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Culture, compliance, and confidentiality: Taxpayer behavior in the United States and Italy

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ABSTRACT

This paper analyzes the impact of confidentiality of taxpayer information on the level of compliance in two countries with very different levels of citizen trust in government – the United States and Italy. Using identical laboratory experiments conducted in the two countries, we analyze the impact on tax compliance of “Full Disclosure” (e.g., release of photos of tax evaders to all subjects, along with information on the extent of their non-compliance) and of “Full Confidentiality” (e.g., no public dissemination of photos or non-compliance). Our empirical analysis applies a two-stage strategy that separates the evasion decision into its extensive (e.g., “participation”) and intensive (e.g. “amount”) margins. We find strong support for the notion that public disclosure acts as an additional deterrent to tax evaders, and that the deterrent effect is concentrated in the first stage of the two-stage model (or whether to evade or not). We also find that the deterrent effect is similar in the U.S. and in Italy, despite what appear to be different social norms of compliance in the two countries.

1. Introduction

National tax administrations are constantly looking for innovative and cost-effective ways to increase tax compliance, beyond the traditional compliance-inducing measures of increased penalty and audit rates. A novel method that has been increasingly discussed is limited disclosure of taxpayer information in cases of tax evasion. The threat of public “shame” through disclosure adds a non-financial penalty that may induce taxpayers to increase compliance to keep their names clean. However, the threat of public disclosure could instead crowd out intrinsic motivations for compliance, and thereby reduce compliance as a retaliatory action. Disclosure may also increase utility for a subset of individuals who hold a strong anti-tax

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sentiment, an effect that may be reinforced if "contagion" effects exist wherein observing that others have underreported income may reduce one's own compliance. All of these effects may depend on the way in which the psychological costs of shame enter the decision to evade, either as a fixed component or a variable component. Therefore, whether and how public disclosure of taxpayer compliance behavior affects compliance cannot be predicted a priori, and the little systematic evidence of its effects shows somewhat conflicting results. This paper uses a cross-country laboratory experiment to examine the impact of confidentiality of taxpayer information on the level of individual compliance in two settings in which baseline taxpayer attitudes and compliance are arguably different − Italy and the United States.

We first develop a simple model that extends the standard economics-of-crime model of tax evasion (Allingham and Sandmo, 1972) by incorporating a "social norm" of compliance by which taxpayers experience a psychological loss when they violate the norm, following the approach of Alm and Torgler (2011). Public disclosure affects the psychological cost of violating the norm, but disclosure can either increase or decrease the cost, inducing either more or less compliance than under full confidentiality. These conflicting effects occur because the psychological cost of violating social norms is assumed to have both a variable component that depends on the amount evaded and a fixed component that does not.

We then test the model using experiments and applying an empirical estimation strategy that separates the decision of whether to evade or not (e.g., the extensive margin, or "participation") and from the decision of how much to evade (e.g., the intensive margin, or "amount"). Consistent with the notion of a fixed psychological cost of non-compliance, we find strong support for the idea that public disclosure acts an additional deterrent to tax evaders. We also find that the deterrent effect is concentrated in the first stage of the two-stage model (or whether to evade or not). Further, we find that the deterrent effect is similar in the U.S. and in Italy, despite what appear to be different social norms of compliance in the two countries. Finally, we show that this fixed cost is important to measure properly the impact of traditional policy instruments on compliance. Indeed, we demonstrate that empirical approaches that ignore the fixed component are likely to overestimate the effect of standard deterrence instruments.

The impact of explicit disclosure of evasion has seldom been empirically studied at the individual level due largely to the absence of reliable micro-level taxpayer data. Even so, there are some studies that have analyzed the impact of disclosure in naturally occurring environments. Bø et al. (2015) exploit a natural experiment in Norway, where tax data were made available on the internet after 2001. They found on average a slight increase in reported business income after 2002 in communities that previously had limited disclosure. Also, Hasegawa et al. (2013) analyzed disclosure of individual and corporate tax information in Japan, and found that the existence of a "disclosure threshold" encouraged some underreporting of income. Perez-Truglia and Troiano (2015) conducted a field experiment to study the effect of increasing the publicity of online lists with names, tax debts, and other information of tax delinquents maintained in three U.S. states (Kansas, Kentucky, and Wisconsin). They found that increasing the salience of the list by informing neighbors of tax delinquents increased the probability of tax delinquents paying the tax debt in cases of moderate debt (a tax debt lower than $2274), but not in cases of higher debt.

Some laboratory experiments have also looked at the effects of disclosure on taxpayer compliance, with mixed results. Laury and Wallace (2005) conducted a laboratory experiment that implemented a mild form of disclosure and found some suggestive evidence that disclosure has a positive effect on compliance. Fortin et al. (2007) also studied the effects of feedback on tax reporting decisions. In their design, subjects were told the number of subjects who underreported income in the previous round and the mean level of reported income. They found that reported income was slightly lower when subjects received information on others' reporting behavior, but also that an increase in the average level of evasion in the group was associated with an increase in individual reported income. Lefebvre et al. (2011) compared tax reporting behavior across three countries (France, Belgium, and the Netherlands). They found that subjects who observed "bad" examples (e.g., a minimum proportion of subjects reporting truthfully) were less likely to fully report income, but that subjects who saw "good" examples (e.g., a maximum proportion of subjects reporting truthfully) were largely unaffected. They also found differences in reporting across countries, with underreporting more common in France and the Netherlands than in Belgium. Coricelli et al. (2010) focused on the emotional impact of cheating and disclosure in a tax-reporting experiment. In a "pictures" treatment, a subject who was audited and found to have unreported income had his or her photo shown to others in the session. They found higher compliance in their photos treatment, as well as increased "emotional arousal", as measured by skin conductance responses; they also found higher compliance (and higher emotional arousal) after an audit. Casal and Mittone (2016) studied the effect of shaming in various settings in which taxes payments were redistributed to subjects as in public good games. They found some complex types of behavior in which the effect of shaming tax evaders tends to increase compliance. In contrast, Casagrande et al. (2015) did not find any effect of shaming in a random audit game.

Despite these innovative contributions, the impact of disclosure or confidentiality on taxpayer compliance remains unresolved. In particular, there are several important questions about the impact of confidentiality on compliance that are unanswered. First, how does confidentiality affect the decision to evade or not? Second, how does confidentiality affect the decision on how much to evade? Third, do these impacts vary across cultures?

We seek to answer these questions by using laboratory experiments to examine the impact of disclosure in two quite different environments – the United States and Italy. In our cross-country experimental design, an individual is given income, and then must decide how much of the income to report. Taxes are paid on reported income at a preannounced tax rate, and no taxes are paid on unreported income. However, unreported income may be discovered via an audit, and the subject must then pay the unpaid taxes plus a fine based on the unpaid taxes. We introduce two main treatments. In one treatment ("Full Confidentiality"), an individual who is detected evading is financially penalized, but his or her reporting information