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Reducing evasion through self-reporting: Evidence from charitable contributions☆

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ABSTRACT

In absence of third-party reporting, taxpayers are required to self-report information with various degrees of detail, ranging from uncorroborated claims to comprehensive records with receipts. Using a quasi-experimental design applied to noncash charitable contribution deductions, I show that even basic self-reporting requirements are effective at reducing evasion but impose large compliance costs on taxpayers. I find that simplified reporting requirements reduce reporting costs by $55 per person and substantially increase claimed donations. However, half of the new donations are due to evasion. Thus, information reporting should only be imposed on total reported donations above a pre-specified threshold.

1. Introduction

It has been shown that third-party reporting is effective at reducing evasion (Kopczuk and Slemrod, 2006; Gordon and Li, 2009; Kleven et al., 2011), but there are circumstances in which it is infeasible or prohibitively costly. For example, in many tax systems, self-employed individuals are allowed to deduct expenses such as the use of one's personal car or home space for business purposes. Introducing third-party reporting for such transactions is not possible. Requiring organizations to report all contractual payments (as is currently done with Form 1099-Misc for large transactions in the U.S.) would impose large compliance costs, especially for small businesses. In short, it is unlikely that third-party reporting can be imposed on all income, deductions, expenses and credits that individuals and firms claim on their tax returns. In these circumstances, tax authorities rely on self-reported information to access tax liability.

To limit potential cheating, tax authorities require that self-reported accounts follow a set of "self-reporting" rules. These requirements often range in stringency — from basic requirements to provide unsubstantiated details of claimed expenses to more stringent rules that require receipts to be included with tax returns. However, we know little about the effectiveness of self-reporting at curbing evasion: could a requirement to provide potentially unverifiable information reduce cheating by making the cheating process costlier and by increasing the scope of information available to tax authorities? Moreover, welfare implications are also unclear: even the simplest compliance rules can prove to be costly and impose a burden not only on prospective cheaters, but also on law-abiding individuals. This trade-off between evasion and compliance costs suggests that reporting should be imposed only on a subset of the population. Yet current reporting requirements vary greatly across tax items and often impose all-or-nothing requirements. For example, in the U.S., claiming a cash donation deduction requires no reporting, while claiming the Child and Dependent Care Expenses Credit requires individuals to provide detailed descriptions regardless of the amount claimed.

This paper develops a framework to study self-reporting requirements and reporting thresholds for claiming deductions and expenses. I focus on the simplest form of self-reporting regulations — a requirement to provide self-reported details of claimed deductions

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with no requirement to attach receipts. Using a natural experiment, I document the effectiveness of self-reporting requirements against evasion and provide estimates of compliance costs and the magnitude of evasion. Empirical results imply that self-reporting requirements should be imposed only on individuals with reported donations above a pre-specified threshold and that setting such a threshold optimally could lead to substantial welfare improvements.

Since 1917, the U.S. federal government has subsidized charitable contributions in the form of a tax deduction. This favorable treatment makes charitable deductions highly susceptible to evasion. To limit potential misreporting, the IRS has developed a set of rules that make evasion costlier. I use a regulation change in 1985 that relaxed self-reporting requirements for noncash charitable contributions. Prior to 1985, individuals had to submit a detailed statement regardless of the dollar value of the reported donations. Starting in 1985, a formal statement, Form 8283, has been required only when reported noncash donations exceed $500. Employing a novel identification approach, I non-parametrically identify the share of new donations due to lower compliance costs and the share of new donations due to evasion, and I estimate the hassle cost of compliance. I find that relaxing reporting requirements led to a steady increase in reported donations but that more than 50% of these new donations were untruthful. The tax revenue loss, however, was offset by substantial savings for taxpayers because reporting requirements impose large hassle costs: $55 (in 2015 dollars), on average, per person. Thus, the empirical findings suggest that while self-reporting requirements are effective at reducing evasion, they are burdensome and, therefore, should be imposed on only a subset of individuals. A calibration exercise in the appendix suggests that setting the threshold optimally at $350 instead of $500 would have reduced welfare losses from evasion and compliance by 70%.

The empirical approach proceeds in two steps. To estimate the compliance costs associated with Form 8283, I compare the distributions of noncash donations above the reporting threshold before and after the reform. Since reporting requirements have not changed for taxpayers who wish to report more than $500, these individuals will choose to reduce their donations and report $500 only to avoid the hassle of filing Form 8283. Therefore, the size of the missing mass to the right of the $500 threshold allows me to estimate the distribution of compliance costs. I find that individuals are willing to forgo an average of $55 (in 2015 dollars) in order to avoid filling out Form 8283. The magnitude of compliance costs is surprisingly high since it is unlikely that filling out Form 8283 would require more than half an hour of one's time. The cost estimate, however, is consistent with the findings of Benzarti (2015), who estimates that individuals forgo $644, on average, (in 2014 dollars) to avoid filing Schedule A (Itemized Deductions).

Next, I use my estimates of compliance cost to distinguish between truthful and untruthful donations. The 1985 reform increased the threshold from $0 to $500, which resulted in an increase in reported donations below the $500 threshold. To identify which portion of these new donations is due to evasion, I must account for two effects. First, part of the increase in donations in the neighborhood of $500 is due to compliance costs, as described above: some taxpayers choose to reduce their donations and bunch at $500 to avoid the hassle of filling out Form 8283. To account for these individuals, I adjust the post-reform distribution downward by redistributing just enough of the excess mass at $500 to fill in the missing mass above the threshold. Second, since all individuals had to submit a detailed statement before the reform, individuals with high compliance costs who wished to donate small amounts chose to report $0 to avoid the hassle of writing a statement. To account for these taxpayers (who are missing from the observed pre-reform distribution), I extrapolate the compliance cost found in step 1 to identify a "counterfactual" distribution of donations — this counterfactual distribution represents the number of truthful donations prior to the reform if there were no reporting and no evasion. Finally, I quantify evasion as the difference between the adjusted post-reform distribution and the counterfactual pre-reform distribution. Intuitively, once I have accounted for legitimate sources of increased donations (due to the compliance burden before and after the reform), the remaining, unexplained increase in donations at the $500 threshold must be due to evasion.

Overall, I find that at least 48% of the new donations were untruthful. The overall level of evasion, however, is small and suggests that taxpayers find cheating very costly. Even ten years after the reform, the number of donations below $500 remained small. The magnitude of evasion found in this study is generally consistent with evasion estimates from the 1982 Taxpayer Compliance Measurement Program (TCMP) study. Slemrod (1989) finds that among taxpayers who claim a charitable deduction, 27% cheated and overstated their donation by approximately 9%, which corresponds to an average of $96.4 (1982 dollars). My calibration of evasion behavior suggests that approximately 24% of individuals cheat, with an average cheating amount of $350 (1986 dollars).

The findings of this paper are policy-relevant for three reasons. First, the empirical results show that self-reporting requirements are effective against evasion. In circumstances in which third-party reporting is infeasible or too costly, requiring individuals to fill out a form or provide self-reported accounts can reduce evasion. This is a striking result because it shows that merely asking individuals to provide more information – but requiring no proof – can reduce evasion. Second, the findings confirm the intuition that even these minimal requirements come at a cost and should not be ignored by policy makers. Individuals dislike tax paperwork and find it bothersome. Third, the trade-off between compliance and evasion implies that reporting requirements should not be imposed on all taxpayers. Instead, welfare can be substantially improved by setting reporting thresholds optimally. The identification approach further highlights a path to determining these thresholds: it is best to start with stringent requirements and ease them over time, as this allows for estimation of compliance costs and evasion behavior. While the analysis of this paper focuses on noncash charitable donations, the results can be directly applied to other deductions, credits, and business expenses, and particularly to unverifiable expenses such as the use of one's personal car or home space for business purposes, which are likely to become even more prevalent due to increased use of digital platforms such as Uber and Airbnb.

The paper contributes to three areas of research. First, this study contributes to the empirical literature that investigates the effectiveness of information reporting against evasion. While the literature has carefully documented the power of third-party reporting (Kopczuk and Slemrod, 2006; Gordon and Li, 2009; Kleven et al., 2011), little is known about the effectiveness of other approaches. In the U.S. and other OECD countries, tax liability often depends on self-reported measures of income and expenses, with varying levels of supporting documentation requirements (Lederman, 2010). This paper is the first to show that a simple requirement to provide self-reported details of transactions without providing receipts reduces evasion. Previous work has focused on stronger forms of reporting requirements, such as submitting proof of expenses (Fack and Landais, 2016) and providing easily verifiable information (LaLumia and Sallee, 2013).[1]

Second, the paper contributes to a literature that documents and estimates the high costs of complying with tax regulations.

[1] See, also, studies of accounting regulations (Asatryan and Peichl, 2016), monitoring rules (Almunia and Lopez-Rodriguez, 2018), electronic payments (Slemrod et al., 2017), and receipt incentives (Naritomi, 2013).