estimated taxes over the phone. See IRS Form 1040-ES, *supra* note 171.

¹⁷³ Such policies likely would be most effective as new taxpayers enter the system, rather than at targeting established self-employed individuals who have a long history of underreporting significant amounts of income. For the latter group, even if honest-inducing policies did increase the psychic cost of evasion, entrenched behavior might be difficult to change. For example, a rational small business owner with a history of evasion might think that suddenly reporting higher amounts of income would attract an IRS audit.

4. Focus on Tax Return Preparers

Undoubtedly, some taxpayers would be unaffected by the policies described above because they turn to a tax professional to prepare and file their tax returns. Given that tax professionals prepare more than half of tax returns,¹⁷⁴ efforts should be made to induce honesty among return preparers.

The credentials and training of professional tax return preparers vary. Some are certified public accountants (CPAs) or lawyers. Others may be enrolled agents¹⁷⁵ or registered tax return preparers,¹⁷⁶ individuals who are neither lawyers nor CPAs but who have passed a competency exam that allows them to practice before the IRS. Regardless of credentials, all individuals who prepare tax returns for compensation must register with the IRS and obtain a Preparer Tax Identification Number,¹⁷⁷ and all such individuals are subject to ethical guidelines under what is known as “Circular 230.”

Circular 230 is a set of Treasury regulations that govern many aspects of professional tax practice, including return preparation.¹⁷⁸ Among other guidelines, Circular 230 provides ethical standards and duties for tax return preparers. For example, if a tax return preparer has knowledge that a client has omitted income from a tax return, the preparer must advise the client of the legal consequences of the omission.¹⁷⁹ A preparer also must exercise due diligence as to the accuracy of the tax returns that she prepares.¹⁸⁰ Failure to comply with Circular 230 may result in censure, suspension, or disbarment.¹⁸¹

¹⁷⁴ See *supra* note 155 and accompanying text.

¹⁷⁵ Enrolled agents must either pass a three-part exam or have prior experience as an employee of the IRS. They must also complete 72 hours of continuing education every three years. Like CPAs, enrolled agents can represent taxpayers in certain disputes with the IRS, such as during the course of an audit. See IRS, *Enrolled Agent Information*, <http://www.irs.gov/Tax-Professionals/Enrolled-Agents/Enrolled-Agent-Information>, archived at <http://perma.cc/5Q7H-UZUR> (last visited Feb. 21, 2015).

¹⁷⁶ Registered return preparers must also pass a competency exam, but their rights to give advice or represent individuals beyond the preparation of a tax return are narrower than those of enrolled agents. See IRS Publ’n 947, *Practice Before the IRS*, 3 (May 2012), available at <http://www.irs.gov/pub/irs-pdf/p947.pdf>, archived at <http://perma.cc/9NUV-V6JS>. This is not an exhaustive list of lay individuals who are authorized to practice before the IRS. Other permissible categories include enrolled actuaries, students under supervision, and unenrolled agents. See *id.*

¹⁷⁷ See IRS, *PTIN Requirements for Tax Return Preparers*, <http://www.irs.gov/Tax-Professionals/PTIN-Requirements-for-Tax-Return-Preparers>, archived at <http://perma.cc/5PAU-6JEP> (last visited Feb. 21, 2015).

¹⁷⁸ 31 C.F.R. § 10 (2014). Circular 230 covers, among other individuals, attorneys, CPAs, enrolled agents, and registered tax return preparers. *Id.* §§ 10.0, 10.3.

¹⁷⁹ See *id.* § 10.21.

¹⁸⁰ See *id.* § 10.22.

¹⁸¹ See *id.* § 10.50. Tax return preparers also subject themselves to potential civil penalties and criminal sanctions for signing returns that they know to be false or fraudulent. See, e.g., I.R.C. § 6694 (2012) (civil penalty for understatement of taxpayer’s tax liability by return preparer); *id.* § 7206 (criminal sanctions for preparation of a false or fraudulent return).

Despite the fact that tax return preparers are subject to ethical standards, some preparers likely play a role, whether active or passive, in tax evasion among taxpayers. For example, one field study of tax evasion among cash businesses found that many return preparers had implicit understandings with their clients about unreported cash income and adopted a “don’t ask don’t tell” approach.¹⁸² Other preparers in the study played a more active role in their client’s tax evasion, for example, by helping to prepare a false set of books to back up what was reported on the taxpayer’s return.¹⁸³ While many tax return preparers are honest, it is worthwhile to consider policies that would seek to induce honesty among less honest tax professionals.

As one possibility, the Treasury and the IRS could subject tax professionals who are otherwise governed by Circular 230 to an honor code. Many universities, for example, employ honor codes to reduce cheating among students when they take examinations. As discussed above, studies have indicated that signing an honor code immediately before performing a task with a very low risk of detection for cheating reduces cheating to the same level as when subjects were exposed to a very high risk of detection.¹⁸⁴ In other words, honor codes have been shown to be a very effective method of reducing cheating when there is a high opportunity to cheat by raising the psychic cost.

In a similar manner, if tax return preparers were required to sign an honor code in connection with each tax return that they prepared, the psychic cost of dishonest reporting¹⁸⁵ might be higher, resulting in more accurate returns. The statement of the honor code could be brief and should not be a cumbersome addition to certifying preparation of a client’s tax return. The honor code statement might be a short summary of the ethical standards under Circular 230, a brief reminder of the potential sanctions for preparing a false or fraudulent return, or both. To mitigate desensitization that might occur after signing the honor code numerous times, the IRS might vary its contents from year-to-year and keep it brief.¹⁸⁶

¹⁸² See Susan Cleary Morse et al., *Closing the Tax Gap: Cash Business and Tax Evasion*, 20 STAN. L. & POL’Y REV. 37, 43, 59–60 (2009).

¹⁸³ See *id.* at 60–61. The study generally involved prepares with a substantial cash business clientele.

¹⁸⁴ See *supra* notes 136–137 and accompanying text.

¹⁸⁵ This would be aimed at preparers who have knowledge of, or having willingly turned a blind eye to, their clients’ dishonest reporting.

¹⁸⁶ Some degree of desensitization to an honor code or a similar mechanism is likely inevitable, among both tax return preparers and taxpayers. Another useful area of further empirical study would be how the effects of honesty-inducing policies, like calling attention to moral standards, persist over time.

Another, even simpler approach would be to simply move the current tax return preparer signature line to the top of the tax form, as suggested for taxpayers above. Currently, a paid tax return preparer must sign the bottom of Form 1040, directly underneath the taxpayer's signature. Moving the signature line to the top could call attention to moral standards and positively influence tax return preparers in the same way it could influence taxpayers.

5. Creating a Salient "Victim" of Tax Evasion

As discussed above in Part II, empirical studies have demonstrated that the psychic cost of dishonesty increases when individuals perceive that a victim will suffer economic harm as a result of their dishonesty.¹⁸⁷ Indeed, one factor that may strongly contribute to tax evasion is the fact that individuals may view it as a victimless crime, thus allowing them to incur a lower psychic cost when they cheat on their taxes. To counteract this effect, policymakers should strive to make salient to taxpayers that tax evasion is not, in fact, a victimless crime. By identifying specific economic harms imposed on individuals as a result of tax noncompliance, policymakers may be able to raise the psychic cost of tax evasion and reduce cheating.

Who are the "victims" of tax evasion? With the exception of certain excise taxes,¹⁸⁸ most federal taxes collected from individuals are not designated for specific purposes and go to the general revenue fund. In the broadest sense, any person who benefits from government spending is potentially deprived when there is a shortfall in tax revenue collected. Additionally, anyone who pays taxes is likely subject to a higher nominal tax rate to compensate for the tax gap.¹⁸⁹ This breadth of potential victims is beneficial to policymakers because they can choose to focus on any number of government spending programs in identifying specific economic harm resulting from tax evasion.

Policymakers should start, then, by identifying government programs that have the broadest public support. For example, data shows that the majority of Americans oppose cuts to federal spending on education, jobs programs, and food stamps (among other areas).¹⁹⁰ Policymakers could then

¹⁸⁷ See *supra* notes 109–117 and accompanying text.

¹⁸⁸ For example, revenues from the federal gasoline tax are dedicated to the Highway Trust Fund. See JOINT COMMITTEE ON TAXATION, JCX-2-13R, OVERVIEW OF THE FEDERAL TAX SYSTEM AS IN EFFECT FOR 2013, at 18 (Jan. 8, 2013).

¹⁸⁹ This would not necessarily be the case if the government used all of the additional revenue raised from increased tax compliance to increase spending, rather than lower taxes.

¹⁹⁰ See Harris Interactive, *Cutting Government Spending May Be Popular but There Is Little Appetite for Cutting Specific Government Programs* (Feb. 16, 2011), <http://www.harrisinteractive.com/NewsRoom/HarrisPolls/tabid/447/mid/1508/articleId/693/ctl/ReadCustom%20Default/Default>.

identify specific cuts that have been made to popular programs within these areas, for example, a popular education program benefitting school children that has been cut due to lack of funding. By focusing on discrete and sympathetic groups that could benefit from increased tax revenue, policymakers can hone in on a more visible “victim” of tax evasion.

In addition to identifying victims of tax evasion, policymakers must be able to make potential tax evaders aware of such victims, which could be accomplished in several ways. For example, the IRS might run a media campaign, akin to public service announcements, via television or the Internet.¹⁹¹ A brief advertisement might focus on a real locality that experienced a cut to an educational program, feature affected families and teachers, and present a message that every dollar of unreported income tax takes away funding from programs like the one featured.¹⁹² In addition to television, the IRS might display the advertisement on its website and on websites that provide tax preparation software, so that taxpayers will view them when preparing their tax returns.¹⁹³

The IRS could also combine messages intended to highlight victims of tax evasion with messages intended to call attention to moral standards, as discussed above. For example, taxpayers might have to read statements or take surveys in connection with filing their tax return that point out particular programs that are affected by revenue shortfalls. The statements should point out that tax evasion directly impacts such revenue shortfalls. For example, a statement might read:

aspx, archived at <http://perma.cc/2U45-HKYB> (last visited Feb. 22, 2015) (cited in Listokin & Schizer, *supra* note 38, at 200) (arguing that policymakers should link taxes with popular government programs to encourage compliance). In contrast, a majority of Americans support cuts in federal spending on foreign economic aid, foreign military aid, and space programs. See Harris Interactive, *supra*.

¹⁹¹ Other scholars have also advocated the use of media campaigns to improve tax compliance. See, e.g., Kornhauser, *supra* note 38, at 634–36 (recommending, among other strategies, media campaigns to improve taxpayer morale); Susan Morse, *Using Salience and Influence to Narrow the Tax Gap*, 40 LOY. U. CHI. L.J. 483, 504–07 (2009) (suggesting focusing on public goods provided by taxes as a means of fostering social norms of tax compliance).

¹⁹² For example, the news media has covered recent cuts to popular programs like Head Start, which provides education and nutrition services to low-income children. See Christin Nance Lazerus, *Federal Budget Cuts Mean Reductions in Local Head Start Programs*, POST TRIB. (Sept. 20, 2013), available at <http://posttrib.suntimes.com/news/porter/22624656-418/federal-budget-cuts-mean-reductions-in-local-head-start-programs.html>, archived at <https://perma.cc/VA69-B85J?type=pdf>. The message would have to be sufficiently broad so as not to mislead the public into thinking that specific tax dollars were set aside for the featured program.

¹⁹³ The IRS has relied on publicity to encourage compliance in other contexts. See, e.g., Joshua D. Blank & Daniel Z. Levin, *When Is Tax Enforcement Publicized?* 30 VA. TAX REV. 1, 2–5 (2010) (providing evidence of a significant increase in IRS press releases regarding enforcement activities in early April, presumably geared towards tax-filing season).

In 2013, funding was cut to a number of Head Start Programs across the country due to revenue shortfalls in the federal budget, resulting in hundreds of thousands¹⁹⁴ of low-income children failing to receive access to essential educational and nutritional support. Every dollar of tax that goes unreported by U.S. taxpayers directly harms government programs like Head Start.

By focusing taxpayers' attention on individuals who would be harmed by tax evasion, such policies could make the psychic cost of cheating higher and deter noncompliance.

A potential limitation of this approach is that it would require a critical mass of taxpayers to support the government programs highlighted. As discussed above, there is evidence that some government programs enjoy abundant popular support.¹⁹⁵ For some taxpayers, however, messages about government spending to benefit *any* needy group may have no effect on their compliance decisions. Or, worse, such messages could breed resentment in taxpayers who generally do not support tax funding of social programs, which could encourage even lower tax compliance. Such an effect could offset compliance benefits obtained from those who were positively influenced by the messages. Further, as an empirical matter, it might be difficult to determine which government spending programs would be reinstated and which would continue to be defunded in the event that more tax revenue was generated by higher tax compliance. Taxpayers might thus view the suggested link between tax compliance and highlighted victims as too attenuated or even misleading.

This is a delicate area where a particularly thorough amount of empirical testing would need to be undertaken to determine if the compliance benefits obtained outweighed any potential compliance costs. Policymakers might also have better success in portraying potential victims of tax compliance in a less political way. For example, the IRS might simply highlight that tax evasion causes honest taxpayers to pay more taxes.¹⁹⁶

B. Directions for Future Research

To successfully raise tax compliance by increasing the psychic cost of tax evasion, further study remains to determine which behavioral nudges would be most effective in the tax compliance context and whether they could be implemented in a cost-effective manner. This Section discusses potential policies that could be tested both in laboratory settings and through

¹⁹⁴ This total is hypothetical—a reliable estimate presumably could be determined by the government.

¹⁹⁵ See *supra* note 190 and accompanying text.

¹⁹⁶ But see *supra* note 189 and accompanying text.

small-scale field studies of actual taxpayers. Such studies could be conducted at the federal level by the IRS, but could also be conducted by states or localities. This Section also describes the success of other countries, such as the United Kingdom and Denmark, in implementing the findings of behavioral economics into government policies involving taxation.

1. Laboratory Studies

First, substantively, the application of (1) attention to moral standards, (2) categorization, and (3) the presence of a victim to tax compliance merits further research. With the exception of one study of the effect of physically signing a form at the top on tax reporting,¹⁹⁷ most of the above-described empirical work on honesty has involved contexts other than tax compliance. Similar lab studies could be designed to determine whether results from studies involving cheating on various tasks could be replicated in studies involving reporting income on a tax return. For example, lab studies on categorization have demonstrated that subjects cheat more on problem-solving tasks when they are rewarded with tokens (that can be redeemed for cash) as opposed to cash.¹⁹⁸ Researchers could design a similar cash/token study that instead involved tax reporting. For example, subjects could claim various deductions (e.g., for their travel expenses) that would increase or decrease the amount of tax refund they are rewarded. The results could be compared among subjects who are paid an immediate cash refund versus those who are paid in tokens exchangeable at a later time for cash. A finding that tokens led to more cheating might aid in our understanding of the role categorization plays in tax compliance currently.

Of equal importance is further research on the efficacy of honesty-inducing policies in settings that reflect real world taxpayer behavior. More study is particularly merited with respect to potential differences in compliance among paper filers and electronic filers. For example, rather than simply testing whether a physical signature at the top of a tax return would increase tax compliance, studies should also focus on whether electronic signatures or checking a box next to an “I agree” statement before electronically preparing a tax return have the same honesty-inducing effect. Studies where subjects prepare fictitious tax returns by hand could be replicated with simple electronic preparation at a computer. Additionally, researchers should examine whether brief surveys induce honesty by calling attention to moral standards in the same manner that signing a form does.

Although lab studies of taxpayer behavior have potential drawbacks, the upsides make them a valuable tool in this context. Such studies would

¹⁹⁷ *Supra* notes 96–98 and accompanying text.

¹⁹⁸ *Supra* notes 104–107 and accompanying text.

allow researchers to isolate specific factors in a controlled environment free of many complications that actual taxpayers face, such as liquidity problems or other economic factors.¹⁹⁹ For example, researchers who want to examine the effect of electronic signing versus physical signing can more carefully equalize the conditions between those that electronically sign, physically sign, and control subjects who do not sign at all to minimize the influence of additional factors on the results.

Notwithstanding these benefits, a common critique of laboratory studies of taxpayer behavior is that student subjects do not behave in the same manner that an adult taxpayer would, and that subjects may generally behave differently in a lab.²⁰⁰ For example, it's possible that subjects are more compliant in laboratory tests of tax compliance because they feel more closely monitored, or because they want to please the researchers conducting the study.²⁰¹ Evidence shows, however, that the behavior of student subjects does not deviate significantly from that of adults.²⁰² Additionally, results of lab studies of tax compliance have generally been found to be consistent with IRS data on actual taxpayer behavior,²⁰³ indicating that there is not significant deviation from real world behavior when testing tax compliance in a laboratory setting.

2. Pilot Programs

Lab studies of various methods of inducing honesty are only the first step in successfully implementing policies designed to increase the psychic cost of tax evasion. Even in light of evidence that laboratory studies of taxpayer behavior are consistent with real world behavior, care should be taken to determine whether the results of honesty studies are relevant to actual taxpayers operating outside of a controlled setting. Thus, the next step should be government testing through small-scale pilot programs, where specific policies are implemented among test groups in randomized controlled trials.²⁰⁴ Such trials could be conducted by the IRS at the national

¹⁹⁹ See, e.g., James Alm, *Testing Behavioral Public Economic Theories in the Laboratory*, 63 NAT'L TAX J. 635, 641 (2010).

²⁰⁰ See *id.* at 641–42. However, not all lab studies involve student subjects.

²⁰¹ See *id.* at 642.

²⁰² *Id.*

²⁰³ *Id.*; see also Thomas, *supra* note 5, 136–39 (noting that the results of lab studies showing higher tax compliance among taxpayers claiming refunds is consistent with results of studies of IRS audit data on actual taxpayers).

²⁰⁴ Scholars argue that any behavioral interventions should be tested first through pilot programs “given the complexity of conditions, the high uncertainty, and in particular given the incredible [potential] cost of implementing policy.” Amir et al., *supra* note 134, at 451. They also note that pilot testing is particularly appropriate for tax reform, given the potential revenue gain/loss at stake: “How is it that the government cuts taxes by billions of dollars without any pilot

level, or even at state or local levels. For example, the IRS (or an analogous local taxing authority) might identify 3000 individuals who self-prepare their tax returns electronically. Of those individuals, half (1500) might be exposed to the current method of electronically signing their return after it has been completed, while the other half might be asked to electronically sign or verify an accuracy statement before proceeding to fill out the electronic form. The results could be analyzed by determining whether there was an overall increase in reported income (compared to the prior year) among those who signed before as compared to those who signed after they completed the form. Like the Schwartz and Orleans study on the effect of personal norms on taxpayer compliance,²⁰⁵ taxpayer confidentiality could be maintained by reporting results on a group-wide, rather than individual, basis.

Implementing honesty-inducing policies through small pilot programs would allow policymakers to experiment with a variety of different techniques to determine what works and what does not without expending the resources necessary to implement a full-scale change. Additionally, some measures like simply changing the placement of a signature line on an electronic or paper form would not require much additional cost no matter what the size of the study. Due to their advantages, randomized controlled trials have been successfully implemented to determine effective policies in other fields such as criminal law,²⁰⁶ health care,²⁰⁷ and welfare policy.²⁰⁸

3. Similar Approaches in Other Countries

The United Kingdom has already begun implementing honesty-inducing policies on a small scale in an effort to decrease fraud and error in the tax system and in other areas. The government's "Behavioural Insights Team," a special coalition designed to apply findings from behavioral economics

test? Why not give the residents of Rhode Island (just as an example) one of four levels of tax cuts for a year or two and see the effect? Wouldn't this be much more efficient and beneficial in the long run?" *Id.*

²⁰⁵ *Supra* notes 59–64 and accompanying text.

²⁰⁶ See Lawrence W. Sherman, *The Rise of Evidenced-Based Policing: Targeting, Testing, and Tracking*, 42 CRIME & JUST. 377, 409 (2013) (noting that randomized trials of juvenile offenders showed that prosecuting after arrest led to more repeat offenses than those who were "diverted or cautioned").

²⁰⁷ Global HIV Prevention Working Group, *HIV/AIDS and the Global Community: Global Mobilization for HIV Prevention: A Blueprint for Action*, 1 SEATTLE J. SOC. JUST. 297, 315 n.42 (2002) (discussing randomized trials showing efficacy of safe sex programs in preventing HIV).

²⁰⁸ Coalition for Evidence-Based Policy, *Social Programs That Work: Minnesota Family Investment Program*, <http://evidencebasedprograms.org/1366-2/minnesota-family-investment-program>, archived at <http://perma.cc/2U45-HKYB> (last visited Feb. 21, 2015) (noting that successful welfare pilot program in Minnesota instituted in seven counties led to eventual enactment of program by the state).

research to public policy, published a report in 2012 describing the results of some of these studies.²⁰⁹ One trial was undertaken to gauge the effect of “signing at the top” of forms, based on the empirical research described in Part II above, including the auto insurance study.²¹⁰ This trial, conducted by the Behavioural Insights Team in partnership with the Manchester City Council, examined the claiming of Single Person Discounts, which entitle people living alone to a twenty-five percent discount on their local council tax.²¹¹ The government has estimated that UK-wide losses due to individuals falsely claiming a Single Person Discount are potentially as high as £100 million.²¹²

In 2011, the Manchester City Council sent approximately 38,000 letters to residents who had claimed a Single Person discount the previous year. The letter requested that residents complete a form on the reverse side to claim the Single Person Discount if they were still living alone.²¹³ Some residents received the original letter that had been sent in previous years, while others received a new letter with a required signature at the top of the form.²¹⁴ The new letter resulted in a six percent reduction in requests to renew the Single Person Discount as compared to the original letter,²¹⁵ saving the city council an estimated £240,000²¹⁶ in one year for an essentially cost-less change.

Additionally, a coalition similar to the Behavioural Insights Team called the “INudgeYou Team” in Denmark has worked with the Danish Ministry of Taxation to incorporate the findings of behavioral economics into policies that will improve tax compliance. One intervention sought to address difficulties that the Ministry of Taxation was having collecting tax from young people ages fifteen to twenty-five.²¹⁷ After interviewing a number of young taxpayers, and studying the online behavior of youth on websites such as Facebook, the INudgeYou Team found that redesigning the

²⁰⁹ Cabinet Office, Behavioural Insights Team, *Applying Behavioural Insights to Reduce Fraud, Error and Debt*, 3 (Feb. 2012) available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/60539/BIT_FraudErrorDebt_accessible.pdf, archived at <https://perma.cc/5JV5-J32L?type=pdf>.

²¹⁰ *Id.* at 15.

²¹¹ *Id.* at 29–31.

²¹² *Id.* at 29.

²¹³ *Id.* at 30.

²¹⁴ *Id.* at 30–31. The study was also designed to test the effect of several other honesty-inducing policies, such as using simplified language, reducing the salience of the discount, and highlighting the risk of detection. These measures were incorporated into a third letter. *Id.* at 30.

²¹⁵ *Id.* at 31. The findings are described as “initial results” and the report indicates that researchers continue to analyze the results. *Id.*

²¹⁶ See *Nudge Theory Trials “Are Working” Say Officials*, BBC NEWS (Feb. 8, 2012), <http://www.bbc.co.uk/news/uk-politics-16943729>, archived at <http://perma.cc/A2JK-T6TX>.

²¹⁷ Sille Krukow, *Case Feature: Nudging Adolescents into Registering Taxes*, INUDGEYOU.COM (Feb. 13, 2013) (on file with author).

Ministry's website to make it more relatable and familiar was key to encouraging better tax compliance among young people. The changes were described as "an adaptation of a visual universe that the target group knew and understood from the online world they were familiar with."²¹⁸ As was the case with the behavioral interventions in the UK, the INudgeYou Team's policies produced a measureable increase in tax compliance among Denmark's youth.²¹⁹

C. Addressing Potential Objections

Incorporating the findings of behavioral economics into government policies is not without controversy. Critics have argued that such policies lack robust empirical support, lack a solid theoretical underpinning, and are unduly paternalistic. Critics may also argue that increasing the psychic cost of tax evasion imposes collateral costs on the tax system that outweigh its benefits. This Section addresses some of those concerns.

1. Honesty-Inducing Policies Lack Sufficient Empirical Support

A primary criticism of behavioral law and economics is that the results of laboratory experiments often lack real world relevance.²²⁰ The behavioral nudges proposed in this Article are susceptible to this argument that such policies simply will not work in the real world. For example, one oft-cited failed tax policy based on behavioral economics was the implementation of the Making Work Pay Credit, which was a fiscal stimulus intended to jump start a faltering economy by distributing up to \$400 to qualifying individuals (\$800 for married couples) in 2009 and 2010.²²¹ Whereas previous, similar stimuli had been distributed as a lump sum check, the Making Work Pay Credit was administered incrementally through the tax system, by decreasing the amount of tax withheld in each paycheck that the individual received.²²² The change was based on a theory put forth by behavioral economists that individuals would be more likely to spend, and less likely to save, the extra income if they received it in small increments over time, ra-

²¹⁸ *Id.*

²¹⁹ *Id.*

²²⁰ See, e.g., Alm, *supra* note 199, at 637, 641–42; Joshua D. Wright & Douglas H. Ginsburg, *Behavioral Law and Economics: Its Origins, Fatal Flaws, and Implications for Liberty*, 106 NW. U. L. REV. 1033, 1044–52 (2012).

²²¹ IRS, *The Making Work Pay Tax Credit*, <http://www.irs.gov/uac/The-Making-Work-Pay-Tax-Credit>, archived at <http://perma.cc/AZX2-D8F3> (last visited Feb. 22, 2015).

²²² Claudia R. Sahm et al., *Check in the Mail or More in the Paycheck: Does the Effectiveness of Fiscal Stimulus Depend on How It Is Delivered?* 2–4 (Nat'l Bureau of Econ. Research, Working Paper No. 16246, 2010).

ther than as a lump sum.²²³ A subsequent survey of recipients showed that the change in distribution of the credit was unlikely to achieve the intended result, with only thirteen percent of households reporting that they intended to spend the stimulus money in 2009, compared to twenty-five percent who reported spending a 2008 lump sum rebate check.²²⁴ Apparently the incremental distributions for the Making Work Pay Credit were so small that many individuals reported that they did not even notice the extra income and, thus, did not make plans to spend it.²²⁵ Many commentators thus viewed the program as a failure and waste of government spending.²²⁶

Similarly, critics could argue that attempting to translate the results of the honesty studies discussed above into policy would be a waste of government resources. The previous Subsection addresses the argument that the empirical studies showing that honesty can be influenced through external factors lack real world application. There is at least some evidence that lab studies of taxpayer behavior are reliable indicators of actual taxpayer behavior,²²⁷ and, more importantly, policies can and should be first tested through pilot programs to determine their external validity. Such trials would not impose onerous administrative costs due to their small size, and many of the proposed interventions would be so minor (e.g., moving a signature line) that they would require minimal costs in any event. A similar pilot program approach could have potentially saved substantial costs in the

²²³ *Id.* at 4–5; see also Drake Bennett, *Behavioral Economics Foils an Obama Tax Cut?*, BLOOMBERG BUSINESSWEEK (Nov. 10, 2011), <http://www.businessweek.com/magazine/behavioral-economics-foils-an-obama-tax-cut-11102011.html#p1>, archived at <http://perma.cc/4JFY-9933>. One theory that supported the approach taken by the Making Work Pay Credit was Richard Thaler's theory of "mental accounts." Bennett, *supra*. According to Thaler, individuals tend to separate financial resources into various mental accounts, including a "current income" account and an "asset" account. See Richard Thaler, *Anomalies: Saving, Fungibility, and Mental Accounts*, 4 J. ECON. PERSP. 193, 194–95 (1990). Small gains tend to be treated as current income and are more likely to be spent. Larger gains tend to be treated as assets and are more likely to be saved. *Id.*

²²⁴ Sahn et al., *supra* note 222, at 7–11.

²²⁵ *Id.* at 8–10. The study does have limitations, and it is not clear that the Making Work Pay Credit did not have a positive impact on the economy. For example, the data came from taxpayer surveys, which were conducted before all of the 2009 payments had been made. Accepting the accuracy of the responses requires assuming that individuals keep track of and accurately report their spending behavior, and further assuming that they are able to accurately predict how they will behave in the future. See Bennett, *supra* note 223.

Additionally, the outcome of the study conducted by Sahn, Shapiro, and Slemrod suggests that policymakers were wrong in their prediction of how individuals would respond to small, incremental stimulus payments, but it does not suggest that behavioral economics does not factor into this context. Under a purely rational model, it should make no difference in terms of consumption patterns if a credit is distributed in a lump sum or incrementally. That *twice as much* spending was reported to have taken place under a lump sum stimulus versus an incremental stimulus suggests that individuals are still exhibiting irrational behavior. See *id.*

²²⁶ See, e.g., Wright & Ginsburg, *supra* note 220, at 1066; Bennett, *supra* note 223.

²²⁷ *Supra* note 203 and accompanying text.

case of the Making Work Pay Credit. Some policies inevitably will not work as intended, and pilot testing before they are implemented on a wide scale will prevent the government from wasting precious resources.

2. Honesty-Inducing Policies Lack Sufficient Theoretical Support

Another major criticism of behavioral law and economics is that there is no coherent underlying theoretical model on which to base behavioral policies.²²⁸ Whereas neoclassical economics starts from the premise of a rational actor who behaves predictably, the argument here is that behavioral economics results in a number of different models explaining various anomalies in individual behavior without one, unifying theory.²²⁹

The proposals herein are potentially susceptible to the critique that they lack comprehensive theoretical support. Recall that Part III modifies the standard deterrence model of tax evasion by incorporating a psychic cost of tax evasion, *Z*. This updated model incorporates empirical evidence showing that individuals are deterred from cheating not only by monetary costs, but by psychological costs, as well. However, this updated model is not—nor does it claim to be—a comprehensive model of an individual's decision-making process in the context of tax compliance. Just as the neoclassical model does not (nor does it intend to) incorporate non-rational aspects of human behavior, an updated model reflecting the psychic cost of tax evasion inevitably omits a number of other facets of decision-making in the tax compliance context, such as the effect of social norms. Further, as discussed above, it is likely impossible to model the psychic cost of tax evasion with any degree of precision because individual thresholds for psychic cost likely vary from person-to-person. Additionally, the factors discussed in this Article—attention to moral standards, categorization, and the presence of a victim—are no doubt just a few of a multitude of factors that influence the psychic cost of evasion.

But the lack of a comprehensive and unified behavioral model of tax evasion does not detract from the merit of implementing cost-effective tax policies that induce honesty. Although one behavioral theory or model will not fit all individuals,²³⁰ adopting policies based on solid empirical evidence may still alter the behavior of a significant number of individuals. If the marginal cost of implementing such policies is exceeded by the marginal gains resulting from improved tax compliance, then policymakers should be

²²⁸ See, e.g., Alm, *supra* note 199, at 637, 641–42; Wright & Ginsburg, *supra* note 220, at 1052.

²²⁹ See Alm, *supra* note 199, at 637; Wright & Ginsburg, *supra* note 220, at 1052.

²³⁰ See Alm, *supra* note 199, at 650.

able to raise tax revenue efficiently.²³¹ Additionally, concerns that the lack of a unified theoretical model leads to bad policies in practice²³² can be reduced by first pilot-testing those policies in real world settings to determine their impact.

3. Raising the Psychic Cost of Tax Evasion Could Impose Unintended Costs

Critics might also argue that, even if the empirical and theoretical support for raising the psychic cost of tax evasion is sound, such policies could impose unintended costs that would outweigh their benefits. As discussed above, many of the policies proposed in this Article should impose only minor administrative costs on the government and, because the goal would be to collect additional tax revenue through enhanced tax compliance, this additional revenue effectively should pay for these policies. But, even if the administrative costs to the government of implementing such policies were outweighed by additional tax revenue, there could be additional, collateral costs imposed on the tax system. For example, honesty-inducing policies could lead to *lower* compliance among some taxpayers over time if they created backlash.²³³ Taxpayers might resent government efforts to nudge behavior or feel that the government's resort to such tactics lessens its credibility. Such policies might also encourage lower compliance if taxpayers believe adoption of the policies signals that the IRS's current deterrence efforts are ineffective. Additionally, such policies could create complexities in tax return preparation that raise compliance costs for taxpayers.

²³¹ Evaluating the merits of any new tax policy should also take distributional concerns into account, as well. For example, if a study found that increasing the psychic cost of tax evasion disproportionately improved compliance among lower income taxpayers, the result may be that such taxpayers would be subject to a higher effective tax rate as a group than higher income taxpayers who evaded. The distributional impact of the policies recommended above would have to be further studied once it was determined which policies had robust, empirical support. For a discussion of the distributive effects of behavioral nudges, see Brian Galle, *Tax Command . . . or Nudge?: Evaluating the New Regulation*, 92 TEX. L. REV. 837, 874–76 (2014).

²³² See Wright & Ginsburg, *supra* note 220, at 1052. Wright and Ginsburg's criticisms stem largely from concerns that: (1) policies aimed at overcoming cognitive errors will seek to change behavior that is actually rational for the decision-maker; (2) such policies will impose costs on those who are not irrational; or (3) the social costs of such policies will exceed their gains even if all individuals exhibit the particular irrational behavior. *Id.* at 1052–53. The first critique has more force with respect to behavior that is not illegal (e.g., policies aimed at encouraging individuals to save more and spend less). It is harder to support an argument that taxpayers' right to rationally evade taxes should be protected. The second and third critiques are addressed below.

²³³ Even if taxpayers do not change their compliance behavior in any way, the policies could create deadweight loss if they impose guilt or other negative feelings on those who evade. *Cf.* Gary M. Lucas, Jr., *Paternalism and Psychic Taxes: The Government's Use of Negative Emotions to Save Us from Ourselves*, 22 S. CAL. INTERDISC. L.J. 227, 262 (2012).

All policies designed to deter tax evasion carry some risk of taxpayer resentment and backlash.²³⁴ For example, research shows that when tax penalties are set too high, taxpayers may be *less* likely to comply with their tax obligations.²³⁵ Yet, there is no reason that the honesty-inducing policies proposed in this Article would carry a greater risk of creating taxpayer backlash than current policies designed to increase tax compliance like tax penalties and audits.²³⁶ In fact, the honesty-inducing policies, by their very nature, are designed to be subtle nudges that increase *voluntary* compliance among taxpayers and, as such, they should carry a lower risk of crowding out voluntary compliance than policies designed to punish.²³⁷ For example, many taxpayers might not even notice that their signature is required before filling out their tax return instead of after. For potentially controversial policies that aim to create a salient victim of tax evasion by highlighting items of government spending (e.g., spending on healthcare), policymakers should first experiment with various messages to determine which minimize taxpayer resentment.

There is also no reason that honesty-inducing policies should create significant complexity or administrative costs for taxpayers. Requiring signatures where they weren't previously required (e.g., with estimated tax payments), requiring taxpayers to read brief statements, or requiring taxpayers to take brief surveys will add only minimal time to tax preparation. Nothing will change in the overall design of tax returns that would add significant additional complexity or costs to tax compliance, nor will any substantive tax laws change.

In all events, the costs of imposing policies designed to increase the psychic cost of tax evasion would certainly have to be weighed against the benefits. And, the lack of a comprehensive theoretical model of tax compliance makes it difficult to quantify these costs. But we lack a comprehensive model of the costs of our tax policies regardless of whether we incorporate behavioral interventions. The social costs of policies like tax audits or tax penalties are also hard to quantify, and it is possible that these policies also

²³⁴ See *supra* note 26 and accompanying text.

²³⁵ See *supra* note 26 and accompanying text.

²³⁶ Increasing the psychic cost of tax evasion might also be a more accurate means of targeting intentional tax evaders as compared to imposing monetary penalties. The IRS might incorrectly assert tax penalties against "innocent" taxpayers (e.g., a taxpayer who makes an honest mistake in reporting her tax liability who is nonetheless subject to a civil fraud penalty). On the other hand, individuals presumably will not incur the psychic cost of evasion if they have not intentionally evaded their tax liability.

²³⁷ Cf. Galle, *supra* note 231, at 891–92 (suggesting that taxes might crowd out intrinsic motivations more than behavioral nudges do because of the way that people perceive "express dollar-denominated incentives").

create lower compliance among some taxpayers²³⁸ or increased complexity in the tax system. There is no reason, then, to favor current policies with unknown costs over newer policies with unknown costs if it turns out there is good empirical support for the latter. Although tax policymakers must strive for an educated understanding of potential costs of new policies, we should not shut out innovations that could raise much needed tax revenue because we cannot quantify the potential costs with precision.

4. Behavioral Interventions Are Unduly Paternalistic

Critics of applying behavioral economics to government policies have also argued that these types of interventions are overly paternalistic and falsely assume that regulators understand individuals' true preferences.²³⁹ For example, another recent behavioral intervention was the "Save More Tomorrow" program, which allowed employers to change the default for employer-sponsored savings plans to automatic enrollment, so that individuals would have to affirmatively opt out of the plans, instead of having to opt in.²⁴⁰ The idea, which was pioneered by behavioral economists, is that individuals exhibit a "status quo bias" that causes them to adhere to the status quo even if it does not represent their true preferences.²⁴¹ By changing the status quo to enrollment *in* savings plans, policymakers have succeeded in raising the rate of savings when the program has been adopted.²⁴² Critics, however, have argued that these changes do not necessary represent individuals' "true" preferences, but instead merely substitute regulators' preferences for those of individuals.²⁴³ Such policies, the critics argue, are not only prone to error in judging individual preferences, but rest on a slippery slope that could lead to continued, over-intrusive regulation.²⁴⁴

It is not necessary for purposes of this Article to resolve the debate over regulations that aim to correct cognitive errors that purportedly cause people to deviate from their true preferences. Enrollment in savings plans, like other areas that have been traditionally subject to behavioral interventions,²⁴⁵ represents behavior that is truly optional. Thus, a colorable argu-

²³⁸ See *supra* notes 26–28 and accompanying text.

²³⁹ See, e.g., Alm, *supra* note 199, at 638; Galle, *supra* note 231, at 855; Wright & Ginsburg, *supra* note 220, at 1059–61.

²⁴⁰ See THALER & SUNSTEIN, *supra* note 15, at 112–15; Richard H. Thaler & Shlomo Benartzi, *Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving*, 112 J. POL. ECON. S164, S166–69 (2004).

²⁴¹ Thaler & Benartzi, *supra* note 240, at S168.

²⁴² *Id.* at S169.

²⁴³ Wright & Ginsburg, *supra* note 220, at 1056–57.

²⁴⁴ *Id.* at 1075–80.

²⁴⁵ Other areas include consumer finance protections and "sin" taxes on consumption items like cigarettes. See Wright & Ginsburg, *supra* note 220, at 1052–53, 1057.

ment could be made that individual liberty may be at stake when regulators interfere with such behavior.²⁴⁶ And such interventions require policy decisions to be made ahead of time (e.g., that enrollment in savings plans is good and we want to encourage it) about which there may not be a consensus.

This Article, however, advocates behavioral interventions to encourage individuals to comply with their tax liability. Individuals are not at liberty to evade taxes from a legal perspective (though they may do so anyway), and thus there is no freedom of choice interest to be protected in this context.²⁴⁷ Even if it is rational for individuals to evade tax from an economic perspective, we have already made a policy decision—evidenced by our substantive tax laws and procedural mechanisms like audits and penalties—that paying taxes is not voluntary. Thus, applying behavioral economics in this context, by incorporating honesty-inducing policies to encourage higher tax compliance, should not raise concerns of paternalism.

CONCLUSION

The tax gap presents the government with a formidable task. We are losing hundreds of billions of dollars of tax revenue each year due to relatively minor amounts of tax evasion by a significant number of taxpayers. In the aggregate, these sums are quite costly, but enforcement on the individual level is often not cost-effective. Auditing more individuals is likely unrealistic given budgetary limitations and would be politically unpopular even in better economic times. Raising tax penalties faces similar limitations. Without ramping up efforts in these traditional deterrence-driven areas, what can the government do to reign in tax evasion?

There is no time like the present for the IRS to innovate. Not only are we in need of additional tax revenue, but the past several decades have seen important contributions by psychologists and behavioral economists to our understanding of what drives individuals to be dishonest. Importantly, there is much data indicating that honesty is not a fixed trait within an individual but, rather, can be influenced by external factors. The IRS can and should use this knowledge to increase tax compliance by raising the psychic cost of tax evasion.

There is, of course, no guarantee that honesty-inducing policies like signing a form at the top instead of the bottom can be translated into effective policies for actual taxpayers. But many of those policies could be implemented at such a low administrative cost to the government, particularly

²⁴⁶ The counterargument is that “those who feel strongly about their own choices can easily overcome the government’s default.” Galle, *supra* note 231, at 855.

²⁴⁷ See Thomas, *supra* note 5, at 164.

compared to raising audit rates or penalties, that it is certainly worth investigating their potential. Using some of the behavioral nudges proposed in this Article, the IRS could pilot test the efficacy of raising the psychic cost of tax evasion and determine the best manner to do so before implementing any changes on broad scale. Even minor changes, such as making small adjustments to the way that taxpayers fill out their tax form, could generate much needed tax revenue at virtually no administrative cost to the government.

