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'Big Stick' to Responsive Regulation

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A NEW ERA OF TAX ENFORCEMENT: FROM 'BIG STICK' TO RESPONSIVE REGULATION

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This Article explores the economics of crime and compliance as the dominant approach to U.S. tax enforcement of the past three and a half decades. It evaluates the key advantages and disadvantages of the economic model as well as its application to tax. The Article then addresses the multiplicity of taxpayer behavior and the need and prospect of balancing the economically conceived methods of detection and punishment against other, more cooperative, means and developing a broader approach to tax enforcement more generally. The Article explores responsive regulation as a case study for an alternative method to tax enforcement that heavily draws on the economic paradigm but also supplements this approach with other theories, particularly those involving taxpayer identity, conflict escalation, and procedural justice. The Article suggests that this broader, more balanced, and closely tailored method of regulating responsively may enable regulators to draw on the advantages of the economic model while alleviating some of its drawbacks. Responsive regulation may therefore constitute a superior method for regulating tax compliance.

INTRODUCTION

The operation of the federal government is heavily dependent on income taxes; in 2005, about 43 percent of Federal tax revenue in the United States came from individual income taxes and another

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13 percent from corporate income taxes.¹ This amounts to \$927 billion and \$278 billion, respectively² and, compared with Fiscal Year 2004, an increase of 14.6 percent in individual income taxes and 47 percent in corporate income taxes.³ Every year, however, the government collects billions of dollars less in tax money than it believes is owed. This difference between taxes owed and taxes collected, otherwise known as the “tax gap,”⁴ is substantial and has roughly tripled over the past two decades.⁵ Estimates released in February 2006 indicate that the U.S. tax gap for the 2001 tax year stands at approximately \$345 billion,⁶ corresponding to a noncompliance rate of about 16.3 percent of taxes owed.⁷ Through enforcement activities and collection of other late payments, the IRS has sought to close some of this gap, still leaving an enormous net deficit of approximately \$290 billion for the 2001 tax year.⁸

Maintaining the integrity of the tax system is hardly a recent challenge for civilizations. For centuries, tax noncompliance has been notorious for furthering a climate of disrespect, antagonism, and selfishness in the relationship among citizens and between them and their governments.⁹ When taxes are compromised, the

1. U.S. DEP'T OF TREASURY, COMBINED STATEMENT OF RECEIPTS, OUTLAYS, AND BALANCES 11 (2005), available at <http://www.fms.treas.gov/annualreport/cs2005/receipt.pdf>.

2. *Id.*

3. *Id.* at 12.

4. According to the Internal Revenue Service (IRS) the tax gap is “the difference between what taxpayers should have paid and what they actually paid on a timely basis.” I.R.S. News Release IR-2006-28, IRS Updates Tax Gap Estimates (Feb. 14, 2006), available at <http://www.irs.gov/newsroom/article/0,,id=154496,00.html>; see also I.R.S. News Release FS-2005-14, Understanding the Tax Gap (Mar. 2005) (“The tax gap measures the extent to which taxpayers do not file their tax returns and pay the correct tax on time.”), available at <http://www.irs.gov/newsroom/article/0,,id=137246,00.html>. Others clarify that “the tax gap is not equal to the amount of additional revenue that would be collected by stricter enforcement.” Luigi Alberto Franzoni, *Tax Evasion and Tax Compliance*, in 6 ENCYCLOPEDIA OF LAW AND ECONOMICS 52, 53 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000).

5. Alex Raskolnikov, *Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty*, 106 COLUM. L. REV. 569, 574 (2006).

6. I.R.S. News Release IR-2006-28, *supra* note 4.

7. *The Tax Gap and How to Solve It: Testimony Before the Senate Committee on the Budget*, 109th Cong. 3 (2006) (written testimony of Mark Everson, Commissioner, IRS), available at www.senate.gov/~budget/democratic/testimony/2006/everson_taxgap021506.pdf [hereinafter *The Tax Gap*]. Both of these numbers fall at the high end of the range of estimates provided by the IRS in the spring of 2005. I.R.S. News Release IR-2006-28, *supra* note 4.

8. I.R.S. News Release IR-2006-28, *supra* note 4. Notice, however, the statement of the Commissioner of the Internal Revenue Service, Mark W. Everson, that “the vast majority of Americans pay their taxes accurately and are shortchanged by those who don’t pay their fair share.” *The Tax Gap*, *supra* note 7.

9. John S. Carroll, *A Cognitive-Process Analysis of Taxpayer Compliance*, in 2 TAXPAYER COMPLIANCE 228, 228 (Jeffrey A. Roth & John T. Scholz eds., 1989); see also FRANK A. COWELL, CHEATING THE GOVERNMENT: THE ECONOMICS OF EVASION 101–24 (1990) (claiming that noncompliance can generate resentment among taxpayers, eventually escalating to

tax system becomes a deficient means for raising money to pursue and implement government goals, and actual tax collection fails to reflect the statutorily intended taxation plan.¹⁰ This creates disturbing results such as upsetting the distribution of the tax burden and, more generally, wealth in society.¹¹ For instance, when wealthy citizens have better opportunities and means to reduce their tax liabilities compared with other less well-off citizens, the taxes collected are likely to result in a more regressive and less equitable system than Congress intended.¹² Abusive tax practices also jeopardize horizontal equity when opportunities to reduce or eliminate tax liability are distributed unequally.¹³ More generally, in a country with fixed revenue requirements, reducing the tax liability for any given sector of taxpayers, in effect, means that higher and more distortionary taxes are levied on others.¹⁴ All of this, in turn, produces inefficiencies as market competition is affected by the unequal distribution of the tax burden and economic practices motivated by tax abuse, translating to a deadweight loss to society.¹⁵

Despite the evident benefits entailed in improving tax compliance, several factors, including the complexity of the Tax Code, the magnitude and persistent levels of noncompliance, and democratic principles that restrain government agencies from interfering with the private conduct of citizens, combine to make it so that no tax system achieves perfect compliance.¹⁶ Still, due to the size of the tax gap, even a small or moderate reduction in existing noncompliance can yield substantial returns and improve the government's ability to pursue its goals. According to a 2004 Government Accountability Office report, each one percent reduction in the U.S. net tax gap is

these taxpayers undertaking acts of noncompliance as a form of protest against the government and the tax administration or as a means of equalizing the tax burden).

10. See, e.g., Joel Slemrod, *Why People Pay Taxes: Introduction*, in *WHY PEOPLE PAY TAXES* 1, 1 (Joel Slemrod ed., 1992) ("It is impossible to understand the true impact of a country's tax system by looking only at the tax base and the tax rates applied to that base. A critical intermediating factor is how the tax law is administered and enforced. What is apparently a highly progressive tax rate structure may, in fact, be proportional, or even regressive, if taxes levied on the wealthy are not collected. What is apparently a tax base finely tuned to reflect individual differences in ability to pay may, in fact, produce a capricious distribution of tax liabilities if the tax law is selectively enforced.").

11. See Louis Kaplow, *How Tax Complexity and Enforcement Affect the Equity and Efficiency of the Income Tax*, 49 *NAT'L TAX J.* 135, 140-42 (1996).

12. See James Andreoni, Brian Erard & Jonathan Feinstein, *Tax Compliance*, 36 *J. ECON. LITERATURE* 818, 818 (1998).

13. Franzoni, *supra* note 4, at 55.

14. Andreoni et al., *supra* note 12, at 818.

15. See Franzoni, *supra* note 4, at 55; Andreoni et al., *supra* note 12, at 818.

16. I.R.S. News Release IR-2006-28, *supra* note 4 (indicating the administrative inaptness to completely eliminate the tax gap).

likely to yield more than \$2.5 billion annually.¹⁷ Thus, a 10 to 20 percent reduction could translate to \$25 to \$50 billion or more in additional revenue annually.¹⁸

In recent years the Internal Revenue Service (IRS) has taken a number of steps to bolster enforcement and ease the tax gap. The IRS budget request for Fiscal Year 2005 was \$10.674 billion, \$490 million more than the amount proposed for Fiscal Year 2004.¹⁹ Three hundred million dollars of this increase was allocated for enforcement.²⁰ The enforcement budget was used to raise the number of audits of high-income taxpayers to 221,000 reviews in Fiscal Year 2005, the highest number of reviews in 10 years.²¹ Similarly, the number of audits of all taxpayers increased to 1.2 million in 2004, 20 percent more than the year before.²² As a result of these steps and others, the IRS reported an increase in its enforcement revenue of nearly 40 percent, from a total of \$33.8 billion in 2001 to \$47.3 billion in 2005.²³ However, despite these increases in enforcement and revenue, the difference between taxes owed and taxes collected in the United States remains considerable.²⁴ This raises the question whether the steps taken thus far are sufficient to

17. *Tax Compliance: Reducing the Tax Gap Can Contribute to Fiscal Sustainability but Will Require a Variety of Strategies: Hearing Before the S. Comm. On Finance* (GAO-05-527T3), 109th Cong. 3, 16 (2005) (statement of David M. Walker, Comptroller Gen. of the United States), available at <http://www.gao.gov/new.items/d05527t.pdf>.

18. *Id.* at 16 (adding that a significant reduction of the tax gap is likely to depend on improvement in tax compliance rates).

19. INTERNAL REVENUE SERV., BUDGET IN BRIEF, FISCAL YEAR 2005, at 4 (2004).

20. The remainder of the increase, \$190 million, was allotted for reinvestments in consumer service, maintenance of existing levels of performances, and physical infrastructure consolidation. *See id.*

21. I.R.S. News Release IR-2006-28, *supra* note 4. Here, high-income taxpayers are defined as those taxpayers earning \$100,000 or more annually. *Id.*

22. *Id.*

23. *Id.* The increase in revenue between 2001 and 2005 due to examination measures is \$9.8 million, and from document matching is \$1.5 million, totaling \$11.3 million of additional tax money collected. This is compared with an increase in revenue of \$2.2 million due to other forms of collection during that time. *See id.* (enforcement revenue tbl.). *See, however,* more recent reductions in enforcement and revenue. According to IRS estimates, in 2008 the audit rate of individuals fell to 1.01% (from 1.03% in 2007), a decrease that was most pronounced with respect to high wealth individuals where the audit rate fell to 5.57% from 6.84% in 2007. In 2008 collections also fell for the first time in a decade, down 4.7% from 2007, to \$56.4 billion. INTERNAL REVENUE SERV., FISCAL YEAR 2008 ENFORCEMENT RESULTS, available at http://www.irs.gov/pub/irs-news/2008_enforcement.pdf.

24. Importantly, the tax gap estimates take only certain components of income misreporting into account. These estimates do not consider, for instance, taxes that are legally minimized. Once accounted for, tax noncompliance (broadly defined) may provide a more realistic (albeit gloomy) description of taxpaying behavior and the challenge of protecting the integrity of the tax system. Note, for example, recent headlines suggesting that two-thirds of corporations paid zero income taxes in the U.S. between 1998 and 2005. Jennifer Kerr, Most Companies in US Avoid Federal Income Taxes, ABC News, Washington DC, August 12, 2008, available at: <http://abcnews.go.com/Business/wireStory?id=5561455>.

alleviate the problem of tax noncompliance. If not sufficient, what alternatives are available to government agencies and other regulatory institutions?

This Article explores one alternative solution to the problem of noncompliance. It suggests that expansion of the traditional tax compliance analysis to include responsive elements of regulation, as illustrated in the Australian Tax Office's (ATO) approach to tax enforcement, may yield a more useful and forward-looking method for improving tax compliance than those available under other systems. The responsive regulation approach is based on the proposition that effective enforcement requires a dynamic and gradual application of less to more severe sanctions and regulatory interventions.²⁵ This range of sanctions and interventions balances traditional authoritarian deterrence with strategies that rely on persuasion and encouragement through three states of communication: cooperation, toughness, and forgiveness.²⁶ The Australian approach also advocates developing a deeper understanding of the motives, circumstances, and characteristics of taxpayers, so tax authorities can tailor enforcement to more effectively deliver compliance.²⁷ With responsive regulation, the intent is to preserve the basic principles of economic analysis that view taxpayers as rational actors seeking to maximize their expected utility. Responsive regulation goes a step further, however, and also considers other parameters, including the way that society, morality, and ethics affect taxpayer behavior and, particularly, the manner in which the taxpayer-tax administration relationship shapes compliance.

Given that the ATO first introduced responsive regulation in its administration during the late 1990s, compliance improvement data on this approach to tax is somewhat limited at this point. This Article therefore focuses on fleshing out the underlying principles and rationales of the Australian paradigm. In a few years, the Australian model can be evaluated against more comprehensive data and empirical work. In the meantime, the interest countries such as the United Kingdom and Canada show in the Australian model, and the implementation of this approach in New Zealand and East

25. JOHN BRAITHWAITE, *TO PUNISH OR PERSUADE* (1985).

26. IAN AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE* (1992).

27. See CASH ECONOMY TASK FORCE, AUSTRALIAN TAXATION OFFICE, *IMPROVING TAX COMPLIANCE IN THE CASH ECONOMY 18-21* (1997) [hereinafter *CASH ECONOMY TASK FORCE 1997*], available at <http://www.ato.gov.au/content/downloads/SB39065.pdf>; CASH ECONOMY TASK FORCE, AUSTRALIAN TAXATION OFFICE, *IMPROVING TAX COMPLIANCE IN THE CASH ECONOMY 19-21* (1998) [hereinafter *CASH ECONOMY TASK FORCE 1998*], available at <http://www.ato.gov.au/content/downloads/SB39073.pdf>.

Timor, may indicate that the responsive interpretation to tax enforcement is more than a passing phase.²⁸

Part I of this Article discusses the main reasons tax compliance is a challenge for tax administrations and the manner in which economic analysis offers important insights into and methodological guidance for understanding tax noncompliance and fostering compliance. Part II reviews the origins of the economic analysis of compliance, explains how the economic model was introduced into the area of tax enforcement, and explores recent developments and challenges in that area. Part III discusses key advantages and disadvantages of the economic approach to tax enforcement and concludes that the economic model is persuasive in many respects yet flawed in others. In Part IV, the Article introduces the Australian approach to tax enforcement, and explains the manner in which this approach draws on the economics of crime and compliance model and how it moves beyond the economic realm to rely on other theories. The Article suggests that as a result of this multi-faceted approach, the Australian paradigm has the potential to capture the strengths of the economic model while also addressing some of its drawbacks. Part V summarizes and concludes, suggesting that the Australian approach may mark the beginning of a new era of tax enforcement.

The focus of this Article is personal income tax compliance, although much of the discussion provides important insight into other tax and regulatory areas. Regrettably, there are many important issues that fall outside the scope of this Article. Most notably, the Article does not explicitly discuss the underground economy, or the difficulties with collecting taxes internationally, nor does it consider the relative advantages and disadvantages of sales taxes or Value Added Tax (VAT) compared with income taxation in terms of their ease of enforcement. These issues, although important, are left for future inquiries.

28. For an interesting discussion on the implementation of responsive regulation in tax enforcement in Australia, New Zealand, and East Timor, see Jenny Job, Andrew Stout & Rachael Smith, *Culture Change in Three Taxation Administrations: From Command-and-Control to Responsive Regulation*, 29 LAW & POLICY 84 (2007) (focusing on issues of organizational culture and change). For an OECD report on tax enforcement that references the Australian model and related research efforts, see FORUM ON TAX ADMINISTRATION COMPLIANCE SUB-GROUP, ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, *Compliance Risk Management: Managing and Improving Tax Compliance* (2004), <http://www.oecd.org/dataoecd/44/19/33818656.pdf>.

For a more recent analysis, this time with respect to U.S. tax administration, see Marjory E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*, in 2 Nat'l Taxpayer Advocate, 2007 Report to Congress 138 (2007) (exploring the role of "tax morale" in the IRS's enforcement and research efforts).

I. THE PROBLEM AND MODELING OF TAX COMPLIANCE

The difficulties of tax enforcement emerge, largely, because the variables that define the tax base are not usually observable.²⁹ Without detailed information about the taxpayer's transactions and her overall financial and other tax-related standing, no one but the taxpayer can know whether she is truthful and accurate in her reports to the tax authority. To a certain degree, verifying information may be obtained by means of costly audits or third-party reporting, such as by banks and employers.³⁰ Assuming this information is acquired in a timely and cost-efficient manner and is found to be accurate and coherent, the tax base becomes verifiable.³¹ In other cases, however, as when the taxpayer is involved in transactions that are beyond the reach of the tax authority and official statistics, including where income is received by way of cash transactions, the tax base is almost impossible to verify.³²

The taxpayer is able to use the unobservable nature of the tax base to her advantage, or in other cases make innocent mistakes and report partial or otherwise incorrect figures on her tax return in a manner that is difficult to detect. At times it can also be difficult for the tax administration to clearly identify those taxpayers who are most likely to be noncompliant. Key determinants for taxpayer compliance, such as the perceived probability of detection and the benefits of evasion, can be tricky to capture and compute. These shortcomings make it extremely complicated to not only detect or correct noncompliance but also to study and better understand its possible causes and facilitators. Amidst these difficulties, economic analysis intervenes and offers methodological guidance for, and important insights into, understanding and addressing the issue of tax noncompliance.

Over the past four decades, the economic analysis of compliance has played a pivotal role in elucidating the issue of compliance and, specifically, pinpointing those factors involved in the lack of compliance of taxpayers. As they examine compliance issues, analysts simplify the many complexities involved to produce a coherent

29. See Robert A. Kagan, *On the Visibility of Income Tax Law Violations*, in 2 *TAXPAYER COMPLIANCE* 76 (Jeffrey A. Roth and John T. Scholz eds., 1989); see also Franzoni, *supra* note 4, at 54–55 (adding that tax evasion and avoidance and their harmful consequences may in fact be worsened by laws or even constitutions when they are drafted as if the tax base is observable because this limits the corrective instruments available to the government, such as setting tax rates according to their degree of enforceability).

30. Kagan, *supra* note 29, at 79.

31. Franzoni, *supra* note 4, at 54.

32. *Id.*; Kagan, *supra* note 29, at 88.

framework that draws attention to the essential questions at hand.³³ Modeling tax compliance also allows analysts to examine and compare the possible consequences of different enforcement strategies. This, in turn, enables policymakers to deliberate on and offer alternative policy instruments to employ.³⁴

Notwithstanding valuable information that becomes available through economic analysis, economic models provide, at best, “tentative guidance . . . in well-specified circumstances.”³⁵ Because models, by definition, simplify a much more complex reality, they can be subject to criticism as being unrealistic.³⁶ Improvements in data and methodology help bring models closer to real-life scenarios. All models, however, have their shortcomings, and these must be recognized when models are implemented to generate policy recommendations. With these limitations in mind, the next Part of this Article will introduce the basic elements of the economic model of compliance with the law. It will then explore the application of the economic model to taxation and will discuss developments and challenges in that area.

II. ECONOMIC ANALYSIS AND TAX ENFORCEMENT

A. Criminal Law Enforcement and the Deterrence Hypothesis

*“The profit of the crime is the force which urges a man to delinquency: the pain of the punishment is the force employed to restrain him from it. If the first of these forces be the greater, the crime will be committed; if the second, the crime will not be committed.”*³⁷

The principal model for analyzing compliance with the law derives from the classic work in utilitarianism of Jeremy Bentham and

33. See John Creedy, *Tax Modelling*, in 1 TAXATION AND ECONOMIC BEHAVIOUR: INTRODUCTORY SURVEYS IN ECONOMICS 133, 135–36 (John Creedy ed., 2001).

34. *Id.* at 135.

35. *Id.* at 136; see also Frank Cowell, *Carrots and Sticks in Enforcement*, in THE CRISIS IN TAX ADMINISTRATION 230, 231 (Henry J. Aaron & Joel Slemrod eds., 2004).

36. See, e.g., Michael G. Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J. PUB. ECON. 323, 325 (1972) (“Even though we ignore these points, we hope to have retained enough of the structure of the problem to make the theoretical analysis worthwhile.”); see also Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws*, in NAT’L TAXPAYER ADVOCATE, 2 2007 REPORT TO CONGRESS 44, 55–57 (2007) (discussing the importance of utilizing various alternative models to understand taxpayer compliance).

37. JEREMY BENTHAM, PRINCIPLES OF PENAL LAW (1788), reprinted in 1 JEREMY BENTHAM, THE WORKS OF JEREMY BENTHAM, at 399 (John Hill Burton ed., 1843) (footnote omitted).

Cesare Beccaria who laid the foundation for a framework of analysis that tells a relatively straightforward and realistic story of human behavior.³⁸ The basic premise of the utilitarian theory is that people behave rationally in order to maximize their expected utility.³⁹ In the context of compliance the assumption is that, facing several plausible courses of action, some of which are legal while others are not, individuals choose whether to commit a crime or not based on which option has the better prospect of increasing their utility.⁴⁰ The economic approach to crime and compliance, although influential at the time of its conception, received very little attention from later theorists and policymakers until Gary Becker modernized it in his path-breaking article *Crime and Punishment: An Economic Approach*.⁴¹

In the decades prior to the publication of Becker's article, discussions of crime were dominated by the opinion that criminal behavior is caused by mental illness and social oppression and that criminals are no more than victims of their life circumstances.⁴² These attitudes began to have a major influence on social policy, as governments enacted laws to expand the rights of those who were essentially lawbreakers.⁴³ Becker not only rejected the presumption that criminals are helpless victims of their situation but he also took issue with the associated policy implications, which, according to

38. *Id.* See generally JEREMY BENTHAM, *THE THEORY OF LEGISLATION* (Richard Hildreth trans., Harcourt, Brace & Co. 1931); CESARE BECCARIA, *ON CRIMES AND PUNISHMENTS* (David Young trans., Hackett Pub. Co. 1986) (1764); Gary S. Becker, *Nobel Lecture: The Economic Way of Looking at Behavior*, 101 J. POL. ECON. 385, 391 (1993) ("One reason why the economic approach to crime became so influential is that the same analytical apparatus can be used to study enforcement of all laws, including minimum wage legislation, clean air acts, insider trader [sic] and other violations of security laws, and income tax evasions.").

39. According to the utilitarian model, people have preferences and choose among different alternatives in a manner that maximizes the likelihood of obtaining their preferred outcomes. The expected utility of any decision alternative is assessed by identifying the possible consequences or outcomes, assigning a desirability or utility to each outcome, and attaching likelihoods to the different outcomes. Each outcome is multiplied by its likelihood, and the discounted outcomes, or weight, are summed to "create" the expected utility of that alternative. The alternative with the most favorable expected utility is then selected and implemented. See Carroll, *supra* note 9, at 229; see also Marco R. Steenberg, Kathleen M. McGraw & John T. Scholz, *Taxpayer Adaptation to the 1986 Tax Reform Act: Do New Tax Laws Affect the Way Taxpayers Think About Taxes?* in *WHY PEOPLE PAY TAXES* 9, 14 (Joel Slemrod ed., 1992) (suggesting a dominance of self-interest, particularly, in the study of human behavior in public choice theories of economics, as well as motivational theories in psychology).

40. See generally Bentham, *supra* notes 37–38; BECCARIA, *supra* note 38.

41. Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

42. Becker, *supra* note 38, at 390.

43. *Id.*

him, “reduced the apprehension and conviction of criminals and provided less protection to the law-abiding population.”⁴⁴

Instead of adhering to theories of mental illness and social oppression, Becker’s work explores the possibility that criminal behavior is rational and that regulators and policymakers should address it as such.⁴⁵ Becker returns to the utilitarian principles of Bentham and Beccaria to suggest that, ultimately, individuals decide whether to commit a crime or obey the law based on a reasoned calculation of the costs and benefits of either course. Since the final consequences of criminal behavior are generally uncertain, Becker draws on the common assumption that people act as if they are maximizing expected utility and that utility is a positive function of income. In Becker’s words:

[A] person commits an offense if the expected utility to him exceeds the utility he could get by using his time and other resources at other activities. Some persons become “criminals,” therefore, not because their basic motivation differs from that of other persons, but because their benefits and costs [resulting from compliance and noncompliance with the law] differ.⁴⁶

Focusing on the costs and benefits associated with human behavior, the “deterrence hypothesis” emerges. It suggests that, if individuals are rational decisionmakers seeking to maximize expected utility, the way to foster compliance with the law is to deter individuals from acts of noncompliance by ensuring that the expected utility of noncompliance will be lower than the expected utility of compliance.⁴⁷ In particular, Becker’s analysis advances the proposition that public resources ought to be allocated to policy measures of two kinds: one aimed at detecting noncompliers, and the other designed to ensure devastating consequences for offend-

44. *Id.*

45. Despite Becker’s approach to crime, concepts like depravity, insanity, abnormality, deviance, and deprivation are still widely used to characterize those who commit crimes outside of the realm of the economic analysis, especially for hate crimes and crimes of passion. See Erling Eide, *Economics of Criminal Behavior*, in 5 ENCYCLOPEDIA OF LAW AND ECONOMICS 345, 345 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000). For that matter, criminologists have generally been more interested in rehabilitation and treatment, and many are reluctant to accept studies of deterrence in general and models of criminal behavior based on rational choice theory in particular. However, these scholars still pay close attention to the empirical studies in the economics of crime literature, and sociologists have recently carried out similar research. See *id.* at 346; Becker, *supra* note 38, at 391 (citing literature).

46. Becker, *supra* note 41, at 176.

47. *Id.* at 176–79.

ers.⁴⁸ According to this line of thinking, balancing enforcement resources between these two measures becomes the regulatory key to effectively deter offenders and promote compliance as the rational choice of behavior.⁴⁹

B. The Allingham-Sandmo Model of Tax Evasion

Compared with the general economic theory of crime, its tax noncompliance counterpart is a relatively recent development, dating back a little over thirty-five years and, particularly, to the much-cited article *Income Tax Evasion: A Theoretical Analysis*, by Michael Allingham and Agnar Sandmo.⁵⁰ Allingham and Sandmo extend Gary Becker's work on the economics of crime and compliance to taxation using modern risk theory. Their 1972 publication serves as a cornerstone in this area, leading to a large number of scholarly contributions either commenting or expanding on their essay.⁵¹

48. In a recent article, Becker explains that he first began to think about crime in the late 1960s after driving to Columbia University for an oral examination of a student in economic theory. Becker was late and had to decide quickly whether to take the extra time to put his car in a parking lot or risk getting a ticket for parking illegally on the street. Confronted with this dilemma, Becker contemplated the faster solution of parking on the street and assessed the likelihood and severity of getting a ticket for violating the city parking regulations. He reached the conclusion that it was worth it for him to take the risk and park on the street. As Becker was walking away from his car to the examination room, it occurred to him that "the city authority had probably gone through a similar analysis" and that "[t]he frequency of their inspection of parked vehicles and the size of the penalty imposed on violators should depend on their estimates of the type of [rational] calculations potential violators like me would make." Interestingly enough, Becker did not get a ticket for his parking violation that day. Becker, *supra* note 38, at 389–90 (emphasis added).

49. See, e.g., Becker, *supra* note 41, at 208 ("The conclusion that 'crime would not pay' is an optimality condition and not an implication about the efficiency of the police or courts; indeed, it holds for any level of efficiency, as long as optimal values of p and f [i.e., the probability and severity of punishment] appropriate to each level are chosen."); see also *id.* at 209 ("The main contribution of this essay, as I see it, is to demonstrate that optimal policies to combat illegal behavior are part of an optimal allocation of resources.").

50. Allingham & Sandmo, *supra* note 36. Other early attempts to model tax evasion after the economics of crime include, for example, Serge-Christophe Kolm, *A Note on Optimum Tax Evasion*, 2 J. PUB. ECON. 265 (1973) and Balbir Singh, *Making Honesty the Best Policy*, 2 J. PUB. ECON. 257 (1973).

51. Note that from the outset Becker intended his analysis to provide a theory broadly applicable to compliance including compliance in the context of tax reporting. See Becker, *supra* note 41, at 170 ("Although the word 'crime' is used in the title to minimize terminological innovations, the analysis is intended to be sufficiently general to cover all violations, not just felonies—like murder, robbery, and assault, which receive so much newspaper coverage—but also *tax evasion* . . .") (emphasis added); see also Allingham & Sandmo, *supra* note 36, at 323 ("On the one hand our approach is related to the studies of economics of criminal activities, as e.g. in the papers by Becker (1968) and by Tulkens and Jacquemin (1971). On the other hand it is related to the analysis of optimal portfolio and insurance policies in the economics of uncertainty, as in the work by Arrow (1970), Mossin (1968a) and several others.").

Like previous research in crime, Allingham and Sandmo build their analysis around the individual, this time the taxpayer, who becomes the potential criminal.⁵² Their model, which I will call the A-S model or framework, explores the decision to evade taxes at the moment when the taxpayer is filling in her tax return. The issue of compliance is presented as a portfolio allocation problem in which the taxpayer must decide what portion of her income to allocate to various activities, some of which are legal (income declared on the tax return), while others are illegal (income not declared).⁵³ Specifically, the model examines the way compliance decisions relate to how the taxpayer perceives that her economic opportunities and well-being are affected by enforcement measures, such as audit probability and the severity of sanctions, as well as by the Tax Code more generally, including applicable tax rates.

Allingham and Sandmo begin their analysis by considering a basic model in which the authorities decide on the Tax Code and the enforcement mechanisms, while each taxpayer acts as if her own actions do not influence these decisions.⁵⁴ The taxpayer is taken to be familiar with the tax legislation, the probability of an audit, the taxes she is liable for, and the penalty for failing to pay that amount in the event that she is caught and convicted.⁵⁵ Other important simplifications usually include the assumptions that the taxpayer is risk-averse,⁵⁶ that the tax system is income-based, and that the tax-

52. See, e.g., Allingham & Sandmo, *supra* note 36, at 323 (“Our objective in this paper is . . . analyzing the individual taxpayer’s decision on whether and to what extent to avoid taxes by deliberate underreporting.”).

53. Allingham & Sandmo, *supra* note 36, at 323. Unlike Becker’s model of compliance where the income from crime is a variable separate from legal income, in the A-S framework the taxpayer’s initial income becomes a reference point where tax evasion will be undertaken if the expected utility from evasion is higher than the utility of the initial income. See Eide, *supra* note 45, at 347. A somewhat similar analysis to the portfolio allocation framework was construed such that a person allocates her time (compared with income or wealth) between legal and illegal activities. See, e.g., PETER SCHMIDT & ANN D. WITTE, AN ECONOMIC ANALYSIS OF CRIME AND JUSTICE: THEORY, METHODS, AND APPLICATIONS (1984); Kenneth I. Wolpin, *An Economic Analysis of Crime and Punishment in England and Wales 1894–1967*, 86 J. POL. ECON. 815 (1978).

54. Allingham and Sandmo label this framework as “the static analysis.” See Allingham & Sandmo, *supra* note 36, at 324–30.

55. *Id.* at 324. For a useful review of these assumptions, see, for example, Brian Erard, *The Influence of Tax Audits on Reporting Behavior*, in WHY PEOPLE PAY TAXES 95, 96 (Joel Slemrod ed., 1992) (“In these models, taxpayers are already aware of the (exogenous) probability of audit and detection; they know their true taxable incomes; and they are familiar with the penalties for noncompliance.”).

56. Allingham and Sandmo take the common assumption that taxpayers’ behavior conforms to the Von Neumann-Morgenstern axioms for behavior under uncertainty where individuals’ cardinal utility function is increasing and concave, featuring income as its only parameter. Marginal utility is assumed to be positive and decreasing, so that taxpayers are generally risk averse. In other words, at some point, the taxpayer would not opt for evasion

payer's actual income is exogenously given and is known to the taxpayer but not to the government's tax collector.⁵⁷ Tax is assumed to be levied at a proportional rate on declared income, which represents the taxpayer's decision variable.⁵⁸ With some constant probability, the tax authority may investigate the taxpayer and reveal the actual amount of her income.⁵⁹ If this happens, the taxpayer would have to pay tax on any amount of undeclared income at a penalty rate that is higher than the tax rate.⁶⁰ Finally, the decision whether to evade or comply is analyzed as if it is the only dilemma with which the taxpayer is concerned,⁶¹ and the analysis ignores possible inter-relationships between this decision and other economic choices the taxpayer may face including, for example, decisions concerning labor supply and tax avoidance.⁶² The basic A-S analysis also assumes that time is composed of a single period⁶³ and that only one form of evasion is available.⁶⁴

Patterned after the utilitarian paradigm, the taxpayer is taken to follow expected utility theory and make compliance decisions based solely on the consequences for her net income.⁶⁵ The A-S framework accordingly implies that the taxpayer is tempted to seize the opportunity of cheating on her taxes whenever it is worth the chance of being caught and bearing the associated penalties.⁶⁶ The

despite likely increases in expected utility because the risk would be too high for her taste. See Allingham & Sandmo, *supra* note 36, at 324.

57. *Id.* at 324. We can assume, more realistically, that part of the taxpayer's income is known to the government such as due to information provided by third party reporting. In this case, the analysis would apply to that portion of the income that remains unknown, because it would not pay for the taxpayer to try to avoid taxes on the known part. See *id.* at 324 n.1; see also, e.g., *infra* notes 98–99 and accompanying text.

58. *Id.* at 324.

59. *Id.*

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

61. Allingham & Sandmo, *supra* note 36, at 323–32.

62. *Id.* at 323.

63. *Cf. id.* at 332–37 (laying out the dynamic case); see also Cowell, *supra* note 35, at 240 (explaining that with regard to the basic A-S model, one can imagine that each year essentially the same gamble takes place without there being any “memory” in the system).

64. See Allingham & Sandmo, *supra* note 36, at 324.

65. *Id.*

66. The taxpayer has a choice between two main strategies: She may declare her income in full or she may declare less than that amount; in the latter case, she will also need to decide what portion of her income to declare and what portion to conceal. If the taxpayer chooses to conceal some or all of her income, her payoff will depend not only on her decision regarding whether and to what extent to evade taxes, but also on whether she is investigated by the tax authorities and becomes subject to some or all of the associated penalties. The taxpayer is therefore confronted with a classic dilemma of choice under uncertainty, which has also been described as a “lottery calculation” or a “gamble.” Under

taxpayer compares the expected utility gained from evasion—considering the taxes she will not pay—with the expected cost of the penalty—the nominal penalty discounted by the probability that this penalty will be imposed.⁶⁷ If caught, the taxpayer will need to pay the penalty for evasion coupled with the shortfall in tax. When the net expected value of evasion is positive, the taxpayer will evade, and, when it is negative, she will comply.⁶⁸

Examining the relationship among the taxpayer's (1) actual income, (2) her tax rate, (3) penalty rate, (4) probability of detection, and (5) tax evasion, the Allingham and Sandmo analysis leads to results that partly contradict available compliance data, suggesting that there is no clear relationship among actual income, the tax rate, and evasion.⁶⁹ However, the results for the *penalty rate* for eva-

such conditions, the taxpayer's failure to report her true income may not necessarily subject her to the full extent of the law. Therefore evasion is not always an irrational course of action. If the taxpayer is not investigated, she is better off when evading than when being honest. If she is investigated and punished, she might be worse off—depending on the severity of the penalty imposed. See Cowell, *supra* note 35, at 231–33. In this context, an audit, for example, “is simply an instance of a taxpayer losing the ‘tax lottery.’” Erard, *supra* note 55, at 96.

67. See, e.g., Joel Slemrod & Shlomo Yitzhaki, *Tax Avoidance, Evasion, and Administration*, in 3 HANDBOOK OF PUBLIC ECONOMICS 1423, 1451–52 (Alan J. Auerbach & Martin Feldstein eds., 2002); Becker, *supra* note 41, at 176 (arguing that taxpayers consider expected penalties rather than nominal ones).

68. Consider an example given by John Carroll where a taxpayer contemplates an illegal deduction that reduces the tax she must pay by \$100 and where the probability of an audit is estimated to be 5 percent. If audited, the taxpayer would have to pay the \$100 plus a penalty of 50 percent of the income owed, here \$50. To simplify the example, Carroll ignores interest rates and treats the taxpayer as risk-neutral. According to this scenario, the analysis would involve two main alternatives: (1) not taking the deduction, in which case the result is some initial amount of income, W , and (2) taking the deduction. There are two possible outcomes to taking the deduction: (1) W plus \$100 if the taxpayer is not audited, and (2) W minus \$50 if she is audited and punished. The expected utility of being honest is $U(W)$, and the expected utility of cheating is $.95[U(W+100)] + .05[U(W-50)]$. As a point of reference for a risk-neutral taxpayer, Carroll conveniently assumes that $U(W)=0$ and that $U(W+X)=X$, so that the expected utility of being honest is 0 compared to 92.5 for cheating ($.95 \times 100 - .05 \times 50$). With the expected utility significantly higher for noncompliance compared with compliance, the taxpayer in this example is expected to cheat. Carroll, *supra* note 9, at 229–30.

69. Allingham & Sandmo, *supra* note 36, at 329–30. As Sandmo explains, in the original A-S model an increase of the tax rate has an ambiguous effect on tax evasion because there is an income effect which is negative: higher taxes make the taxpayer poorer and, therefore, less willing to take risks. But there is also a substitution effect that works in the direction of increased evasion. The substitution effect on evasion in the A-S model occurs because the net penalty (i.e., the difference between the penalty rate and the tax rate) goes down when the tax rate increases due to the fact that the penalty rate is held fixed when the tax rate increases. The decrease in the net penalty in effect increases the incentive to under-report income. This substitution effect would be present under the more general but weaker assumption that the penalty rate increases less than proportionally with the tax rate. See Agnar Sandmo, *The Theory of Tax Evasion: A Retrospective View*, 58 NAT'L TAX J. 643, 647–48 (2005). However, if the fine is imposed on the evaded tax (instead of on the evaded income) the substitution effect disappears because the penalty increases with the tax rate. In this

sion and the *probability of detection* are unambiguous. The A-S model confirms Becker's analysis in finding that a higher penalty rate or probability of detection tends to discourage evasion.⁷⁰ While the expected tax yield falls with a decrease in the probability of detection, the loss of tax revenue can generally be compensated by an increase in penalty rate, such that the two enforcement alternatives emerge as substitutes for one another.⁷¹

C. The Economic Analysis of Tax Compliance: Beyond the Allingham-Sandmo Model

The economic approach to tax compliance, as it appears in the A-S framework, reduces enforcement policies to two key considerations: the penalty rate and the probability of detection. In other words, the A-S analysis suggests that in order to control evasion, detection has to be stepped up, penalties need to be increased, or both. While this conclusion generally provides an intuitively appealing approach for addressing the tax evasion phenomena, real-world tax compliance and enforcement mechanisms are much

case, there remains only an income effect, which establishes a negative relationship between the tax rate and evasion. Yitzhaki, *supra* note 60. In other words, if absolute risk aversion decreases as income increases, higher tax rates should lead to greater income declarations and a reduction in evasion. Unfortunately, this result goes against common intuition about the relationship between the marginal tax rate and evasion according to which an increase in tax rate provides a greater incentive to evade. It also goes against much of the empirical evidence indicating a strong positive association between marginal tax rates and evasion. For surveys of empirical work in this area see Sandmo, *supra*, at 647 n.8. Similarly, when it comes to the relationship between actual income and evasion, a higher gross income should increase evasion if individuals are more willing to engage in risky activities as they become richer and have more money to spare and/or shelter from taxation. *Id.* at 647. According to Erling Eide, "[t]he reason why increases in various incomes and gains increases crime is that punishment in the case of decreasing absolute risk aversion produces a smaller reduction in expected (total) income. For risk-neutral people an increase in the probability or severity of punishment and a decrease in the gains to crime will reduce the supply of crime, whereas changes in exogenous income, and in the remuneration of legal activity have no effect. Here, changes in the latter income components do not change the bite of punishment." Eide, *supra* note 45, at 350–51. *But see id.* at 348 ("For the common assumption of decreasing absolute risk aversion an individual will allocate a larger proportion of his income to tax cheating the higher his exogenous income and the higher the gains from crime.").

70. See Allingham & Sandmo, *supra* note 36, at 330. These two variables are of particular interest for policy purposes since "[t]he former is a parameter over which the tax authority exercises direct control; [while] the latter it may be assumed to control indirectly through the amount and efficiency of resources spent on detecting tax evasion." *Id.*

71. *Id.* at 330. This result supports the gambling analogy where rational gamblers take fewer risks if the odds are worsened, suggesting that adjustments to either the detection or punishment parameter can have a restraining impact on evasion. See *supra* note 66.

more complex than this analysis suggests.⁷² Efforts to add the necessary depth and realism to the study of tax compliance have resulted in the A-S framework being the subject of considerable research over the past three and a half decades.

Early attempts to add credibility to the A-S analysis are already evident in the original 1972 article where Allingham and Sandmo briefly analyze a dynamic case of tax evasion that incorporated an element of time.⁷³ These efforts continued with later models that depart from the static framework—in which the taxpayer makes only one tax report independent from past or future tax filings—and embrace a more realistic framework whereby the taxpayer makes a sequence of interdependent tax filings.⁷⁴ This modification to the basic A-S model of evasion is necessary because real-life enforcement decisions are not made in isolation. For instance, once a taxpayer is discovered to have cheated, the authorities are likely to investigate her honesty for other periods.⁷⁵ Similarly, because income tax reporting is normally an annual event, the taxpayer is expected to make a decision regarding her present and future reports based on what she has learned from past reporting and auditing experiences.⁷⁶

Another important development in the A-S framework involves efforts to further endogenize the probability of detection. Allingham and Sandmo originally assumed the probability of detection

72. See, e.g., Allingham & Sandmo, *supra* note 36, at 324–25 (“This formal representation of the taxpayer’s choice situation is in some ways a significant simplification of his real world situation; in particular, the present formulation ignores some of the uncertainty elements. [For example,] it abstracts from the fact that the tax laws to some extent leave it to the discretion of the courts to determine [the type of penalty levied]” and even that the penalty rate “may itself be uncertain from the point of view of the taxpayer.”); cf. Dick J. Hessing, Henk Elffers, Henry S. J. Robben & Paul Webley, *Does Deterrence Deter? Measuring the Effect of Deterrence on Tax Compliance in Field Studies and Experimental Studies*, in *WHY PEOPLE PAY TAXES* 291, 291 (Joel Slemrod ed., 1992) (referring to Allingham and Sandmo’s effort to incorporate risk aversion, reputation, and time into their analysis and stating that “the [A-S] model is not quite as simple as has sometimes been claimed.”).

73. Allingham & Sandmo, *supra* note 36, at 333 (“The purpose . . . is to investigate the dynamic rather than the comparative static aspects of his declarations: for example whether for fixed parameters (tax rates, etc.) his declarations will increase or decrease over time, rather than whether in a fixed period the declaration will increase or decrease [sic] if a parameter is changed.”). For more information on Allingham and Sandmo’s dynamic analysis, see *id.* at 332–37.

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

75. Allingham & Sandmo, *supra* note 36, at 333.

76. Andreoni et al., *supra* note 12, at 824.

to be exogenous to the taxpayer.⁷⁷ However, as suggested above, actual audit probability is not random or fixed and generally depends on the particular characteristics of the taxpayer. To give one example, in the United States, the IRS develops formulas for selecting returns to audit based on their likelihood to contain noncompliant items, and it also often focuses on the potential to maximize enforcement revenue by means of audit adjustments.⁷⁸ For these reasons, audit rates vary across taxpayers. Returns of high-income individuals are generally examined more frequently compared to those with lower incomes, and larger corporations are examined more often than smaller ones.⁷⁹

Based on the relationship evident in real-world enforcement between taxpayers' income levels and their audit probability, commentators on the A-S analysis suggested further modifying the analysis so that the probability of audit will not be fixed but rather become a dynamic function of reported income and evasion.⁸⁰ Building on this suggestion, another mode of analysis emerged that relaxes the unrealistic assumption according to which taxpayers and the tax administration ignore each other's actions. In the modified analysis, the model treats the interaction between taxpayers and the tax administration more as a strategic game—where each party makes the best response to the other's strategy in light of available information—than a static gamble.⁸¹

77. Allingham & Sandmo, *supra* note 36, at 331. Note the dissatisfaction that Allingham and Sandmo expressed with respect to this feature of their 1972 analysis (“This may not be entirely satisfactory, but a natural hypothesis on the nature of the dependence does not immediately suggest itself.”). *Id.*

78. Robert E. Brown & Mark J. Mazur, *The National Research Program: Measuring Taxpayer Compliance Comprehensively*, 51 U. KAN. L. REV. 1255, 1262–64, 1267 (2002).

79. See, e.g., *id.* at 1266–67 (discussing the process of case-building); see also Allen Kenney, *Everson Touts Increased IRS Enforcement in Fiscal 2004*, 105 TAX NOTES 1071, 1071 (2004).

80. See, e.g., Michael J. Graetz, Jennifer F. Reinganum & Louis L. Wilde, *The Tax Compliance Game: Toward an Interactive Theory of Law Enforcement*, 2 J.L. ECON. & ORG. 1 (1986); Jennifer F. Reinganum & Louis L. Wilde, *Equilibrium Verification and Reporting Policies in a Model of Tax Compliance*, 27 INT'L ECON. REV. 739 (1986); Jennifer F. Reinganum & Louis L. Wilde, *Income Tax Compliance in a Principal-Agent Framework*, 26 J. PUB. ECON. 1 (1985).

81. In this game, the IRS' aim is to maximize revenue collected while the taxpayer responds by deciding how much of her income to report. This approach to modeling compliance results in two basic classes of models according to the timing in which the tax authority can credibly commit to an audit strategy. In the first group of models, the tax agency announces and commits to an audit strategy using a cut-off rule before the taxpayers file their returns. All returns reporting an income below the cut-off point are audited with probability one, whereas those who report a higher income are not audited at all. In the second group of models, the tax agency does not commit to an audit strategy prior to the filing session, but instead decides which taxpayers to audit after all returns have been filed and based on the information they reveal. This class of models takes the form of a sequential-move game with a number of possible equilibriums. See sources cited *supra* note 80. For a useful review of these models, see Andreoni et al., *supra* note 12, at 827–831.

One final variation of the A-S model worth paying attention to incorporates labor-supply decisions as endogenous to the taxpayer's gross income.⁸² This type of model recognizes that "[i]t is unreasonable to believe that the taxpayer has not thought about the possibility of evading taxes before he sits down to fill out his income tax return"⁸³ and that "[m]ore probably, he has thought about this [matter] before making decisions about the allocation of his work and leisure hours or about the composition of his investment portfolio."⁸⁴ Accordingly, models that incorporate labor-supply decisions look beyond the basic A-S framework which offers two behavioral responses—evasion or compliance—and consider that the taxpayer may respond to taxation in other ways. These responses generally include changing work effort, altering consumption and savings decisions, and choosing legal (compared to illegal) tax reduction strategies.⁸⁵ Models in this group usually focus on how variables such as the tax and wage rates affects the taxpayer's responses and the manner in which any one response affect the others.⁸⁶ Unfortunately, though this type of model adds realism to the analysis of tax compliance, incorporating labor-supply considerations makes uncertain the effect of changing the enforcement variables, thus eliminating the relatively simple computations of the original A-S framework. As a result, "[d]epending on the taxpayer's marginal disutility from labor and her risk attitudes, all predictions become possible."⁸⁷

In an effort to obtain a more thorough understanding of tax compliance, researchers continue to develop credible models that, among other things, examine the role tax practitioners play in compliance; extend the number of items on which taxpayers report; and also address the possible impact of tax morale, justice, and fairness considerations on taxpayer behavior.⁸⁸ Despite these expansions and others, the focus of the economic analysis of tax compliance on only two key enforcement measures, punishment and detection, remains unsatisfactory and not on a par with real-

82. See, e.g., John H. Pencavel, *A Note on Income Tax Evasion, Labor Supply, and Nonlinear Tax Schedules*, 12 J. PUB. ECON. 115 (1979); Frank A. Cowell, *Taxation and Labour Supply with Risky Activities*, 48 *ECONOMICA* 365 (1981).

83. Sandmo, *supra* note 69, at 651.

84. *Id.*

85. Slemrod & Yitzhaki, *supra* note 67, at 1436.

86. *Id.*

87. Franzoni, *supra* note 4, at 58.

88. For a few examples, see Andrew D. Cuccia, *The Effects of Increased Sanctions on Paid Preparers: Integrating Economic and Psychological Factors*, 16(1) J. OF AM. TAX. ASSOC. 41 (1994); Brian Erard & Jonathan S. Feinstein, *The Role of Moral Sentiments and Audit Perceptions in Tax Compliance*, 49 PUB. FIN./FINANCES PUBLIQUES 70 (Supp. 1994); Steven Klepper & Daniel Nagin, *The Role of Tax Preparers in Tax Compliance*, 22 POLICY SCIENCES 167 (1989).

world enforcement practices or needs. Furthermore, the underlying assumption of the economics of compliance—that every taxpayer is engaged in some type of rational calculation where she will conceal income as long as the return on noncompliance is positive—does not neatly coincide with observed behavior.⁸⁹ According to survey information, the majority of people consider themselves to be honest in their tax reporting,⁹⁰ and presumably they are, if the estimated noncompliance rate of 16.3 percent is accurate.⁹¹ In fact, it has repeatedly been suggested in the tax compliance literature that “[g]iven the current mild sanctions and low probability of detection . . . [one] would predict that virtually everyone should be evading tax.”⁹² In other words, instead of asking “Why do people evade taxes?” we should be asking “Why do people pay them?”⁹³

The next Part of this Article will explore the strengths and shortcomings of the economics of crime view of compliance, particularly as it relates to tax enforcement. It will also evaluate the merits of the query commonly raised on the reasons behind the observed, high levels of taxpayer compliance. The Article will then make a case for developing a more comprehensive interpretation of taxpayer behavior in order to better understand tax compliance and address noncompliance.

89. See, e.g., Michael J. Graetz & Louis L. Wilde, *The Economics of Tax Compliance: Fact and Fantasy*, 38 NAT'L TAX J. 355, 358 (1985) (“Application of the standard economic theory of crime to tax avoidance cases . . . produces an unambiguous prediction of behavior: throughout the 1970s *no one* should have paid the taxes they owed . . .”); see also Alfred Blumstein, *Model for Structuring Taxpayer Compliance*, in INCOME TAX COMPLIANCE: A REPORT OF THE ABA SECTION OF TAXATION, INVITATIONAL CONFERENCE ON INCOME TAX COMPLIANCE 159, 160–61 (1983) (making the point that the penalties for overstating deductions or failing to report income are too low to deter potential evaders); Jonathan Skinner & Joel Slemrod, *An Economic Perspective on Tax Evasion*, 38 NAT'L TAX J. 345 (1985); Kent W. Smith & Karyl A. Kinsey, *Understanding Taxpaying Behavior: A Conceptual Framework with Implications for Research*, 21 LAW & SOC. REV. 639 (1987). It is important, however, to distinguish between different categories of income that, if underreported, are not subject to the same probability of detection. For example, wage income is typically reported by the employer, and an attempt to underreport it by the taxpayer would, therefore, be detected with high probability. In that case the economic model predicts that there will be no attempt at evasion, a prediction that is generally supported by available compliance data. See *infra* note 98 and accompanying text. Moreover, a taxpayer's subjective assessment of the probability of audit is not necessarily equal to the actual audit rate. In fact, studies indicate that most people overestimate the probability of detection, and this could go some way toward explaining non-evading behavior. See, e.g., James Alm, Gary H. McClelland & William D. Schulze, *Why Do people Pay Taxes?*, 48 J. PUB. ECON. 21 (1992).

90. Michael Wenzel, *Misperceptions of Social Norms About Tax Compliance (1): A Prestudy* (Ctr. for Tax Sys. Integrity, Austl. Nat'l Univ., Working Paper No. 7, 2001), available at <http://ctsi.anu.edu.au/publications/WP/7.pdf>.

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

92. Hessing, et al., *supra* note 72, at 292 (citations omitted).

93. *Id.*

III. AN EXPANDED VIEW OF TAXPAYER BEHAVIOR

A. A Closer Look at Enforcement Strategies:
Deterrence and General Prevention

Empirical and experimental studies tend to support the economic model of compliance to the extent that they generally identify a negative relationship between the probability and severity of punishment and the rate of crime. In other words, an increase in either the probability or the severity of punishment can change the expected utility of noncompliance from positive to negative, thereby deterring potential offenders and, overall, decreasing the level of crime.⁹⁴ This effect has also been identified in the area of tax compliance.⁹⁵ The correlation between increased enforcement and compliance appears to be stronger, however, when the probability of detection is increased than when the punishment is made more severe.⁹⁶ In either case, enforcement efforts relying exclusively on punitive strategies do not always alleviate the problem of noncompliance and, at times, might even worsen the situation.⁹⁷

More specifically, tax enforcement findings generally support the conclusion that taxpayers are highly responsive to perceived or actual risk of detection in their compliance decisions. According to IRS estimates, compliance is most likely where the risk of detection is significant, such as where third-party reporting or withholding exists. Approximately one percent of all wage, salary, and tip income is misreported, contributing about \$10 billion to the tax gap.⁹⁸ In contrast, non-farm sole proprietor income, which is subject to little third-party reporting or withholding, has a significantly

94. See, e.g., Eide, *supra* note 45, at 355–60 (reviewing empirical studies).

95. See, e.g., Paul J. Beck, Jon S. Davis & Woonoh Jung, *Experimental Evidence on Taxpayer Reporting Under Uncertainty*, 66 ACCT. REV. 535 (1991); Charles T. Clotfelter, *Tax Evasion and Tax Rates: An Analysis of Individual Returns*, 65 REV. ECON. & STAT. 363 (1983); Nehemiah Friedland, Shlomo Maital & Aryeh Rutenberg, *A Simulation Study of Income Tax Evasion*, 10 J. PUB. ECON. 107 (1978); Ann D. Witte & Diane F. Woodbury, *The Effect of Tax Laws and Tax Administration on Tax Compliance: The Case of the U.S. Individual Income Tax*, 38 NAT'L TAX. J. 1 (1985). These findings are not entirely conclusive. For a review of additional studies and some contradictory results, see Hessing, et al., *supra* note 72.

96. See, e.g., Becker, *supra* note 41, at 176 (“[A] change in the probability has a greater effect on the number of offenses than a change in the punishment. . . .”) (citing Lord Shawness (1965) (“Some judges preoccupy themselves with methods of punishment. This is their job. But in preventing crime it is of less significance than they like to think. Certainty of detection is far more important than severity of punishment.”)); see also Dan M. Kahan, *Social Influence, Social Meaning, and Deterrence*, 83 VA. L. REV. 349, 380 (1997).

97. See *infra* text accompanying notes 106–119.

98. I.R.S. News Release IR-2006-28, *supra* note 4.

higher rate of misreporting at approximately 57 percent, which contributes about \$68 billion to the tax gap.⁹⁹

In terms of the punishment parameter, fines and other types of penalties also generally improve compliance. However, when it comes to real-life behavior, minor adjustments in penalty rates are likely to go unnoticed and so not to affect compliance.¹⁰⁰ Some researchers go as far as to argue that heavy penalties do not always produce better compliance results compared with lighter ones, especially when detection probability is high.¹⁰¹ In certain studies, the effect of an increase in the severity of punishment is not statistically significant, and a statistically significant positive effect on criminal behavior is also occasionally identified.¹⁰² Ultimately, penalties generally serve as less of a deterrent for committing crimes than the probability of detection. Edward Cheng summarizes this point nicely, reporting that the effect of deterrence tends to decrease rapidly and nonlinearly with lower probabilities of enforcement, and tougher punishments are often unable to offset these losses.¹⁰³

Despite the heightened deterrent effect of detection compared with punishment, a concern for low-cost tax administration may lead policymakers to favor raising penalties over increasing costly detection to improve compliance. In other words, given a fixed enforcement budget, efforts to maximize deterrence and raise the most revenue at minimal cost might dictate extreme but rare punishments.¹⁰⁴ To this end, one might especially endorse fines and other monetary sanctions rather than more resource-intensive forms of punishment, such as imprisonment and probation.¹⁰⁵

99. *Id.*; see also Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695 (2007) (stressing the role statutory mechanisms play in inducing compliant results); Kagan, *supra* note 29 (finding that compliance with the tax law is high for items that are most visible such as interest income and salary subject to withholding, but low for items that have little or no “paper trail” such as cash transactions, different types of business expenses, or charitable contributions).

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

101. See, e.g., Nehemia Friedland, *A Note on Tax Evasion as a Function of the Quality of Information About the Magnitude and Credibility of Threatened Fines: Some Preliminary Research*, 12 J. APPLIED SOC. PSYCHOL. 54 (1982).

102. Eide, *supra* note 45, at 358–60 (reviewing literature).

103. Cheng, *supra* note 100, at 659–60.

104. See, e.g., Becker, *supra* note 41, at 180–81; see also Sandmo, *supra* note 69, at 648 (arguing in a different context that in the modeling literature of policy optimization, it is usually assumed that the collection agency’s objective is to maximize revenue raised).

105. See, e.g., Becker, *supra* note 38, at 391 (“Fines are preferable to imprisonment and other types of punishment because they can deter crimes effectively if criminals have sufficient financial resources Moreover, fines are more efficient than other methods because the cost to offenders is also revenue to the state.”). Note that one underlying assumption here might be that if extreme punishment is effective in creating a deterrence force, there will be

Unfortunately, however, even when effective in improving compliance, an enforcement strategy of extreme and rare penalties might still be a poor strategic choice because of the repercussions that are likely to accompany it. For example, rare and extreme punishments can provoke community outrage. The idea that the government does out just punishment is undermined when extreme sanctions are disproportionately imposed on lesser offenses.¹⁰⁶ And when it comes to serious crimes, inflicting heavy penalties on the rare few that are caught is arbitrary, draconic, and highly discriminatory.¹⁰⁷ Such an approach could lead to underenforcement as tax administrators become conflicted between their legal obligations and moral judgment.¹⁰⁸ Imposing rare but severe sanctions may also result in an increase in the severity of crimes committed as offenders realize that the sanctions imposed will be extreme regardless of the actual offence committed and attempt to maximize their gain from crime.¹⁰⁹ With extreme consequences for noncompliance, the possibility of erroneous penalties and the punishment of those who violate the law because of ignorance or honest mistake also becomes particularly disturbing.

To be sure, taking any form of punitive enforcement to an extreme threatens the democratic nature of society and carries a risk of inflaming a broader conflict between citizens and the government. Such an approach to tax enforcement might set the tone for a taxpayer-tax authority relationship that is dominated by feelings of antagonism and distrust.¹¹⁰ This type of interaction is likely to “crowd out” whatever intrinsic motivations taxpayers have to com-

no actual need to impose penalties because people will be compliant. This, however, does not mean that such an approach is politically or socially acceptable, feasible, or credible.

106. See, e.g., Sandmo, *supra* note 69, at 660 (“[F]or penalties to be socially acceptable, they probably must be set so that in the eyes of the general public, they ‘fit the crime.’”).

107. Cheng, *supra* note 100, at 660.

108. See, e.g., Dan M. Kahan, *Gentle Nudges vs. Hard Shoves: Solving the Sticky Norms Problem*, 67 U. CHI. L. REV. 607, 608 (2000).

109. Cowell, *supra* note 35, at 249–50.

110. See, e.g. BRUNO S. FREY, NOT JUST FOR THE MONEY: AN ECONOMIC THEORY OF PERSONAL MOTIVATIONS (1997); Bruno S. Frey, *A Constitution for Knaves Crowds Out Civic Virtues*, 107 ECON. J. 1043 (1997); Lars P. Feld & Bruno S. Frey, *Tax Compliance as the Result of a Psychological Tax Contract: The Role of Incentives and Responsive Regulation*, 29 LAW & POL’Y 102 (2007); see also Lars P. Feld & Bruno S. Frey, *Tax Evasion in Switzerland: The Role of Deterrence and Tax Morale* (Ctr. For Res. in Econ., Mgmt. & Arts, Working Paper No. 2006-13, 2006), available at <http://www.crema-research.ch/papers/2006-13.pdf>; Bruno S. Frey & Lars P. Feld, *Deterrence and Morale in Taxation: An Empirical Analysis* (CESifo, Working Paper No. 760, 2002) [hereinafter Frey & Feld, 2002 Working Paper], available at <http://www.cesifo-group.de/~DocCIDL/760.pdf>.

ply with their tax obligations and might also lead them to actively resist paying their taxes, either legally or illegally.¹¹¹

From an economic perspective, even when an increase in enforcement is feasible, conducive to democratic values, and results in an increase in compliance, it might still be suboptimal to raise these efforts to the maximum.¹¹² Enforcement expenditures represent a real cost to the economy, while the revenue collected can be viewed as a mere transfer from the private to the public sector.¹¹³ Furthermore, increased enforcement of the tax system can also have disincentive effects similar to an increase in tax rates and base and should therefore be handled with caution and restraint.¹¹⁴ Finally, in addition to the considerations that counsel against

111. See, e.g., Frey & Feld, 2002 Working Paper, *supra* note 110 (analyzing 1970–1995 tax compliance data from 26 Swiss cantons and finding that taxpayers respond in a systematic way to how the tax authority treats them. In particular, taxpayers’ willingness to pay their taxes, or their tax morale, is supported, or even raised, when tax officials treat them with respect. In contrast, an emphasis on authoritarian means to force taxpayers pay their dues generally leads to a distrust of citizens and a crowding out of tax morale, translating to lower levels of tax compliance); see also Lars P. Feld & Bruno S. Frey, *Trust Breeds Trust: How Taxpayers Are Treated*, 3 *Economics of Governance* 87 (2002). In this context, noncompliance is particularly likely when taxpayers view the use of threat and legal authority to be illegitimate or unreasonable. This may involve administrative disrespect for taxpayers or an arbitrary refusal to take their concerns into account in the enforcement process. See e.g., EUGENE BARDACH & ROBERT A. KAGAN, *GOING BY THE BOOK: THE PROBLEM OF REGULATORY UNREASONABLENESS* (1982); see also AYRES & BRAITHWAITE, *supra* note 26; E. ALLAN LIND & TOM R. TYLER, *THE SOCIAL PSYCHOLOGY OF PROCEDURAL JUSTICE* (1988); TOM R. TYLER, *WHY PEOPLE OBEY THE LAW* (1990); Robert A. Kagan & John T. Scholz, *The Criminology of Corporation and Regulatory Enforcement Strategies*, in *ENFORCING REGULATION* 67 (Keith Hawkins & John M. Thomas eds., 1984). Several authors have written on the possibility of harmful effects of punitive enforcement in tax more generally. See, e.g., Valerie Braithwaite & John Braithwaite, *An Evolving Compliance Model for Tax Enforcement*, in *CRIMES OF PRIVILEGE: READINGS IN WHITE-COLLAR CRIME* 405, 406 (Neal Shover & John Paul Wright eds., 2001) (“Tax enforcement is an area where the effects of deterrence and compliance approaches are unknown. When taxpayers are audited, for example, and a penalty is imposed, it is unclear whether they learn that they got away with a lot of things that the audit did not detect Sometimes an audit succeeds in deterring cheating in the long run, but in the year or two after audit taxpayers believe they are unlikely to be audited, and this has a dramatic negative effect on compliance in those two years.” (internal citation omitted)); Carroll, *supra* note 9, at 234 (“[A]udits, withholding, and reporting requirements, and ‘Big Brother’ data files that cross-check taxpayers with reports of income sources, charities, utility companies, and so forth seem necessary to increase the risk of detection. However, such tactics may only create a larger under-ground economy and less visible ways to cheat.”); Karyl A. Kinsey, *Theories and Models of Tax Cheating*, in 18 *CRIM. JUST. ABSTRACTS* 402, 416 (1986) (arguing that deterrence-based tools like tax audits frequently backfire by teaching tax cheaters how much is being overlooked by the tax administration).

112. In this context, raising enforcement to the maximum means increasing enforcement until one dollar spent yields one dollar in revenue.

113. Slemrod, *supra* note 10, at 1–2.

114. *Id.*; cf. Franzoni, *supra* note 4, at 62 (suggesting that it is not obvious that curbing or eliminating evasion is necessarily a desirable goal since such efforts might be economically unsound in potentially shutting down beneficial economic activities that cannot bear the cost of taxation).

extreme enforcement, empirical evidence suggests that even such moderate means may fail to effectively promote compliance. When researchers tested the rate and probability of punishment at moderate levels, consistent with those observed in actual tax enforcement, they found the deterrent effects to be quite small.¹¹⁵

Taken as a whole, the findings suggest that a broad enforcement approach, where detection and punishment become complementary strategies, rather than extreme substitutions, and more importantly, where nonpunitive enforcement mechanisms are also considered, might be a superior alternative to relying only on authoritarian deterrence. In fact, enforcement efforts that rely exclusively on punitive measures and the severity and probability of punishment are likely to be short-sighted at best and counterproductive at worst. Taxpayers adapt, take up new strategies of noncompliance, and become increasingly sophisticated in their risk assessment of being caught and penalized for wrongdoing.¹¹⁶ In an area as complex and controversial as tax, legalistic and authoritarian attempts at shaping behavior lead to a never-ending process, as efforts to address one type of undesirable behavior leave countless others unattended.¹¹⁷ A broader, more constructive and forward looking definition of deterrence than the one adopted by the traditional economic analysis of tax compliance ought to look beyond the use of threat and legal authority. It should encompass other factors and mechanisms that offer a preventive force against crime.

The literature of crime has generally interpreted preventative measures as a way to take into consideration the external conditions that affect law-abiding norms and morals in addition to the direct monetary costs and benefits attached to compliant and noncompliant choices.¹¹⁸ Read in this light, an expansive characterization of

115. James Alm, Betty Jackson & Michael McKee, *Deterrence and Beyond: Toward a Kinder, Gentler IRS*, in *WHY PEOPLE PAY TAXES* 311, 322–23 (Joel Slemrod ed., 1992).

116. Carroll, *supra* note 9, at 258 (indicating that evidence of people's behavioral adaptations to undermine increased enforcement is available in a wide range of regulatory areas, including with respect to shoplifting, drunk driving, and family violence). *But see* Cheng, *supra* note 100, at 668 (“[W]hen searching for solutions to undesirable conduct, legislatures naturally incline toward establishing new rules that prohibit and punish the conduct. The machinery—police, prosecutors, courts, prisons—is already in place; the legislature might as well use it.”).

117. Doreen McBarnet, *When Compliance is Not the Solution but the Problem: From Changes in Law to Changes in Attitude*, in *TAXING DEMOCRACY: UNDERSTANDING TAX AVOIDANCE AND EVASION* 229 (Valerie Braithwaite ed., 2003); Valerie Braithwaite, *Dancing with Tax Authorities: Motivational Postures and Non-compliant Actions*, in *TAXING DEMOCRACY: UNDERSTANDING TAX AVOIDANCE AND EVASION* 15, 15 (Valerie Braithwaite ed., 2003). *See generally* Braithwaite & Braithwaite, *supra* note 111, at 406–07.

118. Eide, *supra* note 45, at 353.

deterrence would seek to improve tax compliance not only by means of adversely curbing illegal activity but also by constructively fostering legal behavior, such as by balancing punitive deterrence with education, encouragement and assistance so as to facilitate a broad base for taxpayer compliance. A familiar practice in regulatory programs generally, this balanced approach is considered a particularly appropriate technique in complex areas like taxation. In these areas where compliance is notoriously difficult and not always in the short-term self-interest of the regulated, the very classification and detection of noncompliance become challenging as well.¹¹⁹

B. The Multiplicity of Taxpayer Behavior

*“Common sense and everyday observations tell us that people refrain from tax evasion—as well as from speeding, shoplifting, and polluting the environment—not only from their estimates of the expected penalty, but for reasons that have to do with social and moral considerations.”*¹²⁰

Human behavior is multifaceted and it is influenced by many factors. In the context of taxation, taxpayers' disposition toward public institutions, ethics, morals and norms, as well as the perceived fairness of the tax system are all highly instrumental in shaping behavior.¹²¹ Moreover, enforcement policies themselves are more complex than mere combinations of penalties and audit

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

120. Sandmo, *supra* note 69, at 649–50.

121. Some academics suggest, for example, that taxpayers may not process personal consequences, but, instead, focus on doing the “right thing”—determined from legal, moral, social, utilitarian, or personal consequence viewpoints—leading to a “norm-processing” rather than an “outcome-processing” model of decision making. *See, e.g.*, John S. Carroll, *How Taxpayers Think about Their Taxes: Frames and Values*, in *WHY PEOPLE PAY TAXES* 43, 47 (Joel Slemrod ed., 1992); *see also* BENNO TORGLER, *TAX COMPLIANCE AND TAX MORALE: A THEORETICAL AND EMPIRICAL ANALYSIS* (2007) (developing the concept of tax morale as an inherent affinity of taxpayers to comply with their tax obligation and exploring a broad range of parameters affecting this affinity); 2 *TAXPAYER COMPLIANCE* (Jeffrey A. Roth & John T. Scholz eds., 1989) (examining social science perspectives and influences related to taxpayer compliance); Richard D. Schwartz & Sonya Orleans, *On Legal Sanctions*, 34 *U. CHI. L. REV.* 274, 281–82 (1967) (finding that taxpayer compliance and, particularly, the reaction taxpayers have to different enforcement mechanisms depends, to some extent, on these taxpayers' socio-economic characteristics).

probabilities. Institutional and procedural factors, such as tax administrators, tax courts, and tax advisors, as well as the manner in which these bodies interact with the taxpayer community, affect tax compliance.¹²² The standard economic analysis tends to shy away from accounting for the effect these various determinants have on compliance. Increasingly, however, scholars have begun collecting empirical evidence on the role nonmonetary parameters play in shaping taxpaying behavior generally, and improving tax compliance and constraining noncompliance in particular. At the same time, there have been growing attempts to incorporate these parameters into the more formal economic analysis.

The traditional economic literature on tax compliance examines taxpayer behavior through the decisions of a single individual.¹²³ Set in this way, the analysis falls short of putting the issue of tax compliance in its broader societal setting and, consequently, misses important explanatory opportunities. One example of this oversight is the limited range of goods examined in the standard analysis, which tends to portray individuals as concerned only with their private consumption while displaying total disregard for public goods and services.¹²⁴ Evidence, however, shows that taxpayer behavior depends not only on private consumption capacity but also on what taxpayers believe they obtain from public goods and services. Taxpayers expect to receive some return on the taxes they pay, and, not only do they care about these returns, but they also evaluate whether the tradeoff is equitable compared to what other taxpayers appear to receive.¹²⁵ Alm et al., for example, find greater willingness to comply with the tax law among taxpayers who believe they benefit from public goods.¹²⁶ Spicer and Becker find that individuals who are told their taxes are heavier than others evade by

122. For example, when taxpayers are asked to justify their tax evasion, they commonly respond by saying that they have been treated unfairly by the tax system. Although this answer can be regarded as a mere defense of one's own self-interested behavior, it may also indicate that taxpayers take into account institutional and environmental factors that go beyond the probability and severity of punishment. See Sandmo, *supra* note 69, at 651; see also Alm et al., *supra* note 115, at 313 (“[D]etection and punishment cannot explain the compliance behavior of all individuals. The percentage of tax returns that are subject to detailed audit is quite small in most countries, and penalties are seldom more than a fraction of unpaid taxes. . . . However, compliance in many countries remains relatively high. Additional factors must play a role—perhaps a dominant one—in tax compliance.” (footnote omitted)); *supra* note 89 and accompanying text.

123. See *supra* note 52 and accompanying text.

124. Cowell, *supra* note 35, at 240.

125. In fact, there is some evidence to suggest that perceptions of individual incomes may play less of a role than perceptions of fairness and social outcomes associated with the tax law. See, e.g., Steenbergen et al., *supra* note 39.

126. James Alm, Betty R. Jackson & Michael McKee, *Estimating the Determinants of Taxpayer Compliance with Experimental Data*, 45 NAT'L TAX J. 107 (1992).

relatively high amounts, while those who are told their taxes are lower than others evade by relatively small amounts.¹²⁷

One study that compared the impact various information sources have on taxpayers found that social influence and, specifically, perceived attitudes toward noncompliance of those people with whom taxpayers discuss taxes have the strongest impact on these taxpayers' commitment to comply with their tax obligations.¹²⁸ That is, taxpayers' commitment to paying taxes is affected not only by what taxpayers believe they receive for paying taxes and by their relative gain or loss in consumption compared to that of others, but it may mostly be impacted by social interaction and the extent to which noncompliance is perceived to be prevalent in the taxpayers' social environment. When taxpayers believe that people around them generally cheat, they are more likely to cheat themselves, and when taxpayers believe others are usually honest, they are more willing to pay their own taxes honestly.¹²⁹ It becomes clear, therefore, that taxpaying behavior is not only the result of isolated calculations of the immediate monetary costs and benefits taxpayers expect to incur from compliance as opposed to noncompliance. Taxpaying behavior is also a collective process where information, experiences, attitudes, and patterns of behavior are shared among taxpayers, impacting their assessments of costs and benefits and, consequently, their compliance with the tax law.

Some scholars go as far as to argue that moral, ethical, and societal factors play a role in compliance that may be more important

127. Michael W. Spicer & Lee A. Becker, *Fiscal Inequity and Tax Evasion: An Experimental Approach*, 33 NAT'L TAX J. 171 (1980). Even though there is evidence that perceived inequalities in the tax system are related to noncompliance, the evidence is not entirely conclusive. For example, PAUL WEBLEY ET AL., *TAX EVASION: AN EXPERIMENTAL APPROACH* (1991), reached an opposite conclusion from Spicer and Becker. However, Robert Mason & Lyle D. Calvin, *Public Confidence and Admitted Tax Evasion*, 37 NAT'L TAX J. 489 (1984), found that dissatisfaction with the tax system is not directly related to reported noncompliance but that it changes other attitudes and beliefs that may impact compliance. For further analysis of these findings see COWELL, *supra* note 9, at 219–20; Andreoni et al., *supra* note 12, at 851.

128. John T. Scholz, Kathleen M. McGraw & Marco R. Steenbergen, *Will Taxpayers Ever Like Taxes: Responses to the U.S. Tax Reform Act of 1986*, 13 J. ECON. PSYCHOL. 625 (1992); *see also* Steenbergen et al., *supra* note 39.

129. *See, e.g.*, sources cited *supra* note 128; *see also* COWELL, *supra* note 9, at 101–24; John T. Scholz, *Trust, Taxes, and Compliance*, in *TRUST AND GOVERNANCE* 135 (Valerie Braithwaite & Margaret Levi eds., 1998). When taxpayers see that others disregard statutory taxes, creating an unjust disparity in the allocation of the tax burden or leading to a reduction in the quality or quantity of public goods and services, they may rationalize resisting payment of their own taxes. Andreoni et al., *supra* note 12, at 851; *cf.* ROBERT H. FRANK, *CHOOSING THE RIGHT POND: HUMAN BEHAVIOR AND THE QUEST FOR STATUS* (1985) (discussing the role of relative standing as key in shaping individuals' perceptions of well-being and, consequently, the actions they take).

than the threat of legal punishment.¹³⁰ Grasmick and Scott find, for example, that, while the relationship between the threat of legal punishment and intention to evade taxes is statistically significant, anticipated feelings of guilt and social stigma attached to tax evasion are more strongly associated with deterrence.¹³¹ Similarly, Mason and Mason argue that an appeal to taxpayer conscience or civic virtue can improve tax compliance more than the threat of legal sanctions.¹³² Other scholars, such as Blumenthal et al., Leandra Lederman, and Alex Raskolnikov, clarify that detection and punishment could be complementary strategies to moral, ethical, and social appeals, especially when they are applied to different groups of taxpayers.¹³³

Notwithstanding the issue of how much weight to assign to various enforcement considerations, the mere incorporation of nonmonetary parameters and influencers into the traditional economic analysis of tax compliance often results in a better description of real-world taxpaying behavior than a theory built only on selfish monetary assumptions.¹³⁴ Staying within the economic paradigm, the rationality proposition no longer implies narrow materialism or pure self-interest. Instead, rationality now reflects the reality that most taxpayers are constrained by a range of considerations and that these considerations lead them to obey the tax law when the sum of all potential costs of noncompliance,

130. See, e.g., Dan M. Kahan, *Trust, Collective Action, and Law*, 81 B.U. L. REV. 333 (2001); see also Steenbergen et al., *supra* note 39, at 32 (concluding that perceptions of individual outcomes played less of a role than perceptions of individual fairness and social outcomes associated with the 1986 Tax Reform Act).

131. 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 (1982) (suggesting that policies increasing the sense of moral duty to obey the law among taxpayers may significantly improve compliance).

132. Laurie Mason & Robert Mason, *A Moral Appeal for Taxpayer Compliance: The Case for a Mass Media Campaign*, 14 LAW & POL'Y 381, 394 (1992).

133. Marsha Blumenthal, Charles Christian & Joel Slemrod, *Do Normative Appeals Affect Tax Compliance? Evidence from a Controlled Experiment in Minnesota*, 54 NAT'L TAX J. 125 (2001); Joel Slemrod, Marsha Blumenthal & Charles Christian, *Taxpayer Response to an Increased Probability of Audit: Evidence from a Controlled Experiment in Minnesota*, 79 J. PUB. ECON. 455 (2001); Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453 (2003); Alex Raskolnikov, *Relational Tax Planning Under Risk-Based Rules*, 156 U. PA. L. REV. 1181 (2008); see also Kristina Murphy & Karen Byng, *Preliminary Findings from The Australian Tax System Survey of Tax Scheme Investors* (Ctr. For Tax Sys. Integrity, Austl. Nat'l Univ., Working Paper No. 40, 2002), available at <http://ctsi.anu.edu.au/publications/WP/40.pdf>.

134. Note, for example, the incorporation of reputation already in the A-S analysis. Alingham & Sandmo, *supra* note 36, at 332–37; see also, e.g., Erard & Feinstein, *supra* note 88 (adding guilt and shame into the analysis of evasion).

including likely moral, ethical, and social sanctions, outweigh the expected gain.¹³⁵

In sum, although the standard economic approach to compliance serves as a useful starting point for understanding taxpayer behavior, the overly narrow focus of this framework restricts its utility. Ultimately, this approach might lead policymakers to reach misguided conclusions that require enforcement that is too punitive such that it becomes politically unsound and counterproductive in its effect on compliance. Fortunately, as the above discussion reveals, real-world tax administration does not implement effective levels of deterrence and yet compliance rates remain generally high. This suggests that when it comes to the behavior of the taxpayer, motives other than the desire to maximize one's net income must be considered. Extending the analysis of tax compliance to consider such additional motives requires developing a better understanding of the many influencers on taxpayer behavior and the manner in which enforcement policy can properly and effectively address them. Researchers and administrators in Australia have been involved in this particular line of investigation during the past decade, with results that bear important implications for the enforcement of tax compliance in Australia, as well as in other industrialized countries and regulatory areas.

The next Part will review the research in motivations and, particularly, those motivational influencers identified to be most commonly associated with taxpaying behavior. The Article will then introduce the concept of responsive regulation and explore the manner in which this approach to regulation brings key elements of enforcement together to foster tax compliance.

135. Cf. Becker, *supra* note 38, at 385–86 (“[T]he economic approach I refer to does not assume that individuals are motivated solely by selfishness or material gain. It is a *method* of analysis, not an assumption about particular motivations. Along with others, I have tried to pry economists away from narrow assumptions about self-interest. Behavior is driven by a much richer set of values and preferences. The analysis assumes that individuals maximize welfare *as they conceive it*, whether they be selfish, altruistic, loyal, spiteful, or masochistic.”).

IV. THE AUSTRALIAN APPROACH TO TAX ENFORCEMENT

A. Motivational Postures: Attitudes, Behavior,
and Service Delivery

*“Regulating people through understanding the simultaneous emergence and retreat of various postures means that at the most fundamental level, regulation rests on the art of managing relationships.”*¹³⁶

Innovative research in regulation has identified a group of motivational influencers, best known today as “motivational postures,” that capture the way regulated entities position and think about themselves in relation to the regulatory authority.¹³⁷ The basic principle behind the concept of motivational postures is that the beliefs, values, and attitudes of regulated actors lead them to adopt a particular posture (or stance) toward the regulator.¹³⁸ In the context of compliance with tax law, motivational postures capture the manner in which taxpayers see themselves as they relate to the tax system and its administration and, particularly, the amount of social distance they wish to place between themselves and these functions.¹³⁹ This distance indicates the taxpayers’ degree of accep-

136. Braithwaite, *supra* note 117, at 21.

137. See Valerie Braithwaite, *Games of Engagement: Postures within the Regulatory Community*, 17 LAW & POL’Y 225 (1995); Valerie Braithwaite, John Braithwaite, Diane Gibson & Toni Makkai, *Regulatory Styles, Motivational Postures and Nursing Home Compliance*, 16 LAW & POL’Y 363 (1994). People possess many beliefs, values, and attitudes that are often multi-dimensional, difficult to identify, and may appear to be inherently contradictory, especially when they translate to behavior. When it comes to strategic planning of enforcement, what researchers found to be helpful in understanding and determining the motivational influencers for taxpaying behavior was looking at motivations not in the abstract but in relation to adherence to the regulatory authority. See CASH ECONOMY TASK FORCE 1998, *supra* note 27, at 22–24, app.1 at 61–62 (1998); Braithwaite, *supra* note 117, at 24 (“Motivational postures are proving to be useful markers of degree of consent, cooperation and commitment that underlies the human system as it comes into contact with the administrative/technical tax system.”).

138. Braithwaite, *supra* note 117, at 17–18 (explaining that individuals and groups regularly evaluate authorities in terms of what they stand for and how they perform). Over time, beliefs and attitudes for the authority are developed; they are socially shared and challenged. Individuals then develop rationalizations for their feelings and use values and ideologies to justify the motivational posture they possess. Braithwaite & Braithwaite, *supra* note 111, at 410 (“Motives shape the values and attitudes we publicly espouse to defend our position to ourselves and others. We all approach regulators with our own world view of how we want to and ought to engage with the regulatory system.” (internal citation omitted)).

139. Bogardus uses the term “social distance” to refer to the degree to which individuals or groups have positive feelings toward other ethnic groups and attribute status to them. EMORY S. BOGARDUS, IMMIGRATION AND RACE ATTITUDES (1928). The contemporary work in motivational postures, however, examines the concept of social distance in the context of the regulator-regulated relationship. See *supra* note 137 and accompanying text.

tance or rejection of the tax authority and, accordingly, the extent to which these taxpayers are open to the authority's influence.¹⁴⁰

Strategies for inducing compliance are likely to vary in their effectiveness depending on the motivational posture of the targeted taxpayers. In other words, different regulatory and enforcement measures can be successful when dealing with taxpayers who see themselves as law-abiding citizens versus those taxpayers who see themselves as opportunistic. Moreover, taxpayers who feel the tax administration has insulted or treated them disrespectfully may respond differently to particular enforcement mechanisms than taxpayers who feel that the tax authority has treated them with dignity and that it acts with integrity and legitimacy.¹⁴¹ For this reason, tax administrations that seek to understand the taxpayers' full range of motivational influencers may be better situated to effectively target and encourage taxpayers to "do the right thing" and comply with their tax obligations, while at the same time retaining the capacity to monitor and constrain those motivations that might lead taxpayers down the path of noncompliance.¹⁴²

Five key motivational postures have been identified as relevant to the realm of tax compliance. These are: (1) commitment, (2) capitulation, (3) resistance, (4) disengagement, and (5) game playing.¹⁴³ The first two postures, commitment and capitulation, are compliant in nature, the former more than the latter. They suggest the taxpayers' cooperative interaction with and acceptance of the tax system and authority.¹⁴⁴ The latter three postures,

140. Motivational postures can be viewed as indicators for the degree to which the taxpayer identifies herself to be a full participant in the tax system and her resulted susceptibility to the influence of its administration. This will reflect on the taxpayer inclination to not only comply with existing rules and regulations but also cooperate once these are reformed. Braithwaite, *supra* note 117, at 18; see also Valerie Braithwaite & Jenny Job, *The Theoretical Base for the ATO Compliance Model* 1, 10 (Ctr. for Tax Sys. Integrity, Austl. Nat'l Univ., Research Note 5, 2004), available at <http://ctsi.anu.edu.au/publications/RN5.pdf>.

141. See, e.g., CASH ECONOMY TASK FORCE 1998, *supra* note 27, app.1 at 61–62; Michael Wenzel, *The Multiplicity of Taxpayer Identities and Their Implications for Tax Ethics*, 29 LAW & POL'Y 31 (2007); cf. Carroll, *supra* note 121, at 48.

142. CASH ECONOMY TASK FORCE 1998, *supra* note 27, at 23, app.1 at 62.

143. *Id.* at 22–24 (discussing the first four postures). For complementary reviews, see Braithwaite, *supra* note 117, at 18; Braithwaite & Braithwaite, *supra* note 111, at 410–11. See generally *supra* note 137 and *infra* note 145. For variations of the Australian model, note that in New Zealand, for example, the tax administration adopted a compliance model similar to the Australian one but featuring only four postures. In the New Zealand model, game-playing was taken to be a potential subcategory within each of the other four postures. See Tony Morris & Michele Lonsdale, *Translating the Compliance Model into Practical Reality*, in 2004 PROCEEDINGS OF THE INTERNAL REVENUE SERV. RESEARCH CONFERENCE 57, 61–62 (2005).

144. Valerie Braithwaite, *A New Approach to Tax Compliance*, in TAXING DEMOCRACY: UNDERSTANDING TAX AVOIDANCE AND EVASION 1, 3 (Valerie Braithwaite ed., 2003); CASH ECONOMY TASK FORCE 1998, *supra* note 27, at 21.

resistance, disengagement, and game playing, represent increasingly defiant states of mind with the taxpayers' growing distance and dislike toward the tax authority, the system of taxation, and what taxpayers perceive they stand for.¹⁴⁵

When commitment and capitulation are high, the tax administration is more likely to gain compliance from taxpayers. The posture of commitment expresses the taxpayers' understanding that the tax administration is a necessary institution for democracy and suggests a feeling of moral obligation to advance the common good and voluntarily pay due taxes.¹⁴⁶ Capitulation reflects acceptance of the tax authority and its officials as legitimate and the belief that they are positively responsive to taxpayers as long as taxpayers behave according to the law and obey the authorities.¹⁴⁷ However, when the defiant postures of resistance, disengagement, and game playing are dominant, things are rather different. As Valerie Braithwaite, a leading scholar in the research in motivational postures, explains: defiant postures are likely to coincide with feelings of being threatened by the tax system or administration, low satisfaction with democracy, anti-government and pro-market attitudes, relatively weak identification with being a citizen and an honest taxpayer, higher than average investment in aggressive tax planning, and a desire to abolish the tax system.¹⁴⁸ Taxpayers who hold defiant postures are consequently more likely to be unaf-

145. See, e.g., Braithwaite, *supra* note 144, at 3–4; CASH ECONOMY TASK FORCE 1998, *supra* note 144. Taxpayers usually have a basic “comfort zone” that reflects their general stance toward the tax administration and the law. However, motivational postures are the result of a dynamic interaction between the taxpayer and the administration. Accordingly, the taxpayer can demonstrate more than one posture in any specific encounter, and she may also vary her attitude depending on the nature of a given interaction. There is some compatibility among the postures. Commitment and capitulation are generally compatible so that where they exist, disengagement and resistance are unlikely to be present. Disengagement is more compatible with resistance and game playing. According to Valerie Braithwaite, none of these correlations, however, is sufficiently high to conclude that taxpayers can be placed on a simple adversarial-cooperative dimension. See Braithwaite, *supra* note 117, at 22–24; see also Valerie Braithwaite, *The Community Hopes, Fears and Actions Survey: Goals and Measures* (Ctr. for Tax Sys. Integrity, Austl. Nat'l Univ., Working Paper No. 2, 2001), available at <http://ctsi.anu.edu.au/publications/WP/2.pdf>; Valerie Braithwaite, Monika Reinhart, Malcolm Mearns & Rachele Graham, *Preliminary Findings from the Community Hopes, Fears and Actions Survey* (Ctr. for Tax Sys. Integrity, Austl. Nat'l Univ., Working Paper No. 3, 2001), available at <http://ctsi.anu.edu.au/publications/WP/3.pdf>; Valerie Braithwaite, Kristina Murphy & Monika Reinhart, *Taxation Threat, Motivational Postures, and Responsive Regulation*, 29 LAW & POLICY 137 (2007).

146. See, e.g., Braithwaite & Braithwaite, *supra* note 111, at 411.

147. *Id.*

148. Braithwaite, *supra* note 117, at 24.

fectured by persuasion, or by the traditional punitive measures of being caught and punished for noncompliance.¹⁴⁹

Resistance, the first defiant posture, reflects the taxpayers' distrust over the tax authority's commitment to cooperate with and be respectful of them.¹⁵⁰ These taxpayers may be watchful and feel the need to fight for their rights or otherwise curb the power of the tax administration.¹⁵¹ Disengagement is a more extreme attitude that stems from the taxpayers' deep disenchantment with the tax system and its administration.¹⁵² The main objective of disengaged taxpayers becomes withdrawal from any interaction with the tax administration rather than challenge its authority.¹⁵³ By mentally positioning themselves outside the regulatory reach, the disengaged can further that end and cut themselves off from attempts of persuasion and influence. This makes it extremely difficult for the tax administration to gain compliance.¹⁵⁴

The final defiant posture is game-playing. With a game-playing posture, taxpayers view the law as something to respect or ignore depending on which approach better advances their self-interest.¹⁵⁵ Unlike disengagement, game-playing remains bounded within the regulatory realm. However, rather than comply with the spirit of the law, players use the letter of the law to *de facto* undermine its intent.¹⁵⁶ The existing literature suggests that traditionally, elite groups have most commonly practiced this posture.¹⁵⁷ However, as

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

150. *See, e.g.,* Braithwaite & Braithwaite, *supra* note 111, at 411.

151. *Id.*

152. Braithwaite & Job, *supra* note 140, at 10–11.

153. Braithwaite, *supra* note 117, at 18.

154. Existing research indicates that disengagement is generally the posture most difficult for authorities to manage. *See e.g.,* Braithwaite et al., *supra* note 137, at 383–84; *see also* Braithwaite & Job, *supra* note 140, at 11 (making the point that when the taxpayer cuts herself off from the authority, the only regulatory option left to the authority is to make noncompliance impossible).

155. McBarnet, *supra* note 117, at 229–33. The game playing posture emerged from discussions with tax officials and taxpayers over matters of compliance. Although this type of behavior has been previously studied in the context of economic regulation, it has yet to be extensively examined in other regulatory contexts, especially by social scientists. *See* Braithwaite, *supra* note 117, at 18–19; Valerie Braithwaite, Monika Reinhart & Jason McCrae, *Game Playing with Tax Law* (Ctr. for Tax Sys. Integrity, Austl. Nat'l Univ., Research Note 8, 2004), available at <http://ctsi.anu.edu.au/publications/RN8.pdf>.

156. McBarnet, *supra* note 117, at 229–33. With “disengagement and game playing,” “[c]itizens see the power of government as irrelevant to their lives. The choice is whether they acknowledge the authority or step outside its reach.” Braithwaite & Job, *supra* note 140, at 10.

157. Thirteen percent of the recipients of the 2000 national survey conducted by the Centre for Tax System Integrity at the Australian National University were identified as game players. On the other hand, approximately ninety-two percent of the survey respondents indicated the posture of commitment and seventy-three percent recognized the posture of

aggressive tax avoidance strategies become increasingly available to, and acceptable by, the general public, the game-playing mindset is likely to spread and become a more serious problem for enforcement.¹⁵⁸

The more committed people are to paying taxes, the less likely they are to put effort into tax minimization strategies. The postures most strongly associated with aggressive forms of tax avoidance are game-playing and resistance, while evasion is a more likely option for those who are resistant or disengaged.¹⁵⁹ However, being committed or capitulated does not necessarily prevent taxpayers from misconduct. Behavior is the result of a variety of inputs, only some of which are related to beliefs and attitudes, and so, consistency between mental states and behavior should not automatically be assumed.¹⁶⁰ The tax administration must acknowledge the disparity

capitulation in themselves. Fifty-five percent of the respondents reported holding a resistance posture. Least pervasive was disengagement with only seven percent of respondents identifying themselves that way. Braithwaite, *supra* note 117, at 23, and 19–24 more generally (providing a brief analysis of the 2000 *Community Hopes, Fears and Actions Survey*).

158. See, e.g., Braithwaite & Braithwaite, *supra* note 111, at 406–07 (“Increasingly, the problem for large business firms is not tax evasion, but adoption of sophisticated strategies for circumventing tax laws . . . [W]hat is true for the largest corporations is also true for the wealthiest individuals.”). Braithwaite & Braithwaite report that the accounting firms in the United States once known as the “Big Five” have been able to increase their profits substantially through offering their clients more aggressive tax minimization strategies. They indicate, for example, that Ernst & Young and Deloitte & Touche reported a 29 percent jump in their profits from tax service in the United States in 1997 and, overall, between 1993 and early 2000, tax revenue for the Big Five has grown at twice the pace of audit revenue. The worry with these expansions is that they will trigger a race to the bottom where other players will assume that adopting aggressive tax practices is the only way to stay competitive. *Id.*; see also Braithwaite & Job, *supra* note 140, at 11 (arguing that “[t]he public response of dissociation [of taxpayer from the tax authority and their tax obligations] has the potential for posing a major threat to the regulatory effectiveness of tax authorities, and more broadly democratic governance.”). The game playing posture is a reminder that compliance itself could become a problem when it is defined as compliance with rules as written. Doreen McBarnet suggests that in the context of taxation the goal for enforcement ought to be securing long-term compliance with the intent—rather than with the black letter—of the law. Doreen McBarnet, *The Construction of Compliance and the Challenge for Control: The Limits of Noncompliance Research*, in *WHY PEOPLE PAY TAXES* 333 (Joel Slemrod ed., 1992); see also Kristina Murphy, *Regulating More Effectively: The Relationship Between Procedural Justice, Legitimacy, and Tax Non-compliance*, 32 *J.L. & Soc’y* 562, 564 (2005).

159. Braithwaite, *supra* note 117, at 33 (discussing the findings from the Australian 2000 *Community Hopes, Fears and Actions Survey*); cf. PAUL WEBLEY ET AL., *supra* note 127 (finding that taxpayers who indicate alienation from or negative attitudes toward laws and the government are considerably more likely to engage in evasion). For a discussion on the relationship between attitudes and behavior more generally, see *infra* notes 161–164 and accompanying text.

160. Braithwaite, *supra* note 117, at 35 (“All too often, authorities make the assumption of consistency between attitude and behavior: People who do the wrong thing are bound to be nasty pieces of work, and need to be treated like the villains they are.”). In fact, empirical evidence indicates that the relationship between motivational postures and behavior is empirically weak in that motivational postures do not, necessarily, lead to acts of obedience or

between motivational postures and taxpayer behavior and be cognizant and responsive to both in order to promote compliance. Crucially, the administration does not only serve as a passive observer of the behavior and attitudes of taxpayers, but it also affects them considerably.

It is well understood today that the perceptions taxpayers have of the procedural justice of the tax system—how the tax administration treats them and other similarly situated taxpayers—affect the legitimacy these taxpayers attribute to the administration and the extent to which they accept its authority.¹⁶¹ This, in turn, impacts the taxpayers' levels of compliance. Taxpayers who believe that the tax administration and its officials make an effort to be fair and respectful are more likely than those with more negative perceptions to assign greater legitimacy to the tax system, align with its administration, and, consequently, comply with their tax obligations.¹⁶² Further, positive behavior by the tax administration increases the likelihood of compliance because of the tendency for people to react in a like manner to behavior they experience from others.¹⁶³ In accordance with this rule of reciprocity, helpful and

disobedience. Disparities between the motivational postures taxpayers hold and the compliance-related actions they take are also likely to reflect environmental conditions such as reference groups and the nature of the interaction between taxpayers and the tax administration. *Id.* at 16–17, 33 (commenting that inconsistencies between postures and behavior goes against the expectation that attitudes and behavior be related and consistent and that such an expectation implies rationality, comprehension, and thought that are not always present in human behavior. In fact, the conceptualization of attitudes and behavior as distinct is in keeping with empirical findings in the area of tax enforcement as well as the broader realm of human behavior).

161. See, e.g., LIND & TYLER, *supra* note 111; TYLER, *supra* note 111; Tom R. Tyler & Kathleen M. McGraw, *Ideology and the Interpretation of Personal Experience: Procedural Justice and Political Quiescence*, 42 J. Soc. ISSUES 115 (1986); Tom R. Tyler, *Justice, Self-Interest, and the Legitimacy of Legal and Political Authority*, in BEYOND SELF-INTEREST 171, 171 (Jane J. Mansbridge ed., 1990).

162. See TYLER, *supra* note 111 (for the general relation between perceptions of procedural justice, legitimacy and obedience to the law). For taxpayer behavior, see COWELL, *supra* note 9 (reviewing the attitudinal and experimental literatures and finding that individual attitudes and perceptions of the tax system are generally related to compliant behavior); Murphy & Byng, *supra* note 133; Kristina Murphy, *Turning Resistance into Compliance: Evidence from a Longitudinal Study of Tax Scheme Investors* (Ctr. For Tax Sys. Integrity, Austl. Nat'l Univ., Working Paper No. 77, 2005), available at <http://ctsi.anu.edu.au/publications/WP/77.pdf> (analyzing 2002 and 2004 survey data in the case of Australian taxpayers who were caught investing in mass marketed tax schemes in the late 1990s. According to the analysis, tax scheme investors who were more likely to think the 2002 settlement offer extended by the Australian Tax Office was fair were less likely to hold onto resistant views toward the ATO and more likely to be compliant with their tax obligations in 2004).

163. Smith, *supra* note 119, at 225 (citations omitted); see also CASH ECONOMY TASK FORCE 1998, *supra* note 27, app.1 at 62 (indicating that, ideally, if the tax authority treats the taxpayer with fairness and respect, the taxpayer will try to comply because it is “the right thing to do.”).

respectful service may also coax a broader normative commitment of compliance among taxpayers when they believe that the tax administration acts positively toward them as a matter of general practice.¹⁶⁴

The result of taxpayer/tax-authority interaction may be different, however, for taxpayers who do not trust or respect the tax authority or for those who feel deeply threatened by it.¹⁶⁵ When taxpayers feel uneasy with the tax authority, such as when they anticipate or experience a particularly unpleasant interaction with tax officials, these taxpayers might adopt coping mechanisms to protect themselves against the tax administration's disapproval.¹⁶⁶ These coping mechanisms often boil down to an acute sense of polarization, where taxpayers interpret differences with the tax system and its administration as conflicts between "us" and "them."¹⁶⁷ At this point, a friction, or rift, is likely to emerge between taxpayers and the tax system and its administration.¹⁶⁸ When the tax administration employs punitive strategies that communicate disapproval, this friction is expected to amplify with the rise in perceived disapproval, exacerbating feelings of animosity and defiance.¹⁶⁹ One key challenge for tax officials in this situation is to change the motivational postures taxpayers hold. Tax officials may be able to do this by offering cooperation, positive and helpful ser-

164. Smith, *supra* note 119, at 227; Lars P. Feld & Bruno S. Frey, *Tax Compliance as the Result of a Psychological Tax Contract: The Role of Incentives and Responsive Regulation*, 29 LAW & POL'Y 102 (2007). For a good discussion of the role that administrative practices play in affecting taxpayer compliance, see Leandra Lederman, *Tax Compliance and the Reformed IRS*, 51 KAN. L. REV. 971 (2003).

165. Taxpayer distrust or hostility toward the tax administration could be the result of experiences taxpayers have directly with the tax administration or due to other, indirect interactions, such as what taxpayers observe from the experiences of others or based on norms and habits of a reference group. Direct contact with the tax administration can be gained, for example, while the taxpayer is being audited and resenting the intrusive treatment, or even from the failure to be audited when such failure is viewed as a weakness on the part of the administration. Note, for example, that there is evidence to suggest that personal experience with audits might increase tax resistance. M. W. Spicer & S. B. Lundstedt, *Understanding Tax Evasion*, 31 PUB. FIN./FINANCES PUBLIQUES 295 (1976).

166. Braithwaite & Job, *supra* note 140, at 8, 11.

167. Braithwaite & Braithwaite, *supra* note 111, at 411–12 (advancing the argument that the way to understand the interaction between the taxpayer and the tax administration as well as the taxpayer need for a coping mechanism in certain circumstances is through theories of shame and identity); see also Eliza Ahmed & Valerie Braithwaite, *A Need for Emotionally Intelligent Policy: Linking Tax Evasion with Higher Education Funding*, 10 LEGAL & CRIMINOLOGICAL PSYCHOL. 1 (2005). For a useful review of some of the theories relevant to the regulator-regulated relationship, in a different context, see JOHN BRAITHWAITE, *RESTORATIVE JUSTICE AND RESPONSIVE REGULATION* 79–90 (2002).

168. Braithwaite & Braithwaite, *supra* note 111, at 411.

169. *Id.* at 412.

vice, and open dialogue as a first response to conflicts.¹⁷⁰ When the offer of cooperation is met with compliance by taxpayers, toxic feelings, including antagonism, resentment, and distrust, can be diffused. This, in turn, enables the tax authority to (re)connect with taxpayers on a positive level so as to eventually elicit voluntary compliance.¹⁷¹

In cases where the offer of cooperation from the tax authority is not met with compliance, tax officials must be firm, but also fair, in bringing to account those who remain defiant. Whatever steps the tax administration takes must not, as much as possible, adversely affect compliant taxpayers or escalate existing conflicts beyond what is necessary to gain compliance.¹⁷² Maintaining open communication and positive and professional service even through the toughest encounters with taxpayers becomes instrumental to effective enforcement. Such strategies not only help protect the integrity of the tax system and administration, but they are also valuable in order to turn taxpayer resistance into cooperation. According to available evidence, in most cases, even when taxpayers hold resentment and anger toward the tax system and administration, they also hold goodwill that creates an opportunity to draw out the more cooperative motivational postures and behaviors.¹⁷³ The main question therefore is not whether the tax administration should punish taxpayers who are noncompliant. Rather, it is how the administration can balance punitive enforcement against other, more constructive, measures to address existing noncompliance while also nurture relationships of partnership and cooperation with the taxpayer community.¹⁷⁴

The next Part of this Article will draw on the Australian experience beginning in the late 1990s to suggest that an effective approach to achieving taxpayer compliance, mutual respect, and sustainable cooperation includes a hierarchy of lesser sanctions

170. *Id.* (explaining that trying cooperation remains the best first choice for achieving the goal of changing motivational postures to more compliant ones but adding that offering cooperation to non-compliers may not always be the response that regulators want to make); see also *supra* notes 163–164 and accompanying text (citing literature on reciprocity).

171. Braithwaite & Braithwaite, *supra* note 111, at 412.

172. CASH ECONOMY TASK FORCE 1998, *supra* note 27, at 57.

173. For example, according to survey information, while 87 percent of taxpayers who were caught investing in mass marketed tax schemes in the late 1990s were highly resistant in 2002, about 93 percent of them also articulated clear committed views. Murphy & Byng, *supra* note 133, at 11. For discussions on the transition from taxpayer resistance to cooperation via the implementation of more cooperative and better tailored administrative practices, see Murphy, *supra* note 162, and more generally, Sagit Leviner, *An Overview: A New Era of Tax Enforcement-From "Big Stick" to Responsive Regulation*, 2 REGULATION & GOVERNANCE 360, 371–72 (2008).

174. Murphy, *supra* note 158, at 564, 589.

and regulatory interventions, the possibility of severe and certain sanctions for noncompliance in the background, and a broad understanding of taxpayers' motivational postures.

B. Responsive Regulation and the Australian Compliance Pyramid

"Through incentives and threats and public statements of what the community considers proper and improper, the law is used as an instrument to shape and maintain behavior."¹⁷⁵

"The model of the regulatory pyramid suggests regulatory strategies, while the social rift model describes the posturing of those subject to regulation. The ATO Compliance Model brings these different sides of the regulatory relationship together to summarize the process of conflict escalation, not with the intention of avoiding conflict so much as managing it."¹⁷⁶

Until the mid-1990s, the regulatory style of the Australian Tax Office, like the regulatory approach of most tax administrations in the industrial world, was authoritarian.¹⁷⁷ This regulatory method, commonly referred to as "enforced compliance" or "command and control regulation," developed out of the economics of crime and compliance paradigm. It called for the establishment of optimal, clear-cut rules for taxpayers to follow and the forceful enforcement of these rules through the threat of detection and legal punishment.¹⁷⁸

Despite its widespread dominance, opponents of command and control often argue that this strategy misinterprets human behavior and the meaning of noncompliance, and that its one-solution-fits-all approach is poorly suited for regulating compliance.¹⁷⁹ The many complexities of the tax compliance problem suggest the need for a comprehensive strategy of enforcement that fosters long-term compliance. Yet "[a]n approach which relies simply on detecting non-

175. Carroll, *supra* note 121, at 44.

176. Braithwaite & Braithwaite, *supra* note 111, at 413.

177. Valerie Braithwaite, *A New Approach to Tax Compliance*, in TAXING DEMOCRACY: UNDERSTANDING TAX AVOIDANCE AND EVASION 1, 1 (Valerie Braithwaite ed., 2003); Jenny Job & David Honaker, *Short-Term Experience with Responsive Regulation in the Australian Taxation Office*, in TAXING DEMOCRACY: UNDERSTANDING TAX AVOIDANCE AND EVASION 111, 111-13 (Valerie Braithwaite ed., 2003).

178. Job & Honaker, *supra* note 177, at 112.

179. See, e.g., AYRES & BRAITHWAITE, *supra* note 26; BARDACH & KAGAN, *supra* note 111; NEIL GUNNINGHAM & PETER GRABOSKY, SMART REGULATION: DESIGNING ENVIRONMENTAL POLICY (1998); BRAITHWAITE, *supra* note 167; MALCOLM K. SPARROW, THE REGULATORY CRAFT (2000).

compliance and imposing sanctions on detected non-compliers will tend to be short term in its effect and increasingly resource intensive.”¹⁸⁰ The Australian tax administration took to heart the criticisms of the command and control method. With the release of the 1998 Cash Economy Task Force Report, the administration embraced a new approach to enforcement that shifted the regulatory emphasis from authoritarian deterrence to a method of responsive regulation.¹⁸¹

In their 1992 book entitled *Responsive Regulation: Transcending the Deregulation Debate*, Ian Ayres and John Braithwaite conceptualize responsive regulation as an approach that does not suggest any definitive program or a set of perceptions prescribing a single best way to regulate. Instead, Ayres and Braithwaite envision responsive regulation as a method that advances the proposition that regulation should be context-dependent and yield different solutions depending on the regulatory circumstances at hand.¹⁸² An administration that adopts responsive regulation commits itself to investigating and taking into consideration the problems, motivations, and circumstances of the regulated parties. It is an administration that emphasizes dynamic operation, assumes commitment to assisting the regulated actors in their compliance efforts, and strives to enforce compliance across the board, even when the regulated are highly resistant.¹⁸³ At the same time, there is also less reliance on strategies that are based only on threat of detection and legal penalties.¹⁸⁴

Ayres and Braithwaite utilize the principles of responsive regulation to offer a holistic model for regulating compliance.¹⁸⁵ An expanded version of their model was endorsed in the 1998 report of the Australian Cash Economy Tax Force, after which it was adopted across the board for regulating tax compliance in Australia.¹⁸⁶ The Australian compliance model is represented by a pyramid with each of its three faces articulating one key aspect of compliance.¹⁸⁷ These include: (1) the motivational postures taxpayers are most likely to

180. CASH ECONOMY TASK FORCE 1998, *supra* note 27, at 47.

181. *See generally id.* The ATO started by examining enforcement in the building and construction industries where evidence suggested a high level of cash transactions. *See* Job & Honaker, *supra* note 177; Neal Shover, Jenny Job & Anne Carroll, *The ATO Compliance Model in Action: A Case Study of Building and Construction*, in *TAXING DEMOCRACY, UNDERSTANDING TAX AVOIDANCE AND EVASION* 159 (Valerie Braithwaite ed., 2003). For the concept of responsive regulation, *see generally* AYRES & BRAITHWAITE, *supra* note 26. *See also infra* notes 182–184 and accompanying text.

182. AYRES & BRAITHWAITE, *supra* note 26, at 5.

183. *Id.* at 35–40, 47–51.

184. *Id.* at 4–5.

185. *See, e.g., id.* at 35–40.

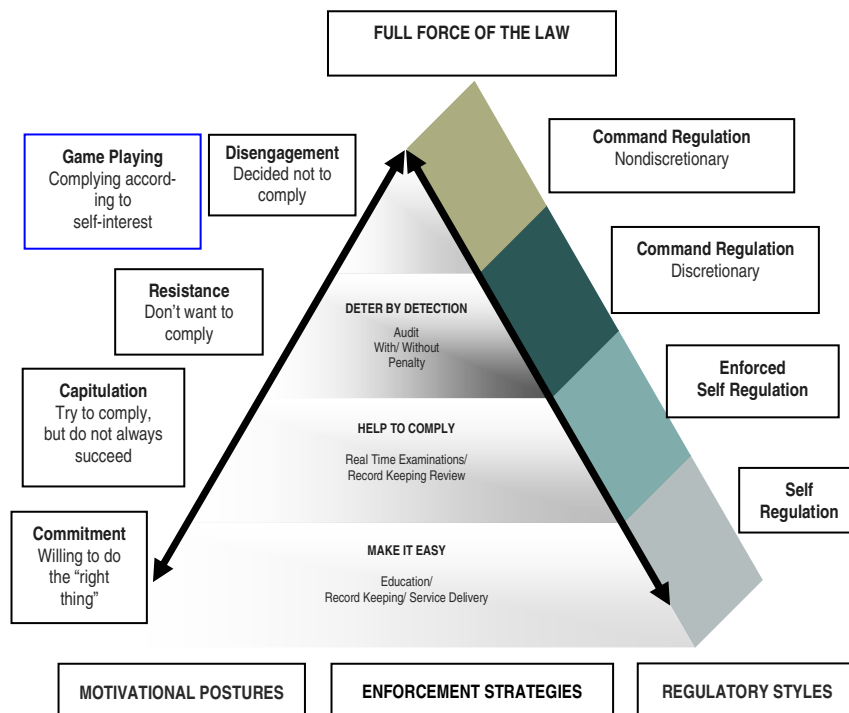
186. CASH ECONOMY TASK FORCE 1998, *supra* note 27, at 22–26.

187. *Id.*

hold toward the tax system and its administration and display in their interactions;¹⁸⁸ (2) the enforcement strategies at the tax administration's disposal;¹⁸⁹ and (3) corresponding regulatory tools.¹⁸⁹ In this model, the motivational postures, regulatory measures, and enforcement mechanisms have a range of severity. The cooperative postures, lenient enforcement strategies, and less intrusive regulatory styles are set closer to the base of the pyramid. The areas higher on the model are reserved for defiant postures and for harsher and more authoritarian enforcement and regulatory practices.¹⁹⁰

THE AUSTRALIAN COMPLIANCE PYRAMID

Adapted from the 1998 Australian Cash Economy Tax Force Report



188. See *supra* Part IV.A.

189. See *supra* note 186. But see AYRES & BRAITHWAITE, *supra* note 26, at 36; John Braithwaite, *Large Business and the Compliance Model*, in *TAXING DEMOCRACY, UNDERSTANDING TAX AVOIDANCE AND EVASION* 177, 178 (Valerie Braithwaite ed., 2003) (explaining that the idea behind the compliance model is to offer strategies and knowledge as to how to go about enhancing tax compliance. It is not a recipe but a model to guide strategic thinking); see also Braithwaite & Braithwaite, *supra* note 111, at 408–09 (“[What is important] is not the content of the enforcement pyramid but its form. Different kinds of sanctioning are appropriate to different regulatory arenas.”).

190. CASH ECONOMY TASK FORCE 1998, *supra* note 27, at 24–26; see also AYRES & BRAITHWAITE, *supra* note 26, at 35–40.

The tit-for-tat (TFT) strategy, a familiar practice in law and economics and the game theory literature,¹⁹¹ was introduced into the compliance model as the actual means for regulating responsively.¹⁹² In adopting the compliance model, with its TFT methodology, the ATO rejected the more traditional deterrence style of enforcement that is grounded in a static calculation of the probability of compliance based on the expected size and risk of punishment. Now, the ATO seeks to balance positive persuasion and encouragement with punitive deterrence and incapacitation in a dynamic fashion.¹⁹³ It embraces the understanding that people care about different things in different contexts and that they often possess multiple—even contradictory—selves: people can have a caring, socially-responsible self as well as an opportunistic self. Monetary considerations may motivate individuals at one point and a sense of social responsibility at another.¹⁹⁴ Accordingly, an enforcement strategy grounded in punishment or persuasion alone is fundamentally deficient as it will either undermine the good will of taxpayers or be exploited by their sense of greed.¹⁹⁵ Both persuasion and punishment have strengths and shortcomings in delivering compliance. The key to successful regulation is therefore not to decide between one approach or the other but to establish a workable compromise between the two such that these strategies complement each other.¹⁹⁶

When utilizing the TFT methodology, the tax administration balances encouragement and persuasion with punitive deterrence through three stages of communication with the taxpayer: cooperation, toughness, and forgiveness.¹⁹⁷ At the heart of this approach is the understanding that the tax administration and the taxpayer

191. Robert Axelrod & William D. Hamilton, *The Evolution of Cooperation* 211 SCIENCE 1390, 1393–94 (1981); ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* (1984).

192. See generally AYRES & BRAITHWAITE, *supra* note 26, at 19–53.

193. See, e.g., *id.* at 51.

194. Braithwaite, *supra* note 137.

195. See generally BRAITHWAITE, *supra* note 25 (discussing the need and feasibility of balancing punishment against persuasion in the context of the coal mining industry). See also *supra* note 173 and accompanying text (examining the case of the mass marketed tax scheme investors).

196. *Id.*; see also Braithwaite & Braithwaite, *supra* note 111, at 405 (“Decades of research on regulatory rule enforcement prompted a battle of sorts between those who favor a deterrence approach and those who promote compliance approaches, between punishment and persuasion. Now the debate has changed focus to ‘how to get the right mix of the two.’”); cf. Smith, *supra* note 119, at 229 (“If a balance of strategies emphasizing both positive incentives and the detection and punishment of non-compliance is to be effective, then the two strategies must symbiotically reinforce each other, rather than detract from each other.”).

197. AYRES & BRAITHWAITE, *supra* note 26, at 21. The method of balancing positive service with punitive deterrence coincides quite nicely with the idea of implementing a preventative approach discussed earlier. See *supra* notes 118–119 and accompanying text.

are partners in an ongoing relationship and that they impact and affect one another.¹⁹⁸ The tax administration therefore works to initiate each interaction with the taxpayer at the bottom of the compliance pyramid where it assumes the taxpayer holds cooperative postures and accordingly relies on self-regulation and means of assistance and encouragement.¹⁹⁹ In this way, the tax administration first appeals to the social responsibility of the taxpayer in order to foster and maintain compliance. The administration aims to cultivate relationships of good citizenship, trust and alliance, while avoiding the use of unnecessary punitive measures that might undermine the goodwill and intrinsic motivations of the taxpayer to voluntarily comply.²⁰⁰ If the taxpayer chooses to cooperate, tax officials must remain at the bottom of the pyramid and embrace cooperation.²⁰¹ If the taxpayer decides not to cooperate, TFT instructs the tax administration to move proportionally higher on the model, incrementally generating more authoritarian means of enforcement and regulation.²⁰²

By communicating its capacity and willingness to get tougher with cheaters, the tax administration taps into the economics of crime and compliance paradigm. It raises the cost of noncompliance and encourages the taxpayer to choose her socially responsible, law-abiding self over her opportunistic self. This, in turn, increases the effectiveness of persuasion and encouragement at the bottom of the pyramid.²⁰³ However, by implementing the TFT strategy, whereby the tax administration is both tough and forgiving, the administration does more than merely escalate enforcement and regulation in response—and in proportion—to taxpayer defiance. It also dynamically manages the relationship (and conflicts) with the taxpayer by leaving the option of cooperation always within reach. As soon as the taxpayer chooses cooperation, the TFT strategy instructs the tax administration to

198. Accordingly, the TFT strategy commands, among other things, that there be an open communication channel between the administration and the taxpayer in which the tax authority explains the legal obligations of the taxpayer and the consequences for noncompliance, and that the imposition of these consequences depends on the behavior of the taxpayer. Cf. CASH ECONOMY TASK FORCE 1998, *supra* note 27, at 57; see also Feld & Frey, *Tax Compliance as the Result of a Psychological Tax Contract*, *supra* note 110 (conceptualizing a psychological contract between the government and taxpayers, in which taxpayers not only expect to receive certain returns on the taxes they pay but also for the authorities to treat them with dignity and consideration).

199. AYRES & BRAITHWAITE, *supra* note 26, at 21; see also BRAITHWAITE, *supra* note 167, at 30.

200. See *supra* notes 110–111.

201. AYRES & BRAITHWAITE, *supra* note 26, at 21.

202. *Id.*

203. *Id.* at 26–27.

reward cooperative behavior by gradually moving down the pyramid and de-escalating enforcement and regulation.²⁰⁴

The triangular makeup of the Australian model with its wide base and narrow top implies that a substantial proportion of individual taxpayers are positioned closer to the bottom of the pyramid, or, in other words, that most people generally want to comply with their tax obligations.²⁰⁵ Fewer taxpayers are assumed to be involved in more serious forms of noncompliance and, therefore, located higher on the model.²⁰⁶ Evidence on individual tax compliance suggests that these predictions are generally accurate. Survey information from the U.S. and Australia indicates, for example, that about two-thirds of individual taxpayers intend to pay their taxes in full,²⁰⁷ results that are supported by the current level of U.S. tax compliance, standing as high as 83.7 percent.²⁰⁸ At the same time, however, this evidence suggests that approximately one-third of taxpayers do not necessarily plan to comply.

In order to safeguard a culture of obedience to the law, if taxpayers follow through with noncompliance, sanctions must remain severe and certain. The height of the compliance pyramid and its array of regulatory and enforcement measures express both the ability and willingness of the tax administration to escalate enforcement and regulation. This signals to the taxpayer that the administration holds a credible commitment “never to give in.”²⁰⁹ With this commitment, the tax administration communicates to taxpayers that it will be cooperative as its first choice but that, if the taxpayer resists cooperation, it will use a heavier hand until compliance is gained.²¹⁰

204. *Id.* at 21; see also BRAITHWAITE, *supra* note 167, at 30–31.

205. Braithwaite, *supra* note 177, at 5; see also Braithwaite & Job, *supra* note 140, at 2. Compare the case of large corporate compliance displaying more of an age-shaped model than a pyramid. Here, most taxpayers will actively seek to minimize their taxes yet generally implementing legal, as opposed to illegal means, such that they be located in the midsection of the model. Braithwaite, *supra* note 189, at 179–80.

206. Braithwaite, *supra* note 177, at 5.

207. Braithwaite, *supra* note 189, at 179 (citation omitted).

208. See, e.g., *supra* note 7 and accompanying text. Interestingly, the current rate of compliance remains fairly consistent with the rates estimated almost twenty years ago. Lederman, *supra* note 164, at 1009 (indicating that 1988 U.S. tax compliance rate was 83 percent).

209. AYRES & BRAITHWAITE, *supra* note 26, at 40–41 (adding that “the greater the heights of punitiveness to which an agency can escalate, the greater its capacity to push regulation down to the cooperative base of the pyramid”). According to Ayres and Braithwaite, the most severe enforcement and regulatory strategies should be visible so that taxpayers will perceive the tax administration as having an image of great power or “invincibility.” *Id.* at 44–47; see also CASH ECONOMY TASK FORCE 1998, *supra* note 27, at 24–25.

210. See, e.g., CASH ECONOMY TASK FORCE 1998, *supra* note 27, at 26, app.1 at 63 (suggesting that individual personalities matter less when everyone knows that the role of the

In sum, although the Australian approach emphasizes self-regulation vis-à-vis voluntary compliance, persuasion, and encouragement at the bottom of the pyramid, adoption of the compliance model does not suggest that the tax administration is reluctant to identify and punish noncompliers. However, by first offering cooperation rather than disciplinary sanctions, tough enforcement is expected to be considered more procedurally fair by taxpayers, and this sense of fairness may better promote alignment and cooperation with the tax administration.²¹¹ Often, the mere knowledge of the tax administration's willingness and capacity to execute severe punishments will enhance taxpayers' confidence in the tax administration and serve as a powerful form of persuasion that furthers a climate of voluntary compliance.²¹² In the words of Ayres and Braithwaite: "[R]egulators will be more able to speak softly when they carry big sticks (and, crucially, a hierarchy of lesser sanctions). Paradoxically, the bigger and more various are the sticks, the greater the success regulators will achieve by speaking softly."²¹³

V. SUMMARY AND CONCLUSIONS

*"My work may have sometimes assumed too much rationality, but I believe it has been an antidote to the extensive research that does not credit people with enough rationality."*²¹⁴

Over the past three and a half decades, understanding the causes for and facilitators of taxpayer compliance and noncompliance has been the focus of much analysis in tax administration

regulator is to be cooperative first and then to introduce sanctions only when there is no cooperation). However, one may doubt the feasibility of the tax administration to escalate and de-escalate enforcement and regulation in everyday situations. *See, e.g.*, Robert Baldwin and Julia Black, *Really Responsive Regulation*, 71(1) *THE MODERN LAW REVIEW* 59, 63–64 (2008) (providing a good critic of responsive regulation generally); Gregory Rawlings, *Taxes and Transactional Treaties: Responsive Regulation and the Reassertion of Offshore Sovereignty*, 1 *LAW & POL'Y* 51 (2007) (discussing the issue of responsive regulation in the international context. Here, the difficulty of escalating enforcement and regulation is most pronounced when dealing with Offshore Finance Centers (OFC) without having strong enforcement capacity from the outset. Under such conditions, OFCs can extract protection under state sovereignty and the option of bilateral agreements).

211. *See supra* notes 110–111, 161.

212. AYRES & BRAITHWAITE, *supra* note 26, at 40–51; CASH ECONOMY TASK FORCE 1998, *supra* note 27, at 25; *cf.* Steven M. Sheffrin & Robert K. Triest, *Can Brute Deterrence Backfire? Perceptions and Attitudes in Taxpayer Compliance*, in *WHY PEOPLE PAY TAXES* 193 (Joel Slemrod ed., 1992) (suggesting the importance of effective enforcement that is visible to the taxpayer community).

213. AYRES & BRAITHWAITE, *supra* note 26, at 19 (internal citation omitted).

214. Becker, *supra* note 38, at 402.

research. Research efforts have been undertaken in the hope of gaining a better handle on how to foster tax compliance and minimize the tax gap. In this ever-expanding area of study, important advances have been made in modeling the taxpaying decisionmaking process and, more recently, exploring the relationship between taxpayers and the tax authority and how this relationship shapes compliance. These developments were accomplished against the backdrop of a growing body of survey information, as well as empirical and experimental work. More than anything, however, the extensive research has demonstrated that tax noncompliance is a serious and complex problem, subject to a wide range of causes and influencers.

To a great degree, the economic paradigm dictates efforts to enforce tax compliance. The economic model emphasizes the consequences of behavior and the extent to which these consequences serve people's self-interest as the most important determinants for compliance. According to this model, taxpayers who fail to comply with their tax obligations are not manifesting antisocial or deviant characteristics. These taxpayers are simply rational actors who attempt to maximize their expected utility given the costs and benefits associated with the courses of action available to them. Enforcement techniques drawing on the economic model, therefore, look to decrease the expected utility of noncompliance by increasing the probability or the severity of punishment for offenders, thereby deterring potential lawbreakers and promoting tax compliance as the rational (meaning, beneficial) choice of behavior.

While the research in compliance is far from conclusive, it does appear to support the economic model to the extent that taxpayers are generally sensitive to the expected payoffs of compliant and noncompliant behavior. Other things being equal, taxpayers who face higher probabilities of detection or punishment tend to comply more than those who face lower risks. Increasingly, however, there is a growing understanding among tax researchers and administrators that there is more to compliance than the probability and severity of punishment. A host of considerations influence taxpayers, including the desires to comply with social norms, to be honest citizens, to avoid the psychological stress attached to dallards with the tax authority, and to correct perceived injustices in the tax system.

Understanding the reasons for and influences on taxpayer behaviors has a direct impact on the design of enforcement policies and their capacity to improve compliance. If taxpayers care about

matters beyond narrowly defined self-interest, applying enforcement strategies that rely exclusively on monetary considerations—particularly through authoritarian deterrence of detection and punishment—might not only be ineffective. Such an approach could also backfire by undermining the goodwill and intrinsic motivations of taxpayers to comply, generating distrust and antagonism, and ultimately exacerbating (rather than easing) the problem of noncompliance. Instead of abandoning enforcement policies based on detection and punishment, these enforcement mechanisms should be balanced against other measures that will complement punitive deterrence and offset its negative repercussions. This Article has advanced the proposition that this balance can be achieved by broadening the definition of deterrence to include measures that nurture the social responsibility and ethics of taxpayers and that aim to encourage tax compliance as well as discourage noncompliance.

The Australian compliance model offers a framework that incorporates a balanced and forward-looking approach to the enforcement of taxes such as just described. Drawing on the principles of responsive regulation and the motivational posturing doctrine, the Australian model conceptualizes behavior not only as a result of the needs, desires, and constraints of an autonomous taxpayer but it also considers that the taxpayer is heavily influenced by environmental conditions, including norms, values, and habits, and by the nature of the taxpayer/tax-authority interaction. By emphasizing the role that this interaction plays in shaping taxpayer behavior, the tax administration is empowered to own up to its administrative responsibilities and explore the different ways in which it can manage this relationship. The idea here is not only to enforce compliance where it is deficient. The idea is to also strengthen and manage compliance fairly and efficiently, such that voluntary reporting improves both in scope and duration. The emphasis on voluntary reporting is especially important in taxation given that the tax law is constantly changing and is often complex and vulnerable to manipulation. Instead of putting endless efforts into meeting unrealistic expectations of compliance, enforcement policies might be more effective if they emphasize self-regulation through assistance and persuasion, and only when necessary shift to punitive enforcement and intrusive regulation.

The Australian compliance model makes a case for the superiority of an enforcement strategy that is gradual and proportional in its capacity and willingness to apply sanctions. It represents a move away from static deterrence advocated by early economic theorists

and embraces a dynamic framework that reflects the interplay of the taxpayer/tax-authority interaction. Accordingly, the regulatory goal is no longer to identify a particular recipe for optimal deterrence, but instead to find an optimal way to play “the enforcement game.”²¹⁵ An administration that endorses the Australian approach, employing its tit-for-tat methodology, plays the enforcement game responsively. It works to protect the taxpayer community against lawbreakers while leaving room for the fostering tax morale.

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

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

215. AYRES & BRAITHWAITE, *supra* note 26, at 51.

and how incapacitation can be achieved in taxation through measures other than prosecution and incarceration.

In addition, to generalize the Australian model to tax administrations in other countries, more work is needed to identify relevant compliance problems, to understand the characteristics of local taxpayer communities, and to explore the political and societal support for different enforcement and regulatory strategies. All these issues and others may be addressed partly through the trial and error of enforcement efforts and partly through empirical and experimental work. The responsiveness of the Australian model may become especially problematic, however, if tax agents and administrators interpret and apply the model in ways that are inappropriate or otherwise unintended by the supporting enforcement policy. This risk is inherent in administrative practices generally, but the combination of an escalating range of enforcement and regulation, the complex and fluid nature of motivational postures, and the extent of discretion in a dynamic administrative style of interaction might lead to overly lenient or harsh enforcement compared to a more conventional approach.

At the end of the day, the main advantage of the Australian model may be its ability to offer tax administrators and researchers a broad, even if incomplete, roadmap for tax enforcement that incorporates a set of checks and balances on punitive deterrence. Furthermore, the Australian model touches on critical issues in compliance and regulation that are well deserving of policy attention and debate. The fact that this model does not come with a self-explanatory guide may not necessarily be a disadvantage, as it forces tax administrators and policymakers to debate and reach decisions in a deliberate and intentional manner. In a few years, as the Australian tax administration continues releasing compliance improvement data and different prototypes of the original compliance model are developed in Australia and elsewhere, we may be in a better position to evaluate the advantages and disadvantages of the responsive approach to taxation and, particularly, the role it plays in increasing the integrity of the tax system. In the meantime, more efforts should be devoted to the undertaking of comparative work that investigates the relevance of responsive regulation to U.S. tax administration,²¹⁶ to test the hypotheses of the Australian model, and to generate important insights and advances in both the theoretical analysis and the empirical research of compliance.

216. *E.g.*, JOHN BRAITHWAITE, *MARKETS IN VICE, MARKETS IN VIRTUE* (2005) (examining the application of responsive regulation to area of corporate taxation in Australia and the United States).

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Until we have more information, we should be careful not to dismiss what could be the promising beginning of a new era of tax enforcement.