Comments on Tax Compliance and Enforcement
David Weisbach

March 30, 2016

It is a great pleasure to comment on Joel Slemrod’s survey of new research on tax compliance and enforcement. What comes across clearly from his survey is that the field is flourishing. Perhaps what is not so clear is that this flourishing is largely due to his efforts. Much of what we know about compliance and enforcement can be traced to work by Slemrod, his co-authors and his numerous students.

It is also clear from Slemrod’s survey that the credibility revolution has made its way into this area. Modern studies now use a range of techniques to better understand how features of the tax system or policy interventions affect compliance.

What did we learn from these new studies? To a great extent, the studies confirm my priors on issues of compliance and enforcement. First, most evasion is in the self-employed and other informal sectors. We suspected this from a number of sources including information from the Internal Revenue Service. New studies using approaches such as the traces of income approach confirm this. Second, reporting and withholding is effective, which is likely an important reason for the informal/formal compliance differences. And finally, audits and deterrence are important. Enforcement matters. If there are no cops on the highway, people will speed.

The recent work that Slemrod surveys, though, gives us a better sense of some of the nuances. For example, third-party reporting increases the amounts of the reported items that taxpayers state on their returns, but may also induce offsetting behavior. In Carrillo, Pomeranz, and Singhal (2014), firms in Ecuador subject to reporting increased their stated income but almost completely offset the increase by also increasing costs which were not subject to information reporting. The Slemrod et al. (2015) study of credit card reporting in the US finds a similar although smaller effect.
The effects of enforcement are more subtle than the speeding analogy lets on. In Slemrod, Blumenthal, and Christian (2001), a randomized control trial involving threat of audit letters caused middle and low income taxpayers to report more income but high-income taxpayers reported lower income. The authors speculate that these taxpayers viewed their initial tax return as a negotiation rather than an attestation and wanted to start the negotiation from a more extreme position.

Slemrod’s discussion of the effect of norms on compliance is interesting. I think most people not familiar with the previous literature would have guessed that norms about compliance are important. If you think all of your friends and neighbors are cheating, you may be more likely to cheat because (1) the social sanctions from being caught will be lower and (2) if relative income matters, not cheating puts you at a disadvantage.

Prior studies that attempt to manipulate norms, however, have not found an effect. Slemrod discusses two new studies, Bott et al. (2014) and Hallsworth (2014) which do find effects from attempts to change norms. Bott et al consider a randomized field experiment in Norway in which a moral appeal in a letter almost doubled the average foreign income reported. Hallsworth et al considered a randomized field experiment in the UK that included an appeal to social norms and found an increase in compliance.

Slemrod says that his priors on norms are moved somewhat by these results. Mine are not, at least not by much. The Hallsworth et al study examined a very special situation involving the payment of an already reported liability, so I think it has little relevance to general reporting or compliance issues. This leaves just Bott et al, which took place in Norway. It is not clear the extent to which a study of the norms of Norwegians will have external validity.

As has been well-discussed in the literature outside of tax compliance, the shift toward better identification in economics, while greatly increasing the credibility of reported results, has not come without costs, and these costs are loom large when studying tax compliance. There are two primary costs. The first is that better identification has led to offsetting concerns about external validity. To identify an effect, studies look for a feature of a tax system, such as a
discontinuity or notch, or they manipulate a feature of a tax system such as the risk of audit in a particular circumstance. These features are embedded in a larger tax system and culture, which may be unique. To take some examples from the studies, researchers have considered compliance issues in Ecuador (Carrillo, Pomeranz, and Singhal (2014)), Norway (Bo, Slemrod, and Thoresen (2015)), Greece (Artavanis, Morse, and Tsoutsoura (2015)) Estonia (Paulus and others (2015)), the UK (Halsworth et al. (2014)), Pakistan (Best et al. (2015), and Kleven and Waseem (2013)) and Japan (Hasegawa et al. (2013)). If one is concerned with the design of a tax system or the enforcement rules in say, the United States, it is not clear the extent to which we can learn from studies of, say, norm manipulation in a country with a completely different culture and tax system. To go back to the Bott et al (2014) study of norm manipulation in Norway, if we have studies in the United States showing no effect, to what extend should we take the information from Bott et al to mean we should modify our priors about how US taxpayers will behave? To what extend should we take the differences in results to mean Norwegians are different from Americans? The problems get worse as the development levels, culture, and tax systems get further apart. Evasion may be very sensitive to details. How much can the Norwegians take from a study about Pakistan and how much can the French learn from studies of Ecuador?

A second concern is that an insistence on careful identification means that some effects that may be of central importance cannot be studied. Take norms once again. It may take a very long time to change norms about tax compliance. The changes may only take effect on a large scale as people’s perceptions of overall compliance change. There is no way to measure these changes while meeting modern standards for identification even if the effects of norms are real and large. It may be very cost-beneficial for the Internal Revenue Service to focus on norms of compliance even if we cannot determine this within modern standards of identification.

Notwithstanding the extensive work surveyed by Slemrod, there remains much that I would like to know about enforcement and compliance. I would like to know more about the distributional impacts of evasion. How much evasion is the wealthy using Swiss bank accounts (see Zucman (2014)) and how much is middle class small businesses using cash? What is the elasticity of evasion for
different income groups? And, how does the marginal cost of reducing evasion vary across income groups? To design optimal systems, we need estimates of parameters of this sort.

I would also want to know how evasion and avoidance relate to one another (and the distributional impact of avoidance). I would guess that they are substitutes. On the margin, if people are optimizing the mix of the two, they may be very good substitutes. The social consequences, however, may be different.

Can we say anything about why some people evade while others comply when they are similarly situated? What characteristics would cause one small cash business to evade when other cash businesses do not? Are there network effects, so, say, dry cleaners in New Jersey evade while accountants in Minnesota comply?

Studies of evasion take tax system as basically fixed and consider small perturbations, such as random assignment of audit letters or an increase in reporting for a particular type of income. The possibilities for evasion, however, should be central elements in the design of the overall system. For example, as is widely discussed, a retail sales tax has substantially larger evasion opportunities than a VAT even though both are theoretically (i.e., without evasion) the same tax base. The widespread preference for a VAT over a retail sales tax is driven by this concerns about avoidance. There are likely to be many other design choices that are similarly driven by evasion or avoidance. The choice between an origin and destination base may be determined by the evasion and avoidance opportunities in an origin base because an origin base requires transfer pricing, which is notoriously subject to manipulation (rarely treated as criminal so falling into the avoidance category). What about the choice between a firm-level business income taxa like the Comprehensive Business Income Tax from Department of the Treasury (1992) and an individual-level business income tax like that proposed by Toder and Viard (2014). We have intuitions about these issues. Given the flowering of research into evasion, is there anything modern research techniques can say about these central design issues?

Slemrod in his conclusion includes a hypothetical State of the Union speech in which the President lays out the case for fighting evasion. The argument is
straightforward: fighting tax evasion helps the innocent taxpayer who complies with his obligations. People should want the government to fight evasion.

The speech ends with a standing ovation from both sides of the aisle. The case seems compelling to me but the prospect of the standing ovation not so much. But why? If the speech were about some other type of crime that was on the order of magnitude as tax evasion, the standing ovation would be plausible. Everyone hates paying their taxes, but they should like it if others pay theirs. I don’t want to have to pay more taxes to support the cheaters. The sheer unlikeliness of Slemrod’s hypothetical State of the Union, though, shows that somehow this reasoning is not widespread.

My experience is with the United States, where this odd dynamic seems clear. Do other cultures have the same dynamic where tax evasion is seen as a different sort of crime than other, facially similar, financial crimes? That is, is this dynamic something special to the United States or something special about taxation?

In all, Slemrod provides us with an excellent survey of recent developments in the field. I am looking forward to 10 more years of research and Slemrod’s next survey.

References


